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Knee-Capping the Competition

The Tax Exempt Status of Crown Corporations in Canada

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Executive Summary

This paper examines how the tax exempt status afforded Crown corporations in Canada offends fundamental principles of tax equity and fairness. It describes the legal and constitutional basis for this exemption as well as its interpretation and application by the courts in Canada. It also contrasts it with the different legal and constitutional treatments of similar state entities in the United States. This is followed by a brief description of how, to some extent, this legal regime has been modified in Canada, at least at the federal level. A prescription for eliminating this fundamental disconnect between the legal and constitutional regime in Canada and the principle of a fair and equitable tax system is then suggested using an example from British Columbia.

In 2003, the BC legislature passed new legislation regarding the British Columbia Ferry Corporation. That legislation provided that this Crown corporation was no longer to be considered an agent of the Crown. This automatically made it subject to all provincial and federal taxation resulting in full tax equity and fairness. This is a model that all other governments in Canada could follow. All that is required is the necessary political will.

Introduction

> ***Each level of government is immune from taxation by another... This immunity extends to Crown corporations.***

The concepts of equity and fairness have been universally accepted as essential ingredients of any good tax system.[1] The two of central importance for the purposes of this paper are the notions of horizontal equity (similarly situated persons should be taxed similarly) and vertical equity (the incidence of a tax should be based on the ability to pay). Violations of these principles can cause distortions and inefficiencies in any tax regime.

There is one feature of the Canadian tax regime that constitutes a particularly egregious violation of these two basic principles. This is the tax exempt status given to federal and provincial Crown corporations. Their legal status arises from not only the common law and statutory rules of Crown agency but also the constitutional protection arising from section 125 of the *Constitution Act, 1867,* which states that each level of government is immune from taxation by the other. This immunity extends to Crown corporations as agents of those governments.

Most studies of the efficiency and fairness of the Canadian tax system do not place much emphasis on this aspect of taxation in Canada. This is strange, in light of the long history of a high degree of government intervention in our economy.

The Fraser Institute's 2008 study of the investment climate for private sector business factored in tax and regulatory burdens, but it made no particular reference to the tax unfairness that arises when Crown corporations compete with private sector firms in the marketplace.[2] However, the C.D. Howe Institute, in its 2007 study of the federal Export Development Corporation (EDC), did reference tax exempt status as a key factor contributing to what it described as the EDC's surprising ability to earn profits.[3] The Institute did note that its call for privatizing the EDC's short-term export credit insurance facility would result not only in a more efficient delivery of this product but also an actual increase in tax revenue for the government because of the EDC's loss of its tax exempt status. However, this was only mentioned as one of many consequences of such privatization.

This paper will briefly examine the justification for the existence of Crown corporations — at least those operating directly in the marketplace. It will show how the tax exempt status creates inequities and unfairness in the tax system.

Of particular interest are the exemptions from corporate income tax, as this creates the most direct competitive advantage for Crown corporations carrying on commercial activities in the marketplace.

This paper will then examine how this tax exempt status legally and constitutionally arose in Canada. Some reference will be made to how this status is quite often altered by individual governments in specific cases. There will then be a brief description of one example where the tax exempt status of a provincial Crown corporation was eliminated without any legal difficulty. This example could be a model for such needed reform.

> *"It creates distortions in the marketplace that result in horizontal inequities..."*

The justification for Crown corporations engaging in commercial activity in the marketplace.

Two justifications are usually given for the state to be directly involved in commercial activities:

(a) the private sector is not able to or is completely unwilling to engage in such commercial activities, or,

(b) even if the private sector could do so, it could not do so quickly or efficiently enough to meet the state's public policy objectives.

A classic example of the latter was the nationalization in 1961 of the British Columbia Electric Company by the otherwise free enterprise Social Credit government under W.A.C. Bennett. Bennett's view was that the private sector did not have the ability to deliver the desired power policy and products in a reasonable time frame. It is this second ground that is relevant for our purposes, as we are not concerned with those market or other activities where the private sector cannot, or chooses not to, be engaged.

In Canada, such state involvement in commercial activity usually takes the form of the Crown corporation and such agencies acquire the tax exempt status. This in turn creates distortions in the marketplace and results in horizontal tax inequity with the resultant unfair tax advantage over private sector competitors.

In a federation such as Canada, Crown corporations that operate in the marketplace with tax exemptions can produce more than just an unfair competitive advantage over their private sector rivals; their tax exempt status can cause vertical inequity and distortions that can discriminate against the private sector.

