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The Case for a Canadian Offer-in-Compromise Program

Colin Jackson, *Dalhousie University Schulich School of Law*



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The Case for a Canadian Offer-in-Compromise Program

*Colin Jackson**

Unlike the American Internal Revenue Service, the Canada Revenue Agency (CRA) is not permitted to compromise a tax debt or to accept less than the full amount that an impecunious taxpayer owes. Recent estimates of undisputed-uncollected tax debts in Canada approach \$29 billion, suggesting it may be time for a change. This article advocates for the implementation of an offer-in-compromise program as a way to mitigate these uncollected tax debts and to promote overall equity in the tax system. The author argues that if the CRA has discretion to accept less than the full amount owed in certain cases, where the unique circumstances warrant such a compromise, the tax system as a whole will benefit. Further, safeguards within the system can mitigate concerns regarding moral hazard, where possible forgiveness of tax debts may incentivize risky behaviour. Such a system would operate on a case-by-case basis to determine if a compromise is warranted, and if so, the amount to be collected based on the individual taxpayer's "ability to pay".

* PhD Candidate, Schulich School of Law, Dalhousie University. My thanks to Shu-Yi Oei, Kim Brooks, Geoff Loomer, Faye Woodman, Nayha Acharya, the anonymous reviewers and the participants in a session of the Dalhousie Law Graduate Students' Seminar series who all offered helpful feedback on earlier iterations of this project.

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Introduction: Dealing with the Impecunious Tax Debtor

Nestled, almost parenthetically, in the fifth volume of the *Report of the Royal Commission on Taxation (Carter Report)*, between a paragraph about various other administrative issues relating to the collection of tax and a paragraph expressing concern about tax debtors leaving Canada with taxes owing, lies the commissioners' thoughts on a compromise program for Canadian tax debtors.¹ The *Carter Report* suggests that an "offer of compromise" program be instituted, similar to that available for tax debtors in the United States. The program would allow tax debtors who owe more than their net worth to settle the debt for a lower amount. Settlements would be made public as a safeguard against abuse, and the program would not be available to taxpayers who had intentionally

1. Canada, Royal Commission on Taxation, *Report of the Royal Commission on Taxation* (Ottawa: Queen's Printer, 1966) vol 5 at 149, 157-59 [*Carter Report*].

understated their income. No further analysis or discussion is provided, and the proposal was not included in the list of recommendations at the end of the chapter.² While the *Carter Report* has been highly influential and continues to be discussed nearly fifty years later, the compromise suggestion has received little academic attention.³

The Canadian tax system allows some leeway for debtors who are unable to pay their assessed taxes. Debtors may be able to arrange a payment plan to allow them to pay their tax bill in instalments over time. They can also ask for interest and penalties to be waived or cancelled. In rare cases, the federal cabinet may grant a remission order, allowing tax to be forgiven, along with interest and penalties. When all else fails, tax debts can be discharged in bankruptcy. However, in the normal course of business, the Canada Revenue Agency (CRA) is forbidden from compromising to settle a debt.

In the United States, on the other hand, the Internal Revenue Service (IRS) has the power to settle for less than the full amount owed where a tax debtor offers at least as much as the IRS expects to be able to collect.⁴ Rather than pursuing potentially long and costly collection action and pushing tax debtors into bankruptcy, the IRS may compromise. The experience has been largely positive, allowing the US government to “get more by asking less”.⁵

In similar situations, the CRA has less flexibility. The tax system is built on the fundamental principles of horizontal and vertical equity, and

2. *Ibid.*

3. See e.g. W Neil Brooks, ed, *The Quest for Tax Reform: The Royal Commission on Taxation Twenty Years Later* (Toronto: Carswell, 1988); Kim Brooks, ed, *The Quest for Tax Reform Continues: The Royal Commission on Taxation Fifty Years Later* (Toronto: Carswell, 2013) [K Brooks, *Fifty Years Later*]. The compromise recommendation was mentioned by Harold Buchwald in *Administration and the Carter Report*, but the discussion in the literature seems to have gone no further. Harold Buchwald, *Administration and the Carter Report* (Don Mills, Ont: CCH Canadian, 1967).

4. I use the terms “compromise” and “settlement” in this article to refer to the situation where the tax authority accepts less than the full amount that the government is owed. However, as one anonymous reviewer aptly put it, if the government is able to collect as much or more than it expected to otherwise, the offer-in-compromise program might simply be thought of as “doing it the easy way, rather than the hard way”.

5. Shu-Yi Oei, “Getting More by Asking Less: Justifying and Reforming Tax Law’s Offer-in-Compromise Procedure” (2012) 160:4 U Pa L Rev 1071 [Oei, “Getting More”]. See also Shu-Yi Oei, “Who Wins When Uncle Sam Loses?: Social Insurance and the Forgiveness

allowing the tax collector to cut special deals with particular taxpayers would seem to run counter to the goal of taxing likes alike. In this article, I argue that a well-designed compromise mechanism could be incorporated into Canada's tax collection system in a way that would improve—rather than undermine—equity.

As detailed below, there is reason to think that a compromise mechanism might help the CRA's debt collection efforts, as collection seems to be a growing problem in Canada. These concerns should not be overblown; the vast majority of taxpayers in Canada pay on time without any intervention.⁶ Even so, on March 31, 2012, the amount of undisputed tax, interest and penalties that was uncollected by the CRA was \$29 billion.⁷ Between 2006 and 2012, the total tax debt outstanding grew faster than both GDP and net tax revenue.⁸ The growth in the amount that the CRA wrote off as "uncollectable" also outpaced net revenue and GDP growth over the same period.⁹ Moreover, this growth in outstanding debt occurred while the CRA was making significant improvements to its collection procedures.¹⁰ The CRA calls resolving outstanding tax debts "a critical element in protecting Canada's tax base" and in securing revenue to fund social programs.¹¹ A compromise mechanism might be

of Tax Debts" (2012) 46:2 UC Davis L Rev 421 [Oei, "Social Insurance"]; Nina E Olson, "Minding the Gap: A Ten-Step Program for Better Tax Compliance" (2009) 20:1 Stan L & Pol'y Rev 7; US, Government Accountability Office, *IRS Offers In Compromise: Performance Has Been Mixed; Better Management Information and Simplification Could Improve the Program* (GAO-06-525) (2006) [GAO, *Offers in Compromise*].

6. 94.5% of individuals and 90% of corporations that owe tax pay on time. See Canada Revenue Agency, *Annual Report to Parliament 2012–2013* (Ottawa: CRA, 2013) at 36 [CRA, *Annual Report*]; Office of the Auditor General of Canada, *2013 Spring Report of the Auditor General of Canada* (Ottawa: OAG, 2013) at 89 [OAG, *Spring Report*].

7. See OAG, *Spring Report*, *supra* note 6 at 89.

8. See *ibid* at 100 (uncollected tax, interest and penalties increased by 61%, from \$18 billion to \$29 billion, while net tax revenue grew 28.7%, from \$258 billion to \$332 billion). The growth in uncollected tax debt was also noticed by the news media. See Jason Fekete, "Canada Revenue Agency Owed \$29-Billion as Uncollected Tax Debt Soars 60% Since 2006 Audit", *National Post* (25 April 2013), online: <www.nationalpost.com>; "Uncollected Tax Debt Soars to \$29B: Auditor General", *CTV News* (1 May 2013), online: <www.ctvnews.ca>.

9. See OAG, *Spring Report*, *supra* note 6 at 100 (\$2.8 billion was written off as uncollectable in 2012, up from \$1.9 billion in 2006).

10. See *ibid* at 88.

11. CRA, *Annual Report*, *supra* note 6 at 36.

implemented as another tool for the CRA to use to resolve outstanding debts and fight the growth in uncollected tax.

I previously called for more exploration of compromise mechanisms in the Canadian tax system.¹² This article takes up only a part of that call. While there are still unexplored arguments about the merits of compromise elsewhere in the tax system, my focus in this article is on the context of tax collection.¹³ At this final stage in the life cycle of a tax assessment, the amount of tax has been assessed and any dispute over the correctness of the assessment has been resolved. The question that remains is the following: What norms should govern the tax collector when the taxpayer is unable to pay the bill in full?

I begin by explaining the offer-in-compromise program in the United States. Following that, I outline the existing mechanisms that give the CRA and tax debtors some flexibility in working out the payment of tax. In drawing this comparison, I note that some of the language and goals of the offer-in-compromise program already exist in Canadian law.

In the next Part of the article, I pursue three lines of argument that suggest a compromise program could be designed to enhance the equity of the tax system. First, I argue that there is some inequity that the design of the tax system cannot eliminate. The diversity of human arrangements precludes us from drafting a taxing statute that perfectly captures each person's ability to pay. A compromise program could offer the opportunity to correct some of these inequities after the fact. As an alternative to this first line of argument, I take the taxing statute as the standard of equity. Given this premise, a compromise program could still be supported if it worked to improve collections and compliance, thereby moving the system closer to the equitable ideal envisioned in the statute. Finally, I note that while Canada's tax system eschews compromise, tax debts are compromised elsewhere in Canadian law. So, the effect of this strict approach might not be to enforce the idea of equity promoted by the *Income Tax Act (ITA)*,¹⁴ but rather to outsource most of the decision making

12. See Colin Jackson, "Settlement and Compromise in Canadian Income Tax Law Since Carter" in K Brooks, *Fifty Years Later*, *supra* note 3, 295.

