Public Policy Limitations on the Deductibility of Fines and Penalties: Judicial Inertia

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I. INTRODUCTION

Despite an aura of settled authority, the scope and extent of public policy limitations on the deductibility of fines and penalties for income tax purposes continues to generate litigation. An examination of Canadian judicial decisions dealing with the question reinforces the conviction that it may be more important to educate oneself in the obvious than to investigate the obscure. Before making any analysis of the scope of the limitation, one must determine whether the existence of the public policy doctrine is premised on judicial authority as is alleged. Only by disposing of this preliminary question can one proceed to the more controversial issue of canvassing and evaluating the conflicting policy criteria to provide a framework for implementing the limitation.

For the purpose of subsequent analysis, it is imperative to clarify two preliminary points. First, it is assumed for the purpose of this paper that an amount expended by a taxpayer in payment of a fine or penalty is an amount which is sufficiently related to the process of earning revenue that it is not immediately excluded by the statutory prohibition against the deductibility of personal or living expenses. Second, the use of the term “public policy” in this paper is restricted to what the courts have either declared or assumed to be public policy outside the express words of the Income Tax Act, and does not extend to any built-in legislative policies reflecting social and economic concerns.

The latest decision of the Federal Court dealing with the deductibility of fines and penalties paid by a taxpayer provides a useful focus for examination in assessing the two fundamental but controversial issues discussed in this paper: (1) Is there a public policy limitation based on authority which conclusively prohibits the deduction of amounts expended for judicially imposed fines and penalties in all circumstances? (2) Assuming an affirmative finding on the first question, has the scope of the doctrine been adequately framed in the context of relevant criteria?

II. NATURE OF THE PROBLEM

In Day & Ross Ltd. v. The Queen the taxpayer, a New Brunswick...
company engaged in the trucking business, was fined $70,153 during the taxation years 1966 to 1971 for violation of provincial highway weight-restriction laws. The taxpayer, in computing its net income for the years in question, claimed the amount of the penalties imposed as a deduction and was successful in its claim before the Federal Court, Trial Division. In reaching its conclusion that the fines paid were deductible, the Court approached the issue of deductibility on the basis of a two-pronged test:

(i) Were the fines an outlay made for the purpose of producing income for the plaintiff taxpayer so as to meet the requirement of the exception to the prohibition contained in s. 18(1)(a)?

Dubé J. had little difficulty in accepting that “... the fines paid by the plaintiff ... resulted from the day-to-day operation of its transport business and were paid as a necessary expense ...” This finding in and of itself, it is submitted, should have been sufficient to decide the question of deductibility of the penalties paid by the taxpayer.

(ii) Having determined that the fines paid by the taxpayer were deductible on the first test, could the taxpayer be denied the deduction on the basis of some “broader principle”?

It is upon this second test that the decision is of interest, because of the questions it answers and those it leaves unanswered for the future. The Court concluded that the fines could be deducted and were not precluded from deductibility on the basis of any “broader principle” applied to the facts of the case. In reaching this conclusion the Court was influenced by four elements in the particular fact situation:

(a) tight control was impractical, if not impossible in the highly competitive road transport industry;
(b) the violations were unintentional, in that the taxpayer in many instances relied on weights declared by customers when loads were picked up en route from factories, potato plants, and fish plants;
(c) the ready availability of advance overweight permits at the request of a shipper showed that the weight restrictions could easily be overcome; and
(d) the violations were “... not outrageous transgressions of public policy.”

While the presence of these four elements may have assisted the Court in determining the particular question at hand, it still remains to be answered whether the first three were independent criteria or merely indications that the transgressions were not “outrageous”? Does the decision predict a trend in the judicial approach towards the elusive doctrine of public policy limitations, or is it no more than another movement in the wide domain of the shifting sands of “broader principles”? Should a subsequent Court be prepared to follow the decision where the facts indicate an intentional violation premised on the basis of a cost/benefit analysis? Put another way, what if control by the taxpayer is both practical and possible but is not considered to be desirable in an economic sense? Hence, the value of the case for predictive purposes lies in the enunciation of the statement that in certain suitable circumstances a taxpayer will not be denied a deduction for a fine imposed by a

\[\text{4 Id. at 791 (F.C.), 715 (C.T.C.), 6438 (D.T.C.).} \]

\[\text{5 Id. at 794 (F.C.), 718 (C.T.C.), 6440 (D.T.C.).} \]

\[\text{6 Id.} \]
statute merely on the assertion of some "broader principle." However the case
does not provide a framework of analysis to determine the suitability of the
particular circumstances and it leaves unanswered, as indeed it is compelled
to do, the more important question as to the perimeters of those "certain
suitable circumstances." The fact that the decision is not applicable to all
questions of deductibility of fines and penalties is seen in a later decision of
the Tax Review Board in Canadian Motor Sales Corp. v. M.N.R.7 Here
the Board denied the taxpayer a deduction for a $150,000 penalty imposed
under the Customs Act.8 This latter case, quite apart from its reiteration of
the nondeductibility of penalties, is interesting in that it brings full circle a
line of reasoning which commenced in England in 1920.9

