inconstitutionnelles et ont accordé des remèdes innovateurs comme les injonctions structurelles, les tribunaux canadiens, influencés par la doctrine anglo-saxonne d'équité, sont allés beaucoup plus loin quant à l'exigence du respect de l'équité procédurale et des principes de justice fondamentale dans les processus décisionnels affectant la vie, la sécurité et la liberté des personnes incarcérées dans les pénitenciers.

Au Canada, les études portant sur les impacts de l'intervention judiciaire et de la reconnaissance des droits fondamentaux des personnes incarcérées sont quasi-inexistantes. Des études empiriques et théoriques plus poussées contribueront non seulement à la compréhension du développement de ce mouvement et de ses effets mais apporteront aussi des éléments additionnels de réflexion dans le débat sur la valeur de la protection constitutionnelle des droits et libertés et sur la légitimite et l'efficacité de l'intervention des tribunaux dans ce contexte. Les résultats de mes propres recherches sur l'émergence et l'impact du droit carcéral au Canada indiquent que l'intervention judiciaire dans ce domaine a forcé le législateur et l'administrateur a intégrer dans la loi et la pratique les exigences jurisprudentielles concernant le respect de la règle de droit pendant l'incarcération proprement dite[262] et sous le régime des libérations conditionnelles.[263] Les tribunaux ont ainsi contribué a l'émergence d'une nouvelle justice carcérale, leur intervention a suscité l'adoption de normes législatives respectant la dignité humaine, l'équité procédurale et les droits fondamentaux et leur implication a, dans les faits, entraîné plusieurs améliorations concrètes dans le cadre des pratiques décisionnelles. L'analyse des diverses modifications législatives ou réglementaires adoptées sous l'impulsion décisions judiciaires témoigne de l'importance primordiale de l'intervention judiciaire dans l'engendrement de ces nouvelles normes de justice carcérale.

Il est permis de penser que, sans cette intervention judiciaire importante et constante et sans la constitutionnalisation des droits et libertés, la reconnaissance législative des droits fondamentaux des personnes incarcérées au Canada aurait été beaucoup plus lente.

262 L. Lemonde, "L'evolution des normes dans l'institution carcerale" (1995) 10:1 *Rev. can. Droit et Societe/Can. J. Law & Society*, 125-170; L. Lemonde, "Historique des normes juridiques dans les penitenciers au Canada" (1995) 28:1 *Revue Criminologie*, 97-117.

263 L. Lemonde, "L'impact de l'intervention judiciaire sur l'evolution des normes canadiennes en matiere de liberation conditionnelle" (1995) 40:3 *Revue de droit de McGill/McGill L.J.*.

OBSTACLES TO EQUITY: AN ANALYSIS OF THE TAXATION OF DISABILITY INCOME IN CANADA AND PROPOSALS FOR REFORM

by
David Schulze*

Canadians must rely on a variety of public and private sources of income replacement in case of disability, ranging from Workers' Compensation to civil litigation. Their tax treatment is inconsistent: some are taxable income while others are exempt.

Inconsistent treatment creates inequities between disabled individuals; it also prevents the integration of benefits from different sources. For certain programs, exemptions for contributions and taxation of benefits creates inequities between able-bodied contributors and disabled beneficiaries.

The Carter Commission recommended deduction of premiums and the taxation of benefits for Unemployment Insurance and private disability insurance so that only the net increase in wealth was taxed. But the final result benefitted contributors at the expense of beneficiaries. Since social assistance and Workers' Compensation remained exempt, a horizontal inequity was created in relation to beneficiaries of comparable programs.

Personal injury damages are tax-exempt, apparently because part of it is compensation for injury, pain and suffering. But even beneficiaries of pure income replacement programs also suffer these non-economic losses due to their disability.

The only consistent treatment of disability income is to make it all taxable or all exempt.

Including personal injury damages under comprehensive taxation would create major administration and collection problems. Taxing provincial programs such as social assistance, Workers' Compensation and public automobile insurance would reduce net benefits while producing the most revenue for the federal government.

A comprehensive exemption would create greater equity between able-bodied contributors and disabled beneficiaries, provided it was accompanied by taxation of all contributions to income replacement programs which would also balance the lost tax revenue.

Des obstacles à l'équité: analyse de l'impôt sur le revenu des invalides au Canada et propositions de réforme

Les Canadiens invalides doivent chercher diverses sources publiques et privées de revenu de remplacement, depuis les prestations de la Commission des accidents du travail jusqu'aux actions civiles. Or, le classement de ces revenus par Revenu Canada est inconséquent: certains sont imposables, d'autres non.

Cette inconséquence crée des injustices entre différents invalides et empêche l'intégration des prestations provenant de diverses sources. Dans certains régimes, les exemptions consenties aux cotisants et l'imposition des prestations crée des iniquités entre les cotisants valides et les prestataires invalides.

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La commission Carter a recommandé la déduction des primes et l'imposition des prestations reçues de l'Assurance-chômage et des régimes privés d'assurance-invalidité, de sorte que seule l'augmentation nette du revenu serait imposée. Mais cette mesure a profité aux cotisants aux dépens des prestataires. L'aide sociale et les prestations de la Commission des accidents du travail restant exemptes, une iniquité horizontale a été créée parmi les prestataires de programmes pareils.

Les dommages-intérêts pour blessures corporelles sont exempts, apparemment parce qu'ils sont adjugés en partie pour les douleurs et souffrances. Mais les prestataires de simples programmes de remplacement de revenu souffrent tout aussi bien des pertes non économiques par suite de leur invalidité.

En fait, le seul traitement conséquent du revenu reçu par suite d'une invalidité est de l'imposer ou de l'exempter quelle qu'en soit la source.

Or, imposer les dommages-intérêts pour blessures corporelles poserait de grands problèmes d'administration et de perception. Le gouvernement fédéral gagnerait plus à imposer l'aide sociale et les prestations de la Commission des accidents du travail et de l'assurance-automobile publique, mais une telle mesure diminuerait les gains nets.

Une exemption compréhensive assurerait une plus grande équité entre les cotisants valides et les prestataires invalides, à condition que soient imposées toutes les cotisations versées aux programmes de remplacement de revenu. Cette condition compenserait également la perte de recettes fiscales.

Little thought seems to have been given to the national taxation policy in relation to the disabled. The legislation is a patchwork of rules. It has grown up bit by bit over the years. The pieces often do not fit together. There is no meaningful overall policy, no well-rounded whole.

There are only fragments of a policy. This policy seems to be that "the government will help some of the disabled, in some ways, some of the time." This is understandable perhaps; so too does the common law unfold. But it cannot be allowed to continue thus.[1]

I. INTRODUCTION[2]

Canadians cannot count on any single, integrated program for income security in case of disability.[3] If impairment of a psychological or physical function prevents a person without other resources from earning employment or business income, she faces a long list of potential sources of income replacement but social assistance is the only one for which every Canadian is potentially eligible. By contrast, countries such as Finland, Sweden and the Netherlands have universal disability pension programs available to all individuals, supplemented by earnings-related disability benefits.[4]

1 Canadian Rehabilitation Council for the Disabled, *A Brief to the Royal Commission on Taxation*, September 1963.

2 I would like to thank Professor Neil Brooks of Osgoode Hall Law School for his helpful comments on an earlier draft of this paper, as well as the anonymous reviewers for this journal.

3 S. Torjman, *Income Insecurity: The Disability Income System in Canada* (Toronto: G. Allan Roeher Institute, 1988).

4 I.R. Zeitzer & L.E. Beedon, "Long-Term Disability Programs in Selected Countries" (1987) 50 *Social Security Bulletin* 8.

Canadian income tax law matches the varied sources of available income replacement with inconsistent treatment: some forms of disability income are taxable, while others are tax exempt. This is proof of either confusion or disinterest by the legislature in the face of the financial problems of the disabled.

Inconsistent treatment for different forms of disability income prevents the primary goals of Canadian tax policy from being achieved. These goals are horizontal and vertical equity, neutrality, and simplicity. Overall, the tax system results in horizontal inequity among the disabled, vertical inequity between the disabled and the able-bodied, and a lack of both neutrality and simplicity.

The goal of horizontal equity in tax policy seeks to ensure that "individuals and families in similar circumstances bear the same taxes."[5] Under the Royal Commission on Taxation's definition, "vertical equity requires that those in different circumstances bear appropriately different taxes."[6] Those with the highest incomes have the most spending money left over after making non-discretionary expenditures and should bear progressively higher tax rates. This allows the system to "redistribute some of the power to consume goods and services in favour of the lowest income groups",[7] who otherwise have little left over after their non-discretionary expenditures.

