THE TAXPAYER AND FISCAL LEGISLATION

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When rendering judgment in the case of *Courey v. A.-G. Quebec*[1] Mr. Justice Collins of the Superior Court of the Province of Quebec observed:[2]

> "Taxation statutes must be construed strictly in accordance with their terms and not with regard to the equities of the situation. The power to tax carries with it unfortunately the power to injure and destroy and one of the great fundamental problems today of our own and other countries of the democratic world is to prevent taxation from sapping away exhausting and destroying the fundamental liberties of the individual. The duty of the Court is to interpret the law as it finds it but as the multitude of these laws and regulations both Dominion and Provincial unfold before the Court in the never ending stream of important cases which come before it for decision, the Court by reason of the judicial nature of its duties and its function as the impartial and independent arbiter of the legal rights of the citizens cannot help but look askance upon the constantly increasing encroachments upon human liberties and rights whether enacted in the form of taxation, social legislation or otherwise and perforce it often asks itself 'whither are we going'?"

The gradual emergence of the welfare state, the ever increasing governmental direction of the nation's economy and the enormous defense commitments of recent years have been principally responsible for the marked increase in governmental activity which has given birth to this multitude of laws and regulations. The foreseeable future discloses no indications of a departure from this established pattern.

In the wake of these developments the taxpayer must be prepared to accept encroachments upon his economic liberty, as necessities of our age, and he must likewise be prepared to accept his full share of the resultant responsibility. At the same time he must ensure that the state does not in the guise of necessity, undermine inadvertently the principles upon which our constitution is founded.

In accepting these infringements of his liberty, he should at least have the assurance that they are being made in strict accordance with Dicey's famous "Rule of Law". Apart from political sanctions the "Rule of Law" should be the individual's most important and most cherished protection against the omnipotent power of the state.

Dicey attributed in part the following meaning to the "Rule of Law":

> "... that no man is punisbable or can be lawfully made to suffer in body or goods except for a distinct breach of the law established in the ordinary legal manner before the ordinary courts of the land. In this sense the tule of law is contrasted with every system of government based on the exercise by persons in authoriry of wide, arbitrary or discretionary powers of constraint."[3]

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[1][1949] C.T.C. 266.

[2]At p. 277-8.

[3]Dicey, A. V., *Law of the Constitution*, 9th ed. by E. C. S. Wade, p. 188.

The courts have long recognized that taxing statutes to a degree impose penalties upon individuals or at least impose burdens that are tantamount to penalties.[4] The arbitrary or discretionary imposition of taxes is therefore incompatible with the first meaning of the "Rule of Law". Consequently, it is the duty of the courts, in protecting the liberty of the individual, to interpret the enactments of Parliament in a manner compatible with this basic principle of the "Rule of Law" and to ensure that those persons or bodies who wield the taxing powers of the state only impose such taxation as is expressly authorized by Act of Parliament.

Furthermore this meaning of the "Rule of Law" suggests that the individual should at all times know or be capable of finding out what the law is. To be guilty of a distinct breach of the law, the law itself must be distinct and should not be obscured by the exercise of arbitrary or discretionary powers.

> "It is important that the individual should have the assurance that the law can be ascertained with reasonable certainty. A person who takes the trouble to consult his lawyer ought to be able to ascertain the legal consequences of his actions."[5]

Clearly the existence of discretionary and arbitrary powers makes it impossible for the individual to ascertain the legal consequences of his actions for only a soothsayer can accurately predict the manner in which discretion will be exercised.

Yet even in the absence of arbitrary or discretionary powers, the individual may be unable to ascertain the consequences of his actions because of the language of the statute with which he is concerned. In such instances he may unwittingly be guilty of a distinct breach of the law simply because of the imprecision and ambiguity of legislation.

In perhaps no other area of the law is certainty of the legal consequences of one's actions more important than in the realm of fiscal legislation. The commercial world in particular cannot function effectively in the ominous shadows of tax uncertainties. Today, no commercial venture should be undertaken without first formulating a reasonably accurate estimate of the resultant tax consequences. In fact, good business practice must often be abandoned because of the unfavourable tax consequences which might result.

Historically the courts of the United Kingdom have buttressed the defences of the uncertain taxpayer by laying down certain canons of construction which have particular application to revenue legislation.

The first rule of importance is that the subject is not to be taxed without clear words for that purpose. The longevity of this rule is evidenced by the following statement of Lord Ellenborough in *Williams v. Sangar*.[6]

> "In the construction of these Tax Acts, we must look to the strict words, however we may sometimes lament the generality of expression used in them; but we must construe those words according to their plain meaning with reference to the subject matter."

