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SIMPLIFICATION AND REFORM*

BY ROBERT COUZIN**

I. INTRODUCTION

Efficiency of collection, stability of revenues, and simplicity in compliance and administration at an acceptable level lie at the very origin of taxation. Rulers found that the restraint and discipline required to substitute such regular exactions for irregular plunder was worth the effort. In the long run, it paid to preserve the goose. Tax systems have been modified and improved in many ways through the ages, but they have not become any simpler.

The increasing complexity of taxation should be viewed in the context of increasingly complex social and business organization, the emergence of the market-driven economy, and the further interaction of such market forces with state command or influence. Also relevant are our contemporary conceptions of equity, derived from seventeenth- and eighteenth-century political theories that ground our conception of the nation-state. All these facts have undoubtedly shaped the tax system.

A central event in this context is the choice of income as a major tax base. That selection reflects several of the modern objectives of taxation and, indeed, of the state. Equally important has been the rising cost (albeit in a world of rising product) of both warfare and welfare, basic ends of taxation. Such revenue requirements substantially widened the scope of income taxation. Only one-seventh of the British work force paid income tax in 1914,

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** Stikeman, Elliott, Toronto.

while today subjection to income tax and the political franchise are nearly coextensive. The confluence of all these trends has engendered an overwhelming complexity.

The development of income taxation in this century is a striking indictment of the representative process of lawmaking. I am reminded of the diner who complains after a meal in which the vegetables were over-cooked, the meat of poor quality, the bread stale, and the wine past its prime. The diner's companion agrees and adds: "and such small portions." Amendments and revisions to the tax system have often been tardy, ill-conceived, inappropriate, and ineffective. Alas, unlike the poor food, the portions have been all too generous.

Since the Second World War, we have witnessed the income tax systems in several Western countries collapsing under their own weight of complexity. Cycles of action and reaction have been recognized not only as bad policy, but as bad politics. Tax reform, by no means a new idea, acquired a new rhetoric. Part of that rhetoric is simplification.

Many who look back with nostalgia to the simplicity of the pre-1972 *Income Tax Act* may wonder that simplification was a goal in 1962. Yet, the Order in Council establishing the Carter Commission included a requirement that the Commissioners consider and report on "the changes that may be made to achieve greater clarity, simplicity and effectiveness in the tax laws and their administration."¹

In this paper, I seek to clarify the relationship between simplification and reform, with particular reference to the Carter Commission and the fate of its proposals. It is my thesis that tax reform is a juncture at which simplification can be advanced. It need not be a source of additional complexity. The Commission seems to have perceived the relationship in this way. However, the actual reforms of 1971, and especially the continuing tax reform of the 1970s and 1980s, certainly belie my proposition.

After considering the general relationship between simplification and reform, I will touch upon an example where

¹Canada, Royal Commission on Taxation, *Report*, vol. 1 (Ottawa: Queen's Printer, 1966) (Chair: K.LeM. Carter) at vi [hereinafter *Report*].

reform has complicated what it could have simplified: the taxation of capital gains. I will then explore the relationship in different dimensions, looking not to examples, but rather to interactions between simplicity and other goals of the system. In one direction, I will follow the road to equity, and in another the heavily travelled path of tax avoidance.

II. INTERFERENCE OF SIMPLIFICATION AND REFORM

Complexity is often viewed as the inevitable by-product of reform. On this view, other tax policy goals, particularly equity, leave no room for simplicity. On the contrary, I suggest that convoluted drafting: fuzzy, illogical, and inconsistent concepts and poor administrative organization cause (or, more precisely, constitute) complexity. These can and should be mitigated, not aggravated, by reform.

I have elsewhere dared to espouse some views regarding the process of simplification.² I put forward as a working definition that "a tax measure may generally be said to enhance tax simplification if it facilitates compliance." Tax simplification is too often equated with improvements in statutory drafting, and the simplification of language is undoubtedly an important part of the process. The goal in this arena is measured by clarity, not certainty or even brevity. More important than correction of drafting is, however, simplification of the tax system's underlying concepts. The statute is improved internally by greater logical consistency among its various elements. Externally, simplification requires increasing correlation between statutory notions and the reality of activities, transactions, and institutions to which the *Act* applies. Finally, I echoed the recent focus upon a third element: administration. Obviously, the administration of the tax system depends to a great extent upon both the statutory language being applied and the underlying concepts. In addition, however, the administrative application of the statute itself is in need of simplification through greater uniformity,

²R. Couzin, "The Process of Simplification" (1983) 32 Can. Tax J. 487.

heightened efficiency, and the dissemination of accurate and timely information.