13. The argument for compromise in the dispute resolution context has received some attention. See Daniel Sandler & Colin Campbell, "Catch-22: A Principled Basis for the Settlement of Tax Appeals" (2009) 57:4 Can Tax J 25.

14. RSC 1985, c 1 (5th Supp) [*ITA*].

around the compromise of tax debts to the bankruptcy system. Given this insight, I argue that the goals of tax policy and tax administration would be better served by a compromise system administered by the tax authority and would be responsive to the specific concerns of tax policy. In the concluding section, I review the features of a compromise program that follow from the comparative analysis and arguments based on equity.

I. Offers-in-Compromise in the United States

The explicit power to compromise has a long history in the United States.¹⁵ The *Internal Revenue Code* grants wide discretion to make compromises. The Treasury Secretary or the Attorney General “may compromise any . . . case”, subject only to the requirement to keep a legal opinion on record.¹⁶ However, the practice has long been to restrict the situations in which the IRS has authority to compromise. As early as 1879, the position of the Attorney General was that the power to compromise could only be exercised where there was either doubt about the taxpayer’s liability or doubt about the collectability of the debt.¹⁷ In the contemporary regulations, the long-standing grounds for compromise—doubt as to liability and doubt as to collectability—have been joined by the promotion of effective tax administration.¹⁸ In this Part, I review how these grounds are used to

15. See HR 1284, 40th Cong. (2d Sess 1868), 15 Stat 125 at 166. For a more detailed review of the history of this provision, see I Jay Katz, “An Offer in Compromise You Can’t Confuse: It Is Not the Opening Bid of a Delinquent Taxpayer to Play Let’s Make a Tax Deal with the Internal Revenue Service” (2012) 81:7 Miss LJ 1673. An earlier, less constrained version of the compromise power appeared in 1863. See Cong Globe, 37th Cong, 3rd Sess (1863), reprinted in JS Seidman, *Seidman’s Legislative History of Federal Income Tax Laws, 1938–1861* (New York: Prentice-Hall, 1938) at 1060.

16. See IRC § 7122(a) (2012 & Supp I 2014); *Botany Worsted Mills v United States*, 278 US 282 (1929) (the US Supreme Court held that this provision provides the exclusive means of compromising tax debts, so settlements that fail to comply with its requirements are invalid and unenforceable).

17. See 16 Op Att’y Gen 248 (1879); Katz, *supra* note 15 at 1683–85 (reporting that leading up to the enactment of the *Revenue Act of 1913*, numerous opinions of the Attorney General held that valid claims against solvent taxpayers could never be compromised, and early Treasury Regulations adopted this rule as well). *Revenue Act of 1913*, c 16, 38 Stat 114.

18. 26 CFR § 301.7122-1(b) (2014).

increase the amount that the IRS collects from impecunious tax debtors and to bring those previously non-compliant taxpayers into compliance.

In the IRS's view, the offer-in-compromise program has four objectives:

1. To "[e]ffect collection of what can reasonably be collected at the earliest possible time and at the least cost to the government";
2. To "[a]chieve a resolution that is in the best interests of both the individual taxpayer and the government";
3. To "[p]rovide the taxpayer with a fresh start toward future voluntary compliance with filing and payment requirements"; and
4. To "[s]ecure collection of revenue that may not be collected through any other means".¹⁹

In addition to these goals, which focus on the quick and efficient collection of tax and on the bilateral relationship between the IRS and a particular taxpayer, the current National Taxpayer Advocate adds that the program may have beneficial effects for "tax morale".²⁰ That is, taxpayer compliance will be improved because the offer-in-compromise program increases the perception that "the IRS treats [taxpayers] with courtesy and respect and provides reasonable opportunities to resolve a tax liability when [taxpayers] lapse".²¹

Doubt as to collectability is the most common ground for compromise,²² and my suggestion of a compromise mechanism in Canadian tax law uses mainly "doubt as to collectability" as its model.²³ Offers based on doubt as to liability are less common, but its availability functions as an alternate avenue for a taxpayer to have her liability reconsidered where she was unable to contest it through the usual

19. US, Internal Revenue Service, *Internal Revenue Manual*, § 5.8.1.1.4 (2008), online: <www.irs.gov/irm> [IRM].

20. See Olson, *supra* note 5 at 26.

21. *Ibid.*

22. See GAO, *Offers in Compromise*, *supra* note 5 at 1.

23. See Richard CE Beck, "Is Compromise of a Tax Liability Itself Taxable?: A Problem of Circularity in the Logic of Taxation" (1994) 14:1 Va Tax Rev 153 at 157, citing Michael I Saltzman, *IRS Practice and Procedure*, 2nd ed (Boston: Warren, Gorham & Lamont, 1991); Kevin P McLaughlin, "Strategies for Compromising Tax Debts" (2011) 211:6 J Accountancy 50.

mechanisms in the time allowed.²⁴ Accordingly, the main focus here will be on the US system's treatment of offers based on doubt as to collectability, with some reference to offers based on the promotion of effective tax administration.

A. Doubt as to Collectability

Broadly speaking, offers based on doubt as to collectability are accepted if the taxpayer offers at least as much as the IRS expects to be able to collect. The taxpayer must also make significant financial disclosure and commit to ongoing compliance with his tax obligations. The *Internal Revenue Code* provides that an acceptable offer should leave the taxpayer with sufficient resources to provide for basic living expenses.²⁵ The Code directs the Secretary to publish national and local allowances and to consider, based on the facts and circumstances of each individual case, whether those guidelines are applicable.²⁶ Moreover, the IRS is directed to provide special treatment to low-income taxpayers and is prohibited from "reject[ing] an offer-in-compromise from a low-income taxpayer solely on the basis of the amount of the offer".²⁷

In making an offer based on doubt as to collectability, the taxpayer must make a full and detailed disclosure of her financial situation. The

24. See Oei, "Social Insurance", *supra* note 5 at 437, citing Saltzman, *supra* note 23 at para 15.07(1)(b)(i); *IRM*, *supra* note 19, §§ 4.18.2.4 (2008), 5.8.1.1.3 (2013) to 5.8.1.1.4 (2008) (IRS officers are directed to treat an offer based on doubt as to liability as they would an audit reconsideration, and the matter is handled by IRS's "examination function", rather than the "collection function", which handles other types of offers).

25. IRC § 7122(d)(2)(A) (2012 & Supp I 2014).

26. *Ibid.* 26 CFR § 301.7122-1(b)(2) (2014). Doubt as to collectability is defined as follows: "Doubt as to collectability exists in any case where the taxpayer's assets and income are less than the full amount of the liability." *Ibid.*

27. IRC § 7122(d)(3)(A) (2012 & Supp I 2014). According to the IRS:

A low-income taxpayer is an individual whose income falls at or below poverty levels based on guidelines established by the U.S. Department of Health and Human Services (HHS). Taxpayers claiming the low-income exception must complete and submit the Income Certification for Offer in Compromise Application Fee worksheet, along with their Form 656 application package.

US, Internal Revenue Service, *Revamped Offer in Compromise Program Plays New Role in Collection Process* (FS-2006-22) (July 2006) online: <www.irs.gov/uac/Revamped-Offer-in-Compromise-Program-Plays-New-Role-in-Collection-Process> .

prescribed form requires the taxpayer to disclose information about all of the following: employment; personal assets owned, including bank accounts, life insurance policies, real estate, vehicles and other valuable items; household income and expenses; secured debts; and historical information about bankruptcies, lawsuits and transfers of assets for less than full value.²⁸ Further, the form asks the taxpayer to attach documentation in support of the information provided: recent paystubs, bank statements, mortgage statements and so on.²⁹ Taxpayers that are corporations, partnerships or limited liability companies have a different, but similarly demanding, disclosure requirement.³⁰

At the end of the form, the taxpayer calculates a “minimum offer amount” based on her income and expenses, the equity in her assets and how quickly she proposes to pay the offered amount. This minimum offer amount is referred to elsewhere as the “reasonable collection potential”, and the evaluation of an offer based on doubt as to collectability generally turns on it.³¹

According to the *Internal Revenue Manual*, the reasonable collection potential reflects the amount that the IRS would be able to collect, including through the use of administrative and judicial collection remedies.³² The determination includes a projection of the taxpayer’s future ability to pay, taking into account factors such as age, health, marital status, dependents, education, training, experience and employment status.³³ If the taxpayer offers an amount equal to or greater than the reasonable collection potential, the IRS generally accepts it. It is worth highlighting that the calculation of reasonable collection potential—and therefore the acceptability of the offer, in most cases—does not depend at all on the

28. US, Internal Revenue Service, Form 433-A (OIC), “Collection Information Statement for Wage Earners and Self-Employed Individuals” (January 2014), online: <www.irs.gov/pub/irs-pdf/f433aai.pdf> .

29. *Ibid* at 8.

30. US, Internal Revenue Service, Form 433-B (OIC), “Collection Information Statement for Businesses” (May 2012), online: <www.irs.gov/pub/irs-pdf/f433b.pdf> .

31. See US, Internal Revenue Service, Tax Topic 204, “Offers in Compromise” (23 May 2013), online: <www.irs.gov/taxtopics/tc204.html> [Tax Topic 204]; *IRM*, *supra* note 19, § 5.8.4.3 (2013).

32. *IRM*, *supra* note 19, § 5.8.4.3(2) (2013).