III. JUDICIAL AUTHORITY FOR NONDEDUCTABILITY

Was it necessary on the strength of authority for Dub6 J. in Day & Ross
Ltd. to rest his conclusion, in part at least, on the basis of any "broader
principle" of public policy? The answer to this question depends on whether
there exists authority for denying deductions of fines on a public policy basis.
It is generally felt that the decision of the English Court of Appeal in I.R.C.
v. Alexander Von Glehn & Co.10 gave birth to the doctrine of a public
policy limitation for income tax deduction purposes. Certainly it remains the
single most cited case in this area, and for that reason alone it is worth exam-
inig.11 The case concerned the deductibility of a penalty of £3,000 for
breaches of the orders and proclamations relating to the Customs (War
Powers) Act12 in connection with certain consignments of goods. The tax-
payer had been exporting goods to neutral countries without taking reason-
able steps to prevent them from reaching enemy countries. The Court of Ap-
peal upheld the decision of the trial Judge and denied the taxpayer a deduc-
tion for the penalty paid in computing net income. Lord Sterndale M.R., in
approaching the question of deductibility, was concerned with the equivalent,
albeit more restrictive, prohibition now contained in paragraph 18(1) (a),13
stating:

I doubt whether the damages in the present case can properly be called a trading
loss... I think that the payment of these damages was not money expended "for

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9 Nondeductibility of a penalty was actually conceded by counsel for the taxpayer:
see supra note 7, at 2042 (C.T.C.), 34 (D.T.C.).
T.L.R. 463 (C.A.).
Transport Ltd. v. M.N.R. (1965), 38 Tax A.B.C. 332, 19 D.T.C. 504; Minister of Finance
12 1915, Geo. 5, c. 31 (U.K.).
the purpose of the trade" . . . . I do not think that this was connected with or arising out of such trade, manufacture, adventure, or concern, and still less do I think that it was a disbursement . . . "wholly and exclusively laid out or expended for the purpose of such trade . . . ."14 (emphasis added)

The other members of the Court of Appeal similarly formulated their decision on the basis of the "purpose test." Thus, Lord Warrington rested his conclusion on the basis that

It is not a loss connected with or arising out of the trade . . . . It is not a commercial loss . . . . Now it cannot be said that this disbursement was made in any way for the purpose of the trade or for the purpose of earning the profits of the trade.15 (emphasis added)

The third member of the Court of Appeal, Scrutton L.J., adopted a similar approach and answered the particular question "... whether in the case of these penalties imposed on the traders because they had so acted in exporting goods as to break the law, they can say that the penalties were paid for the purpose of earning profits or were expenditures necessary to earn the profits . . . ."16 by denying deductibility (emphasis added). Admittedly, one detects an undercurrent of a policy influence in Scrutton L.J.'s comment that "... I am inclined to think, though I do not wish finally to decide it, that the Income Tax Acts are to be confined to lawful businesses, and to businesses carried on in a lawful manner . . . ."17 It is dubious, however, whether His Lordship's reservations, which did not materialize in later judgments,18 may be considered sufficient authority for a public policy limitation.

Clearly, the emphasis of the decision in Alexander Von Glehn19 was on the "purpose test," the equivalent of which is now found in the prohibition of paragraph 18(1)(a). It is unfortunate, however, that this line of reasoning was derailed by two casual comments when the issue was first presented in Canada. In Luscoe Products Ltd. v. M.N.R.20 the Canadian taxpayer was fined $1,000 under the Liquor Control Act21 for marketing a cough remedy which did not contain sufficient medication to prevent its use as alcohol. The Board denied deduction of the fine and analysed the issue from the perspective of whether the expense was one that was incurred for the purpose of gaining or producing income, and not a payment to acquire or protect capital. The Board conceded that "... if the expense is one which normally accepted business practice of the trade or industry concerned recognizes as a necessary

15 Id. at 569 (K.B.), 594 (L.J.K.B.), 342 (L.T.), 464 (T.L.R.).
16 Id. at 573 (K.B.), 596 (L.J.K.B.), 343 (L.T.), 464 (T.L.R.).
17 Id. at 572 (K.B.), 596 (L.J.K.B.), 343 (L.T.), 464 (T.L.R.).
19 Supra note 10. In basing their decision on the "purpose test," their Lordships placed substantial reliance on an earlier decision of the House of Lords in Strong & Co. v. Woodifield, [1906] A.C. 448, [1904-7] All E.R. 953, which examined a similar question as to whether a disbursement was expended for the purpose of a trade [Emphasis added].
and likely expense and it does not conflict with any specific prohibition in the Act, it will be allowed ...."\(^{22}\)

An identical question appeared before the Tax Appeal Board in *King Grain & Seed Co. v. M.N.R.*\(^{23}\) The taxpayer had claimed a deduction of $233 with respect to a fine imposed on it for permitting one of its trucks to be overloaded while travelling on a highway in Michigan. Once again the taxpayer was denied a deduction. The important question, however, remains: was the decision premised on the basis of

(i) a finding that the expense was not incurred to earn income, or

(ii) some "broader principle" or public policy?

