Tax Working Group
Te Awheawhe Tāke

Tax Working Group Public Submissions Information Release

Release Document

February 2019

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[1]

From:	Walker, Robyn (NZ - Wellington) [1]
Sent:	Tuesday, 6 November 2018 2:42 PM
To:	TWG Submissions
Cc:	John Payne [1] Scott McCutcheon [1] McCalman, Patrick (NZ - Wellington); Ng, Brendan (NZ - Wellington)
Subject:	CTG - Feedback on TWG's Interim Report
Attachments:	CTG - TWG Place Mat Interim Report.pdf; F2-51-1980-eng.pdf; F2-241-1971-eng.pdf; Z1-1962-1-4-2-eng.pdf; CTG - TWG Interim Report Feedback (Final).pdf

Hi

Please find attached the following documents:

- The Corporate Taxpayer Group's feedback on the TWG's Interim Report.
- An accompanying one page infographic highlighting the Corporate Taxpayer Group's position.
- Background information in relation to Canada's capital gains tax / amortisation rules (as requested by TWG members).

Please let us know if you have any queries in relation to the attached.

Kind regards

Robyn

Robyn Walker
National Technical Director | Tax
[1]

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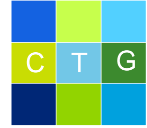


6 November 2018

Tax Working Group
via email: submissions@taxworkinggroup.govt.nz

Dear Tax Working Group

FUTURE OF TAX: INTERIM REPORT

Further to the feedback provided directly to TWG members and Officials at our workshops on 15 October, 29 October and 31 October 2018, the Corporate Taxpayers Group ("the Group") is writing to document this feedback provided on the Tax Working Group's *Future of Tax: Interim Report* ("the Interim Report").

The Group appreciates the opportunity to comment on specific issues that are of particular interest to our members. The Group is also appreciative of the work that the TWG and Officials have done to date, recognising the enormity of the task before the TWG and the wide breadth of issues that must be considered.

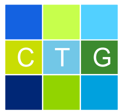
INTRODUCTORY COMMENTS

The Group has focussed its comments on the key issues that the Group has identified as the most important from the Interim Report. Given the scope of the Interim Report and the Group's varied membership, silence to an issue or lack of detail is not intended to be read as support (or a lack of support), but merely recognises the restricted timeframe and limited resources available to all stakeholders in this consultation process.

With this in mind, the Group notes that it is strongly concerned about the proposed timelines for legislating and implementing the changes arising from the Tax Working Group workstreams. The Group understands the desire to have tax policy in place ahead of the General Election, however this does not necessarily have to extend to having legislation 'ready in waiting'. The Group's concern is that, subject to the decisions made, there just is not enough time to complete the significant amount of work required, as what is being considered reflects a significant and broad overhaul of some key areas of New Zealand's tax system.

Following from this, the Group would also like to re-emphasise the importance that any changes arising from recommendations made by the TWG (and accepted by the Government) should be consulted on in full, in accordance with the Generic Tax Policy Process ("GTPP"). It is vital that detailed policy decisions are not made by the TWG without the proposals being considered by the wider public in the usual way. The Group would also support some or all of the TWG members staying on in an advisory capacity, post release

We note the views in this document are a reflection of the views of the Corporate Taxpayers Group and do not necessarily reflect the views of individual members.



of the Final Report. Given the wide range of issues and views that the TWG members have had to consider, the TWG members hold significant "IP" and are best placed to consider these potential changes to the tax system.

Where proposals require significant changes to systems and processes the Group would strongly support the deferral of the application date of these proposals until at least 1 April 2022. While at first glance many of the recommendations that have already been made (and those yet to come) may seem small, these will in reality require significant changes to systems and processes. These changes will have to be made by Inland Revenue, taxpayers and other affected third parties (such as financial institutions and fund managers), incurring significant costs and resources. This position is exacerbated when considering that whether some of these changes go ahead or not will be subject to a General Election – i.e. if a 1 April 2021 application date is retained, systems changes will have to be built well in advance, only to potentially be redundant if there is a change in government.

Some of the proposals not subject to major systems and process changes and the result of the general election should, subject to our comments below in relation to GTPP and productivity, be progressed as soon as possible where it is in New Zealand's best interest to do so.

Further, a number of the issues require careful consideration which should not be rushed. The full process of GTPP needs to be undertaken to ensure that issues are suitably considered and addressed. In this regard the Group considers that it would be useful to adopt a staged approach whereby issues are addressed with sufficient time allowed for proper consideration. The Group considers that given the immediate issue seems to be the under taxation of property that these issues should be addressed first. Once these are addressed, the taxation of equity and asset and business sales can be considered. This would allow sufficient time to ensure that the issues of double taxation, potential impacts on capital markets and productivity, the application of roll over relief etc are properly addressed to determine whether such reform should be undertaken and if so the form it should take. The Group is concerned that absent such an approach there is a risk of unintended consequences arising which may materially impact the economy.

As stated in a recent Productivity Commission Report, "*… many aspects of New Zealand's productivity story are under-researched, important parts of the analysis and policy conclusions offered … are in need of further work. For example, a deeper understanding of the impact of the tax system on capital intensity and productivity is highly desirable.*"[1] From the Group's perspective, it is important that such work is done before any changes are advanced, so that everyone is comfortable that what is being done is what is best for New Zealand.

This submission is separated into three appendices, covering:

- **Appendix One**: Extending the taxation of capital income
- **Appendix Two**: Taxation of savings
- **Appendix Three**: Business tax changes

We discuss these issues in more detail below. Please let us know if you have any queries in relation to this submission, or would like to discuss any of these points further.

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[1] Can the Kiwi fly? Achieving Productivity Lift-off in New Zealand; Paul Conway, New Zealand Productivity Commission (2018)
https://www.productivity.govt.nz/sites/default/files/Can%20the%20Kiwi%20Fly_Achieving%20Productivity%20Lift%20off%20in%20New%20Zealand_Paul%20Conway%200618.pdf (page 22)

For your information, the members of the Corporate Taxpayers Group are:

1. AIA Sovereign
2. Air New Zealand Limited
3. Airways Corporation of New Zealand
4. AMP Life Limited
5. ANZ Bank New Zealand Limited
6. ASB Bank Limited
7. Auckland International Airport Limited
8. Bank of New Zealand
9. Chorus Limited
10. Contact Energy Limited
11. Downer New Zealand Limited
12. First Gas Limited
13. Fisher & Paykel Appliances Limited
14. Fisher & Paykel Healthcare Limited
15. Fletcher Building Limited
16. Fonterra Cooperative Group Limited
17. Genesis Energy Limited
18. IAG New Zealand Limited
19. Infratil Limited
20. Kiwibank Limited
21. Lion Pty Limited
22. Meridian Energy Limited
23. Methanex New Zealand Limited
24. New Zealand Racing Board
25. New Zealand Steel Limited
26. New Zealand Superannuation Fund
27. NZME Limited
28. Pacific Aluminium (New Zealand) Limited
29. Powerco Limited
30. Shell New Zealand (2011) Limited
31. SKYCITY Entertainment Group Limited
32. Sky Network Television Limited
33. Spark New Zealand Limited
34. Summerset Group Holdings Limited
35. Suncorp New Zealand
36. T & G Global Limited
37. The Todd Corporation Limited
38. Vodafone New Zealand Limited
39. Watercare Services Limited
40. Westpac New Zealand Limited
41. WSP Opus
42. Z Energy Limited
43. ZESPRI International Limited

We note the views in this document are a reflection of the views of the Corporate Taxpayers Group and do not necessarily reflect the views of individual members.

Yours sincerely

[1]

John Payne
For the Corporate Taxpayers Group

APPENDIX ONE – EXTENDING THE TAXATION OF CAPITAL INCOME

1. Initial comments

1.1. As a general rule, most sophisticated businesses do not operate with the expectation of generating income through making capital gains; and on that basis the Group would not expect that a predictable stream of tax revenue could be gathered from imposing a capital gains tax on the sale of businesses / business assets. The Group should consider the fiscal implications of a CGT when the next significant market correction occurs given this will likely have a negative impact on government revenue.

1.2. However, the Group is of the firm view that any extension of the taxation of capital income must be designed deliberately and with care, to ensure that any identified inequity in the tax system is dealt with appropriately, without any unintended consequences potentially creating further inequity and without disproportional compliance costs being placed on business.

1.3. One of the goals of an extension of the taxation of capital income would be to incentivise greater investment in the productive economy. The Group generally supports greater investment in productive assets (and a corresponding move away from investment in the speculative economy), however the Group questions whether a broad capital gains tax will achieve this or whether the opposite will occur.

1.4. Based on the statistics provided in the TWG's background papers, 46% of investments by New Zealand households are taken out of the capital gains tax base (being owner-occupied housing).[2] This means that for a significant portion of the potential capital gains tax base, there will be no change in the taxation treatment.

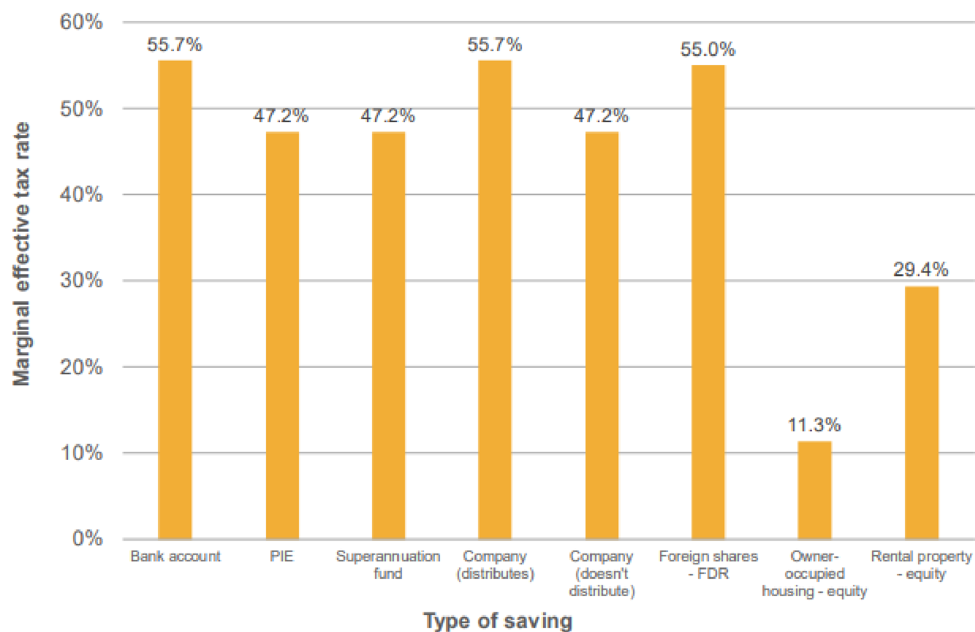
1.5. What is left, aside from non-owner occupied residential housing, is largely what have been termed 'productive investments' which are fully taxed on any income generated. If these are then taxed by a capital gains tax, this would increase the hurdle to invest in these assets, prima facie seemingly discouraging investment in these assets (as opposed to reallocating investment to these assets).

1.6. In a world of falling corporate tax rates, while the TWG recommends New Zealand should retain its 28% rate, the lack of a capital gains tax in a business environment is one of the very few competitive advantages the New Zealand tax system offers businesses looking to locate themselves in New Zealand.

Problem definition

1.7. As the Group understands it, the primary issue here is the under-taxation of owner occupied housing and other residential property. The Group refers to the effective tax rate table on page 40 of the TWG's *Future of Tax: Submissions Background Paper*.

[2] Extending the Taxation of Capital Income: Discussion Paper for Session 8.



1.8. The table above clearly shows that owner-occupied housing and rental property related savings are undertaxed relative to other assets.

1.9. The extended five-year bright-line test (and ring-fencing of rental losses if introduced) in part are designed to address these issues and should be given time to take effect, as these measures may sufficiently address any inequities in housing.

1.10. If, after the impact of these two measures has been evaluated, it is considered that more action is required, then other options should be considered (such as a capital gains tax targeted on residential rental properties)

A staged approach

1.11. In the Group's view, any extension of the taxation of capital income must take a staged approach, dealing with the most pressing area(s) / assets first (and reviewing the actual impact of introducing a capital gains tax on these assets), before expanding the scope of the capital gains tax wider to other assets.

1.12. This means that if a capital gains tax is to be introduced, it should initially only be introduced in relation to residential rental property, as this has been identified as one of the significant issues. The Group is of this view because:

- A broad extension of the taxation of capital income is not a simple task – it will require a significant overhaul of New Zealand's tax system.
- A staged approach recognises that there just isn't enough time and resources to introduce a more comprehensive capital gains tax at this stage. To rush the process risks introducing a capital gains tax that is poorly designed and ineffective in meeting its proposed goals.
- A targeted extension of the taxation of capital income to residential rental housing (excluding the family home) will be relatively easily implemented and will work with existing systems and legislation – no significant overhaul required.

- Any changes beyond this targeted approach will require extended consultation, with multiple discussion documents and a wide rewrite of the Income Tax Act 2007 – the consequences of which cannot be easily quantified.

- If poorly designed, a broad capital gains tax may have the negative effect of driving investment away from the productive sector. The Group is strongly of the view that such a broad tax should only proceed if it can be certain that that it will not have a negative impact on capital markets. The TWG should seek an updated figure 21 (above) taking into account the final model proposed by the TWG to ensure the tax rates do not result in material over or under taxation compared with the current position. Analysis should also be undertaken regarding the potential impact on the overall level of New Zealand capital available to be invest in the productive sector. Taxing gains on equity investments is likely to have significant and direct correlation with a material reduction in available capital as discussed further below.

1.13. We also note that there are a number of issues that still need to be worked through. We strongly recommend that these issues are worked through and taken into account by the TWG when determining whether to support CGT. The outstanding issues include:

- The taxation of livestock
- The taxation of land development costs
- How bad debt deductions of financial arrangements which are currently not deductible are incorporated in a CGT and the other issues noted on page 180 of the Interim Report.

Taxation of equity

1.14. The Group's main concern is that if a capital gains tax is introduced in relation to shares in companies and other equity interests, this may have a negative impact on capital markets. This concern is noted in the Interim Report on page 33 (paragraph 24).

1.15. The danger here is that this may drive capital investment in New Zealand away from the NZX and equity investments into growing companies and into other forms of investment[3], leaving New Zealand reliant on foreign capital (which will not be exposed to a capital gains tax). This would be contrary to New Zealand's national interest. It is vital that there are strong and available sources of capital for New Zealand companies to grow, and a strong and liquid New Zealand capital market (with domestic investors) is a critical part of this.

1.16. The introduction of a capital gains tax on equity is a taxation on the rewards that investors receive for taking risk. Care needs to be taken to ensure that the level of taxation on this activity does not dissuade investment from the productive sector and does not dissuade individuals from taking entrepreneurial risks. While it might be stated that other countries have a capital gains tax, the Group would note that New Zealand's tax system is very comprehensive and does not include tax concessions of the type that other jurisdictions commonly have in place (which have the effective of counter balancing any possible over taxation). For example, the Group understands that Australia's superannuation rules are overlaid to essentially negate the imposition of capital gains tax in a number of situations. Further, not only does New Zealand have a very comprehensive tax base it also has one of the highest corporate tax

[3] Particularly residential housing

rates. Both of these factors need to be carefully considered before introducing a further tax burden on the productive sector.

1.17. It may also have the unintended consequence of driving current New Zealand based entities offshore (and out of the New Zealand tax base) as they relocate to jurisdictions with stronger capital markets. Each such progression merely amplifying the negative impact on the New Zealand market with the risk of further migration as a result.

1.18. If a capital gains tax is introduced, some New Zealand corporates may consider that their New Zealand shareholders would face a lower tax under FDR, compared to a realised capital gains tax. As such, these corporates would be best to relocate out of New Zealand so that their New Zealand shareholders can obtain FDR treatment – an undesirable implication of these proposals.

1.19. In the Group's view, this is an area where extreme caution is required, and decisions should only be made once there is more information about the impact on capital markets. If it is clear that there will be a negative impact, any proposed capital gains tax should not be extended to equity.

1.20. More generally, the Group has concerns in relation to double taxation when taxing the gain from the sale of shares. There may be taxation not only of retained earnings to date, but also of future earnings. The premium on sale is the present value of future cash flows, therefore the taxation point is advanced, leading to double taxation. Any capital gains tax must deal with these issues appropriately, as the imputation rules do not cover all scenarios.

Compliance costs

1.21. The Group is very concerned about the significant increase in compliance costs that a capital gains tax regime would introduce into the New Zealand tax system. The potential cost of the regime to both taxpayers and Inland Revenue should not be underestimated (simply consider the number of assets which would need to be valued; there will be hundreds of thousands of them), and a cost-benefit analysis must be undertaken to determine whether the quantum of revenue that a capital gains tax would collect is sufficient to justify introducing such compliance costs.

1.22. To illustrate the potential compliance costs, we note that the South African capital gains regime has guidance of over 900 pages and anecdotally the Group understands that the cost of complying with the capital gains tax regime in Australia makes up a disproportionate portion of their tax system's compliance costs.

2. Design issues

2.1 If, despite our submissions above to the contrary, a more comprehensive capital gains tax is recommended, this following section discusses the critical design issues to be considered.

Roll-over relief

2.2 The Group submits that there must be wide rollover relief available to businesses if a capital gains tax is to be introduced.

2.3 By taxing capital gains, the taxation point of assets is brought forward, but without appropriate rollover relief this will lock businesses in, which becomes a particular issue in relation to underperforming assets i.e. there is an impediment to their

realisation and restructuring. If part of the function of a capital gains tax is to stimulate the productive economy, wide rollover relief is required to ensure that businesses can continue to expand and grow without an additional tax burden hampering economic growth.

2.4 In particular, this rollover should, at a minimum, extend to changes in corporate structure (such as demergers / spin outs, mergers and acquisitions and amalgamations), where there is no underlying change in the economic ownership. There will also need to be an allowance for small changes in ownership.

2.5 Rollover relief must also extend to disposition of assets where funds are realised but are subsequently reinvested. To not do so will lock businesses into an existing asset and significantly restrict their potential growth and increase in productivity. Further, imposes a cash tax cost reduces the equity available to the business.

2.6 This form of relief should also apply to business premises where they are sold and replaced with other business premises.

2.7 The Group supports transactions within a wholly owned group being excluded from the calculation of taxable income (i.e. they should be subject to rollover treatment, or be treated as excluded income like currently occurs with transactions between members of a consolidated tax group).

2.8 The Group also notes that there are some other situations where it will be appropriate to apply roll-over relief, but that these may not be covered by the factors above. Take the following two examples:

- Example 1: Company A and Company B both contribute assets to an incorporated joint venture, taking shares in the joint venture. This should qualify for roll-over relief despite not being a wholly owned group transaction, as to do otherwise would disincentivise such transactions and such productive activity (note the corporate has not realised its asset as it has unmarketable shares).

- Example 2: If Company X and Company Y were to merge, capital gains tax should not apply to the extent there has been a share transaction.

Loss ring-fencing

2.9 <u>All capital losses should be able to be offset against all income of a taxpayer</u>. If Government wishes to fully tax realised capital gains then it must also allow for the full tax deductibility (and in theory the refundability) of realised losses.

2.10 The Group considers that loss ring fencing results in the proposed CGT regime being unfair for many taxpayers and will introduce significant complexity and compliance costs (with associated enforcement costs for Government).

2.11 If there is a concern over taxpayers "cherry picking" for realisation but applying roll over relief for gains then the Group considers that the proper approach to such is a limited anti-avoidance rule which has a consistency purpose. Such rules already exist in tax legislation where similar arbitrages may exist (for example accrual versus market value methodologies).

2.12 It has also been suggested that a capital memorandum account could be established, for entities to record all such losses. Under this approach losses would only be allowed to the extent that they exceed total realised gains that have benefitted from rollover relief.

Goodwill

2.13 In the Group's view, there is a significant issue of double taxation in relation to goodwill, being the taxation of goodwill on the sale of the business by a vendor, then taxation again of the income of the purchaser that the goodwill brings in over time. Such goodwill recognises the present value of the future cash flows of the business over the funding rate. In this respect taxing goodwill represents a wind fall gain to the Crown that it brings forward the taxation of future earnings.

2.14 Reflecting that goodwill is the present value of future cash flows, the Group considers that <u>the proper treatment of goodwill should be to allow the purchaser to amortise goodwill over a period of time to match the tax cost on the cash flows which it represents</u>. To not do otherwise is akin to double taxation. Resolving this issue of double taxation is critical. Further, the conclusions reached on this matter have the potential to influence how we should tax equity.

2.15 The Group has appended to this submission a number of documents in relation to the amortisation of goodwill in Canada. Canada introduced both a capital gains tax (at a 50% inclusion rate) and a goodwill amortisation regime in 1972. The US allows amortisation of intangibles over 15 years.

2.16 The Group does not favour the view that goodwill should be seen as part of the cost of an asset and so not deductible until sale. This is based on two main rationales:

- Firstly as noted above the taxation of goodwill is an acceleration of cash flows to tax which should be offset as part of an amortisation regime;

- The reality is that business goodwill has a limited life. As businesses are disrupted and evolve, any goodwill acquired is unlikely to be the goodwill that exists on sale. In addition there are situations where goodwill has a finite life, for example goodwill associated with a fixed or terminating life. This occurs regularly when commission income streams are acquired where the underlying income stream has a finite life.

2.17 In the Group's view, goodwill is not a permanent asset but something that diminishes and must be replaced. Business disruption is real and significant and all industries need to reinvent themselves, as buying a business today does not automatically mean that it is worth something in the future. If a business remains stagnant the value of its brand will decline.

2.18 There is an argument raised by Officials that marketing / advertising type expenditure goes towards building goodwill (and so by proxy there are deductions allowed against goodwill). However the Group does not consider this to be the case. There are too many public instances of where businesses have failed to maintain the value of their brand, and have suffered as a result. Not allowing amortisation of goodwill results in a distortion between the treatment of organic goodwill, where all the costs are deductible as ordinary operating expenditure (as the expenditure does not have an underlying capital nature) and acquired goodwill, where the deductibility of the expenditure is effectively recaptured at sale and is then not amortisable for the purchaser. This distortion has the potential to negatively impact the efficiency of the market.

Consolidated groups

2.19 The consolidated group rules are a concessionary regime designed to ensure that companies that are part of a tax consolidated group are treated as a single company for tax purposes, recognising that this gives groups the flexibility to structure their affairs as they wish without needing to account for intra-group transactions. There are a number of issues to work through in relation to consolidated groups if a capital gains tax is introduced, as this would have the potential to undo what has been done in the consolidation regime. In particular, the impact on the tax cost base calculations need to be considered.

2.20 The Group would not like to see the rules used in this area in Australia, shifted over to New Zealand. The Australian rules are extremely complex and difficult to work through, and would introduce significant compliance costs and risk into the tax system.

Cost base / cash flow assumptions

2.21 In relation to fungible assets, the Group considers that taxpayers should be allowed to adopt their accounting cost flow and cost base assumptions.

2.22 In the absence of such then the cost flow assumptions should be similar to those allowed for trading stock (i.e. FIFO or a weighted average).

2.23 There are considerable issues to be worked through in relation to the tax basis calculations for shares. This is an extremely complex area and rules will be required to deal with all the transfers of value in and out of an entity. In practice, this has proven to an area of considerable difficulty in countries that have a capital gains tax. If a model can be developed where goodwill was amortisable, such that taxing / amortisation was simply a matter of timing, it might be possible in the context of an imputation regime to reach a conclusion that it is not necessary / appropriate to tax gains on shares (and not allow amortisation of cost base). Such as approach would remove all of this complexity as well as the issues in relation to the treatment of listed shares as discussed previously (domestic versus foreign, etc).

Transition

2.24 The Group has <u>significant concerns with the compliance costs that would be introduced by a valuation day approach</u>. There will be an overwhelming number of valuations to be undertaken / recognised and valuers will simply not have the capacity to undertake the quantum of work that is required[4]. It will be necessary to value all houses (other than the family home, acknowledging use of RV but noting the issues with credibility of such values), every business asset, the value of every business as a whole, individual business lines; the value of individual shareholdings in every company in New Zealand (listed and unlisted). Inland Revenue will also not have the resources to review all valuations as these assets are eventually sold. Further, such reviews may take place many years after the valuations were undertaken which may limit the effectiveness of any review.

2.25 In the Group's view, a time bar approach must be taken to valuations. I.e. taxpayers should have to file their valuations with Inland Revenue with respect to the commencement date, and the Commissioner should then have a four-year period to challenge this valuation. The Group notes that a similar approach was taken to

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[4] For example, it should not be assumed that the owners of over 600,000 residential rental properties would want to rely on rateable values or valuations generated based on computer algorithms

forestry i.e. standing timber. However there will be challenges to address with a filing approach, as large corporates will have fixed asset registers with thousands and thousands of line items, and thousands of shares etc, all of which must somehow have their value approved. In addition, the goodwill in each business will need to be separately identified and valued. When these numbers are extrapolated over the tax base, the Group just does not see how transition into the regime will work under a valuation day approach.

2.26 The Group notes that the median approach will be unfair to many taxpayers with significant compliance costs and uncertainty. Taxpayers who have recently acquired significant business will obviously have a higher cost whereas established competing businesses may have a significantly lower cost. The median rule, in the cases of subsequent capital losses produces a bias to newer business as opposed to older established business. Further, determining an historic cost, as well as market value on the effective date further increases the compliance burden (and risk). Many organisations have been in existence for decades, and in some cases more than a century, and having access to records for original cost; conversion of pounds to decimal currency; identifying all acquisitions, disposals and internally generated assets (including goodwill), over time from original inception of a business to ultimate sale will be extremely complex (if not impossible).

2.27 The Group would suggest that the compliance and enforcement costs of the valuation day approach (and median approach) are modelled to determine whether those costs outweigh the benefits or not.

2.28 If it is considered that there is an undue compliance burden, then consideration should be given to the Australian approach over the valuation day approach (i.e. to exempt assets acquired prior to the introduction of their capital gains tax). This will overcome the compliance costs issue of a valuation day approach. While delaying the collection of revenue, in the Group's view the savings in compliance costs more than makes up for this. It may be argued that such an approach may result in lock in, however this should not be any more the case than if a valuation day approach was used with appropriate rollover mechanisms.

2.29 The Group notes that a balance date approach is preferred for taxpayers (as opposed to a hard 1 April 20XX date) as auditors and directors will have scrutinised numbers and values already (instead of having to separately do this for the date of introduction of a capital gains tax). That is, we assume (or recommend) reference to 1 April 20XX is the beginning of the income year not the fixed date.

2.30 Appropriate 'acceptable rules of thumb' will need to be introduced as an alternative to reduce compliance costs (where taxpayers wish to take this option). These should include, at a minimum:

- The acceptance of the value being the accounting fair market value (i.e. where the IFRS rules are applied by the taxpayer to value assets at fair market values).

- The use of rateable value for real property, plus any capitalised costs incurred post the RV being published, noting that this is a blunt tool and other valuations such as QV or CoreLogic could be considered, as these provide more real time data of market values taking into account actual sales in the relevant area. This should include allowing taxpayers to take the next RV as some RV's may be historic.

- The use of a corporate share price to value its own business in the case, albeit unlikely, that it sells its entire business.

2.31 There are also issues with unlisted companies to consider, whether an asset is a capital gains asset or not (a line-drawing issue) and partial sales. Partial sales are a significant issue as businesses often only sell part of their business, for which there can be no single identifiable market value due to the nature of what is sold and the fact that there are no comparables, as all businesses are unique.

Safety measures

2.32 The Group acknowledges that various safeguards / rules will need to be put in place to prevent inappropriate outcomes from any capital gains tax. Where possible, these should be kept to a minimum and a general anti-avoidance rule (GAAR) should be used instead.

2.33 A GAAR would be preferable as opposed to having every transaction that is subject (or potentially subject) to capital gains tax having to incur significant compliance costs in taking unnecessary steps that are aimed every potential mischief. Given the stretched timeline and inevitable complexity of any capital gains tax legislation, the rules should be kept as simple as possible.

APPENDIX TWO – TAXATION OF SAVINGS

1. Initial comments

1.1. The Group considers that a strong domestic source of New Zealand savings would provide an alternative to the reliance that New Zealand has on foreign capital.

1.2. The Group supports a wider review of the taxation of savings to determine whether the current TTE regime acts as a disincentive to savings. In undertaking this review, the Government must be clear on its savings objectives.

1.3. Given the large portion of savings which even under a capital gains tax regime would remain in non-taxed owner occupied housing, the Group is concerned that further increasing the tax burden on savings (which a capital gains tax will do) may further discourage savings outside of the family home.

1.4. As it has already been decided that it is not possible to tax owner occupied housing for political reasons, rather than increasing the tax on other forms of saving, consideration should be given to lowering the tax burden to counter the current tax disincentive. This suggests a capital gains tax on savings and equity should not be advanced.

1.5. If a comprehensive capital gains tax is introduced, the whole area of savings will need to be revisited. For example, a more tax advantaged superannuation regime (such as that in Australia) should be considered to ensure that the overall tax impost is appropriate. Simply taxing all capital gains on equities at full marginal tax rates will put us materially out of step with Australia.

2. Specific issues

New Zealand shares are double taxed under a CGT

2.1 NZ shares are double taxed both in terms of undistributed earnings and also future earnings.

2.2 Future earnings are double taxed because the goodwill represents the present value of future cash flows, which are also taxed when they are derived.

Investment distortions need to be minimised

2.3 There is a risk that if different tax treatments exist, this will drive fund flows (for better or for worse). I.e. if direct investment is more favourably taxed than indirect, persons will invest directly as opposed to indirectly (and vice versa). The same can be said if different investment vehicles are taxed differently.

2.4 Tax should not be the driver of the manner of investment by New Zealanders and as a general rule the tax system should be designed to ensure neutrality (to the extent possible) except where a compelling rationale exists justifying a contrary approach.

2.5 The same risk applies if different asset classes are taxed differently (i.e. this will also drive the manner of investment). If, for example, New Zealand keeps FDR but does not apply this to NZ shares (and a capital gains tax is applied), the NZ shares for some companies will be more highly taxed than they are at present (but foreign shares are not). The risk is funds moving away from NZ shares, with the unintended consequence of a loss of liquidity in the NZX.

2.6 It also needs to be considered whether taxation of the sale of shares will see investors introduce additional risk and leverage (i.e. borrow further so that the after tax impact is the same as if there was no tax).

2.7 As noted above, some New Zealand corporates may determine that FDR for its shareholders is a better outcome, and this change may force in part them to leave New Zealand.

Realisation-based tax

2.8 The taxation of managed funds has challenges under a realisation-based tax, however options exist to address this. In exploring these options, the above points in regards to neutrality are critical.

2.9 Some of these issues include:

- Fairness (for new / exiting investors)
- May be asymmetrical (e.g. a deduction for costs as incurred, and only taxed on gain when sold)
- Doesn't address the issue of inflation

2.10 A realisation approach will be complex, and will not be understood by PIE members and may lead to inappropriate outcomes.

- For example the Group is of the view that any contribution from an existing member may trigger a cost base reset for all other members. Given there are more than 2.8 million New Zealanders in KiwiSaver who contribute different amounts on a regular basis, the calculations involved will be daily (at least) across the 2.8 million investors and will need to be done on each and every Australasian share investment individually.
- Further, it is not clear in the Interim Report whether member transfers between funds of a scheme (e.g. from conservative to balanced) or even between schemes, would trigger a taxing event. If it does (and the Group does not see that it will under a pure realisation approach), members would be left with a reduced retirement fund purely from rebalancing their investment of choosing another scheme provider. Not only is this inequitable, it will potentially incentivise behaviour in the wrong way and therefore a lack of competition between scheme providers.

2.11 For an accruals regimes, there is a significant issue as taxpayers (outside the managed funds context) may not have the cash to pay the tax and inflation is not addressed. Such a method would not be preferred.

2.12 Accrual taxation is likely to be particularly problematic for property PIEs as their assets are illiquid and difficult to value. In the event accrual taxation is considered, care should be taken that this does not result in a change in the tax treatment of property assets held on revenue account by a PIE, noting that cash flow constraints are typically the most severe in this context.

2.13 In the Group's view, there could be a real advantage to adopting a risk-free rate of return method. This method will be relatively simple to introduce, would 'level the playing field' and minimise volatility, as well as providing more certain cash flows for

the Government. In the Group's view, a real risk-free rate should be used (i.e. one that takes into account inflation).

2.14 An accrued taxation, extension of FDR or RFRM approach should only be adopted if it is simple to understand and can be applied on a basis that it removes inequities between different investors as much as possible (in particular direct retail investors). Otherwise distortions will arise which may lead New Zealanders to prefer to invest directly, creating an increased risk for such investors (as they lose access to expert advisors) and undermines KiwiSaver. For example, if accrued taxation was chosen, a careful and singular level of non-inclusion should occur, taking into account more detailed market analysis of turnover of such equities (the Group would not be opposed to such an approach provided an appropriate level of non-inclusion is applied).

Treatment of inflation

2.15 This is a general issue as inflation can distort taxpayer choices. This is particularly true in relation to interest, resulting in a high effective tax rate as the inflation component of interest is taxed. More work needs to be done in relation to interest on savings (for example when interest is earned in a KiwiSaver account).

Existing FDR rules

2.16 There are issues with the existing FDR rules to be considered, including:

- The 5% rate of FDR being set too highly. The Group would support a reduction in the 5% rate. However care should be taken if FDR is set too low a distortion could arise resulting in a preference to invest in offshore equities compared to New Zealand equities. This is another area where more research should be done to ensure that distortions are not created.

- As has been previously acknowledged, there can be an issue in relation to FDR and hedging, as foreign equity investments are taxed under FDR but any corresponding hedging arrangements are treated as financial arrangements and taxed comprehensively. Changes were introduced in 2013 to address this issue and allow application of FDR to hedging contracts. The Group supports these changes in principle. However, while these have worked for a handful of entities, the rules are difficult to apply in practice for the vast majority of taxpayers and the Group considers these should be reviewed and simplified to make them work.

Overall however, the Group considers that the current FDR regime is working well, particularly given its simplicity and the low compliance costs under the regime (the FDR experience should be considered when weighting up a capital gains tax versus adopting RFRM.

2.17 It has been suggested that the FDR regime (if applied more broadly to the taxation of equity) could be an elective one, so that if taxpayers wish to be taxed under FDR they can, or if they wish to be taxed on actual gains / losses they can elect for that. Currently sophisticated investors are troubled by FDR because they are paying tax when they have not made any money and then there are other investors for whom a simpler approach may work best. Such an approach would also force the FDR to be set at a rate that more closely reflects a rate comparable to realised capital gains.

Interim Report recommendations

2.18 The Group notes that the recommendations made by the TWG (see page 52 of the Interim Report), while not necessarily issues for the Group, need to be considered in further detail to ensure that any changes are workable.

2.19 In particular, there is a level of detail to be worked through in relation to the removal of ESCT, as the question of whether the $48,000 threshold has been breached has the potential to become complicated if the rules are not appropriately set. For example, there may be issues if taxpayers have multiple jobs, or if their pay increases during the year.

2.20 In the Group's view, a simpler way of increasing savings for those earning below the $48,000 threshold would be to either increase the member tax credit this group of earners is eligible to receive or having Inland Revenue administer the ESCT exemption (i.e. employers withhold ESCT and Inland Revenue credits this back to eligible employees). Such a change could be implemented with no compliance costs to employers (the removal of ESCT has the potential to create material compliance costs for all employers).

2.21 The Interim Report also notes that the TWG is considering the removal of the CV option for individuals and family trusts (see page 159). The Group would support this change as it will help to 'level the playing field' between those taxpayers investing in PIEs versus those investing directly.

Application date

2.22 Noting the Group's comments in Appendix One about a staged introduction of a capital gains tax (if a capital gains tax is to be introduced at all), the Group notes that this is particularly important when it comes to the taxation of equity.

2.23 The Group submits there should be a deferral of the 1 April 2021 application date for any capital gains tax (and other changes to the taxation of equity) until at least 1 April 2022. Organisations should not be making significant changes to their systems, at great cost, if these changes will become unnecessary if there is a change of Government. The systems changes that will be required under these changes could take anything from 12 – 24 months and sufficient lead in time is required.

2.24 This position is exacerbated when considering:

- The likelihood of the changes to the PIE rules for Australasian shares;
- The fact that the General Election may be as late as September 2020;
- The need for investment funds to be able to apply the changes immediately; and
- New Zealand's position is different, in that the TTE model (and in particular the middle 'T') makes the implementation of a tax on capital gains on equity extremely complicated.

APPENDIX THREE – BUSINESS TAX CHANGES

1. Issues to be advanced – A competitive effective tax rate

1.1. The Interim Report recommends that the corporate tax rate not be reduced for the time being. If the corporate tax rate cannot be lowered to a competitive tax rate, then the tax base on which that higher rate is levied needs to be reconsidered.

1.2. In the Group's view, the Final Report must consider the effective tax rate that applies to businesses and in particular, there are a number of issues that the Group considers should be advanced for New Zealand to remain competitive and to attract foreign capital. If these issues are not advanced, there will be an additional drain on New Zealand businesses that is greater than the current 28% corporate tax rate.

1.3. It has previously been considered that the appropriate effective tax rate for non-resident investors is <28% (notwithstanding the recent BEPS changes have material increased this rate). The Group suggests that the TWG recommend against any further tightening in these areas and increasing the effective tax rate on non-residents by further tightening of the interest deductibility / thin capitalisation rules.

1.4. The Group is of the strong view that in areas where the tax treatment has been shown to be inappropriate, changes must be made to rectify the position. Many of the arguments against some of the business positive measures have been that these will be revenue negative, however all this argument highlights is that certain sectors are being continually overtaxed and no efforts are being made to change this. The Group considers that many of these measures are merely neutralising (i.e. they are restoring the tax system to a place where it does not incentivise investment one way or another) and will help increase the integrity of the tax system.

1.5. The Group also considers that the Final Report should make the point that if there are any recommendations that can easily be picked out and advanced / completed, outside of TWG process, this should be done.

1.6. The issues the Group considers should be advanced are detailed below.

Greater alignment of tax treatment with accounting

1.7. In the Group's view, more should be done to align the corporate tax code with accounting standards, particularly where IFRS standard accounts are being prepared. Areas that would particularly benefit from more overlap include:

- Tax depreciation
- Provisions and accruals
- Unexpired expenditure / prepayments

1.8. The current arbitrary rules in relation to these areas result in compliance risk for taxpayers, particularly when many of the issues are merely those of short timing differences. Greater alignment with accounting would reduce compliance costs with little risk. The IFRS accounting standards are internationally acceptable standards that are independently audited and there is little justification for having a complex tax overlay to simple accounting treatment.

Self-assessment model

1.9. In the Group's view, there is scope to reduce compliance costs and increase the efficacy of the current self-assessment model, by giving taxpayers greater autonomy in managing their tax affairs. For example:

- Remove the requirement for taxpayers to have to seek Commissioner's approval to issue Buyer Created Tax Invoices.
- Allow special rate certificates and certificates of exemption to be granted retrospectively. In a commercial world, payments often need to be made before there is time for a certificate can be granted and taxpayers should be able to determine the rate at which tax is to be withheld (if at all) at that time.
- Increase the period of validity for a certificate of exemption.
- Remove the requirement to file a change of imputation ratio notice with Inland Revenue (or at least introduce a minimum threshold to allow for small changes in imputation ratio).

Black hole expenditure

1.10. Prior to the formation of the Tax Working Group, the Group had been working closely with Officials in relation to a solution to black hole feasibility expenditure. Substantial work on this issue has been performed and possible solutions have been explored with the Group, which the Group would like to see completed as soon as possible. This should not be considered a fiscal cost issue as it is merely clarification of a position close to that which was the accepted position prior to the Trustpower tax case decision (which occurred relatively recently).

1.11. In addition to feasibility expenditure, there are a number of other categories of black hole expenditure in the New Zealand tax system, where tax deductions are not available for legitimate business costs. See our original submission for more details in relation to these.

1.12. The Group submits that a broader 'catch all' rule should be introduced to provide a tax deduction for black hole expenditure that is not otherwise covered by specific legislation. This could be similar to the approach taken in Australia, whereby there is a deduction allowed for black hole expenditure which is otherwise not deductible, under which the deduction is to be spread over 5 years. This should be advanced regardless of whether a comprehensive capital gains tax is introduced or not, as it is a deduction for legitimate business expenditure which generally declines in value or becomes worthless.

Depreciation on buildings

1.13. The Group strongly supports depreciation deductions being reinstated for certain types of buildings, particularly industrial and commercial buildings. This should be advanced regardless of whether a capital gains tax is introduced or not, otherwise there will be an unwarranted tax bias against investment in such (productive) assets.

1.14. The Group agrees with the comments in the background paper[5] that depreciation should never have been removed on industrial and commercial buildings. In reality,

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[5] https://taxworkinggroup.govt.nz/sites/default/files/2018-09/twg-bg-3985469-appendix-c--depreciation-on-buildings.pdf

these types of buildings have been shown to depreciate, and the analysis on the depreciability of buildings provided at the time depreciation was removed has been noted as inaccurate.

1.15. If depreciation is reinstated, the rate of depreciation must be set appropriately based on what is the estimated useful life of a commercial or industrial building. The Group refers the TWG to the studies detailed in Inland Revenue's *Repairs and maintenance to the tax depreciation rules: An officials' issues paper*, which notes that while estimates of economic depreciation rates of building depreciation are not settled, a 3% diminishing value rate of depreciation is reasonable[6]. That is, depreciation should be reinstated at the rates applying prior to the 2011/12 income year. The Group understands that a phased approach may be taken to the reintroduction of depreciation and supports this to the extent that the end position will reflect the reality of the situation (e.g. that buildings do depreciate and at an appropriate rate).