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[4] *Infra*, note 25.

[5] Wade and Phillips, *Constitutional Law*, 4th ed. by E. C. S. Wade at p. 51.

[6] (1808) 10 East. 66 at p. 68.

Language to the same effect has been employed many times over in subsequent decisions of courts both in the United Kingdom and Canada.[7]

For the most part the same decisions, and many more, support the subsidiary and second rule of construing taxing statutes, namely, that an ambiguity will be construed in favour of the individual. As early as 1825 this rule was accepted by judges in the United Kingdom without reference to authority. For example, Bayley J. in the case of *Waterhouse & others v. Keen*[8] stated:

> "... but where there is any ambiguity in the language used, the construction must be in favour of the public, because it is a general rule, that where the public are to be charged with a burden, the intention of the Legislature to impose that burden must be explicitly and distinctly shown."

These two rules help immeasurably in rendering more certain the position of the taxpayer. Moreover, they lend support to the application of the meaning of the Rule of Law discussed above.

Closely associated with the two rules of interpretation is the well established principle that a taxpayer is entitled to arrange his affairs so as to keep the incidence of taxation at a legal minimum. The courts have long accepted and sanctioned such actions by the taxpayer, and in so doing, they have probably echoed public sentiment.

The following are perhaps the most celebrated judicial declarations of the taxpayer's right to take positive steps to minimize tax consequences:

> "My Lords, the highest authorities have always recognized that the subject is entitled so to arrange his affairs as not to attract taxes imposed by the Crown, so far as he can do so within the law, and that he may legitimately claim the advantage of any express terms or any omissions that he can find in his favour in taxing Acts. In so doing he neither comes under the liability nor incurs blame."[9]

> "It is trite law that His Majesty's subjects are free, if they can, to make their own arrangements so that their cases may fall outside the scope of the taxing Acts. They incur no legal penalties and, strictly speaking, no moral censure, if, having considered the lines drawn by the legislature for the imposition of taxes, they make it their business to walk outside them."[10]

> "... No man in this country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his stores. The Inland Revenue is not slow — and quite rightly — to take every advantage which is open to it under the taxing statutes for the purpose of depleting the taxpayer's pocket. And the taxpayer is, in like manner, entitled to be astute to prevent, so far as he honestly can, the depletion of his means by the Revenue ..."[11]

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[7]For example, see *Waterhouse & others v. Keen* (1825) 4 B & C 200 at p. 208; *The Hull Dock Co. v. Browne* 2 B & Ad. 43 at p. 59; *Stockton and Darlington Rly Co. v. Barrett* (1844) 7 Man. & G. 870; *In re Micklethwait* (1855) 11 Exchequer 452 at p. 456; *Doe Dem. Scruton v. Snaith* (1832) 8 Bing. 146 at p. 152; *Reg. v. Barclay* 8 Q.B.D. 306 at p. 312; *Davies v. Evans* 9 Q.B.D. 238 at p. 242; *Ormond Investment Co. v. Betts* (1928) 13 T.C. 400; *Cape Brandy Syndicate v. C.I.R.* (1921) 37 T.L.R. 402; *Cox v. Rabbits* (1878) 3 A.C. 473; *A.G. v. Wilts United Dairies* (1922) 91 L.J.K.B. 897; *Russel (Inspector of Taxes) v. Scott* [1948] 2 All E.R. 1, at p. 5; *Shaw v. M.N.R.* [1938-39] C.T.C. 346 at p. 348; *Connell v. M.N.R.* [1946] C.T.C. 303 at p. 308; *George W. Argue v. M.N.R.* [1948] C.T.C. 235 at p. 245; *Fasken Estate v. M.N.R.* [1948] C.T.C. 265 at pp. 275-6.

[8]4 B & C 200 at p. 208.

[9]*C.I.R. v. Fisher's Executors* (1926) 10 T.C. 302 at p. 340 per Lord Sumner.

[10]Per Viscount Sumner in *Levene v. C.I.R.* 13 T.C. 486 at pp. 501-2.

[11]*Ayrshire Pullman Motor Services v. C.I.R.* (1929) 14 T.C. 754 at pp. 763-4.