My attempt to link simplification with compliance is not mere intellectual musing. The Canadian income tax system is built upon self-assessment and voluntary compliance. Such voluntarism is worthy from a socio-political point of view. It is also critical to the efficiency of the system, measured by the accuracy of the assessment and the cost of collection. Thus, facilitating administration and compliance (both of which I subsume in the former) is an official, as well as an academic, sense of simplification.³

The process of "reform", as its name implies, entails a restructuring, reordering, or reaction of the tax system. We usually associate the need for reform with imperfection or corruption. The Christian church required "reformation" in the sixteenth century because, the reformers claimed, it had taken the wrong path and transgressed its own first principles. Reform is thus associated, not merely with change, but with betterment. Tax reform attracts all of these connotations, and strongly emphasizes a "fresh start."

The goals of tax reform have been variously stated. Often there is concern expressed whether these goals are consistent with any tax simplification at all. In my earlier effort, I concluded that tax simplification is one policy goal among others, and merits some weight when the inevitable trade-offs occur. Clearly, it has not had a fair shake to date. This same view was expressed by the government in the 1984 small-business simplification proposals.⁴

A metaphor for the interference between simplification and other tax reform goals is the physics of two independent wave sources. Pebbles dropped in a pond create an interference pattern. There are nodes, where wave crests from one source cross troughs from the other, cancelling out and leaving nothing. There are also double crests, points where the two interfering waves reinforce one another. So it is that conflicting tax policies may form nodes; both

³Hon. M.A. Wilson, Minister of Finance, *Guidelines for Tax Reform in Canada* (Ottawa: Department of Finance, 1986) at 3; Canada, Department of Finance, *Simplifying Taxes for Small Business* (Ottawa: Department of Finance, 1984) at 1.

⁴*Simplifying Taxes for Small Business*, *ibid.*

cannot survive. There are also double crests, points where simplification and other objectives may coincide.

The Carter Commission perceived simplification in this way: not as an impediment to or an inevitable casualty of tax reform, but as an integral part of it. There can be no clearer statement of the double crest formed by competing tax policy goals than this: "a policy is inefficient if an objective could have been more adequately realized without at the same time having to sacrifice the realization of another objective."⁵ While recognizing that there are policy conflicts, the Commissioners also noted that inefficiency arises where the trade-offs are misunderstood and "it is erroneously believed that in pursuing one objective it will necessarily mean another will be less adequately realized." This theory extends to simplification, as to other goals. One could cite, as an example, the Commissioners' proposals regarding the taxation of capital gains, which were expressly designed to provide incremental simplification and greater equity.⁶

Tax reform in the 1980s has elevated simplification to top billing. While the Carter Commission considered it a worthwhile exercise, and part and parcel of the tax reform process, recent polemic expressly extols the virtues of simplification as a forgotten but no less worthwhile objective. Thus, in the United States, the President's proposals that preceded the 1986 tax reform were entitled "Proposals to the Congress for Fairness, Growth and Simplicity." Interestingly, the report cites complexity as a policy anathema, not merely because it renders compliance more difficult and revenue collection less efficient, but also because of its positive correlation with another tax evil: inequity, and the perception of inequity.⁷ In Canada, the same message appeared in the 1985 budget paper on corporate tax reform.⁸ Here, the goals of the

⁵*Report*, vol. 2, *supra*, note 1 at 23.

⁶*Ibid.* vol. 1 at 15.

⁷*The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* (Washington: U.S. Government Printing Office, 1985) at 1-2.

⁸Hon. M.A. Wilson, Minister of Finance, *The Corporate Income Tax System: A Direction for Change* (Ottawa: Department of Finance, 1985).

reform were stated to be market efficiency (read: minimum of interference), certainty (not predictability but stability), simplicity (ease of compliance), and stability of tax revenues.