In addition to being equitable, Canadian tax policy also seeks to achieve a certain level of neutrality and simplicity. That is, taxes should not by themselves distort social and economic choices and it should be possible to assess tax liability with reasonable ease and certainty.[8]

Currently, the only discernible goal in the tax system's treatment of these programs is that for some of them, such as private disability insurance and Unemployment Insurance (which includes sick benefits), tax law seeks horizontal equity between the disabled who receive benefits and the able-bodied employed who earn identical amounts of money from their work.

I believe that the main goal of tax policy for the disabled should be to achieve vertical equity by shifting more of the tax burden from disabled people to those whose ability to earn an income has not been impaired and who are better able to bear the burden. Most of the disabled are significantly poorer than those able to earn employment or business income.[9] If the comparison is made between a beneficiary and a contributor under any one particular income-replacement program, this will always be the case because none of them offers 100 per cent income replacement.

In this paper, two options for reform are evaluated: making all forms of disability income taxable or making all forms exempt. I argue for total

5 Canada, Royal Commission on Taxation, *Report: Taxation; Introduction, Acknowledgments and Minority Reports*, vol. 1, (Ottawa: 1966) at 4.

6 *Id.* at 4-5.

7 *Id.* at 6.

8 C.M. Allan, *The Theory of Taxation* (Harmondsworth: Penguin Books, 1971) at 38-39.

9 A survey conducted in 1986 among disabled adults living outside of institutions found that 57.3 per cent had a total annual income of less than $10,000: Canada, Statistics Canada, *The Health and Activity Limitation Survey; Highlights: Disabled Persons in Canada* (Ottawa: 1990) at 5-17.

exemption because it would increase both horizontal and vertical equity, would be easier to administer and, if accompanied by certain other changes, might increase tax revenues.

II. A BRIEF SURVEY OF DISABILITY INCOME SOURCES AND TAXATION

There is no single category in the *Income Tax Act*[10] for the income to which a disabled person is specially entitled. There is a non-refundable credit for those with a "severe or prolonged mental or physical impairment"[11] which reduces tax liability for those with a long-term disability. However, its primary purpose is to compensate for the costs associated with prolonged disability, as demonstrated by the fact that it is integrated with the credit for medical expenses and that both these credits are transferable to a spouse or supporting relative, presumably because they help pay these costs.[12]

At the same time, a disabled person in Canada may be eligible to receive income under a variety of public or private plans, ranging from sick pay to Veteran's disability pensions, and may also be able to recover money for personal injuries through civil litigation. The tax treatment for this income is as varied as the sources themselves, as demonstrated by Table I. For instance, private pensions are generally counted as taxable income whether or not they are for disability,[13] but a few are covered by exemptions based on the identity of the recipients, such as those for members of the Royal Canadian Mounted Police and for veterans.[14] The two most common forms of long-term income replacement receive completely opposite treatment: Workers' Compensation benefits were made tax exempt by statute in 1942, merely confirming departmental practice,[15] while Canada Pension Plan (CPP) disability benefits have been taxable since the Plan's inception in 1966.

If the tax treatment of income designed to compensate for disability is inconsistent, then the inability to earn income because of a disability is effectively treated as an occasional, unusual or accidental condition. The only other form of income to which its treatment seems comparable is prizes, some of which are exempt, while others are taxable. For instance, scholarships and prizes "for achievements in a field of endeavour ordinarily carried on by a taxpayer" are taxable.[16] On the other hand, winnings from lotteries and other contests, as well as "any prize that is recognized by the general public and that is awarded for meritorious achievement in the arts, the sciences or service to the public" are tax exempt.[17]

10 S.C. 1970-71-72, c.63 as am.

11 *Id.*, ss. 118.3, 118.4.

12 Approximately 30 per cent of the taxpayers who claim the credit are spouses or supporting relatives of the disabled: Ontario Fair Tax Commission, *Fair Taxation in a Changing World* (Toronto: University Toronto Press, 1993) at 316.

13 S.C. 1970-71-72, c.63 as am., s.56(1)(a).

14 *Id.*, s.81(1)(d)(e) and (i). War disability pensions were originally tax exempt, became taxable in 1933 and were exempted again during World War II, Canada, Royal Commission on Taxation, *Specific Types of Personal Income* (Study No. 16) by D.J. Sherbaniuk (Ottawa: 1967) at 272.

15 *Id.* at 254-55; S.C. 1942-43, c.28, s.4.

16 S.C. 1970-71-72, c.63 as am., s.56(1)(n).

17 *Income Tax Regulations*, Consol. Regs. of Canada, c.945 as am., Part LXXVII. This

TABLE I: Tax Treatment of Disability Income

Source	*Treatment*
military service disability pension	not taxable
Workers' Compensation benefits	not taxable (but included in income for calculation of means-tested credits)
R.C.M.P. disability pension	not taxable
personal injury damages or settlement	not taxable
investment income from personal injury damages or settlement:	
within a structured settlement	not taxable
investment income on lump sum damages or settlements:	
person under 21 years	not taxable
person over 21 years	taxable
no-fault automobile insurance disability benefits	not taxable
Criminal Injuries compensation	not taxable
wage benefits (sick pay)	taxable
private short- or long-term disability insurance or trust benefits:	
group plan with any employer contributions	taxable; employee contributions deductible when benefits received
individual plan or group plan paid for solely by the employee	not taxable; contributions not deductible
life insurance disability payment	not taxable; contributions not deductible
private disability pension	taxable; contributions deductible when made, 17% credit against up to $1000 in benefits
Canada and Quebec Pension Plan	taxable; 17% credit disability benefits against contributions when made
Unemployment Insurance sick benefits	taxable; 17% credit against contributions when made
social assistance	not taxable (but included in income for calculation of means-tested credits)

Yet if disability is not seen merely as random misfortune, but rather as a potential occurrence in the lives of all income-earners, then consistent treat-

provision could be called "the Nobel Prize exemption." Presumably this exemption applies even if the arts or the sciences are the taxpayer's "ordinary field of endeavour", so long as the prize enjoys sufficient public recognition and rewards "meritorious achievement."

ment can ensure that the amount of net (after-tax) replacement income available to those affected will be predictable, regardless of its source. In addition, if it is inevitable that a certain proportion of income-earners will become disabled, then it becomes important to consider their financial position specifically in relation to those who remain able-bodied and employed.

III. EVOLUTION OF THE TAX STATUS OF PUBLIC PROGRAMS: FROM THE CARTER REPORT TO THE PRESENT

1. Introduction

The most concrete disadvantage of disability for most individuals is that it interferes with their earning an income through business or employment. If they cannot work, public programs, such as Workers' Compensation, Unemployment Insurance (UI), the Canada and Quebec Pension Plans (CPP/QPP) and social assistance, are the forms of income replacement for which they are most likely to be eligible.

Only tax-exempt Workers' Compensation is designed specifically to address disability, but it does not cover workers disabled outside of the course of their employment. Most wage-earners will be eligible for taxable UI sick benefits on a short-term basis and most of those who earned business or employment income will have made sufficient contributions to the CPP/QPP to be eligible for their taxable disability benefits on a long-term basis. For those with no other resources, tax-exempt social assistance remains a last resort.

The failure of the tax system to address the role of public programs other than Workers' Compensation as disability income has produced arbitrary differences in net income between individuals who suffer from similar disabilities but rely on different forms of income replacement. This has been one of the major sources of horizontal inequity among the disabled.

Some individuals will also be covered by private plans, especially disability insurance. Recipients of these benefits are treated differently based on who paid the premiums, but the result is also that some are treated differently from those who are dependent on certain tax-exempt public forms of income replacement. This is an additional source of horizontal inequity.

The taxation of both UI and private disability insurance was directly addressed by the Carter Report[18] in 1966 and its advice was largely followed in the federal government's 1972 tax reform. An examination of the treatment which the Report proposed for these forms of income demonstrates the assumptions — as well as the misapprehensions — on which much of the current tax system is based. The Report did not compare these two sources of income to other programs which are designed to address roughly similar needs, and the resulting legislative changes extended the inconsistent treatment of disability income under the tax system.

18 Canada, Royal Commission on Taxation, *Report: Taxation of Income; Part A - Taxation of Individuals and Families*, vol. 3, (Ottawa: 1966) at 525 [hereinafter "Carter Report"]. While the Carter Report's recommendations were not adopted in their entirety they were the major inspiration for the 1972 tax reform and provided the most complete statement of its purpose and motivation.