> "It was not, I think, denied — at any rate it is incontrovertible — that the deeds were brought into existence as a device by which the respondent might avoid some of the burden of surtax. I do not use the word device in any sinister sense, for it has to be recognized that the subject, whether poor and humble or wealthy and noble, has the legal right so to dispose of his capital and income as to attract upon himself the least amount of tax."[12]
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> "Every man is entitled if he can to order his affairs so 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."[13]

Canadian courts have for the most part diligently abided by the principles of these precedents.[14] The right to avoid taxation is merely the inescapable conclusion that results from the rule of strict interpretation; *i.e.* having found the taxpayer outside the lines drawn by the legislature it is not the court's concern whether he got there by accident or design.

Nevertheless, in recent years there appears to be a growing tendency on the part of the judiciary to regard with disfavour the taxpayer's attempts to minimize his tax liability. For example, in the case of *Howard de Walden v. C.I.R.*[15] Lord Greene, M.R. said:

> "For years a battle of manoeuvre has been waged between the legislature and those who are minded to throw the burden of taxation off their own shoulders on to those of their fellow subjects. In that battle the legislature has often been worsted by the skill, determination and resourcefulness of its opponents of whom the present appellant has not been the least successful. It would not shock us in the least to find that the legislature has determined to put an end to the struggle by imposing the severest of penalties. It scarcely lies in the mouth of the taxpayer who plays with fire to complain of burnt fingers."

And Lord Simon stated in *Latilla v. C.I.R.*[16]:

> "*Judicial dicta* may be cited which point out that, however elaborate and artificial such methods may be, those who adopt them are "entitled" to do so. 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 matter, 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."

A similar sentiment has been expressed by Mr. W. S. Fisher of the Income Tax Appeal Board, as it then was, in *Grant v. M.N.R.*[17] where he said:

> ". . . But the taxation principles involved are so fundamental, to my way of thinking, that I feel that I cannot close my eyes or divert my mind from dealing with them as they occur to me, in order that all the taxpayers of Canada may feel that each taxpayer, in so far as it is humanly possible to ensure that he is doing so, is paying his full and just share of the tax burden imposed by Parliament in and for the year in which the tax should have been paid, and is not obtaining, by some slip or chance or trick of fortune, the opportunity to avoid his full share of income tax payments to the disadvantage — or indeed the increased liability — of those other taxpayers who have no opportunity whatsoever, even if they had the inclination, to avoid payment of the taxes imposed and collected from them."

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[12] *C.I.R. v. Duke of Westminster* [1936] A.C. 1 at pp. 7 and 8 per Lord Atkin.

[13] *Ibid*, per Lord Tomlin at p. 19.

[14] See *A.-G. Canada v. J. T. Wait Co.* [1938-39] C.T.C. 1, at pp. 10-11 per McDougall J.; *Malkin v. M.N.R.* [1938-39] C.T.C. 128 at pp. 135-6 per Maclean J.; *A.-G. Canada v. Cohn* [1956] C.T.C. 138; *Shulman v. M.N.R.* [1961] C.T.C. 385 at p. 396 per Ritchie, D. J.

[15] [1942] 1 All. E.R. 287 at p. 289.

[16] [1943] 1 All. E.R. 265 at p. 266; [1943] A.C. 377 at p. 381.

[17] 1 T.A.B.C. 417 at p. 421.

Some observers have attributed this noticeable trend in the thinking of some members of the judiciary to the change that has taken place in the purpose of revenue legislation. Instead of being employed solely to collect money for public purposes, taxing statutes have become economic and social instruments of considerable import.[18]

We must ask ourselves whether these recent changes in the magnitude and nature of fiscal legislation necessitated by increased governmental activity justify a departure from the established judicial principles surrounding its application.

The barrier of canons of construction behind which the taxpayer has legitimately and successfully arranged his affairs to minimize the tax burden is confronted with two formidable weapons; the one resting in the hands of the judiciary, the other in the hands of the legislature.

Judges who believe that tax avoidance is not worthy of dutiful citizens tend to look beyond the letter of the law to the social and economic exigencies of the day, and to construe the intention of the legislature accordingly. In many areas of the law, where the position of the individual is not prejudiced, this inclination should perhaps be encouraged. In matters of taxation its merits are open to serious doubt not only because it facilitates unauthorized encroachments upon the economic liberty of the individual, but also because it creates uncertainties that are of real detriment to the business community. Nevertheless, the judiciary has invoked the intention of the legislature in interpreting fiscal legislation. This rule of construction derives from Lord Coke's judgment in Heydon's Case and is commonly known as the "mischief rule". It may be summarized as follows:

> "1. What was the law before the Act was passed; 2. What was the mischief or defect for which the law had not provided; 3. What remedy Parliament has appointed; and 4. The reason of the remedy."[19]

Now the mischief rule is clearly at odds with the literal rule of interpretation that has in the past been considered by the highest judicial authority to be imperative in the construction of fiscal legislation. Nonetheless Canadian courts have on occasion invoked the rule to determine the intention of Parliament in enacting certain revenue legislation.[20] Obviously it can be argued that this canon of construction is as much to the advantage of the taxpayer as it is to the taxing authority. Unfortunately, however, as a precedent of our judiciary it opens the door to abuses that could seriously compromise the liberty of the individual. Once judges begin voyaging outside of the literal

[18]Gwyneth McGregor, "Literal or Liberal", (1954) 32 Can.B. Rev. 281 at p. 283.