The theme continued in the government's October 1986 tax reform paper.⁹ We need, the Minister said, a fairer tax system. It should be simpler for Canadians to understand and comply with the self-assessment system and voluntary compliance. The Economic Council, in its contribution, emphasized fairness, simplicity, and stability (of legislation), among other goals.¹⁰ Most recently, in his budget speech earlier this year, the Minister of Finance, the Hon. Michael Wilson, reiterated the goals of tax reform as the creation of a fairer and more effective tax system that will play a role in stimulating investment, and encouraging dynamic business activity, job creation, and economic growth.¹¹ Simplicity was not named. One likes to think it was subsumed in the word "effective," or perhaps needed no further underscoring. A cynic might suggest that the Minister had seen the first draft.

III. THE TAXATION OF CAPITAL GAINS

In Canada, as elsewhere, special regimes of capital gains taxation (or exemption) have been a perennial enemy of simplification. Viewing the world through pre-1972 glasses, the Carter Commission clearly saw that the differential treatment of capital gains and other forms in incremental wealth was a source of undue complexity. "[I]t is the attempt to distinguish between capital and income gains, in order to tax the one at a different rate than the other, that creates the complexity and uncertainty."¹² Distinctions, it appears, breed complications.

⁹*Guidelines for Tax Reform in Canada*, *supra*, note 3.

¹⁰Economic Council of Canada, *Road Map for Tax Reform: The Taxation of Savings and Investment* (Ottawa: Can. Govt. Pub. Centre, 1987) at 6.

¹¹Hon. M.H. Wilson, Minister of Finance, *The Budget Speech* (Ottawa: Dept of Finance, 1987) at 11.

¹²*Report*, vol. 1, *supra*, note 1 at 15.

A similar message is conveyed in the recent report of the Economic Council of Canada. A significant source of complexity in the income tax system, it notes, is the definition of the tax base. Since the base is not grounded in uniform and consistent principles, taxpayers may arrange their affairs so that similar activities are taxed differently. This leads to erosion of the base and consequent legislation to close perceived loopholes. The result is further complexity. It is significant that the Economic Council cited the taxation of capital gains as a "classic example" of the problem.¹³

Whatever the economic or legal rationalization for the distinction between capital gains and ordinary income, the differential taxation of the two has undoubtedly engendered complexity in drafting, conceptual underpinnings, and administration. More precisely, it is the interaction between the intellectual severing of fruit and tree on the one hand and the increasing sophistication and complication of commercial and other economic transactions on the other, that has led to complexity. If the income tax system imposed a flat rate of tax on an undefined income base with no deductions or credits, no special rules, and no tax on corporate or other intermediaries, the special treatment of capital gains would still render compliance more difficult, but only in the sense that taxpayers and administrators would be forced to examine receipts and characterize them as falling within or without the tax base. This effect should not be underestimated, but it is only a small part of the actual complexity that has arisen due to the differential treatment of capital gains. The real problem can be traced directly to the impact of the distinction between the two types of receipt in a universe populated by incorporated companies, financial intermediaries, partnerships, and trusts.

This differentiation has led to great complexity in the statute, measured by the quantity of enactments specifically required to deal with it, and the subtle and recondite concepts underlying such legislation. Prior to 1972, a substantial portion of the anti-avoidance provisions dealt, in one way or another, with the problem of dividend stripping, the conversion of taxable dividend income into tax-free capital gains. This problem obsessed the Carter Com-

¹³Economic Council of Canada, *supra*, note 10 at 6.

mission, and perhaps with good reason. Their solution, as noted above, was not to revile stripping but to bury it. They would have accomplished the task by full integration and full taxation of capital gains.