For example, provincial governments can be tempted to nationalize successful private sector producers of goods and services operating in their province. This would result in a loss of tax revenue for the federal government (in particular, federal corporate income tax) and a consequent windfall for the provincial government.[4] It can also

cause serious horizontal inequities between provinces. For example, a provincial Crown corporation could be providing goods and services but because it is immune from federal and provincial taxes (nothing prevents a provincial government from exempting any of its agents from provincial taxes), it could do so at a lower cost than its private sector competitors.

This could also create further tax distortion in the federation. Private sector entities that consume goods and services provided by the Crown entity could purchase them at a lower cost. This could be an inducement for private sector entities operating in other provinces that are also consumers of such goods and services to relocate to the province where the Crown entity is carrying on such business.[5]

> ***"This could be an inducement to relocate to the province where the Crown entity is carrying on business..."***

The Legal and Constitutional Basis for Crown Corporation Tax Exempt Status in Canada

(a) At Common Law and by Statute

Even in the absence of any statutory or constitutional provision, if a legal entity meets the test of being an agent of the Crown (federal or provincial) then it is entitled to any common law or statutory immunities or privileges of the Crown.[6] One of those immunities is exemption from taxation. An extreme example of how far this principle has been applied by the courts, although not specifically related to tax exemption, was in relation to the general immunity that the Crown has from the provisions of any statute.

In *R. v. Eldorado Nuclear,*[7] the Supreme Court of Canada ruled that two Crown corporations that produced uranium and had clearly engaged in price-fixing were exempt from the anti-trust provisions of the Combines Investigation Act. The Court characterized their powers as broad enough to include any marketing activity including illegal marketing. This provides some sense of how far the law has gone to protect the operations of state entities. The attitude of the courts and therefore the law generally is to assume that if legislation empowers an agent of the Crown to engage in any activity, commercial or otherwise, then the Court should give a broad interpretation to the scope of that power on the basis that the Court should not second-guess the public policy behind the statute.

For an entity to attain Crown agency status, normally there must be a statute or regulations pursuant to a statute that expressly grants that status. However, even in its absence, an entity can still be an agent of the Crown if there is sufficient legal control of the corporation by the government.

(b) Section 125 of the Constitution Act, 1867

These legal immunities afforded Crown corporations, including potential immunity from taxation, are further reinforced by virtue of section 125 of the *Constitution Act, 1867.* This section provides that "No Lands or Property belonging to Canada or any Province shall be liable to Taxation." This means federal taxes do not apply to provincial government property, and provincial taxes do not apply to federal government property. All entities that meet the test of being agents of the Crown therefore enjoy the same constitutional exemption. In this way, both levels of government including their agents, such as Crown corporations, are immune from any taxes imposed by the other level. This exemption has been interpreted by the courts to extend to a private sector corporation that has a contract with the Crown if the contract results in the corporation acting not as an independent contractor but rather as a direct servant of the Crown.[8]

> ***"Both levels of government, including their agents, such as Crown corporations are immune from any taxes imposed by the other level."***

However, in any particular case, the exemption also depends on whether the Court characterizes the financial imposition in the legislation as actually constituting a tax. It has been held that provincial or municipal regulatory charges in relation to the use of land (e.g., charges for the supply of water) are not strictly taxes and therefore federal Crown corporations and their property are not exempt from them. This applies equally to provincial Crown corporations in relation to federal regulatory charges.

Another distinction that is often made, resulting in the exemption not applying to a financial obligation arising from legislation, is if the court characterizes it as a mere administrative charge. In the case of *Re: GST,*[9] the Supreme Court of Canada held that provincial Crown corporations, although they were exempt from the payment of the GST as purchasers, were liable, as suppliers, to collect and remit the GST. The Court held that although this created a financial cost to the Crown corporation doing business in the marketplace, it did not trigger the constitutional exemption. This case assisted somewhat in levelling the playing field from the inequity and distortions resulting from tax exemptions afforded Crown corporations.

The classic case interpreting section 125 in which the courts characterized something that clearly appeared to be a tax to be something else is the *Johnnie Walker* case.[10] The Judicial Committee of the Privy Council (the final court of appeal for Canada until 1949) held that the provincially owned and controlled liquor stores in British Columbia had to pay a federal customs duty on imported liquor products. The Court simply characterized the purpose of legislation to be a tariff measure and not a revenue measure, therefore not technically imposing a tax. However, this case is a clear exception to the general trend of the courts, which has been not to limit the extent of this tax exemption regime.