[19]Heydon's Case (1584) 3 Rep. 7b in *Maxwell on Interpretation of Statutes*, 10th ed. at p. 19.

[20]For example, see *O'Connor v. M.N.R.* [1943] C.T.C. 255 at p. 272; *Might v. M.N.R.* [1948] C.T.C. 144 at p. 144; *M.N.R. v. The Great Western Garment Co. Ltd.* [1949] C.T.C. 343 at p. 343; Note: In the O'Connor case, Thorson J. expressly invoked the rule of Heydon's Case and in the other decisions it was the intention of Parliament that was considered without a specific reference to the mischief rule. For a discussion of these cases and this trend in interpretation, see Gwyneth McGregor, *op. cit.*

meaning of the words before them in search of that often elusive spirit of the law, the position of the taxpayer becomes hazardous. As Park J. said in rendering judgment in *Doe Dem. Scruton v. Snaith*,[21] an 1832 decision:

> "We must look to the precise words of these revenue acts, because in some degree, they operate as penalties."

To the extent that they operate as penalties they encroach upon the liberty of the individual just as much, and sometimes at a greater personal sacrifice, than many other forms of penal legislation. Social, economic, or other factors should therefore be excluded from the consideration of the judiciary when concerned with fiscal legislation. In this regard one is reminded of the words of Lord Atkin in rendering a forceful dissenting judgment in the case of *Liversidge v. Anderson*[22] when he said:

> "I view with apprehension the attitude of judges who on a mere question of construction when face to face with claims involving the liberty of the subject show themselves more executive minded than the executive. Their function is to give words their natural meaning, not, perhaps, in wartime leaning towards liberty, but following the dictum of Pollock, C. B. in *Bawditch v. Balchin* (1850) 5 Ex. 578, cited with approval by my noble and learned friend Lord Wright in *Barnard v. Gorman* (1941) A.C. 378 at p. 393: 'In a case in which the liberty of the subject is concerned, we cannot go beyond the natural construction of the statute' . . . It has always been one of the pillars of freedom, one of the principles of liberty for which on recent authority we are now fighting, that judges are no respecters of persons and stand between the subject and any attempted encroachments on his liberty by the executive, alert to see that any coercive action is justified in law."

What certainty there is in fiscal legislation would be quickly erased if the written word is not adhered to. Those who think otherwise should give some consideration to the following excerpt from 'Through the Looking Glass' which was quoted by Lord Atkin in rendering the dissenting judgment referred to above:

> "'When I use a word', Humpty Dumpty said in rather a scornful tone, it means that what I choose it to mean, neither more nor less: 'The question is, 'said Alice, 'whether you can make words mean so many different things: 'The question is,' said Humpty Dumpty, 'which is to be master — that is all.'"

The second weapon is that which has been introduced in the form of legislation which purports to tax the "intention" of the taxpayer.

The following provisions are contained in the Income Tax Act.[23]

> "Section 137 (1). In computing income for the purposes of this Act, no deduction may be made in respect of a disbursement or expense made or incurred in respect of a transaction or operation that, if allowed, would unduly or artificially reduce the income."
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> "Section 138 (1). Where the Treasury Board has decided that one of the main purposes for a transaction or transactions effected before or after the coming into force of this Act was improper avoidance or reduction of taxes that might otherwise have become payable under this Act, the Income War Tax Act, or the Excess Profits Tax Act, 1940, the Treasury Board may give such directions as it considers appropriate to counteract the avoidance or reduction . . .
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> (6) An avoidance or reduction of taxes may be regarded as improper for the purpose of this section although it is not illegal."

[21](1832) 8 Bing. 146 at p. 152.

[22][1942] A.C. 206 at p. 244.

[23]R.S.C. 1952 c. 148.