The half taxation of capital gains introduced in 1972 seemed, paradoxically, rather more complicated than total exemption. Significant amendments were made, indeed, whole new systems established, to accommodate a type of income that was neither fish nor fowl. This was a great challenge in the area of corporate distributions in view of the decision, fair enough in itself, to enable the "tax-free half" of the gain to be realized indirectly through one or more corporate intermediaries. To make matters worse, a political judgment was made, again on equity grounds, that pre-system capital gains should not be garnered into the tax base. This required a valuation day and a host of new rules to preserve the transitional relief through subsequent transactions, substitutions, and reorganizations and, once again, through corporate and other intermediaries. Transitional rules invariably lead to complexity. In fact, transition costs should always be considered in assessing tax amendments even if the overall result is to simplify the system. A further policy decision required the creation of a "tax-free zone" to prevent the taxation of phantom gains, increments of value after 1971 in respect of assets that had declined in value before that time. The transitional rules and their progeny are still with us. Such rules are very difficult to rescind, even much later when the number of taxpayers affected by the relief dwindles.

The anti-avoidance structure dealing with the differential treatment of capital gains, and especially surplus stripping, was also recreated (or "reformed") in 1972. I will refer to it again in the context of tax avoidance. It is interesting to note the creative attempt that was made in the 1970s to simplify this structure by reducing the preference for capital gains as against the particular source of income with which the tension was the greatest: taxable dividends. This was done, not by complex changes to the regime of capital gains taxation, but through an increase in the dividend tax credit. Significant structural simplification resulted. Paid-up capital deficiency and debt limit rules were repealed, as was designated

surplus. There were, however, complexity costs elsewhere in the system associated with the change, notably in the small business area.

The next important event was the enactment of the lifetime capital gains exemption in 1985. Whatever the incentive or policy (or political) justifications, there can be little question about its structural effects. Prior attempts to bring capital gains taxation closer to dividend taxation were undone at a stroke. Part of the elaborate anti-avoidance structure that had been dismantled in the 1970s was re-enacted (new rules for computing paid-up capital, revised surplus-stripping rules, and specific anti-avoidance rules). Capital markets have already responded, and investors have not been slow to seek out economic transactions that will enable them to "earn" capital gains (preferably with borrowed money). Pressures in the current tax reform to deal with matters such as passive investment income (reminiscent of the restricted interest expense of the 1981 budget) are undoubtedly increased by the capital gains exemption.

Politically, it would be difficult for this government, or even future governments, to eliminate the exemption and embrace the Carter Commission's proposals respecting capital gains (although, ironically, the 1986 U.S. tax reform did eliminate their special treatment). Nor is it clear that there are not inherent difficulties in the full taxation of such gains absent some kind of indexing. More creative approaches to the taxation of capital wealth are probably required. In the more immediate term it would not be surprising to find a move in this and subsequent tax reforms towards a reduction in the differential treatment of capital gains and other forms of income. This could involve taxation of a higher percentage of non-exempt capital gains, as well as restrictions on the exemption or reductions in its value. In the longer term, there seems no doubt that significant simplification of the income tax system requires a different basis for taxing capital.

IV. TAX AVOIDANCE AND SIMPLIFICATION

Several important tax policy goals are seriously undermined by tax avoidance. It can adversely affect the quantum and the stability of revenues. Since not all taxpayers have the same ability to avoid taxation, any abuses tend to reduce horizontal and vertical equity. Even if they do not, the perception that they do can damage the voluntary compliance that permits self-assessment and efficient collection. From the beginnings of income taxation, a good deal of the amending and reform process has been directed against tax avoidance. The correlation between complexity in the income tax law and its administration and the effort to manage, if not eliminate, tax avoidance or abuse is undoubtedly very high.

Dealing with abuse is an inherently complicated exercise. However, much of the convoluted drafting, the Byzantine concepts, and the unadministrable aspects of the tax system can be traced to a confusion in defining abuse and in deciding how to deal with it. Today's tax incentive becomes tomorrow's loophole (for example, MURBS). The lines between what is permitted and what is not are often unclear, not only because they are hard to draw, but because no one has decided where to try to draw them.

The Carter Commission provided a useful definition of tax avoidance: changing the form of an activity, organization or asset in order to escape the tax that would otherwise apply.¹⁴ The Commission has also left us with an important paper on the subject.¹⁵ This appendix, written more than twenty years ago, exhibits an almost eerie contemporaneity. The issues, the problems, and the solutions seem to be unchanged, notwithstanding the major tax reform of 1971; the numerous statutory shifts and dodges since; and two decades of case law, including some recent decisions that most of us thought important.