2. The Carter Report's recommendations for UI and its silence concerning social assistance

While UI obviously protects income against economic contingencies, its sick benefits also make it a temporary disability program for most wage-earners. The Carter Report's discussion therefore offers an explicit rationale for the taxation of one form of disability income which can be tested against the criteria of vertical and horizontal equity set out in this essay. The Report's dominant concern was neutrality between different forms of income generally, but not between forms of income replacement, nor equity between those with and without employment income.

When UI benefits became taxable in 1972, premiums also became eligible for a deduction,[19] converted into a credit in 1988.[20] The Carter Report argued:

> Not to tax unemployment insurance benefits would bestow a tax advantage on the man who, despite the fact that he was unemployed for some time during the year, had a larger total income, including unemployment insurance benefits, than the man who worked full time for lower wages.[21]

The Report had also unsuccessfully recommended the taxation of Workers' Compensation benefits after a background paper insisted on "the manifest inequity of exempting these payments from the tax base, when working taxpayers receiving remuneration in the same amount must pay tax on it. ..."[22] The issue was therefore neutrality between unemployed beneficiaries and employed workers eligible under the same income replacement program. An Ontario study later confirmed that taxing UI benefits would achieve "important intra-class transfers from individuals who receive unemployment insurance benefits to individuals who obtain income only from wages and salaries."[23]

It seems that for the Carter Report's analysis, the condition of being employed was the starting point — implicitly, "normalcy" — and so there was no exhaustive comparison of forms of income replacement, nor any concern for ensuring neutrality between them. The absence of any reference to social assistance in its recommendations is striking. Carried over into legislation, the result is that a low-income earner who collects UI sick benefits set at 57 per cent of her salary, effectively pays the same tax as a co-worker who had to take a 43 per cent cut in pay over the same period. Yet she will likely end up keeping less money than if she had collected tax-exempt social assistance instead.

Consider a single person who began working in 1994 with weekly earnings of $290.79 (about $7.25 per hour) and fell ill after 35 weeks: if she collected UI sick benefits, she could have collected $165.75 per week (57 per cent of

19 R.W. Boadway & H.M. Kitchen, *Canadian Tax Policy* (Toronto: Canadian Tax Foundation, 1980) at 65.

20 S.C. 1970-71-72, c.63 as am., s.118.7.

21 Canada, *Specific Types of Personal Income*, *supra* note 14 at 257.

22 *Id.*

23 Ontario, Department of Treasury and Economics, Taxation and Fiscal Policy Branch, *Analysis of the Federal Tax Reform Proposals; Staff Papers* (Toronto: 1970) at 62.

TABLE II: Tax Consequences* in 1994 of Unemployment Insurance Sick Benefits Compared to Ontario General Welfare for A Single Low-wage Earner

Unemployment Insurance		
35 weeks @ $290.79 salary		$10,177.65
2 weeks @ $ 0 waiting period		0
15 weeks @ $165.75 UI sick benefits @ 57% of salary		$ 2,486.25
Gross income		$12,663.90
Taxes	(gross x 17% less $1,097.52 + 54.5%)	–$ 1,630.50
GST credit	(maximum for a single individual)	+$ 304.00
Property Tax Credit	($250 + 10% of annual rent @ $4,968, less 2% of gross Income over $4,000)	+$ 573.52
Net income		$11,910.92
General Welfare		
35 weeks @ $290.79 salary		$10,177.65
4 months @ $663 General Welfare (includes maximum rental subsidy)		$ 2,652.00
Gross income		$12,829.65
Taxes	(salary × 17% less $1,097.52 + 54.5%)	–$ 977.49
GST credit	(maximum for a single individual)	+$ 304.00
Property Tax Credit	($250 + 10% of annual rent @ $4,968, less 2% of gross income over $4,000)	+$ 570.21
Net income		$12,726.37

*This example ignores both CPP and UI contributions deducted from pay and their corresponding tax credits because the effect is neutral for purposes of the comparison.

her salary) for a maximum of 15 weeks, after a two week waiting period. In the unlikely event that she was ineligible for UI benefits, she could instead have collected exactly the same amount on a monthly basis from Ontario's General Welfare, which for a single unemployable individual was set at $663 per month (4 × $165.75).[24]

Unfortunately for our hypothetical disabled claimant, she would have both previously worked enough weeks and have had a sufficient reason for leaving her employment in order to be eligible for UI. As illustrated in Table II, by the end of the year, collecting tax-exempt social assistance would otherwise have produced a $815.45 advantage, or the equivalent of almost five extra weeks of her UI sick benefits.[25]

24 R.R.O. 1980, Reg. 441 as am. This figure makes the assumption she receives the maximum $414 rental subsidy, not an unreasonable one if she is living alone in Metropolitan Toronto.

25 The two-week waiting period without benefits under UI seems to distort the example,

The Carter Report ignored this issue of neutrality between forms of income replacement. It was principally concerned with the possibility that an UI beneficiary who had spent part of the year working for high pay might obtain a tax advantage over someone who worked the whole year for lower wages. When the White Paper on Taxation endorsed taxing UI benefits in 1969, it extended this analysis with the following unsupported assertion:

> Many of the benefits are received by employees with average or higher than average incomes who are unemployed for relatively short periods, and whose annual incomes equal or exceed the annual earnings of others. The higher their incomes the greater the tax benefit.[26]

But while correct on the point that the exemption was regressive, the White Paper neglected to mention that so too was the proposed new deduction for premiums. Moreover, contrary to its assertion, the receipt of UI benefits was actually concentrated among low-income earners.[27]

The final result was to abolish a nominally regressive exemption on income which was mostly earned in the lowest brackets and to tax that income instead; at the same time the change added a deduction whose benefit was greatest in the higher income brackets. An Ontario study calculated that the increased revenue from taxing UI benefits would have substantially exceeded the loss due to the new deduction for premiums if it had been implemented in 1969. However the effect would also have been a net tax increase for all groups earning less than $5000 annually and a net decrease for all groups earning over $20,000; the largest decrease went to the group in the middle range, earning between $5000 and $9999.[28] The effect of the tax change was therefore to compound the same income inequality due to unemployment which the income replacement program was originally designed to address.

The need for income replacement itself never appears to have been part of the Carter Report's concerns regarding UI and it was never addressed. As we have seen, the Report instead reflected a concern that recipients might in some way gain an advantage over those who were eligible but continued to be employed.[29] Its approach to taxing UI as income, therefore, was to collect only the difference "between what the employee put into the plan, either directly or indirectly, and what the employee takes out," achieved by allowing

but even after imagining it away, the tax disadvantage remains, though it is smaller. In any case, someone applying for social assistance in Ontario after 35 weeks of paid employment would still "lose" one week of income in a year because social assistance is paid per calendar month, while UI is paid every two weeks.

26 E.J. Benson, Minister of Finance Canada, *Proposals for Tax Reform* (Ottawa, 1969) at 11.

27 *Supra* note 23 at 62-63.

28 *Id.* at 63.

29 It is difficult not to see in this recommendation the traditional conservative fear of rewarding idleness among the poor. The background study maintained "the case for taxation of unemployment insurance is strengthened" by the fact that seasonal workers were eligible even when they had no expectation of working in the off-season, and explicit reference was made to allegations that this group abused UI, *Sherbaniuk*, *supra* note 14 at 258, 274.

the taxation of benefits and the deduction of premiums.[30]

3. A comparison of the Carter Report's recommendations on disability insurance and Workers' Compensation

A similar preoccupation with taxing the gain derived by those who became eligible to collect benefits was applied by the Carter Report to private disability insurance:

> A procedure that permitted the deduction of all contributions and then brought into income all benefits received would ensure that each beneficiary was taxed only on the net increment in his tax base, regardless of the extent to which the increase in economic capacity was derived from the employer contribution, the property income, or the mortality gain or loss.[31]

Deductibility thus avoided the difficulty of distinguishing for tax purposes not only the small amount of investment income on the insurance policy's savings element, but more importantly, the gain enjoyed by a claimant who collected more in benefits than she had contributed in premiums.

There is a perfect internal consistency to this analysis, which analogizes the "mortality gain" realized by being able to collect insurance benefits "early" to a gain on the relatively small amount of capital invested in premiums, and thereby renders it taxable income.[32] However, when the "gain" on which taxes are imposed arises precisely because of the inability to earn income, the results can be perverse. We have already seen that when the same logic was applied to the "unemployment gain" which UI beneficiaries enjoyed over those who "lost" by remaining employed, it produced regressive results as among all taxpayers who made contributions to the plan. For the beneficiaries themselves, the net value of their benefits was actually reduced and they ended up at a disadvantage relative to those in a similar position who were eligible for tax-exempt social assistance.