33. *Ibid*.

amount of the tax debt.³⁴ Instead, it reflects a pragmatic appreciation of the amount that the IRS could expect to collect given the taxpayer's current circumstances.³⁵

(i) Faith in the Tax System as a Ground to Accept or Refuse an Offer

Public policy considerations may cause the IRS to refuse an otherwise acceptable offer. The *Internal Revenue Manual* emphasizes that such refusals should be extremely rare and are based on projected public reaction to the compromise.³⁶ According to the Manual, the IRS will exercise discretion to refuse an offer on public policy grounds where “public reaction to the acceptance of the offer could be so negative as to diminish future voluntary compliance by the general public”.³⁷ This standard is not met simply because acceptance would generate public interest, including critical public interest. Nor is it met simply because a taxpayer was prosecuted, including prosecutions for tax violations.³⁸ The Manual gives three examples of scenarios that may warrant rejection:

- (a) “The taxpayer has in the past, and continues to openly encourage others to refuse to comply with the tax laws”;
- (b) “Indicators exist showing that the financial benefits of a criminal activity are concealed or the criminal activity is continuing”; or
- (c) “The taxpayer engaged in a pattern of conduct suggesting intentional dissipation of assets.”³⁹

Both the general rule that public reaction should be considered and the specific examples are helpful reminders that, while the IRS's main goals in the offer-in-compromise program relate to the collection of tax from a particular taxpayer and the health of the bilateral relationship between

34. The obvious exception being that the compromise offer will usually be rejected where the IRS reasonably expects that it might be able to collect the full amount owed.

35. It also engages with the tax policy idea of “ability to pay” in a way that is explored below.

36. *IRM*, *supra* note 19, § 5.8.7.7.2(2) (2014).

37. *Ibid.*

38. *Ibid.*, § 5.8.7.7.2(4) (2014).

39. *Ibid.*, § 5.8.7.7.2(3) (2014).

the IRS and that taxpayer, the IRS is mindful of the program's effect on the broader community and the system as a whole.

Similarly, special circumstances may lead the IRS to accept an otherwise unacceptable offer based on doubt as to collectability. That is, the IRS may settle a tax debt for less than the reasonable collection potential where there are compelling concerns of economic hardship, public policy or equity. These offers are evaluated in the same way that offers based on the promotion of effective tax administration are evaluated. The criteria and procedures are discussed in the following section.

B. Effective Tax Administration

In 1998, Congress encouraged the IRS to develop offer-in-compromise procedures that would consider factors like “equity, hardship, and public policy where a compromise . . . would promote effective tax administration”.⁴⁰ The Treasury Regulations developed in response explain that, even where the tax liability is both valid and fully collectable, the IRS may compromise a tax debt to promote effective tax administration.⁴¹

The IRS may compromise on this ground where full collection would cause economic hardship or where the taxpayer identifies “compelling public policy or equity considerations” and “demonstrate[s] circumstances that justify compromise even though a similarly situated taxpayer may have paid his liability in full”.⁴² The IRS is also called upon to consider the effect that either full collection or compromise would have on the public's perception of the tax system. The regulations acknowledge that in some cases, full collection would undermine public confidence in the tax system.⁴³ On the other hand, the IRS is forbidden from compromising to promote effective tax administration where the compromise “would undermine compliance by taxpayers with the tax laws”.⁴⁴ The factors discussed below, which may ground an offer based on the promotion

40. *Internal Revenue Service Restructuring and Reform Act of 1998*, Pub L No 105–206, 112 Stat 685; US, *Conference Report to Accompany HR 2676* (HR Rep No 105-599) (Washington, DC: US Government Printing Office, 1998) at 289. For more detail on the historical evolution of offer-in-compromise procedures, see Katz, *supra* note 15.

41. 26 CFR § 301.7122-1(b)(3) (2014).

42. *Ibid.*, § 301.7122-1(b)(3)(ii) (2014).

43. *Ibid.*

44. *Ibid.*, § 301.7122-1(b)(3)(iii) (2014).

of effective tax administration, are the same factors that the IRS will consider in evaluating an offer based on doubt as to collectability with special circumstances.

(i) Economic Hardship

The IRS may compromise to accept less than the full amount due, even if that amount could be collected, if the collection would result in economic hardship to the taxpayer. The Treasury Regulations define economic hardship with relation to payment of basic living expenses.⁴⁵ Three points are worth highlighting in the definition. First, this ground is only open to individuals. Corporations, partnerships and limited liability companies have no living expenses, so the IRS will not entertain a claim to economic hardship.⁴⁶ Second, the IRS is directed to look at the unique circumstances of the individual who seeks the compromise.⁴⁷ Third, in considering these individual circumstances, only a basic standard of living is protected. The IRS will not accept compromises to allow the taxpayer to sustain an affluent lifestyle.

(ii) Public Policy and Equity

The criteria for an acceptable offer based on public policy and equity grounds are less clear. The regulations state that these compromises are justified where the collection of the full debt would “undermine public confidence that the tax laws are being administered in a fair and equitable manner”.⁴⁸ The taxpayer in such a case is expected to “demonstrate

45. 26 CFR § 301.6343-1(b)(4) (2014).

46. *IRM*, *supra* note 19, § 5.8.11.2.1(2) (2008).

47. The regulations provide several examples of the unique factors that can support a finding of economic hardship. Economic hardship may be found in three circumstances: For when a taxpayer’s entire income is expected to be exhausted in supporting dependants who have no other means of support, see 26 CFR §§ 301.7122-1(c)(3)(i)(B), 301.7122-1(c)(3)(iii) (2014); for when a taxpayer’s assets, while sufficient to pay the tax debt, may be needed because of a long-term illness or disability, see 26 CFR §§ 301.7122-1(c)(3)(i)(A), 301.7122-1(c)(3)(iii) (2014); and for when the tax debt could only be satisfied by liquidating an asset that the taxpayer depends on to provide a basic standard of living, see 26 CFR §§ 301.7122-1(c)(3)(i)(C), 301.7122-1(c)(3)(iii) (2014).

48. 26 CFR § 301.7122(b)(3)(ii) (2014).

circumstances that justify compromise even though a similarly situated taxpayer may have paid his liability in full”.⁴⁹

Examples provided in the regulations offer some clarification about what it might mean to provide fairness and equity by treating similarly situated taxpayers differently. The first supposes that the taxpayer was hospitalized for a serious illness, almost continuously, for several years. Being incapacitated, the taxpayer was unable to manage his financial affairs. The example also assumes that the taxpayer’s overall history of compliance with the tax system does not weigh against compromise. In the second, the hypothetical taxpayer was reasonably diligent and, again, has a good history of compliance. However, due to bad advice received from the IRS, the taxpayer faces a steep tax bill.⁵⁰ The *Internal Revenue Manual* adds that a compromise may be appropriate in the case of a not-for-profit, charitable or exempt organization whose provision of an essential service to the community would be jeopardized by the collection of the full debt, or where the delinquency was caused by the criminal or fraudulent actions of a third party.⁵¹

C. Terms and Conditions: Payment and Compliance

The taxpayer’s debt will be compromised as part of an accepted offer only if the taxpayer honours the terms and conditions of that offer. The taxpayer is required to make an immediate payment to have the offer considered. The required payment is either twenty percent of the total offer value if the offer is to be paid in five or fewer monthly payments (called a “lump sum payment”) or the first monthly payment if the offer is to be paid over a longer period (called “periodic payment”). In the case of periodic payment, the taxpayer is required to continue making the

49. *Ibid.*

50. See 26 CFR §301.7122-1(c)(3)(iv) (2014). Note that elsewhere, the *Internal Revenue Code* provides relief from penalties and interest in the same situations. See IRC § 6404 (2012 & Supp I 2014) (which provides for the full abatement of penalties and interest resulting from erroneous written advice of the IRS); IRC § 6651(a) (2012 & Supp I 2014) (provides for the abatement of penalties with a showing of reasonable cause, which the *Internal Revenue Manual* states may include a taxpayer’s illness); *IRM*, *supra* note 19, § 20.2.7.1 (2014). See also Katz, *supra* note 15 at 1730–36.

51. *IRM*, *supra* note 19, § 5.8.11.2.2.1(4)–(5) (2008).

monthly payments while the offer is being considered.⁵² If the offer is ultimately rejected, payments made will be applied to the taxpayer's debt.⁵³

The taxpayer also agrees to remain in compliance—filing returns and paying taxes—for a five-year period after the offer is accepted.⁵⁴ As the offer form makes clear to the taxpayer, any material breach of the compliance term may result in the IRS pursuing collection of the entire debt.⁵⁵ Studies of the offer-in-compromise program indicate that it has significant success at bringing non-compliant taxpayers into compliance. A review of a statistical sample of 84 of 28,018 offers based on doubt as to collectability that were accepted in the 1999 fiscal year showed that “virtually all” of the taxpayers were in compliance with all of the terms of their compromise offers in 2003.⁵⁶ A broader study conducted by the IRS concluded that eighty percent of the individual taxpayers whose offers were accepted between 1995 and 2001 had remained in compliance.⁵⁷

52. IRC § 7122(c) (2012 & Supp I 2014).

53. US, Internal Revenue Service, Form 656, “Offer in Compromise” (January 2015) at 4, online: < www.irs.gov/pub/irs-pdf/f656b.pdf >.

54. *Ibid* at 5.