U.S. Comparison: Protection from tax does not apply to commercial activity

Although there is no express provision in the U.S. Constitution comparable to section 125, the U.S. Supreme Court very early on enunciated a judge-made rule to the same effect.[11] In subsequent cases,[12] the Supreme Court ruled that immunity does not extend to a state entity whose activities are primarily commercial as opposed to strictly governmental. If this constitutional rule applied in Canada, then the unfair and inequitable tax advantage that arises in favour of Crown corporations engaged in commercial activities would be virtually eliminated.

> ***"If this (US) constitutional rule applied in Canada, then unfair and inequitable tax advantage would be virtually eliminated."***

This distinction was rejected by the Supreme Court of Canada in *Re: Exported Natural Gas Tax.*[13] In that case, the federal government attempted to argue that a federal export tax should apply to a provincial Crown corporation's activities in delivering a provincially owned resource to the market. The Court reasoned that all of the value added to the resource (the commercial activity in extracting, processing and transporting it to the point where it was a saleable commodity) was simply to preserve the province's constitutional right to revenue from the sale of its own natural resources.[14]

There may be an opportunity for our courts to revisit this issue, a development that would be welcome. The weight of constitutional opinion is that there is no such distinction in Canadian law, a distinction that could go a long way in ending this tax distortion. This opinion is largely based on the Canadian historical, cultural and ideological affinity for state intervention in the marketplace. This is fundamentally different from the attitude in the United States. A classic example of this is the point made by W.H. McConnell in his *Commentary on the British North America Act.*[15] On page 369, concerning the section 125 constitutional immunity, he states:

> Does this work a hardship on competing private industries, for instance, or on local government bodies that cannot tax a direct instrumentality of the Crown? The answer may reside partly in the fact that rarely does a government launch a commercial undertaking or Crown Corporation purely in an effort to compete for private profit … it operates the enterprises to provide a public service in areas where it is needed but would not be economically feasible solely on a profit basis.

This assumes that governments in Canada never engage in commercial activities in the marketplace for the primary purpose of making a profit. This point will be dealt with in the conclusion.

How the provincial and federal governments removed this tax exemption for Crown corporations

> ***Statutory or regulatory provisions** may provide for such entities to be expressly subject to taxation...*

This discussion paper will not list the variety of ways where governments have removed such an exemption from Crowns other than to mention a few examples at the federal level. The federal *Financial Administration Act,*[16] categorizes federal Crown corporations according to whether they engage in what can be called truly governmental functions as opposed to commercial or quasicommercial functions. Other statutory or regulatory provisions may provide for such entities to be expressly subject to provincial and federal taxation, thus removing the section 125 immunity. The most common example is the provision for federal Crown corporations to make grants to municipalities in lieu of their exemption for payment of property taxes. A comprehensive and detailed examination of the exceptions to the rule might prove useful.[17]

Of particular interest are incidences where governments chose to remove the tax exemption from Crown agents, not only for certain indirect or consumption taxes but particularly, as noted above, for corporate income tax.[18]

A simple legislative solution

As a result of some court decisions as well as voluntary but ad hoc legislative and regulatory actions by individual governments, the inequitable and distorting tax exempt status for federal and provincial Crowns that carry on commercial activities has been somewhat ameliorated. However, the legal and constitutional reality is still not satisfactory, because any government at any time can reverse these actions.

In the absence of an actual constitutional amendment repealing Section 125 in whole or in part (which is not foreseeable), a simple and uniform legislative solution should be considered. Each level of government could enact legislation repealing this constitutional tax exemption for all Crown agencies or at least those engaged in commercial activities, and do so across the board. As we have seen, the rationale for state engagement in commercial activity in the market, often in competition with private sector players, is that the state has determined that the private sector cannot perform the activity with the necessary efficiency. If that is indeed the case, then governments should be prepared to allow for at least a level playing field. If the private sector still cannot carry out those commercial activities with the same efficiency as the Crown agency, then the government will have won the justification argument. Absent a level playing field, there is no way to come to such a conclusion.