In the event, the government's 1972 tax reform did not apply even the perfect consistency to disability insurance which the Carter Report had recommended. The trade-off, which would have made premiums deductible in return for the taxation of benefits, was imposed only on group plans to which the employer had made some contribution and which were established after June 19, 1971.[33] On the surface, this measure reflected the White Paper's stated objective of redressing the advantage enjoyed by

30 Carter Report, *supra* note 18 at 525. This also meant there would be no need to bring the employer's contributions to the plan into the employee's taxable income as a benefit because they would be deductible in any case. The same reasoning applied to the entirely employer-paid Worker's Compensation premiums.

31 *Id.* at 437.

32 The Carter Report was in fact so blinded by the notion of a potential windfall that it categorized disability insurance not with "retirement income plans [which] are concerned primarily with long-term income maintenance", but within the "type of plan [which] is designed to provide shorter term income protection or lump sum payments in the event of income ceasing unexpectedly" — thereby entirely failing to see its use in providing continuing and regular payments in the event of a long-term disability, *id.* at 401.

33 S.C. 1970-71-72, c. 63 as am., s. 6(1)(f); *Income Tax Application Rules*, 1971, Part III, s. 19.

business-owners and the self-employed, by allowing workers to deduct more employment expenses (also an explicit rationale for the deduction of UI premiums). But the fact that group plan premiums paid exclusively by employees were not made similarly deductible, suggests its principal effect was to avoid the somewhat complex process of apportioning a group premium among individual employees as a taxable benefit.

The provision did, however, attempt scrupulously to respect the Carter Report's desire to tax only the difference between premiums paid and benefits collected: the employee's portion of jointly-paid premiums are not a deduction against current income but only against the taxable benefits themselves and only premiums paid under the particular plan which pays the benefits are deductible.[34] Only wage-earners are affected by this provision, since Revenue Canada's policy is not to allow business-owners or professionals to deduct premiums for income-replacement plans (only premiums for insuring the business's overhead expenses are deductible).[35]

The postponed deduction of premiums does have the advantage of largely mitigating what would otherwise be the regressive aspect of any deduction. (Deductions from income are always regressive, since they are most valuable to those in the highest tax brackets.) But the provision was enacted in a period of low inflation and makes no adjustment for the declining real value of the contributions over time. As a result, the deductions actually made by disability insurance beneficiaries against that income are undervalued and, ultimately, beneficiaries are taxed on more than their real net gain under the policy.

The premiums for a plan paying taxable disability insurance benefits will generally be higher because larger payments are needed to provide the same net income. It may therefore seem surprising that an estimated 50 per cent of employers choose them over employee-only paid plans,[36] which would offer lower premiums, entirely deducted from employees' salaries. An underwriter's textbook explains that employer contributions are important because they ensure "careful and proper administration, which ... will help to eliminate abuses of the plan by certain employees."[37] That is, when employers have an "active interest" in the policy, they become an intermediary to discourage claims.[38] The perverse effect of this is simply to increase the relative importance of employer-paid premiums, deductible as a business expense, in comparison to benefits taxable as personal income.

34 Thus an employee who changes employers or is merely transferred so as to be covered by a different plan will lose the possibility of deducting previous premiums from future benefits received, Canada, Revenue Canada, Taxation, *Interpretation Bulletin: Income Tax Act, Wage Loss Replacement Plans*, No. IT-428 (30 April 1979) at para. 13.

35 Canada, Revenue Canada, Taxation, *Interpretation Bulletin: Income Tax Act, Overhead Expense Insurance* v. *Income Insurance*, No. IT-54 (26 May 1975). This position was upheld in *R.* v. *MacIntyre*, 75 DTC 5240 (F.C.A.).

36 A. Kyle & D. Thibeault, "Opposing Forces" (July-August 1991) 15 *Benefits Canada* 18 at 18.

37 G.N. Watson & B.R. Ouimet, "Elements of Group Insurance" in *CLU Textbook Library* (Don Mills: The Institute of Chartered Life Underwriters of Canada, 1984) at 6-13.

38 This process is described in detail in D. Schulze, "The Industry of the Living Dead: A Critical Look at Disability Insurance" (1993) 9 *J.L. & Social Pol'y* 221 at 205-207.

It is also important to note that the 1972 tax reform failed to adopt the Carter Report's recommendation that Workers' Compensation benefits be taxed. The maximum Workers' Compensation benefit level in most provinces is 75 per cent of gross earnings or 90 per cent of after-tax earnings, while long-term disability insurance plans generally pay between 50 and 70 per cent of gross income, usually reaching the higher level only when benefits are taxable.[39]

As a result, a single individual under 65 collecting insurance benefits would have incurred a tax liability in 1994 if her pre-disability income had been any more than $15,704.29. At 70 per cent replacement, this income would produce disability insurance benefits higher than $10,993.00, the combined amount of income entitled to the basic personal, disability and maximum individual Goods and Services Tax credits.[40] A person whose "severe and prolonged mental or physical impairment"[41] arose in the course of employment would be entitled to entirely tax-exempt Workers' Compensation benefits. With the same pre-disability income as our hypothetical insurance beneficiary, the maximum level of benefits might easily produce a higher gross income replacement of 75 per cent, whose value the tax exemption would then only increase.

The effects of the Carter Report's recommendations on disability insurance, especially after their inconsistent implementation by Parliament, look roughly similar to those for UI. The results are regressive as between all those covered by a plan because they produced a net reduction in the income available to actual beneficiaries, while allowing a tax exemption for employer's contributions made on behalf of those who remained employed and able-bodied. The measure also created a horizontal inequity between those collecting taxable private insurance benefits and those eligible for tax-exempt Workers' Compensation.

IV. THE EXEMPTION FOR PERSONAL INJURY PAYMENTS AND WHAT IT TELLS US ABOUT DISABILITY AND TAXES

1. The current exemption for personal injury recoveries

Another important source of income for the disabled is an award of damages that may be obtained by suing a person who is responsible for their condition. There is no provision in the *Income Tax Act* which includes damages for personal injury as income and the case law holds that they are not taxable because from the point of view of the recipient they are "in no sense earned or gained in the pursuit of any calling or trade or from property but arose from the injury done him."[42]

At the same time, under Canadian common law and in the application of the Civil Code in Quebec, the courts do not take into account the effect of taxation on future earnings when assessing damages for their loss.[43] This is entirely appropriate, since a discount for taxes would detrimentally affect the plaintiff and benefit the tortfeasor, without yielding any revenue to the state.[44] However, it leaves open the question of why the injured party should do better than the *status quo ante* to which tort law is intended to return her, by receiving lost wages free of tax.

No explicit rationale for the exemption of personal injury recoveries exists, but it is most often attributed to the difficulty of categorization: the payment of damages in tort law "encompasses recoveries for both economic harms, such as medical expenses, lost wages, and earning capacity, and noneconomic harms, such as pain and suffering, and humiliation."[45] A leading American case suggested that the exemption reflects "apparently a feeling that the injured party, who has suffered enough, should not be further burdened with the practical difficulty of sorting out the taxable and nontaxable components of a lump sum award."[46]

Some support for this explanation is found in the fact that, traditionally, Canadian courts did not identify the components of tort damages, though in recent years judgments increasingly itemize the grounds for the amounts awarded.[47] Moreover, the exemption has been extended to no-fault automobile insurance benefits, even though they may explicitly categorize the purpose of the amounts paid. (The personal injury exemption's hold on the fiscal imagination may also explain the long-standing exemption for Workers' Compensation benefits.)

2. The effect of the current policy: Disability without trauma, benefits without exemption

The most significant distinction between most tax-exempt forms of disability income and those which are taxable, such as private disability insurance and CPP/QPP disability benefits, is that the latter are paid without a requirement to identify any traumatic injury or any tortfeasor to which the disability can be causally linked. For instance, no-fault automobile insurance benefits receive the same treatment as settlements arising from an action in tort and are tax-exempt. Disability insurance benefits are also paid regardless of fault, but they are taxable.

Many people owe their disability to chronic illness, for which it is usually impossible to identify a single cause. With nobody to sue and no clear link to their work, their disability entitles them to only three possible sources of income: social assistance, private disability insurance or CPP/QPP disability

39 L.E. Coward, *Mercer Handbook of Canadian Pension and Benefit Plans*, 10th ed. (North York: CCH Canadian Ltd., 1991) at 190, 188; Kyle & Thibeault, *supra* note 34 at 19.

40 The threshold figure could be somewhat higher depending on provincial tax credits, such as for property and sales tax.

41 The test, with a medical certificate, for the disability credit, S.C. 1970-71-72, c.63, s.118.3(1).

42 *Cirella* v. *R.*, [1978] C.T.C. 1 (F.C.T.D.) at 5.