55. *Ibid*; US, Internal Revenue Service, Form 656-L, “Offer in Compromise (Doubt as to Liability)” (February 2012) at 2, online: < www.irs.gov/pub/irs-pdf/f656l.pdf > (a similar clause, though worded differently, is found in the form for offers based on doubt as to liability).

56. See US, Treasury Inspector General for Tax Administration, *Monitoring of Accepted Offers in Compromise Is Generally Effective, but Some Improvement Is Needed* (Washington, DC: Department of the Treasury, 2004) at 2, online: < www.treasury.gov/tigta/auditreports/2004reports/200430043fr.pdf > (57% of the taxpayers studied had remained in voluntary compliance, 39% had some compliance issue that was resolved and only 4% of the taxpayers were non-compliant).

57. US, Treasury Inspector General for Tax Administration, *The Offer in Compromise Program Is Beneficial but Needs to Be Used More Efficiently in the Collection of Taxes* (2006-30-100) (Washington, DC: Department of the Treasury, 2006) at 7, citing IRS Offers in Compromise Program, *Analysis of Various Aspects of the OIC Program* (September 2004). The eighty percent includes taxpayers who had some compliance issue resolved after a first collection notice. See US, National Taxpayer Advocate, 2009 Report to Congress, vol 1 at 205, online: < www.irs.gov/pub/tas/1_09_tas_arc_vol_1_preface_toc_msp.pdf >; Olson, *supra* note 5 at 25–26.

II. Room to Manoeuvre in Canadian Law

As a general rule, the Canadian tax system refuses to compromise tax assessed. An account of the law is sometimes given based on subsection 220(1) of the *Income Tax Act*, which reads in part: “The Minister shall administer and enforce [the *Income Tax Act*]”.⁵⁸ Courts have often placed heavy weight on the word “shall”, with the effect of removing any discretion the Minister (or his delegates in the CRA) might have.⁵⁹ Due, in part, to this constraint, the issues that the offer-in-compromise program deals with—impecunious tax debtors and the sense that the tax system sometimes works unfairly—are dealt with in the Canadian tax system in different ways.

Canadian tax collectors have some room to help impecunious taxpayers in some circumstances. The CRA may agree to an instalment plan to help a taxpayer manage her debt. The taxpayer relief provisions of the *ITA* allow penalties and interest to be waived or cancelled in some cases.⁶⁰ While the *ITA* does not allow the CRA to forgive tax, the *Financial Administration Act (FAA)* allows the federal cabinet to do so.⁶¹ Finally, as a general rule, tax debts are treated as ordinary, unsecured debts and are dischargeable in bankruptcy.

In this Part, I look at these four mechanisms by which taxpayers may have all or part of their tax debt forgiven. I note that some of the goals and the language of the offer-in-compromise program are reflected in the ways in which the CRA is able to work with Canadian tax debtors.⁶² Thus, while the design of the Canadian tax system acknowledges the same issues, the CRA is prohibited from taking much of the action available to the IRS to resolve them.

58. *Supra* note 14, s 220(1).

59. See e.g. *Ludmer v Canada (CA)* (1994), [1995] 2 FC 3, 182 NR 125 [cited to FC]. The often quoted passage reads: “Neither the Minister of National Revenue nor his employees have any discretion whatever in the way in which they must apply the *Income Tax Act*. They are required to follow it absolutely, just as taxpayers are required to obey it as it stands.” *Ibid* at 17.

60. *ITA*, *supra* note 14, s 220(3.1).

61. RSC 1985, c F-11, s 23(2) [*FAA*].

62. Here, I refer to and discuss CRA publications and internal documents. It should be clear, however, that these represent the CRA’s interpretations of the goals of, and constraints imposed by, the statutes and jurisprudence.

A. Payment Arrangement

Where a taxpayer is unable to pay the full amount she owes, the CRA is willing to “work with [her] to develop a repayment plan”.⁶³ That is, the CRA may be willing to accept repayment of a large debt in smaller instalments over time. However, consistent with the Canadian tax system’s strictness regarding compromises, the CRA will only accept such an arrangement “after [the taxpayer has] reasonably tried to get the necessary funds by borrowing or rearranging [her] financial affairs”.⁶⁴ In the absence of a successful taxpayer relief application (discussed below), the taxpayer will be charged interest on the arranged payments.

B. Taxpayer Relief: Interests and Penalties

Some of the goals and the language of the offer-in-compromise program are shared by the taxpayer relief provisions of the *ITA*. These provisions empower the CRA to waive or cancel penalties or interest and to offer other relief from various deadlines. An information circular issued by the CRA explains the taxpayer relief provisions as follows:

The legislation gives the CRA the ability to administer the income tax system fairly and reasonably by helping taxpayers to resolve issues that arise through no fault of their own, and to allow for a common-sense approach in dealing with taxpayers who, because of personal misfortune or circumstances beyond their control, could not comply with a statutory requirement for income tax purposes.⁶⁵

The language here is similar to that used by the IRS in evaluating offers-in-compromise based on effective tax administration. It recognizes that in some cases, fair administration of the tax system means something other than complete and strict enforcement of the statute. The *ITA*, however, limits the CRA’s discretion in dealing with these situations to interest and penalties, which implies that the unfairness in the system has to do with the inherent harshness of deadlines, and not with the substance

63. Canada Revenue Agency, “When You Owe Money: Collections at the CRA” (15 May 2014), online: <www.cra-arc.gc.ca/gncy/cllctns/menu-eng.html#cntpnw>.

64. Canada Revenue Agency, “Payment Arrangements” (13 November 2009), online: <www.cra-arc.gc.ca/tx/ndvdl/tpcs/ncm-tx/pymnts/rngmnts-eng.html>.

65. Canada Revenue Agency, Information Circular IC07-1, “Taxpayer Relief Provisions” (31 May 2007) at para 8 [CRA, IC07-1].

of the tax assessed under the Act.⁶⁶ The CRA divides the circumstances that may justify relief from interest and penalties into three broad categories: extraordinary circumstances, actions of the CRA and inability to pay or financial hardship (though relief may be granted in other situations as well).⁶⁷

(i) Extraordinary Circumstances

The CRA may grant relief from interest and penalties that resulted from extraordinary circumstances beyond the taxpayer's control.⁶⁸ The form used in requests for taxpayer relief provides a non-exhaustive list of extraordinary circumstances: “[n]atural or human-made disaster”; “[d]eath/accident/serious illness/emotional or mental distress”; and “[c]ivil disturbance”.⁶⁹ This list contemplates a flood, fire, death in the immediate family or a major disruption in services—like a postal strike—that may prevent taxpayers from meeting their obligations under the *ITA*.⁷⁰ Unlike US tax laws, the *ITA* allows the Minister to offer relief only from penalties and interest—the tax itself may not be compromised.

The *Taxpayer Relief Procedures Manual* directs CRA officers to look closely at these requests and to grant relief only to the extent that the taxpayer's default was caused by the extraordinary circumstances described. The taxpayer is asked to provide supporting documentation, such as police or fire reports, insurance statements, doctors' notes or death certificates, to explain how the event prevented compliance and to describe what other means the taxpayer pursued in order to remain compliant.⁷¹

66. See Jackson, *supra* note 12 at 304–05.

67. CRA, IC07-1, *supra* note 65 at paras 23–24.

68. *Ibid* at para 25.

69. Canada Revenue Agency, Form RC4288, “Request for Taxpayer Relief” (27 August 2014) at 1.

70. CRA, IC07-1, *supra* note 65 at para 25.

71. Canada Revenue Agency, *Taxpayer Relief Procedures Manual* at para 7.3, online: Taxnet Pro <v2.taxnetpro.com> [CRA, *Taxpayer Relief Manual*].

(ii) Actions of the CRA

Relief from interest and penalties may also be granted where the interest and penalties arise primarily because of errors or delays of the CRA.⁷² Again, the *Taxpayer Relief Procedures Manual* directs officers to be thorough in evaluating claims made by taxpayers to ensure both that the taxpayer's default was a direct result of some delay or error of the CRA, and that the delay or error was not attributable to incorrect information provided by the taxpayer or the taxpayer's own lateness.⁷³ However, CRA officials are also encouraged to proactively identify situations that may be appropriate for relief. For example, where the CRA takes an unduly long time completing an audit or resolving an objection, relief from penalties and interest may be offered without a request being made.⁷⁴

(iii) Inability to Pay and Financial Hardship

The CRA will rarely consider financial hardship as a ground for the forgiveness of penalties in the absence of extraordinary circumstances.⁷⁵ However, it may waive or cancel interest where it is able to confirm that a taxpayer is unable to pay. The examples that the CRA provides to illustrate when this may be appropriate bear some resemblance to situations considered under the offer-in-compromise program in the United States. Where a taxpayer's inability to pay has already led to collection being suspended or arranged via an extended payment arrangement, the CRA may waive interest.⁷⁶ Or, where payment of the accumulated interest would cause a "prolonged inability to provide basic necessities", cancelling all or part of the interest may be appropriate.⁷⁷

72. See CRA, IC07-1, *supra* note 65 at para 26 (these may include errors in processing a taxpayer's return, in publically available material, or in information given directly to a taxpayer; or delays in processing a return, completing an audit or resolving an objection).

73. CRA, *Taxpayer Relief Manual*, *supra* note 71 at para 7.4.

74. *Ibid* at para 7.4.1.