1.16. There are a number of transition issues to be considered if depreciation is reintroduced, including the value that is used when depreciation is 'turned back on' and losses on buildings (to the extent there is no capital gains tax on these buildings).

Seismic strengthening

1.17. The Group supports the deductibility or depreciation of seismic strengthening costs and notes that if introduced, this must be backdated so that those who have already undertaken seismic strengthening are not unduly penalised for having done this early.

Compliance cost measures

1.18. The Group generally supports the proposed compliance cost measures outlined in the Interim Report (see page 108, paragraph 14.5). These include increasing the provisional tax threshold, increasing the year-end closing stock adjustment and increasing the $10,000 limit for the automatic deduction for legal fees.

1.19. Other changes the Group would suggest include:

- Increasing the threshold for "low value assets" (whereby an immediate deduction can be taken) from $500 to $1,000.
- Increasing the maximum amount thresholds in Determination E12 for the unexpired portion of accrual expenditure (noting the Group's view is that tax should follow accounting where audited IFRS accounts are prepared).
- The Group would also support expanding the automatic deduction available for legal fees to other types of expenditure.
- Changes to the non-deductible employee provisions (63-day rules).

1.20. The Group also considers that the various compliance cost thresholds could be reviewed to see if they could be based on a percentage of taxable income, such that there are appropriate thresholds for larger taxpayers to work within.

1.21. The Group would also recommend a broader review and consideration of particular regimes that are compliance cost heavy, but that do not have a corresponding material impact on the tax base. These include the entertainment regime and fringe

[6] http://taxpolicy.ird.govt.nz/sites/default/files/2004-ip-depreciation.pdf, page 51-53.

benefit regime. Both of these regimes can impose significant compliance costs to adhere to the rules, but do not raise a material amount of revenue when considering the relative cost of complying with these.

1.22. As noted earlier, the Group would also welcome a simplification of the depreciation regime. This could include write-offs for low-value asset balances in the tax fixed asset register, reducing the number of depreciation rates for tax / aligning these more closely with accounting and simplification of the asset categories. Another option is to allow application of general default asset class rates.

1.23. The Group suggests a review of the taxation of non-resident employees, as this is another area that is compliance cost heavy for taxpayers. One mechanism for simplifying obligations in relation to particular non-resident employees could be to require employers to consider the taxation of these non-resident employees at year-end only (and complete a wash-up calculation at this point). This would simplify the position for non-resident employees who are frequently in and out of the country and where it is unclear whether they will breach the 92-day (or 183-day) thresholds.

Loss continuity

1.24. The Group considers that the issue of loss continuity extends beyond the start-up type entities noted in the interim report and finds the distinction of small start-ups problematic. The Group supports a review of loss-trading and strongly submits that this should include a review of the loss continuity rules.

1.25. The Group submits that a "same or similar business test" should be introduced to allow the carry forward of tax losses, as an alternative to the existing 49% threshold and similar to what is in place in Australia.

1.26. Officials have already carried out considerable work on this and it could be implemented relatively quickly.

2. Other issues

2.1 Overall the Group is generally supportive of New Zealand's broad-based, low-rate tax (BBLR) system and continues to support BBLR as an appropriate approach for our tax system. BBLR minimises distortions in the tax system and allows for tax to be a relatively neutral factor in decision-making. However, where it in in New Zealand's national interest to do so, changes outside this framework should be considered.

2.2 In recent years, the Group has seen a trend towards detail and complexity, driving inefficiency. Taxpayers should be afforded more time to run their businesses instead of trying to comply with uncertain and complex tax law.

2.3 With this in mind, the Group has the following comments on some of the issues raised in the Interim Report.

- The Group is supportive of the recommendations to leave GST largely untouched. New Zealand's GST system has long been held in high regard as a simple, broad-based system, with few exceptions. GST is on of New Zealand's most efficient and effective taxes and changes should not be made lightly.

- The Group supports retaining the imputation system.

- The Group supports Inland Revenue continuing to invest in the technical and investigatory skills of its staff, but notes that there are wider staff resourcing issues that must be considered.

- The Group supports the establishment of a central Crown debt collection agency to achieve economies of scale and more equitable outcomes across all Crown debtors.

- The Group broadly supports the Interim Report's recommendations in relation to principles in public engagement on tax policy. In particular the Group supports the need for Treasury to play a strong role in tax policy development and the importance of Inland Revenue maintaining deep technical expertise and strategic policy capability.

2.4 In the Group's view, it would be helpful if the TWG's Final Report also provided the following comments:

- Acknowledgement that there are other measures and issues to consider, but there just hasn't been time to cover everything (i.e. the Final Report is not a completely comprehensive review of the areas to be considered under the Terms of Reference).

- Highlighting of the areas where further work is required to reduce tax burdens and compliance costs on business.

- Recommending that Officials continue with previously started work; such as:

    - Blackhole feasibility expenditure
    - Depreciation on leasehold improvements
    - Reform of loss continuity rules
    - Review of entertainment tax rules for gifts
    - Non-resident employee issues
    - Tax pooling issues
    - Active income exemption for branches
    - AIM for large business
    - Tax pass through corporate entities

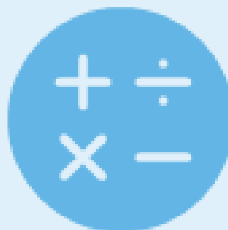
Corporate Taxpayers Group: Tax Working Group Interim Report Feedback

Judging the tax system – the Corporate Taxpayers Group Approach: The 3 C's

Competitiveness: The tax system plays a critical role in our competitive position with our major trading partners and competitors

Compliance Costs: Tax compliance costs of both taxpayers and Inland Revenue should be kept as low as possible

Certainty: Tax rules must be designed to provide certainty, predictability and low business risk



Tax reform equation

The CTG supports BBLR. If there is broadening of the base there needs to be a lowering of the rate or other recycling of revenue into the productive sector. Tax changes can only be evaluated in the context of the wider package of reform.

Growing NZ Inc

New Zealand has a need for capital, from both within NZ and offshore. The tax regime needs to be competitive to bring in foreign and domestic capital. We need to be confident that a capital gains tax will not act counter to this. Let's be aspirational and get out there and compete.

What is best for New Zealand?

"*In broad terms, will the fairness, integrity, revenue, and efficiency benefits from reform outweigh the administrative complexity, compliance costs, and efficiency costs that arise from the proposed additional capital income taxation?*" – TWG Interim Report, page 31.

The CTG believes that in order for the TWG to form the overall judgment above, a targeted and staged approach must be taken to any further taxation of capital:

- Start with residential housing. This has been identified as the most significant issue and source of unfairness.
- Then move on to other areas, only as appropriate and to incentivise savings in the right things. A poorly designed CGT may have a negative impact on capital markets.

There are specific design issues that need more consideration, including valuation, goodwill, effect on consolidated groups, partial sales, rollover and losses.

Let's take the time to get it right from the start and set New Zealand up for a bright future.

The headline tax rate

It is important that the corporate tax rate is competitive so as to attract mobile capital into New Zealand.

The effective tax rate

If the headline rate can't move then what can be done to enhance deductions to reduce the effective tax rate on mobile capital?

Helping business

The tax system should help businesses grow and expand, not hinder their performance through complexity and increased compliance costs. Some changes that can be made include:

- Depreciation on commercial/industrial buildings
- Black hole expenditure should be eliminated
- Loss continuity rules need to be fixed
- Greater alignment of tax treatment with accounting
- Greater autonomy to taxpayers to self-assess
- Reduction of compliance costs

These issues should be advanced so that New Zealand can remain competitive and attract foreign capital and to neutralise any current distortions in the tax system. If not, there will be an additional cost on New Zealand businesses greater than the current 28%.

We support the TWG's recommendations to…

- Leave GST relatively untouched
- Retain the imputation system
- Invest in the technical and investigatory skills of IR staff
- Establish a central Crown debt collection agency
- Give Treasury a greater role in tax policy development

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Review of the Taxation of Capital Gains in Canada

An examination of the Canadian experience
and of issues involved in proposals for change

November 1980

Department of Finance
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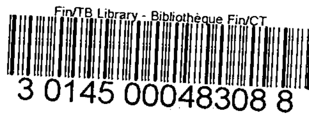
Ministère des Finances
Canada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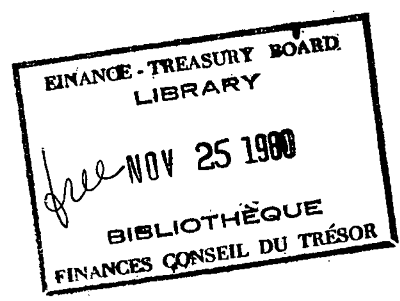
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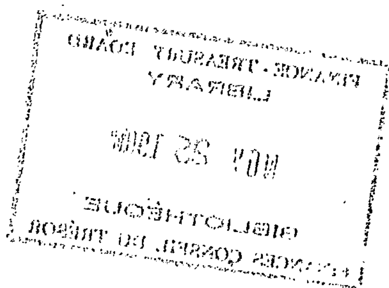

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Introduction

Since the taxation of capital gains was introduced in Canada in 1972, it has been the subject of much discussion. Concerns have been expressed about its impact on the economy. Various proposals for change have been made. These range from complete exemption of capital gains, to exemption for particular types of capital gains such as gains on the sale of shares of public companies, to moving from their present half-taxation to full taxation.

The purpose of this paper is to review the role of capital gains in the tax system, to compare Canada's treatment of capital gains with that of other industrialized countries, to present general information on the Canadian experience since 1972, and to discuss various issues associated with the taxation of capital gains. Taxation of capital gains affects the equity and stability of the tax system and is an important source of government revenue. Because the taxation of capital gains is interwoven with many other provisions of the Income Tax Act, any major change in their tax treatment would require a restructuring of the whole tax system. It is thus crucial that the desirability of any modifications to the tax treatment of capital gains be carefully reviewed and discussed.

Capital Gains and Why They are Taxed

Definition of Capital Gains

The essence of any capital gain is the sale of a capital property for more than its original purchase price plus any costs of selling and buying and costs of improving the property during the time it is held. Capital property includes both tangible property such as land, buildings, machinery and equipment and works of art, and financial assets such as shares, bonds and other securities.

While in concept it may be easy to define capital gains, in practice, differentiation between capital gains and other types of income is fraught with difficulties. Capital gains arise in transactions involving capital property. No precise line can, however, be drawn as to whether a particular asset is or is not a capital property. For example, the sale of real estate by an individual would ordinarily be a capital transaction giving rise to a capital gain. However, the same property, if sold by a real estate firm, would not give rise to a capital gain but ordinary business income since such a sale would be part of its normal business activity, no different from purchases or sales of other goods by business firms in general which give rise to business income. Similarly, purchases and sales of shares and bonds by security dealers are considered to be ordinary business transactions and thus do not give rise to capital gains.

Whether a particular transaction or series of transactions is business activity or not will depend on such factors as the frequency of similar transactions and the motives for and nature of the sale – whether it was unanticipated, so that the return was more of a windfall gain than business income. Of course, such factors matter only if the tax treatment of capital gains differs from that of business income, which is the case in Canada where only half of capital gains are included in income subject to tax.

The Income Tax Act and jurisprudence have established a number of circumstances where increases in the value of an asset are considered to be ordinary income when realized. Any gains associated with buying and reselling inventory are treated as business income. Certain assets, such as resource properties, are deemed not to be capital property so that increases in their value are fully taxed as income when realized. The courts have held over the years that where an investment is made for the purpose of providing income, such as interest or rent, any profit on the sale of the property will be a capital gain, whereas if the primary motive of the investment is to benefit from an increase in the value of property, the investor may be regarded as speculating and the profit therefrom would be treated as ordinary income. A gain is also more likely to be considered business income when the property disposed of is related to the taxpayer's ordinary business.

As the dividing line between capital transactions and business transactions is very often unclear, the difference in tax treatment between the two provides an incentive for taxpayers to organize their affairs so that income appears as a capital gain. Historically, since capital gains have been taxed less heavily than other forms of income under the

Canadian tax system, it is not surprising that these matters have given rise to considerable litigation.

Another major source of difficulty in determining capital gains relates to the fact that appreciation in the value of assets occurs for a number of reasons. On the one hand changing market conditions (due, for example, to changes in incomes or investor expectations or to scarcity of the product) will lead to changes in the values of capital properties. The resulting capital gains can be considered the classic type. Examples include increases in stock prices due to heightened expectations about future corporate performance, and increases in land prices around an expanding city.

On the other hand the appreciation may represent accumulation or accrual of other forms of income, which is then realized on disposal of the property. For example, the appreciation in the value of a bond may represent not only a genuine increase in its value due to market forces but also the value of any accrued but unrealized interest income. If the true capital gain and the interest income are to be treated differently for tax purposes, rules are required to isolate the two components of the sale price.

Similarly, appreciation in the value of a corporate stock may represent accumulation of business profits in the corporation. In many circumstances taxpayers have a choice of realizing this accumulation either as a dividend if the profits are distributed or as a capital gain if the profits are retained and realized indirectly by the shareholder in the price received on the sale of his shares. As long as there are differences in the tax treatment of dividends and capital gains, taxpayers will attempt to structure transactions in order to convert one to the other. Such conversions may take many forms, particularly in the case of closely-held private companies.

Any preferential tax treatment of capital gains requires extensive rules to distinguish them from other forms of income. These rules, by their very nature, tend to be complicated and frequently arbitrary. History and experience with the Canadian tax system provide ample evidence of the difficulties in drawing such distinctions.

One other aspect of the definition of capital gains deserves mention. In public discussions, capital gains, unlike other forms of income, tend to be uniquely regarded as a reward for risk-taking. It is, however, inappropriate to state that all capital gains are a reward for high-risk investments. While risky investments may give rise to capital gains, for tax purposes capital gains are conventionally defined as the profit realized on the sale of *any* capital property, not all of which have the same degree of risk associated with them. For example, holdings of real estate, which are a major source of capital gains, are very often subject to much less uncertainty than are investments in venture enterprises or many small business operations. Clearly, the degree of risk varies from investment to investment, and many investments yielding business income are subject to higher risk than other investments expected to yield capital gains. The relationship between capital gains and the degree of risk-taking is thus quite imprecise.

Why Capital Gains are Taxed

An extensive review of the tax system occurred in the 1960s beginning with the establishment of the Royal Commission on Taxation in 1962 and culminating in major changes in individual and corporate income taxes, including taxation of capital gains, which took effect from January 1, 1972. The tax treatment of capital gains was a major topic of discussion and debate in this review. The Royal Commission recommended that capital gains be fully taxable as are other forms of income which add to a person's power

to command goods and services. The main arguments advanced then for the taxation of capital gains, which continue to be relevant, are as set out below.

An effective self-assessing system must be seen to be fair and equitable; taxpayers must believe that the system is levying taxes on a reasonable basis and that the distribution of taxes is equitable. There are two dimensions to this, and the tax treatment of capital gains has an important bearing on both. First, in a tax system based on ability to pay, all sources of income which increase the economic power of the recipient, including capital gains, should be recognized in determining the tax base. An individual who realizes a $100 gain has the same increased spending and saving alternatives as another person who receives an additional $100 in his paycheque. This principle was upheld by the Royal Commission (the Carter Report) and was given popular expression as "a buck is a buck". Comprehensive taxation would require that all forms of income be fully recognized in determining tax liability, so that those in equivalent positions bear the same level of tax (so-called horizontal equity). If capital gains are not taxed on a par with other income, certain individuals and groups receive preferential tax treatment relative to others who have the same ability to pay.

Second, it has long been accepted in Canada that a tax system based on ability to pay should levy progressively more tax on higher-income taxpayers than those with lower incomes (so-called vertical equity or progressive taxation). Because of the strong concentration of capital gains in higher-income brackets, their tax treatment has an important influence on the progressivity of the tax system. In 1978, for example, the top 1/10th of one per cent of tax filers with incomes above $100,000 accounted for 24.2 per cent of reported capital gains, though their share of total income was only 1.9 per cent. To indicate further the concentration of capital gains, it can be noted that in 1978 some 500 individuals with incomes over $100,000 derived virtually all of their income from capital gains.

Another important reason for the taxation of capital gains is the neutrality of the system. The criterion of neutrality, simply stated, is that taxes should be levied in such a way as to minimize distortions in the working of market forces and in patterns of economic behaviour. Such distortions divert resources from more productive to less productive uses, reduce the efficiency of the economy and, thereby, lower living standards and the potential for economic growth. If one form of return from capital is taxed significantly less than others, there could be misallocation of resources and excessive uneconomic investment in the type of assets most likely to produce this type of return. For example, land and real estate holdings normally yield more of their return in the form of a capital gain. If capital gains receive preferential tax treatment, investment in these assets would, other things remaining the same, be larger than under a neutral tax system. If the aggregate volume of investment remained unchanged, then less funds would be available for investments in assets yielding interest or business profits which are not taxed preferentially.

Non-neutrality also leads to considerable effort and resources being devoted to tax avoidance measures. Pronounced efforts to convert business income into capital gains were made prior to the 1972 tax reform because of the major differential in tax treatment between capital gains and other types of income.

Two further principles for a sound system of taxation are simplicity and certainty. On the one hand, if capital gains were not taxed, the necessity of retaining information to compute gains would be avoided. On the other hand, complex rules would be required to distinguish capital gains from other income and considerable uncertainty would continue to exist about the dividing line in individual cases. As is evident particularly from the

pre-1972 experience in Canada, this distinction would be among the most litigated in the tax system. Certainty would be highest under full taxation of gains because taxpayers would know that whether a transaction yielded capital gains or other income the tax consequences would be identical. There would be no concern as to whether tax authorities and the courts would deem a particular transaction to have given rise to income rather than a capital gain. Nobel laureate economist Paul Samuelson has put the point this way:

> "Old-fashioned tax administrators perpetuate the myth that a capital gains tax leads to administrative headaches. American Treasury and legal experience is just the opposite: It is *hard* to administer an income-tax system if you do not tax capital gains or if you tax them lightly, because then devices multiply to convert ordinary income into the semblance of capital gains."[1]

These were some of the considerations that led the Royal Commission on Taxation to recommend that capital gains be fully taxable as income. In fact, besides recommending full taxation, the commission supported the concept of taxation on an accrual basis, where feasible, in order to ensure uniform tax treatment of all forms of income.

Following the Royal Commission Report, the government published a White Paper in 1969, entitled *Proposals for Tax Reform* which expressed sympathy with the Commission's recommendation for taxation of capital gains as follows:

> "A Canadian who is able to realize a substantial stock market profit or real estate gain clearly has an increased ability to pay; he is better able to pay for a new car, or to pay for stocks and bonds, or to pay income taxes, than is his neighbour who has not had such a gain. At present, Canada does not tax this ability to pay. As a result, some very well-to-do Canadians pay far less tax than others with similar abilities to pay, and less even than others with much lower incomes (all because these particular Canadians receive a large part of their income as 'capital gains'). Moreover, it has been possible for the sophisticated to arrange their transactions in such a way that they receive as capital gains amounts that would have been income had the transaction been carried out in the normal manner."

The 1969 White Paper proposed full taxation of capital gains on a broad range of assets, with the notable exception of gains on shares of widely-held companies. These were to be half-taxable when realized, and 50 per cent of the accrued but unrealized gains on these shares were to be brought into income every five years. The White Paper rationalized half-taxation of capital gains on such shares on grounds of maintaining a balance between the taxation of capital gains and dividends which were to be eligible for the dividend tax credit. Also, half-taxation was to put Canadians in approximately the same tax position regarding capital gains on shares as most of the non-residents who invest in Canada.

Public discussion following the release of both the Carter Report and the White Paper brought forward a number of issues and special considerations regarding the tax treatment of capital gains. In particular, it was argued that the taxation of gains should not be such as to inhibit economic growth. The need for an adequate level of savings for capital investment purposes, the desirability of assuring sufficient risk capital, the adequacy of equity investment and healthy capital markets, and the adjustment for inflation in measuring real capital gains were important issues. In addition, the Eighteenth Report of the Standing Committee on Finance, Trade and Economic Affairs Respecting

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[1] P.A. Samuelson, *Tax Deductibility of Economic Depreciation to Ensure Invariant Valuation*, Journal of Political Economy, December 1964, p. 606.

the White Paper on Tax Reform spoke in 1970 of the need for "taxpayer understanding and acceptance" in presenting their proposal for half-taxation of gains.

The treatment of capital gains eventually adopted in 1972 reflected these diverse concerns. Only one-half of capital gains were to be included with income. This compromise responded to the basic rationale for inclusion of capital gains in income based on the concept of equity, while recognizing the other considerations involved. Other important changes related to the inclusion of capital gains in income were made at the same time. For example, the federal government withdrew from the estate and gift tax field. The top marginal rates of personal income tax were reduced substantially, since the inclusion of capital gains in income broadened the tax base for higher-income taxpayers.

Current Tax Treatment of Capital Gains and Their Significance

There has now been more than seven years' experience with the taxation of capital gains in Canada. In order to provide an indication of the importance of capital gains, this section briefly outlines their current tax treatment and presents empirical information on their volume, revenues from their taxation, and their distribution among taxpayers.

Current Tax Provisions

Generally, one-half of capital gains of individuals and corporations are included in income for tax purposes and subject to tax at the normal personal or corporate rates. While it is common to hear references to a "capital gains tax", this is not really an accurate description as there is no separate tax on capital gains. Capital gains are simply another income source, one-half of which is included with income from other sources in determining taxable income on which a person's tax liability is based.

One-half of capital losses (called allowable capital losses) are generally deductible against taxable capital gains realized in the year. Individual taxpayers may also deduct each year up to $2,000 of allowable capital losses from income from other sources. Unused allowable capital losses may be carried back one year and forward indefinitely to be offset against taxable capital gains and, in the case of individuals, against up to $2,000 of other income. One-half of capital losses on shares or debt of small business corporations may be deducted against other income, without limit, by both individual and corporate investors.

Capital gains that accrued before the end of 1971 are not subject to tax. Taxable capital gains and allowable capital losses are generally recognized for tax purposes only when realized, that is, in the taxation year in which disposition of the property occurs. The gain (or loss) will usually have accrued over a number of years, so that tax on any accrued gain is deferred until the gain is realized.

A taxpayer is deemed to have disposed of capital properties at fair market value at death or when a gift is made. Any taxable capital gains from such deemed disposition are included in the taxpayer's income for that year. A deemed disposition also occurs in certain circumstances when a person ceases to be a Canadian resident.

Gains on the sale of a principal residence are exempt from tax. Exemption also applies to gains on certain cultural properties sold or transferred to an institution or a public authority in Canada and to gains from the disposition, for $1,000 or less, of "personal use" property such as automobiles, boats or artwork. Where personal use property costing less than $1,000 is disposed of for an amount exceeding $1,000, the property is deemed to have cost $1,000. Lottery winnings and similar prizes are also exempt from tax.

Capital gains of individuals from the disposition of Canadian securities (basically, shares or debt of Canadian corporations) qualify, along with interest and dividend income, for a deduction of up to $1,000 of investment income.

The Income Tax Act contains a number of provisions which give opportunity to defer the recognition of gains in specified circumstances. Deferrals, often referred to as "rollovers", are permitted under the following circumstances, among others:

when a property is transfered to a spouse, whether during life or on death;

when certain farm property, or shares of a family farm corporation, are transferred to children or grandchildren;

on gains of up to $200,000, when shares of small business corporations are transferred to children or grandchildren;

when business or farming property is sold and the proceeds are used to acquire another property for similar use; and

on any gains arising on exchanges of property in certain business and corporate reorganizations. (These are described more fully in Appendix I.)

In all of these cases, the tax is deferred until the property is subsequently disposed of in taxable circumstances.

The Income Tax Act provides that the taxation of capital gains may be averaged over a number of years by the purchase of an income-averaging annuity contract. The taxation of the capital gain is thereby spread over the term of the annuity, and the gain does not serve to push the taxpayer into a significantly higher tax bracket, as could occur if all of it were taxable in the year of disposition. In addition, where not all the proceeds of disposition of a property are immediately receivable, only a portion of the gain may be taxable in the year. The remaining portion can be deferred until the proceeds are received. This would occur, for example, when farmland or shares of a private company are sold and the sale price is received in instalments.

It is important to note that deferrals of tax through the various provisions noted above serve to reduce the effective rate of tax on capital gains. In the case where tax on a gain can be deferred for five years, assuming a discount rate of 10 per cent per annum, the deferral benefit, plus the benefit of half-taxation, are equivalent to exempting some 69 per cent of the gain (and taxing the remainder immediately with no deferral). At this same discount rate a deferral of tax for 25 years or longer is tantamount to a complete exemption of gains from tax, as the present discounted value of the tax due 25 years hence is negligible. Or, to put it differently, a deferral is equivalent to the government collecting the tax when due and then immediately giving an interest-free loan to the taxpayer of an amount equal to the tax collected. At an asumed interest rate of 10 per cent, the benefit accruing to a taxpayer from an interest free loan for a 25-year period is almost equal to his current tax liability on capital gains.

Amount of Reported Capital Gains

Capital gains have given rise to significant amounts of income for tax purposes, particularly in recent years.

Table 1 presents the total capital gains and losses, before one-half exclusion, reported by individual taxpayers (columns 1 and 2), their net taxable gains (column 3), i.e., one-half of gains less losses and the net taxable capital gains of corporations, i.e., one-half the

Table 1

Capital Gains and Losses Reported for Income Tax Purposes, 1972-1978

	Individuals			Corporations	
	Total Capital Gains	Total Capital Losses	Net Taxable Gains	Net Taxable Gains	Total Net Capital Gains
	(1)	(2)	(3)	(4)	(5)
			($ millions)		
1972	351.9	162.6	149.0	89.5	368.4
1973	586.2	293.0	245.4	185.8	664.0
1974	731.8	506.2	282.5	223.6	672.8
1975	1,065.3	409.7	404.5	323.8	1,295.1
1976	1,592.8	376.7	632.2	409.5	2,035.0
1977	1,851.3	400.8	773.2	519.6	2,489.5
1978	2,775.9	368.7	1,193.3	795.0*	3,977.2

Notes:
Figures for total capital gains and for total capital losses are not all-inclusive since they are based on net figures reported in tax returns of individuals. They do not include gains deducted by persons reporting net capital losses, or losses deducted by persons reporting net capital gains.
Net taxable gains are one-half of gains less one-half of losses as limited by the $1,000 ($2,000 commencing in 1977) of allowable losses that may be offset against other income and less net additions to reserves for sales proceeds due in later years.
Gains and losses are not reported separately for corporations. The net taxable gains of a corporation are one-half of the excess of capital gains over capital losses. For corporations with losses in excess of gains, there will be a carry-forward to future years. Losses available for carry-forward are not included in the corporate values presented.
Total net capital gains of individuals and corporations are calculated as total capital gains less losses of individuals (Columns 1 and 2) plus twice the net taxable capital gains of corporations.
* Based on preliminary information.
Sources: Revenue Canada, *Taxation Statistics*; Statistics Canada, *Corporation Taxation Statistics* (61-208).

excess of capital gains over losses for each corporation. Total net capital gains (total gains net of losses, before one-half exclusion) reported by individuals and corporations in 1978 were over $3.9 billion.

The table shows a rapid growth in capital gains since they began to be reported for tax purposes in 1972. Total gains reported by individuals (column 1) increased on average by some 40 per cent annually from 1972 to 1978. One important factor behind this growth is the maturing of the taxation of capital gains. Under a mature system, the full amount of the increase in the value of each capital property disposed of in the year over its original purchase price would be recognized for tax purposes. However, in the early years of taxation of capital gains, a substantial portion of such increase was excluded from tax since only the portion of gain accruing after 1971 was recognized for tax purposes. Over time, the proportion of properties acquired after 1971 increases, as does the proportion of gains accruing after that date. Thus the amount of gains reported has been growing rapidly as a natural result of the maturing process. It is only in the last one or two years that the amount of gains reported (and government revenues) bears a reasonable relationship to the expected values in the future.

Losses have not grown as rapidly as gains over this period. This is to a large extent a reflection of stock market performance in that the peak year for losses, 1974, was a poor

year in the market. It may also be due to the differences in the timing of realization of accrued gains and losses.

Table 2 shows the net capital gains of individual taxpayers for the major categories of capital property for the years 1972 to 1978. The distribution of net capital gains for corporations is available only for 1977 and is given in the footnotes to the table. With the exception of the first two years, the dominant source of capital gains for individuals and corporations has been real estate. In 1978, 53 per cent of net capital gains of individuals were derived from sales of real estate and 34 per cent from sales of shares. For corporations in 1977, the proportions were 68 per cent and 16 per cent respectively.

Table 2

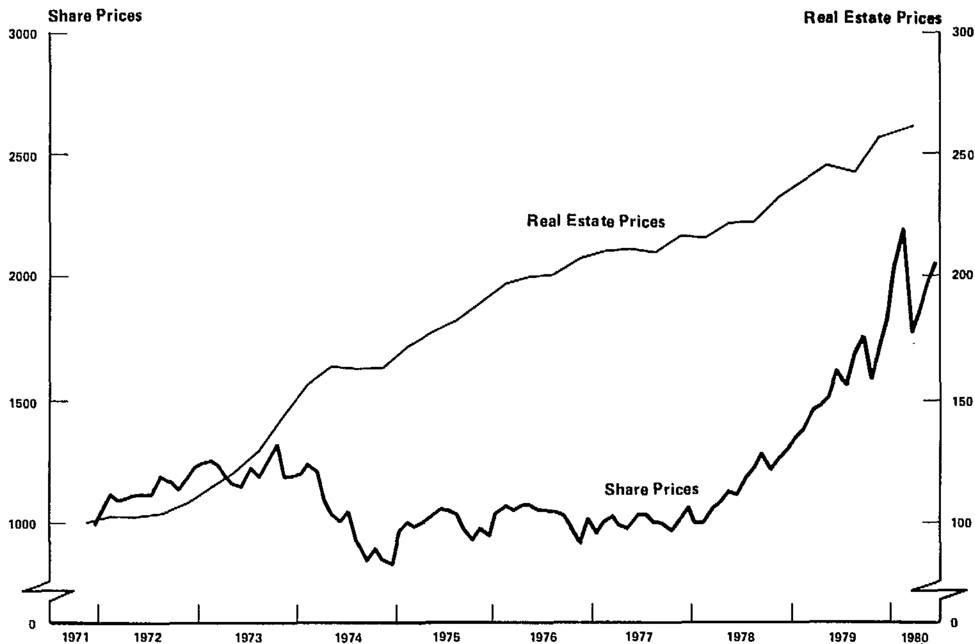
Net Capital Gains or Losses on Various Types of Capital Property, 1972-1978[1]

	Individuals					Corporations[4,5]	Total
	Shares	Real Estate	Bonds or Other Properties	Other[2]	Total[3]		
	($ millions)						
1972	194.8	−21.7	−6.5	22.8	189.4	179.0	368.4
1973	167.1	100.8	−8.1	32.6	292.4	371.6	664.0
1974	−177.0	393.5	−19.6	28.7	225.6	447.2	672.8
1975	−38.7	661.4	−9.1	41.9	655.5	639.6	1,295.1
1976	197.4	952.8	17.7	48.1	1,216.0	819.0	2,035.0
1977[6]	338.8	1,038.6	18.6	54.4	1,450.4	1,039.2	2,489.6
1978	810.8	1,259.9	74.3	242.2	2,387.2	1,590.0[7]	3,977.2

(1) Net capital gains or losses are the difference between the realized capital gains and realized capital losses for each category of property.
(2) "Other" includes gains on personal property and listed personal property, gains allocated to individuals by employees' profit-sharing plans and by trusts and cash bonus payments on Canada Savings Bonds reported as capital gains. The large increase in this type of gain in 1978 was due mainly to cash bonus payments on Canada Savings Bonds which became payable in that year. These bonus payments could be reported as capital gains or interest at the option of the taxpayer.
(3) The total net capital gains are equal to the difference between total capital gains and total capital losses for individuals as shown in Table 1 except for differences due to rounding.
(4) Net capital gains of corporations are the excess of gains over losses before the subtraction of the one-half of gains which are tax-exempt. The net capital gains of corporations are equal to twice the net taxable gains of corporations as shown in Table 1.
(5) The net capital gains of corporations by type of capital property are available only for 1977. The estimated distribution is: shares (15.7 per cent); real estate (67.6 per cent); bonds or other property (16.6 per cent); and other (0.1 per cent).
(6) For 1977, Table 18 of Revenue Canada, *Taxation Statistics*, does not reflect gains and losses on Canadian shares ($238.3 million), Canadian bonds (-$16.1 million) and certain other gains ($22.2 million). These have been added in the above table to make the reported values complete and consistent with other years.
(7) Based on preliminary information.
Sources: Revenue Canada, *Taxation Statistics*; Revenue Canada, *Preliminary Taxation Statistics*, 1978 Taxation Year; Statistics Canada, *Corporation Taxation Statistics* (61-208); and unpublished information from Revenue Canada and Statistics Canada for 1977 and 1978.

These relative proportions are, of course, a reflection of the real estate and stock market performance over recent years as depicted in Chart 1. As is evident from the chart,

SHARE AND REAL ESTATE PRICES
1971 - 1980



Sources: Share prices: The price series used is the Toronto Stock Exchange Composite Index of 300 shares. The values shown are monthly closing quotations commencing in December, 1971 and ending June, 1980.

Real Estate Prices: The price series used is the average dollar value of multiple listing service transactions compiled by the Canadian Real Estate Board. The values shown are quarterly averages commencing in the Final Quarter 1971 and ending in the First Quarter 1980. (4th quarter of 1971 equals 100.)

it was only after 1977 that share prices moved sharply above their 1971 level. This upturn in the stock market is reflected in the significant increase in the ratio of share gains to total gains for individuals, from 23 per cent in 1977 to 34 per cent in 1978. The portion of gains related to dispositions of shares is expected to be still higher in 1979, given the market performance during that year.

Revenue from Taxation of Capital Gains

Table 3 shows the estimated revenues derived by federal and provincial governments from the inclusion of capital gains in income for tax purposes. Federal revenues in 1978, the latest year for which detailed actual data are available, amounted to $450 million, some 1.3 per cent of total federal budgetary tax revenues in that year. (2) Provincial revenues from this source were $200 million in 1978. The revenues from the taxation of capital

(2) It is frequently asserted in public discussions that revenues from taxation of capital gains are less than the cost of their collection by the government. This is not the case. The federal revenues from tax on capital gains in 1978 were some 25 per cent higher than the entire program expenditures of Revenue Canada Taxation for administering the federal and provincial Income Tax Acts, and for collecting contributions to the Unemployment Insurance Plan and the Canada Pension Plan.

Table 3

Estimates Federal and Provincial Revenues from Taxation of Capital Gains(1)

	Taxation Year						
	1972	1973	1974	1975	1976	1977	1978
	($ millions)						
Federal							
Individuals	40	70	80	100	150	175	260
Corporations	30	60	70	95	125	145	190
Total	70	130	150	195	275	320	450
Provincial							
Individuals	14	24	27	35	55	90	130
Corporations	12	24	28	38	50	55	70
Total	26	48	55	73	105	145	200
Total Federal and Provincial Revenues	96	178	205	268	380	465	650

(1) The estimates are the additional revenue gain attributable to the inclusion of capital gains in income for tax purposes. They are thus based on the marginal tax rate for this income source.
Source: Simulations with the Personal Income Tax Micro-simulation Model; Statistics Canada, *Corporate Taxation Statistics*; and preliminary data from Revenue Canada on 1978 corporate tax returns.

gains have been growing rapidly, in part due to the maturing of the structure, as described above.

These values indicate only what the direct impact of eliminating taxation of capital gains would have been in the various years. But any reduction in tax rates on capital gains would undoubtedly lead taxpayers to rearrange their affairs to obtain more of the return on their investments in the form of capital gains, so the eventual revenue cost would be larger than the estimates in Table 3. Taking account of the growth in revenues from this source over the recent past, the improved stock market performance since 1977, and the impact of the behavioural changes that would occur, it is estimated that the reduction in federal revenues in 1980 from elimination of tax on capital gains would be in excess of $750 million. Adding the associated provincial revenue loss would bring the total to over $1 billion.

Distribution of Capital Gains By Income Level

As noted previously, the taxation of capital gains has an important influence on the equity of the overall tax system. Table 4 provides information on the distribution of

capital gains, and the revenues from their taxation, by income class for the 1978 taxation year. The main observations are as follows:

> Higher-income taxpayers account for a disproportionate share of capital gains. For example, taxpayers earning more than $50,000, who accounted for only 0.8 per cent of the taxpayer population, received over 40 per cent of total net taxable capital gains.
>
> The high concentration of capital gains in upper-income brackets is also reflected in the percentage distribution of tax revenues by income class. Taxpayers with income above $50,000 accounted for over one-half of federal revenues from taxation of capital gains.
>
> The proportion of individuals reporting capital gains increases sharply with income, as does the amount of average gain. For example, less than 4 per cent of filers with incomes below $15,000 reported capital gains, while over 40 per cent of those in the over $100,000 income class reported capital gains. The average amount of gain reported increases from about $2,000 in the lower income ranges to over $77,000 in the top income class.

Table 4

Distribution of Federal Tax on Capital Gains by Income Class, Individuals, 1978 Taxation Year

					Filers Reporting Gains	
Assessed Income Class	Share in Taxfiler Population	Share in Total Income	Share in Net Taxable Capital Gains	Share in Federal Tax on Capital Gains	As a Percent of All Filers in the Class	Average Gain
($)						($)
Under 5,000	32.3	5.8	3.0	–	1.2	1,700
5,000 – 15,000	40.8	35.7	15.4	6.1	3.7	2,100
15,000 – 25,000	19.8	34.3	14.9	12.2	5.6	2,700
25,000 – 50,000	6.3	18.1	24.0	27.5	14.6	5,200
50,000 – 100,000	0.7	4.2	18.5	23.8	29.9	16,100
100,000	0.1	1.9	24.2	30.4	44.4	77,100
Total	100.0	100.0	100.0	100.0	2.3	6,500

Source: Simulations with the Personal Income Tax Micro-simulation Model, and Revenue Canada, *Taxation Statistics*

International Comparison of Taxation of Capital Gains

General Comparison

In any evaluation of the Canadian tax treatment of capital gains, it is important to compare Canada's system with those of other industrialized countries. Tables 5A and 5B outline the major features of the treatment of capital gains of individuals and unincorporated businesses in a number of OECD (Organization for Economic Cooperation and Development) countries. Taxation of capital gains of corporations is discussed separately below. Because of significant variations in the tax treatment of capital gains at the state, provincial or local levels within a country, the comparison is, by necessity, confined to the treatment at the federal level. This, however, does not affect the basic conclusions reached here, unless otherwise indicated.

Over all, Canada's tax treatment of capital gains is not out of line with that in other countries. In fact, the combined burden of estate, wealth, gift and capital gains taxes is lower in Canada than in other countries surveyed. The following points deserve note:

Canada taxes capital gains of both individuals and businesses through the income tax system. This approach is also followed by the United States, Japan, France, Norway and Sweden. The United Kingdom, Ireland, and Denmark have separate capital gains taxes. Taxation of capital gains in West Germany, Italy and several other countries is less comprehensive, being restricted to businesses, although some short-term gains of individuals are taxed in full as income. Australia taxes only certain short-term capital gains and these are treated as ordinary income.

Canada's rates of tax on capital gains are lower than in many other countries. Canada's maximum effective federal tax rate on short-term gains is generally lower than in other countries that tax capital gains. On long-term gains, Canada's maximum federal tax rate is below that in the U.S., the U.K., Japan (on real estate and substantial shareholdings only), Sweden and Ireland, and is lower than rates on real estate gains in a range of other countries. Even the combined federal and provincial tax rates in Canada are generally lower than, or comparable to, the central government rates in these countries.

In Canada, gains on the sale of a principal residence are unconditionally exempt. While this approach is followed in a number of countries, there are notable exceptions; in West Germany, for example, they are fully taxable if the residence is sold within two years of acquisition.

Gains on shares and bonds are taxable in Canada, as is the case in a good number of other countries. *Even in countries where they are exempt, speculative gains, short-term gains, and gains on significant holdings (as would usually be the case for a shareholder of a private company) are often fully taxable.*

Table 5(A)

Summary of Tax Treatment of Capital Gains of Individuals
Selected OECD Countries, 1980

	Taxation of Capital Gains	Tax on: A. Estate/ Inheritance B. Wealth	Tax Treatment of Capital Gains on Various Assets				
			Shares		Bonds		Principal Residence
			Short-term	Long-term	Short-term	Long-term	
Canada	General	A. No B. No	One-half taxed as income		One-half taxed as income		E
United States	General	A. Yes B. No	Fully taxable as income(1)	40 per cent taxed as income	Fully taxable as income(1)	40 per cent taxed as income	Deferral if reinvested with fixed exemption for those over age 55(2)
United Kingdom	General	A. Yes B. No	Separate 30-per-cent tax with partial tapering(3)				E
Japan	Partial	A. Yes B. No	Speculative gains and significant holdings taxed(4)		Speculative gains taxed		E
West Germany	Partial	A. Yes B. Yes	Fully taxed as income(5)	E(5)	Fully taxed as income	E	Short-term gains taxed(5)
France	Partial	A. Yes B. No	Taxable with exemption for small transactions(6)				E
Norway	Partial	A. Yes B. Yes	Separate 50-per-cent tax(7)	E	E	E	E
Portugal	Partial	A. Yes B. No	Certain gains taxed at 10-per-cent rate(8)		E	E	E
Belgium	None	A. Yes B. Yes	E	E	E	E	E
Denmark	Partial	A. Yes B. Yes	Fully taxed as income(9)	E	E	E	E
Ireland	General	A. Yes B. No	Separate 30-per-cent tax with reduced rates for longer holding periods				E
Italy	Very limited(10)	A. Yes B. No	E	E	E	E	E
Spain	General	A. Yes B. Yes(11)	Taxed fully as income with reduced rates depending on holding period				E
Sweden	General	A. Yes B. Yes	Fully taxed as income(11)	40 per cent of gain taxed as income	Fully taxed as income(12)	Reduced rates(13)	E
Austria	Partial	A. Yes B. Yes	Speculative transactions taxed as income(14)	E(14)	Speculative transactions taxed as income(14)	E(14)	E
Australia	Partial	A. Yes B. No	Fully taxed as income(15)	E	Fully taxed as income(15)	E	E
Netherlands	Partial(16)	A. Yes B. Yes	Speculative gains and gains on shares which are a substantial interest taxed		Speculative gains taxed		E

GENERAL NOTES: Tables 5(A) and 5(B)
- E indicates exemption.
- In countries where gains on either shares or bonds are generally exempt, they are generally taxable if they are part of the business assets of the individual selling the asset. As well, countries with partial or limited taxation generally tax real property gains.
- Countries with partial taxation generally tax gains on shares and bonds if they are part of the business assets of the seller, and also tax gains on real property.
- All dollar amounts in the table are in the approximate Canadian dollar equivalent of national currencies.