43 *R.* v. *Jennings et al.*, [1966] S.C.R. 532; J.-L. Baudouin, *La Responsabilité civile délictuelle*, 4th ed. (Cowansville: Éd. Yvon Blais, 1994) at 179.

44 I owe this insight to J.M. Dodge, "Taxes and Torts" (1992) 77 *Cornell L.R.* 143 at 161.

45 *Id.* at 145.

46 *Roemer* v. *Commissioner*, 716 F.2d 693 (9th Cir., 1983) at 696, as cited in R.J. Henry, "Torts and Taxes, Taxes and Torts: The Taxation of Personal Injury Recoveries" (1986) 23 *Houston L.R.* 701 at 709-10.

47 J.P. Weir, *Introduction to Structured Settlements: Concepts, Issues and Income Tax Considerations* (LL.M. Thesis, York University, 1982) at 102-104.

benefits.[48] Schemes which are designed to preclude tort actions, such as Workers' Compensation, remain hopelessly biased towards traumatic injuries and rarely compensate chronic illness.[49]

When an individual receives compensation after a traumatic injury, whether under a no-fault scheme or after an action in tort, at least notionally the amount includes compensation both for lost wages and for the injury itself. By contrast, disability insurance or CPP/QPP benefits for chronic conditions are designated simply as income replacement. As we have seen, pure income replacement is fully taxable, while compensation which refers at least in part to physical or psychological injury, is tax exempt.

The problem with this difference in tax treatment, however, is that those with a chronic or degenerative condition do not actually suffer a qualitatively different loss. For instance, whether a leg is lost in an automobile accident or atrophies over time due to a congenital disease, the use of it is still lost. In that sense, even disability benefits nominally paid only to compensate for lost income can be said always also to include an element of compensation for personal injury. Tax theory suggests this in a somewhat perverse way by categorizing an element of the benefits as a "mortality" gain, correctly providing the insight that the income is linked in part to an actual loss of part of one's person.

3. Is disability lost income, lost capital, or a loss beyond measure?

If any compensation for disability must necessarily include elements of both income replacement and payment for personal injury, then their differing tax treatment risks violating the goal of simplicity. Any error in categorization would either undertax or overtax the benefits received. For instance, if only the income replacement element in damages from tort actions were taxable,[50] it would be both possible and in a plaintiff's interest to have the largest part of them designated non-taxable compensation for the personal injury sustained, pain and suffering. On the other hand, it would be completely impossible for a person suffering from a degenerative disease to have any part of QPP/CPP disability benefits designated as anything other than income replacement.

One solution to this problem of categorization is to view all compensation for personal injury as being merely another form of income replacement. The Carter Report took this position when it recommended taxing Workers' Compensation benefits and proposed that this should include lump sums received in the event of death or permanent disability. It reasoned: "Most

48 A 1979 study of Canada Pension Plan disability benefit applicants found that tumours, circulatory and musculoskeletal diseases accounted for 75 per cent of their disabling conditions, "Canada Pension Plan Disability Applicants Study", (Canada, Health and Welfare Canada, 1983) 4 *Research Note* at 3.

49 P.C. Weiler, *Protecting the Worker from Disability: Challenges for the Eighties* (Toronto: Ministry of Labour, 1983) at 16, 50, 56-57. For instance, only 1.84 per cent of Workers' Compensation claims allowed in Ontario in 1980 were for industrial disease.

50 As suggested by E. Yorio, "The Taxation of Damages: Tax and Non-Tax Policy Considerations" (1977) 62 *Cornell L.R.* 701 at 734.

of these payments are made to compensate for lost income that would have been taxed had it been received."[51]

But on tax law principles, the Carter Report's assumption that all personal injury compensation is income replacement is a bit too simplistic:

> At first it seems plausible to include [as taxable income] recoveries relating to lost earning capacity, because they represent an acceleration of includible wages. However, the recovery can equally be characterized as the loss of an asset, namely, wage-earning capacity, commonly referred to as "human capital," the present value of which is determined with reference to lost future wages.[52]

Something other than simply future wages, then, has been lost and is being compensated.[53] Yet the definition of the loss as representing human capital also proves to be unsatisfactory:

> [It] produces nonsensical results for very young taxpayers. In addition, it is inconsistent with other tax rules, including the tax system's normal treatment of human capital. If a personal injury involves a loss of human capital, then it follows that there should be a deduction for **un**compensated personal injury losses; however, no such deduction exists. Further if one has basis in human capital, there should be depreciation deductions to offset wages, but again none exist.[54]

My contention is that there is no satisfactory resolution to this debate. When physical or psychological functions are permanently impaired, it is impossible to characterize the nature of the loss adequately using distinct and limited categories, such as income replacement or compensation for the loss of income-earning capacity.

To subscribe to either the view that compensation for such a loss is only replacement of future income, or that it replaces merely income-earning capacity, is to endorse human alienation through tax law. Such views suggest that healthy human minds and bodies have no meaning outside their role in the production of commodities for exchange. Clearly both emotional and physical health also have a separate and intrinsic value: two healthy legs, to return to the example above, allow not just a walk through the work site but also a walk through the woods. Any attempt to express the loss suffered through disability in exclusively monetary or productive terms will always be inadequate. Tort law attempts to acknowledge the full nature of the loss with heads of damage both for lost earnings and for pain and suffering.

If, in the final analysis, our physical and mental capacities have an

51 Carter Report, *supra* note 18 at 526.

52 *Supra* note 44 at 151.

53 The Supreme Court held "it is earning capacity and not lost earnings which is the subject of compensation" in tort, *Andrews* v. *Grand and Toy Alberta Ltd.* [1978] 2 S.C.R. 229 at 259.

54 *Supra* note 44 at 152-53.

ineffable value, then compensation for their loss will never fit comfortably into tax law categories. Distinguishing the portion paid for lost earnings from that paid for pain and suffering within particular forms of disability income, would prove so difficult that arbitrary distinctions would inevitably be made and some of the disabled would continue to be overtaxed in comparison to others.

The most coherent response to this difficulty is therefore either to leave all of the income untaxed because it includes an indeterminate element which bears no real connection to earnings, or to tax all of the money received because the element which ought to be exempted can never properly be distinguished from the part which merely replaces income.

V. COMPREHENSIVE TAXATION OR EXEMPTION: PROPOSALS FOR REFORM

1. The need for consistency

The consistent tax treatment of disability income is important to its recipients because without it no neutral combination of benefits is possible from among the many sources potentially available to disabled Canadians. So long as some forms of disability income are taxable and others are exempt, disabled individuals will be subject to arbitrary changes in their net income, especially if they make the wrong choices from among the programs for which they are eligible, or when tax-exempt benefits under one program become integrated with taxable income from another.

It is not unusual for programs to have rules designed to integrate these different sources: for instance, most private insurance plans make the Canada or Quebec Pension Plan (CPP/QPP) the first payer whenever beneficiaries are eligible for its taxable disability benefits and merely supplement CPP/QPP up to the promised income replacement level.[55] But the integration of gross benefits, without taking the tax consequences into account can have perverse results. Harry Beatty has pointed out that a person collecting CPP disability benefits in Ontario at a level low enough to get the Guaranteed Annual Income Supplement for the Disabled (GAINS-D) from the province's social assistance program will, if she is not deemed eligible for the disability credit by Revenue Canada, pay enough tax on her CPP to be worse off than if she had never collected anything but social assistance.[56]

Currently a disabled person who is unaware of the tax consequences may choose benefits which actually leave her with a lower net income than necessary, such as failing to pursue tax-exempt Workers' Compensation benefits if taxable payments from an employer-paid insurance program are available.[57] If she does understand the tax implications, she might conceivably make a choice which distorts public finances, such as delaying an application for taxable benefits from a self-liquidating plan such as CPP/QPP until the normal retirement age and collecting social assistance instead, which is paid for out of current government revenues.[58]

If the tax system is to give disabled people neutral choices about the forms of income available to them and ensure that those in similar circumstances receive the same treatment, either all forms of disability income should be made taxable or all of them should be tax-exempt. The remainder of this paper will discuss the advantages and disadvantages of total exemption and comprehensive taxation, but my conclusion is that total exemption is simpler both for the disabled and in terms of collection.