75. See CRA, IC07-1, *supra* note 65 at para 28.

76. *Ibid* at para 27.

77. *Ibid*. Unlike the situation in the United States, in Canada, it is usually only interest—not taxes or penalties—that the administration will consider forgiving. However, the CRA leaves open the possibility of "exceptional situations" in which penalties may be cancelled in whole or in part, such as when a business whose survival is vital to the welfare of the community as a whole is experiencing extreme financial difficulty. *Ibid* at para 28.

C. Remission Orders

While the *ITA* gives the Minister discretion to forgive penalties and interest, he has no power to settle, compromise or forgive tax assessed. He may, however, recommend to cabinet that a remission order be issued pursuant to subsection 23(2) of the *FAA*.⁷⁸ The *FAA* allows the Governor in Council to issue a remission order, forgoing collection of any tax or penalty, including interest, where “the Governor in Council considers that the collection of the tax or the enforcement of the penalty is unreasonable or unjust or that it is otherwise in the public interest to remit the tax or penalty”.⁷⁹ While the CRA has no authority to acknowledge that it would be unjust to collect tax or that the public interest would be served by a compromise of assessed tax, the cabinet is afforded the opportunity to make that decision. This power is used sparingly.⁸⁰ The *Public Accounts of Canada 2013* show that eleven remission orders were issued in the fiscal year ending on March 31, 2013, forgiving tax, penalties and interest of slightly less than \$215,000.⁸¹

D. Bankruptcy

As a last resort, Canadian taxpayers may choose to declare bankruptcy, or may be forced into bankruptcy by their creditors. The Canadian tax collectors, like their American counterparts, have extensive collection

78. *Supra* note 61, s 23(2). See also H Arnold Sherman & Jeffery D Sherman, “Income Tax Remission Orders: The Tax Planner’s Last Resort or the Ultimate Weapon?” (1986) 34:1 *Can Tax J* 801 (a more detailed look at remission orders than is presented here).

79. *Supra* note 61, s 23(2).

80. *Ibid*, s 24(2); CRA, *Taxpayer Relief Manual*, *supra* note 71 (“[a] remission order is a very rare and extraordinary measure that allows the government to provide full or partial relief from a tax or penalty” at para 8.12).

81. Receiver General of Canada, *Public Accounts of Canada 2013: Additional Information and Analyses* (Ottawa: Minister of Public Works and Government Services Canada, 2013) at 2.3–2.5. Of those eleven remission orders, four involved the remission of income tax, others dealt with GST, the provincial part of HST, customs duties, excise and the repayment of credits or benefits offered under the *ITA*. Another remission order was granted in March 2012. A further sixteen remission orders were made in previous fiscal years, but have an ongoing impact. *Ibid*.

powers,⁸² but the commencement of bankruptcy proceedings stays all collection action.⁸³

Similar to the American Bankruptcy Code, the Canadian *Bankruptcy and Insolvency Act (BIA)* provides a list of debts that are not discharged in bankruptcy. Like the American list, it includes student loan obligations, domestic support obligations and debts that result from certain intentional torts.⁸⁴ Unlike the American list, however, the Canadian exceptions to bankruptcy discharge do not include tax claims. The CRA has been an ordinary creditor since 1992, when a large round of amendments to the *BIA* removed most of the Crown's priorities.⁸⁵ As a general rule then, tax debts are ordinary, unsecured debts and are discharged in bankruptcy.⁸⁶ As a result, the amount that the CRA can expect to collect drops significantly once the bankruptcy process begins.

82. See IRC §§ 6321, 6331, 6334, 6671–72, 6901, 7402(a) (2012 & Supp I 2014); *ITA*, *supra* note 14, ss 159–60, 223–24, 224.1, 225, 227.1. The main tools that the IRS has at its disposal are the federal tax lien and levy, judicial collection procedures and third-party liability rules like the one hundred percent penalty for “trust fund” taxes and liability for fiduciaries and transferees. The CRA uses certificates and memorials, garnishment, set-off, seizure and sale of chattels. Third-party liability is imposed on corporate directors, transferees, and trustees and executors. For more on tax collection in the US, see Wm D Elliott, “Leaning on the Lien: Standing on the Promises of IRS” (1988) 18:3 *Cumb L Rev* 581; James K Wilkens & Thomas A Matthews, “A Survey of Federal Tax Collection Procedure: Rights and Remedies of Taxpayers and the Internal Revenue Service” (1986) 3:2 *Alaska L Rev* 269; David M Walker, “The Section 6672 100% Penalty: How to Avoid Going Down with the Ship” (1993) 46:3 *Tax Lawyer* 801; Werner F Wolfen & John R Cohan, “The United States as a Creditor for Taxes” (1957) 35:9 *Taxes* 684. For more on tax collection powers in Canada, see generally Colin Campbell, *Administration of Income Tax 2014* (Toronto: Carswell, 2014), ch 8; Canada Revenue Agency, Information Circular IC98-1R4, “Tax Collections Policies” (1 May 2013); Stephen W Bowman, “Collections in the Insolvency Context” in *Income Tax Enforcement, Compliance, and Administration* (Toronto: Canadian Tax Foundation, 1988) 12:1; Elaine S Sibson, “Revenue Canada’s Long Collection Arm: Jeopardy Orders, Section 160 Assessments, and Directors’ Liability” in *Report of Proceedings of Fiftieth Tax Conference* (Toronto: Canadian Tax Foundation, 1999) 26:1.

83. *Bankruptcy and Insolvency Act*, RSC 1985, c B-3, ss 69(1), 69(1.1) [*BIA*].

84. *Ibid*, s 178(1); 11 USC § 523 (2012 & Supp I 2014).

85. For a discussion of the evolution of Canada’s bankruptcy system, including the reforms of 1992 and 1997, see Jacob S Ziegel, “The Modernization of Canada’s Bankruptcy Law in a Comparative Context” (1998) 33:1 *Tex Intl LJ* 1 [Ziegel, “Modernization of Canada’s Bankruptcy Law”].

86. See *BIA*, *supra* note 83, s 168.1(1) (provides for automatic discharge). However, section 172.1 provides the exception for personal income tax debtors who have more

There are exceptions that give the CRA a stronger hand to play. A statutory deemed trust covers amounts that the debtor was required to deduct or withhold and remit to the Crown (for example, source deductions that employers are required to remit on behalf of their employees).⁸⁷ The Crown also benefits from the “enhanced requirement to pay”, which is a particularly powerful garnishment procedure that works in connection with the statutory deemed trusts to improve the likelihood of the CRA collecting these amounts, even where bankruptcy intervenes.⁸⁸ The CRA’s statutory collection powers also allow it to secure

than \$200,000 of personal income tax debt and whose personal income tax debt represents seventy-five percent or more of the total unsecured claims. *Ibid*, s 172.1. In that case, the debtor must wait a minimum amount of time and then apply for a discharge. For more on the same topic, see E Patrick Shea, *BIA, CCAA & WEPPA: A Guide to the New Bankruptcy & Insolvency Regime* (Markham, Ont: LexisNexis, 2009) at 225–71. It has also been noted that this provision is likely to apply only in rare cases where those with unusually high tax debts seek to misuse the bankruptcy system to favour other creditors over the government. See Janis Sarra, “Economic Rehabilitation: Understanding the Growth in Consumer Proposals Under Canadian Insolvency Legislation” (2009) 24:3 BFLR 383 at 445–46.

87. See *ITA*, *supra* note 14, ss 227(4)–(4.1) (these statutory trusts also survive the rule that statutory trusts in favour of the Crown are not effective in bankruptcy proceedings). See *BIA*, *supra* note 83, s 67(3). As others have noted, this favourable treatment is not extended to the statutory deemed trust created by the *Excise Tax Act* for amounts of GST or HST collected on behalf of the Crown. RSC 1985, c E-15, ss 222(1), 221(3). See Ziegel, “Modernization of Canada’s Bankruptcy Law”, *supra* note 85 at 14; Barbara K Morgan, “Should the Sovereign be Paid First?: A Comparative International Analysis of the Priority for Tax Claims in Bankruptcy” (2000) 74:4 Am Bank LJ 461 at 486; Sharon Hamilton, Adrienne Oliver & Jessica Lyn, “Government Collection of Tax in the Insolvency Context” in *2012 Tax Dispute Resolution, Compliance, and Administration Conference Report* (Toronto: Canadian Tax Foundation, 2013) 18:1 at 18:22–23.

88. *ITA*, *supra* note 14, s 224(1.2). The subsection provides a garnishment procedure along with super-priority, allowing the CRA to intercept payments to the debtor’s secured creditors. The enhanced requirement to pay continues even after a stay of collection action, as these amounts are considered property of the Crown and never become part of the bankruptcy estate. For a brief history of the evolution of the enhanced garnishment power, see Jacob Ziegel, “Section 224(1.2) of the *Income Tax Act* in the Supreme Court of Canada” (1997) 28:1 Can Bus LJ 170 at 170–73; Campbell, *supra* note 82 at 360–66; *Toronto-Dominion Bank v Canada*, 2012 SCC 1, [2012] 1 SCR 3, aff’g 2010 FCA 174, [2012] FCR 197.

a debt by registering it in a public registry.⁸⁹ However, these exceptions serve to highlight the general rule that tax debts will be discharged when the debtor declares, or is forced into, bankruptcy.