The judgment leaves the impression that the Board proceeded on the basis that the expense was not incurred to earn income; this impression is strengthened by the Chairman's adoption of the opinion of learned authors that "... the payments were not incurred for the purpose of earning profits of the trade .... Now it cannot be said that the disbursement is made in any way for the purpose of the trade or for the purpose of earning the profits of the trade."\(^{24}\) This language is virtually identical with that used in the *Alexander Von Glehn* case. The Board, however, went further and fastened upon Scruton L.J.'s comment that the fines were not paid to earn the profits of the trade but "... were unfortunate incidents which followed after the profits had been earned ...."\(^{25}\) and thus ignored the concept that profit results from a process and cycle of business activity, and that net income is the residue remaining after the deduction of expenses from revenues in any given time period.

In the same judgment the Board examined the decision of the Exchequer Court in *Rolland Paper Co. v. M.N.R.*,\(^{26}\) citing it as "the latest authority" on the subject. The Chairman interpreted that decision stating that it stood

... for the proposition that legal expenses incurred in connection with the presentation of a defence of the commission of an alleged unlawful act are deductible but it is significant that this judgment does not establish a rule that when a verdict of guilty is returned the fine imposed by the Court is likewise deductible.\(^{27}\) (emphasis added)

In fact there was nothing significant one way or the other about the fact that the judgment failed to establish such a rule, since the sole question before the Exchequer Court in *Rolland Paper* was the deductibility of legal fees and nothing else. The taxpayer had in fact paid a fine of $10,000 upon criminal conviction, but the assessment appealed from related to legal fees paid in defence of the charge. As Fournier J. characterized the issue:

*The question to be determined* is whether the legal expenses paid by the appellant in the amount of $5,984.27 in the year 1953 were made and incurred for the pur-

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\(^{22}\) *Supra* note 20, at 241 (Tax A.B.C.), 34 (D.T.C.).

\(^{23}\) *Supra* note 11.


\(^{25}\) *Supra* note 10, at 572 (K.B.), 595 (L.J.K.B.), 343 (L.T.), 464 (T.L.R.).

\(^{26}\) *Supra* note 11.

\(^{27}\) *Supra* note 23, at 437 (Tax A.B.C.), 323 (D.T.C.).
pose of gaining income from its business and deductible in computing income . . . 28
(emphasis added)

In both the Luscoe Products and King Grain & Seed decisions the primary focus of the judgments is on the issue of deductibility determined in light of whether the expense is one incurred for the purpose of gaining or producing income and not specifically prohibited by statute. Towards the end of each judgment, however, there is a passing reference to what may be characterized as a public policy influence. In Luscoe Products the Vice-Chairman had concluded, without any discussion of the policy issues involved, that "... It would be preposterous if the appellant company was allowed to deduct this substantial sum from its assessment and thus be enabled to share equally with the public revenue the loss to which it was condemned by reason of its own unlawful act..."29 Five years later in King Grain & Seed, Cecil L. Snyder, Q.C., by then Chairman of the Tax Appeal Board, fortified by his own earlier pronouncement, reiterated on the strength of "... the current authority of Luscoe Products ... it would be contrary to accepted principles if the present appellant ... was allowed to deduct the amount of this fine ... from its assessment of taxable income and thus be enabled to share with the public revenue the loss to which it was condemned by reason of its own negligence ..."30 Thus, both references to public policy were at best casual and cursory, out of the mainstream of reasoning contained in the body of the judgment, and reflected a concern with subsidizing taxpayers by permitting a deduction for fines paid. Nowhere do the judgments refer to any discussion of the "accepted principles." Given a passing reference to public policy made out of the mainstream of the reasons for judgment, should these decisions be taken as definitive authority for a public policy limitation?

It is unfortunate indeed that the Chairman did not lay greater emphasis on the reasoning process contained in Royal Trust Co. v. M.N.R.31 and Rolland Paper, both being decisions of the Exchequer Court handed down subsequent to Luscoe Products and available before the decision of King Grain & Seed. In Royal Trust, Thorson P. outlined the two-step process which has since been accepted as the correct statutory approach to deductions from business income. First, the expenditure should satisfy the commercial and business test of deductibility in the computation of "profit" under subsection 9(1); second, the expenditure cannot fall within the prohibition contained in paragraph 18(1)(a). This process which the learned President first enunciated in Daley v. M.N.R.32 was summarized with clarity in Royal Trust as follows:

Thus, in a case under the Income Tax Act if an outlay or expense is made or incurred by a taxpayer in accordance with the principles of commercial trading or accepted business practice and it is made or incurred for the purpose of gaining or producing income from his business its amount is deductible for income tax purposes.33