SOURCE: Information compiled from Guides to European Taxation (International Bureau of Fiscal Documentation), Taxation of Net Wealth, Capital Transfers and Capital Gains of Individuals (Report of the Committee on Fiscal Affairs of the OECD).

NOTES: Table 5(A)

(1) In the United States gains on assets held under one year are short-term.

(2) In the United States tax on gains on principal residences is deferred as long as proceeds are reinvested in a home. When taxpayer reaches age 55, up to $116,000 of gains on home are exempt.

(3) In the United Kingdom a reduced rate of 15 per cent applies to gains of between $2,750 and $13,750. Tapering relief applies to gains of between $13,750 and $26,125.

(4) Japan also taxes gains on certain large transactions.

(5) West Germany also taxes gains on shares where shareholder has a substantial interest in a company (more than 25 per cent of its share capital). These gains are taxed at one-half the rate on ordinary income. Gains on principal residences are fully taxable if sale occurs within two years of acquisition.

(6) France taxes gains on shares and bonds in various circumstances. Transactions with borrowed money, and other transactions where total annual amount exceeds 1.6 times value of securities owned and sales exceed $28,000 are taxable at 30 per cent. Other transactions totalling more than $42,000 are taxed at 15 per cent. Where shareholder has a substantial interest share gains are taxable at 15 per cent.

(7) In Norway gains realized within two years are short-term. Gains from sale of a substantial portion of a corporation's shares are taxed as ordinary income.

(8) Portugal imposes a separate 10-per-cent tax on one-half the increase in capitalized reserves of companies and one-half the difference between value and issue price of new shares issued to existing stockholders. This tax is payable by the company which must recoup it from shareholders.

(9) In Denmark gains realized within two years are short-term. Certain "extraordinary gains" are also taxed at a rate of 50 per cent.

(10) Italy taxes gains on shares and bonds if the holder engages in "speculative transactions", in which case they are taxed in full as income.

(11) Spain's net wealth tax was introduced as a temporary measure.

(12) Short-term gains in Sweden are those on assets held for less than two years.

(13) In Sweden, on bonds held for two years or more, only a portion of the gain is taxed as income, as follows:
- bonds held between 2 and 3 years: 75 per cent of gain taxed;
- bonds held between 3 and 4 years: 50 per cent of gain taxed;
- bonds held between 4 and 5 years: 25 per cent of gain taxed;
- bonds held 5 years or more: no tax on gain.

(14) In Austria short-term transactions are speculative transactions with sale within one year from date of purchase. Gains on shares of a corporation in which a taxpayer has a substantial interest are taxed at half the normal tax rates.

(15) Short-term gains in Australia are those on sales within one year of acquisition.

(16) In the Netherlands, gains on shares of a company in which the shareholder has a substantial interest are taxed at 20 per cent. Gains on shares or bonds which are regular speculative gains are fully taxed as income. Certain other gains are also taxed such as on liquidation of a company or on sales of shares back to the corporation itself.

Table 5(B)

Additional Features of Taxation of Capital Gains, Individuals
Selected OECD Countries, 1980

	Averaging Provisions	Deductibility of Losses	Treatment of Gains Accrued at Death	Other Features
Canada	Special forward averaging through income-averaging annuities	Against gains and up to $2,000 of other income (unlimited for small business shares and bonds); indefinite carry-forward, one year carry-back	Taxable with deferral for transfers to spouse and for inter-generational transfers of farms and small businesses	First $1,000 of investment income, including gains, exempt
United States	None	Against gains and up to $3,480 of other income; indefinite carry-forward, no carry-back	Exempt prior to 1979, deferral since then	Minimum tax on exempt portion of long-term gains
United Kingdom	None	Against gains only; indefinite carry-forward, three-year carry-back at death	Exempt	Exemption for first $2,750 of gains
Japan	None	Against gains and other income; three-year carry-forward	Deferred	Exemption for first $2,600 of gains
West Germany		Against gains in same year only	Exempt	First $650 of speculative gain exempt
France	None	Against gains in same year only		
Ireland	None	Against gains; indefinite carry-forward	Deferred	First $1,200 of gains exempt
Spain	Reduced rate system acts as averaging device for assets held for several years(1)	Against gains	Taxable	
Sweden	None	Against gains; six-year carry-forward	Deferred	First $280 of long-term gains exempt

For General Notes and Source references see Table 5(A).

NOTE: Table 5(B)
(1) In Spain, depending on the holding period a reduced tax rate applies. For example, if an asset is held for five years only one-fifth of gain is added to income. The average tax rate on total income (including this portion of gain) is then applied to remaining four-fifths of gain.

One important aspect of the taxation of capital gains is the degree to which they may be averaged over a longer period so as to reduce or defer tax. As noted earlier, tax deferrals or averaging provisions can result in a substantial reduction in the effective rate of tax on capital gains. In this regard, Canada's tax treatment is the most favourable to taxpayers among all the countries surveyed. In addition to the general automatic averaging provision of the individual income tax system, individual taxpayers in Canada are permitted to spread the tax on capital gains over a number of years through the purchase of an income-averaging annuity contract. In comparison, few other countries provide for any form of general averaging at all and in these cases the provisions are less generous than in Canada. Besides Canada, only Spain has special averaging provisions for capital gains.

For capital losses, the general rule among the countries surveyed is that, where gains are taxable, losses are deductible. Where capital gains are not fully taxed as income, losses are usually deductible only against capital gains. Canada follows this general pattern, but also permits allowable losses of up to $2,000 to be deductible against other income; no limit applies in the case of losses on small business debt and shares. In addition, Canada allows for an indefinite carry-forward and a one-year carry-back of losses, while in other countries the carry-forward is often restricted to a certain number of years.

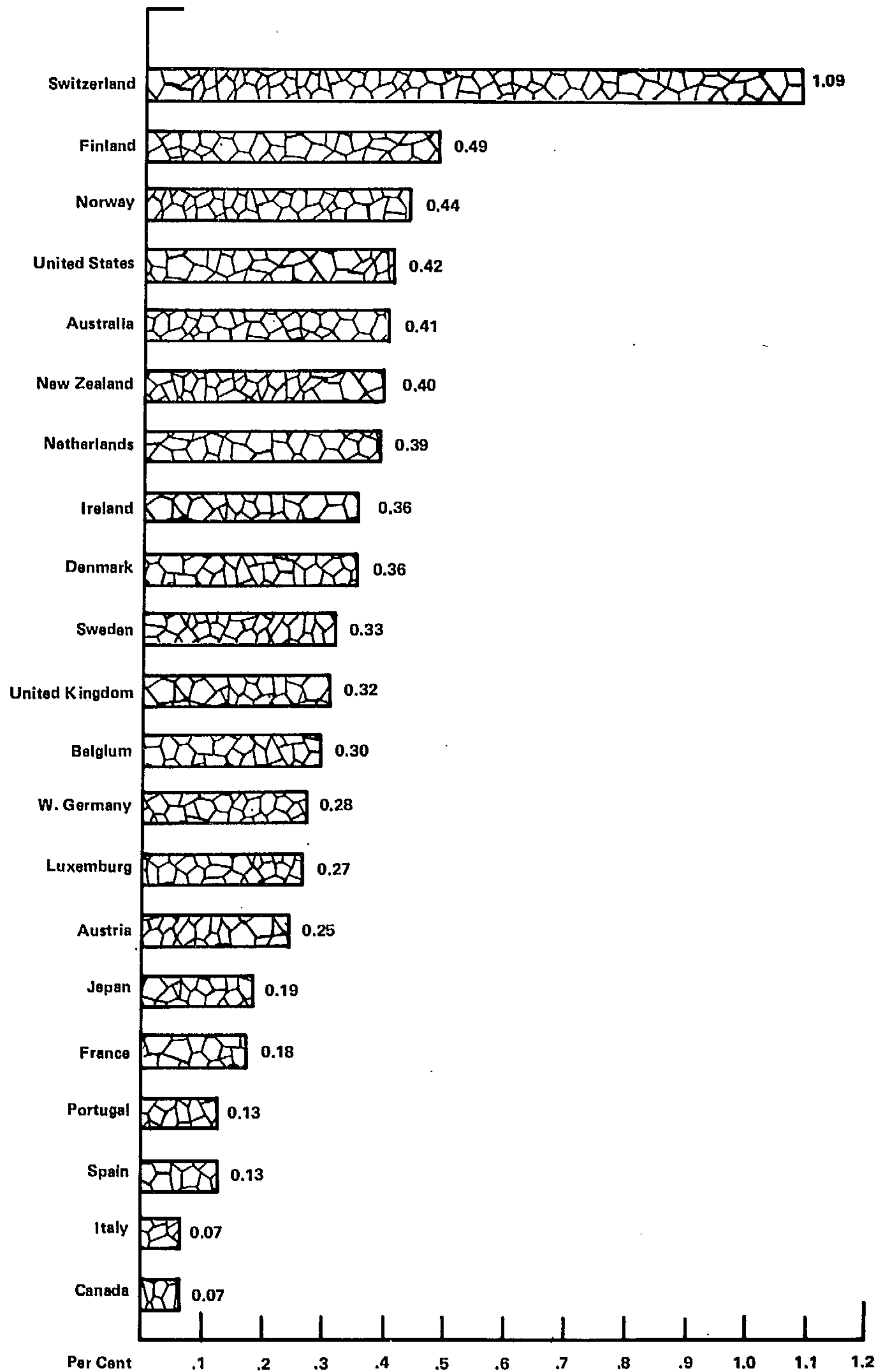
Canada taxes gains accrued at the time of death of the taxpayer as if these gains had been realized. Other countries either defer tax liability until the gain is actually realized on these assets, or exempt accrued gains altogether at the time of death of the taxpayer. However, all these countries have an estate tax and some also levy wealth taxes, whereas Canada has no federal estate or inheritance tax and only one province currently levies succession duties. In aggregate, the burden of estate or inheritance taxes is generally much higher than that of capital gains taxation on death.

As a result of the absence of inheritance and gift taxes at the federal level and in most provinces, Canada's taxation of inheritances, gifts and annual net wealth is the lowest among major industrialized countries. This is illustrated in Chart 2 which shows revenues in 1976 of all levels of government from wealth, estate, inheritance, or gift taxes in 21 OECD countries, expressed as a percentage of each country's gross domestic product.

It is often suggested that the taxation of capital gains at death or when property is gifted was meant to be a substitute for the estate and gift tax that the federal government imposed until 1972. A comparison of tax revenues under the two systems suggests that this has not been the case. For example, federal tax arising from deemed realization of capital gains at death amounted to some $11 million in 1978. In contrast, in 1971 the federal estate and gift tax revenues were over $100 million (equivalent to some $175 million in 1978 dollars). A major reason for this difference is that estate taxes fall on the full value of assets transferred and not just on the increase in value. Also, the base for revenues from the taxation of accrued capital gains at death has been eroded by the tax deferral on inter-generational transfers of farm property and small business shares.

Whatever the reasons, Canada's ranking among OECD countries, as shown in Chart 2, should be an important consideration in evaluating any further reductions in taxes on capital income. Canada's extreme position may already be a cause of concern to the extent that it restricts the government's ability to promote a fair and equitable distribution of income and wealth in the country.

REVENUE FROM TAXES ON INHERITANCES, GIFTS AND ANNUAL NET WEALTH AS A PERCENTAGE OF GROSS DOMESTIC PRODUCTS, VARIOUS OECD MEMBER CONTRIES; 1976



Source: Revenue Statistics of OECD Member Countries, 1976

The discussion above relates to the treatment of capital gains in the hands of individuals. Table 6 provides a very general description of the treatment of capital gains of corporations in selected OECD countries. While the treatment of individual assets in particular circumstances differs significantly from country to country, the table does confirm the relative

generosity of the Canadian provisions at the corporate level as well. Canada taxes one-half of corporate gains at regular corporate tax rates, whereas a number of other countries tax corporate gains fully as income, or provide an alternative tax rate that is not as favourable to taxpayers as that levied in Canada. It is interesting to note that, unlike Canada, many other countries do not generally tax corporate capital gains in the same manner as individual capital gains. For example, West Germany taxes corporate capital gains fully at standard rates, even though long-term capital gains of individuals are fully exempt. The United States requires full inclusion of gains in corporate income, taxable at a special rate of 26 per cent, while in the case of individuals only 40 per cent of a gain need be included in income.

Table 6

International Comparison of Aspects of Tax Treatment of Corporate Capital Gains, Selected OECD Countries

Canada:	One-half of gains taxed at ordinary corporate tax rates implying an effective federal rate of tax of 18 per cent. Deferral of tax on voluntary and involuntary dispositions if property replaced. Generous rollovers for corporate reorganizations.
United States:	All gains included in income for tax purposes. Taxpayers are given the option of calculating tax on gains at the alternative rate of 28 per cent. Deferral of tax on involuntary dispositions if property is replaced. Some rollovers for corporate reorganizations.
United Kingdom:	Gains subject to tax at the reduced rate of 30 per cent. Deferral if proceeds reinvested in similar assets within three years.
West Germany:	Gains taxable at standard rates as ordinary business income. Deferral of tax on certain gains if reinvested in replacement property.
France:	Short-term gains (on property held for less than two years) are subject to normal corporate income tax. Long-term gains attract the reduced rate of 15 per cent with a further 35-per-cent tax on distribution.
Italy:	Gains on disposal of physical assets attract normal corporate tax and local income tax. Deferral of tax on gains reinvested in fixed depreciable assets within three years.

Comparison with the United States

Many commentators focus most closely on the differences in the tax treatment of capital gains between Canada and the United States. The following points elaborate on the differences in the tax treatment of capital gains in the two countries.

Individuals

Only one-half of gains (whether short-term or long-term) arising since 1971 are taxed in Canada. In the U.S., capital gains have been taxable in one form or another since 1913. While only 40 per cent of long-term gains of individuals (those on assets held over one year) are taxed in the U.S., short-term gains are fully taxed at rates ranging up to 70 per cent, significantly higher than the tax on such gain in Canada.

The U.S. system contains a minimum tax of 10 to 25 per cent on the exempt 60 per cent of long-term capital gains of individuals. As a result, the U.S. federal tax rate on long-term gains could be as high as 43 per cent (70 per cent tax rate on 40 per cent of gains plus 25 per cent on remainder). Canada does not have a tax analogous to the minimum tax, so that the corresponding top Canadian federal tax rate on capital gains is only 21.5 per cent.

Capital gains on principal residences are completely tax-exempt in Canada. In the U.S., for persons under 55, a deferral applies only to the extent that the proceeds are reinvested in another home. For persons over 55, an exemption exists, limited to U.S. $100,000 of gains.

Capital gains in Canada may be invested in income-averaging annuity contracts which permit the tax on the gain to be spread over a number of years. No analogous provision exists in the United States.

In Canada, there is deemed realization of gains at death. A tax deferral is permitted in the case of inter-spousal transfers of any property and inter-generational transfers of shares in small businesses and family farms. Capital gains realized at death in the U.S. were, until lately, completely exempt. At the end of 1979 the exemption was withdrawn and the U.S. now provides a deferral until the property is subsequently disposed of by the heirs. However, the United States imposes an estate tax on property passing on death.

Corporations

Canada's tax treatment of corporate capital gains is more generous, since only one-half of these gains are taxed. U.S. corporations must include all gains in income subject to tax but are allowed an alternative tax rate of 28 per cent on long-term gains. This alternative rate is of no benefit to small businesses. In contrast, the taxation of capital gains received by private corporations in Canada is fully integrated with the personal income tax system, which means that in effect there is no separate taxation of gains at the corporate level. Capital gains of public corporations are subject to combined federal and provincial corporate tax rates of 20 to 25 per cent. Canada also permits various tax-free rollovers, i.e., tax deferrals, on both voluntary and involuntary dispositions of depreciable property when the proceeds are used to purchase replacement property. In the U.S. these rollovers only apply to involuntary dispositions. Rollovers for corporate reorganizations apply in more circumstances in Canada than in the U.S.

The Technical Role of Capital Gains in the Income Tax System

Under the Canadian income tax system, taxes are imposed separately on corporations and individuals. However, the taxation of individuals in their capacity as shareholders interacts with the taxation of corporations. Most notably, individuals receive income from corporations, generally in the form of dividends or capital gains. Rules relating to the treatment of this income establish a link between the corporate and individual tax systems. This is the point where, in effect, the individual and corporate tax systems meet. The rules linking the corporate and personal tax systems establish the degree of integration of the two systems. The provisions of any tax system that establish this link are important as they affect crucially many business and investment decisions. In designing these provisions a number of important policy questions arise. For example, will the individual tax system recognize that corporate-source income has already borne tax and, if so, to what extent? Will the two basic methods of realizing income – dividends and capital gains – be taxed uniformly? What rules will apply when assets with accrued capital gains are transferred from individuals to corporations, or between corporations in a merger or reorganization? It is obvious from these questions that the taxation of capital gains is an integral part of the corporate/shareholder tax system and cannot be isolated from other parts of the tax system. This section discusses the evolution of the rules relating to the taxation of dividends and capital gains in the Canadian corporate/shareholder tax system, and the implications of changes in the taxation of capital gains.

Taxation of Dividends and Capital Gains

Two major objectives have influenced the tax treatment of dividends and capital gains of shareholders. First, it is desirable that there be a degree of uniformity between the tax treatment of income earned directly by an individual and income earned through a corporation and distributed to the individual shareholder. To the extent that such uniformity exists, the corporate and shareholder tax systems are said to be integrated.

Perfect uniformity or integration would avoid discrimination and inequities that bias Canadians in their choice of investments and ways in which business is conducted. Second, if capital gains are to be taxed at preferential rates, it must be recognized that distributions from corporations that are in substance dividends can be easily converted into capital gains. The tax system must recognize and deal with cases of such conversions – so-called "dividend stripping" or "surplus stripping" – where they offend tax equity and constitute tax abuse.

Prior to 1972 capital gains were tax-exempt. Individuals were required to include dividend receipts in their income, but were allowed a tax credit of 20 per cent of dividends in partial recognition of the tax already borne by this income at the corporate level. Under that system, withdrawal of corporate surplus in the form of dividends or capital gains gave rise to widely different tax consequences.

An example can best illustrate the difference. Assume that Mr. A incorporated OPCO with capitalization of $10,000, that the company had earned $80,000 and that its earnings had enjoyed the low corporate tax rate of 21 per cent. Its after-tax earnings were thus $63,200. Assume further that A's marginal tax rate was 50 per cent and that he wished to withdraw the company's after-tax earnings. As one option, A could simply direct OPCO to pay as dividends all of its $63,200 surplus to him. Net of the dividend tax credit, he would have paid individual income tax of approximately $18,960 on the dividends.

Alternatively, in the absence of rules to prohibit the transactions, he could realize the earnings by selling his shares to a newly-incorporated holding company owned by him, Holdco. The sale would give rise to a $63,200 capital gain, all of which would be exempt from tax. OPCO could then be liquidated by either winding-up or amalgamating and its assets could be used by Holdco to pay for the purchase of the OPCO shares from A. This series of transactions is referred to as a surplus strip of the corporation.

Under the pre-1972 system, surplus stripping techniques were counteracted by complex rules which attempted to ensure that the accumulated underlying corporate surplus would, in practice, be taxed at an appropriate rate when it was distributed. These rules proved to be not only very complex and arbitrary but also technically defective.

In 1950, the first of the anti-stripping rules, the "designated surplus" provision, was introduced. It designated the undistributed income of a corporation on hand at the time its control was acquired by another corporation. The rule disallowed the usual tax exemption for intercorporate dividends on the distribution of designated surplus to the controlling corporation. It effectively nullified a number of surplus stripping transactions, such as that described above, which depended on being able to pass the surplus tax-free between corporations. The effect was to impose a tax of approximately 50 per cent on designated surplus distributions and this, combined with the income tax that had already been paid on the profits, resulted in the removal at the corporate level of the tax benefit that the original shareholder sought to achieve.

The designated surplus rules contained some basic defects that made them at the same time relatively easy to circumvent and inappropriate when they applied. For example, these rules imposed the distribution tax on the purchaser rather than on the vendor who was, after all, the person attempting to obtain the surplus tax-free. In addition, the rules did not always properly measure the underlying surplus, nor did they cover acquisitions of less than a controlling interest.

On the other hand, the rules interfered with various legitimate business reorganizations. For example, consider a common case where various business activities were carried on by separate corporations all under the control of a holding company. Liquidation, amalgamation or other reorganization within the corporate group could trigger the designated surplus provisions on any internal distributions arising on or after the reorganization. In contrast, if the operation of the various businesses had been carried on in separate divisions within one corporation, any profits earned in one line of business could be freely transferred for use in another part of the corporation's activities without any tax consequences.

When it became clear that the designated surplus approach was not effective, a "ministerial discretion" provision was introduced in 1963 to contain a groundswell of surplus-stripping developments. In the absence of a reasonable and workable system, this created taxpayer uncertainty, further administrative difficulties and otherwise unnecessary expenditure of time and effort in the planning of business transactions and in the enforcement of the law.

The inability of the government to check surplus stripping abuses was, in fact, the primary impetus for a comprehensive review of the tax system in the early 1960s. It led to the establishment of the Royal Commission on Taxation. While the Commission was given a broad mandate to report on all aspects of the Canadian tax system, tax avoidance through surplus stripping was a primary concern of the government prior to the establishment of the Commission.

The Commission's recommendation for full taxation of capital gains would have solved the surplus stripping problem. This recommendation was, however, not adopted by the government. Instead, the new system put in place in 1972 included half-taxation of capital gains and significant changes in the dividend tax credit mechanism. Shareholders receiving dividends from taxable Canadian corporations were required to "gross-up" the amount of the cash dividend received by one-third and include this amount in their income for tax purposes. They paid tax on the grossed-up amount, but were eligible for a federal and provincial dividend tax credit of roughly 25 per cent of their grossed-up dividends (the credit was roughly equivalent to the amount of the gross-up). This ensured that, with respect to corporations subject to a tax rate of 25 per cent, the combined corporate and personal tax on income earned through the corporation would be roughly equivalent to the tax payable if the income had been earned directly by the shareholders. Since a 25-per-cent rate was applicable to the active business income of small Canadian-controlled private corporations, the system achieved integration for dividends from such corporations.

The first column of Table 7 illustrates this calculation by considering the example of a small private business corporation which earned $100. After paying $25 of corporate tax it distributed $75 of dividends to its shareholders. Under the 1972 rules they, in turn, grossed-up these dividends to $100 and paid tax at their applicable personal marginal tax rates. In computing their final personal tax liability they were allowed a dividend tax credit of $25. They thus included in their income an amount effectively equivalent to the pre-tax corporate income and received a credit for the tax already paid at the corporate level. The total corporate and personal tax was the same as would have been payable if the income had been earned directly by the shareholders.

While this system resulted in a high degree of integration of the corporate and personal tax for shareholders of small private companies, it suffered from a major drawback. It continued to levy more tax on dividends than on capital gains, only one-half of which were taxed. The system thus still provided opportunities for surplus stripping in the case of closely-held private companies. To continue the earlier example, the $75 of after-tax corporate income, if left in the corporation, would normally result in a $75 appreciation in value of the corporation's shares. If the individual shareholder could have realized this increment as a capital gain the combined corporate and personal tax on the $100 of corporate-source income would have been much lower than if the increment had been paid out as dividends. For an individual in a 50-per-cent tax bracket, the total corporate and personal tax on the $100 of business income received in dividends was $50. If this individual instead realized capital gains, the combined corporate and personal tax on the $100 of business income was $43.75 ($25 corporate tax plus a personal tax of $18.75 on the taxable capital gain of $37.50). For individuals in higher tax brackets the difference between tax on dividends and tax on capital gains was much larger.

With the introduction of half-taxation of capital gains in 1972, the rate of tax on designated surplus was reduced from 50 to 25 per cent. There were other substantial amendments to the designated surplus rules. Nevertheless, it turned out that the rules could still be circumvented, in some cases through the use of the tax-free rollover provisions that

Table 7

Taxation of Active Business Income Earned by a Canadian-Controlled Private Corporation and Distributed to its Shareholders

		1972 Rules	1978 Rules
		($)	
1	Pre-tax corporation income	100	100
2	Less corporate income tax	25	25
3	Equals corporate surplus available for distribution to shareholders	75	75
	A. Withdrawal of Corporate Surplus As Dividends		
4	Dividend received by shareholder	75	75
5	Plus gross-up of dividends (33 1/3 per cent and 50 per cent of dividends received under 1972 and 1978 rules respectively)	25	37.50
6	Equals amount added to shareholders' income for purpose of individual income tax	100	112.50
7	Shareholders individual income tax (at the assumed rate of 50 per cent)	50	56.25
8	Less dividend tax credit	25	37.50
9	Equals net individual income tax on dividends	25	18.75
10	Total corporate and individual income tax (lines 2 + 9)	50	43.75
	B. Withdrawal of Corporate Surplus as a Capital Gain		
11	Capital gain on the sale of corporation shares	75	75
12	Taxable capital gain	37.50	37.50
13	Shareholders' individual income tax	18.75	18.75
14	Total corporate and individual income tax (lines 2+13)	43.75	43.75

had been made available. In addition, the rules continued to interfere with legitimate business reorganizations. An analysis in 1974 found over 30 anomalies in the rules. These were addressed by adding new provisions and concepts to the law, but at the cost of greater complexity which created new problems without solving all the old ones.

Two other approaches were available to solve the problem at this stage. Either the tax on capital gains could have been raised or the tax on dividends reduced. In 1977 the government

chose the latter option and raised the dividend gross-up and tax credit from one-third to its current level of one-half of cash dividends received. This enrichment of the dividend tax credit lessened the differential between the taxation of dividends and capital gains, reduced the incentive for converting one to the other and permitted a considerable simplification of the rules designed to guard against tax abuse. As illustrated in Table 7 (second column), the differential at a 50-per-cent personal marginal tax rate was reduced from $6.25 to zero. For taxpayers with marginal rates below the 50-per-cent range (the exact threshold rate varies from province to province) it is now advantageous to receive corporate surplus in the form of dividends as opposed to capital gains. Capital gains are still more attractive than dividends for those with tax rates in higher ranges, but the differential is far less significant.

While this change achieved some simplification it was not without cost. First, the reduction in the tax on dividends reduced federal and provincial revenues by a significant amount. For 1979 the revenue cost is estimated to be some $200 million.

Second, while the change narrowed the difference between the effective individual income tax rates on dividends and on capital gains, it widened the gap between individual tax rates on dividends and on other forms of income. Table 8 shows the combined federal and provincial marginal individual tax rates on dividends, capital gains and other types of income at various taxable income levels. As can be seen the tax rates on dividends are now substantially lower than on other income. For most taxpayers (other than those in high tax brackets) the tax rates on dividends are less than one-half of those on other income. The tax on dividends is roughly equal to the tax on capital gains for those in upper-income brackets (from $39,792 to $99,788 of taxable income).

Third, the enrichment of the dividend tax credit detracted from integration of the corporate and shareholder tax systems for dividends from small Canadian-controlled private companies. The personal tax on business income earned through such companies is now lower than on the same type of income earned directly. This created incentives to incorporate purely for tax reasons and to receive employment income and other forms of

Table 8

Combined Federal/Provincial[1]
Marginal Tax Rates on Dividends, Capital Gains, and Other Income at Various Income Levels, 1980

Taxable Income	Combined Federal/Provincial Marginal Tax Rate		
	Dividends	Capital Gains	Other Income
$		%	
Under 18,238	0	18	36
18,238 – 23,212	7	21	42
23,212 – 39,792	16	24	48
39,792 – 64,662	25	27	54
64,662 – 99,480	31	29	58
Over 99,480	40	32	64

(1) The provincial tax rate used in the example is 49 per cent of federal basic tax. This is an average provincial rate on federal basic tax.

income through a corporation. This resulted in attempts by high-income professionals (such as doctors, dentists, lawyers and accountants) and senior executives to provide their services through a corporation where this was possible. In order to prevent tax avoidance through such actions, amendments were made recently to the Income Tax Act to restrict the application of the low small business tax rate. Specifically the rate of tax on corporations providing certain professional, personal or other services was raised from 25 to 33 1/3 per cent. Thus, for this type of income, the corporate/shareholder tax system again became approximately integrated. The tax system continues, however, to be over-integrated for other forms of business income earned in other Canadian-controlled private corporations.

Whatever the advantages and disadvantages of the current system the fact is that the tax on dividends and capital gains is roughly in balance in the case of small Canadian-controlled private corporations eligible for the low (25 per cent) corporate tax rate. Any reduction in the rate of tax on capital gains would disturb the balance. To avoid tax abuse, widening of the difference between the effective rates of tax on capital gains and dividends would require a fundamental restructuring of the current system, with little likelihood of a satisfactory resolution of the surplus stripping problems faced earlier.

In spite of the considerable simplification achieved in 1978, the tax system continues to contain a general ministerial discretion provision that can be invoked to prevent blatant tax abuses. This provision has been criticized by tax practitioners and taxpayers as it makes the determination of tax liability subject to the discretion of the Minister of National Revenue on a case-by-case basis, which is contrary to sound tax principles. Its continued presence is indicative of the genuine difficulty in designing workable rules to determine the tax on surplus distributions where there is a differential treatment of dividends and capital gains. If the tax on capital gains were reduced or eliminated, increased reliance on such a provision to protect the tax system would be inevitable. While unsatisfactory, such reliance would be perhaps the only solution to the problem of minimizing tax avoidance.

It has been suggested that possibilities for surplus stripping exist only in the case of private, closely-held companies. It is thus claimed that the tax on other forms of capital gains could be reduced or eliminated without significant adverse consequences to the tax system. Such a view neglects the existence of a number of tax-free rollover provisions (described in Appendix I) in the current system. These provisions were introduced to facilitate corporate reorganizations designed to improve efficiency or to respond to changing market conditions. The rollover provisions would have to be restricted if certain types of capital gains were given preferential treatment. The difficulties created by rollover provisions in granting selective exemptions from capital gains taxation are discussed in greater detail in Section 8.

Effects on Investment and Growth

Adverse effects on savings, investment and economic growth are often put forward as the main justification for eliminating the tax on capital gains.

The concerns expressed fall into three main areas: effects of capital gains taxation on aggregate savings and investment; the extent to which it biases the flow of savings away from risky investments; and the relationship between taxation of capital gains and corporate financial liquidity. Each of these is examined below in turn.

Effects on Aggregate Savings and Investment

The issue here is whether, if there is a prospective capital shortage resulting from inadequate savings and investment, the inclusion of capital gains in income contributes to this inadequacy.

At one level this concern takes the form of questioning whether Canadian rates of private sector saving will be sufficient over the next decade to finance needed investment without upward pressure on interest rates or excessive resort to foreign borrowing. Alternatively, the concern may simply be that Canadian capital investment levels are inadequate and that an appropriate method of encouraging investment is to increase personal savings by reducing the tax on capital gains.

Whether current rates of savings and investment are adequate can be judged only against some relevant criteria. Three that can be used are estimated future capital requirements, past Canadian savings rates that allowed the country to experience reasonable rates of economic growth, and savings rates in other countries.

Although developing a list of future investment projects and summing them to arrive at future capital requirements is superficially plausible, it proves on inspection to be generally unreliable and to obscure important economic realities. Given limited resources, any increase in investment in one area means less resources are available for other wants such as consumption or other investment projects. If savings and investment are at levels consistent with achievable and sustainable growth rates, it is not clear why a list of investment projects calling for much higher levels of capital requirements should be given credence. If any investment is profitable enough to attract financing, it will go forward; if it does not meet this market test, there appears to be little reason not to delay or abandon it.

Of course, there may be projects of extreme national importance that cannot attract private sector financing because of their scope or the risks involved. Cases such as this call for project-specific government assistance rather than for broad-based tax measures such as reduction in taxation of capital gains.

A second benchmark for analysing the adequacy of Canadian savings is to compare current with past experience.

Table 9 presents information on the various sources of savings and total savings as a proportion of gross national product (GNP) in Canada since 1950. The following points are notable:

Total gross savings (and investment) as a share in GNP (line 6) have been remarkably stable over the period, averaging some 23 to 24 per cent. There is no evidence of a decline since the introduction of capital gains taxation, though any effects of taxation of capital gains on savings, at the aggregate level, may have been masked by other offsetting influences.

The net domestic private sector savings rate[3] (line 7) has risen significantly during the 1970s. This is due to a large increase in personal sector savings coupled with a roughly constant share of business savings in GNP. The increase in private sector savings has been offset by declines in government savings (due to a large extent to deficits at the federal level) leaving the net domestic Canadian savings rate (line 8) in the 1970s slightly lower than it was in the latter half of the 1960s.

Table 9

Components of Canadian Savings as a Percentage of Gross National Product, Selected Periods

	1950-54	1955-59	1960-64	1965-69	1970-74	1975-79
			(%)			
1 Personal Sector	5.4	3.1	3.0	3.7	5.1	6.9
2 Business Sector	3.8	4.2	3.8	4.0	3.4	4.0
3 Government	3.0	1.8	1.6	3.8	3.2	−0.6
4 Non-Residents	1.3	3.6	1.7	1.3	0.3	2.4
5 Capital Consumption Allowances	10.2	12.0	12.2	11.6	11.0	10.9
6 Total Gross Savings	23.5	24.9	22.4	24.4	23.3	23.7
7 Net Domestic Private Sector Savings (lines 1 + 2)	9.2	7.3	6.8	7.7	8.5	10.9
8 Net Domestic Savings (lines 1 + 2 + 3)	12.2	9.1	8.4	11.5	11.7	10.3

Notes:
Business savings are undistributed corporate profits. They include savings of government business enterprises and are net of the inventory valuation adjustment. Personal sector savings include savings of unincorporated businesses and the adjustment to reflect accrued but unrealized farm income arising out of the operation of the Canadian Wheat Board. Government savings are any excess of revenues over expenditures for all levels of government combined. Savings by non-residents take the form of net capital inflows, both direct and portfolio, into Canada.
Total gross savings equals total gross capital formation except for differences due to the residual error of estimate in the National Income and Expenditure Accounts. Net domestic savings equals net investment.
Details may not add to totals due to the residual error of estimate in the National Income and Expenditure Accounts.
Source: Statistics Canada, *National Income and Expenditure Accounts.*

(3) Net savings is gross savings less that amount needed to maintain the capital stock in the face of depreciation due to wear and tear and obsolescence. Net savings equals net investment.

Non-residents have provided a larger portion of savings in the 1970s (line 4) than in the past, with the exception of the 1955-1959 period. Annual data reveal, however, that the role of non-residents has been declining since 1975.

Inflation does have a distorting effect on the measurement of savings. Savings have, however, gone up in real terms and real increases in the personal sector savings rate during the 1970s accounted for more than half the nominal increase shown in Table 9.(4)

It is clear from this information that private sector savings cannot be judged inadequate when compared with past levels. Private sector savings are, in fact, now higher than their historical levels and have been a cause of concern in terms of their short-term impact on aggregate demand and employment. The government has had to initiate fiscal measures to stimulate consumption and investment expenditures. Such measures have resulted in deficits in the government accounts.

The adequacy of Canada's savings rate can also be assessed by comparing it with rates in other countries. Table 10 shows rates of gross private-sector savings as a percentage of gross domestic product (GDP) for OECD countries. Canada's savings rate is midway in the range reported for these countries. It ranks above those in the United States, France and the United Kingdom.

Whether or not there are insufficient Canadian savings, would a reduction in taxation of capital gains materially affect total savings and investment? This cannot be answered in the abstract, as it depends on how much saving actually responds to rates of return available to savers.(5)

Based on available evidence, reductions in tax on capital gains appear unlikely to produce a large increase in Canadian savings. First, empirical evidence suggests that savings are not very responsive to changes in the after-tax rate of return. Recent estimates suggest the elasticity of savings with respect to changes in rates of return to be, at most, 0.3.(6) That implies that a 10-per-cent increase in the after-tax rate of return to savers, i.e., from 10 to 11 per cent would increase savings by 3 per cent, i.e., from 20 to 20.6 per cent of income.

Second, while the tax revenue from inclusion of capital gains in income for tax purposes is important, it is a relatively small fraction of the total tax on investment income. Other elements such as the corporate income tax and personal taxation of dividend and interest income are far more substantial. Thus, changes in the tax treatment of capital gains would not produce large changes in the average return from savings.

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(4) See *The Recent Behaviour of the Personal Savings Rate*, Department of Finance, April 1980, p.45.

(5) Any increase in rates of return (brought about, for example, by a reduction in tax on capital gains) will not necessarily increase savings. The increased return from savings makes using income for current consumption less attractive as opposed to saving for consumption in the future, thus tending to induce more savings. On the other hand, the increased return means that any given level of savings results in larger possible consumption in the future. An increase in the after-tax return to saving from, for example, 5 to 10 per cent permits an individual, who had a target accumulation of $5,000 a year from now, to reduce his current savings from $4,762 to $4,545. The theoretical effect of increases in after-tax return on savings is thus ambiguous and is a matter for empirical analysis. As noted in the text, empirical studies have found the relation between savings and rates of return to be weak.

(6) These estimates are disputed for various methodological reasons and they should be regarded as the maximum possible response. For many years it was, in fact, estimated that a 10-per-cent increase in after-tax rates of return would cause, *at most*, a one-per-cent increase in savings i.e., an elasticity of 0.1.

Table 10

Gross Private Sector Domestic Savings as a Percentage of Gross Domestic Product, Selected OECD Countries Ranked by Size of Savings Rate, 1972-1976

	Average Gross Private Savings Rate[1] 1972-1976	Gross Private Savings Rate 1976
	(%)	
Japan	29.8	29.3
Austria	26.9	27.2[3]
Italy	22.5	24.1
Switzerland	26.1	23.3
Belgium	24.3	23.3
Netherlands	22.5	22.7
Australia	21.4	21.2
Greece	23.7	21.1
Germany	21.5	20.9
Canada[2]	20.0	20.6
France	21.0	19.7
Spain	21.0	18.0
United Kingdom	15.9	18.0
Norway	18.4	17.9
United States	17.6	17.2
Finland	20.7	16.8
Sweden	18.0	15.4
Denmark	12.5	12.7
Portugal	20.2	12.6[3]

(1) Gross private savings equals net personal and business savings plus social security funds and non-governmental capital consumption allowances.
(2) The gross private savings rates presented in this table differ slightly from those calculated from Table 8 because of the use of gross domestic product rather than gross national product in the denominator and certain methodological differences in the OECD data.
(3) 1975 data.
Source: OECD, *National Accounts of OECD Countries*, 1976, Volume II.

Full exemption of capital gains from tax would raise the after-tax return on total private savings by about 2 1/2 per cent, i.e., from, say, 10 to 10.25 per cent.[7] Under optimistic assumptions about the responsiveness of savings, the increased return to savers resulting from full elimination of the tax on capital gains would raise private savings by $325 million per year. Relatively this amount is not large. It represents about one-half of one per cent of annual private investment in non-residential construction and machinery and

(7) This estimate for 1976 is obtained by expressing the revenues from taxation of capital gains as a percentage of after-tax (personal plus corporate) investment income accruing to Canadian residents. Investment income includes the portion of corporate profits accruing to Canadian residents and private sector international miscellaneous investment income. Taxes subtracted from income include corporate profits tax as well as individual income tax on interest, dividends (net of dividend tax credit), capital gains and other investment income. Data on corporate taxes are taken from the national accounts. Individual taxes were estimated from Revenue Canada statistics on individual tax returns. Data on pre-tax income flows are generally from the National Accounts.

equipment. It is less than 5 per cent of current rates of net capital inflows from abroad. Thus, even full elimination of the tax on capital gains could not be expected to have any noticeable impact on total investment or the requirements for foreign capital inflows.

Moreover, any added savings resulting from tax reductions on capital gains would not necessarily be channelled into increased investment in business plant and equipment. The immediate benefit of any tax reduction would accrue primarily to holders of real estate investments and corporate shares. Capital gains on business plant and equipment are relatively insignificant. Added demand for corporate stock could indirectly facilitate business investment, by making it easier for corporations to raise new equity. *However, a large portion of the stimulus to equity markets would be in respect of already outstanding shares, and would merely provide windfall gains to existing shareholders.* Also, if the measure were to result in a larger government deficit that was financed by borrowing, total savings available to the business sector could in fact fall. Alternatively, if the increased deficit were financed by a general increase in other taxes, some portion would fall on investment income and business profits, thus directly affecting the return on investment.

These facts reinforce the viewpoint that reductions in capital gains taxation are not a particularly effective method of increasing the share of Canada's output going to investment in business plant and equipment. Far more direct methods exist of directing fiscal resources to the promotion of capital accumulation over the medium and longer term.