In that appendix, the two basic legislative approaches, specific rules and general rules, are reviewed. The advantages and disadvantages of each are noted. One drawback to specific rules is

¹⁴Report, vol. 4, *supra*, note 1 at 21.

¹⁵*Ibid.* vol. 3 at 537ff.

their complexity: they are "responsible for much of the obscurity of the Act, couched as such legislation often is in tortuous and obscure language of unparalleled complexity and difficulty."¹⁶

In another appendix, dealing with the then current avoidance problem of surplus-stripping (now making a comeback),¹⁷ the same preference for general avoidance rules is expressed, in different terms. The historical perspective in this discussion is particularly interesting. It reviews the pre-1949 and post-1948 legislation culminating in the predecessor to subsection 247(1).

There is a striking similarity in the history of the legislation to prevent surplus stripping in the two periods. In each case, attempts were made originally to enact legislation that detailed the then known methods of surplus stripping and detailed the tax consequences of using the particular method. In each case, the attempts failed and the subsequent amendments to extend or strengthen the legislation were unsuccessful until, ultimately, resort was had to discretionary legislation.¹⁸

The Carter proposals approached some tax avoidance problems through neither general nor specific rules but, instead, through changes to the tax system that circumvented the problem, a kind of conceptual pre-emptive strike (for example, full integration and full taxation of capital gains). Nonetheless, the message of the Commission, and in particular these two appendices, may fairly be said to be that specific anti-avoidance rules, while they undoubtedly have their place, tend not to work. There are advantages and disadvantages to each approach, but ultimately nothing fails like failure.

In this respect, it is also interesting to compare the Australian experience.¹⁹ High rates of personal tax and an extremely narrow income tax base appeared to invite tax avoidance. The narrowness of the base was due partly to statutory provisions, particularly the lack of taxation of capital gains, and partly to a

¹⁶*Ibid.* vol. 3 at 556.

¹⁷*Ibid.* vol. 4 at 597ff., Appendix D.

¹⁸*Ibid.* vol. 4 at 603-604.

¹⁹This brief summary is based upon, but cannot do justice to, the excellent article by Richard Krever, "Tax Reform in Australia: Base Broadening Down Under" (1986) 34 *Can. Tax J.* 346.

series of judicial decisions that seemed to condone dividend-stripping, assignments of income, and other such schemes. Until the 1970s, a compromise formula had been worked out by revenue authorities and tax advisors to distinguish non-taxable sales of shares from dividend-stripping schemes giving rise to ordinary income. Perhaps because of increased sophistication or economic pressures, the compromise broke down. The lengths to which tax advisors and their clients went were indeed extreme. As in the Canadian context, one of the key defences for the fisc was maintaining a link between the taxation of the seller of shares and the subsequent activities of the purchaser, particularly where the two deliberately organized the transaction with a view to effecting a disappearance of surplus. In an Australian case, however, the High Court found the sellers of shares not liable to tax as a consequence of subsequent actions of the purchasers, even if the whole scheme was deliberately organized as the surplus-strip.

That case, *Slutzki v. FCT*,²⁰ gave rise to the infamous "bottom of the harbour" schemes. The original plans were known as "dry Slutzkins." Taxed retained earnings of a corporation were distributed without the second-level distribution tax by means of a sale of shares, the familiar dividend-strip of the 1960s in Canada. However, the more adventurous soon developed what were known as "wet Slutzkins," involving the sale of shares of companies with as yet undischarged current-year tax liabilities. In this case, not only was there a tax-free capital gain to the seller, but the mainstream corporate tax was not paid, either. On the theory of *Slutzki*, the seller took the position that whether or not the purchaser ever caused the tax to be paid was not his concern, even if the seller could confidently predict the result. The corporate shell, bereft of assets but still possessed of its tax liability, was all the revenue officials could ever find. Company records, it was said, could be found at the bottom of the harbour, whence the sobriquet "wet."