28 Supra note 11, at 336 (Ex. C.R.), 161 (C.T.C.), 1097 (D.T.C.).
29 Supra note 20, at 242 (Tax A.B.C.), 34 (D.T.C.).
33 Supra note 31, at 83 (Ex. C.R.), 44 (C.T.C.), 1062 (D.T.C.).
While the Chairman in *King Grain & Seed* initially embarked on this statutory approach to the deductibility of fines, he appears to have been misled by the opinion of the authors Hannan and Farnsworth, that "... it seems doubtful whether fines imposed as a result of an infraction of the law would ever be regarded as proper deductions no matter what the nature of the business...." If this opinion was based on the *Alexander Von Glehn* decision, as it would appear to be, then it lacked support in the reasons for judgment of the Court of Appeal. Reference by the Chairman to the decision of the Exchequer Court in *Espie Printing Co. v. M.N.R.*, decided a year earlier, would have revealed the proper interpretation to be extracted from *Alexander Von Glehn*. As Thurlow J. had earlier observed:

> It is noteworthy, however, that the grounds of the decision were not that the penalty was incurred for doing something illegal in the course of the business but that the penalty was not a commercial loss and thus not a "loss ... connected or arising out of such trade" within the meaning of an exception to a general statutory prohibition....

His Lordship remained consistent in his approach to a similar question in *M.N.R. v. Pooler and Co.*, where in deciding that a fine of $2,000 paid to the Toronto Stock Exchange was not deductible, he did so on the basis that it had "... not been established that the outlay or expense in question was incurred to any extent for the purpose of gaining or producing income..." from the taxpayer's business. Further, he was cautious enough to steer away from any "broader principle", stating that "...[i]n this view, apart from any broader principle which may or may not be applicable in the particular circumstances to exclude its deduction, the fine could not... escape the prohibition of section 12(1)(a)...."

Notwithstanding the authority of the earlier cases limiting the deductibility of fines on the bases of a "purpose test," the question of whether a deduction should be denied on the basis of some wider policy criteria continued to attract passing reference. Thus, in *Atomic Transfer Ltd. v. M.N.R.*, another case involving overloaded trucks in contravention of provincial statutes, the fines were disallowed on the basis that they were "... not incurred for the purpose of gaining or producing income within the meaning of paragraph (a) subsection (1) of section 12 of the *Income Tax Act*, because they are not expenses connected with or arising out of trade." Here, as in *Day & Ross Ltd.*, evidence before the Board showed that the taxpayer was in the business of transportation of general merchandise and it was possible to have inadvertent overloading. The Board, in addition to determining the question

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35 *Supra* note 11.
36 *Id.* at 431 (Ex. C.R.), 148 (C.T.C.), 1092 (D.T.C.).
38 *Id.* at 23 (Ex. C.R.), 533 (C.T.C.), 1324 (D.T.C.).
39 *Id.* at 22 (Ex. C.R.), 532 (C.T.C.), 1324 (D.T.C.).
40 *Supra* note 11.
41 *Id.* at 452 (Tax A.B.C.), 154 (D.T.C.).
on the basis of the "purpose test," made a passing reference that "... it would be against public policy to allow such penalties or fines even if a profit resulted," without any citation of authority or exploration of public policy considerations.

Hence it is clear that, commencing with a casual statement, the public policy doctrine has through a process of self-serving repetition been elevated to the stature of authority, with its foundation as secure as that of an inverted pyramid. It is unfortunate, indeed, that the Tax Appeal Board did not heed the caution of Judge Learned Hand that it is not desirable for a lower court to embrace the exhilarating opportunity of anticipating a doctrine which may be in the womb of time, but whose birth is distant.

A rigorous analysis of the cases denying the deuctibility of fines in the computation of net income reveals two traits. First, the articulated ratio common to the decisions is the application of the "purpose test" now contained in the prohibition of paragraph 18(1)(a). It is a long leap from that position to infer as a matter of law, as Revenue Canada has done, that the Courts have formulated a conclusive proposition that all "... fines or penalties which arise out of judicial proceedings are not allowed as deduction[s] from income." Rather, the ratio of the earlier cases should be restrictively interpreted as to particular factual situations, and the "purpose test" itself viewed as a question of factual determination. As observed earlier, the Federal Court in Day & Ross Ltd. had no difficulty in finding as a question of fact that "... the fines paid by the plaintiff ... resulted from the day-to-day operation of its transport business and were paid as a necessary expense." This approach reinforces the view that paragraph 18(1)(a) has tended to attract a more liberal interpretation with the passage of time.

Second, a passing reference may be found in some of the decisions to that "broader principle" known as public policy. Not one of the decisions contains any analysis of the "broader principles," and any public policy limitation, if one exists in authority, is found as an appendage to a judgment which concentrates its legal analysis elsewhere. Indeed it is likely that the courts have deliberately camouflaged the public policy issues behind the language of the "purpose test" contained in the statutory prohibition behind paragraph 18(1)(a).