III. The Case for Compromise in the Canadian Context

The tax systems of Canada and the United States experience some of the same issues related to impecunious tax debtors, and both recognize that, at times, full collection of the amount assessed seems unfair. The comparison above shows that Canada's tax system sees unfairness that may be created by deadlines and allows the tax authority, in appropriate cases, to remedy that unfairness by offering relief from penalties and interest. While the CRA is not empowered to compromise tax assessed, the federal cabinet or a court in bankruptcy proceedings may. The American tax system incorporates the offer-in-compromise program that allows the tax authority to forgive not only penalties and interest, but tax as well. The compromise program allows the tax authority in the US to collect more, and to collect sooner, from tax debtors who are unable to pay in full, and its aims include mending the relationship between the tax debtor and the tax authority. In this Part, I argue that Canada would be well-served by moving toward the American offer-in-compromise approach.

The most obvious argument in favour of compromise is that it would allow the CRA to collect more revenue at less cost. The tax collector, like any other creditor, could be given free rein to maximize collections and minimize cost. The government could rationally weigh a tax debtor's offer, considering the amount of the offer, the amount it expects to be able to collect through the usual channels, the cost of collection action, the risks and costs of bankruptcy proceedings and so on. With a reasonable appreciation of the various factors, the CRA would sometimes conclude that compromise would be the most cost effective solution.

89. *ITA*, *supra* note 14, ss 223(2)–(3), 223(5). This course of action provides the Crown the same protection that is offered to a judgment creditor who registers his debt in a public registry. *BIA*, *supra* note 83, s 87(2).

However, collecting tax more quickly and at less cost are not the only goals—or even the primary goals—of tax administration and tax policy. Administering the taxing statute requires both a concern for fairness among taxpayers (equity) and a concern for the incentives that might be created by the way that the system is administered (neutrality). Further, if abandoning the strict approach to tax collection hurts taxpayers’ faith in the tax system, compliance may undermine the revenue benefits of compromise. Similarly, if the system is administered in a way that creates perverse incentives or avoidance opportunities, the financial gains will be lost.

In this Part, I suggest that a well-designed compromise mechanism within the Canadian tax system would be preferable to the status quo. I present three reasons to believe that a compromise mechanism would improve the equity of Canada’s tax system: it could correct existing inequities; it could improve collections and compliance; and it could move more of the decision making about compromise into the tax system, where tax policy goals would be central.

A. Improving the Equity of an Inevitably Inequitable System

(i) Ability to Pay in the Canadian Tax System

It is generally accepted that fairness in the tax system requires taxation in proportion to the taxpayer’s ability to pay.⁹⁰ It is worth noting at the outset that “ability to pay” as either a slogan or an organizing principle has been the subject of some criticism.⁹¹ Some see taxation based on the level of benefits received from the government as more efficient and more equitable, though perhaps impractical in a modern welfare state like Canada.⁹² Criticisms of the conceptual coherence of taxation based on ability to pay have led some proponents of progressive income taxation

90. See *Carter Report*, *supra* note 1, vol 2 at 10.

91. For a review of various arguments against ability to pay, see Stephen Utz, “Ability to Pay” (2002) 23:4 *Whittier L Rev* 867.

92. See Richard M Bird & J Scott Wilkie, “Tax Policy Objectives” in Heather Kerr, Kenneth J McKenzie & Jack M Mintz, eds, *Tax Policy in Canada* (Toronto: Canadian Tax Foundation, 2012) 2:1 at 2:3.

to advance other philosophical grounds to support it, while others have refined and defended ability to pay.⁹³

Here, I do not engage in the debate around the merits of taxation based on ability to pay. I simply note that the idea has been broadly accepted and discuss how the ideal of taxation based on ability to pay is rendered into a practical tax system. The key point in this discussion is that a practical tax system entails numerous departures from the ideal. These departures will exist even under the contestable assumption that there is an agreed upon and clear notion of what we mean by “ability to pay”. Moreover, these departures are not mistakes that can be corrected. Our tax system is imperfect—the necessary by-product of moving from the conceptual into the operational. I do not believe that the claim here ought to be particularly controversial. After all, remission orders under the *FAA* and the taxpayer relief provisions in the *Income Tax Act* are based on the premise that the tax system will, at times, work in unfair ways and that some discretion to offer relief is required.⁹⁴

The *Carter Report* sought to establish a taxation system built around equity and requiring taxation in proportion to ability to pay.⁹⁵ The Royal Commission, like many others, saw an income tax using the Schanz-Haig-Simons definition of income—the value of consumption plus the change in net worth over the relevant period—as the best measure of an individual’s ability to pay taxes.⁹⁶

93. See Joseph M Dodge, “Theories of Tax Justice: Ruminations on the Benefit, Partnership, and Ability-to-Pay Principles” (2004) 58:4 Tax L Rev 399. Dodge writes in response to Liam Murphy, Thomas Nagel and Deborah Geier who question the conceptual coherence of the ability to pay norm and argue for other norms to justify progressive income taxation. See Liam Murphy & Thomas Nagel, *The Myth of Ownership: Taxes and Justice* (New York: Oxford University Press, 2002); Deborah A Geier, “Time to Bring Back the ‘Benefit’ Norm?” (2004) 33 Tax Notes Intl 899. Meanwhile, Stephen Utz concludes his review of thinking around ability to pay as follows: “[T]he ability to pay tradition lives on as a piece of traditional disinformation, a license not to confront foundational issues, and distraction from the genuine difficulty of analyzing our shared assumptions about tax fairness”. See Utz, *supra* note 91 at 950.

94. *FAA*, *supra* note 61; *ITA*, *supra* note 14, s 220(3.1); *CRA*, IC07-1, *supra* note 65 at para 8.

95. *Carter Report*, *supra* note 1, vol 1 at 4, vol 2 at 10, 17.

96. *Ibid*, vol 3 at 23; Richard B Goode, *The Individual Income Tax* (Washington, DC: Brookings Institution, 1976) at 11, 21; Henry C Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (Chicago: University

However, as a reader of the *Carter Report* will quickly realize, fleshing out the system within those parameters requires difficult decisions to be made. At times, it requires that the ideally equitable tax—the tax which would best reflect the taxpayer’s ability to pay—be sacrificed in favour of the practical administration of the system or out of a concern for the incentives that the tax system might create. In many circumstances, there will simply be no practicable set of rules that is capable of adequately and fairly capturing the ability to pay of all taxpayers. Below, I present an example to illustrate the difficulty inherent in crafting a set of rules to assess taxable income in a way that accurately reflects the ability to pay of members of a diverse population.

To take one example, the system will need to separate personal consumption, which by definition is included in income, from amounts spent in the process of earning income that ought to be deductible because we seek to apply the tax only on profit. As Boris Bittker pointed out, advocates of the comprehensive tax base “cannot be blamed for the haziness of this distinction”, it owes simply to the fact that “our lives are not so compartmentalized that . . . borderline items can be readily classified”.⁹⁷ If real estate agents are all required to wear suits, then perhaps the cost of the suit (or the additional cost of wearing a suit rather than some alternative) ought to be deductible from real estate agents’ incomes. Our intuitive answer may be different, however, for a particular real estate agent who enjoys wearing suits and wears them even while she is not working. Many other examples of mixed business/personal expenses are conceivable: “the lawyer who can use his secretary on personal errands; the physician who reads the *National Geographic* before putting it in his waiting room; the executive whose family occupies empty seats

of Chicago Press, 1938) (Henry Simons put the definition as follows: “the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question” at 50). Dodge, *supra* note 93 at 401–02, 449–50 (this definition of income has been called “the cornerstone of modern income tax theory” at 400). The idea is credited to Simons as well as Georg Schanz and Robert Haig. See Georg Schanz, “Der Einkommensbegriff und die Einkommensteuergesetze” (1896) 13 *FinanzArchiv* 1; Robert M Haig, “The Concept of Income: Economic and Legal Aspects” in Robert M Haig, ed, *The Federal Income Tax* (New York: Columbia University Press, 1921) 1.

97. Boris I Bittker, “A ‘Comprehensive Tax Base’ as a Goal of Income Tax Reform” (1967) 80:5 *Harv L Rev* 925 at 952–53.

on a company plane”.⁹⁸ In practice, no set of rules will satisfactorily treat each of these situations according to our notions of income or ability to pay. The system needs to make assumptions that will be reasonably fair for most taxpayers, most of the time.

We could similarly consider the treatment of in-kind income, the perpetual debate over family taxation or the myriad of other cases in which the drafters of a taxing statute need to make difficult choices.⁹⁹ I did not present this example to flag problems that need to be solved, nor to suggest that the debates are futile. Some sets of rules will certainly be more equitable than others, and the choices made in drafting the rules are important. However, the diversity of human affairs means that no taxing statute will ever perfectly capture our notion of ability to pay in every case. There will be some whose situations and arrangements were not anticipated or were not well reflected by the rules. While the tax system strives to turn our ideal notion of ability to pay into a practical figure of taxable income, we cannot expect it to do so perfectly.

98. *Ibid* at 952.