The result was a new assault on tax avoidance. Australia already had section 260, which might have been regarded in the abstract as a reasonably tough general anti-avoidance provision. It did not seem to have had the desired result, because of an

²⁰(1977), 7 A.T.R. 166.

exception of "ordinary commercial or family dealing." The section was also found deficient by the courts in not providing for an alternative result. That is, the section enabled a court to disregard a transaction, but did not seem to permit any recharacterization in order to determine the tax liability. The new approach to anti-avoidance included both specific and general provisions. The government took aim at the tax avoidance schemes it knew about that had escaped the application of section 260. It enacted a new general anti-avoidance provision, a new and improved section 260, without the "ordinary and commercial dealings" exception, and with appropriate powers to reconstruct the tax result. There were also amendments to the Australian equivalent of our *Interpretation Act*, requiring a court in interpreting a provision of a statute to choose the construction that would promote the purpose or object underlying the statute. This is similar to a rule already contained in our *Interpretation Act*,²¹ and could also be viewed as a legislative statement of the rule espoused by the Supreme Court of Canada in the *Stubart* decision.²² A further amendment to the Australian legislation governing interpretation of statutes expressly permitted the use of extrinsic materials, such as parliamentary debates and explanatory memoranda.

Canada has not had its "wet Slutzkins" on the scale of Australia's. There have been analogous cases, in which aggressive tax planning leaves, as its residue, a corporation without assets that may or may not have a tax liability (depending on whether the scheme works). We certainly have our own "made in Canada" tax avoidance problems. The scientific research tax credit, while it undoubtedly financed a good deal of real live scientific research, also created a new corps of tax avoidance promoters. Many of the same people who brought us unintelligible and improbable srtcs have also created (or sold) Brazilian research partnerships and other well-nigh indefensible (from a policy, if not a legal perspective) tax avoidance plans. Less extreme, but probably more troublesome from the fiscal point of view, have been loss trading schemes involving accrued and

²¹*Interpretation Act*, R.S.C. 1970, c. I-13, s. 11.

²²*Stubart Investments Ltd v. The Queen*, [1984] C.T.C. 294 (S.C.C.).

unrealized ("pregnant") capital or trading losses, purchase of corporate shells with recoverable corporation tax, washing of accrued profits through loss companies, sale of accumulated scientific research expenditures, and other devices, most of which seem to have been dealt a blow in the Department of Finance 15 January 1987 press release. The tax entrepreneurs devoted to wringing money out of the tax base, together with the infamous "overhang" of unused deductions and credits, will undoubtedly continue to exert a market pressure of tax revenues.

The development of the legislative approach to tax avoidance is intimately linked to the problem of complexity and ensuing difficulties in compliance. I recall a comment made in Plato's *Republic*. Discussing business transactions, legal proceedings, and regulations for markets, Socrates asks his interlocutor whether we can realistically legislate these matters. The answer is negative. In the new republic, there will be no need to dictate to men of good breeding. They will themselves determine what rules are needed; indeed there is no other choice. "Otherwise, they will spend their lives making a host of petty regulations and amending them in the hope of reaching perfection."²³ The problem is obviously not new.

Since 1971, the income tax system has been amended and re-amended with great attention to detail, and with significant incremental complexity, in the continuing battle against tax avoidance. A large part of the process has been aimed at protecting the tax on corporate contributions. This would include the subtleties of the new designated-surplus system created in 1971, fine-tuned on many occasions, and finally repealed in 1977. One could add the paid-up capital deficiency, debt limit, and other arcana of the mid-1970s, and their recent counterparts in the paid-up capital amendments following upon the capital gains exemption. Also related to the taxation of corporate distributions and capital gains are the "capital gains strip" rules of section 55 and the underlying code of administrative practice that has created, by fiat, a mirror image of designated surplus.