Effects on Risk-taking

The issue here is to what extent the present tax treatment of capital gains contributes to an insufficient level of risk-taking in Canada. Are smaller, riskier businesses, start-ups, high-technology businesses and the like being hampered by the taxation of capital gains? Often in public discussions this concern is also expressed in a feeling that the tax system is discouraging "entrepreneurship" or "risk-taking". This particular concern is not over Canada's total flow of savings and investment but rather over the allocation of the flow among competing uses.

Some people feel that the taxation of capital gains discourages what they regard to be desirable entrepreneurial activities which are important for Canada's future growth. In addition, they note that tax provisions such as deductions for pension plan contributions, registered retirement savings plans, other deferred income plans, the favorable tax treatment of personal residences, the exemption of the investment income portion of life insurance proceeds, and various other tax shelters bias Canadian savers towards placing their funds into these forms of saving as opposed to other ventures.

This attitude is based on the assumption that capital gains are most likely to accrue in risky ventures and, therefore, the taxation of capital gains will tend to reduce risk-taking. However, as noted earlier, capital gains, as defined for tax purposes, accrue on a wide range of assets not all of which entail high risk. In addition, risky ventures frequently yield a return in the form of business income and not capital gains. Thus, tax relief for capital gains may not be an effective means of encouraging risk-taking. It is also not obvious that the taxation of capital gains necessarily reduces the propensity to take risks. While capital gains are taxable, the government does share in capital losses within limits through their deductibility from other sources of income (in the case of shares and debt of Canadian-controlled private corporations, losses are immediately deductible from other income without limit). This sharing by government in losses through the tax system offsets to some degree the potential impact of any bias against risk-taking.

It is true that the current tax system does promote a larger flow of savings into personal residences and pension plans. This does not result from the taxation of capital gains per se. In the case of personal residences it is due in part to the exemption from tax on any capital gains and from the fact that imputed income on the equity in a home is not taxed in Canada. Savings in pension plans are encouraged directly through deductibility of contributions and deferral of tax on investment income. These preferences were provided as a matter of deliberate government policy. If they result in an undesirable bias in the allocation of savings, the logical course of action would be to modify or withdraw the preferences rather than to extend preferences to other investments.

The alleged implications for risk-taking from the taxation of capital gains are extremely difficult to quantify and analyze. There is no way to quantify the riskiness of a particular business. There is no necessary close correlation between size and risk, or innovation and entrepreneurship, though small ventures are very often more risky than larger ones. Even the idea of a "start-up" is not well defined, since a new corporation can be formed on the amalgamation or winding up of old corporations and since an existing corporation can start up a new line of business or new venture without incorporating a new entity. Certainly, it is possible to produce particular examples of businesses that have not been able to obtain the capital they want, when they want it, or at a price that is acceptable. However, a function of capital markets is to allocate capital and not all investments will be attractive to investors. One of the major difficulties in this area is to distinguish between the natural and legitimate rationing of credit, the ordinary function of the market system, and cases where market imperfections or the structure of the tax system have an undesirable impact.

Another implication of the imprecise nature of phenomena such as riskiness, innovation, and entrepreneurship is that it is extremely difficult to design tax measures that promote businesses with these characteristics. A broad-based reduction of tax on capital gains would apply to gains earned in a variety of companies which do not possess the attributes that the measure is trying to support. It would thus be inefficient and potentially costly. However, attempting to single out gains on shares in certain businesses for special treatment, in order to improve the target-effectiveness of the measure, would involve detailed rules and bureaucratic discretion, and would lead to increased complexity and uncertainty in the application of tax law, both of which could easily vitiate the effectiveness of the measure.

The federal tax system contains a number of specific measures designed to enhance the attractiveness of various kinds of investments. Examples include the lower tax rate on small business, accelerated depreciation, and tax credits for research and development and for certain specified categories of investment. Approaches such as these may be more fruitful than singling out particular capital gains for preferential tax treatment.

Effects on Corporate Financial Liquidity

It is sometimes argued that taxation of capital gains coupled with preferential tax treatment of certain less risky returns to saving has biased Canadians against investing in corporate equity, and that this trend is reflected in poor stock market performance, declining individual participation in stock markets, institutionalized saving, and difficulty for corporations in raising new equity as reflected in rising debt-equity ratios.

While recognizing the difficulties encountered by the business sector in raising equity capital, the effects of taxation of capital gains on equity markets should not be overstated. Capital gains and dividends are taxed at lower effective rates than interest payments. This

is the result of half-taxation of capital gains, the dividend tax credit, and the tax deferral on accrued but unrealized gains.

In addition, other influences that have affected equity markets may well have been much more important than the taxation of capital gains. *Indeed, as Chart 3 shows, Canadian markets have outperformed those in the U.S. since tax reform, and especially in 1978 and 1979, despite the fact that Canada began taxing capital gains in 1972, while capital gains have been subject to taxation in the United States since 1913.* It is apparent that factors such as uncertainty, inflation, relatively high pre-tax return on interest-bearing assets, and lowered expectations of economic and profit performance due to worldwide economic trends have been far more influential than taxation of capital gains in influencing stock market performance. This suggests that changes in capital gains taxation might well have only a small and transitory effect on market performance and on the ability of corporations to obtain new equity financing. Also, as noted earlier, under such a measure a significant share of benefits would accrue as windfall gains to existing holders of outstanding equity.

There has also been concern that individual investors have not been participating in stock markets with the result that markets are becoming more institutionalized, their breadth and liquidity are being reduced, and institutions are not providing funds to smaller, newer enterprises. It is true that the percentage of the adult population receiving dividend income fell between the late 1960s and 1970s, as shown in Table 11.

However, data for 1977 and 1978 suggest that the decline may have been halted and reversed, and the improved market performance in 1978 and 1979, along with the enrichment of the dividend tax credit in 1978, could well lead to further increases in individual participation. Moreover, lowered individual participation may well have been due not so much to taxation of capital gains as to poor performance of equity markets in the first half of the 1970s, the relatively high nominal yield on debt instruments, and

COMPARISON OF COMMON STOCK PRICE PERFORMANCE CANADA AND THE UNITED STATES 1971 - 1980

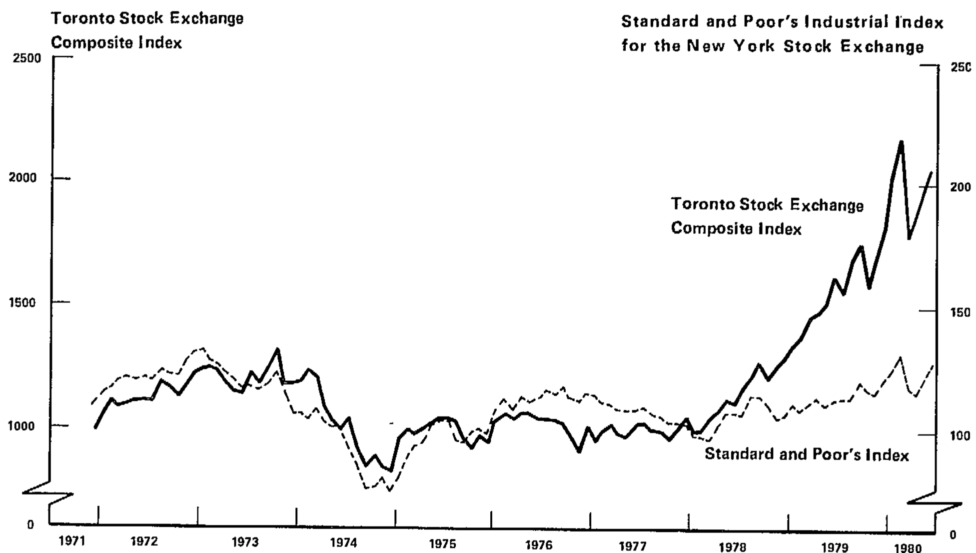

Table 11

Individual Stock Ownership Trends as Indicated by Tax Filers Reporting Dividend Income, 1968-1978

	Tax Filers with Dividends	
	Number	As a Percentage of Adult Population(1)
	('000)	(%)
1968	871	6.3
1970	998	6.9
1972	888	5.8
1973	907	5.8
1974	892	5.6
1975	884	5.4
1976	836	5.0
1977	857	5.0
1978	971	5.6

(1) Adult Population is population age 15 or over.
Source: Revenu Canada, *Taxation Statistics.*

individual investor perceptions of the relative risks and returns involved in alternative investments under existing world economic conditions.

One of the reasons leading commentators to recommend changes in taxation of capital gains is the apparent "lack of strength" in corporate balance sheets. It is widely noted that the ratio of debt to equity has risen in recent years. This is believed to increase the financial risks of corporations, including that of bankruptcy.

The ratio of debt to equity for industrial corporations during the 1970s is shown in Table 12. It is clear that the ratio of total debt to shareholders' equity has increased over the period. The magnitude of the increase, however, depends upon the way the debt-equity ratios are calculated. The debt-equity ratio referred to by commentators often includes deferred taxes in total debt. Deferred taxes arise because the tax system permits a write-off of depreciable assets and other costs that is faster than companies use for financial reporting purposes. Potentially, the difference in taxes on the two bases may be payable in the future and is thus shown as a deferred tax liability in companies' financial statements. However, as long as companies do not actually decline in size, the deferred tax liability is not likely ever to become payable. As a result, the deferred taxes have the characteristics of a permanent source of financing without an attached interest cost, so that it is more appropriate to include these with equity than with debt. Indeed, one of the major purposes of the introduction of fast write-offs in the 1970s, i.e., the two-year write-off for manufacturing and processing equipment, was to improve corporate cash flow and the ability of business to finance new investment. *Including deferred taxes with equity (second column of Table 12) leads to the conclusion that increases in the debt-equity ratio up to 1975 were not as significant as is often suggested. Since 1975, conventional as well as adjusted debt-equity ratios have been declining.*

Table 12

Debt-Equity Ratios, Private Non-Financial Corporate Sector, All Industries, Canada, 1970-1978

	Total Debt to Shareholders' Equity(1)	Adjusted for Deferred Tax Liabilities(2)
1970	1.07	0.92
1971	1.06	0.91
1972	1.07	0.91
1973	1.08	0.92
1974	1.14	0.95
1975	1.19	0.97
1976	1.19	0.96
1977	1.18	0.95
Revised Series(3)		
1975	1.43	1.18
1976	1.42	1.16
1977	1.38	1.13
1978	1.38	1.12

(1) The definition of debt adopted here covers all liabilities.
(2) Adjusted debt-equity ratios are total debt less deferred tax liabilities to shareholders' equity plus deferred taxes.
(3) Starting with the third quarter of 1978, a new sample of industrial corporations was introduced by Statistics Canada and financial information on the new basis made available back to 1975. There are major differences in the coverage of the revised series and the resulting debt-equity ratios are not comparable with the previous series.
Source: Department of Finance, *Rate of Return and Investment Profitability*, April 1980.

It must also be remembered that increases in the debt-equity ratio are advantageous to corporations in an inflationary period. The advantage arises from the fact that all of the nominal interest costs are deductible from income subject to corporate tax, even though part of these interest costs in an inflationary period merely represents a return of capital to the lender sufficient to ensure that the real value of his bond holding is not eroded. As a result, corporations prefer to finance relatively more by debt and thus obtain a deduction for more than their real costs of borrowing.

Another reason why corporations prefer financing by debt is that the general deductibility of interest costs results in income being taxed only once, that is, in the hands of the lending corporation or individual. In contrast, financing by equity leads to both corporate tax on the income and personal tax on any dividend distribution. While the dividend tax credit reduces the shareholder tax by more than the amount of tax paid at the corporate level in the case of small businesses, the offset is not complete for many large corporations. The basic asymmetrical tax treatment of dividends and interest at the level of the corporate tax can lead to more of a bias in favour of debt finance than does the taxation of capital gains.

Any change in the tax treatment of capital gains would have its largest impact on the use of corporate profits rather than on the extent of financing by debt or equity. *A preferential treatment of capital gains vis-à-vis dividends results in a bias towards corporations retaining income rather than paying it out to shareholders in the form of dividends.* This leads to

larger accrued share gains. The bias arises for two reasons. First, for high-income shareholders, tax on realized capital gains is less than on dividends. Second, for all taxpayers, the personal tax on capital gains that arise from retained earnings can be deferred merely by holding the security and not realizing any immediate gain. A reduction in tax on capital gains would exacerbate this bias. *From the point of view of the efficient use of the economy's savings over the longer run, it is not clear that encouraging financing of projects out of retained earnings without recourse to the test of capital markets is a suitable policy.*

Issues in Taxation of Capital Gains

The previous sections have described the role and importance of capital gains under the Canadian tax system. This section discusses certain issues that have been raised in public discussions about the method of taxation of capital gains. They do not relate directly to the basic question of whether capital gains should be included in income for tax purposes. Rather, they relate to the measurement of capital gains and the operation of other specific tax provisions. The issues considered here are the determination of capital gains in an inflationary period, the treatment of capital losses, the lock-in effect, and the problems arising from the lumpiness of capital gains.

Inflation and the Measurement of Capital Gains

Perhaps the major criticism levied against the current provisions relating to the taxation of capital gains is that they fail to distinguish between real capital gains and those which are purely nominal. *It is argued that increases in the value of assets which merely keep pace with inflation in no way enhance the economic power of the asset holder and ought not, therefore, be subject to taxation. Indeed, the imposition of tax in these circumstances can be tantamount to a levy upon capital and so quite inappropriate under the guise of income taxation.*

While this effect is generally recognized, it must be noted that there are several provisions which, for many taxpayers, substantially mitigate the tendency of the present tax system to tax purely inflationary gains. In the first place, only one-half of realized gains need be taken into income for purposes of taxation. Second, since only realized gains are subject to tax, taxpayers usually have the option of deferring the actual payment of the tax. Actual tax liabilities may, therefore, be minimized by timing realizations in such a way as to match them with realized losses. As well, since tax on accrued gains can be deferred, its impact in present value terms is lessened. Third, any interest costs incurred to finance the capital property are fully deductible for purposes of taxation each year as incurred, while only half of the associated gain is included and then only when realized. Given the discount rates which have prevailed in recent years, these tax rules reduce significantly the effective rate of tax on taxable gains. Moreover, in an inflationary environment, only a portion of interest payments on debt is a real cost to the borrower, the remainder merely represents a compensation to the lender for the decline in the real value of debt. To measure real income accurately, only real borrowing costs should be deductible. Last, the exclusion from taxable income of the first $1,000 of investment income, including capital gains, provides a further offset to the effects of inflation on the measurement of capital gains.

Data are not available to determine the extent to which taxation of illusory gains in recent years has been offset by the factors noted above. However, Table 13 provides illustrative examples of the extent of this offset. As the value of the offset depends on the length of time assets are held and on the proportion of the purchase price financed by borrowing, the table covers a range of cases. It shows, for various combinations of holding period and ratio of debt to purchase price, the threshold rate of inflation below

which the current tax system results in less tax than would a system of taxing *inflation-adjusted capital gains, in full, as accrued*. For example, for an asset that is 50-per-cent debt financed and that is held for four years before being disposed of, the current tax provisions more than compensate for the lack of inflation adjustment as long as the inflation rate is less than 13.2 per cent per annum. If this asset is held for five years or longer the current treatment compensates for lack of adjustment at any rate of inflation. *It is clear that for capital properties financed predominantly by borrowing, the current tax system provides full offset at all foreseeable rates of inflation. In fact, the current system over-compensates in a significant range of cases.*

Table 13

Annual Inflation Rates below which Current Tax Treatment of Capital Gains is more Favourable to Investors than Full Taxation of Inflation-Adjusted Capital Gains on an Accrual Basis

Holding	Percentage of Purchase Price Financed by Borrowing				
Period	0	30	50	75	90
(years)			(annual % inflation rates)		
1	3.6	5.3	7.8	21.5	*
2	3.8	5.7	8.8	*	*
3	4.0	6.2	10.3	*	*
4	4.2	6.8	13.2	*	*
5	4.5	7.5	20.0	*	*
7	5.1	9.8	*	*	*
10	6.3	*	*	*	*
15	11.1	*	*	*	*
20	*	*	*	*	*

* Indicates that current tax treatment is more beneficial at all inflation rates.

Notes:

1. The table does not take into account the fact that the first $1,000 of investment income, including capital gains, is not taxable.
2. It is assumed that the capital property appreciates in real terms at 3.5 per cent per year and that the real cost of borrowing is 2.0 per cent. An after-tax discount rate of 1.2 per cent is assumed. The offset depends on the size of real gains. The current tax treatment is more beneficial than shown in Table 13 if the capital property appreciates in real terms at a higher rate than 3.5 per cent per year and less beneficial if the real rate of appreciation is less than 3.5 per cent.
3. The debt is assumed to be amortized over the holding period of the asset.

While these various factors do not provide an appropriate offset in all cases to the taxation of purely nominal gains under the present system, it is, nevertheless, probable that the revenue yielded by this system is of the same order of magnitude as that which would result from the full taxation of inflation-adjusted capital gains on an accrual basis. The distribution of liabilities would, however, differ significantly under the two systems. It is important to inquire, therefore, if there is available any practicable comprehensive or partial adjustment mechanism which would significantly improve the taxation of capital gains in an inflationary environment.

Indexing of Costs of Capital Properties

Indexing is, perhaps, the proposal most frequently put forward to deal with the mismeasurement of capital gains during inflationary periods. In concept, this proposal is very simple. It involves increasing the cost base of a capital property annually by a factor based upon a price index. For example, the cost of an asset purchased for $10,000 could be indexed to $10,600 after a year of inflation at 6 per cent. Thus, only appreciation of the asset in excess of 6 per cent would be taxable if the asset were sold at the end of the year.

A number of policy concerns arise in designing a suitable indexing mechanism for capital gains. These include the consequences of providing inflation adjustment for capital gains alone and not for other forms of investment or business income, the need for an appropriate adjustment for debt-financed assets, and the technical complexity of the provisions. These are discussed in turn below.

Scope of Indexing

Inflation distorts the measurement of not only capital gains but also other forms of investment and business income. For example, in an inflationary period, if a taxpayer puts $1,000 in a savings deposit yielding 10-per-cent interest income, and inflation in the year is 6 per cent, some $60 of nominal interest income does not represent a real increase in his ability to pay taxes. However, the full $100 of nominal interest income is taxed. The mismeasurement of business income under current accounting conventions based on historical costs is widely recognized. It occurs since financial statements which fail to take account of inflation understate the cost of inventories and depreciable assets and thereby overstate profits. The overstatement of profits is offset to the extent that a company is not required to report the benefit to the business due to a decline in the real value of its debt liabilities.

The distorting impact of inflation on the measurement of income has long been recognized and has been the subject of extensive investigation. Unfortunately, while our understanding of these effects has been considerably enhanced, the accounting profession in Canada has not yet formulated a comprehensive system for measuring the impact of inflation upon income. Given the dependence of the tax system on generally accepted accounting principles, it is not yet possible to deal with the capital gains/ inflation interaction within the context of a comprehensive adjustment mechanism that would embrace both capital gains and other forms of income. Indeed, it is necessary to caution that even if such a comprehensive adjustment mechanism available, the potential transfer of tax revenue to foreign treasuries which could result from its earlier adoption here might delay its use in Canada for tax purposes, until comparable mechanisms were operative in other jurisdictions.

While there is no comprehensive inflation-adjustment mechanism available at this time, it has been suggested that the Canadian tax structure would be improved if a partial adjustment mechanism were applied to capital gains alone. The concept is straightforward. The adjustment would take the form of an annual adjustment to the cost base of capital property, using an appropriate price index. Only dispositions at prices in excess of the indexed cost base would then generate taxable gains.

This partial approach gives rise to several policy concerns. In the first place, it is discriminatory. While it is acknowledged that inflation distorts the measurement, and hence the taxation, of virtually all forms of investment and business income, only capital gains would benefit from the adjustment. This would add further to the advantages now accorded to capital gains vis-à-vis other forms of income with attendant economic and capital market implications.

Second, unless restrictions were imposed upon the scope of capital gains indexing, it would not be possible effectively to segregate the inflation adjustment of capital gains from that of business income and interest income. A consideration of the repercussions of such an adjustment on depreciable property and debt instruments should make this clear.

It is now widely recognized that accounting for depreciable assets on the basis of historic cost is one of the major sources of distortion in the measurement of income in an inflationary setting. With replacement costs possibly much higher than historic acquisition costs, it is recognized that, ignoring incentive provisions, the capital cost allowances (CCA) permitted under the tax system tend to overstate taxable income. Some form of indexation or adjustment of depreciable property is thus a part of virtually every comprehensive scheme for restating income to take cognizance of the effect of inflation. What is less widely recognized is that an inflation adjustment for capital gains alone would be tantamount to creating a capital cost allowance loophole for those taxpayers who were in a position to dispose of depreciable assets which had risen in value as a consequence of inflation. An example may serve to make this clear.

Consider the case of someone whose depreciable assets, purchased at a price of $100 per unit, now have a market value of $200. If the CCA rate allowed on these assets is 20 per cent, the original purchaser could claim a deduction of $20 in the first year in determining taxable income. In contrast, anyone who could establish a cost base at a market value level of $200 would be able to avail himself of the higher CCA ($40) associated with the inflated value of these assets. A restricted adjustment mechanism applying only to capital gains would provide incentives to taxpayers to indulge in artificial buy-and-sell or swap transactions to establish higher values for capital cost allowance purposes.(8) Most of such transactions are not now advantageous because the difference between the sale price of an asset and its undepreciated capital cost is taxable either as a recapture of depreciation previously claimed or as a capital gain. With the indexation of capital gains, the write-up of the cost base of the assets would eliminate any tax upon purely nominal gain and the transaction would thus become advantageous. This would be tantamount to a back-door way of indexing capital cost allowances for some taxpayers. Such back-door indexing would be inefficient and undesirable as it would not be available to all businesses and would again be a partial adjustment of business income. Moreover, where a depreciable asset was sold at a price below its indexed cost base, the deductibility of any resulting capital loss from income, if permitted, would be equivalent to a retroactive inflation adjustment of depreciation allowances previously claimed.

As a second example consider the indexing of debt instruments that give rise to interest income. Such instruments are capital properties and would be eligible for inflation adjustment. Ignoring again the effects of half-taxation of capital gains, such an adjustment would be tantamount to inflation adjustment of interest income. *For example, the adjustment of the cost base of Canada Savings Bonds would give rise to a capital loss on their redemption which taxpayers could use to reduce their income. Deductibility of this inflation-created loss from income would be identical to taxing only that portion of interest received that represented a return in excess of the rate of inflation.*

While inflation adjustment of interest income may or may not be desirable, achieving it by indexing capital gains would raise the revenue costs of capital gains indexing and would be discriminatory in that only some types of interest-earning assets would be eligible for an adjustment. For example, such an adjustment could not apply to savings deposits. Moreover, such an ad hoc adjustment to interest income of lenders could

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(8) Appendix II provides an example of this process.

give rise to capital market distortions and large revenue cost if borrowers continued to be allowed full deduction for their interest expense.

If, for such reasons, back-door extensions of indexing to other investment income or business income were not desirable, it would be necessary to exclude depreciable assets and interest-earning assets from the scope of indexing. Another alternative would be to deny the deductibility of inflation-created capital losses on such assets from other income. Any such restrictions would, in turn, give rise to other complexities. For example, assets can be held by individuals directly or through a corporation. When they are held in a corporation its shares would be eligible for indexing adjustment and thus gains on the underlying assets would be indexed implicitly. It would be discriminatory and inequitable to deny indexing on assets held directly but to index gains on the same assets if they are held indirectly through a corporation.

If it were decided to index at least all investment income it would be necessary to determine how comprehensive such an adjustment should be. Should it extend to bank accounts and term savings deposits? Since investment income other than capital gains is fully taxable, should the inflation adjustment be fully deductible or only half deductible as in the case of capital gains? Or should capital gains become fully taxable under an inflation-adjusted system? Should any inflation adjustment of interest income be restricted only to individuals or also apply to corporations?

Decisions on the scope of inflation adjustment would have a significant impact on its equity, economic effects and on its practicability. They would also be a major determinant of its revenue cost.

Adjustment for Debt

Undoubtedly, serious problems would arise in attempting to index capital gains for assets which are financed by debt. The asymmetry of the present tax treatment of capital gains and associated financing costs has already been noted: gains are subject only to a 50-per-cent inclusion when realized, while any associated financing costs are fully deductible when incurred. To index the former while ignoring the benefit conferred upon the borrower by the erosion of the real value of his indebtedness through inflation would be to overcompensate for the effects of inflation.

Consider the example of an investor who borrows $8,000 to acquire a capital property costing $10,000, the remaining $2,000 being available from his own resources. Assume further that he must pay interest on the borrowed funds at the rate of 5 per cent, that no inflation is expected or occurs in the course of the year, and that, as a consequence of an increase in the demand for the property in question, he is able to dispose of it at the end of the year at a price of $10,500. The following summarizes these events and their taxation under the present tax system:

1	Purchase price of property	$10,000
2	Selling price of property	10,500
3	Nominal capital gain	500
4	Real capital gain	500
5	Amount borrowed	8,000
6	Nominal interest cost	400
7	Real interest cost	400
8	Real income (line 4 – line 7)	100
9	Loss for tax purposes (one-half line 3 – line 6)	(150)

It is evident from the example that this taxpayer has experienced a real capital gain of $500, has incurred a real borrowing cost of $400, and has had a net increase in real income or net worth of $100. Under the present tax regime, he would be required to take into income one-half of his nominal gain of $500, or $250, and would be permitted to deduct his entire nominal interest cost of $400. He would thus have a loss of $150 for tax purposes, which could be used as an offset to other income. This favourable tax result is, of course, attributable to the requirement that only half of the nominal gain be included in income for purposes of taxation.

If on the conditions of this example a fully anticipated inflation of 5 per cent is superimposed then the taxpayer is actually made better off. The situation of the taxpayer is improved still further if he is permitted to index the cost base of eligible capital property. The results may be summarized as follows:

1	Purchase price of property	$10,000
2	Selling price of property	11,000
3	Nominal capital gain	1,000
4	Real capital gain	500
5	Amount borrowed	8,000
6	Nominal interest cost	800
7	Real interest cost	400
8	Real income before tax (line 4 – line 7)	100
9	Loss for tax purposes without indexation of gain (one-half line 3 – line 6)	(300)
10	Loss for tax purposes with cost base indexed (one-half line 4 – line 6)	(550)

Again, the taxpayer's real income is $100, but if he were permitted still to claim the full nominal borrowing cost and required to include only one-half of the real gain as a result of indexing, he would be able to claim a loss for tax purposes of $550 as an offset to other income. This disparity between the actual increase in real income and the loss which would otherwise be claimable makes clear the necessity of reducing the nominal interest cost by the amount of the decrease in the real value of the sum borrowed, i.e., reduce nominal interest costs by $400, equal to 5 per cent of $8,000. This would again result in a loss of $150 for tax purposes, as in the first example. Of course, it may be argued that, with the indexing of the cost base of the property generating the capital gain, there is no longer any rationale for including only one-half of the real capital gain in income for purposes of taxation. It is clearly the case, however, that the taxpayer should be permitted to deduct only the real cost of borrowed funds or, alternatively, that he be required to take into income an amount equal to the decrease in the real value of the sum borrowed.

Before commenting on possible ways of taking debt into consideration in indexing capital gains, it should be noted that if borrowers were required to add to their incomes the decline in the real value of their indebtedness, lenders ought, logically, to be permitted to exclude from income that portion of interest receipts that merely represents the decline, or compensation for the decline, in the real value of the amount lent. If this were not done, but borrowers were required to take into income the decline in the real value of the amount borrowed, a significant capital market distortion would result.

The ease with which a debt adjustment could be introduced into the tax system depends crucially on the scope of permitted indexing. For example, if it were intended that all investment and business income benefit from the adjustment process, than all income-

producing assets and associated liabilities would be subject to indexation. This would result in debtors being required to take into taxable income each year an amount equal to their total outstanding debt subject to indexation times the inflation rate for the year; lenders would be permitted a similar deduction for the decline in the real value of their loan assets. Debtors would not be required to make any adjustment in respect of personal loans. Since a distinction between personal loans and other forms of indebtedness is already incorporated into the tax system, for purposes of determining the deductibility of interest costs, this would occasion no additional complexity.

If indexing is to apply only to capital gains, however, then it would be necessary to separate from a taxpayer's total debt the portion that is, or is deemed to be, associated with properties giving rise to capital gains. However, since it is generally impossible to associate particular assets with a particular debt, any allocation of debt to particular assets of the taxpayer would be arbitrary. The debt adjustment would thus have to be computed in aggregate taking into account all the capital and business assets and non-personal liabilities of the taxpayer. The overall ratio of debt to assets for a taxpayer would be used to determine what proportion of his capital properties were considered to be debt-financed. The indexing adjustment would only apply to the remaining fraction. For example, if non-personal debt represented 50 per cent of relevant assets and the inflation rate was 10 per cent, the inflation adjustment would be to add 5 per cent to the cost base of capital properties eligible for indexing. A number of consequences flow from the need to determine the debt adjustment on a balance-sheet basis:

Because the amount of debt can vary during the time any capital property is held, it would not be sufficient to make the debt adjustment only in the year the property is sold. An appropriate debt adjustment would require annual computation of the amount of inflation adjustment for all properties held in the year with the associated debt adjustment based on the portfolio of assets and liabilities held in the year. The taxpayer and Revenue Canada would be required to maintain a record of the cumulative inflation adjustments to the cost base of each property until each is sold. Even though the adjustment would be computed for each year separately, it would not be reflected in the tax return of the taxpayer until the eventual disposition of a given property when the realized gains would be subject to tax.

In the case of corporations, the requirement to file a full annual balance sheet could be a relatively simple task as they are already required to prepare such a statement for financial accounting purposes. It would, however, be a new requirement for individual taxpayers, and accounting for changes in balance sheets during the course of a year would be difficult.

It would be necessary to decide which assets and liabilities are to be included in individuals' balance sheets. Presumably the debts would not include personal loans, carrying charges on which are not deductible for tax purposes. Consideration would have to be given to the inclusion of personal-use property, pensions, RRSPs and resource properties. Presumably personal residences would not be included in assets nor would mortgages thereon be included in debts. Recognition might have to be taken of the fact that mortgages can be incurred to finance purchases of financial assets.

The various items in the balance sheet would be assigned the same values as currently for tax purposes. Thus, depreciable properties would be valued at their historical costs net of capital cost allowances. Financial assets would be valued at their acquisition cost. Any appreciation in the value of properties would not be recognized in the

balance sheet until it had been realized for tax purposes. Deferred income plans, if they were included in the portfolio, would be assigned a value equal to the cumulative value of contributions.

Treatment of Private Corporations

As discussed earlier, if not all assets are subject to inflation adjustment a question arises as to how the indexing adjustment would apply when the ineligible assets are held through a corporation. Unless special provisions apply, indexing of corporate shares would effectively extend indexing to ineligible assets. While this effect would occur in both public and private corporations it would be of most concern in the latter case given the scope of individual control over private companies. One, and perhaps the only, solution to this problem would be to deny the application of indexing to private company shares directly. The indexing adjustment would be calculated on any eligible assets held by the company with the associated debt adjustment computed by using the company's debt-asset ratio. The resulting inflation adjustment would be allocated to the individual shareholders. They, in turn, would reduce the adjustment allocated to them by their own debt-asset ratio and add the resulting amount to the cost base of their shares in the company. There are at least two major difficulties with this approach.

First, allocation of the inflation adjustment, determined at the corporate level, to individual shareholders would inevitably be arbitrary wherever there are different classes of shares. Ideally this allocation should be in proportion to each shareholder's share in the assets of the company. In practice, it is extremely difficult to determine these proportions in a variety of circumstances.

Second, in the case of associated companies and chains of companies, the inflation adjustment would have to be flowed through to the ultimate individual shareholders. Each corporation in the chain would be required to calculate the indexing adjustment using its debt-asset ratio. Because a sequential application of the indexing adjustment would be different than that which would be determined on a consolidated basis, this would yield inaccurate results. The resulting inaccuracy would be greater the larger the number of corporations in the chain.

Special rules would also be required to determine the indexing adjustment when private company shares were disposed of in exchange for public company shares. Taxation of accrued capital gains on private company shares can be deferred through the use of a tax-free rollover provision. If private company shares were not to be indexed directly, as contemplated in the scheme above, it would be necessary to ensure that the indexing adjustment on the public company shares acquired in any exchange commenced only after the date of exchange, and was not retroactive to the original date of purchase of the private company shares. This would be relatively easy if the adjustment were made for each year separately. It would, however, be very complex to take into account such exchanges of property if the adjustment were delayed and computed in one step at the time of eventual sale.

Technical Issues

In implementing an inflation-adjustment scheme a number of technical issues would arise. Decisions on these sorts of issues would significantly affect the simplicity and practicability of any indexing scheme.

Date of Acquisition and Disposal of Property

For the calculation of indexing adjustments, the starting point is the date on which the asset was acquired, for it is the rate of inflation between the acquisition date and the date of disposal for which an inflation adjustment would be made.

The acquisition date, however, is not always simple to determine. Improvements to a property affecting the cost base might have been made at different times. Identical properties such as shares of a corporation might have been acquired at different times. Whereas at present a taxpayer is required to pool such properties and average their cost when sold, only an annual balance sheet adjustment type of indexing would permit such pooling. If not done each year, the result would be much greater record-keeping requirements for taxpayers and considerable administrative complexity. Property acquired at different times by an unincorporated business can be rolled over into a corporation in exchange for shares. When those shares are sold, under an indexing system there might have to be complex calculations based on acquisition costs of both the original and the replacement property.

Many of these problems could be avoided if the indexing adjustment were to be computed on an annual basis, though this in itself would require increased record keeping for taxpayers. Annual calculation would permit incorporation of improvements and new acquisitions of identical property into the computations as they occurred. In the absence of annual computation of the adjustment it could be extremely difficult for the tax authorities to verify, after a number of years, whether any asset sold had been held for the period indicated.

Surplus Stripping

The adjustment for inflation could lower tax on capital gains relative to dividends and could thus open up possibilities of tax abuse through surplus stripping, as described in earlier sections. As was discussed in detail there, this is a major issue and it is crucial to the equity and effectiveness of taxation of corporations and their shareholders.

Valuation Date

Any inflation adjustment should apply only in respect of inflation occurring after the introduction of the measure. For properties acquired in the past it would be necessary to determine the cost base to which indexing applied.

Ideally this base should be the value of the property on the date of introduction of the measure. An alternative would be to apply the adjustment to the original acquisition cost of the property. This alternative would under-compensate those whose property had appreciated in value between the date it was acquired and the date indexing started and over-compensate those whose properties had decreased in value. On the other hand, establishing a new value would be cumbersome for assets which are not regularly traded or are unique, such as real estate, private company shares, and art work. Transitional rules to the new system might be required.

Other Technical Issues

In implementing an inflation adjustment, decisions would also be required as to the price index to be used, the frequency with which the adjustment is made (annually, quarterly), the treatment of assets acquired or disposed of during the adjustment period, and similar matters. While such issues are important, and could affect the equity of the indexing adjustment, they do not pose insuperable technical difficulties.

Conclusions on Indexing Adjustment

In summary, indexing of capital gains is not straightforward. It is perhaps for this reason that no industrialized country has yet adopted a systematic indexing mechanism. This section of the paper has identified a number of important policy and technical issues. The

most important of these relates to the fact that inflation affects the measurement of not only capital gains but also other forms of investment and business income. There are no economic or tax policy reasons for singling out capital gains for inflation adjustment. In fact, because of various provisions under the current tax system the over-taxation of capital gains because of inflation is significantly less than for these other forms of income.

If, for some reason, it were decided to index capital gains in isolation, its scope would have to be severely restricted in order to prevent back-door indexing of other forms of income. Interest-earning assets and depreciable assets could not be eligible, nor could the adjustment apply directly to private company shareholdings. The indexing adjustment would have to be reduced where assets were financed by borrowing. It would be necessary to compute the adjustment each year based on a balance sheet, covering a wide range of assets and liabilities, submitted by each taxpayer owning eligible property. Even with this range of restrictions the indexing adjustment would not be accurate in a range of circumstances.

Tapering

Tapering is an alternative mechanism that is sometimes suggested as a method of providing inflation adjustment of capital gains. It involves including a smaller portion of a capital gain in taxable income the longer the asset has been held. For example, gains realized during the first year of ownership of a capital property might be fully taxable, with the proportion of gains included in income declining by, say, 10 percentage points each year thereafter. After a holding period of 10 years, gains would be completely exempt from tax, unless some maximum tapering adjustment were specified.

Table 14

Portions of Capital Appreciation Representing Real Gains for Selected Holding Periods

(1) Years	(2) Disposition Price	(3) Total Capital Apprecia-tion	(4) Cost Base Adjusted for Inflation	(5) Real Gain (2-4)	(6) Portion of Capital Appreciation Representing a Real Gain (5-3)
		($)			(%)
0	10,000		10,000		
1	11,000	1,000	10,700	300	30.0
5	16,105	6,105	14,026	2,079	34.1
10	25,937	15,937	19,672	6,265	39.3
15	41,772	31,772	27,590	14,182	44.6
20	67,275	57,275	38,697	28,578	49.9
25	108,347	98,347	54,274	54,073	55.0

Note: The appreciation in the price of the asset is assumed to be 10 per cent per year. Prices are assumed to rise at 7 per cent per year.

Although there is often an impression that tapering is a less complex alternative to indexation, this is not the case. It suffers from many of the same problems as indexing, and would exacerbate other deficiencies in the capital gains tax system described below such as the lock-in effect. A further major objection to tapering is that it does not produce a reasonable approximation to taxation of real capital gains. Table 14 shows the ratio of real to total capital gain realized by an investor on a $10,000 asset which appreciates in value at 10 per cent a year while inflation is 7 per cent a year. It is clear that the ratio of real to nominal gains rises the longer the asset has been held. Thus, tapering is the opposite adjustment to that required for a true inflation adjustment. It effectively would result in an exemption of real capital gains. It is thus not a suitable mechanism for inflation adjustment.

Capital Losses

Currently, allowable capital losses are generally deductible against taxable capital gains and, for individuals, against up to $2,000 of other income. Capital losses on shares and debt of small business corporations are deductible against other sources of income without limit. Any unused losses may be carried forward indefinitely to be deducted in future, subject to the same limits. The question arises as to why, if gains are taxable, there should be a limit on the deductibility of losses against other income.

Conceptually, an accrued capital loss reduces a taxpayer's ability to pay taxes as do other losses. Restrictions on deductibility of losses thus can result in an unfair distribution of tax burden and can bias taxpayers against investing in risky assets, as the tax system is not neutral in its treatment of gains or losses. However, the taxation of capital gains is on a realization and not an accrual basis. Taxpayers thus have a great deal of flexibility in the timing of their transactions. They can very often choose when to realize accrued capital gains and losses. If there were no limit on the deductibility of realized losses, a taxpayer could realize a loss on a particular asset, thus reducing tax payable substantially, even though he had accrued but unrealized capital gains on other assets. This would open up avenues for undue tax reduction for those with significant holdings of capital properties that were not open to other taxpayers.

One possibility would be to allow taxpayers unlimited deduction for realized capital losses to the extent that they exceeded accrued, unrealized capital gains. Such a measure would improve the neutrality of the current tax system, but would require an annual valuation of all capital properties in any year in which the allowance was utilized.

Lock-in Effect

A lock-in occurs when taxpayers with assets which have appreciated in value hold on to those assets because no tax is payable on accrued gains. The advantages of deferring realization of accrued capital gains can be substantial. At an interest rate of 10 per cent, an extra year's deferral is equivalent to excluding a further 4 to 5 percentage points of the gain from tax. Investors may thus decide, for tax reasons, to continue holding an asset even though an alternative asset with a higher prospective yield is available. The lock-in effect inhibits reallocation of capital to where it can earn the highest return. The resulting misallocation of funds makes it more difficult for new firms to attract funds away from investments in established ventures.

Empirical evidence on the seriousness of the effect is not available. However, recent moves in Canada to permit tax-free inter-generational transfers of shares in small business corporations and incorporated farms have undoubtedly acted to increase the lock-in

effect. Without abandoning the taxation of capital gains, the only means of lessening the lock-in effect would be to move toward taxation of capital gains on an accrual basis, either annually or at some other fixed interval.

Liquidity and Bunching of Gains

In addition to the lock-in effect, two other issues are often identified. First, on a property held for several years, capital gains can accumulate to a substantial sum. When these gains are realized on disposition of the property, their taxation in the single year, the year of disposition, could push individuals into a higher tax bracket and the resulting tax would be higher than if the capital gains were brought into income over a number of years. This phenomenon, commonly referred to as the bunching effect, is a direct consequence of taxation of capital gains on a realization basis rather than an accrual basis.

The issue of bunching has been dealt with under the Canadian Income Tax Act through the provision of income averaging annuity contracts. Taxpayers may, through such annuity contracts spread the tax on capital gains over a number of years. Canada is the only O.E.C.D. country that provides such a flexible and generous mechanism for averaging the tax burden on capital gains. There are also other provisions which mitigate or reduce the adverse tax consequences of bunching of capital gains. Where payment is received in instalments, the taxation of gains may be spread over the full payment period. The provision for general averaging automatically operates to reduce the effective tax rate in years of abnormally high income, whatever its source. Of course, a large proportion of gains accrue to taxpayers in the top marginal rate bracket, who cannot be pushed into a higher tax bracket by any gain realized in the year.

One general type of solution of this problem, to the extent it exists, would be a move toward some form of accrual taxation, but this may not be practicable because of difficulties in valuation of properties.