99. See Simons, *supra* note 96 (on the subject of income definition generally, and in-kind income in particular, Simons noted that “some arbitrary delimitations are unavoidable” at 42–43). See also Kim Brooks, “Delimiting the Concept of Income: The Taxation of In-Kind Benefits” (2003) 49:1 McGill LJ 255. The literature on family taxation is enormous. Some key texts include: *Carter Report*, *supra* note 1, vol 3, ch 10; Boris I Bittker, “Federal Income Taxation and the Family” (1975) 27:6 Stan L Rev 1389; Neil Brooks, “The Irrelevance of Conjugal Relationships in Assessing Tax Liability” in John G Head & Richard Krever, eds, *Tax Units and the Tax Rate Scale* (Melbourne: Australian Tax Research Foundation, 1996) 35. For more recent forays into the debate, see Chris Sprysak, “Taxing Me or We: Yet Another Look at the Carter Commission’s Recommendation for Joint Returns” in K Brooks, *Fifty Years Later*, *supra* note 3, 265; Jack Mintz & Matt Krzepkowski, “No More Second-Class Taxpayers: How Income Splitting Can Bring Fairness to Canada’s Single-Income Families” (2013) 6:15 SPP Research Papers 1. For a recent policy forum in the Canadian Tax Journal, see Matt Krzepkowski, “Policy Forum: Tax Consequences of Income Splitting for Canadian Households” (2013) 61:3 Can Tax J 681; Elisabeth Gugl, “Policy Forum: The Impact of the Income-Splitting Proposal on Labour Force Participation and Other Household Decisions” (2013) 61:3 Can Tax J 695; Lisa Philipps, “Policy Forum: Real Versus Notional Income Splitting—What Canada Should Learn from the US ‘Innocent Spouse’ Problem” (2013) 61:3 Can Tax J 709. For present purposes, the key point is that any treatment (or non-treatment) of familial relationships in the tax statute reflects assumptions about the impact of those relationships on taxpayers’ abilities to pay, and that these assumptions will not be universally true.

(ii) Ability to Pay in the Offer-in-Compromise Program

The result of the analysis above is that a dose of humility may be in order: The taxing statute is not perfect and so the impecunious tax debtor may have been one of the unfortunate few for whom the statute's calculation of income did not accurately reflect her ability to pay. In deciding whether to accept a compromise offer, the IRS looks at the taxpayer's financial situation, considering all of the decisions the taxpayer has made, her misfortunes and windfalls, the amount she actually needs to maintain herself and her dependants, and her prospects for earning money in the future. Here, the IRS refers to a taxpayer's "ability to pay", though not with any obvious reference to the complex academic discussion of ability to pay as a norm grounding the income tax system.¹⁰⁰ In gauging ability to pay for the purposes of the offer-in-compromise program, the IRS attempts to estimate how much it can reasonably expect to collect, given the taxpayer's assets and its judicial and administrative collection remedies.

The offer-in-compromise program's view of ability to pay is something like what Richard Goode called "the crudest sense" of ability to pay: "In the crudest sense, ability to pay means only the possession of resources that can be turned over to the state. A pauper can pay little in taxes whereas a millionaire can pay much."¹⁰¹ Goode argued that ability to pay as a tax norm needed to convey something more.¹⁰² Still, in building a tax system based on a more meaningful definition of ability to pay, the crudest sense should not be completely forgotten. Ability to pay should mean something more, but where the crudest sense is violated—where the system demands much of a pauper—it might indicate that the system's estimation of that taxpayer's ability to pay is mistaken.

We cannot assume that the tax system always does a good job of enforcing equity between taxpayers. Where a taxpayer is unable to pay, it might be that the rules, while generally acceptable, did not adequately reflect her particular family situation, employment circumstances or health

100. See e.g. Tax Topic 204, *supra* note 31; *IRM*, *supra* note 19, § 5.8.1.1.3 (2013).

101. Goode, *supra* note 96 at 17.

102. Goode's definition is as follows: "Ability to pay taxes is the capacity for paying without undue hardship on the part of the person paying or an unacceptable degree of interference with objectives that are considered socially important by other members of the community." *Ibid.*

care needs. Perhaps her occupation demands that she incur extraordinary expenses that are not recognized by the rules, or perhaps some disaster or misfortune has drastically affected her assets while leaving her tax debts intact. In short, it may be the case that some idiosyncrasy of her situation has made it such that the tax laws of general application do not produce an equitable result in her case.

In those cases, compromise would not reduce the equity of the system. On the contrary, to forgive some portion of those debts would be to correct inequities in the tax system. To design a compromise system that isolates these cases may prove a significant challenge. As a first step, I suggest admitting that our tax system is not perfectly equitable and that, in some cases, forgiving a portion of a taxpayer's debt will be the most equitable course. The next step is to suggest that the pool of cases in which a taxpayer is unable to pay her tax debts is a reasonable pool to draw from in considering where the system may have gone wrong in estimating taxpayers' abilities to pay.

B. Collecting More of the Tax Assessed Under the Statute

An objector might argue that the tax system is, if not perfect, at least perfectible. If there are inequities in the system, it might be preferable to attempt to correct them, rather than implement a stopgap measure. Similarly, an optimist might hope that over time and on a large scale, the various inequities in the system would work themselves out. Or, even if inequities exist in the tax system, one might argue that the *Income Tax Act* represents our best collective judgment about what an equitable tax system looks like. The appropriate trade-offs between equity and other tax policy concerns have already been made, and the results of those choices should be enforced, not compromised, by the tax collector.

If the taxing statute is our standard of equity, then the path to more equity is simply better compliance. From this starting point, the question then becomes whether the tax authority can compromise to improve compliance or increase collections. The answer is not as clear as it is when discussing administrative savings. Even if we are persuaded that there are cases where vigorous pursuit of all available remedies costs more than it is worth, and that a compromise would result in a better financial situation for the government, we might be willing to spend that extra money in

pursuit of debts for the sake of ensuring that each taxpayer pays his fair share.

However, there are at least two ways in which we might expect compromises to increase equity under these assumptions, both of which are contained in the US offer-in-compromise model. The first is to set the bar for compromise at an increase in the amount collected, as the US offer-in-compromise program does. Thinking only in terms of the efficiency of administration, we might want the tax authority to make a rational economic decision based on the amount it could collect through its collection powers, the cost of pursuing that collection and the administrative cost of the compromise program. To increase the equity of the system, we would want to ensure that the accepted compromise narrows the gap between the tax assessed and the tax collected. That is, the taxpayer should offer more than the tax authority expects to be able to otherwise collect.

In the US, studies of the offer-in-compromise program indicate that tax debtors can and do offer more than the IRS is able to collect otherwise. To fund a compromise offer, debtors borrow from family, friends or commercial lenders, or draw from retirement assets that the IRS would not otherwise levy or seize.¹⁰³ As a result, accepted compromises allow the IRS to collect more, on average, than it is able to collect when it rejects an offer. Accepted offers also tend to result in more collection than the IRS collects on the general pool of debts that are still unpaid after two years.¹⁰⁴

The bargain also has the potential to improve compliance over time, even if equity is sacrificed in the short term. If forgiving a tax debt creates some inequity in the current year (or over the past several years), but makes the system more equitable in the future, the result might be an increase in equity overall. The offer-in-compromise program attempts something like that by making the compromise contingent on the forgiven taxpayer's compliance over the next five years. As noted above, the offer-in-compromise program in the US has had significant success

103. See US, National Taxpayer Advocate, *2007 Annual Report to Congress*, vol 1 at 379 [NTA, *2007 Annual Report*].

104. See Oei, "Getting More", *supra* note 5 at 1083–85 (summarizing findings of the National Taxpayer Advocate's 2006 report). See also NTA, *2007 Annual Report*, *supra* note 103.

at encouraging voluntary compliance among previously non-compliant taxpayers.

Moreover, in discussions about sacrificing some equity in the present to gain compliance (and therefore equity) in the future, it is important to remember how much equity the system stands to lose. In the Canadian context, where the Crown's tax claims rank as ordinary, unsecured claims and can be discharged in bankruptcy, the CRA should be able to successfully identify cases in which the government has relatively little to lose by agreeing to a compromise.

C. Compromising with Tax Policy Goals in Mind

One possible objection to the inclusion of more forgiveness in the tax system is that Canadian taxpayers already have several avenues to have their debts forgiven. Canadian policy-makers have simply chosen to locate most of these outside the tax system for the sake of preserving the integrity of the system. Indeed, Canadian taxpayers have several possible avenues to pursue a compromise or settlement of their tax debts: the partial forgiveness under the taxpayer relief provisions; the total forgiveness possible with a remission order; and the discharge of a debt that might be accomplished using the *Bankruptcy and Insolvency Act*. However, none of these offer the combination of administrative simplicity and the ability to be tailored towards tax policy goals as a full compromise mechanism located within the tax system itself would.

Remission orders can be recommended by the CRA—through the Minister of National Revenue—but can only be given by the federal cabinet. According to the wording of the provision, remission orders are to be granted where “the collection of the tax or the enforcement of the penalty is unreasonable or unjust or that it is in the public interest to remit the tax or penalty”.¹⁰⁵ This wording sounds something like the equitable stopgap that I suggest a compromise procedure might be, but it lacks any other benefits. Remission orders are necessarily rare. The process is not tailored to benefit the government as a creditor, nor does it reflect concerns specific to tax policy.

The taxpayer relief provisions have similar properties. They may be less administratively burdensome than remission orders, but they offer little

105. *FAA*, *supra* note 61, s 23(2).

opportunity for the government to improve its position as a creditor. The amount of relief they can provide is limited. In most cases, the analysis will focus on the circumstances that prevented timely compliance with the *Income Tax Act*, and what steps the taxpayer took to try to comply, ignoring whether the debtor has the resources to pay the full debt.