It may be suggested that since the end result is the same, whether it be premised on the "purpose test" of paragraph 18(1)(a) or on an inarticulated public policy doctrine, it serves little purpose to distinguish between the two to determine the reasons for disallowance. Such an approach has a certain superficial appeal. While the "purpose test" serves the net income concept that it was intended to serve, the test itself has evolved in a statutory setting. Hence, the old test of "wholly exclusively and necessarily" found in sub-

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42 Id.
43 Spector Motor Service Inc. v. Walsh, 139 F.2d 809 at 823 (2d Cir. 1944).
45 Supra note 3, at 794 (F.C.), 718 (C.T.C.), 6440 (D.T.C.).
section 6(a) of *Income War Tax Act* has given way to the more liberal phrasing of paragraph 18(1)(a). Again, the “purpose test” is one which may be used to evaluate a given fact situation. In contrast, a limitation based on an inarticulated notion of public policy, albeit potentially flexible, tends in fact to be applied in a rigid manner. Further, the premises of the public policy doctrine as applied in Canadian tax cases dealing with the deductibility of fines and penalties remain undefined and unanalysed. In this undefined state the doctrine may be used as an instrument of moral stricture a deterrent mechanism, without regard to its impact on the policy of taxing statutes and the purpose which tax policy seeks to serve.

**IV. TAX POLICY CRITERIA**

When one shifts the focus of attention from the proposition here submitted, that there is no adequate authority for a blanket policy denial of deductions for all fines and penalties, to search for an adequate discussion of the considerations to be evaluated in formulating a “broader principle” (if such a principle is considered desirable at all), one is immediately impressed by the void in judicial analysis of this question in Canadian tax decisions. This absence of analysis is both unfortunate and understandable: unfortunate in that judicial decisions founded on so-called “accepted principles” create an aura of reasoned consideration and evaluation where none exists; understandable in that tax policy analysis attracts little attention in the arena of litigation and should perhaps be best left to a legislative forum. Any discussion of a doctrine of public policy in tax matters, be it founded on statutory or common law authority, must view the policy issues from two perspectives. First is the perspective of tax policy itself and the purposes it seeks to serve. Second is the policy of the statute which, upon being violated, gives rise to the fine or penalty.

“Tax policy” itself is merely a convenient label attached to a multitude of tax objectives which are often in conflict with each other. While the objectives of tax policy may at times be in conflict, the underlying premise of a tax structure, to levy a tax on the net income of a taxpayer, has long been settled in Canada, the U.S. and U.K. The premise itself is derived from the concept of “income,” which has been best described by the Haig-Simons formulation of the net accretion of economic power between two points in time. Thus, the primary thrust of the taxing statute is to levy a tax on the net realized income of a taxpayer which represents a pragmatic adaptation of the net accretion to wealth concept. If one accepts as a starting point this notion of taxation of net income, it is readily apparent that *prima facie* any denial of a business expense, whether it be legitimate, illegal, immoral or otherwise, shifts the structural foundation of the taxing statute. This is not

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46 R.S.C. 1927, c. 97.  
47 See generally the jurisprudence under s. 9(1) and s. 18(1)(a) Income Tax Act, supra note 2 and predecessor sections.  
to suggest that such a shift is not permissible, but merely to argue for an exercise of caution before making a structural adjustment — such caution being manifested by informed analysis. Prima facie any denial of an expense which has been made or incurred for the purpose of earning revenue, moves the structural foundation of the taxing statute in the direction of imposing a tax on gross income. Since the shift is at variance with the fundamental premise of the tax structure, it should be clearly justified, articulated, and permitted, if at all, in narrowly delineated circumstances. Such was the approach of Mr. Justice Stewart in Commissioner of Internal Revenue v. Tellier where he stated "...we start with the proposition that the federal income tax is a tax on net income, not a sanction against wrongdoing... One familiar facet of the principle is the truism that the statute does not concern itself with the lawfulness of the income that it taxes...."

Since the concept of net income is one founded on its component parts of revenue and expenses, it may serve the purpose of analysis to examine the tax treatment of revenue from an illegal business or activity, illegal expenses incurred in pursuit of a legal business, and expenses incurred in pursuit of an illegal business, in an attempt to extract a rationale for the tax treatment afforded these various items of revenue and expenses; then to inquire whether this rationale is applicable to the question of whether fines and penalties should be deductible. As to the first item, revenue from an unlawful business, there appears to be no doubt at all that moral and ethical considerations will not exclude income from such illegal activities from being brought into income. As Viscount Haldane put the position of the Privy Council in Minister of Finance v. Smith:

There is nothing in the Act which points to any intention to curtail the statutory definition of income, and it does not appear appropriate under the circumstances to impart any assumed moral or ethical standard as controlling in a case such as this the literal interpretation of the language employed.

It is clear then, at least on the revenue side, inclusion is not precluded by the illegality of the revenue generating activity and the notion of income as being an accretion to wealth is preserved.

The second item concerns illegal expenses incurred in the conduct of a legal business. Should the taint of illegality preclude the deductibility of the expense? The Minister attempted in one such situation to persuade the Exchequer Court in Espie Printing to deny the taxpayer a deduction on the

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49 The concept of realization modified by statute in some situations in order to serve other objectives, e.g., s. 70(5), Income Tax Act, supra note 2.