2. Comprehensive taxation: theoretical consistency at the expense of simplicity

At first glance, comprehensive taxation of disability income appears preferable in terms of neutrality, simplicity and even equity. The special expenses incurred by the disabled could be recognized through a more flexible and more generous Disability Tax Credit and medical expense credit.[59] However, not all of the disabled face major expenses, while most receive relatively low benefits. As a result, taxing benefits which are currently exempt will merely reduce the limited income available to the disabled unless such a measure is combined with an increase in the income tax threshold for low-income earners generally, since it is currently set far below the poverty line.[60]

Comprehensive taxation would also create a fiscal problem in federal-provincial relations because the three largest sources of disability benefits brought into taxable income would be the provincial programs of social assistance, Workers' Compensation and (where it exists) public automobile insurance. Without personal credits effectively high enough to maintain their beneficiaries' exemption from tax liability, the federal government would be increasing its own revenues. At the same time it would force the provinces either to increase benefits or see the net level of benefits paid decline.

Finally, comprehensive taxation would include personal injury recoveries, creating a formidable political and administrative challenge. A remarkable number of American scholars have recommended taxing damages for per-

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55 Coward, *supra* note 39 at 209-10.

56 H. Beatty, "Comprehensive Disability Compensation in Ontario: Towards an Agenda" (1991) 7 *J.L. & Social Pol'y* 100 at 139.

57 A disabled client represented by the author at Parkdale Community Legal Services in Toronto in 1992 declined to appeal the reduction of his tax-exempt benefits before the Workers' Compensation Appeal Tribunal (WCAT) because he was already assured of taxable private group insurance benefits and could not stand the stress of the WCAT hearing, due to his angina.

58 This example is hypothetical and such a choice would be very risky for a disabled person: if she were ever to be disqualified from social assistance after the limitation period for CPP or QPP disability benefits had expired but before retirement age, she would be left without any resources whatsoever.

59 This would respect L.A. Frolik's precept, "The use of income, not the source of income, should give rise to tax relief." See his article, "Personal Injury Compensation as a Tax Preference" (1985) 37 *Maine L.R.* 1 at 22.

60 Ontario, Fair Tax Commission, *Working Group Report: Low Income Tax Relief*, (Toronto, 1992) at 26-27, 33.

sonal injury,[61] but such a change appears unlikely for political reasons. Bertram Harnett long ago remarked that the exemption owes its existence to "the feeling that the taxation of recoveries carved from pain and suffering is offensive and the victim is more to be pitied rather than taxed." He concluded: "The great social feeling engulfs the tax logic."[62]

But neither do the advocates of taxing personal injury recoveries satisfactorily address the practical problems for both collector and taxpayer. For the disabled recipient of damages or a settlement, a major problem in paying taxes on the amount would be that of "bunching": if it is paid in a lump sum, she will receive a very large amount meant to compensate her for a permanent loss, all in a single year. Without any special provision, she would pay taxes on most of this lump sum at the highest marginal rate and would only benefit from a single year's worth of personal credits, deductions and exemptions.

It is obviously inequitable that money meant to support a disabled person over many years should attract a higher tax liability merely because it is paid at once, rather than in instalments. Reforming the law of damages to force plaintiffs to accept periodic payments might appear an easy solution to this problem. However, such a measure would arbitrarily deprive the plaintiffs of a degree of control over their financial lives and require them either to rely on the on-going solvency of the defendant or to choose a single form of investment immediately.[63]

Solutions based on the tax law mechanism of averaging have been proposed by advocates of taxing damages.[64] Unfortunately, none of these proposals give much consideration to the practical realities of tort victims. For instance, Lawrence Frolik proposes use of an existing American ten-year income averaging option for pension payments as a model,[65] but a young person who is permanently disabled in an accident could easily receive a lump sum meant to support her for another 50 or 60 years of life.[66] Similarly, Edward Yorio suggested damages could be declared and taxes paid in a single year: the taxpayer could then refile periodically and receive refunds while the injury lasts.[67] This would in effect leave the government paying a partial annuity to the tort victim, since the refunds would include an interest component.[68] But more importantly, the refunds could continue for a lifetime if the injury was permanently disabling.

61 Yorio, *supra* note 50; Frolik, "Personal Injury Compensation as a Tax Preference", *supra* note 59; M.L. Morris, "Taxing Economic Loss Recovered in Personal Injury Actions" (1986) 37 *U. of Florida L.R.* 735; M.W. Cochran, "Should Personal Injury Damage Awards Be Taxed?" (1987) 38 *Case Western Reserve L.R.* 43.

62 B. Harnett, "Torts and Taxes" (1952) 27 *N.Y.U.L.R.* 614 at 627.

63 In addition, the law of damages falls under exclusive provincial jurisdiction over property and civil rights under the *Constitution Act, 1867*, s.92(13) and it would not necessarily be changed for the sake of federal tax reform.

64 Frolik, *supra* note 59 at 11-12; Morris, *supra* note 61 at 742-43, 759-60; Cochran, *supra* note 61 at 49.

65 Frolik, *supra* note 59 at 12.

66 For instance, the plaintiff in *Andrews* v. *Grand and Toy Alberta Ltd.*, *supra* note 53.

67 Yorio, *supra* note 50 at 719.

68 S.C. 1970-71-72, c.63 as am., s.164(3).

The sophistication of the averaging mechanism which would be required is illustrated by the problem of medical expenses. The advocates of taxing damages agree this component should be deductible: "When a taxpayer is reimbursed for an expense that he incurred because of an injury, he is simply being made whole without any economic gain."[69] But as a general rule, the reimbursement of future medical expenses through damages will be taxed as part of a single lump sum at the highest marginal rate, while the deductions will take place at a much lower rate, year by year, as the expenses arise.

Proposals to deal with this problem include either a "radical anti-bunching provision" or something similar to deductions allowing carryover and carryback of certain disaster losses by businesses to years before and after they occur.[70] Not only would these proposed mechanisms still need to deal with the problem of deductible medical expenses which arose for the rest of the taxpayer's lifetime, it is obvious that they would subject a tort victim to continuing tax calculations of considerable complexity.

The example of medical expenses also illustrates a problem of tax collection on damages: it would be in the tort victim's interest to have as little as possible designated as taxable income replacement and as much as possible designated as deductible medical expenses. The government would frequently have to review the allocation of the amounts paid and would often have to revise them.[71]

The advocates of taxing damages point out that the tax system already frequently deals with problems of allocation,[72] especially in the context of business losses involving both lost profits and injury to capital assets.[73] Malcolm Morris has suggested using the plaintiff's pleadings as the starting point for the analysis, though he admits they may often not be available or may not be accurate and that the existence of a potential tax liability will bias their drafting.[74]

Finally, not all damages will fall under the headings of lost income and medical expenses. The more difficult category is compensation for pain and suffering. Legislators could take the decision to tax these amounts, which Frolik describes as the "forced conversion of a zero-basis asset" into income, that is, the replacement of a body part by money.[75] However, the public is unlikely to be won over by unsentimental arguments such as the following: "Once the income is received, it possesses the same value [as a body part] to the recipient and ought to be taxed as such."[76]

Taxation would subvert the goal of compensating pain and suffering by reducing the net amount,[77] so it seems likely courts would begin to gross up

69 Yorio, *supra* note 50 at 711.

70 Frolik, *supra* note 59 at 10-11; Cochran, *supra* note 61 at 50-51.

71 For an idea of the issues which could arise at the margins, consider the example from a decided case of a disabled person who deducted the cost of building a therapeutic swimming pool in his home, cited by Frolik, *supra* note 59 at 13.

72 Morris, *supra* note 61 at 744.

73 Yorio, *supra* note 50 at 708, 702-703.

74 Morris, *supra* note 61 at 750-51, 760-62.

75 Frolik, *supra* note 59 at 20-22, 23.

76 *Id.* at 31.

77 Yorio, *supra* note 50 at 733-34. However, this result would not be entirely unfair since,

the awards to take the tax loss into account, as they already do for awards for future care which earn taxable interest.[78] Yet as one judge has recently admitted, it is difficult for the court to be sure it is making the correct assumptions when calculating the future effect of tax rules on changeable factors such as income and personal expenses.[79]

On the other hand, if damages meant to replace income were taxable while compensation for pain and suffering remained exempt, the allocation problems discussed above for medical expenses could become even more acute: plaintiffs would attempt to estimate the first category as low and the second as high as possible.[80]

Comprehensive taxation of disability income would provide consistency. Unfortunately, without close cooperation by those administering programs which currently provide tax-exempt benefits, it could also result in a reduction of net income for many of the disabled. In addition, comprehensive taxation would have to include personal injury awards, but the timing of their payment would pose a serious bunching problem, while the elements of an award for which deductions would be justifiable on tax policy grounds would create a potential for misallocation and avoidance. On the grounds of simplicity, a comprehensive exemption is preferable.