The second issue relates to liquidity difficulties that arise when the timing of the payment of the tax on capital gains and the receipt of proceeds from disposition of property are not coincident. Taxation of capital gains on a realization basis, as opposed to on an accrual basis, does minimize the occurrence of such difficulties. There are, however, circumstances, when tax is payable on accrued capital gains even when there is no cash sale of the property or when the proceeds need to be reinvested immediately. These include relocation of a business, inter vivos transfer of farm property or small businesses among family members and deemed disposition at death. In these cases, the requirement for tax payments might require sale of business assets or loss of control of a family farm or business.

In response to these particular cases of liquidity problems, the government has introduced special provisions that allow assets to be rolled-over and taxation of capital gains deferred until a sale actually giving rise to liquid funds occurs. Transfers of capital property to a spouse do not lead to immediate taxation of capital gains. In 1977, a provision was introduced whereby taxation of capital gains is deferred where a replacement property of a similar type is purchased. Typical examples are the relocation of a business from a city centre or movement of a farm operation away from an expanding city. Inter-generational transfers of unincorporated farm property have been possible without taxation of capital gains since tax reform. This rollover was extended to shares in a family farm corporation in 1978. In that year, an inter-generational transfer deferring taxation of capital gains on up to $200,000 of accrued gains in a small business corporation was also introduced.

In these situations, gains are taxable only when the property is eventually sold outside the family or without a reinvestment in the business. At that time, funds will be available to pay tax obligations. It should be noted that while such rollovers and deferrals do serve a useful social and economic purpose, they result in reduction in the effective tax rate on capital gains.

Finally, in the case of deemed disposition at death, liquidity problems that might otherwise arise are mitigated by allowing taxpayers to remit tax in instalments over up to 10 years.

Selective Exemptions from Tax on Capital Gains

A number of proposals have been made for selective exemptions from taxation of capital gains. Examples include exempting gains on the shares of Canadian-controlled public corporations and gains on farm property.

The first concern in analyzing such proposals must be their appropriateness from the viewpoint of general economic and social policy. Any such proposals provide incentives for investors to place more of their savings in particular assets. This implies some withdrawal of funds from other areas. Can this reallocation of resources be justified as making a net contribution to economic growth, regional development, Canadian ownership or other desirable objectives? Is the tax system necessarily the most efficient instrument for providing such incentives? What are the consequences of such changes for the equity of the tax system? Any selective exemption will benefit certain taxpayers who are in a position to take advantage of it, or may provide windfall gains to those who have an existing interest in the economic activity selected. It could mean higher taxes for others. Are these effects justified? The fact that incentives for one activity mean less investment elsewhere and higher taxes for others is an important consideration in policy decisions as to the desirability of selective exemptions.

Beyond these concerns, there are some less obvious but very significant technical implications that would flow from the adoption of any such proposal. These implications can be placed in two broad groups. The first relates to the definitions and decisions which would need to be made to specify the scope of a partial exemption and fit it into the income tax system. This would inevitably introduce further complexities into the tax system and, for some proposals, a set of workable rules might not be possible. The second category relates to the interaction of the exemption with existing tax provisions. This interaction might lead the exemption to be broader than intended, and would require either coincidental changes in other tax provisions or the acceptance of leakages of tax revenue through tax avoidance. These considerations are set out in general terms below.

Difficulties Related to the Scope of Selective Exemptions

A selective exemption or tax reduction, by its very nature, requires the drawing of a line between eligible and ineligible activities of taxpayers. The workability, effectiveness and simplicity of any selective measure depends on the ease with which such lines can be drawn. In practice, accurate and fair separation between eligible and ineligible situations would not always be possible, given the wide range of real situations that exist, many of which may fall very close to any line that is drawn. Also, rules would often be required to deal with the treatment of taxpayers or activities during the transition to their new eligibility status. Following are some of the major issues that arise in providing selective exemptions from, or reductions of, tax on capital gains.

Defining Eligibility

Defining eligibility is by far the most difficult step because of the presence of numerous borderline cases under any chosen definition. Concepts such as farming, manufacturing,

common shares, public companies and private companies, while easily recognizable, are often hard to describe in the precise fashion required for tax legislation. For example, if relief were to be provided for shares of Canadian-controlled public companies, one would need to decide how Canadian control was to be determined. Should the relief apply to common shares only (voting, non-voting) or should it extend to preferred shares that are convertible into common, to all preferred shares, to rights, warrants, and income debentures? Would Canadian control be determined by 50-per-cent ownership of a class or classes of shares or would some other concept of effective control be necessary? How would the true beneficial ownership of shares be determined? This effective control test should take cognizance of the dispersion of shareholdings, the residence and/or nationality of the management and the characteristics of different classes of shares, and would inevitably require rules to look through registered shareholders to determine the ultimate shareholders.

Similarly, a selective measure for the farming sector would require definitions of farm property and an eligible farmer. What would be the treatment of a farm property which is also used for some other purpose, i.e., a piece of land temporarily in farm use pending development? Should the measure be confined to bona fide farmers or extended to anyone who happens to own farm property, i.e., hobby farmers, investors and developers holding undeveloped farm land? If the former, what criteria distinguish a bona fide farmer? One could consider such factors as the extent of personal interest in the operations, the number of years spent on the farm, or the proportion of income derived from farming. Some of these criteria cannot be applied for tax purposes as they cannot be quantified. Others are arbitrary and could result in genuine farmers being ineligible. For example, the proportion of an individual's income from farming varies from year to year depending on market and other conditions, and bona fide farmers may rent out their land to others for a period of time because of illness or retirement.

Change in Use or Status

Under the Canadian tax system, capital gains are generally brought into income only when the property is sold. The capital gains that are realized would generally have arisen over a number of years. If there were a selective exemption for property in certain uses and if the property had been employed in both eligible and ineligible uses, it would presumably be appropriate to have apportionment rules to determine what proportion of the realized gain was eligible for the exemption. In the absence of such rules there would be an incentive for taxpayers to convert the property to qualifying property before its disposition in order to qualify the entire gain for the special treatment.

Consider the example of capital gains tax relief for Canadian-controlled public company shares discussed previously. It is not uncommon for control of a corporation to change and corporations may change status from private to public and vice versa. A rule requiring the revaluation of a company's shares each time its status changed could present serious problems of administration and enforcement.

Treatment of Corporate Activities

Often, activities eligible for a selective tax measure will be carried on by both individuals and corporations, private and public. Tax equity would thus require that the benefits of a selective exemption be extended to individuals and corporations alike. However, including corporations in any measure magnifies the problems of defining eligibility outlined above. It would be extremely difficult, for example, to provide a partial exemption for the gain on a corporation's shares to the extent that it reflects underlying increases in the value of eligible property.

Valuation Day

Finally, given that capital gains are generally taxed when realized and not when accrued, a decision would have to be made as to the coming into force of a measure for selective exemption. The treatment of accrued gains from 1972, when the taxation of capital gains first became applicable, up to the date of implementation of the exemption would have to be determined. A full exemption for all gains would result in windfall benefits to those holding the exempt assets when the measure was introduced and would involve substantial revenue costs to the government. These windfalls could be significant given that capital assets are typically held for a number of years. Any such exemption would be resented by those who happened to sell their assets just before the effective date of the measure and thus were required to pay tax on the gains realized. To overcome these problems, eligible assets would have to be valued as of the date of the measure and only subsequent appreciation from that value would qualify for the exemption. Valuations are a difficult matter for assets which do not trade frequently. In order to ensure fairness, a new valuation day would require transitional rules similar to those needed in 1972 when capital gains were made taxable.

Interaction of Selective Exemptions with Existing Tax Provisions

Selective exemptions for capital gains would interact with the rollover provisions and the provisions affecting corporate surplus distributions.

The rollover rules could be used to broaden significantly the scope of capital gains tax relief for selected types of property or groups of taxpayers. For example, the income tax system provides for transfers of most property free of capital gains tax from a shareholder to a corporation. Tax is deferred until subsequent sale of the transferred property or the shares of the corporation. If capital gains on the sale of shares of corporations were tax-exempt, there would be an incentive to convert properties – that is, to transfer assets to a corporation in exchange for its shares, which could then be sold under tax-exempt circumstances.

Unless these conversion opportunities were curtailed, corporations could become intermediaries for the exchange of non-qualifying property for shares, thereby essentially broadening the exemption to encompass all capital gains. If the gains accrued to the time of transfer were to be taxed on the eventual sale of the shares, rules would be required to determine what portion of the shareholder's ultimate gain was taxable. The alternatives would be to deny the taxpayers the benefit of the current rollover provisions or to deny the exemption for shares received in a exchange of ineligible or non-qualifying property. While addressing tax avoidance possibilities, a denial of the rollover provisions could interfere with desirable business reorganizations.

As noted earlier, the new, enriched dividend tax credit, introduced in 1977, ensures that a large proportion of dividends are taxed at roughly the same rate as capital gains, i.e., at one-half of the normal rates on other sources of income. If this balance were to be disturbed through a selective or general measure for capital gains on shares, it could require reintroduction of rules to prevent unacceptable tax abuse by surplus stripping (artificial conversion of dividends into capital gains). Such rules, when they previously applied, were among the most complex in the tax system and hindered otherwise desirable corporate reorganizations.

In summary, a selective exemption could not be introduced in isolation without complex changes to the existing rules. If incentives are to be provided to certain sectors in the economy, it might be more efficient and simpler to do so through an expenditure program or a subsidized loan.

Conclusions

Taxation of capital gains is an important element of the income tax system. Capital gains add to a taxpayer's ability to pay. The question of whether such gains should be recognized in the determination of tax liability has important equity implications. Capital gains are concentrated among higher-income taxpayers and their taxation thus contributes to the progressivity of the individual income tax.

Taxation of capital gains plays an important role in the tax system itself. Without it, other features of the tax system would require change. This is particularly so in the corporation/shareholder tax area where the existing system can largely ignore the distinction between share gains and dividend distributions.

Taxation of capital gains is an important revenue source for the federal government and for provinces. Their revenue yield is estimated to be more than $1 billion in the current year. Their importance as a revenue source will grow in future as the system continues to mature. To eliminate the tax would require significant increases in other areas of taxation.

From various perspectives, the current tax treatment of capital gains is imperfect. Taxation of only half of capital gains, and other tax preferences that lower their effective rate of tax, are counter to the principle of tax equity, and to some extent result in misallocation of resources in Canada. On the other hand, the lack of proper inflation adjustment can cause an overstatement of true capital gains with the result that the tax can be levied on gains that are illusory. Taxation of gains when realized, rather than when accrued, induces taxpayers to continue holding a particular asset longer than may be economically desirable. This lock-in effect has undesirable implications for the efficiency of capital markets. The restrictions on the deductibility of capital losses against other income can produce a bias against risk-taking. The preferential treatment of capital gains, which necessitates a range of special tax provisions, results in complexity for both taxpayers and tax administrators. While these imperfections are well recognized, they are the outcome of the compromises among conflicting policy objectives that have been made in designing the system. A number of imperfections would be removed if Canada taxed all capital gains in full as accrued. This would enhance tax equity and neutrality, eliminate the lock-in effect and permit losses to be fully and immediately deductible. Taxing capital gains like other forms of income would reduce complexity, though periodic evaluation of certain assets to determine accrued gains would be a partially offsetting complication. Under such a system, there would be stronger justification for inflation adjustment of capital gains, assuming that such adjustment were technically feasible. However, when capital gains were first brought into income for tax purposes in 1972, the government rejected full taxation in order to provide incentives to Canadians to save and invest and to put them on roughly the same footing as foreigners investing in Canada. Also, capital gains on principal residences were not made subject to tax on social policy grounds.

Non-taxation of capital gains would not simplify the law nor appreciably ease the problem of administration and compliance. Indeed, capital gains cannot be exempted from tax in isolation: a major restructing of the whole of the Income Tax Act would be

required. The effective rates of tax on wealth in Canada are already the lowest among OECD countries. Given that the federal government and most of the provinces do not impose any taxes on wealth or estates, exemption of capital gains would leave Canada as the only industrialized country that permitted large amounts of wealth to be accumulated and to be passed between generations without any tax liabiliy. Also, there is no evidence that exempting capital gains would be a cost-effective method of promoting saving and investment or economic growth.

The current tax system does not distinguish between real capital gains and those which are purely nominal. Increases in the value of assets which merely keep pace with inflation in no way enhance the economic power of the asset holder and ought not, therefore, be subject to a tax on income. However, it must be recognized that the measurement of other forms of investment and business income are equally affected by inflation. To provide an inflation adjustment for capital gains could be regarded as discriminatory. In fact, capital gains do already enjoy significant tax preferences relative to other forms of income. In many cases these offset, or more than offset, the lack of explicit inflation adjustment.

Also, inflation adjustment of capital gains would not be straightforward. Simply indexing the cost base of capital property, and doing nothing else, would not be acceptable, both from the point of view of tax equity and economic efficiency. A proper inflation adjustment which took account of debt financing would be quite complex. It would require individual taxpayers to file a statement of their assets and liabilities each year. It could not apply directly to private company shares. Depreciable property and interest-earning assets would also have to be excluded from the adjustment. Even with these qualifications, the adjustment would not be accurate in a number of cases. It is for these reasons that no industrialized country has provided comprehensive inflation adjustment of capital gains or other investment or business income. If inflation adjustment of capital gains were to be provided, the rationale for their half-taxation would be weakened.

A number of suggestions have been put forward for selective exemptions from tax on capital gains. Such suggestions need to be analyzed in terms of their overall economic implications, their cost-effectiveness, their effect on government revenues, and thus the need for tax increases elsewhere. Exemptions can have important effects on the tax system that must be taken into account. Alternatives to tax exemptions, including grants or subsidized loans, may be more efficient in providing selective incentives.

Appendix I

Capital Gains Rollovers

One of the important objectives in the taxation of corporations and shareholders is to avoid unnecessary impediments to legitimate formations or reorganizations of corporations and partnerships. The rules to accomplish this generally defer the taxation of capital gains that arise in certain types of dispositions by allowing the accrued capital gain to be "rolled over" for recognition in a subsequent transaction.

Following are some of the important rollover provisions that permit corporations and their shareholders to defer taxation of capital gains:

The transfer of most business property such as inventories, depreciable assets and capital assets, such as shares, to a Canadian corporation in exchange for shares of the corporation. This rollover is widely used upon incorporation. It also enables many corporate reorganizations, including business consolidations and divisions, to be carried out on a tax-free basis. In essence it permits assets to be transferred to the corporation at their original cost rather than at fair market value, in order that no tax arises on the transfer.

The disposition by a shareholder of shares of an amalgamating Canadian corporation in exchange for shares of the new Canadian corporation. The shareholder is considered to have disposed of his shares of the amalgamating corporation at his original cost and to have acquired the shares of the new corporation at that same cost. Taxation of capital gains is deferred until subsequent sale.

The winding-up of a wholly-owned Canadian subsidiary corporation into its Canadian parent corporation. In this case, the parent corporation is deemed to have disposed of its shares in the subsidiary for proceeds equal to their adjusted cost base, thereby ensuring no immediate tax to the parent. Similarly, the subsidiary is deemed to have disposed of, and the parent is deemed to have acquired, the subsidiary's assets at their tax cost so that the transfer of assets does not result in taxation of the subsidiary.

The arm's-length exchange by a shareholder of his shares of a particular corporation in exchange for shares of a Canadian corporation under circumstances where the shareholder does not acquire control of the other corporation. This is an important rollover which facilitates take-overs. As with the amalgamation rollover, this provision allows the shareholder to treat the exchange as having been effected at his tax cost. The acquiring corporation is given a full fair market value tax cost on the shares provided it acquires an aggregate of at least 10 per cent of the corporation's shares.

A number of internal corporate share rearrangements such as share conversions and other reorganizations of a corporation's capital stock. These share exchanges and reorganizations can be effected without immediate tax consequences, and facilitate transactions ranging from estate freezes to reorganizations designed to improve the capital structure of businesses facing cash-flow or other problems.

Appendix II

Adjustment to Income for Depreciable Property Under Alternative Tax System

The text indicates that, unless restrictions were imposed upon the scope of capital gains indexing, it would not be possible to segregate effectively the inflation adjustment of capital gains from other forms of income. This appendix gives an example of this problem in the case of depreciable property.

Assume a depreciable property was bought for $100, that it has been allowed a depreciation rate of 20 per cent and is sold for $105. Inflation between the time of purchase and the sale of the property is 10 per cent. The table summarizes the adjustments to the taxpayer's income arising from the property under three alternatives: the current system, a system of indexing capital gains only, and a system of inflation accounting of both depreciation claims and capital gains. Under inflation adjustment of capital gains only, any sale of the property for a price between $80 (the undepreciated capital cost) and $100 would continue to result in a recapture of depreciation, any sale between $100 and $110 (the inflation-adjusted cost base) would result in a capital loss, and only sales for a price in excess of $110 would give rise to a capital gain. Under a system where both depreciation allowance and capital gains were indexed, sales for a price up to $110 would result in recapture of the depreciation, and sales in excess of this threshold would give rise to capital gains. As the table shows (line 8), neglecting differences arising from half-taxation of capital gains, these two systems would yield identical adjustments to taxpayers' incomes. In effect the inflation adjustment of capital gains becomes a substitute for inflation indexing of depreciation allowances. This is evident from the fact that the amount of capital loss under a system that indexed only capital gains is exactly equal to the amount of additional depreciation and capital gains. Furthermore, if only capital gains are indexed, there is an advantage for taxpayers to buy and sell depreciable property to establish a higher cost base for future depreciation purposes. Such transactions are generally not advantageous under the current system because of the tax consequences of recapture of depreciation and taxation of capital gains on an historic cost basis.

Table 15

Adjustment to Income for Depreciable Property Under Alternative Tax Systems

	Current System	Inflation Adjustment of Capital Gains Only	Inflation Adjustment of Depreciation & Capital Gains
		($)	
1 Historical cost	100	100	100
2 Inflation-adjusted cost	n/a	110	110
3 Depreciation at 20%	20	20	22
4 Undepreciated capital cost (UCC)	80	80	88
5 Sale price	105	105	105
6 Recapture of depreciation	20	20	17
7 Capital gain	5	–5	0
8 Adjustment to taxable income with full taxation of capital (line 6 + line 7 – line 3)	5	–5	–5
9 Adjustment to taxable income with half-taxation of capital gains (line 6 + half line 7 – line 3)	2.5	–2.5	–5

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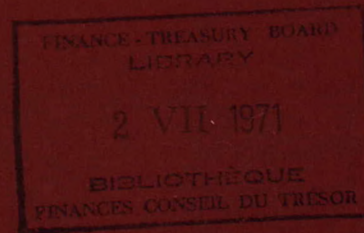
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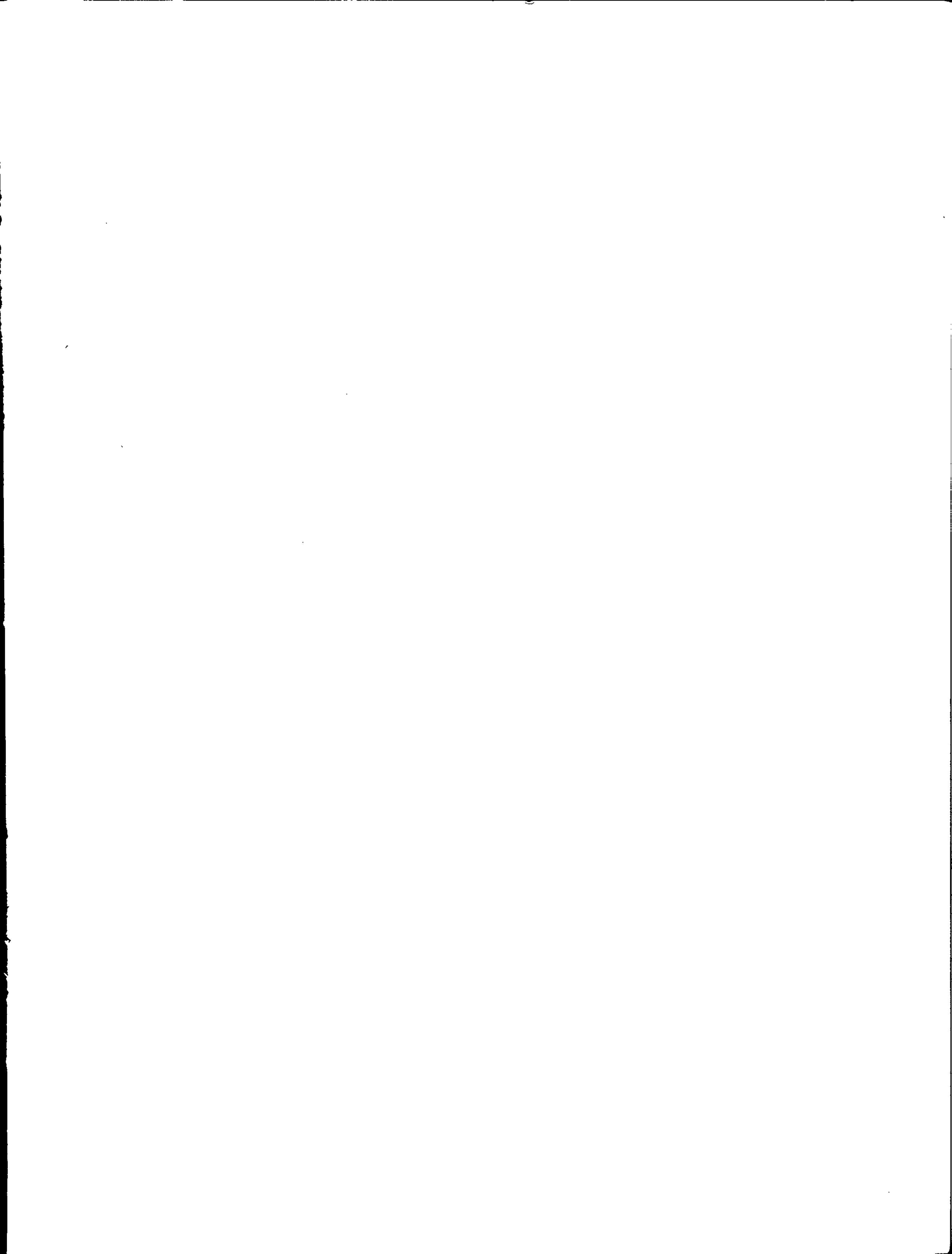

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Introduction

This document summarizes the main provisions of the legislation to reform personal and corporation income taxes, introduced as part of the June, 1971, budget of the Minister of Finance to take effect in 1972.

To permit immediate study, the legislation has been tabled budget night in the form of a Notice of Ways and Means Motion. Under this House of Commons procedure, the legislation is introduced in the form of a bill at the end of the budget debate.

Certain provisions initially described in narrative form will be incorporated in the bill at its introduction. These provisions relate to changes during the period of transition from the old system to the new system, and they include reductions in tax rates for the years 1973 to 1976. The reductions will be set out in detail in the legislation to fulfill the government's undertaking that revenues produced under the new system will not exceed the total that would be produced if the present system remained in effect. The reductions are described in explanatory material accompanying the narrative description of the transitional measures.

This summary, organized under much the same headings as the White Paper on tax reform, explains the proposed new tax system in non-technical terms to permit as wide an understanding as possible of the legislation, which is of necessity written in complex language.

Tables at the end of the chapter on Personal Income illustrate the taxes payable at various income levels for individual taxpayers. A synopsis at the end of the document compares the bill's provisions with the present law, with the proposals of the White Paper and with the recommendations of the Commons Committee on Finance, Trade and Economic Affairs and the Senate Committee on Banking, Trade and Commerce, which studied the White Paper.

1

Personal Income

- *Personal exemptions will be raised to $1,500 from $1,000 for single persons, and to $2,850 from $2,000 for married persons.*
- *Child care expenses will be deductible up to $500 per child under 14, with a maximum of $2,000 per family.*
- *An employment expense deduction of 3 per cent of employment income, up to $150 a year, is introduced. No receipts needed.*
- *All taxpayers with married exemption and income solely from wages and salaries will pay less tax than at present. Taxpayers with single exemption and employment income only will pay less tax on incomes under $8,000; above this level the tax increase will not exceed $78 a year.*
- *All taxpayers age 65 and over will receive a special exemption of $650. The guaranteed income supplement will be exempt from tax.*
- *Moving expenses will be deductible for taxpayers changing jobs.*
- *Calculation of tax is simplified by use of a single rate schedule. Top rate, including standard 30-per-cent provincial tax, will be 61.1 per cent.*
- *Employer-paid living expenses for jobs at distant work sites will be made tax-free to more taxpayers.*
- *Limit on deductible donations to charities increased to 20 per cent of income from 10 per cent. Standard deduction for medical expenses and charitable donations remains at $100.*
- *To be taxed as income:*

    One-half of capital gains
    Payments from income maintenance plans to which employer has contributed
    Adult training allowances
    Allowances paid under the Textile and Clothing Board Act
    Unemployment insurance benefits (contributions deductible)
    Scholarships, fellowships and bursaries with $500 exemption
    Amounts contributed on an employee's behalf to a public medical care plan

- *Two types of income averaging replace most of the existing options and create a broader and more generous system than proposed in the White Paper. General averaging will apply automatically when a tax return shows income 10 per cent higher than the preceding year and 20 per cent higher than the average of four preceding years. Forward averaging will permit taxpayers to spread unusual lump-sum receipts over future years through purchase of income-averaging annuities.*
- *Amounts in a pension plan or deferred profit-sharing plan which a taxpayer could withdraw in 1971 may be taxed under existing rules if withdrawn later in a lump-sum.*
- *Maximum deductible contributions are raised to $2,500 from $1,500 for registered pension plans and deferred profit-sharing plans; and to $4,000 (or 20 per cent of earned income) from $2,500 for registered retirement savings plans.*
- *Ten-per-cent foreign investment limit based on cost of assets is established for pension plans, registered retirement savings plans and deferred profit-sharing plans in future. Special tax on excess over 10 per cent.*

The public debate on tax reform strongly supported measures to give tax relief to Canadians of lower incomes. The major changes proposed by the bill for personal income taxes mark a serious attempt to recognize the growing mobility of Canadians and their changing patterns of family life.

The increase in personal exemptions is the broadest and most fundamental move to extend tax relief. Deductions for the costs of child care will ease the burden of a major major expense for working parents. Other significant costs confronting taxpayers and their families become deductible items, such as moving expenses and certain employment expenses.

The legislation introduces a more balanced and fairer approach to taxation of income by making a number of benefits taxable for the first time. In most cases these are payments or allowances that are essentially the same as wage and salary income, and used for the same general purposes.

In addition to these changes in the law which would take effect at the start of the new system, the legislation provides for two systems of income averaging to reduce tax rates on significant increases in income.

Personal Exemptions

The legislation raises personal exemptions to $1,500 from $1,000 for a single taxpayer, and to $2,850 from $2,000 for a married taxpayer.

Changes in the schedule of tax rates will be made at the same time to concentrate the benefit of the exemption increases among lower-income taxpayers and permit larger exemption increases than would otherwise be possible.

The bill changes the existing formula for reducing the married exemption as the wife's own income increases. If she has income of more than $250 in a year, her husband reduces the $1,350 exemption claimed for her by one dollar for each dollar of her income. If she has income of $1,600 or more, both husband and wife file as if they are single.

An unmarried person, including a widow or widower, can claim the married exemption for supporting a brother, child or other relative if that person lives in the taxpayer's home. But a taxpayer claiming the married exemption in these circumstances may not claim the $300 or $550 deduction for that dependant as well.

Current exemptions for dependants are maintained at $300 for dependants under age 16 and $550 for dependants 16 and over. The bill alters the present formula for reducing the benefits of the exemption when a dependant's income rises. The $300 exemption will be reduced by one dollar for each two dollars of the dependant's income in excess of $1,000. The $550 exemption will be reduced by one dollar for each dollar that the dependant's income exceeds $1,050. Thus, there will be no exemption where dependants have sufficient income to be taxable.

The special exemption of $500 for individuals age 70 and over will be increased to $650 and be made available to all taxpayers age 65 and over. Guaranteed income supplement payments will be exempt from tax; however, they will be included in income in determining whether pensioners may be claimed as dependants. Individuals who are blind or confined to a bed or wheelchair now receive a special deduction of $500. This will be increased to $650.

The standard deduction of $100 in lieu of itemized medical expenses and charitable donations will continue to be available to everyone. Thus total exemptions and deductions will be at least

for a single individual ($1,500 + $100) – $1,600

for an individual with full married status ($2,850 + $100) – $2,950

elderly taxpayers

single, age 65 or over ($1,500 + $100 + $650) – $2,250

married status, age 65 or over ($2,850 + $100 + $650) – $3,600

Child Care Expenses

The legislation permits the deduction of child care expenses up to $500 for each child under age 14 and a maximum $2,000 per family. This is in addition to the general deductions for children as dependants and it will normally be claimed by the mother.

The White Paper commented that the difficulty of adequately caring for children when both parents are working, or when there is only one parent in the family and he or she is working, is both a personal and social problem. It estimated that the child care deduction would assist several hundred thousand families.

The Commons committee termed the child care deduction a major innovation for the Canadian tax system. It suggested that the relief be extended to cover the situation where there is a parent at home unable to care for the children because of permanent mental or physical infirmity. This is incorporated in the legislation along with other extensions to cover special situations. The bill permits a deduction for expenses of caring for a child over age 14 who is dependent because of mental or physical infirmity.

Child care expenses which qualify under the bill include baby-sitting costs; day nursery care and up to $15 a week (not exceeding $500 a year) towards lodging paid at schools and camps. Amounts paid to dependants of the taxpayer or to relatives under age 21 will not qualify. Receipts bearing the social insurance number of the individual who performed child care services must be retained.

The deduction will normally be taken by the child's mother but it can be deducted by the child's father if he is a widower, or divorced or separated. He may also make the deduction if the mother is incapable of caring for herself or children or if she is confined for 14 days or more to bed, wheelchair, hospital, mental hospital or prison. For such periods, the father's deduction is limited to a maximum of $15 per week for each child to a total of $60 per week, subject to the over-all limits of $500 per child or $2,000 per year for the whole family.

The child care expense deduction is made from earned income, which for this purpose includes salary, wages, income from carrying on a business, adult training allowances and awards such as scholarships, fellowships and grants. The deduction may not exceed two-thirds of the earned income of the parent making the deduction.

Employment Expenses

The bill provides a deduction for employment expenses of up to 3 per cent of income from an office or employment, to a maximum of $150 a year. No receipts are required.

For many years the law has permitted those in business or the professions to deduct expenses reasonably related to earning income. Employees, however, have been limited to such deductions as union dues and contributions to pension plans. They could not deduct such expenses as the cost of tools and special clothes. The new employment expense deduction attempts to bring the calculation of income for the two groups into better balance.

The legislation also prevents businessmen deducting certain expenses which tend to be personal in nature such as membership in clubs. The right to deduct expenses of attending conventions will be more closely defined. Both businessmen and employees will have to include in income the benefit derived from personal use of a company car.

On the other hand, the legislation allows employees to deduct child care and moving expenses and unemployment insurance contributions, and permits them to exclude from income amounts or benefits received from employers to cover the costs of working away from home.

Income for purposes of the employment expense deduction includes wages, salary and taxable benefits received from an employer, and adult training allowances and research grants. It does not include income from a pension or retirement plan, remuneration as a corporation director or unemployment insurance benefits.

The employment expense deduction is not permitted to a salesman, who may deduct expenses incurred in earning commissions. An individual who holds an elected office will be able to take the deduction only to the extent that it exceeds any tax-free expense allowance he may receive.

Elected members of school boards, boards of education and other elected officers may exclude one-third of their total remuneration as an expense allowance in the same way as members of provincial legislatures and elected municipal officers.

Moving Expenses

The bill provides a deduction of moving expenses by taxpayers who change jobs. The deduction applies both when a person changes employers and when he is transferred by his present employer.

The deduction is available to employees, self-employed persons and full-time students who are not otherwise reimbursed for the costs of the move. The costs will be deductible from income from the new job.

Both the Commons and Senate committees recommended that taxpayers be allowed to deduct their expenses in the year they move or the next year. This is incorporated in the bill to recognize that job-hunting may take time and result in a delay in moving the family.

The deduction is intended to help remove a deterrent to mobility and to put taxpayers who pay their own moving expenses more nearly on a par with others whose moving expenses are paid by their employers.

The new residence must be at least 25 miles closer to a new job location. This is intended to ensure that the move is caused by the new job and not just a personal desire to change accommodation.

Moving expenses include the cost of travel of the taxpayer and members of his household, board and lodging while travelling, transportation and storage costs of household effects, the cost of cancelling a lease and the selling costs of the old residence.

Students who move from a post-secondary school or university to work may deduct moving expenses. Students who win awards for study at other locations may deduct moving expenses from the award.

The deduction does not apply to the expenses of moving into or out of Canada with the exception of certain provisions for students. Foreign students who come to Canada may deduct moving expenses from their grant, as may Canadians who go abroad to study under a grant from a Canadian source.

Away from Home Expenses

Under existing law, construction workers at distant work sites may receive tax-free from their employers amounts covering expenses of transportation, board and lodging. The bill extends this to all employees.

The revision recognizes that many people besides construction workers must leave their normal residence and live and work temporarily at a place where they cannot reasonably be expected to establish homes for their wives and families.

The provision will apply, as it does now, only to an employee who leaves his ordinary residence. It will not apply to a single individual who does not maintain a permanent residence in which he supports a dependant. It is necessary that the employee be away from his ordinary residence for at least 36 hours and the work site must be far enough away that he could not reasonably be expected to return home daily.

Among those who will benefit are lumber and mining workers, oil well drillers, exploration crews, employees at isolated bases and those who work at remote construction sites but do not qualify as "construction workers".

Additional Items of Income

Under the legislation a number of new items will become taxable. Although the income base is widened in this way, new deductions permitted in other sections will make the whole system much more equitable.

To be taxed as income:

- one-half of capital gains;
- payments under an income maintenance insurance plan to which the employer has made a contribution. (Contributions made by the individual since 1967 under the plan will be deductible from any payment he receives);
- allowances paid under the Adult Occupational Training Act, not including the portion for personal or living expenses while away from home for his training;
- allowances paid under the Textile and Clothing Board Act;
- scholarships, fellowships and bursaries with a $500 exemption;
- amounts contributed on an employee's behalf to a public medical care plan.

Many employees receive unemployment insurance benefits for part of a year although they may have earned substantial income during the rest of the year. The change to make these benefits taxable and contributions deductible will produce a more balanced and equitable system.

The bill specifically establishes a taxable value for the personal use of a company automobile. The value will be at least one per cent per month of the original cost of the car or one-third of the rental.

Scholarships, fellowships

Scholarships, fellowships and bursaries in cash or kind will be taxable with a $500 exemption. Research grants, Canada Council and like grants will be taxable, with the costs of equipment, fees, travel, laboratory charges, etc., deductible.

A student with scholarship income would typically have exemptions and deductions totalling at least $2,700. He would be exempt on $500 of the scholarship income, he would have the basic exemption of $1,500, a deduction for his tuition (say, $600) and the standard deduction of $100.

Canadians who leave Canada on a temporary basis to study or teach will continue to be taxed by Canada.

Medical Expenses

As proposed in the White Paper, the bill provides for three general adjustments in treatment of medical expenses.

Amounts contributed by an employer on behalf of his employees to a public medical care plan will be a taxable benefit to the employee (but this will not include payments for retired employees).

Medical expenses for which an individual has been reimbursed under an insurance plan may not be treated as medical expenses for tax purposes.

Premiums paid by an individual to non-government medical or hospital plans will be classed as deductible medical expenses.

The bill also expands the existing list of deductible medical expenses to include payments to a school or other institution for the care and training of mentally or physically handicapped or disabled persons, including those with special learning disabilities.

In the past, an amendment of the Income Tax Act was necessary to expand the list of appliances and equipment required by handicapped or disabled persons and deductible as medical expenses. The bill specifically adds some items to the list and provides that items may be added to this list in future by order in council. This will make possible faster adjustment of the list to respond to improved design of such equipment.

Charitable Donations

The limit on charitable donations is increased to 20 per cent of income from the existing limit of 10 per cent. The existing $100 standard deduction for charitable donations and medical expenses in lieu of itemized receipts is retained.

The legislation provides that donations to national amateur athletic associations will be deductible in the same manner as gifts to charitable organizations.

To qualify, an athletic association created under federal or provincial law must be a non-profit organization, have as its primary purpose and function the promotion of amateur athletics in Canada on a nationwide basis, and be accepted for registration by the Minister of National Revenue.

Tax Rates

Changes are made in the rate schedule to produce revenue approximately equal to present revenues less the amount of the 3-per-cent surtax, and to produce a smooth progression of taxes up the income scale.

The method of calculating personal taxes will be greatly simplified by melding existing special taxes and deductions into a single schedule. These special items include the old age security tax of 4 per cent, the social development tax of 2 per cent and the special tax reduction on basic tax limited to $20. The tax of 4 per cent on foreign investment income is cancelled. The 3-per-cent surtax will not apply in 1972.

One result of the new rate schedule-exemption combination will be to eliminate uneven results in the present rate schedules. For example, the ceilings of $240 on the old age security tax and $120 on the social development tax have resulted in a higher marginal tax rate (28.66 per cent) for taxable income between $4,000 and $6,000 than for the next bracket of taxable income between $6,000 and $8,000 (where the rate is 26.78 per cent). In future, marginal rates will go up in even and gradual steps as taxable income increases.

The existing system has provided for calculation of a federal basic tax, which is abated or reduced by 28 per cent in nine provinces and by 50 per cent in Quebec to allow for provincial income taxes. The higher abatement in Quebec allows Quebec to finance alone certain programs that are financed jointly with other provinces by the federal government. Under the new bill, provincial taxes will be calculated as a percentage of total federal tax, instead of the present system of abatements from "basic tax". The new standard rate of provincial tax will be 30 per cent of total federal tax, which will produce approximately the same provincial revenue as at present.

The result of the new rate schedule and a standard 30-per-cent provincial tax will be *combined* federal and provincial tax rates ranging to 61.1 per cent. This compares with an existing range to 82.4 per cent.

The top rate of 61.1 per cent compares with a White Paper top rate of about 50 per cent and follows the recommendation of the Commons committee for a top rate of 60 per cent, cutting in at taxable income of $60,000.

All taxpayers claiming the married exemption and with income solely from wages and salaries will pay less tax than at present. Taxpayers who claim the single exemption and have only employment income will pay less tax on incomes under $8,000. No single-status taxpayer above this level will have a tax increase of more than $78 on his employment income.

All taxpayers age 65 and over will receive a special exemption of $650. Together with the increase in basic exemptions and the new exemption for the guaranteed income supplement, this will eliminate or reduce taxes for most elderly taxpayers.

Reductions from the existing levels of tax are possible because the income base is broadened to include capital gains and a number of other items, because the 3-per-cent surtax is repealed, and because of reforms in the low rate of tax on corporate income and changes in the taxation of investment income of corporations.

The reductions are more pronounced when compared with the White Paper proposals. First-year revenues under

the White Paper system would have been increased by $160 million; under the legislation, first-year revenues will be reduced. Further, the White Paper contemplated 1971, not 1972, as the first year of the new system; by 1972 the increase in revenues at White Paper rates would be have been larger than $160 million.

INCOME AVERAGING

Two distinct types of income averaging are provided in the bill and will replace most of the options available under the old law. They are significantly broader and more generous in scope than the averaging system proposed in the White Paper.

The first is a *general averaging* system which applies *each year.* It cushions the tax effect of significant increases in income and ensures that a taxpayer is not penalized for an unusually successful period.

The second is *forward averaging* which permits a taxpayer to spread the taxes on certain large receipts over a *number* of years. It can be applied in addition to general averaging.

Farmers may continue to use the present five-year block averaging system for their income. The bill has provisions to prevent overlapping use of the two systems.

General Averaging

The bill provides that an automatic tax reduction can occur when an individual's income for the year shows an unusual increase over the average for the previous four years. This will alleviate the result of applying a progressive tax system in a year of unusually high income.

An automatic calculation will be made by the Department of National Revenue using information on the taxpayer's returns for the taxation year and the preceding four years. The taxpayer will not have to elect or make the calculation. The calculation can never increase the tax payable. When the calculation reduces the tax it will increase the taxpayer's refund or reduce any unpaid balance.

The White Paper said general averaging should be available to everyone and should not be difficult to operate. Because individuals are taxed on their income each year using a progressive schedule of rates, any large receipt or extra amount received in a year will normally be taxed more heavily than if it is received over a period of years. Present rules provide that certain lump-sum receipts may be taxed under a variety of special formulas. These formulas are not uniform and they do not apply to all income.

The proposal to tax capital gains will substantially increase the number of cases where individuals have unusual amounts of income in certain years. This increases the need for a satisfactory averaging formula.

Averaging is intended to apply to an unusual amount of income in a year and a method must be established to determine what is unusual. The White Paper proposed that taxpayers could average when their income exceeded their average income for the preceding four years by 33 1/3 per cent. This was criticized as being too restrictive.

The new formula permits taxpayers to average when their income is 20 per cent more than the average of the preceding four years and 10 per cent more than the immediately preceding year. This will make averaging available to more taxpayers and allow more income to be averaged when an individual has a substantial unusual receipt. But it will still reduce the benefit from averaging for individuals with steadily rising incomes.

Under the bill the averaging calculation will first apply in 1973 using only one preceding year.

To cover individuals just entering the labor force the bill provides that a minimum $1,600 income will be assumed for the preceding years.

For an individual who moves to Canada from another country and becomes resident here the calculation will apply to the one, two or three immediately preceding years in which he was a resident in Canada for the entire year.

In the case of a return filed for an individual who has died during the year, any increase in the year over the past four years will be averaged.