50 383 U.S. 687 at 691 (2d. Cir. 1966).


53 Supra note 11.
basis of a sweeping assertion of public policy. The Court rejected the Minister's suggestion and permitted a deduction on the basis of the concept of "net income," stating that the expression "... 'net profit or gain'... connoted not gross receipts from a business but gross receipts less the expenses incurred to obtain such receipts...." Having satisfied himself that the expenses were deductible under the concept of net income, Thurlow J. considered the fact of illegality to be irrelevant in determining whether the expense was or was not incurred for the purpose of earning income. It was the "purpose test" and the concept of "net income" which prevailed, with Thurlow J. stating:

For my part, I do not see how the illegality of the arrangements with the employees or of the payments has any bearing on the question whether these wages were wholly, exclusively, and necessarily laid out or expended for the purpose of earning the income. Whether the expense was or was not so incurred seems to me to be a question on which the illegality or otherwise of the payments or of the arrangements under which they were made leads to no conclusion one way or the other. I do not see how the net profit or gain can be properly computed without deducting such expenses whether they or some of them bear the taint of illegality or not. (emphasis added)

The third category contemplated involves those situations where the expense has been incurred in the pursuit of an illegal business. This category contains two situations which should be approached separately. First, those expenses incurred in connection with an illegal business, but which are not inherently illegal. Second, those expenditures incurred in an illegal business activity, which are inherently illegal. An opportunity to judicially consider the deductibility of both of these types of expenses arose in M.N.R. v. Eldridge, where the taxpayer was engaged in running a call girl operation and freely admitted the illegal nature of the business. The Minister’s Notices of Assessment allowed for the deduction of certain expenses, e.g., wages of telephone operators, telephone, room rentals, refreshments, taxis, bad debts, in arriving at the taxpayer’s taxable income. The dispute before the Exchequer Court involved the taxpayer’s claim for additional deductions with respect to expenses incurred. These expenses involved both of the types described above. Those which were not inherently illegal included items of rent, legal fees, bail bond fees, etc. Also claimed were expenses which may be considered inherently illegal, such as alleged bribes paid to members of the law enforcement authorities for protection, and alleged bribes made to officials of the civic administration.

In considering the deductibility of the first category of expenses—those not inherently illegal—Cattanach J. had no difficulty in permitting the taxpayer deduction where the taxpayer satisfied the Court as to the authenticity

55 Id. at 432 (Ex. C.R.), 155 (C.T.C.), 1093 (D.T.C.).
56 Supra note 18, at 766 (Ex. C.R.), 551 (C.T.C.), 5342 (D.T.C.).
57 Id. at 765 (Ex. C.R.), 547 (C.T.C.), 5341 (D.T.C.).
58 Id. at 771 (Ex. C.R.), 556 (C.T.C.), 5344 (D.T.C.).
of the payments. In allowing the deductions the Court was quite obviously adhering to the concept of taxation on the basis of net income. It is the treatment of the second category of expense—those inherently illegal—which leaves some unanswered questions. It is clear that in denying the taxpayer her deductions for the alleged bribes, Cattanach J. proceeded on the basis of an absence of proof stating that:

The evidence which I received was not of this nature and accordingly I have not been satisfied that payments for protection were made . . . . I have not been convinced that these gifts were, in fact, made and even if they were made, no evidence has been adduced from which I could ascertain the number of such gifts and so compute their value.59

Having dispensed with the issue before the Court on the basis that the taxpayer failed to discharge the onus of proof, it was not necessary for Cattanach J. to consider the question in the context of public policy limitations. His Lordship certainly left a strong inference that, had he been satisfied as to the authenticity of the alleged bribes, he would have been inclined to permit deduction. Not having been called upon to definitively answer the question it is dubious whether this inference can be raised to the status of a ratio sub silentio.

The common characteristic of the three categories discussed, namely, revenue from an illegal business, illegal expenses of a legal business, and expenses incurred in an illegal business, is that the tax treatment afforded the items either conforms to a notion of income as being an accretion to wealth in the case of revenue inclusion, or to the concept of net income in the latter two situations. (Net income itself is no more than a derivative of the net accretion of wealth concept.) That this net income concept is fundamental to the tax structure cannot be overemphasized. If the concept is to be preserved and promoted as being one which is considered desirable, does it permit the denial of an expense deduction on the basis of some "broader principle"? Further, if it is deemed desirable that "broader principles" supersede tax policy considerations, should this be achieved legislatively or judicially?

It is difficult to appreciate the logical consistency of permitting the deduction of an illegal expense in a legal business or the deduction of an expense of an illegal business on the rationale that it conforms to a concept of net income, while at the same time denying a deduction for a penalty imposed due to that same illegality. At the very least, internal consistency would demand equivalent treatment of a penalty imposed for an illegal act as an expense incurred for an illegal business. From a purely structural point of view, the deduction of both expenses incurred in illegal businesses and penalties imposed for illegal acts, should be considered deductible. Since the Income Tax Act is structured on a modified concept of net accretion to wealth, it is possible to suggest that illegal gains and illegal expenses share a common bond. Thus, revenue from an illegal activity is included in the tax base since it enhances the taxpayer's wealth. At the same time, expenditures which reduce the taxpayer's wealth should be deducted from the tax base in order to provide a reasonably accurate assessment of a taxpayer's net accretion to wealth. Inclusion of the former and denial of deduction for the latter would

59 Id.
cause a structural shift in the underlying foundation of the taxing statute. Such a shift should only be made, if at all, on the basis of a well-reasoned analysis of the public policy criteria.