3. The advantages and disadvantages of a comprehensive exemption

a) Revenue implications

The major disadvantage of achieving neutrality between forms of disability income by making all of it tax exempt is the revenue which would be lost. However, in practice the exemption would merely be extended to three more forms than under the current system: UI, the Canada and Quebec Pension Plans and employer-supported insurance plans.

It would not be enough simply to exempt the sickness and disability benefits of UI and CPP/QPP because of the risk of seriously distorting beneficiaries' behaviour. Most would naturally prefer to receive the more valuable tax-exempt benefits. Since the reasons for ceasing to work can be complex, those able to make some argument that sickness or disability was the reason for their retirement or unemployment would have a financial incentive to do so. As a result, the exemption would have to include all UI and CPP/QPP benefits.

A blanket exemption for UI and CPP/QPP should hold a certain attraction for the federal government, which is responsible for the two programs. If

as pointed out above, those who receive personal injury awards are not the only disabled individuals who experience pain and suffering, they are simply the only ones for whom a certain amount of compensation carries that designation.

78 *Watkins* v. *Olafson*, [1989] 2 S.C.R. 750.

79 Hugessen J.A. wrote in *Thibodeau* v. *Canada* [1994] 2 C.T.C. 4 (F.C.A.) at 14, that "income tax seeks to be precise, virtually to the last penny", but "the awarding... of damages is notoriously imprecise".

80 On the other hand, the cap the courts have imposed on this head of damages would limit its usefulness for tax avoidance, *Andrews* v. *Grand and Toy Alberta Ltd.*, *supra* note 53; *Thornton* v. *Board of School Trustees of School District No. 57*, [1978] 2 S.C.R. 267; *Arnold* v. *Teno*, [1978] 2 S.C.R. 287. The cap is also applied under the Civil Code in Quebec: Baudouin, *supra* note 43 at 173, 179-80.

all payments under these plans were to become tax exempt, the federal government would lose the income tax it currently collects on them, but their value to recipients would increase by the larger combined amount of federal and provincial taxes. As a result, the federal government would have increased the effective level of UI and CPP/QPP benefits without increasing the level of contributions.

Making all pension income received from CPP/QPP tax-exempt would also most logically be combined with an end to the pension income credit,[81] which currently offers a disproportionate benefit to those who retired from high-income employment. Since the credit is only available against pension income other than CPP/QPP benefits, it is useless to retired low-income earners whose employers did not offer private pension plans. (For example, in 1988 only 585,600 or 16.7 per cent of the 3,497,630 individuals who deducted contributions to Registered Pension Plans from their taxable income earned $20,000 or less).[82] The credit represented a tax expenditure estimated at $230 million in 1989 which would therefore be recouped.[83]

The revenue lost by making all disability income tax exempt could be off-set by bringing all contributions to group private health and disability insurance plans into taxable employment income, whether made by or for employees. The tax expenditure involved in not taxing employer-paid premiums for private insurance is considerable: it was estimated by the Department of Finance to be $1.14 billion in 1989,[84] while the Canadian Life and Health Insurance Association estimated a value of closer to $2.4 billion during a campaign to discourage taxation of premiums in 1993.[85]

Generally, it can be assumed that tax revenues will always be greater if contributions to any given scheme are counted as taxable income and the benefits are exempt. The reason is simple: there will always be more employed than disabled people and they will pay more in contributions than the disabled collect in benefits. For instance, Canadian life and health insurance companies collected $2.852 billion in premiums for insured disability income plans in 1990,[86] but paid out only $1.963 billion in disability income benefits.[87] Similarly, even under the actuarially less sound

81 S.C. 1970-71-72, c.63 as am., s.118(3)(7)(8).

82 My calculations based on Canada, Revenue Canada Taxation, *Taxation Statistics* (Ottawa, 1990), Table 2 at 107.

83 Canada, Department of Finance, *Government of Canada Personal Income Tax Expenditures* (Ottawa: 1992) at 13.

84 *Id.* at 12.

85 R. Howard, "It's hard to defend a three-martini lunch" *The Globe and Mail* (26 February 1994) B1 at B2.

86 This figure is arrived at by subtracting premium income for insured extended health care, supplementary hospital and dental plans from total premium income for insured accident and sickness plans, Canadian Life and Health Insurance Association, *Canadian Life and Health Insurance Facts* (Toronto: Canadian Life and Health Insurance Association, 1991) at 47, 45.

87 Data from a special Canadian Life and Health Insurance Association survey suggest that if creditor's disability insurance as well as accidental death and dismemberment benefits are taken into account, total benefits paid are somewhat higher at $2.096 billion, *id.* at 53.

UI plan, premiums were paid by 11,773,220 income-earners in 1988, while benefits were part of the income of only 2,846,370 tax-filers; for the Canada and Quebec Pension Plans, the 12,026,370 contributors vastly outnumbered the 2,522,950 pensioners.[88] Thus contributions will always provide a larger pool of potentially taxable income than will benefits.

Equally important is that because income security plans are always designed to provide less than full replacement, benefits will also be concentrated in lower tax brackets than those in which contributions are paid. For instance, in 1988 individuals earning less than $20,000 in annual income declared $5.735 billion in Canada and Quebec Pension Plan benefits, amounting to 60.55 per cent of all benefits declared. In the case of UI, individuals declaring less than $20,000 accounted for 48.17 per cent of all benefits declared at $4.883 billion, while the $1.098 billion the same group paid in premiums made up only 23.38 per cent of all tax-deductible contributions.[89]

Thus, even under a hypothetical scheme where total contributions to an income replacement plan were no greater than benefits paid out, taxation of contributions would produce higher revenues because they would be declared by individuals paying tax at a higher marginal rate. When disability is the reason for the income replacement, the difference is only increased to the extent that the tax liability is cancelled out by the disability and medical expense credits.[90]

Creating a total exemption for disability income would reduce tax revenues, particularly if income replacement benefits generally were made tax-exempt to avoid distorting choices. This could be compensated by eliminating certain provisions such as the exemption for disability insurance premiums and the pension income credit, whose benefits are in any case spread inequitably. In principle, taxing contributions to income replacement programs will always produce greater revenues than the benefits paid out because they are paid by a larger number of individuals with higher taxable incomes.

b) The case for eliminating all deductions for premiums

Higher revenue is not the only reason to tax contributions instead of benefits under income replacement programs. The standard analysis allows for two possible treatments. If all the contributions to the plan were included in taxable income, then benefits should be tax exempt because they were paid for with after-tax income. Alternatively, if premiums are deductible, a deferral of tax effectively takes place and must come due when the benefits are actually received. But it is difficult to design the proper deductions so that only the net increase in wealth derived from the plan is left over for the purpose of taxation.

As noted above, the Carter Report argued that if disability income were taxable and all contributions were deductible, the result would be to tax only

88 My calculation based on Revenue Canada Taxation, *supra* note 82, Table 2 at 107.

89 *Id.* The income distribution of Canada and Quebec Pension Plan contributions is not included because the allowable amount reported was capped at the lesser of $478 or two per cent of earnings, while all Unemployment Insurance premiums paid were reported.

90 S.C. 1970-71-72, c.63 as am., ss. 118.3, 118.2.

the net increase to the taxpayer's wealth. This was made up of employer contributions, the interest accumulated on the premiums, and the mortality gain or loss resulting from the time at which benefits were paid.

But if, as under the current rules for private disability insurance, premiums were deductible only when insurance benefits were actually received, those deductions would be too low because inflation during the intervening years would make their real value decline. On the other hand, if premiums were deductible when they were made, long before benefits might actually be received, they would be overvalued. Deductions would be against an employed person's income taxable at the highest marginal rate, but the benefits would replace less than 100 per cent of previous income and would probably be taxed at a lower rate.

Another justification for allowing the deduction of premiums under a scheme which provides for taxation of disability income categorizes the premiums as an employment expense. Under this analysis, benefits are seen purely as income replacement, but the premiums paid to secure them are not considered ordinary consumption, on the grounds that if no income replacement is ever paid, no true benefit is derived from them.

Yet if, as argued above, all compensation for disability includes not just income replacement, but also an element of compensation for personal injury, then it cannot simply be categorized purely as an employment expense and the cost of securing it should not be entirely deductible. Since it is impractical to apportion the two elements and make contributions partially deductible, counting the entire amount in taxable income is the simplest measure.