When all else fails, the CRA accepts less than it is owed in bankruptcy proceedings. As discussed above, most tax debts are treated as ordinary, unsecured claims in bankruptcy. However, prior to insolvency, the Crown is not an ordinary creditor in an important sense. Other creditors have the option of working with the debtor to restructure or settle their claims. They have the option of making the rational decision to accept less than they are owed for the sake of collecting sooner and avoiding bankruptcy proceedings. The CRA has strong powers to enforce collection prior to bankruptcy, but is constrained in settlement talks in a way that other creditors are not.

Moving more of our decision making about forgiveness of tax debts into the tax system, rather than leaving it to the federal cabinet or the bankruptcy system, would allow the compromise mechanism to be designed with tax policy goals in mind. Bankruptcy and insolvency legislation is animated by a number of factors and concerns: a desire for the orderly settlement of debts, fair treatment of creditors, a fresh start for the debtor and so on. Tax policy, on the other hand, reflects concerns for equity among taxpayers, economic efficiency and the administrative practicality of the tax system.

In some cases, the goals of tax policy and of insolvency law are well-aligned. Both demonstrate sensitivity to economic efficiency and the functioning of the market. However, the equitable or fairness goals of insolvency regimes are usually said to be limited to fairness or equity among creditors, while tax policy aims for fairness or equity among all members of society. Compromise in the tax system could be geared toward this broader equitable concern.

Moreover, removing the prohibition against pre-bankruptcy settlement of tax debts would arguably be more consistent with the framework of the 1992 reforms to the bankruptcy system. The policy underlying those amendments was to have the bankruptcy process treat tax debts (other than withholdings) in the same way as it treats other debts. Authorizing the Minister to settle tax debts—just as other creditors

can settle—would more closely align the treatment of tax debts with other debts before insolvency.¹⁰⁶

D. Responding to Concerns About Moral Hazard

A reader who has followed me this far may be satisfied that a compromise procedure would yield practical administrative benefits and might not violate equity, but may still have concerns about the incentives that a compromise procedure may create. Taxpayers might be more inclined to make risky investments or to increase their consumption where they know that forgiveness of tax debts is available. This is an application of the “moral hazard” concept that evolved from the study of insurance and is now commonly applied in many areas of law.¹⁰⁷ Broadly speaking, moral hazard refers to the “perverse consequences of well-intentioned efforts to share the burdens of life”.¹⁰⁸ More concretely, in the area of insurance, where the concept originated, moral hazard refers to a natural tendency to engage in riskier behaviour (or do less to mitigate risks) when the risks are insured.¹⁰⁹

One way to think about the offer-in-compromise program is as a mechanism for sharing the risks of default on tax debts, and so moral

106. See generally CRB Dunlop, *Creditor-Debtor Law in Canada* (Toronto: Carswell, 1981) at 27–38 (on the formalities required for an ordinary creditor to properly accept less than full payment, which vary slightly depending on the province).

107. See Tom Baker, “On the Genealogy of Moral Hazard” (1996) 75:2 *Tex L Rev* 237 at 237 (Baker reports that the concept comes up in the law and economic analysis of such varied areas as health care, banking regulation, products liability and business law).

108. *Ibid* at 239.

109. See Steven Shavell, “On Moral Hazard and Insurance” (1979) 93:4 *QJ Economics* 541 at 541. *A Dictionary of Economics* defines “moral hazard”, in part, as follows:

The observation that a contract which promises people payment on the occurrence of certain events will cause a change in behaviour to make these events more likely. For example, moral hazard suggests that if possessions are fully insured, their owners are likely to take less good care of them than if they were uninsured. The consequence is that insurance companies cannot offer full insurance. Moral hazard results from asymmetric information and is a cause of market failure.

John Black, Nigar Hashimzade & Gareth Myles, eds, *A Dictionary of Economics*, 3rd ed (Oxford University Press, 2009) *sub verbo* “moral hazard”.

hazard concerns can be raised.¹¹⁰ However, the literature on moral hazard also suggests the solution to these concerns. The moral hazard literature recognizes that deductibles and co-insurance are ways of reducing the effect of moral hazard. The mechanism can be explained as follows: If moral hazard results from the difference between the actual loss and the loss as “felt” by the insured, deductibles and co-insurance offer ways to reduce the gap between actual loss and felt loss, and thereby reduce the moral hazard.¹¹¹

The offer-in-compromise program may appear generous, as a large debt may be forgiven with the payment of only a small fraction of the amount owed. However, there should be little doubt that the forgiven debtor is made to feel the loss in a substantial and lasting way, as she commits to pay as much of the tax debt as her financial situation allows. In addition to the fee and the non-refundable deposit, offers are only accepted where IRS officials are satisfied that the offer represents substantially all of the debtor’s ability to pay. The requirement of compliance for five years further ensures that the repayment is “felt” by the debtor for some time. Moreover, it is worth keeping in mind that, in this context, imposing the full liability on the tax debtor is usually not an option. Thus, the gap that ought to be considered in discussing the moral hazard added by the compromise procedure is not the gap between the actual loss and the loss felt by the debtor, but the gap between the loss that would have been felt without the compromise (via bankruptcy, for example) and the loss felt through the compromise procedure.

E. Responding to Concerns About Accountability

A final possible objection relates to accountability. Only the federal cabinet currently has the power to remit a tax debt. An offer-in-compromise program would give similar (though more tightly controlled) discretion to unelected public servants. Even if the government stands to collect more tax money without violating the tax policy principles of equity, neutrality and administrative simplicity, some may have concerns about whether the principle of equality before the law

110. See Oei, “Social Insurance”, *supra* note 5 (Oei develops the idea of tax non-collection as a form of social insurance).

111. See Baker, *supra* note 107 at 270.

(or the public perception of equality before the law) requires that political actors retain direct responsibility for the forgiveness of tax debts.

In thinking through this concern, it is important to remember that the CRA already has wide discretion on how and whether to take collection action, and has limited resources with which to pursue tax debts. So, while the CRA has no discretion to compromise a debt for the purpose of collecting more or sooner, it is necessarily forced to choose which debts to pursue and which debts not to pursue. Moreover, the public has very little information about these decisions. Some information is provided in the CRA's annual report, and more detail is uncovered periodically by the auditor general.¹¹² Given the sparseness of the public's current information about the CRA's collection efforts, an offer-in-compromise procedure that includes aggregated tracking and reporting of accepted compromise offers and amounts collected might represent a modest improvement in the accountability and oversight of these processes.

Conclusion: Review of Design Considerations

While the case for some theoretical compromise program is made out above, the details of such a program would be significant. I have suggested several possible justifications for compromise and each might suggest slightly different criteria that a compromise program should consider. To conclude, I return to the various design considerations to examine the question of whether a program could be devised that would meet all of the goals.

To satisfy a concern about administrative practicality, the program ought to accept offers where the result is a net gain for the fisc, taking into account the amount of the offer, the amount that the tax authority can reasonably expect to collect if it rejects the offer, the cost of pursuing those collection methods and the cost of processing the compromise. There is a certain amount of uncertainty we can expect in performing this calculation. The amount of the debt that could be collected is never certain until the debt is either paid in full or discharged in bankruptcy. However, we can safely assume that those charged with tax collection have enough experience to make a reasonable, educated decision about

112. See e.g. CRA, *Annual Report*, *supra* note 6; OAG, *Spring Report*, *supra* note 6.

whether the compromise is likely to net more revenue than the exercise of their collection powers would.

However, an approach to forgiveness in the collections context that takes equity seriously might require more of the taxpayer that seeks to have a debt forgiven. We might consider equity to have been sacrificed if the tax authority compromised simply to save the cost of fully pursuing collection action. On the other hand, if the compromise allows the tax authority to obtain as much or more than they expected to be able to collect, and assuming that the tax authority's expectations are informed and reasonable, it becomes very difficult to argue that the compromise has decreased equity in the system. Even if the compromise creates inequities—perhaps because of the imbalance of information between the taxpayer and the CRA, the tax authority may underestimate the amount that could be collected—these temporary inequities might be acceptable if the taxpayer follows through on a promise to be compliant in the future, improving the long-term equity of the system.

An offer-in-compromise program also needs to take seriously the incentives created by a compromise system. To this end, the *Carter Report* recommended that all compromises be made public.¹¹³ The American offer-in-compromise program currently requires an application fee and a non-refundable deposit, which are also likely to be helpful in curbing abuses of the program. I suggested above that we need not be overly concerned about the risks of moral hazard for two main reasons. First, while the American offer-in-compromise program forgives a debt and thereby socializes the risk of inability to pay a tax debt, it also ensures that the tax debtor is made to bear as much of the loss as possible. While the actual loss is still greater than the loss felt by the debtor, the loss felt is significant. Second, these risks are already socialized in other ways. The discharge of tax debts in bankruptcy and the broader social safety net already provide tax debtors with some insurance against the risks of default. To be clear, we cannot expect to eliminate the effect that the introduction of a compromise program would have. Where it is available, some taxpayers will change their behaviour and end up relying on the program. I suggest, however, that measures can be taken to reduce the frequency and intensity of this problem, as in the United States. Moreover,

113. *Carter Report*, *supra* note 1, vol 5 at 149.

in the Canadian context where bankruptcy discharges tax debts, it seems that the tax authority has little to lose.