V. PUBLIC POLICY CRITERIA

To this juncture the discussion in this paper has focused on the absence of common law authority to universally preclude the deduction of fines and penalties imposed for contravention of non taxing statutes, and an examination of tax policy arguments calling for consistent adherence to a concept of net income. It remains to be discussed whether from the perspective of some wider public policy, a structural shift in tax policy should be consistently applied to deny both the expense and the penalty, and the appropriate vehicle for implementing such a radical shift. That the *Income Tax Act* is used to implement policies other than that of revenue generation is beyond debate.60 These policies have traditionally embraced, albeit with varying degrees of enthusiasm, the redistribution of wealth, as well as social and economic measures. The question remains whether tax statutes should further public policy, however defined, and if so, what should be the appropriate forum to analyse and debate such public policy. While it serves the purpose of providing a convenient label, public policy itself is a hybrid and elusive notion. In the context of deductions of penalties incurred as a consequence of business activity, it may include moral and ethical considerations, mechanisms intended to deter or stimulate particular forms of conduct considered detrimental or beneficial, and economic value judgments.

Moral and ethical considerations, perhaps of necessity, remain the most elusive input into the development of public policy. Rarely articulated in the context of tax decisions, they may be indiscriminately injected into argument without elaboration. *Day & Ross Ltd.* illustrates the inherent danger of this process where counsel for the Crown submitted that “... there is a broader principle which would exclude the deduction of a fine incurred by the taxpayer, either in the course of business, or otherwise ....”61 In support of this suggestion, the Crown made reference to various English decisions, notably *Beresford v. Royal Insurance Co.*62 quoting Lord Atkin, that, “... the absolute rule is that the Courts will not recognize a benefit accruing to a criminal from his crime.”63

Is it important, however, in evaluating the perimeters of an “absolute rule” to bear in mind both the context in which, and the social milieu prevailing, when the statement was made. *Beresford* involved the payment on an insurance policy to the personal representative of a person who had committed suicide. In that particular era, suicide was characterized as a heinous

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60 Can.: Department of Finance, *Budget Document* (Ottawa: March 31, 1977) at 32 where the Minister of Finance identifies, *inter alia*, economic stimulation, regional development, equity, and tax simplification as the specific objectives that guided the choice of the measures put forward [Emphasis added].

61 Supra note 3, at 792 (F.C.), 716 (C.T.C.), 6439 (D.T.C).


63 Id. at 599 (A.C.), 607 (All E.R.).
crime and Lord Atkin was influenced by the characterization of the times, as evidenced by his reliance on Sir John Jervis' statement that "... self murder is wisely and religiously considered by the English law as the most heinous description of felonious homicide." 64 His Lordship went on to state that "... the suicide is a felon: on the inquisition his goods were forfeited (though apparently not his lands)." 65 Earlier in the judgment, Lort Atkin referred to In the Estate of Crippens, 66 which was concerned with the administration of the estate of a deceased wife who had been murdered by her husband, and to Hall v. Knight and Baxter 67 where on the strength of public policy a beneficiary found guilty of manslaughter was denied from taking under the will.

The Minister also made reference to Cleaver v. Mutual Reserve Fund Life Assoc. 68 and the statement of Fry L.J. contained therein:

It appears to me that no system of jurisprudence can with reason include amongst the rights which it enforces rights directly resulting to the person asserting them from the crime of that person. 69

It should be kept in mind that the case involved suit on a life policy where the beneficiary of the policy had been convicted of murder of the assured. It appears reasonable from the context of these cases that Lord Atkin's "absolute rule" was intended to apply to the prevailing societal perception of heinous crimes. Further, it is dubious whether the reasoning of a judicial tribunal in 1938 can, indiscriminately and without modification, be applied forty years later and ignore the proliferation of statutes and regulations in the past two decades. Public policy inherently involves notions that are uncertain and fluctuating, varying with changing economic needs, social customs, and the moral aspirations of a people. In such a setting, "absolute rules" serve merely to entrench the perceptions of the past and discourage examination in the context of present needs. Although Dubé J. in Day & Ross Ltd. does not specifically reject the notion of an absolute rule, His Lordship leaves the impression that he would at the very least distinguish situations involving "outrageous transgressions of public policy" from lesser violations. 70