Forward Averaging

The purpose of forward averaging is to spread unusual lump-sum receipts in equal portions over the current and future years. Forward averaging will be accomplished through the purchase of a special type of annuity called an income-averaging annuity. Taxes will be payable when annuity payments are received. The annuity may be for life or for a period of up to 15 years.

For example, a taxpayer has an unusual receipt of $12,000 and wants to spread it over eight years. He uses $10,500 of the sum to buy an annuity of $1,500 per year for seven years (ignoring interest). He has $1,500 income in the first year, and an equal amount from the annuity over each of the nest seven years. In this way, the tax on the original $12,000 is spread over eight years.

Unusual receipts eligible for forward averaging:

1. Capital gains.
2. Income from production of a literary, dramatic, musical or artistic work.
3. Income from activities as an athlete, musician or public entertainer.
4. A single payment received from a superannuation or pension plan such as a return of contributions upon termination of employment or the death of an employee.
5. A payment upon retirement of an employee in recognition of long service.
6. A single payment received from a deferred profit-sharing plan upon retirement or withdrawal as a member from such a plan or upon the death of a member of such a plan.
7. A payment received under a death benefit plan for employees.
8. A return of premiums received from a registered retirement savings plan upon the death of the annuitant.
9. Proceeds from disposition of depreciable property.
10. Proceeds from sale of inventory or certain accounts receivable on the termination of a business.
11. Proceeds from disposition of certain special property such as business goodwill.
12. Benefits received by an employee under a stock option plan.

The portion of the unusual receipt left after buying the annuity must be at least as large as the payment expected in each year of the annuity.

To qualify for forward averaging the annuity must be purchased within 60 days after the end of the year. An "income-averaging annuity" will be a contract that meets certain requirements including the following:

1. It must be purchased by a single premium from a person authorized under the laws of Canada or a province to carry on an annuities business.
2. It must provide for payment to the purchaser of a series of equal amounts each year starting not later than 10 months after the contract is purchased; these yearly amounts may be divided into monthly or other periodic payments throughout the year.
3. Payments may be for a specific number of years up to 15, or for the lifetime of the purchaser. A life annuity may not have a guaranteed term of more than 15 years and an individual age 70 or over may not purchase an annuity for a guaranteed term greater than the difference between his age and 85.

RETIREMENT PLANS

Deductible contributions to retirement plans are increased substantially. This will serve both to improve retirement incomes and to make available large additional sums for investment and growth.

The bill raises the limits on contributions to registered pension plans and deferred profit-sharing plans to $2,500 from $1,500. Contribution limits on registered retirement savings plans are raised to $4,000 (or 20 per cent of earned income) from $2,500.

A taxpayer who has accumulated funds in a registered pension plan or deferred profit-sharing plan under the present system may apply the old averaging provisions to lump-sum withdrawals of those amounts made after the new system begins.

Registered Retirement Savings Plans

The proposed legislation repeals the previous flat rate of 15 per cent which applied to amounts paid upon death under a registered retirement savings plan. These payments, referred to as a return of premiums, will be included in income but will be eligible for special treatment. Such payments to a widow or a widower may be transferred tax-free into another registered retirement savings plan or used to buy an income-averaging annuity. Where such an amount is received by any other person it may be used to buy an income-averaging annuity.

Proceeds from cancelled or amended plans will continue to be taxable, but the bill also repeals the minimum tax of 15 per cent. Payments of such proceeds to non-residents will be subject to a 25-per-cent withholding tax.

As the White Paper observed, it is essential to be sure that tax-free funds cannot be diverted through investment in such a way as to bring current benefits to those who control retirement plans. It is therefore necessary to provide penalties for investments made contrary to the rules.

The present rules concerning non-qualified investments of deferred profit-sharing plans will therefore also apply, with some modifications, to investments of registered retirement savings plans. It will not be necessary to dispose of past investments that would be disqualified under the new rules.

Any income of a trust for a registered retirement savings plan from operating a business will be subject to tax. Any trust for a plan that borrows money will lose its tax-exempt status.

Foreign Investments

The legislation limits foreign investments of employee pension plans, registered retirement savings plans and deferred profit-sharing plans to 10 per cent of the cost of their assets. Past foreign investment limits have been based on foreign income rather than cost of foreign assets, and the limits have not applied to registered retirement savings plans. A special tax will be imposed on excess foreign investments held at the end of each month. This will be one per cent of the cost of the excess investments held.

If the cost of foreign investments held on budget day 1971 exceeds the 10-per-cent limit, plans will not be taxed on this excess or forced to reduce it, but they will be taxed on any additional purchases of such investments while over the limit.

Comparative Tables

TABLE 1

Present Schedules of Rates Applied to Taxable Income

	Federal Tax		Combined Federal and 28% Provincial Tax	
Taxable Income Bracket	*Tax at the beginning of the bracket*	*Tax rate on income in the bracket*	*Tax at the beginning of the bracket*	*Tax rate on income in the bracket*
$	$	%	$	%
0 – 909	0.00	11.72	0.00	14.80
909 – 1,000	106.55	13.92	134.55	17.00
1,000 – 1,643	119.20	16.08	150.00	20.00
1,643 – 2,000	222.57	16.50	278.57	20.42
2,000 – 3,000	281.50	18.75	351.50	23.51
3,000 – 4,000	469.00	20.25	586.60	25.57
4,000 – 6,000	671.50	22.50	842.30	28.66
6,000 – 8,000	1,121.50	19.50	1,415.50	26.78
8,000 – 10,000	1,511.50	22.50	1,951.10	30.90
10,000 – 12,000	1,961.50	26.25	2,569.10	36.05
12,000 – 15,000	2,486.50	30.00	3,290.10	41.20
15,000 – 25,000	3,386.50	33.75	4,526.10	46.35
25,000 – 40,000	6,761.50	37.50	9,161.10	51.50
40,000 – 60,000	12,386.50	41.25	16,886.10	56.65
60,000 – 90,000	20,636.50	45.00	28,216.10	61.80
90,000 – 125,000	34,136.50	48.75	46,756.10	66.95
125,000 – 225,000	51,199.00	52.50	70,188.60	72.10
225,000 – 400,000	103,699.00	56.25	142,288.60	77.25
400,000 –	202,136.50	60.00	277,476.10	82.40

Federal tax includes the old age security tax, the social development tax and the 3 per cent surtax, and is after deducting the 20 per cent reduction (maximum $20) and the provincial abatement of 28 per cent of basic tax.

Combined tax includes the federal tax and a provincial income tax at 28 per cent of basic tax.

TABLE 2

Proposed Schedule of Rates for 1972 Applied to Taxable Income

Taxable Income Bracket	*Federal Tax*		*Combined Federal and 30% Provincial Tax*	
	Tax at the beginning of the bracket	*Tax rate on income in bracket*	*Tax at the beginning of the bracket*	*Tax rate on income in the bracket*
$	$	%	$	%
0 – 500	0	17	0	22.1
500 – 1,000	85	18	110.50	23.4
1,000 – 2,000	175	19	227.50	24.7
2,000 – 3,000	365	20	474.50	26.0
3,000 – 5,000	565	21	734.50	27.3
5,000 – 7,000	985	23	1,280.50	29.9
7,000 – 9,000	1,445	25	1,878.50	32.5
9,000 – 11,000	1,945	27	2,528.50	35.1
11,000 – 14,000	2,485	31	3,230.50	40.3
14,000 – 24,000	3,415	35	4,439.50	45.5
24,000 – 39,000	6,915	39	8,989.50	50.7
39,000 – 60,000	12,765	43	16,594.50	55.9
60,000 –	21,795	47	28,333.50	61.1

Initial federal rate of 17 per cent reduced in 1973 to 15 per cent, in 1974 to 12 per cent, in 1975 to 9 per cent and in 1976 to 6 per cent.

TABLE 3

SINGLE TAXPAYER – NO DEPENDANTS

All Income from Salary or Wages

Income	*Present Tax*	*White Paper*	*New Bill*	*Change from Present Tax*	
				White Paper	**New Bill**
$	$	$	$	$	$
1,200	15	–	–	– 15	**– 15**
1,400	44	–	–	– 44	**– 44**
1,600	74	11	–	– 63	**– 74**
1,800	104	54	32	– 50	**– 72**
2,000	133	96	75	– 37	**– 58**
2,500	230	207	187	– 23	**– 43**
3,000	331	324	304	– 7	**– 27**
4,000	563	576	547	+ 13	**– 16**
5,000	817	841	803	+ 24	**– 14**
6,000	1,100	1,132	1,076	+ 31	**– 24**
7,000	1,387	1,448	1,355	+ 61	**– 32**
8,000	1,657	1,780	1,654	+ 124	**– 3**
9,000	1,924	2,122	1,960	+ 198	**+ 36**
10,000	2,229	2,481	2,285	+ 251	**+ 56**
11,000	2,538	2,839	2,616	+ 301	**+ 78**
12,000	2,894	3,206	2,967	+ 313	**+ 73**
13,000	3,254	3,590	3,331	+ 336	**+ 77**
14,000	3,661	3,974	3,734	+ 313	**+ 73**
15,000	4,073	4,372	4,137	+ 299	**+ 64**
20,000	6,334	6,574	6,373	+ 240	**+ 39**
25,000	8,651	8,878	8,648	+ 227	**– 3**
30,000	11,170	11,405	11,144	+ 235	**– 26**
50,000	21,928	21,645	21,765	– 283	**– 163**
75,000	36,806	34,445	36,429	–2,361	**– 377**
100,000	52,715	47,245	51,704	–5,470	**–1,011**

The present tax is current tax including old age security tax, social development tax and the 3 per cent surtax, plus provincial tax at 28 per cent of basic tax.

White Paper tax is federal tax plus provincial tax at 28 per cent as shown in the White Paper.

Tax under the new bill is federal tax for 1972 using a new rate schedule and a basic exemption for single taxpayers of $1,500, plus provincial tax at 30 per cent of federal tax.

In calculating tax under the new bill taxpayers receive the employment expense deduction of 3 per cent, maximum $150. No account has been taken of other proposed adjustments to income, such as taxation of capital gains.

In all cases it is assumed that taxpayers take the optional standard deduction of $100.

Taxpayers are assumed to be under age 65.

TABLE 4

MARRIED TAXPAYER – NO DEPENDANTS

All Income from Salary or Wages

Income	*Present Tax*	*White Paper*	*New Bill*	*Change from Present Tax*	
				White Paper	**New Bill**
$	$	$	$	$	$
2,200	15	–	–	– 15	– **15**
2,400	44	–	–	– 44	– **44**
2,600	74	–	–	– 74	– 74
2,800	104	–	–	– 104	– **104**
3,000	133	2	–	– 131	– 133
3,500	230	108	98	– 122	– 132
4,000	331	219	211	– 112	– 120
5,000	563	461	450	– 102	– 113
6,000	817	729	709	– 88	– 108
7,000	1,100	1,010	980	– 90	– 120
8,000	1,387	1,316	1,253	– 71	– 134
9,000	1,657	1,647	1,550	– 10	– 107
10,000	1,924	1,980	1,849	+ 56	– 75
11,000	2,229	2,337	2,171	+ 108	– 58
12,000	2,538	2,696	2,496	+ 157	– 42
13,000	2,894	3,054	2,844	+ 160	– 50
14,000	3,254	3,437	3,195	+ 183	– 59
15,000	3,661	3,821	3,593	+ 160	– 68
20,000	5,870	5,929	5,759	+ 59	– 111
25,000	8,188	8,233	8,034	+ 45	– 154
30,000	10,655	10,688	10,460	+ 33	– 195
50,000	21,361	20,928	21,011	– 433	– 350
75,000	36,188	33,728	35,604	–2,460	– 584
100,000	52,045	46,528	50,879	–5,517	–1,166

The present tax is current tax including old age security tax, social development tax and the 3 per cent surtax, plus provincial tax at 28 per cent of basic tax.

White Paper tax is federal tax plus provincial tax at 28 per cent as shown in the White Paper.

Tax under the new bill is federal tax for 1972 using a new rate schedule and a basic exemption for married taxpayers of $2,850, plus provincial tax at 30 per cent of federal tax.

In calculating tax under the new bill taxpayers receive the employment expense deduction of 3 per cent, maximum $150. No account has been taken of other proposed adjustments to income such as taxation of capital gains.

In all cases it is assumed that taxpayers take the optional standard deduction of $100.

Taxpayers are assumed to be under age 65.

TABLE 5

MARRIED TAXPAYER – TWO DEPENDENT CHILDREN UNDER AGE 16

All Income from Salary or Wages

Income	Present Tax	White Paper	New Bill	Change from Present Tax White Paper	Change from Present Tax New Bill
$	$	$	$	$	$
2,800	15	–	–	– 15	– 15
3,000	44	–	–	– 44	– 44
3,500	118	–	–	– 118	– 118
4,000	210	83	73	– 127	– 137
5,000	422	309	302	– 113	– 120
6,000	663	568	553	– 96	– 110
7,000	928	841	816	– 87	– 112
8,000	1,215	1,132	1,089	– 83	– 126
9,000	1,496	1,448	1,370	– 48	– 126
10,000	1,764	1,780	1,669	+ 17	– 95
11,000	2,044	2,122	1,976	+ 78	– 68
12,000	2,353	2,481	2,301	+ 128	– 52
13,000	2,677	2,839	2,634	+ 161	– 43
14,000	3,038	3,206	2,985	+ 168	– 53
15,000	3,414	3,590	3,351	+ 177	– 63
20,000	5,592	5,652	5,486	+ 60	– 106
25,000	7,910	7,956	7,761	+ 47	– 149
30,000	10,346	10,381	10,156	+ 35	– 190
50,000	21,022	20,621	20,675	– 401	– 347
75,000	35,818	33,421	35,238	–2,397	– 580
100,000	51,643	46,221	50,513	–5,423	–1,130

The present tax is current tax including old age security tax, social development tax, and the 3 per cent surtax, plus provincial tax at 28 per cent of basic tax.

White Paper tax is federal tax plus provincial tax at 28 per cent as shown in the White Paper.

Tax under the new bill is federal tax for 1972 using a new rate schedule and a basic exemption for married taxpayers of $2,850, plus provincial tax at 30 per cent of federal tax.

In calculating tax under the new bill taxpayers receive the employment expense deduction of 3 per cent, maximum $150. No account has been taken of other proposed adjustments to income such as taxation of capital gains.

In all cases it is assumed that taxpayers take the optional standard deduction of $100.

Taxpayers are assumed to be under age 65.

TABLE 6

SINGLE TAXPAYER – NO DEPENDANTS

Not Eligible for 3% Employment Expense Deduction

Income	*Present Tax*	*White Paper*	*New Bill*	*Change from Present Tax* *White Paper*	**New Bill**
$	$	$	$	$	$
1,200	15	–	–	– 15	**– 15**
1,400	44	–	–	– 44	**– 44**
1,600	74	22	–	– 52	**– 74**
1,800	104	65	44	– 38	**– 60**
2,000	133	109	88	– 24	**– 45**
2,500	230	224	204	– 6	**– 26**
3,000	331	346	326	+ 15	**– 5**
4,000	563	608	579	+ 45	**+ 16**
5,000	817	883	844	+ 66	**+ 27**
6,000	1,100	1,178	1,117	+ 77	**+ 17**
7,000	1,387	1,498	1,400	+ 111	**+ 13**
8,000	1,657	1,830	1,699	+ 174	**+ 42**
9,000	1,924	2,176	2,009	+ 252	**+ 85**
10,000	2,229	2,534	2,334	+ 305	**+ 105**
11,000	2,538	2,893	2,669	+ 355	**+ 131**
12,000	2,894	3,264	3,020	+ 370	**+ 126**
13,000	3,254	3,648	3,392	+ 394	**+ 138**
14,000	3,661	4,032	3,795	+ 371	**+ 134**
15,000	4,073	4,435	4,198	+ 362	**+ 125**
20,000	6,334	6,643	6,442	+ 309	**+ 108**
25,000	8,651	8,947	8,717	+ 296	**+ 66**
30,000	11,170	11,482	11,220	+ 312	**+ 50**
50,000	21,928	21,722	21,849	– 206	**– 79**
75,000	36,806	34,522	36,521	–2,284	**– 285**
100,000	52,715	47,322	51,796	–5,393	**– 919**

The present tax is current tax including old age security tax, social development tax and the 3 per cent surtax, plus provincial tax at 28 per cent of basic tax.

White Paper tax is federal tax plus provincial tax at 28 per cent as shown in the White Paper.

Tax under the new bill is federal tax for 1972 using a new rate schedule and a basic exemption for single taxpayers of $1,500, plus provincial tax at 30 per cent of federal tax.

In calculating tax under the new bill it is assumed that taxpayers do not have any income from salary or wages. No account has been taken of the credit for dividends or new adjustments to income such as taxation of capital gains.

In all cases it is assumed that taxpayers take the optional standard deduction of $100.

Taxpayers are assumed to be under age 65.

TABLE 7

MARRIED TAXPAYER – NO DEPENDANTS

Not Eligible for 3% Employment Expense Deduction

Income	*Present Tax*	*White Paper*	*New Bill*	*Change from Present Tax* *White Paper*	**New Bill**
$	$	$	$	$	$
2,200	15	–	–	– 15	**– 15**
2,400	44	–	–	– 44	**– 44**
2,600	74	–	–	– 74	**– 74**
2,800	104	–	–	– 104	**– 104**
3,000	133	22	11	– 111	**– 122**
3,500	230	132	122	– 98	**– 108**
4,000	331	248	240	– 83	**– 91**
5,000	563	500	488	– 63	**– 75**
6,000	817	771	748	– 46	**– 69**
7,000	1,100	1,055	1,021	– 45	**– 79**
8,000	1,387	1,364	1,295	– 23	**– 92**
9,000	1,657	1,697	1,594	+ 40	**– 63**
10,000	1,924	2,033	1,895	+ 108	**– 29**
11,000	2,229	2,391	2,220	+ 162	– 9
12,000	2,538	2,749	2,546	+ 211	+ 8
13,000	2,894	3,110	2,897	+ 216	+ 3
14,000	3,254	3,494	3,251	+ 240	– 3
15,000	3,661	3,878	3,654	+ 217	– 7
20,000	5,870	5,998	5,827	+ 128	**– 43**
25,000	8,188	8,302	8,102	+ 114	**– 86**
30,000	10,655	10,765	10,536	+ 110	**– 119**
50,000	21,361	21,005	21,094	– 357	**– 267**
75,000	36,188	33,805	35,696	–2,383	**– 492**
100,000	52,045	46,605	50,971	–5,440	**–1,074**

The present tax is current tax including old age security tax, social development tax and 3 per cent surtax, plus provincial tax at 28 per cent of basic tax.

White Paper tax is federal tax plus provincial tax at 28 per cent as shown in the White Paper.

Tax under the new bill is federal tax for 1972 using a new rate schedule and a basic exemption for married taxpayers of $2,850, plus provincial tax at 30 per cent of federal tax.

In calculating tax under the new bill it is assumed that taxpayers do not have any income from salary or wages. No account has been taken of the tax credit for dividends or new adjustments to income such as taxation of capital gains.

In all cases it is assumed that taxpayers take the optional standard deduction of $100.

Taxpayers are assumed to be under age 65.

TABLE 8

SINGLE TAXPAYER – AGE 65 TO 69 – NO DEPENDANTS

No Income from Employment

Income Plus G.I.S.	*Present Tax*	*White Paper*	*New Bill*	*Change from Present Tax* *White Paper*	**New Bill**
$	$	$	$	$	$
960 + 660	77	26	–	– 51	– 77
1,200 + 540	95	52	–	– 43	– 95
1,400 + 444	110	75	–	– 35	– 110
1,600 + 340	124	96	–	– 28	– 124
1,800 + 240	140	118	–	– 22	– 140
2,000 + 144	159	142	–	– 17	– 159
2,500	230	224	55	– 6	– 175
3,000	331	346	169	+ 15	– 162
4,000	563	608	413	+ 45	– 150
5,000	817	883	670	+ 66	– 147
6,000	1,100	1,178	939	+ 77	– 161
7,000	1,387	1,498	1,212	+ 111	– 175
8,000	1,657	1,830	1,505	+ 174	– 152
9,000	1,924	2,176	1,804	+ 252	– 120
10,000	2,229	2,534	2,122	+ 305	– 107
11,000	2,538	2,893	2,447	+ 355	– 91
12,000	2,894	3,264	2,792	+ 370	– 102
13,000	3,254	3,648	3,143	+ 394	– 111
14,000	3,661	4,032	3,533	+ 371	– 128
15,000	4,073	4,435	3,936	+ 362	– 137
20,000	6,334	6,643	6,146	+ 309	– 188
25,000	8,651	8,947	8,421	+ 296	– 230
30,000	11,170	11,482	10,891	+ 312	– 279
50,000	21,928	21,722	21,486	– 206	– 442
75,000	36,806	34,522	36,124	–2,284	– 682
100,000	52,715	47,322	51,399	–5,393	–1,316

The amount of guaranteed income supplement payable to single persons with low incomes is shown in addition to other income. The present tax and White Paper tax are calculated on the combined amounts. Under the new bill the guaranteed supplement will not be subject to tax.

The present tax is current tax including old age security tax, social development tax and the 3 per cent surtax, plus provincial tax at 28 per cent of basic tax.

White Paper tax is federal tax plus provincial tax at 28 per cent as shown in the White Paper.

Tax under the new bill is federal tax for 1972 using a new rate schedule and a basic exemption for single taxpayers of $1,500 plus a special exemption of $650. It includes provincial tax at 30 per cent of federal tax.

In calculating tax under the new bill it is assumed that taxpayers do not have any income from salary or wages. No account has been taken of the tax credit for dividends or new adjustments to income such as the taxation of capital gains.

In all cases it is assumed that taxpayers take the optional standard deduction of $100.

TABLE 9

MARRIED TAXPAYER – AGE 65 TO 69 – NO DEPENDANTS

No Income from Employment

Income Plus G.I.S.	*Present Tax*	*White Paper*	*New Bill*	*Change from Present Tax*	
				White Paper	New Bill
$	$	$	$	$	$
2,200 + 600	104	–	–	– 104	– **104**
2,400 + 540	124	9	–	– 115	– **124**
2,600 + 492	149	42	–	– 107	– **149**
2,800 + 444	179	75	–	– 104	– **179**
3,000 + 396	209	108	–	– 101	– **209**
3,500 + 276	285	195	–	– 90	– **285**
4,000 + 144	362	283	88	– 79	– **274**
5,000	563	500	326	– 63	– **237**
6,000	817	771	578	– 46	– **239**
7,000	1,100	1,055	844	– 45	– **256**
8,000	1,387	1,364	1,117	– 23	– **270**
9,000	1,657	1,697	1,400	+ 40	– **257**
10,000	1,924	2,033	1,699	+ 109	– **225**
11,000	2,229	2,391	2,008	+ 162	– **221**
12,000	2,538	2,749	2,334	+ 211	– **204**
13,000	2,894	3,110	2,669	+ 216	– **225**
14,000	3,254	3,494	3,020	+ 240	– **234**
15,000	3,661	3,878	3,392	+ 217	– **269**
20,000	5,870	5,998	5,532	+ 128	– **338**
25,000	8,188	8,302	7,806	+ 114	– **382**
30,000	10,655	10,765	10,206	+ 110	– **449**
50,000	21,361	21,005	20,731	– 356	– **630**
75,000	36,188	33,805	35,299	–2,383	– **889**
100,000	52,045	46,605	50,574	–5,440	**–1,471**

The amount of guaranteed income supplement payable to a married person with a low income whose spouse is not eligible for the old age pension or guaranteed supplement is shown in addition to other income. The present tax and White Paper tax are calculated on the combined amounts. Under the new bill the guaranteed supplement will not be subject to tax.

The present tax is current tax including old age security tax, social development tax and the 3 per cent surtax, plus provincial tax at 28 per cent of basic tax.

White Paper tax is federal tax plus provincial tax at 28 per cent as shown in the White Paper.

Tax under the new bill is federal tax for 1972 using a new rate schedule and a basic exemption for married taxpayers of $2,850 plus a special exemption of $650. It includes provincial tax at 30 per cent of federal tax.

In calculating tax under the new bill it is assumed that taxpayers do not have any income from salary or wages. No account has been taken of the tax credit for dividends or new adjustments to income such as the taxation of capital gains.

In all cases it is assumed that taxpayers take the optional standard deduction of $100.

TABLE 10

SINGLE TAXPAYER – AGE 70 OR OVER – NO DEPENDANTS

No Income from Employment

Income Plus G.I.S.	*Present Tax*	*White Paper*	*New Bill*	*Change from Present Tax*	
				White Paper	**New Bill**
$	$	$	$	$	$
1,600 + 340	50	–	–	– 50	**– 50**
1,800 + 240	65	9	–	– 56	**– 65**
2,000 + 144	80	31	–	– 49	**– 80**
2,500	133	109	55	– 24	**– 78**
3,000	230	224	169	– 6	**– 61**
4,000	446	474	413	+ 28	**– 33**
5,000	689	742	670	+ 53	**– 19**
6,000	957	1,024	939	+ 67	**– 18**
7,000	1,244	1,331	1,212	+ 87	**– 32**
8,000	1,523	1,664	1,505	+ 141	**– 18**
9,000	1,790	1,997	1,804	+ 207	**+ 14**
10,000	2,075	2,355	2,122	+ 280	**+ 47**
11,000	2,384	2,714	2,447	+ 330	**+ 63**
12,000	2,713	3,072	2,792	+ 359	**+ 79**
13,000	3,074	3,456	3,143	+ 382	**+ 69**
14,000	3,455	3,840	3,533	+ 385	**+ 78**
15,000	3,867	4,224	3,936	+ 357	**+ 69**
20,000	6,102	6,413	6,146	+ 311	**+ 44**
25,000	8,420	8,717	8,421	+ 297	**+ 1**
30,000	10,912	11,226	10,891	+ 314	**– 21**
50,000	21,645	21,466	21,486	– 179	**–159**
75,000	36,497	34,266	36,124	–2,231	**–373**
100,000	52,380	47,066	51,399	–5,314	**–981**

The amount of guaranteed income supplement payable to single persons with low incomes is shown in addition to other income. The present tax and White Paper tax are calculated on the combined amounts. Under the new bill the guaranteed supplement will not be subject to tax.

The present tax is current tax including old age security tax, social development tax and the 3 per cent surtax, plus provincial tax at 28 per cent of basic tax.

White Paper tax is federal tax plus provincial tax at 28 per cent as shown in the White Paper.

Tax under the new bill is federal tax for 1972 using a new rate schedule and a basic exemption for single taxpayers of $1,500 plus an additional deduction of $150 and the extra $500 deduction for persons age 70 or over. It includes provincial tax at 30 per cent of federal tax.

In calculating tax under the new bill it is assumed that taxpayers do not have any income from salary or wages. No account has been taken of the tax credit for dividends or new adjustments to income such as taxation of capital gains.

In all cases it assumed that taxpayers take the optional standard deduction of $100.

TABLE 11

MARRIED TAXPAYER – AGE 70 OR OVER – NO DEPENDANTS

No Income from Employment

Income Plus G.I.S.	*Present Tax*	*White Paper*	*New Bill*	*Change from Present Tax White Paper*	**New Bill**
$	$	$	$	$	$
2,200 + 600	30	–	–	– 30	**– 30**
2,400 + 540	50	–	–	– 50	**– 50**
2,600 + 492	73	–	–	– 73	**– 73**
2,800 + 444	95	–	–	– 95	**– 95**
3,000 + 396	118	–	–	– 118	**– 118**
3,500 + 276	185	82	–	– 103	**– 185**
4,000 + 144	259	165	88	– 94	**– 171**
5,000	446	371	326	– 75	**– 120**
6,000	689	635	578	– 54	**– 111**
7,000	957	911	844	– 46	**– 113**
8,000	1,244	1,208	1,117	– 36	**– 127**
9,000	1,523	1,531	1,400	+ 8	**– 123**
10,000	1,790	1,864	1,699	+ 74	**– 91**
11,000	2,075	2,212	2,008	+ 137	**– 67**
12,000	2,384	2,570	2,334	+ 186	**– 50**
13,000	2,713	2,929	2,669	+ 216	**– 44**
14,000	3,074	3,302	3,020	+ 228	**– 54**
15,000	3,455	3,686	3,392	+ 231	**– 63**
20,000	5,638	5,768	5,532	+ 130	**– 106**
25,000	7,956	8,072	7,806	+ 116	**– 150**
30,000	10,397	10,509	10,206	+ 112	**– 191**
50,000	21,078	20,749	20,731	– 329	**– 347**
75,000	35,879	33,549	35,299	–2,330	**– 580**
100,000	51,710	46,349	50,574	–5,361	**–1,136**

The amount of guaranteed income supplement payable to a married person with a low income whose spouse is not eligible for the old age pension or guaranteed supplement is shown in addition to other income. The present tax and White Paper tax are calculated on the combined amounts. Under the new bill guaranteed supplement will not be subject to tax.

The present tax is current tax including old age security tax, social development tax and the 3 per cent surtax, plus provincial tax at 28 per cent of basic tax.

White Paper tax is federal tax plus provincial tax at 28 per cent as shown in the White Paper.

Tax under the new bill is federal for 1972 using a new rate schedule and a basic exemption for married taxpayers of $2,850 plus an additional deduction of $150 and the extra $500 deduction for persons age 70 or over. It includes provincial tax at 30 per cent of federal tax.

In calculating tax under the new bill it is assumed that taxpayers do not have any income from salary or wages. No account has been taken of the tax credit for dividends or new adjustments to income such as taxation of capital gains.

In all cases it is assumed that taxpayers take the optional standard deduction of $100.

TABLE 12

Operation of General Income Averaging for Individuals

Assume that a married taxpayer with no dependants has income as follows:	1972	$ 8,000
	1973	9,000
	1974	9,000
	1975	10,000
	1976	22,000

Income Calculations:		
Average of years 1972 to 1975 inclusive		$ 9,000
120% of average income	(A) $10,800	
110% of income in 1975	(B) 11,000	
Threshold amount is the greater of (A) and (B)		11,000
Excess of income in 1976 over threshold amount ($11,000 + $2,200)		11,000
Divide this excess by 5		2,200
Add this 1/5 excess to threshold amount		13,200
Tax Calculations:		
Tax on $13,200		$ 2,967
Tax on threshold amount ($11,000)		2,220
Difference is tax on 1/5 excess		$ 747
Multiply tax on 1/5 excess by 5 = tax on excess		$ 3,735
Tax on threshold amount		2,220
Total is tax on income of $22,000 in 1976		$ 5,955

The example applies the proposed rate schedule for 1972.

The taxable income for 1976 is $19,050, calculated as follows:

Income		$22,000
Less: personal exemption	$2,850	
standard deduction	100	2,950
Taxable income		$19,050

The tax on income of $22,000 in 1976 without averaging would be $6,737. Thus the tax saving from averaging in this example is $782.

If the income in the above example for the year 1976 were $32,000 the saving from averaging would be $1,758. Unless the taxpayer's income in 1976 exceeds $11,950 there would be no saving from averaging. Table 13 gives some further examples of the results from using the general averaging formula.

For comparative purposes the averaging examples are identical to those used in the White Paper. In the above example, the tax savings from averaging under the White Paper system were $446 in the situation where income in the last year was $22,000 and $1,455 when income increased to $32,000. In examples 1 to 5 of Table 13 the corresponding tax savings under the White Paper were $314, $316, $185, $173 and $671 respectively.

TABLE 13

Operation of General Income Averaging for Individuals

	1972	1973	1974	1975	1976
	$	$	$	$	$
Example 1					
Income	2,100	2,100	2,100	2,100	8,000
Tax saving from averaging					146*
Example 2					
Income	2,000	2,000	6,000	8,000	10,000
Tax saving from averaging					NIL
Example 3					
Income	6,000	6,000	6,000	6,000	15,000
Tax saving from averaging					343
Example 4					
Income	10,000	6,000	9,000	11,000	18,000
Tax saving from averaging					265
Example 5					
Income	15,000	15,000	15,000	15,000	40,000
Tax saving from averaging					679

The examples apply the proposed rate schedule for 1972.

For these calculations it is assumed that the taxpayer is married with no dependants and has no other deductions except the $100 standard deduction and the $2,850 personal exemption.

*Where 110 per cent of the previous year's income or 120 per cent of the average income for the four previous years is less than the total personal exemptions and deductions, the threshold amount is the total of personal exemptions and deductions ($2,950 in this example).

2

Capital Gains

- *The legislation establishes a general rule that one half of capital gains will be included in income and taxed at normal personal or corporate rates.*
- *A second general rule is that all taxpayers may deduct one-half of capital losses against one-half of capital gains; individual taxpayers may also deduct up to $1,000 of capital losses against other income. The deductions may be made in the current year, preceding year or any number of subsequent years until losses are fully absorbed.*
- *Gains will generally be taxable and losses deductible when a taxpayer sells an asset, when he makes a gift of an asset, or at his death. Capital gains will be deferred on gifts or bequests to wife or husband.*
- *With the inclusion of capital gains in income and the taxation of accrued gains at death, federal estate and gift taxes will be eliminated. These taxes will end December 31, 1971.*
- *The White Paper proposal for valuation of listed shares every five years is dropped.*
- *Any gain realized by a taxpayer in selling his home and up to an acre of surrounding land will be entirely exempt. Alternatively, a farmer may deduct $1,000 per year from gain on sale of home and farm property.*
- *No gain realized on an item of personal property will be taxed unless the asset's selling price is more than $1,000.*
- *Provisions to defer gains will be permitted in the case of destruction or expropriation, sales of property to a controlled corporation and certain corporate reorganizations.*
- *Gains on assets held at the start of the system may be measured against the higher of original cost or Valuation Day value.*

Debate on the White Paper revealed a clear consensus that the taxation of capital gains should be part of the Canadian tax system. The debate did not, however, support the full taxation of gains as recommended by the Royal Commission on Taxation, or the White Paper's modified system of full rates on assets other than shares of widely-held Canadian corporations.

The Commons committee said it was the view of the private sector and provincial governments that "capital gains should not suffer the same weight of tax as other income", and the committee recommended taxing one-half of realized gains as a general rule.

The legislation proposes to include one-half of capital gains in the taxpayer's income to be taxed at personal rates if the taxpayer is an individual, or at corporate rates if the taxpayer is a corporation. The system makes capital gains part of the progressive rate system for individuals, taxing gains in the same manner as other income, according to ability to pay.

Let us assume that a taxpayer has other taxable income of $10,000, a marginal tax rate of 35 per cent and receives a capital gain of $100 on sale of shares. He would take $50 into income and pay $17.50 on the gain. On the same gain, another taxpayer with $25,000 of taxable income and a marginal rate of 50 per cent would pay $25.

The legislation drops a proposal of the White Paper to tax accrued gains on listed shares every five years. As indicated in a paper submitted by the Minister of Finance to the two parliamentary committees, two important consequences follow from any decision to eliminate such periodic valuation.

The first is the need to tax accrued gains on death to prevent the perpetual deferral of tax. The legislation makes gains taxable at death, but also eliminates federal estate and gift taxes.

The second is the requirement to limit the amount of losses that may be deducted in any one year from ordinary income, because taxpayers will have more control over the timing of gains and losses on their readily marketable assets.

The legislation permits a deductible loss to be absorbed fully over a period of time, just as averaging provisions will reduce the immediate tax impact of a large gain received at one time. But a taxpayer may not deduct capital losses from other income in full as proposed by the White Paper.

The legislation permits an individual to deduct one-half of capital losses in a year first against one-half of capital gains in that year, and up to $1,000 of any deductible excess against other income. If part of the loss is still not absorbed, it may be applied in the same manner for the previous year and any number of future years until it is absorbed.

The following table shows how an individual taxpayer obtains a deduction for one-half of a $30,000 capital loss in the year of the loss (Year 3), the previous year and subsequent years.

	Year 1	*Year 2*	*Year 3*	*Year 4*	*Year 5*	*Year 6*
	$	$	$	$	$	$
CAPITAL GAINS (LOSSES)	2,000	4,000	(30,000)	6,000	4,000	20,000
CALCULATION OF TAXABLE INCOME						
Ordinary income less expenses and personal exemptions	10,000	10,000	10,000	10,000	10,000	10,000
Taxable capital gains	1,000	2,000	–	3,000	2,000	10,000
	11,000	12,000	10,000	13,000	12,000	20,000
Deductible capital losses:						
– from taxable capital gains	–	2,000	–	3,000	2,000	4,000
– from ordinary income	–	1,000	1,000	1,000	1,000	–
	–	3,000	1,000	4,000	3,000	4,000
TAXABLE INCOME	11,000	9,000	9,000	9,000	9,000	16,000

- In Year 3 a taxpayer suffers a capital loss of $30,000, of which $15,000 (one-half) is deductible. Since there are no capital gains in that year the maximum deduction is $1,000. This leaves $14,000 to be deducted.
- The taxpayer then recalculates his taxable income for the previous year, Year 2, and the deduction in that year is $3,000, ($2,000 against capital gains and $1,000 against ordinary income). This leaves a balance of $11,000.
- In Year 4 the deductible capital loss is $4,000, ($3,000 from capital gains and $1,000 from ordinary income), leaving a balance of $7,000.
- In Year 5 the deductible capital loss is $3,000, ($2,000 from capital gains and $1,000 from ordinary income), leaving a balance of $4,000 to be carried forward to Year 6.
- In Year 6 the balance of $4,000 is deducted.

Corporations may deduct capital losses against capital gains, but not against other income. They have the same provisions as individual taxpayers for carrying losses back one year and forward until absorbed.

When control of a corporation changes, any unused capital losses will expire and may not be deducted from gains realized by the corporation after control changes. This provision is necessary to prevent dealing in corporations with capital loss carry-overs.

Because capital gains will not be fully taxed like other income, it will be necessary to continue to distinguish between income receipts and capital receipts. There will be no change in the tax position of taxpayers in the business of dealing in certain assets; their profits on transactions in these assets continue to be fully taxable as business income and their losses fully deductible as at present.

Homes

The government has expressed the view that as a general rule Canadians should not be taxed on the increase in value of their homes. The White Paper proposed to accomplish this by a formula exempting profits of up to $1,000 a year and allowing for actual improvements or a flat $150 a year. Provisions to defer gains would have been allowed a taxpayer who sold one home and bought another because he had moved his family in changing jobs.

Many who commented on the provisions felt that substantial tax liabilities would still occur in areas where pressure on the housing market pushed prices up strongly and that homeowners would continue to face uncertainty about their tax position. It was also argued that the economic use of our housing stock might be inhibited if families could not "move up" to larger homes as they grew and established themselves.

The government has decided that these arguments can best be met by a complete exemption. This will save homeowners from valuation problems and meet the very strong views of Canadian homeowners and many other Canadians who aspire to home ownership.

The legislation exempts a taxpayer's principal residence, together with up to an acre of surrounding land if the land "contributes to the use and enjoyment" of the home as a residence.

More than one surrounding acre may qualify for exemption in limited circumstances if the taxpayer establishes that it is necessary for use and enjoyment of his residence. If a taxpayer lives in a co-operative housing unit, any gain on the sale of his shares in the co-operative housing corporation is exempt.

In some cases the complete exemption of a farmer's farm house and one acre may be less beneficial to him than the White Paper formula for a $1,000 annual deduction against gains on his farm house and all his farm property. He may choose either formula.

As a general rule, when a personal asset is converted to a business use, it would be treated as having been sold at its fair market value. However, if a taxpayer rents his principal residence and elects not to depreciate it as a business asset, it will remain exempt for four years.

The exemption for principal residences is not extended to second homes, such as summer homes and cottages, for reasons of equity. A taxpayer with more than one home will have to declare which is his principal residence. It is also necessary to limit the amount of surrounding land in order to control the exemption.

Personal Property

The government believes Canadians should not be caught up in needless record-keeping to account for the costs and returns they experience in the normal course of collecting stamps, and coins, or occasionally buying and selling paintings and sculptures.

The White Paper proposed to minimize record-keeping and prevent abuse by providing that when a taxpayer sells such an asset he would not be taxed unless the proceeds exceeded $500. Realized gains would have been taxed at full personal rates.

Some groups argued that capital gains on personal property should not be taxed at all because Canadians are collectors, not traders; but clearly, a complete exemption within a general system of capital gains would invite taxpayers to enter such a trade to the distortion of both the price structure and the ownership of works of art. To make gains realizable only on death would be no solution; tax could be avoided simply by a sale before death.

As recommended by the Commons committee, the legislation replaces the $500 floor with a floor of $1,000 and makes items of personal property subject to the one-half rule on realization.

If the proceeds of sale of a personal asset exceed $1,000, the individual may deduct from those proceeds either his cost or $1,000, whichever is greater. Record-keeping will be necessary only if the cost of the asset exceeds $1,000. Items normally sold as a set will be regarded as part of a single asset and a series of sales of the items will be regarded as a single sale in applying the $1,000 limit.

For example, let us assume an individual buys an antique in 1973 for $900 and sells it in 1975 for $1,500. His gain is $500 (the difference between $1,000 and $1,500) and he includes $250 (half of $500) in his income.

Losses will not be deductible unless the item sold costs more than $1,000. If an asset does cost more than $1,000, the deductible loss will be computed by deducting from the cost either the proceeds or $1,000, whichever is greater.

As the White Paper explained, a loss on a personal item that depreciates through use could not be deductible because it would amount to government subsidization of personal expenses. There will be no deduction, for example, for losses on furniture, cars, boats and cottages.

Personal-use property that does not depreciate through use is defined to include paintings, prints, rare folios, manuscripts, books, etchings, drawings, sculptures, or other similar works of art, jewellery and coin and stamp collections. On these items, losses will be deductible against gains realized on the sale of other personal property. Deductibility against other income would not be consistent with the personal nature of the assets. If gains in the current year are not sufficient to absorb the deductible loss, the balance can be offset against such gains in the immediately preceding or the following five years.