A second thread running through the amendments dealing with tax avoidance over the last fifteen years is the attempt to

²³ *Plato's Republic*, F.M. Cornford ed. (Oxford: Oxford Univ. Press, 1945) at 116.

confine losses, credits, and deductions to the taxpayer who has suffered or been allowed them. This can be seen in the capital cost allowance restrictions successively applied to real estate (1972); leasing properties (1976); and hotels, yachts, and similar assets (1985). The 27 November 1986 press release dealing with changes to the tax treatment of intercorporate dividends described the most recent in a series of provisions commonly lumped together as the "term-preferred share rules" as "simply one more step in preventing the inappropriate transfer of unusable tax deductions to outside investors." This series of amendments dates back to the original term-preferred share rules of 1978, which have been amended and expanded in virtually every budget since. The 15 January 1987 release was, of course, expressly directed to the transfer of unused losses and deductions. This latter problem seems to loom large, particularly in the corporate tax reform of today. The "overhang" has been referred to in recent budgets. It is very large, and seems to inflate to fill the schemes concocted to use it.

The cycle of action and reaction, as predicted by Plato, has not eliminated tax avoidance, although it has created complexity. This is the worst kind of feedback: the complexity itself breeds more tax avoidance. History suggests that general or even discretionary tax avoidance legislation will close the cycle, at least for a time. Specific anti-avoidance legislation will always be with us, regardless of the potential enrichment of general rules. Yet the general provisions will likely become more prominent precisely because the specific rules multiply. It is often said that one difficulty with detailed anti-avoidance provisions is that they provide taxpayers with a "road map". By delineating precisely what is prohibited, the legislator suggests by indirection what is permitted. We are left with a modified Raskolnikov theory of taxation: everything is permitted that is not expressly prohibited.

In his 1987 budget speech, the Minister of Finance announced that "to ensure a fairer and more stable income tax system" there will be improved general anti-avoidance rules. Such rules can facilitate compliance, and thereby increase the level of simplicity in the income tax system. However, that need not be the case.

Obviously, the rules must be well thought out and framed in a manner that takes into account the judicial approach to tax

avoidance. One foreseeable danger is that general anti-avoidance rules will be too specific. The strength of a general rule, which can also be its weakness, is the plasticity or ambiguity of language, which enables the rule to be applied through the exercise of judgment in unforeseeable situations. This is why such rules necessarily create some uncertainty, yet it is also why they can be made to work. A technical drafting style, carving out permitted exemptions or etching the outlines of proscribed behaviour, can undermine the general thrust of the rule.

To reduce the uncertainty and to make the rule effective, there must be a concerted and consistent exercise of judgment regarding its application: by the Department of National Revenue in its administrative posture; by the Department of Justice in its recommendations respecting litigation, and in the positions taken by it in conducting litigation; and, ultimately, by the courts.

V. NEUTRALITY AND HORIZONTAL EQUITY

Neutrality in the tax system is increased when the interference of taxation with economic decisions taken in otherwise efficient markets is reduced. Generally, this goal is related to the use of income taxation to deliver incentives or discriminate between economic industries, activities, or transactions. Horizontal equity, as the Carter Commission put it, requires that "individuals and families in the same circumstances bear the same taxes."²⁴ Horizontal equity should, perhaps, be considered a facet of neutrality; a tax system that does not interfere with economic decisions should treat economic equals equally.

The current system is far from neutral. Opposition parties and the press are quick to highlight inequities (although often of the vertical, rather than the horizontal, orientation) between individuals and industries. Somehow, taxpayers standing in the ruts on the playing field tend to recognize the lack of neutrality more readily than those on the mounds. While in some areas the statutory rules that offend the principle are quite obvious, there is no simple test

²⁴Report, vol. 1, *supra*, note 1 at 4.

for determining horizontal equity or neutrality generally. An elegant method was practiced in ancient Greece. Where a man upon whom a levy was imposed considered another to be richer, and therefore more justly chargeable, he might challenge the other either to assume the burden of that taxation or to make an *antidosis*, a compulsory exchange of all their property. It is interesting to speculate on the results were such a procedure applied in contemporary society.

Equity in general, and horizontal equity in particular, is commonly cited as a goal that is inherently inimical to simplification. Given my comments above regarding the effect of anti-avoidance rules on complexity, this view is perhaps understandable. However, it is misconceived. Indeed, complexity itself is inequitable. As the current Minister of Finance has said: "The more complicated the tax system, the more difficult it is to understand — and the fewer the taxpayers who can make the best possible use of its provisions. This is not fair to the average taxpayer. A simpler, more understandable tax system will lead to greater fairness."²⁵ The same, I believe, applies to neutrality. Complexity makes it more likely that two similarly-situated persons or economically equivalent transactions will be afforded different tax treatment.