Recently the first judgment has been rendered under the provisions of Section 137 (1) in the case of *Isaac Shulman v. M.N.R.*[24]

In this case Mr. Justice Ritchie was faced with the extraordinarily difficult assignment of construing the meaning of the word "artificially", ". . . in a statute whose very existence is the essence of artificiality, as that term is used to distinguish from natural reality . . ."[25]

A literal reading of the section in question reveals that it is not necessary for the taxpayer to have the intention of artificially reducing income so long as that is the result. Yet, the learned judge seems to have regarded the intention of the taxpayer as a principle consideration in finding for the Crown.

> "In my opinion, the primary object of injecting Shultup into the management set up was to reduce the income tax payable by the appellant on his professional income. . ."[26]

The judgment does not furnish us with a definition of "artificially" and one wonders whether in future "intention" will be considered as a criteria of artificial. If so, then this section can be invoked to tax the intention of the taxpayer as opposed to the economic results of the transaction in which he engages.

On the other hand, section 139 (1) directs the court to consider the intention of the taxpayer. Such a provision provides the taxing authorities with a means of destroying in one fell swoop the fundamental principles of fiscal law that the judiciary has maintained, with few exceptions, since the inception of revenue legislation.

An American tax specialist, Edwin S. Cohen, has examined such provisions in United States legislation in an article appropriately entitled 'Taxing the State of Mind'[27]. The following observations should have equal application to any provision that attempts to levy tax on the basis of the intention of the taxpayer.

> "When the existence or non-existence of a tax liability is made to turn upon the taxpayer's purpose to avoid a tax, we are called upon to examine his state of mind. In the case of corporations and deceased persons this is an especially difficult task. But it is even more so when the statute requires a finding as to whether tax avoidance is "the principal purpose", or "one of the principal purposes", or "a major purpose" of a transaction; for then we are called upon to weigh various coexistent purposes and determine their relative importance. Whether this can be accomplished as a practical matter on a fair and rational basis is open to serious doubt. Whether it is proper to attempt it is a matter I think we should review with considerable care . . .
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> . . . It is my view that if two taxpayers engage in identical transactions the income tax result should be the same for both, even though one of them may be motivated in part by the knowledge that his taxes will be reduced thereby and the other may be ignorant of the tax effect or give no substantial consideration to it. The income tax, I submit, should be levied on the basis of economic effect of transactions and not by reference to subjective motives of taxpayers to minimize the tax burden."

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[24][1961] C.T.C. 385.

[25]*Ibid.*, Editorial note, p. 385.

[26]per Ritchie, D. J., at p. 400.

[27]The Tax Executive, April 1960, p. 200.

After a lenghty review of the relevant legislative provisions and jurisprudence, the writer concludes:

> "The issue is a significant one of tax philosophy. It is time, I believe, to re-examine the test on a broad basis. The fundamental principles, I submit, should be restated in terms which require simply adequate business justification for the taxpayer's actions. If this be present, the tax structure should be satisfied without our seeking to gauge the extent of his tax consciousness in a hazardous effort to probe his state of mind."

As Edwin Cohen suggests, the criterion of adequate business justification may constitute a satisfactory alternative to legislation which creates a tax liability on the basis of intention. However, the principal purpose of this article is not to propose solutions to practical problems of taxation but rather to focus attention on the nature of fiscal legislation as a whole as it involves the liberty of the individual.

When one considers, as did Mr. Justice Collins, that the power to tax carries with it the power to injure and destroy, it is impossible to give countenance to such provisions as section 138 of the Income Tax Act where the taxpayer may be penalized for the avoidance of tax which the Treasury Board has decided is improper although not necessarily illegal.

Unfortunately the existence of legislation which permits such arbitrary taxation probably does not arouse public concern to the same extent as legislation which confers arbitrary powers permitting encroachments upon physical freedom or freedom of expression. It would seem therefore that liberty may be especially vulnerable to abuse in the realm of fiscal legislation. This is a danger which should receive careful and continual consideration by the judiciary, the legal profession and the legislature.

Any conceivable benefits that can be derived from the introduction of the mischief rule in interpreting taxation statutes or by the enactment of legislation which permits arbitrary assessment on the basis of intention should be carefully evaluated against the damage that may be created by a departure from the established principles of the philosophy of taxation which have been briefly considered in this article. Those who argue that the departure is justified because everyone must bear his full share of the increased demands upon the public revenue should recognize and accept that it will be accomplished at the expense of business uncertainty and individual liberty. Those who justify such a departure on the ground of economic and social necessity should reflect upon this quotation of William Pitt.

> "Necessity is the plea for every infringement of human freedom. It is the argument of tyrants; it is the creed of slaves . . ."[28]

[28]House of Commons Debates, November 18, 1783.