Again, it may be suggested that the allowance of a deduction for a fine reduces the ultimate impact or "sting" of the penalty by permitting the taxpayer to reduce the after-tax cost of the penalty, thereby reducing the deterrent value of the penal provision in the statute violated by the taxpayer. This argument represents the single most persuasive reason for the disallowance of penalty deductions, and rests on the implicit premise that in such matters the tax objective of economic neutrality should be subservient to the general interests of society as reflected in its statutes and regulations. The argument is a powerful one indeed, until it is turned around to ask whether the denial of a deduction may have the ultimate effect of increasing a civil or criminal

64 Id.
65 Id.
69 Id. at 156 (Q.B.), 133 (L.J.Q.B.), 224 (L.T.).
70 Supra note 3, at 795 (F.C.), 718 (C.T.C.), 6440 (D.T.C.).
penalty, which may or may not have been intended by the legislative policy behind the statute violated. Thus, it is conceivable that indiscriminate judicial application of a public policy limitation to all situations may cause the legislative policy behind an enactment to be varied in an unintended manner. For this reason alone, the development of any public policy limitations would be best left to a legislative forum which could consider the question in a wider framework than that which is possible in an adversary proceeding. The danger of judicial distortion of legislative policy is more acute where the policy has been applied without any analysis, as is the experience in Canadian tax decisions.

A variation of the “reduced sting” argument is one which suggests that allowance of a deduction would result in the ultimate cost, albeit a reduced cost, to be felt differently by taxpayers. Thus, a high marginal rate taxpayer would bear a lesser net after tax cost than one with a lower marginal rate. The converse must, of course, hold equally true. The effect of disallowance is to differentiate between the high marginal rate taxpayer who pays the penalty from more expensive after-tax dollars than his low marginal rate counterpart. Arguments based on the phenomena of differential impacts offer little towards a resolution of the public policy issue in that the cause of the differential impact is the rate structure, which is unrelated to the public policy question of deductibility.

Again it may be suggested, as indeed it was by the Board in both *Luscoe* and *King Grain & Seed*, that allowance of a deduction would not only reduce the sting of the penalty, but would permit the taxpayer's penalty to be “subsidized” and thus shift the tax burden to other taxpayers. If, however, allowance of any business expense incurred for the purpose of earning income is viewed as a “subsidy,” the impact here is no different from that observed elsewhere in the Act. Thus, the allowance of a deduction for an illegal expense incurred in the conduct of a lawful activity, or an expense incurred in pursuit of an illegal business would similarly have the effect of a “subsidy.” Ultimately, the “subsidy theory” must surely rely for its legitimacy on some inarticulated premise that all income of a taxpayer belongs to the Crown, and that whatever the Crown does not retain is converted into a subsidy for the taxpayer.

VI. CONCLUSION

Two questions emerge from the preceding discussion: (a) Should the tax structure be judicially molded to serve as an ancillary instrument to further “penalize” or “subsidize” taxpayers? (b) If tax policy is to be considered subservient to general public policy, should this be achieved in a judicial forum without legislative deliberation? It has been argued that, at least in Canada, the notion of a blanket public policy limitation on the deduction of all fines and penalties lacks any foundation based on authority. Further, quite apart from authority, so called “accepted” and “broader” principles have never been analysed, rarely discussed, and usually fervently followed by judicial tribunals. It remains impossible to determine the extent and scope of the limitation in its currently concealed state, and exposure of the doctrine to judicial and legislative consideration may serve its development.
Inherent in the difficulty of development of the doctrine are the opposing pulls of tax policy and “broader principles.” Indiscriminate application of these “broader principles” distorts the underlying tax policy to levy a tax on the net income of a taxpayer. At the same time, denial of a deduction attaches a serious punitive consequence without express or implied legislative approval, To suggest that universal disallowance of all fines can be justified on the basis of some presumed intention of every legislative and quasi-legislative forum in this country stretches the limits of credulity.

Given the elusive nature of a public policy doctrine, whether it be premised on moral, ethical, deterrent, or tax subsidy considerations or some combination thereof, suggests that the doctrine be legislatively considered in order to define its rationale and stipulate its limits. Advocacy of a legislative approach does not suggest that any judicial input into the development of public policy is eradicated: rather, that judicial application of a public policy limitation should be constrained to those “outrageous transgressions” where Lord Atkin’s “absolute rule” would clearly accord with societal interests and expectations without specific legislative articulation.

As a preliminary distinction, judicial denial of deductions both for those expenses which are inherently illegal and fines resulting from such illegal activities could be justified on the basis of larger societal interests without legislative specification. The term “illegal” should be limited to those offences which are contained in the Criminal Code.\(^{71}\) While many offences fall outside the Code, the Code does represent, at the very least, the lowest common denominator of what society considers undesirable conduct. Any further restrictions on the deductibility of fines would be better left to a Parliamentary forum for evaluation of the conflicting criteria applicable. Such a forum would be better equipped to consider the nature and quantum of a penalty provision and the legislative policy behind the enactment.

While it is premature to determine the length and the intensity of the shadow cast by Day & Ross Ltd., it is probably time to bring the doctrine of public policy limitations on tax deductibility within the sphere of legislative evaluation and control.

\(^{71}\) Criminal Code, R.S.C. 1970, c. C-34.