The lack of neutrality may derive from interpretation and administration. The Chief Justice of the Supreme Court of Canada recently took aim at a particular example of "formalism" often urged by taxpayers, and surprisingly conceded in argument by counsel for the Crown, that would place wealthy individuals in a better position to deduct interest on borrowed money merely by ordering their affairs so that the borrowing can be directly traced to an "eligible" rather than an "ineligible" use.²⁶

However, more often inequity is the conscious and intentional result of legislation. Various tax incentives, exemptions, and credits are openly designed to favour one type of industry, activity, or transaction over another. These provisions inevitably make compliance more difficult, and the income tax system thereby

²⁵Hon. M.H. Wilson, Minister of Finance, Address (Canadian Tax Foundation, 24 November 1986) at 7 [unpublished].

²⁶*The Queen v. Phyllis Barbara Bronfman Trust*, [1987] 1 C.T.C. 117 at 126, 130 (S.C.C.).

more complex. It is not surprising that tax reforms, at least of recent vintage, generally take aim at such incentives.

The only way to promote one activity over another through the tax system is to remit tax to the likely participants. Base-broadening involves the reduction or elimination of such preferences, thereby promoting neutrality and horizontal equity. In many cases, this involves simplification as well. Base-broadening may further complicate the system, if it is half-hearted, contrived, or equivocal. There is also, admittedly, an inherent complication arises from the difference between the tax base and either accounting income or ordinary conceptions of income. To this extent, achieving neutrality does tend to exacerbate complexity. To the extent that the broader base may be eroded by taxpayers' ingenuity, anti-avoidance rules are required, and these, too, generate more complexity. Overall, however, tax reform can simplify compliance while enhancing neutrality and equity — which is not to say that it will.

V. *EPILOGUE*

Since these remarks were prepared, the terms of the 1987 tax reform have been announced. It was not hard to be prescient about their impact on simplification. A few observations are nonetheless appropriate by way of postscript, or perhaps post mortem.

Lip service continues to be paid to simplicity (fewer brackets, fewer preferences) but the stunning legislative package speaks louder. Base-broadening turns out to be not quite so simple, and transitions even more complex than one might have expected. In addition to the traditional sources of complexity, tax reform provides many new ones, in surprising places. A perfect example is something as mundane as automobile expenses. Compliance will surely be more costly, and less complete. The commission salesman with a leased vehicle is limited to a deduction determined by the formula

$$A/B * (C + (D/E * F))$$

but not exceeding the lesser of

$$(A * B)/30 - C - D - E$$

and

$$(A*B/.85C) - D - E$$

(where each variable is differently defined in each formula).

The specific areas treated in the remarks above are also illustrative. Capital gains are more taxed, but not fully taxed, leaving the usual tensions in place. The capital gains exemption is, as predicted by most, reduced, but it is still there. Indeed, it is more complex than ever due to political constraints in connection with small business and farming. To make matters worse, a kind of passive loss system is included, but only for purposes of determining the capital gains exemption. All this, and minimum tax as well.

The assault on tax avoidance continues on all fronts. There are new specific anti-avoidance measures along with the much-heralded general anti-avoidance rule. Among the former, one should probably include the quite astonishing revision of the preferred share provisions, which retain all the former classifications, add some new ones and provide a bewildering increase in overall complexity. The general anti-avoidance rule does seem to be general (so much so that at least one commentator has argued that it oversteps the rule of law). The curious and somewhat inaccurate attempt to incorporate by reference the civilian notion of *abus de droit* in subsection 245(4) is sure to provide a source of continuing consternation and administrative dithering (and hence complexity). It is perhaps ironic that the French text of this very subsection should be so different from the English, suggesting that the drafters themselves may not have been in full agreement regarding its meaning.

There will almost certainly be renewed cries for simplification, and perhaps even some renewed efforts to simplify in limited areas (attribution rules?). It is likely that the complex reform will take root and sprout yet additional complexity as it is amended and reformed to meet the inevitable difficulties it will create.