> ***In 2003, BC chose to eliminate the tax exempt status of this Crown corporation - Section 19(3): it ceases to be an agent of the government...***

An example from British Columbia: BC Ferries

There is a useful and ready example at hand. In 2003, the government of British Columbia chose to eliminate the tax exempt status for a particular Crown corporation, namely the BC Ferry Corporation. Section 19(3) of the *Coastal Ferry Act*[19] provides that this provincial Crown corporation created by earlier legislation is to continue but with the express condition that it ceases to be an agent of the government; also the provincial Minister of Finance ceases to be its fiscal agent. This Crown corporation is now subject to all federal and provincial taxes including corporate income tax.

Other sections of the *Act* maintain provincial government control for much of its activities. In this way, the government maintains control of the operations of the corporation but without the distortions and inequities of the tax exemption. This could be the model for other provinces and the federal government to adopt.

Conclusion

The current legal and constitutional tax exempt status for Crown corporations at both levels of government clearly violates basic principles of tax equity. The attitude of the courts and governments has been to maintain this tax inequity, although, increasingly on an ad hoc basis, governments have been legislating and agreeing to remove it in part. However:

- Without a uniform approach to eliminating this tax distortion, there will continue to be a basic disconnect between the legal and constitutional tax regime and the basic principles necessary for a good and fair tax system.
- Those institutional attitudes are based on a false historical and almost ideological notion that governments do not compete directly with the private sector merely for making profit but for some broader public purpose. The fact is that governments often enter and stay directly engaged in commercial activities in the marketplace for the very purpose of maximizing government revenue; in essence to make a profit for the state. In those cases, there is no justification for the maintenance of the current regime for Crown agency tax exemption. In those cases where the state is convinced it can, through one of its entities, provide goods or services more efficiently than can the private sector, it should be willing to prove the point by ensuring a level playing field.
- All that is required is for both levels of government to pass the necessary legislation; the model is before us in the form of BC Ferries. This would be a very simple legal solution to overcome the current unsatisfactory legal and constitutional tax exemption regime for Crown corporations in Canada. The real question is whether governments will have the political will to do so.

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ENDNOTES

1. One of the best statements and description of such principles which also includes a succinct but useful history of their historical development and origin can be found in the *Tax Policy Concept Statement: Guiding Principles for Tax Equity and Fairness* issued by the Tax Division of the American Institute of Certified Public Accountants (2007).
2. Keith Godin, Milagros Palacios and Niels Velduis, "Canadian Provincial Investment Climate" in *Studies in Entrepreneurship and Markets* issued by the Fraser Institute, (December, 2008).
3. Macij Kotowski, "Insuring Canada's Exports: The Case for Reform at Export Development Canada" in *C.D. Howe Institute Commentary,* No. 257, (December, 2007).
4. Marianne Vigneault, "The Interaction of Federal and Provincial Taxes on Business", *Working Paper* 96-11, prepared for the Technical Committee on Business Taxation, Department of Finance, Government of Canada, December, 1996 at page 20.
5. Ibid., p. 20.
6. Peter W. Hogg, *Constitutional Law of Canada,* Loose-leaf edition (Scarborough, Thomson-Carswell) at page 10-4.
7. (1983) 2 *Supreme Court Reports* 551.
8. *Montreal v. Montreal Locomotive Works* (1947) 1 *Dominion Law Reports* 161 (Privy Council).
9. (1992) 2 *Supreme Court Reports* 445.
10. *A-G. B.C. v A-G. Can. (Johnnie Walker)* (1924) *Appeal Cases* 222.
11. In the early leading case of *McCulloch v. Maryland* (1819) 17 *United States Reports* (4 Wheat) 316 in which Chief Justice Marshall justified the U.S. Supreme Court's reading this rule into the U.S. Constitution with his famous remark that "the power to tax involves the power to destroy".
12. The leading case being *South Carolina v. United States* (1905) 199 *United States Reports* 261.
13. (1982) 1 *Supreme Court Reports* 1004.
14. Hogg, op.cite., at page 30-31.
15. H. McConnell, *Commentary on the British North America Act* (Toronto, MacMillan of Canada) (1977).
16. *Revised Statutes of Canada,* 1985, chapter F-11.
17. For example, the March 2007 federal budget had a provision to extend the application of all provincial sales taxes to federal crown corporations.
18. For example, some of the major federal crown corporations engaged in commercial operations such as Canada Post Corporation, the CBC, Farm Credit Corporation, Via Rail and the Cape Breton Development Investment Corporation actually pay federal corporate income tax. But, only Via Rail from this list also pays provincial corporate income tax. Therefore, tax inequities and distortions remain.
19. *Statutes of British Columbia,* 2003, Chapter 14.

FURTHER READING

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