Persons in the business of dealing in such assets will, of course, continue to be taxable in the normal manner.

Valuation Day

With the introduction of a system taxing capital gains for the first time, rules must be provided to guarantee that only gains arising after the start of the system are taxed.

The basic guarantee for this purpose is the establishment of a Valuation Day close to the commencement of the system. Gains and losses will generally be measured from this day.

As the White Paper explained, Valuation Day will be announced after it has passed; to name the day in advance would be to invite speculation that would drive up asset prices arbitrarily.

On some assets, post-Valuation Day gains may represent only a recovery or partial recovery of the original cost paid for the asset. As explained later, special transitional provisions permit such recoveries to be made tax-free.

Most taxpayers will not be affected by Valuation Day. Their most important assets will be exempt from capital gains tax. This will be the case with a taxpayer's home and with all personal effects of a value below $1,000. The great majority of personal possessions decline rather than increase in value over time.

Further, Valuation Day has no application to an asset acquired after the system starts. It is important only in the case of assets held at that time, and becomes relevant only when three further circumstances come together:

1) the taxpayer sells the asset;
2) the sale results in a gain or a loss; and
3) the gain or loss is taxable or deductible even after exemptions are taken into account.

No taxpayer is required to report any information to the Department of National Revenue on Valuation Day. There are circumstances under which he may wish to obtain certain information on or after Valuation Day about some of his assets. The most important circumstances are as follows:

1) When he owns a second residence, cottage, farm or rental real estate.

   A reasonable value may be established by sales of comparable property in the area. Taxpayers may wish to record information of this kind, which is widely available.

2) When he owns antiques, art collections or other similar items worth more than $1,000.

   Again, there are a number of ways to establish such values. These articles may already have their values established for insurance purposes.

3) When he owns shares in public corporations, certain bonds and other widely traded securities.

   Most of these securities are covered daily in widely published listings. They are available from newspapers, stock exchanges and brokers.

4) When he owns shares or other interests in private corporations.

   There is no standard formula for establishing values in this area. The taxpayer may wish to obtain professional advice or help.

All taxpayers will receive information about Valuation Day from the Department of National Revenue.

A taxpayer's reasonable valuation of an asset will be accepted by the department.

Assets Held at the Start of the System

The legislation provides that capital gains and losses on assets held at the start of the system may be measured against either their actual cost or their value on Valuation Day.

This provision expands a proposal in the White Paper and ensures that a gain under the new system is not taxed if it represents merely a recovery of all or part of the original cost of the asset. The counterpart of this provision will be that an asset's decline in value will not be deductible if it is merely a return to its original cost.

This will accomplish the objective of taxing only what might be called "real" gains after the new system starts, and permitting a deduction only for "real" losses under the new system.

Three sets of circumstances illustrate the application of the rule.

If an asset is sold for an amount that is less than both the original cost and the value on Valuation Day, then a capital loss will result to the extent that the sale price is below the lower of the cost price or Valuation Day value.

If an asset is sold for an amount that lies between its original cost and its value on Valuation Day, neither a capital gain nor a capital loss results for tax purposes.

If an asset is sold for an amount that is greater than both the original cost and the value on Valuation Day, a capital gain will result to the extent that the sale price exceeds the greater of the cost price or the Valuation Day value.

This range between cost and Valuation Day value might be called a "tax-free zone". The following table shows the result of transactions made below, within and above this zone.

	$	$	$
Cost or amortized cost	100	100	100
Valuation Day value	80	90	110
Tax-free zone	80 – 100	90 – 100	100 – 110
Proceeds	75	95	115
Gain (loss)	(5)	–	5

Where cost records are unavailable, or where it is to the taxpayer's advantage, he may elect to use Valuation Day value as the basis for computing gains and losses on all his assets. In this event he foregoes the "tax-free zone". One alternative or the other must be used for all assets.

If a taxpayer has made a number of purchases of the same asset (e.g., common shares in a corporation) he will calculate one average cost for those on hand at the start of the system and another for those subsequently acquired. When part of these assets are sold, the "first-in, first-out" method will determine which average cost is used to calculate a capital gain or loss.

Gifts and Bequests

In general, accrued gains on capital assets will be taxable at death. The combination of this provision with estate taxes could in some instances result in substantial tax impact arising on the death of a taxpayer.

The Commons committee recommended that the impact be lessened by a substantial reduction of estate taxes. The Senate committee recommended that the estate tax field should be vacated in favor of the provinces.

A reduction of estate taxes to the extent suggested by the Commons committee would result in a revenue loss of about half the $55 million now received by the federal government from this source. Since 1964, provincial governments have received about 75 per cent of all death duties in Canada; 75 per cent of federal estate taxes are turned over to seven provinces and the others either levy their own death duties to the same extent or receive the equivalent amount by combining their own death duties and federal payments.

Two provinces now return their entire share of estate taxes to estates and it is no longer possible to establish a uniform national system of death duties through federal legislation.

In these circumstances, it has been decided that the federal government will vacate the estate and gift tax field on December 31, 1971.

No capital gains tax will be imposed on bequests from husband to wife or wife to husband. A wife inheriting property from her husband will acquire the assets at her husband's original cost. No capital gains tax will be payable until the wife sells the property or transfers it by gift or bequest.

When a taxpayer makes a gift of an asset, he is considered to have sold it at fair market value and he brings into income half the difference between his cost and that

value. Again, the accrued gain on property given by a husband to his wife either outright or through a trust is not taxed at that time. When the asset is sold, the capital gain will be the difference between its selling price and the husband's original cost. One half of this gain will be included in the husband's income as if he had continued to own the asset. This attribution rule is similar to existing rules for income earned on property transferred to a spouse or to a person under 19 years of age.

Depreciable Property

When depreciable property is transferred on death, the deceased will be considered to have sold the property at an amount midway between fair market value and the original cost less depreciation. This deemed sale price will be used as the basis for calculating recaptured depreciation and capital gains taxes.

Deferred Recognition of Gains

Normally when a taxpayer disposes of a property, a taxable gain or loss results. However, in the case of a property which is destroyed or expropriated, the capital gain may be deferred if the compensation received is reinvested by the end of the following year in equivalent property. The cost of the new property will be reduced by the amount of the capital gain arising from the disposition of the old property.

For example, a property which originally cost $100 is expropriated and the compensation received is $300. This is a capital gain of $200. However, if the taxpayer uses the proceeds to buy another property at a cost of $500, the capital gain of $200 is not taxed. Instead it reduces the cost basis of the new property to $300. If the taxpayer later sells the new property, any gain or loss is measured from the adjusted cost basis of $300.

When a taxpayer transfers property to a controlled corporation a deferral is permitted under special rules. Similar provisions apply to exchanges of shares and certain corporate reorganizations. These are detailed in the chapter on Corporations and Shareholders.

Special rules for transferring assets to partnerships and trusts and for valuing partnership and trust interests held at the start of the system are detailed in the chapter on Business and Property Income.

Leaving and Entering Canada

Under the White Paper an individual would have paid tax on his accrued capital gains when he gave up Canadian residence. If it is a sound principle to require taxpayers to meet their income tax obligations when leaving the country, it is no less fair in principle to tax capital gains enjoyed while the taxpayer has shared the rights and responsibilities of residence in Canada.

It was argued that the proposal would seriously deter the mobility of Canadians, especially when a Canadian resident is contemplating a short-term transfer to another country to work or study.

The legislation offers the taxpayer a choice. He may pay tax on his accrued gain at departure with an exemption for the first $5,000 of gains. Alternatively, the taxpayer may elect to defer any capital gain at that time and agree to file a return as a resident of Canada in any year in which he sells assets. Reasonable security would have to be given at the time of departure to cover the tax on the accrued gain. In filing a Canadian tax return when assets are sold he would pay tax on his world income and receive credit for any foreign taxes paid.

When a taxpayer moves to Canada he will be treated as if he at that time purchases his assets at their fair market value. This will ensure that Canada imposes tax only on gains enjoyed while he is in Canada.

These rules for entering and leaving Canada do not apply to Canadian assets on which a non-resident would normally be taxed, as outlined below.

Non-Residents

The general rule to bring one-half of capital gains into income and to allow a deduction of one-half of capital losses will apply to non-residents on the sale of

- real property interests situated in Canada;
- assets used in carrying on business in Canada;
- interests in certain partnerships and trusts;
- shares in Canadian private corporations;
- shares in Canadian public corporations; where the non-resident owned a 25 per cent or greater interest.

The extension of the tax on capital gains to non-residents is subject to tax treaties between Canada and other countries.

3

Corporations and Shareholders

- *The legislation modifies the main elements of the existing system of taxing corporations and their shareholders to achieve greater fairness and efficiency. The legislation does not establish an integrated system as proposed in the White Paper.*
- *The dividend tax credit will be increased to 33 1/3 per cent from 20 per cent and included in income before the tax calculation. The combination of the two changes will make the credit more valuable to lower-income shareholders.*
- *A reformed low rate of corporate tax is retained as a small business incentive; the rate is 25 per cent on the first $50,000 of business income of Canadian-controlled private corporations. The low rate is no longer available to public corporations or foreign-controlled corporations.*
- *The general rate of tax for corporations is 50 per cent, reducing by one percentage point annually to 46 per cent in 1976.*
- *On investment income (including one-half of capital gains but excluding dividends) of private corporations 25 percentage points of the tax paid is refunded to the corporation as it pays dividends to shareholders. For every $3 of dividends paid, $1 of tax is refunded. The refundable tax provisions do not apply to public corporations.*
- *Dividends received by one corporation from another corporation generally continue to be exempt from tax. However, dividends received by private corporations from non-subsidiary corporations are subject to a special 33 1/3-per-cent tax which is fully refunded to the corporation as dividends are paid to shareholders; for every $3 of dividends paid, $1 of tax is refunded.*
- *The cost of the refundable tax on investment income and dividend income will be borne by the federal government.*
- *One-half of capital gains realized by private corporations can be distributed tax-free to Canadian shareholders.*
- *On the incorporation of a proprietorship or partnership and on certain corporate reorganizations, realization of capital gains may be deferred, provided the person transferring the assets to a corporation retains a certain percentage interest in that corporation.*
- *Surplus accumulated before the start of the new system may be paid out to shareholders tax-free, on payment of a special 15-per-cent tax by the corporation on undistributed income.*
- *The new rules for taxing corporations will apply from January 1, 1972, with special rules for corporations whose fiscal years straddle that date.*
- *Dividends received by shareholders after December 31, 1971 will be eligible for the reformed dividend tax credit of 33 1/3 per cent.*

The present system of taxing corporations and their shareholders provides for one tax when income is earned by a corporation, and a second tax when the after-tax income of the corporation is distributed to shareholders as a dividend.

Assuming a provincial rate of 10 per cent, all corporations now pay income tax at the rate of 21 per cent on the first $35,000 of taxable income and 50 per cent on taxable income in excess of $35,000. A corporation with $35,000 or more of income in a year pays $10,150 less than if the corporate rate was 50 per cent. This two-rate system was introduced in 1949 and its objective was to assist small corporations in accumulating funds to finance business expansion.

A Canadian individual receiving a dividend from a "taxable Canadian corporation" has been allowed to reduce his income tax by 20 per cent of the dividend. For shareholders of corporations with annual earnings of $35,000 or less, the 20-per-cent tax credit in effect offsets the 21-per-cent corporation tax paid. For shareholders of larger corporations, the dividend tax credit partially offsets the corporation tax paid and provides an incentive to Canadians to invest in Canadian corporations.

The present system also provides that in most instances dividends may flow tax-free from one Canadian corporation to another. This is necessary to limit the taxation of corporate income to the intended two tax payments – one by the corporation earning the income and the second by the individual receiving a dividend.

THE NEW SYSTEM IN BRIEF

The new bill retains the basic features of the present system of taxing corporations and their shareholders, with some modifications to make the system more equitable.

Dividend Tax Credit

The legislation increases the dividend tax credit to 33 1/3 per cent, but it is now included in income. These two changes make it relatively more beneficial to low-income shareholders than the existing tax credit. The credit continues to be available on all dividends from "taxable Canadian corporations", regardless of corporation taxes paid. The following table illustrates the mechanics of applying the new dividend tax credit:

	Marginal Rate of the Taxpayer		
	25%	40%	60%
Dividend received	$300	$300	$300
Add dividend tax credit – 33 1/3%	100	100	100
Taxable amount	$400	$400	$400
Income tax before credit	$100	$160	$240
Less dividend tax credit – 33 1/3%	100	100	100
Income tax payable	$ 0	$ 60	$140
After-tax dividend	$300	$240	$160

If the dividend tax credit exceeds the tax on the dividend, the excess will reduce other taxes payable. The excess is not refundable.

Under the present tax system the dividend tax credit is 20 per cent and is a "tax-free amount" (not included in income). The mechanics of applying the existing tax credit are illustrated in the following table:

	Marginal Rate of the Taxpayer		
	25%	40%	60%
Dividend received	$300	$300	$300
Income tax before credit	$ 75	$120	$180
Less dividend tax credit – 20%	60	60	60
Income tax payable	$ 15	$ 60	$120
After-tax dividend	$285	$240	$180

The following table shows the after-tax income for shareholders with marginal tax rates ranging between 25 per cent and 60 per cent on a $300 dividend, received under the old and new system.

Dividend: $300

	After-tax Income	
Marginal Rate	New	Old
25%	$300	$285
30%	280	270
40%	240	240
50%	200	210
60%	160	180

Small Business Incentive

The legislation continues a low rate of corporate tax, but on a more selective basis aimed at direct assistance to small business. The rate will be 25 per cent on the first $50,000 of business income of Canadian-controlled private corporations. The cost of the incentive will be borne by the federal government. The incentive will result in an annual tax saving of up to $12,500 for a corporation with $50,000 of income. It will not be available on investment income or to public corporations or foreign-controlled corporations.

A public corporation is defined as a corporation whose shares are listed on a prescribed Canadian stock exchange or traded "over the counter", or a corporation that meets certain conditions and either is designated by the Minister to be, or elects to be, a public corporation. A private corporation is any corporation that is not a public corporation or that is not controlled by a public corporation.

Under the present system the 21-per-cent low rate of corporate tax is available to all corporations, regardless of their size, their financial resources, or their need for funds to finance growth. However, the new legislation will reserve the benefit of the incentive to small corporations, by providing that as soon as $400,000 of taxable income has been accumulated, the low rate will no longer be available. The legislation also stipulates that income taxed at the low rate must be used in the business or paid out as dividends which will be taxable to shareholders. Otherwise the benefits of the low rate on that income will be eliminated. These changes, then, will limit the incentive to smaller private Canadian-controlled corporations that require, and in fact use, the tax savings to invest in their businesses or to pay dividends to shareholders.

Special rules will apply in the initial calculation of the incentive for corporations whose fiscal years straddle January 1, 1972.

Investment Income

The effect of new rules for taxing the investment income of private corporations will be to impose a tax on the corporation and on its shareholders when the income is distributed that in total is approximately equal to the tax payable if the shareholders had personally received the investment income. This means that the system is neutral in the taxation of investment income, neither penalizing nor benefitting individuals who choose to make their investments through a corporation rather than the more normal practice of personally owning investments. These new rules eliminate the need for special tax treatment for "personal corporations".

For private corporations, investment income other than dividends (such as interest, rent, royalties and one-half of capital gains) will be subject to the normal rate of corporate tax, 25 percentage points of which will be refunded to the corporation when dividends are paid to shareholders. On dividends received from portfolio investments (where the ownership interest is 50 per cent or less) the tax is 33 1/3 per cent, which is fully refunded to the corporation when dividends are paid to shareholders. The refunded tax will ensure that investment income received by a private corporation is no longer taxed at a considerably lower rate than investment income received directly by individuals. Dividends received by a private corporation from a subsidiary corporation (more than 50-per-cent ownership interest) continue to be tax-exempt as under the present system.

One further feature of the new system is that one half of capital gains realized by private corporations may be distributed tax-free to shareholders. When viewed together with the refundable tax provisions and dividend tax credit, this will result in approximately the same total taxes as if the shareholder had personally received the capital gain.

Dividends received by public corporations continue to be exempt from tax as under the present tax system and other investment income is taxed at the general rate.

RATES OF TAX

General Rate

Under the present system the rates of tax for corporations are 21 per cent on the first $35,000 of taxable income and 50 per cent on the excess.

Under the new bill, the general rate of tax is 50 per cent in 1972, reduced annually by one percentage point to 46 per cent in 1976. However, this rate is reduced by the small business incentive and partly offset by the refundable tax provisions for investment income of private corporations.

Small Business Incentive

The legislation provides that a Canadian-controlled private corporation pays a 25-per-cent tax on the first $50,000 of business income and the general rate on business income in excess of $50,000. (These rates include an assumed 10-per-cent provincial tax).The term "business income" means the net profit from carrying on an active financial, commercial, industrial or professional business.

In order to limit the low rate of tax to small corporations, the legislation provides that once a corporation has accumulated taxable income of $400,000 the benefits of the low rate of tax will no longer be available. This accumulation is calculated by adding the taxable income for each year after the new system starts and by deducting 4/3 of taxable dividends paid to shareholders. This deduction cannot be made for dividends which occasion a refund.

If a corporation has business income of $50,000 each year and has no other income and pays no dividends the accumulated taxable income will be $400,000 at the end of eight years and therefore the benefits of the low rate will no longer be available. This is shown in the following table. In 1980 (the ninth year of the example) the low rate is not available because the cumulative limit of $400,000 has been reached.

	1972	1973	1974	1975	1976	1977	1978	1979	1980
After-Tax Income:	$	$	$	$	$	$	$	$	$
Active business income	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000
Income tax – $50,000 at 25%	12,500	12,500	12,500	12,500	12,500	12,500	12,500	12,500	–
– $50,000 at 46%									23,000
After-tax income	37,500	37,500	37,500	37,500	37,500	37,500	37,500	37,500	27,000
Accumulated Taxable Income:									
Taxable income for the year	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	–
Taxable income for previous years	–	50,000	100,000	150,000	200,000	250,000	300,000	350,000	400,000
Accumulated taxable income	50,000	100,000	150,000	200,000	250,000	300,000	350,000	400,000	400,000
Maximum amount allowed	400,000	400,000	400,000	400,000	400,000	400,000	400,000	400,000	400,000
Amount of taxable income that can be accumulated in subsequent years before the low rate is withdrawn	350,000	300,000	250,000	200,000	150,000	100,000	50,000	–	–

To ensure that the low rate is not applied to more than $50,000 of business income by a group of related corporations, the present rules for determining associated corporations are retained. The maximum annual amount of $50,000 to which the low rate can be applied must be allocated within the group of corporations, and the accumulated taxable income limit of $400,000 will be determined for the group as a whole.

As long as the accumulated taxable income of a corporation is less than $400,000 it may use the low rate of tax. By paying regular dividends to its shareholders, a corporation can systematically reduce this accumulation and in many cases the benefits of the low rate will be available indefinitely. Every $3 of dividends paid reduces accumulated taxable income by $4, except that dividends which result in a refund of tax cannot be deducted.

This provision will be important to many small corporations unable to use the tax saving that results from the incentive for business expansion because their shareholders depend on regular dividends as a main source of income. One example would be a family-controlled enterprise. If these corporations pay dividends to their shareholders the net effect is, first, to tax the corporate income at the individual shareholders' rates of tax, and secondly, to preserve the use of the low rate for future years.

For example if a corporation has business income of $40,000 it will pay a tax of $10,000 (25 per cent) and will have $30,000 available for business purposes or for payment of dividends. If it pays a dividend of $30,000 out of after-tax income, the deduction on the $3-for-$4 ratio means that another $40,000 of business income may be taxed in future at the low rate, (assuming the corporation has not gone beyond the $400,000 cumulative limit because of other income).

The effect of paying a dividend out of income that has been taxed at the low rate is to tax the corporation's income at the individual shareholder's rates. As indicated below, this occurs because the 33 1/3-per-cent reformed dividend tax credit completely offsets a corporate tax of 25 per cent.

Corporation

Low rate income	$40,000
Tax at 25%	10,000*
Available for dividends	$30,000

Shareholders

Dividends received	$30,000
Add dividend tax credit – 33 1/3%	10,000
	$40,000
Income tax thereon (say at 40%)	$16,000
Less dividend tax credit – 33 1/3%	10,000
Tax payable	$ 6,000*

In total the tax is $16,000 * on the corporation's low-rate income of $40,000 ($10,000 paid by the corporation and $6,000 paid by shareholders) which is equal to the tax that would have been paid had the shareholders earned the income in their own hands, assuming the shareholders' tax rate to be 40 per cent.

The main objective of continuing the incentive is to provide private corporations with funds for use in their businesses. Many closely-held corporations do not require funds of this magnitude for business purposes and it is the government's intention to extend the incentive only to income used for direct business purposes.

The legislation provides that when income taxed at the low rate is used for non-business purposes an additional tax shall be paid at the rate of $1 for each $2 so used and this tax is refunded when the funds used for ineligible investments are reinvested in business assets or paid out as dividends to shareholders.

For example, if a corporation earns $40,000 of business income and pays tax of $10,000 (25 per cent) it has $30,000 of after-tax income to be used in its business. If the corporation invests $20,000 of this income in marketable securities, it would be required to pay an additional tax of $10,000. The net effect is to impose a 50-per-cent tax on the original income. If the $20,000 is later used for business purposes or paid out as dividends, the $10,000 additional tax will be refunded.

Investments that do not qualify include portfolio investments in shares of other corporations, bonds, mortgages and similar items. Cash and short-term notes are not included and therefore a corporation can accumulate cash or invest its excess funds in short-term notes in preparation for future expansion without being required to pay an additional tax.

If two private corporations become associated or amalgamate, the rules for limiting the small business incentive will not apply retroactively. If the combination of their separate accumulated taxable incomes is more than $400,000, the benefits of the low rate will no longer be available. However, the bill does not require the group to pay back any of the savings that resulted from using the low rate. Such a requirement could seriously impede the free flow of capital.

Nor is a repayment required if a private corporation that has enjoyed the low rate becomes a public corporation, because this would set up a barrier to "going public" and the tax saved will eventually become payable by the corporation's shareholders when dividends are paid to them, as it would if the corporation had remained a private corporation.

If a private corporation that has enjoyed the low rate becomes a foreign-controlled corporation, the bill provides that tax savings from use of the small business incentive must be repaid over a five-year period. This has the effect of taxing the corporation as if it had always been a foreign-controlled corporation, and protects the Canadian revenue against the loss of tax that would otherwise have become payable by Canadian shareholders when the low-rate income is distributed to them as dividends.

INVESTMENT INCOME

The investment income (other than dividends) of a private corporation is subject to the general rate of tax, 25 percentage points of which is refunded to the corporation as it pays dividends to shareholders. This refund provision does not apply to investment income earned by public corporations. Investment income means interest, rent, royaltie, one-half of capital gains and similar types of income that result from holding property. Dividend income is also included in the term investment income, but is taxed separately under different rules.

For example, if a corporation has interest income of $80,000 it will pay a tax of $40,000, of which $20,000 will be refundable.

Interest income	$80,000
Tax – 50%	40,000
After-tax income	$40,000
Refund available	$20,000

For every $3 of dividends paid to shareholders, the corporation will receive a refund of $1. For example, if in the above illustration the corporation pays a dividend of $60,000 it will receive a refund of the full $20,000. Alternatively, if the corporation pays a dividend of only $45,000, the refund will be limited to $15,000 and the remaining $5,000 will still be available.

If a corporation pays a dividend before the end of the taxation year in which investment income is received instead of receiving a refund, it may reduce its tax otherwise payable for the year by the amount of the refund.

If a corporation pays a dividend of $60,000 before the end of the year, the result is that the investment income of the corporation is taxed at the effective tax rates of its shareholders. The reason for this is that the new graduated dividend tax credit completely offsets 25 points of the corporate tax. Subject to timing differences, substantially the same net effect is produced if payment of the dividend is deferred until a subsequent year.

Corporation		
Interest Income		$80,000
Tax – 50%	$40,000	
Less refund (1/3 of dividend paid)	20,000	
		20,000
Paid as dividend		$60,000
Shareholders		
Dividends received		$60,000
Dividend tax credit – 33 1/3%		20,000
		$80,000
Income tax (say at 40%)		32,000
After-tax dividend		$48,000

DIVIDEND INCOME

As under the present system, dividends received by a public corporation from another corporation are exempt from tax unless they are paid out of the designated surplus of a controlled corporation.

Dividends received by a private Canadian corporation from another Canadian corporation are subject to two sets of rules: one for dividends from controlled corporations (more than 50-per-cent ownership) and the other for dividends from portfolio investments (ownership of 50 per cent or less).

Dividends received from controlled corporations continue to be exempt from tax, subject to two exceptions. If they are paid out of designated surplus they are taxed in the hands of the recipient. (This is similar to the rule in the present law.) If a dividend paid by a controlled corporation results in that controlled corporation qualifying for a refund of tax, the receiving corporation pays a special fully refundable tax equal to the refund. This rule is necessary to ensure that the refundable tax is in fact paid on investment income flowing through more than one corporation.

Dividends received on portfolio investments will be subject to a special 33 1/3-per-cent, fully-refundable federal tax. The tax is equivalent to the tax that would have been paid on such dividends by an individual taxpayer at a 50-per-cent marginal rate, and is therefore consistent with the taxation of other investment income of private corporations. This refundable tax will be pooled with the refundable tax on other investment income and subject to refund at the same rate of $1 for every $3 of dividends paid.

If a corporation receives dividends of $60,000 on portfolio investments, it will pay a 33 1/3-per-cent refundable tax of $20,000. If the corporation then pays a dividend of $15,000 it will receive a refund of $5,000. If the corporation pays a dividend of $60,000 before the end of its fiscal year none of the refundable tax will have to be paid. The effect of this is shown as follows:

Corporation	*A* Same Year Flow-Through	*B* Subsequent Year Flow-Through
Dividend income	$60,000	$60,000
Fully refundable tax	–	20,000
Surplus	60,000	40,000
Refund	–	20,000
Dividends paid	$60,000	$60,000
Shareholders		
Dividends received	$60,000	$60,000
Dividend tax credit – 33 1/3%	20,000	20,000
	80,000	80,000
Income tax (say at 40%)	32,000	32,000
After-tax dividend	$48,000	$48,000

Note that the result of paying a dividend of this magnitude is to have the company's dividend income taxed only in the hands of its shareholders and in exactly the same way it would have been if the original portfolio dividends had been received directly by the shareholders. Subject to timing differences, substantially the same net effect is produced if payment of the dividend is deferred until a subsequent year (Column B).

CAPITAL GAINS

The general rule in the legislation is that one-half of a capital gain realized by a private corporation may flow tax-free to its shareholders. This reflects the government's conclusion that capital gains realized in a corporation of this kind should not be subject to further tax when distributed to shareholders.

For example, if a private corporation realizes a capital gain of $2,000 it will include one-half of the gain in income and pay a tax of $500. One-half of the gain ($1,000) will be placed in a capital gains surplus account. Dividends paid by a corporation that are designated by its directors as being paid out of the capital gains surplus account will be tax-free to shareholders.

Since capital gains are considered to be investment income, one-half of the tax paid on the other half of the capital gain is refundable to the corporation when it pays dividends. This is illustrated as follows:

Corporation	
Capital gain	$2,000
Tax – 50% of $1,000	500
	$1,500
Included in ordinary surplus	500
Included in capital gains surplus	1,000
	$1,500
Refund available	$ 250

The capital gains surplus balance of $1,000 can be distributed tax-free to shareholders by the payment of a special dividend and this dividend will not reduce the cost or beginning value of the shareholders' shares. The ordinary surplus can be distributed to shareholders by the payment of a dividend of $750 ($500 from surplus and $250 refund) and assuming an effective tax rate of 40 per cent, the shareholders' tax on the $750 dividend would be $150, calculated as follows:

Shareholders	
Dividend	$ 750
Add dividend tax credit – 33 1/3%	250
	$1,000
Income tax (say at 40%)	400
Less dividend tax credit – 33 1/3%	250
Tax payable	$ 150

The total tax paid by the corporation and its shareholders on the $2,000 capital gain is $400 ($250 by the corporation and $150 by its shareholders). This is exactly the same amount of tax that would have been paid if the shareholders of the corporation had personally realized the $2,000 capital gain, again assuming a 40-per-cent tax rate for the shareholders.

FOREIGN CORPORATIONS RESIDENT IN CANADA

Corporations now resident in Canada but not incorporated in Canada will be considered "Canadian corporations" for all intents and purposes as long as they remain resident. These corporations will be eligible for the low rate if they are Canadian-controlled private corporations, and will be eligible for the refundable tax provisions if they are private corporations. Their Canadian shareholders will be entitled to the reformed dividend tax credit.

This provision applies only to foreign corporations resident in Canada on budget day, 1971. In future, a corporation must be incorporated in Canada to be classified as a "Canadian corporation" and to obtain certain benefits of the new system, such as the new dividend tax credit for their dividends.

DISTRIBUTION OF CORPORATE SURPLUS

The present tax system contains many complex rules for distributing the surplus of a corporation. Generally speaking, the after-tax income of a corporation (referred to as undistributed income on hand) must be fully distributed to shareholders as dividends before capital gains and other tax-free amounts can be distributed. The present system also permits a corporation to pay a special 15-per-cent tax on specified amounts of undistributed income and to distribute tax-free to shareholders the remaining 85 per cent (technically referred to as tax-paid undistributed income). However, the tax-free distribution of the remaining 85 per cent usually has to be made by paying a stock

dividend in redeemable preferred shares which are later redeemed for cash or property. A stock dividend is required because under the present system an ordinary cash dividend paid by a corporation is fully taxable to shareholders regardless of the makeup of the corporation's surplus.

Under the present system, a corporation must distribute its earned surplus (undistributed income on hand) before it can reduce its capital. The new bill will permit a shareholder to receive a return of his investment in a corporation, whether by way of repayment of a loan or by redemption of shares, as a tax-free capital receipt regardless of the corporation's surplus position.

The new legislation simplifies the rules for distributing a corporation's surplus by allowing the directors of a corporation to specify the type of surplus out of which a cash dividend may be paid. This will eliminate the need for stock dividends and similar special forms of distribution.

After the new system starts the surplus of a corporation will be made up of four items:

(1) undistributed income on hand at the start of the system (called "1971 undistributed income on hand");

(2) realized capital gains and other tax-free amounts on hand at the start of the system and any gains accrued at the start of the system and subsequently realized (called "1971 capital surplus");

(3) one-half of capital gains realized after the start of the system; and

(4) the remaining balance, generally made up of after-tax income earned since the start of the system and differences between income for accounting purposes and income for tax purposes.

The legislation provides that a corporation may at any time pay a 15-per-cent tax on all or part of its "1971 undistributed income on hand" and then distribute the net amount tax-free to shareholders. This distribution will be considered as a return of capital to the shareholders, reducing the cost of their shares for purposes of calculating a subsequent capital gain. A corporation's "1971 capital surplus" may also be distributed tax-free to shareholders but only after the 15-per-cent tax has been paid on all "1971 undistributed income on hand". These distributions will similarly be considered as a return of capital.

For private corporations, the legislation provides that one-half of their capital gains may be distributed free of tax as dividends to shareholders, but only after all "1971 undistributed income on hand" and all "1971 capital surplus" has been fully distributed. These capital gain dividend distributions will not reduce the cost or beginning value of the shareholders' shares.

Finally, the legislation provides that all other distributions out of surplus will be treated as ordinary dividends to shareholders, without reference to the corporation's post-1971 undistributed income on hand. In fact, the undistributed income on hand of a corporation will no longer be important, except for the limited purpose of calculating designated surplus where that becomes relevant.

CAPITAL GAINS vs. INCOME

Under the present tax system capital gains are exempt from tax and therefore there can be a significant advantage for shareholders of private corporations to convert income receipts, such as dividends, into capital receipts. For this reason there are a number of rules in the present system to prevent the conversion of taxable income receipts into tax-exempt capital receipts.

Under the new system, capital gains that represent taxable corporate surplus will continue to be taxed at a more favorable rate than will distribution of that surplus as dividends for taxpayers with marginal tax rates above 40 per cent. Therefore it is necessary to continue many of the rules in the present system, such as the designated surplus and the dividend-stripping provisions.

INCORPORATION OF A PROPRIETORSHIP OR PARTNERSHIP

When the capital assets of a proprietorship or partnership are sold to a corporation or when any assets are sold to a corporation the bill provides that any capital gain that would otherwise be taxed may be deferred in certain circumstances. The proprietor or partnership must own at least an 80-per-cent interest in the corporation immediately after the sale and the fair market value of any consideration, other than shares of the corporation, received from the corporation must not exceed the cost or beginning value of the assets. In effect the corporation is considered to have purchased the assets at their cost or beginning value. The proprietor or partnership is considered to have purchased the shares of the corporation at a cost equal to the cost or beginning value of assets transferred to the corporation. This is referred to as a "rollover". The rule also applies to the sale of assets to a subsidiary corporation.

Where cash or any property other than shares of the acquiring corporation is received by a proprietor from a corporation as part consideration for the transfer of assets, this will first reduce the proprietor's cost basis for the shares and then any excess will be taxed as a capital gain.

For example, assume that an individual has capital assets with a total original cost of $10,000. The individual sells these assets to a corporation in exchange for $4,000 cash and 80 per cent of the shares of the corporation. The remaining 20 per cent of the corporation is owned by a third person who paid the $4,000 to the corporation. The corporation is considered to have paid $10,000 for the assets (their original cost). This $10,000 is called the cost basis. The individual is considered to have purchased 80 per cent of the shares of the corporation for $6,000, ($10,000 which is the original cost of the assets, less $4,000 received in cash). If the individual were to subsequently sell his 80-per-cent interest in the corporation for more than $6,000, one-half of the excess would be included in his income.

The legislation also provides that a proprietor or partner is not required to defer any capital gain. If the proprietor elects to treat the sale as if it were made to a third person, i.e., at fair market value, and accordingly includes one-half of any capital gain in his income, the corporation will be considered to have acquired the assets at their fair market value. If the fair market value exceeds original cost the sale can be considered to take place at any value chosen by the taxpayer between these two amounts.

Where a proprietor or partner sells assets to a controlled corporation at a capital loss, this loss is not deductible. The cost basis of the assets to the corporation is fair market value and the loss on sale will be added to the cost basis of the proprietor's or partner's shares.

CORPORATE REORGANIZATIONS

Liquidation of Corporations

On the liquidation of a corporation, the general rule is that there will be a deemed realization of all of the corporation's assets at fair market value at the time of liquidation. Tax will be payable by the liquidating corporation on any gains produced by the deemed realization.

Shareholders of the liquidating corporation will take over any assets received at a cost equal to their fair market value. The value of assets received by a shareholder will be treated as a return of capital on his shares to the extent of the paid-up capital value of his shares in the liquidating corporation. Any amount received in excess of that paid-up capital value will generally be deemed to be a dividend received by the shareholder.

An exception to the "deemed realization on liquidation rule" permits a tax-free rollover on the liquidation by a Canadian corporation of a wholly-owned subsidiary corporation.

Capital Reorganizations

When a corporation reorganizes its capital structure by calling in some or all of its issued shares and issuing new shares in exchange, any capital gain on the exchange transaction may be deferred. The cost basis of the old shares carries over to the new shares and no gain is recognized until the new shares are sold. Where shares of more than one class are received in exchange for the old shares, a set of specific rules spreads the cost basis of the old shares over the new shares for purposes of computing subsequent gains or losses.

As part of an exchange of shares, shareholders sometimes receive cash or other property in addition to new shares. This cash or other property reduces the shareholders' cost basis for the new shares, and if the fair market value of the cash or other property received exceeds the cost basis of the old shares, the excess is taxed as a capital gain.

If no shares are received in exchange for old shares, the transaction is treated as a redemption of the shares for an amount equal to the fair market value of all property received in exchange and the normal rules regarding return of capital by way of redemptions of shares apply. This means that the amount of paid-up capital attributed to the shares will be treated as a tax-free return of capital. Other proceeds received will be treated as an ordinary dividend.

Statutory Amalgamations

When two corporations amalgamate under the provisions of a corporations act, the rules are substantially the same as under the present law. The new amalgamated corporation is treated as a continuation of the two predecessor corporations and all asset accounts, tax reserve accounts, special distribution accounts, etc., are carried over and added together. There is no deemed realization of assets owned by the amalgamating corporations.

When there is an inter-corporate shareholding between corporations that amalgamate, the new bill contains specific rules:

- to ensure that tax is paid on existing designated surplus in respect of the inter-corporate holding;
- to reflect the reduction in paid-up capital that results from the disappearance of the inter-corporate holding; and
- to reflect any difference between the cost of assets for tax purposes and the paid-up capital value of the inter-corporate shareholding that disappears upon amalgamation.

For a shareholder of an amalgamating corporation who receives shares in the new amalgamated corporation in exchange for his old shares, a gain on the transaction may be deferred:

- if he held preferred shares in a predecessor corporation, he receives shares with substantially equivalent rights in the amalgamated corporation, and
- if he held common shares in a predecessor corporation he, together with all other common shareholders of that corporation, receives not less than 25 per cent of the issued shares of each class of common shares of the new amalgamated corporation.

If a shareholder of an amalgamating corporation does not qualify under the above rules, the exchange of his old shares for the shares of the new corporation will be treated as a sale at fair market value, and a capital gain or loss will result.

4

Mining and Petroleum

- *Substantial tax incentives are maintained to recognize the risks involved in exploration and development, the international competition for capital and the levels of incentives available in other countries.*
- *Taxpayers whose principal business is not mining or petroleum will be allowed more generous deductions for Canadian exploration and development expenses.*
- *All taxpayers will be allowed more generous deductions for foreign exploration and development expenses.*
- *Acquisition of mining properties and royalty interests will be treated as exploration and development expenses, and proceeds on disposal will be fully taxable, subject to a sliding-scale exemption.*
- *Three-year tax exemption for new mines will be withdrawn after 1973 and replaced by an accelerated write-off of capital equipment and on-site facilities, including townsite facilities such as sewage plants, roads, schools and hospitals. The accelerated write-off will also apply to a major expansion of an existing facility where capacity is increased by at least 25 per cent.*
- *Present system of automatic depletion for mining and petroleum corporations will continue until 1976.*
- *After 1976 the 33 1/3-per-cent operators' depletion will have to be earned at the rate of $1 for every $3 of eligible expenditures.*
- *After 1976, the 25-per-cent non-operators' depeletion will be cancelled. Starting in 1977 royalty income will be classed as production income and will be eligible for the 33 1/3-per-cent earned depletion.*
- *All eligible expenditures after November 7, 1969 will earn depletion, and the White Paper list of eligible expenditures is expanded. Earned depletion can be accumulated until 1976 and applied thereafter against income.*
- *Rates of depletion for profits on gold or coal will be 33 1/3-per-cent after 1976 and depletion will have to be earned.*
- *Federal corporate tax abatement on mining profits increased by 15 percentage points. This abatement which commences in 1977 would also apply in the Yukon and Northwest Territories.*
- *Shareholders' depletion allowances of up to 20 per cent on dividends from mining and petroleum corporations are discontinued.*

The White Paper proposals were followed in August, 1970 by an announcement of important changes affecting the mining industry. The legislation incorporates these changes, which together will ensure sustained exploration and development, while making really profitable projects subject to a reasonable level of taxation.

Exploration and Development Costs

Existing law permits a corporation whose principal business is mining, oil production and allied activities, to deduct the costs of exploration and development in Canada against any income in the year incurred or in subsequent years. This insures that no tax will be payable until all exploration and development costs have been recovered.

Taxpayers who do not meet the "principal business" test are at present entitled to deduct exploration and development expenses only from mining and petroleum income. To encourage exploration and development in Canada, these expenses will be deductible from other income over a period of time if they exceed mining and petroleum income. Taxpayers will be entitled to put expenses in an asset class and to deduct annually from any income the greater of:

1. an amount equal to their income from mineral and petroleum properties, before any deduction for exploration and development expenses, or
2. 20 per cent of the net book value of the class.

Income from mineral and petroleum properties includes production profits, royalties and proceeds on sale of mineral rights, oil and natural gas rights and royalty interests.

Existing law permits taxpayers to deduct certain foreign drilling expenses from directly related foreign-source income, but this provision is very restrictive. The new legislation permits all taxpayers to put foreign exploration and development expenses in a separate asset class and to deduct annually from any income the greater of:

1. an amount equal to their income from foreign mineral and petroleum properties before any deduction for exploration and development expenses, or
2. 10 per cent of the net book value of the class.

For example, if a taxpayer has foreign exploration and development expenses of $5,000 and if his income consists of $300 in foreign mining income and $6,000 in salary, his deduction is the greater of $300 (the mining income) or $500 (10% of the new class of expenses). He would deduct $500 and the remaining expenses of $4,500 would be available for deduction in subsequent years.

Purchase and Sale of Mineral Rights

Since 1962, the costs of acquiring oil rights or natural gas rights have been deductible as exploration and development expenses, and proceeds on their disposal have been fully taxable. The legislation extends this treatment to mining properties and royalty interests, which are not deductible or taxable under existing law.

Because mineral properties and royalty interests have until now been tax-exempt, a special transitional rule is provided for taxing proceeds on sale of these properties and interests owned at the commencement of the new system. Proceeds on sale of these properties will be taxable to the extent of 60 per cent if sold in the first year of the new system, 65 per cent if sold in the second year, and so on until the ninth and subsequent years when all of the proceeds will be included in income. Because the costs of these properties would be deductible if purchased after the start of the new system, prices can be expected to rise and the transitional rules will provide a fair after-tax return to the present owners.