It should be noted that deductions for contributions to public plans, namely UI and the CPP/QPP, were changed to tax credits in 1988. Contributions to both schemes do not actually resemble insurance premiums, since they are based neither on the contributor's risk nor on her probable level of benefits, while benefits themselves are financed on a "pay-as-you-go" basis rather than on a strict actuarial basis. Instead, the contributions resemble a payroll tax and are regressive, since they are paid at a flat rate. The change in tax treatment seems to confirm this analysis. These contributions went from receiving the same treatment as employment expenses, namely deductions, to being counted as a credit against taxes owing.[91]

The standard view is that the gain under an income replacement program can be captured by making contributions deductible and benefits taxable. However, deductions for contributions are overvalued against income when they are made but undervalued in real terms against benefits received later. It is questionable whether benefits paid due to disability are pure income replacement, in which case contributions are not an employment expense and should not be deductible. Contributions to public plans most closely resemble a payroll tax and their treatment has already been changed from a deduction against income to a credit against taxes owing. It is preferable to allow income replacement plans to be paid for from taxable income and make their benefits tax exempt.

91 The government explained that the result would be more progressive. Canada, Department of Finance, *Tax Reform 1987: The White Paper* (Ottawa, 1987) at 32.

c) Some disadvantages of a total exemption

Any extension of tax-exempt status to more forms of income replacement poses the danger of creating a "poverty trap" for the recipients who might be able to find new employment. For instance, everyone on social assistance has a disincentive to join the labour market, because the loss of benefits and of in-kind assistance, when combined with the tax liability on new employment income, often leave them with a lower net income than before.

Fundamentally, however, these are internal problems of program design at least as much as of tax policy. For instance, in the case of CPP disability benefits, the strict eligibility test of being totally incapable "of regularly pursuing any substantially gainful occupation"[92] already means recipients will lose their entire entitlement if they attempt rehabilitative employment.[93]

Re-entering the paid labour force is a risky proposition which depends not just on the individual's physical abilities, but also on factors such as her age, skills, and the labour market where she lives. If an income replacement program's rules mean that a beneficiary cannot declare herself willing to test her job prospects, without thereby losing all of her benefits permanently, the possible tax consequences will not likely be the deciding factor which keeps her from trying.

A blanket exemption does pose problems of equity. Firstly, it risks creating a general horizontal inequity because recipients will receive their income exempt of tax even when their compensation reaches levels at which wage-earners would pay taxes.[94] But this inequity would occur only infrequently, since the actual amount of income replacement the majority of disabled people now receive is so low that many pay little or no tax.[95] For instance, the maximum amount of CPP disability benefits for an individual without dependent children in 1991 was only $743.64 per month or $8,923.68 annually.[96]

Except in the case of the most generous private plans, if such a horizontal inequity did occur it would actually indicate excessive taxation of low-income earners. The problem would be better remedied by co-ordinating the income tax threshold for wage-earners with the amounts available from this and other non-taxable public income replacement programs.

It is also worth asking whether horizontal inequity truly arises merely because the same gross income is taxed differently when earned by different people. The existing tax system already allows a range of personal characteristics to place different tax burdens on individuals with the same

92 Canada Pension Plan, R.S.C. 1985, c.C-8, s.44.

93 On this point, see Beatty, *supra* note 56 at 124-27.

94 The report proposing a universal compensation scheme for Australia recommended compensation be taxable for this reason, *Report of the National Committee of Inquiry: Compensation and Rehabilitation in Australia* (Canberra: Australian Government Publishing Service, 1974) at 166.

95 This was the view of a New Zealand report which recommended social security benefits remain tax exempt, *Report of the Royal Commission of Inquiry: Social Security in New Zealand* (Wellington: Government Printer, 1972) at 93.

96 Coward, *supra* note 39 at 189.

TABLE III: Tax-exempt Benefits As Replacement of Net (After-tax) Income

Annual pre-disability salary:	$30,000	60,000	100,000
Net* pre-disability income:	$23,750	41,300	62,385
Non-taxable benefits at 60% of salary	$18,000	36,000	60,000
Net ratio of pre-disability income replacement	75.8%	87.2%	96.2%

*Assumes 1991 Ontario and federal tax payable for a single employee with no dependants.
Source: Angus Kyle and Danielle Thibeault, "Opposing Forces" (July-August 1991) 15 *Benefits Canada* 18 at 19.

income, such as age, place of residence or family status.[97] Disability can be seen as a relevant criterion for distinguishing between individuals who may otherwise have equal resources.[98]

Another problem is that a comprehensive exemption is regressive as between disabled people. As illustrated in Table III, it will be most valuable to those with the highest level of benefits: the higher the marginal rates which were paid on pre-disability gross income, the nearer even a partial replacement with tax-exempt benefits will be to the person's after-tax income before the disability. The lower the marginal rate at which a person paid taxes on her pre-disability income, the less valuable the exemption would be to her.

Only the rules of income replacement programs themselves would provide some limit on vertical inequity between recipients: for instance, a provision setting an "all-source maximum" for benefits at 85 per cent of pre-disability income is standard in private disability insurance contracts and benefits are automatically reduced to this amount.[99] Similarly, Workers' Compensation benefits are generally set at a maximum of either 75 per cent of gross income or 90 per cent of net income.[100]

While the exemption would be of little value to disabled people whose total income is too low to incur a tax liability, the exemption would have a special value for those with high benefits and other sources of income. If all of the money these wealthier disabled people received as income replacement were exempt, then any unrelated income (such as interest or stock dividends) would be taxed at the lowest marginal rate and only after the application of personal credits. If there were no exemption, on the other hand, then the declaration of income security benefits would leave this additional income taxable at the top marginal rate.

97 L. Osberg, "What's Fair? The Problem of Equity in Taxation" in A.M. Maslove, ed., *Fairness in Taxation; Exploring the Principles* (Toronto: University of Toronto Press/Ontario Fair Tax Commission, 1993) 62 at 74.

98 See the discussion of criteria of relevance and horizontal equity in L. Green, "Concepts of Equity in Taxation" in *id.* 87 at 90-91.

99 *Supra* note 36 at 19.

100 Coward, *supra* note 39 at 190.

To deal with this problem, it would be possible to accompany even a total exemption with some form of clawback which would include disability benefits in income for the purposes of determining the marginal tax rate for other earnings. However, while such a measure seems appropriate for investment income which simply continues after the disability, if applied to new business or employment income, it could create a strong disincentive to considering rehabilitation and a return to the labour market.

Two exceptions even to an otherwise comprehensive exemption would have to be wage continuation (or sick pay) plans and disability provisions under private pensions, in order to avoid distorting choices about retirement and employment. Unlike private income replacement programs which only provide benefits in the event of disability, wages and private pensions will be received in any event. Making that income tax-exempt when it takes the form of sick pay or pension disability benefits could encourage borderline cases to define themselves as disabled, since a simple medical designation would produce a net increase in value. Sick pay and private disability pensions are already relatively unusual forms of disability income; if they were the only two taxable forms, it would probably make them quite unattractive means of income replacement compared to insurance plans.

VI. CONCLUSION

The patchwork of sources of income replacement for the disabled is matched by income tax law's inconsistent treatment of the forms they take.

The deduction of premiums and the taxation of benefits for UI and disability insurance were meant to ensure that only the net increase in wealth was taxed. But since they were applied only to some programs, the final result has been regressive as between all those insured, has reduced the net income available to beneficiaries and has produced a horizontal inequity between those collecting benefits under taxable and tax-exempt programs.

Disability income has also been distinguished based on whether it is a replacement of future income or compensation for injury. But even benefits nominally paid only to compensate for income lost to disability can be said to include an element of compensation for the impairment it causes, a loss which is more than merely financial. At the same time, personal injury payments always include some replacement of lost income.

The simple solutions are either to tax all income replacement in case of disability or none of it. Comprehensive taxation would capture provincially-run programs such as social assistance and Workers' Compensation. It would either increase the charge on provincial government revenues or else decrease their actual transfers to beneficiaries.

Comprehensive taxation would also have to include court-awarded damages and out-of-court settlements. This poses the political problem of taxing payments designated to compensate pain and suffering. It poses major administration and collection problems, since averaging or anti-bunching provisions would be needed to spread out the tax burden on lump sums, while difficult allocation problems would arise if medical expenses remained deductible.

A comprehensive exemption for all disability income, on the other hand, would create greater vertical equity between the able-bodied employed and the disabled because it would have to be accompanied by the elimination of all deductions for contributions to insurance and pension plans. As a result, that part of their income which the able-bodied spend to insure against disability would be taxed, while the income received based on disability would be tax exempt.

Tax revenues might actually increase, since total contributions to most plans are greater than the benefits paid and because income replacement is taxed at a lower marginal rate because it is never total. The tax revenue lost by exempting QPP/CPP, UI and disability insurance benefits could at least be recouped by taxing employer-paid insurance premiums and ending the pension income credit.

Consistent tax treatment in the form of an exemption would also ensure horizontal equity by removing an arbitrary difference in income levels among the disabled, even if it only increases the net income available to some.