The legislation also provides that no amount will be included in income when individual prospectors and grubstakers sell mining properties to a corporation for shares of that corporation. The individual will be considered to have acquired the shares at no cost and will therefore be taxed on one-half the proceeds of eventual sale of the shares under the normal capital gains rules. The cost of the mining property to the corporation will be considered to be nil and therefore the company will get no deduction for this purchase. This provision will not apply to mining properties purchased by a prospector or grubstaker for resale to a corporation.

New Mines

Under existing law the profits derived during the first three years of operation of a new mine are exempt from Canadian income tax. This three-year exemption will be withdrawn on December 31, 1973.

In place of the three-year tax exemption, the legislation provides for an accelerated write-off of capital equipment and facilities for a new mine. The assets eligible for accelerated depreciation are:

1. a building acquired for the purpose of gaining or producing income from the new mine (except an office building that is not situated on the mine property);
2. mining machinery and equipment including access roads and on-property railroads;
3. a refinery;

4. "social capital" such as sewage plants, water systems, housing, roads, firehalls, schools, hospitals and recreational facilities;
5. airports and docks situated off the mine property, but not railroads.

In each instance the assets must be related to a new mine. The assets listed in items 3, 4 and 5 extend the fast write-off provisions beyond the proposals of the White Paper and the August, 1970, announcement. All of the assets subject to accelerated depreciation will be placed in a new capital cost allowance class, one class for each new mine. Taxpayers will be allowed an annual write-off equal to the greater of

1. an amount equal to the income from the new mine, or
2. 30 per cent of the net book value of the class.

Mining assets not eligible for accelerated depreciation will continue to be depreciable at the same rate as provided by existing law.

The accelerated write-off and the deductions for exploration and development expenses together ensure that the profits from a new mine will not be taxed until after the original investment has been fully recovered.

The accelerated write-off provision will also apply in the case of a major expansion of an existing mine where there has been at least a 25-per-cent increase in milling capacity. The list of eligible assets which will be in a separate capital cost allowance class is the same as for new mines except that "social capital" and off-site airports and docks do not qualify. Taxpayers will be allowed an annual deduction equal to the greater of:

1. an amount equal to income from the expanded mine, or
2. 30 per cent of the net book value of the class.

The present three-year tax exemption for new mines will continue until December 31, 1973. New mines which have come into production in reasonable commercial quantities before publication of the White Paper, November 7, 1969, will be eligible for the exemption but will not be able to take advantage of the new legislation concerning fast write-off. New mines which came into production after November 7, 1969, but before December 31, 1973 will be entitled to elect to take advantage of either incentive but not both. Specifically, taxpayers will be entitled to claim exemption of the profits earned either in the first three years of operation or in the period remaining to December 31, 1973, if that is shorter. At the end of the exempt period they will be entitled to the fast write-off of the capital cost of their eligible mine assets, but only if the book value of those assets is reduced by the full amount of their exempt profits. Taxpayers who do not elect to take the fast write-off will not be required to reduce the book value of these assets by the amount of exempt profits, but their annual write-off will be limited to normal depreciation.

Operators' Percentage Depletion

The legislation follows the White Paper proposal that depletion must be earned by carrying on exploration and development. The formula adopted is that for every $3 of eligible expenditures made after November 7, 1969 a taxpayer would earn the right to deduct $1 of depletion in computing his taxable income after 1976, subject to maximum depletion provisions.

The legislation provides that operators will be allowed to deduct the automatic 33 1/3 per cent depletion until the end of 1976, and that eligible expenditures made after November 7, 1969 can be accumulated for the purposes of calculating earned depletion for 1977 and subsequent years. This transitional provision will provide a gradual introduction to the earned depletion concept.

The types of expenditure that are eligible to earn depletion have been expanded from the White Paper proposals by the August 1970 letter and the list now includes most assets that qualify for accelerated depreciation (other than "social capital") as well as all exploration and development costs which earned depletion under the White Paper proposals. Exploration and development expenditures will be limited to expenditures incurred prior to attaining production in reasonable commercial quantities (the normal starting date for the three-year exemption). The costs of acquiring mineral and oil and gas properties are classified as exploration and development for purposes of expense deduction, but they do not earn depletion.

As announced in the August 1970 letter the definition of expenditures which earn depletion has been enlarged to include new facilities located in Canada to process mineral ores to the "prime metal stage" or its equivalent. Because this incentive is given to encourage the processing of ores in Canada, it is limited to situations where the processing would otherwise be done outside Canada. Also, a new processing facility will not be eligible for accelerated depreciation unless it is an integral part of a new mine or a major expansion of an existing mine.

Rates of depletion for gold and coal will be the same as for other minerals after 1976.

Percentage Depletion for Non-operators

Under the present legislation a depletion allowance of 25 per cent may be deducted by non-operators from their income from mineral and petroleum properties. The White Paper proposed that this depletion allowance be repealed. The legislation extends the automatic depletion allowance until the end of 1976 in order to give non-operators the same five-year introduction that is given to operators. After 1976 the non-operators' 25-per-cent depletion allowance will be cancelled. Royalty income received after 1976 will be classified as production income and will be eligible for the 33 1/3-per-cent earned depletion.

Shareholders' Depletion

Under the present legislation a depletion allowance of up to 20 per cent may be deducted from dividends received from a mining or petroleum corporation, the percentage depending on the proportion of the income of the corporation which is derived from production. This deduction was intended to recognize the wasting nature of mining and petroleum properties and the fact that each dividend received by a shareholder might in fact be partly a return of capital. Under the new legislation, this fact is more accurately recognized by the deduction granted for one-half of capital losses. Accordingly the shareholders' depletion allowance is removed at the start of the system.

Provincial Corporate Tax Abatement

The existing law now permits corporations to reduce their federal income tax by 10 per cent of taxable income to offset the provincial income tax paid by these corporations. As announced by the Minister of Finance in August 1970, when the system of earned depletion comes into effect in 1977 the provincial corporate tax abatement will be increased by 15 per cent of mining production profits, with a ceiling of 25 per cent of taxable income. This increased abatement will apply as well in the Northwest Territories and Yukon. The legislation also provides that provincial mining taxes will no longer be deductible in computing income after 1976. The increased abatement will offset these taxes.

The reduction of federal taxes on mining profits recognizes that the provinces levy mining taxes and that in some circumstances maximum tax rates on income from producing mines could be higher than rates on corporations in other industries. The higher abatement creates room for the provinces to increase their own corporate rates, to leave their rates unchanged and thus flow the entire tax reduction through to mining corporations, or to selectively change their own rates.

5

Business and Property Income

- *Existing principles of taxing business and property income are retained.*
- *Canadian corporations will be allowed a full deduction for interest paid on money borrowed to buy shares in other corporations.*
- *One-half of the cost of goodwill and similar intangible assets will become deductible at a rate of 10 per cent on a declining balance. One-half of the proceeds of sale of such assets will be included in income, with special transitional rules for goodwill owned at the start of the new system.*
- *Membership fees in recreational and social clubs, and the expenses of a yacht, camp or lodge will not be deductible.*
- *Entertainment and convention expenses continue to be deductible on a basis similar to that of the present system, except that conventions become subject to geographical restrictions.*
- *Special rules limit deductions for losses on rental property and vacant land.*
- *Taxpayers in the professions will bring amounts into income as fees are billed.*
- *Farmers and fishermen continue to calculate income on a cash basis and retain special averaging provisions. The basic herd and straight-line depreciation provisions are phased out.*
- *The three-year tax holiday for new co-operatives is withdrawn. Patronage dividends paid will continue to be deductible in computing income, but may not reduce income below 5 per cent of capital employed by members.*
- *Caisses populaires and credit unions will be taxed on a basis similar to co-operatives.*
- *Mutual funds and investment corporations will be treated essentially as conduits between their shareholder – investors and the sources from which their income is derived.*
- *Estates and trusts are taxed on the same basis as under the existing system, except that personal trusts which accumulate income are taxed at the higher of 50 per cent or the personal rate schedule (the flat 50-per-cent rate does not apply to investment income of most personal trusts in existence at the start of system).*
- *There are special rules for valuing trust property, trust interests and partnership interests for capital gains tax purposes.*

General Principles

Under the present tax system the determination of income from a business or property begins with a calculation of profit according to normal commercial or accounting principles. Then a number of adjustments are made to this profit to meet income tax rules. Certain expenditures may not be deducted; for example, personal or living expenses, unreasonable expenses, or expenses that would artificially reduce income. Other rules specify the year in which certain expenditures may be deducted. For example, capital cost allowance provisions set out a maximum annual deduction for the cost of buildings and other depreciable property used to earn income. Still other rules specify the time at which certain items of income are taken into account. For example, if property is sold and the proceeds are to be collected over a number of years, the profit on the sale of property may be brought into income over the payment period for the property.

Interest on Money Borrowed to Buy Shares

The present tax system does not permit a corporation to deduct interest on money borrowed to buy shares of other corporations because the dividends on these shares are normally tax-exempt. To encourage Canadian ownership and investment, the bill provides a full deduction for interest on money borrowed by a corporation to buy shares in any other corporation. The present system allows a deduction for individual taxpayers and this is retained.

This deduction for interest provides a substantial incentive for Canadian corporations to invest in other corporations and permits them to compete on an even footing with foreign corporations. Assuming a tax rate of 50 per cent, the cost of borrowing money for share purchases will be cut in half.

Goodwill and Similar Assets

Certain business expenditures have come to be known as "nothings" because taxpayers could not deduct them in the year incurred (because they were capital in nature) or over a number of years by way of depreciation (because no asset was acquired on which depreciation could be claimed). Goodwill has been an important asset of this kind. If a taxpayer purchased a business, he could not deduct or depreciate the portion of his purchase price that related to the goodwill of the business. Other examples of "nothings" have been costs of incorporation and costs of acquiring intangible rights of an indefinite duration.

The new legislation creates an account comparable to a capital cost allowance class for these assets. Taxpayers will put one-half of their cost in this new class and deduct 10 per cent of the book value on a declining balance basis. Only such assets acquired after the new system starts are eligible for this treatment.

Because "nothings" are very closely related to capital gains and losses, only one-half of the proceeds on their sale will be included in income and one-half of their cost will be deductible in this manner.

In the case of a sale of goodwill in businesses that commence operation under the new system, one-half of the proceeds will be credited to the class, and this will result in a "recapture" or a "terminal loss." That is, if the decline in value is less than the deductions, the difference will be taxable. If it is more, the difference will be deductible.

For goodwill in existence at the start of the new system, the legislation provides that a taxpayer who sells goodwill in the first year of the new system will include 20 per cent of the proceeds in his income, 22 1/2 per cent if the sale is in the second year, 25 per cent if the sale is in the third year, and so on until the thirteenth and subsequent years when 50 per cent of the proceeds will be included in income. This formula is very similar to the proposal in the White Paper except that the percentages are cut in half.

Entertainment and Related Expenses

Under the present tax system there are no specific provisions covering entertainment and related expenses. The Income Tax Act simply provides that expenses are not deductible unless they are incurred for the purpose of earning income, are reasonable, and are not personal or living expenses.

The new legislation provides certain specific restrictions to disallow amounts paid to maintain or operate a yacht, camp, lodge or golf course facility. Also disallowed are amounts paid as membership fees or dues in clubs which exist principally for the purpose of providing dining, recreational or sporting facilities for members.

The deduction permitted by the existing system for expenses of attending two conventions a year will be continued. However, the conventions must be at a location consistent with the territorial scope of the organization.

The new bill also requires that an individual include in income the value of having a company car available for personal use.

The new legislation otherwise continues to permit a deduction for reasonable entertainment expenses incurred to earn income on the same basis as the present system.

Depreciation

The legislation continues the present depreciation, or capital cost allowance system, with three modifications designed to overcome inequities of the present system.

First, the legislation provides that when depreciable property is bequeathed to someone other than a spouse, the beneficiary will take over the property at an amount midway between fair market value and original cost less depreciation. Under the present system the inheritor of depreciable property is allowed to use the fair market value of the property as the base for depreciation, even though the estate is not required to pay any tax on any recaptured depreciation.

Secondly, the legislation provides that in future each rental building costing $50,000 or more will be placed in a separate capital cost allowance class. As each building is sold a taxpayer will bring into income recaptured depreciation or deduct a terminal loss. Under the present system all buildings of a particular construction are pooled and the day of reckoning can be indefinitely postponed by adding new buildings to the pool.

A loss created by capital cost allowance on the rental of real property may reduce other rental income, but not non-rental income. This provision is similar to the White Paper proposal except that it applies only to real property held as an investment and only to losses arising from capital cost allowance, not interest and property taxes.

The carrying charges on undeveloped real property (e.g. vacant land) will not be deductible from other income in situations where the property is being held as a capital investment. These charges, such as interest and property taxes, will be added to the cost of the property for the purpose of calculating a capital gain or loss when the property is eventually sold.

Taxpayers in the Professions

Taxpayers in the professions (doctors, dentists, lawyers, chartered accountants, engineers etc.) have been permitted to compute their income on the "cash basis". This means that amounts are included in income only when cash is received and amounts are deducted only when cash is disbursed.

The new bill requires that these taxpayers record income when fees are billed and expenses when they are incurred for fiscal years ending after December 31, 1971. Because of the difficulty in valuing unbilled time, the legislation provides that work in progress need not be brought into income unless the taxpayer chooses to do so.

To provide for an orderly changeover, accounts receivable at the start of the system will be brought into income over a number of years, on a basis similar to the White Paper proposals. Specifically, these taxpayers will pay tax on the higher of their income computed under the cash basis or billed basis each year, calculated cumulatively, until the original total of deferred income has been eliminated. The deferred income of professional corporations must be reduced by at least 10 per cent each year on a cumulative basis.

The deferred income of professional partnerships must be allocated to partners who will be personally responsible for bringing it into their income over a period of time. To permit a professional to change firms, a partner or proprietor may transfer his deferred income from one firm to another in certain circumstances without the payment of tax.

Farmers and Fishermen

The present tax system contains four special rules for farmers and fishermen. First, they are allowed to compute their income on a cash basis. Secondly, livestock farmers have been able to treat part of their herds as a non-taxable asset – referred to as a "basic herd". Thirdly, farmers and fishermen are not subject to tax on the difference between actual and claimed depreciation when they sell their assets if they depreciate on what is called the straight-line system – computed at rates generally one-half of those used under the normal diminishing balance system, and applied to original cost rather than depreciated cost. Any profit on the sale of such a depreciable asset is considered to be capital gain. Finally, farmers and fishermen are allowed to average their income every five years.

The new legislation continues to permit farmers and fishermen to compute their income on a cash basis and to average their income every five years. However, this special averaging provision will be related to the new general-averaging and the income-averaging annuity provisions so that farmers and fishermen may use the system most beneficial to them.

Because the legislation makes capital gains part of the tax base, the need for the basic herd and straight-line depreciation is substantially reduced. Accordingly the new legislation provides that these two provisions will be phased out.

Livestock farmers will be able to establish a basic herd as at December 31, 1971, but no additions may be made to the basic herd after that date. The accrued gain on a basic herd as at December 31, 1971 will be a tax-free capital gain, as under the present law. When livestock is sold after December 31, 1971 a farmer may consider the sale as being

out of the basic herd or the other herd, subject to special rules, but the legislation requires that the sale reduce the basic herd when the total livestock on hand is less than the remaining total of the basic herd. The proceeds in excess of the value of the basic herd on Valuation Day will be treated as part of farming income and will be eligible for general averaging or the income-averaging annuity.

Straight-line depreciation will continue to be available for assets acquired before the new system starts. Depreciation will be calculated on the diminishing balance system for assets acquired after December 31, 1971. If the assets depreciated on a straight-line basis are subsequently sold for more than original cost or Valuation Day value, the difference will be a capital gain. As at present there is no recapture of straight-line depreciation.

Hobby Farmers

The present system limits the deduction from other income of losses suffered on the operation of what are commonly referred to as "hobby farms". A hobby farmer is a taxpayer who carries on the operation of a farm as a part-time venture, and not as his main source of income. These taxpayers may deduct only $5,000 of farming losses from other income – all of the first $2,500 of loss and one-half of the next $5,000. Any losses not deducted against other income in the year they are suffered may be carried back one year and forward five years and deducted from farming income.

The new legislation continues this $5,000 limitation. In addition, where interest and property taxes have not been deducted because of this limitation, they may be applied against any proceeds on eventual sale of the farm. This procedure will reduce any capital gain that eventually results on the sale of the farm, but will not be allowed to create a capital loss.

Investment Income of Clubs and other Non-profit Organizations

Under the present law certain clubs and other non-profit organizations are exempt from tax on all of their income. Under the new bill, the investment income in excess of $2,000 each year of social and recreational clubs will be subject to tax at the rate of 50 per cent.

Co-operatives, Caisses Populaires and Credit Unions

Under the present tax system a co-operative is exempt from tax for the first three years of its existence. This exemption is withdrawn. Co-ops may continue to deduct patronage dividends; but the deduction may not reduce taxable income below 5 per cent of capital employed by members. The present limit is 3 per cent, calculated on a somewhat broader definition of capital employed. Interest paid to members is a further deduction in arriving at taxable income.

Caisses populaires and credit unions are now exempt from tax. Starting on January 1, 1972 they will be taxed on a basis similar to co-operatives, and permitted reserves for doubtful debts and market liquidity similar to those allowed to banking institutions.

Mutual Funds and Investment Corporations

The main objective of the new legislation is to treat mutual funds and investment corporations essentially as conduits between their shareholder – investors and the sources from which their income is derived.

An open-end mutual fund corporation or a closed-end investment corporation may continue to elect to qualify for preferential treatment as an "investment corporation".

An investment corporation is not taxable on dividends received from taxable Canadian corporations. Other income, including the full amount of capital gains, will be taxed at 25 per cent. Ordinary dividends paid to shareholders will be eligible for the new 33 1/3-per-cent dividend tax credit. By means of special "capital dividends" (or, in the case of an open-end mutual fund corporation, by redemption of its shares), the corporation can obtain a refund of the tax paid on capital gains. These special distributions will be treated as capital gains in the hands of shareholders. Redemptions of shares by an open-end mutual fund corporation will be capital gain (or loss) transactions. Redemptions of shares by a closed-end investment corporation will be subject to the normal rules for other corporations.

If an open-end mutual fund corporation does not qualify as an "investment corporation" the corporation's income and distributions will be taxed as follows:

- Dividends received will be subject to a special 33 1/3-per-cent tax which is refunded to the corporation as dividends are paid to shareholders.
- Capital gains will be taxed at 25 per cent and this tax will also be refunded to the corporation when it pays special "capital dividends" to shareholders or when it redeems shares.
- Other income will be taxed at the normal corporate rate.
- Ordinary dividends paid to shareholders are eligible for the dividend tax credit; special "capital dividends" will be treated as capital gains in the hands of shareholders; and redemptions of shares will be capital transactions.

If a closed-end investment corporation does not qualify as an "investment corporation" it will be taxed as an ordinary corporation.

A mutual fund organized as a unit trust is taxed in much the same manner as under the present system. These funds will allocate their income, and the Canadian dividend and foreign tax credit elements will continue to be flowed through to the unit holders. Capital gains not allocated to unit holders in any year will be taxed in the mutual fund at 25 per cent and this tax will be refunded to the mutual fund on a formula basis as units are redeemed. All redemptions of units will be treated as capital transactions to unit holders and any capital gain or loss will be subject to the general rules.

Trusts

Under the present tax system, all taxable trusts or estates are subject to the same set of rules, the most important of which are as follows:

(1) generally income received by the trust and payable to beneficiaries in the year received is taxable to the beneficiary, not the trust;

(2) income that is not so payable is taxable to the trust, and for this purpose the trust uses the personal rate schedule (although it is not entitled to a personal exemption); and

(3) once the trust has paid income tax on an amount, the balance can usually be distributed in subsequent years without further tax.

The new legislation continues the present tax treatment for the first category of income. This income will be taxed in the hands of the beneficiaries, and deducted in computing the income of the trust.

For trusts which accumulate income, the new bill distinguishes between estates (trusts created by a will) and personal trusts (trusts created by a living person).

In the case of an estate, income not payable to beneficiaries in the year received is taxed to the estate under the same system as at present. The estate uses the personal rate schedule, but is not entitled to personal exemptions.

In the case of a personal trust, income not payable to beneficiaries in the year received is taxed to the trust at the higher of 50 per cent or the personal rate schedule.

The new bill also provides that the minimum 50-per-cent tax on investment income of personal trusts will not apply to trusts in existence on budget day 1971 unless that trust receives additional contributions or borrows any money from a non-arm's-length lender after that date.

The new bill also provides that the preferred beneficiaries of a personal trust or estate may elect to include in their income the income of the trust that is being accumulated for their benefit. If this election is made the income is not taxed to the trust. This election may be made by any or all of the preferred beneficiaries, but the election by each is limited to his share of the trust income. Preferred beneficiaries are defined as the spouse or children of the person who established the trust. When the beneficiaries or their "shares" cannot be ascertained, the bill provides rules based on reasonable but generous assumptions, to determine each beneficiary's share of income. This election will also permit capital gains realized by a trust and otherwise included in its income to be taxed in the hands of lower-rate beneficiaries.

With the introduction of a tax on capital gains a number of special rules are needed to cover trusts. These rules are somewhat complex because of the extreme complexity of trusts, and the following summary is intended to give a general understanding of these rules.

When property is transferred to a trust this will generally be regarded as a sale at fair market value and accordingly a capital gain or loss will result. The cost of the property to the trust will be the fair market value of the property at the date of transfer.

When property is transferred to a special trust under which a spouse is a beneficiary, the capital gain on the transfer can be deferred under certain circumstances. In these cases the trust will take over the property at the cost of the person establishing the trust. On the death of the spouse the trust will be considered to have sold the property at its fair market value and accordingly a capital gain or loss will result. The cost of the property to the trust for tax purposes will then be increased to the fair market value of the property.

For trusts in existence at the start of the new system, the cost of the trust property will be original cost or fair market value on Valuation Day.

When a trust transfers property to its capital beneficiaries, the beneficiaries will take over the property at the trust's cost. This tax-free transfer recognizes the fact that a trust is, in a sense, the agent of its beneficiaries.

If a beneficiary sells or otherwise disposes of an income interest in a trust, all of the proceeds received will be treated as ordinary income but the purchaser will be able to deduct his cost from trust income received. If a beneficiary sells or otherwise disposes of a capital interest in a trust, the capital gain or loss will be measured against his pro rata share of the cost of the trust property to the trust at the time of sale.

The property of a trust, other than a special trust for a spouse, will be revalued every 21 years for capital gains tax purposes. This provision is necessary to prevent the indefinite postponement of capital gains taxes through the use of long-term trusts.

Partnerships

Under the existing tax system partnerships are not taxed as separate entities. Instead, the partners are taxed on their share of the partnership income, as if they had personally received the income. The new bill continues this tax treatment for partnership income, although the computation of income will be made at the partnership level.

Under existing law capital cost allowance may be claimed only by the partners, not by the partnership, although in practice it has often been claimed by the partnership. The new bill provides that capital cost allowance will be taken by the partnership and there are transitional provisions to transfer the depreciation base from the partners to the partnership.

With the introduction of a capital gains tax, rules are necessary to cover situations where property is transferred to a partnership, where property is received from a partnership and where partnership interests are sold. The general rule is that transfers of property to or from a partnership will take place at fair market value and accordingly a capital gain or loss will result. However there are a number of special provisions.

The new bill provides that a partner may contribute property to a partnership without a capital gain being realized. The partnership will simply take over the property at the partner's cost.

The new bill also provides that on its dissolution a partnership may transfer property to its partners without realizing a capital gain provided each partner receives the same percentage interest in that asset as he receives in every other asset distributed. In these situations:

(a) if the cost of the assets distributed is greater than the cost of the partner's partnership interest, the difference is treated as a capital gain; and

(b) if the cost of the assets distributed is less than the cost of the partnership interest, the difference may be spread over the cost of the distributed assets in a prescribed manner.

Where a partnership dissolves and one of the remaining partners carries on the business of the old partnership and uses property of the old partnership, the property may be transferred from the old partnership into the new business at tax cost.

Where a partnership dissolves as a result of the death or retirement of a partner and the remaining partners carry on the business using substantially all of the property of the old partnership, the old partnership will be deemed not to have dissolved.

After the new system starts the sale of a partnership interest or the liquidation of a partnership will generally result in a capital gain or loss, and this gain or loss will be measured from the partner's adjusted cost basis of his partnership interest. For partnerships existing at the start of the system, a partnership interest will be valued on the basis of the cost of the underlying partnership assets. However, if the partnership interest is subsequently sold, a portion of the gain will be exempt provided the buyer agrees to reduce his cost for tax purposes by the "exempt amount". The exempt amount will be the partner's share of that portion of the value of assets of the partnership on hand at the start of the system which would be treated as exempt if sold by the partnership.

6

International Income

- *Most changes in taxation of international income do not take effect until 1976. This will allow time to negotiate new tax treaties and to renegotiate existing treaties.*

Foreign Income of Canadians

- *Dividends received by Canadian corporations from "foreign affiliates" continue to be exempt from tax if paid out of pre-1976 profits. For dividends paid out of post-1975 profits, the exemption continues if profits are earned in a treaty country; if earned in a non-treaty country part or all of the dividends may be exempt, depending on the level of foreign taxes paid.*
- *Two special concessions are extended to non-exempt dividends received from foreign affiliates after 1975. Under the first, Canada will give relief for taxes spared or waived under incentive measures provided in developing countries. In addition, the portion of dividend that would otherwise be taxed will be treated as a return of capital invested before 1976.*
- *After 1972, a Canadian shareholder of a "foreign affiliate" will be required to include in his income his proportionate share of the affiliate's "foreign accrual property income", whether or not that income is distributed. Such income is limited to income from property such as investment income and capital gains.*
- *Taxes paid to political subdivisions of foreign countries will be deductible from foreign income or included in the foreign tax credit calculation, depending on treatment given these taxes in the foreign country.*
- *Foreign taxes on business income in excess of the foreign tax credit available may be carried forward for five years.*
- *After 1975, the foreign tax credit on investment income of individuals will be limited to 15 per cent; any excess over 15 per cent will be treated as an expense.*
- *The exemption from tax for foreign business corporations will be phased out over five years. Dividends paid after 1971 will be eligible for the new dividend tax credit.*

Canadian Income of Non-Residents

- *The general rate of withholding tax on investment income paid to non-residents remains at 15 per cent until the end of 1975, then increases to 25 per cent unless reduced by treaty.*
- *Rate of withholding tax on dividends paid by a corporation with a degree of Canadian ownership continues to be five percentage points less than the general or treaty rate.*
- *Pension and similar payments to non-residents after 1971 will be subject to withholding taxes at the general rate. Old Age Security pensions and $1,290 annually of Canada or Quebec Pension Plan benefits will be exempt. A non-resident may elect to file a Canadian tax return, to calculate his tax on his Canadian non-investment income at graduated personal rates, and thereby to obtain a refund of excess withholding tax, if appropriate.*
- *The special branch tax paid by non-Canadian corporations will be increased to the general withholding tax rate and the allowance for investment will be expanded to include working capital, but will be subject to recapture if investment is reduced.*
- *If the ratio of total shareholders' equity to debt due to non-resident shareholders, who have a 25-per-cent or more ownership interest, is less than 1:3, part of the interest paid to non-resident shareholders will not be deductible.*
- *The rate of tax on non-resident-owned investment corporations remains at 15 per cent until the end of 1975, then increases to 25 per cent. Income of these corporations includes full amount of capital gains that would be taxable to non-residents, but not other gains. As dividends are paid to shareholders, income taxes paid (including one-half the tax on capital gains) will be refunded to the corporation, and these dividends will be subject to normal rate of withholding tax.*

The new legislation reflects some changes in the system of taxing international income, but the basic features of the system continue. Residents of Canada continue to be taxed on their world income, and any foreign taxes paid on this income are taken into account in determining Canadian tax. Non-residents continue to be taxed on their Canadian employment and business income, and the tax will be extended to certain capital gains of non-residents. Investment income received from Canada by non-residents continues to be taxed at a flat rate of withholding tax.

Many of the changes proposed by the new bill will not take effect until 1976. This will allow a reasonable period of time to negotiate new tax treaties with other countries, and to renegotiate existing treaties. Tax treaties are an essential part of the taxation of international income and it is expected that the network of Canada's tax treaties will be considerably expanded before 1976.

The changes in the tax treatment of foreign income of Canadians and in the tax treatment of Canadian income of non-residents are discussed separately below.

FOREIGN INCOME OF CANADIANS

Foreign Tax Credit

Residents of Canada are generally taxable on their world income, even though part of this income may have been taxed in a foreign country. To ensure that foreign income is not subject to double taxation, the foreign tax credit provisions allow foreign taxes to offset the Canadian tax otherwise payable on overseas income.

For example, assume that a resident earns $100 of interest income from abroad, from which a 15-per-cent foreign tax has been deducted. On his Canadian tax return, the $100 would be reported as income and the $15 of foreign tax paid would be deducted from Canadian tax otherwise payable on that income.

Three basic changes to the foreign tax credit provisions are reflected in the new bill.

First, foreign taxes paid on overseas business income in excess of the foreign tax credit available may be carried forward for up to five years. At present there is no carry-forward. This change is effective at the start of the new system.

Second, after 1975 the foreign tax credit on investment income of individuals will be limited to 15 per cent, and any excess over 15 per cent will be treated as a deductible expense. For example, if $100 of foreign interest income had been subject to a 25-per-cent withholding tax abroad, the foreign tax credit would be limited to $15 and the remaining $10 would be treated as a deductible expense. In other circumstances the foreign tax credit will continue to be calculated as at present.

Third, under the present system, no relief is given for income taxes paid to states, provinces or other political subdivisions of foreign countries. The new legislation provides that after 1971 these taxes will be recognized either as a deductible expense or as an income tax eligible for the foreign tax credit. If state or local income taxes are deductible as an expense in the foreign country (as they are in the U.S.) they will be deductible as an expense in Canada. In other circumstances, the state or local income tax will be included in the foreign tax credit calculation.

Foreign Affiliate – Definition

A foreign corporation is a "foreign affiliate" of a taxpayer if:

- it is controlled by the taxpayer, either alone or together with other related taxpayers;
- 25 per cent of its voting shares or 50 per cent of any class of shares are owned, directly or indirectly, by the taxpayer; or
- 10 per cent of its voting shares are owned by the taxpayer, and the taxpayer elects to have the corporation qualify as a foreign affiliate.

The effect of this definition is to include as a foreign affiliate a foreign subsidiary, a foreign sub-subsidiary and any number of foreign corporations in a chain, provided the qualifications are met.

Foreign Affiliate – Dividends

Under the present tax system dividends received by a Canadian corporation from a foreign corporation in which it owns more than 25 per cent of the voting shares are exempt from tax.

Under the new legislation dividends received by a Canadian corporation from a "foreign affiliate" (as defined above) will be exempt from tax if the dividends are paid out of profits earned by the affiliate prior to 1976. Dividends paid out of post-1975 profits will also be exempt if the profits are earned in a country with which Canada has a comprehensive tax treaty.

Dividends paid out of post-1975 profits earned in a non-treaty country will be wholly or partly exempt from

tax in Canada, depending on the amount of income tax paid by the foreign affiliate on its earnings in non-treaty countries and the withholding tax imposed on the dividend. In determining the taxable portion of the dividend, a deduction will be made for foreign taxes imposed on the earnings from which the dividend is paid and by twice the amount of foreign withholding tax imposed on the dividend.

For example, assume that in 1976 a wholly-owned foreign subsidiary earns $1,000 of profit, pays a 30-per-cent tax on this profit and subsequently distributes those earnings as a dividend subject to a 20-per-cent withholding tax.

Foreign Affiliate		
Income		$1,000
Income tax-30%		300
Paid as dividend		700
Less foreign withholding tax-20%		140
Net receipt by Canadian corporation		$560
Canadian Corporation		
Income – dividend received		$700
Deduction for foreign tax:		
Underlying tax on profit	$300	
Twice foreign withholding tax	280	580
Taxable income		$120
Canadian tax payable (50%)		$ 60

The total tax paid in these circumstances would be $500 consisting of $440 of foreign tax and $60 of Canadian tax.

The Canadian tax paid is the same as would be payable under the foreign tax credit provisions for a Canadian corporation that carried on business abroad. In circumstances comparable to those in the preceding example – that is, if the foreign branch earnings of $1,000 attracted $440 of tax abroad – the corporation would pay the same $60 of Canadian tax.

Canadian Corporation		
Income of foreign branch		$1,000
Canadian tax thereon:		
Corporation tax (50%)	$500	
Less foreign tax credit	440	60
Foreign tax		440
Total tax payable		$500

The general effect of the provisions in this area is to place dividends from foreign affiliates in non-treaty circumstances on the same basis as foreign branch earnings of corporations. The Canadian tax imposed on dividends from foreign affiliates and overseas branch earnings is restricted to the amount necessary to bring the total burden of tax, both foreign and domestic, up to the level of Canadian tax.

In order to avoid uncertainty and to avoid impeding investment abroad while an expanded network of tax treaties is concluded, a special concession will apply to dividends received by a Canadian corporation on shares of foreign affiliates owned at the end of 1975. To the extent that any such dividend would otherwise attract Canadian tax, it may be treated as a return of capital. In the previous example, the taxable portion of the dividend received from the foreign affiliate was $120. The Canadian corporation could choose to exclude this amount from its income and instead apply the $120 to reduce the adjusted cost of its shares in the affiliate.

A second concession applies to investments in developing countries. For projects undertaken by the end of 1975, the government has agreed to give relief for taxes "spared" under incentive legislation of such countries. In the absence of this concession Canadians might be discouraged from investing in projects in these countries in advance of a treaty being concluded.

Foreign Affiliates – Diverted Income

The new bill contains special rules for taxing the foreign accrual property income of a foreign affiliate after 1972. The purpose of these special rules is to remove the tax advantage that would otherwise be gained from the transfer of investments abroad, particularly to those jurisdictions which are popularly referred to as "tax havens". These rules will not apply to active business income.

A Canadian shareholder of a foreign affiliate will be required to include in his income his proportionate share of the affiliate's diverted income (generally, investment income and capital gains) whether or not that income is actually distributed to him. Relief will be given for any foreign income taxes paid on that income. A foreign trust in which a Canadian beneficiary has a substantial interest will be treated as a foreign affiliate for purposes of the diverted income rules.

Foreign Business Corporations

The exemption from Canadian tax of a foreign business corporation will be phased out over five years. In 1972, 4/5ths of its taxable business income will be exempt; in 1973, 3/5ths will be exempt, and so on until 1976 when the exemption will no longer apply. Dividends paid by these corporations after 1971 will be eligible for the new dividend tax credit.

Withholding Tax

The general rate of withholding tax on investment income paid to non-residents will remain at 15 per cent until December 31, 1975; thereafter it will increase to 25 per cent unless reduced by treaty.

The existing exemptions from withholding tax for interest on government and government-guaranteed bonds will continue for securities issued before 1976. The special exemption for interest payable to foreign charitable organizations, pension funds and other exempt institutions abroad will be continued.

The rate of withholding tax on dividends paid by a corporation with a degree of Canadian ownership will continue to be five percentage points less than the general rate. Therefore, after 1975 it will be 20 per cent for shareholders in non-treaty countries and will be reduced to 10 per cent for shareholders in most treaty countries.

Pension and Similar Payments

Pension and similar payments will be subject to the non-resident withholding tax after 1971. The rate of withholding tax will be 15 per cent up to 1975 and 25 per cent thereafter, unless reduced by tax treaty. However, pensioners living outside Canada may receive free of withholding tax the full $960 of Old Age Security payments and up to $1,290 from the Canada or Quebec Pension Plans to make the exemption equal to the normal personal exemptions and standard deductions.

The recipient of pension and similar payments will be entitled to file a Canadian tax return, to calculate his tax liability at ordinary personal rates on Canadian income (other than investment income) and to obtain a refund if the tax withheld exceeds his liability.

Branch Tax

Under present law, a foreign corporation carrying on business in Canada through a branch is required to pay a special 15-per-cent tax on the after-tax branch profits that are not re-invested in capital assets. This special tax is altered in the new bill to place non-Canadian corporations that carry on business in Canada through a branch in a comparable position to such corporations that carry on business in Canada through a subsidiary. The rate of tax will be increased to 25 per cent after 1975 unless reduced by treaty. In addition, the allowance for investment in Canadian business assets will be extended to working capital and will be subject to recapture if investment is reduced.

Thin Capitalization

Under present law it is attractive for non-residents who control corporations in Canada to place a disproportionate amount of their investment in the form of debt rather than shares. The interest payments on this debt have the effect of reducing business income otherwise taxed at 50 per cent and attracting only the lower rate of withholding tax on interest paid abroad.

Under the new bill, if the ratio of total shareholders' equity to debt due to non-resident shareholders, having a 25-per-cent or more ownership interest, is less than 1:3, an appropriate part of the interest paid to non-residents will not be deductible. In effect, the part of the debt in excess of the 1:3 ratio will be treated as equity and the interest on that excess as dividends.

Non-resident-owned Investment Corporations

The special tax treatment for non-resident-owned investment corporations (NRO's) is continued in the new bill.

Once the new system is fully operative in 1976, it will provide for:

- a 25-per-cent tax on the income of the NRO, including capital gains that are taxable to non-residents, but excluding other gains; the tax paid (including only one-half of the tax on capital gains) will be refunded to the corporation when the earnings are distributed; and normal withholding tax on dividends paid;
- a requirement that NRO's must be 100-per-cent owned by non-residents, compared with the existing 95-per-cent ownership rule.

Until 1976 the rate of tax on income will stay at 15 per cent and the new ownership rules will not apply.

7

Administrative Changes

- *Onus of proof placed on the Crown to establish the facts necessary to support a penalty.*
- *Restrictions placed on issue of search warrants and retention of seized documents.*
- *Taxpayer entitled to be present at enquiry into his affairs, be represented by counsel, and be provided with a transcript of the evidence.*
- *Faster appeal procedures established; Federal Court rules to govern appeals; questions of fact or law may be referred for an opinion.*
- *Some restrictions placed on changes that may be made in income tax returns reassessed after more than four years.*
- *Appeals allowed against Minister's refusal to register charitable organizations, registered retirement savings plans, or to issue certificates of exemption to non-residents.*
- *A common factual issue affecting two or more taxpayers can be dealt with singly.*

The new legislation contains a number of changes in the administrative and penalty provisions which will benefit the taxpayer. Many of these changes result from representations made by taxpayers and tax practitioners in recent years.

The existing search and seizure powers under the Income Tax Act are being restricted. Some powers of the Minister of National Revenue are being limited. And the appeal sections are being broadened and procedures refined.

In total, the changes combine to produce a substantial reform of the civil rights enjoyed under the Canadian income tax system, and make methods and procedures easier and faster for the taxpayer.

Penalties

A penalty by definition is a form of punishment for wrong-doing, and thus it seems only logical that the Crown should be obliged to prove the facts on which it is based.

Under the existing Income Tax Act, the onus is on the taxpayer to "demolish the basic fact on which his liability for the penalty rests."

The new legislation provides that in the case of appeals from the assessment of penalties, the onus is on the Crown to establish the facts necessary to support the imposition of the penalty as distinguished from the tax.

Search Warrants

Under the existing Income Tax Act, the Minister of National Revenue may issue search warrants with the consent of a judge, whenever he feels they are necessary.

The new legislation safeguards the taxpayer's civil rights by restricting the authorization of search warrants to occasions when there are reasonable grounds for believing that an offence has been committed. Information, on oath, must be submitted to a court.

In addition, documents seized other than by search warrant in the course of an investigation must be returned within a reasonable time unless a court decides otherwise. A person whose documents are seized will have the opportunity of reviewing them.

Enquiries

At the present time, an enquiry may be held in the course of the administration or enforcement of the Income Tax Act without the presence of the taxpayer concerned. The new legislation will entitle the taxpayer, in most cases, to attend or be represented.

Other Changes

The new legislation allows a taxpayer to appeal directly to a court without further consideration by the Department of National Revenue. The purpose here is to speed procedures when it is obvious to both sides that an issue must eventually be decided by the court.

The Minister of National Revenue, with the consent of the taxpayer, will be able to refer questions of law to the court for its opinion. This will allow quick settlement of cases in which there is no dispute as to the facts.

The present tax law allows the Minister to reassess an income tax return more than four years in the past in cases of misrepresentation or fraud. Once a case is opened, however, reassessments may include amounts in no way related to the original basis of assessment. The new legislation restricts such actions.

Appeals will be permitted to the Federal Court if the Minister of National Revenue refuses to register for tax-exemption purposes charitable organizations, deferred profit-sharing plans, retirement savings plans, and certificates of exemption for non-residents. Appeals are restricted to those issues which do not involve any consideration of matters of policy.

In many situations there are questions of fact which affect more than one taxpayer. For example, in the case of an alimony payment, one spouse is concerned because the payment represents a deduction of income; the other spouse, because the payment is an inclusion in income. To speed up settlement of disputed cases, the new legislation will permit a court to determine a common question of fact between two taxpayers.

8

Revenues

The effect of the reform measures on combined federal and provincial government revenues in 1972 is estimated as follows:

Corporation income tax changes	$ + 30 million
Withholding tax changes	+ 5 million
Individual income tax changes	– 290 million
Estate and gift tax changes	– 65 million
	$ – 320 million

These figures relate to combined federal and provincial taxes, with provincial rates at 30 per cent of federal tax on individuals and 10 per cent of corporate taxable income. Of the $320 million reduction in revenue, $315 million is a federal reduction and $5 million is a provincial reduction. Because personal tax rates in some provinces are higher than the equivalent of the new 30-per-cent standard rate, actual provincial revenues from this source are estimated to decline by approximately $23 million. Almost all of this provincial reduction will be offset by the government's revenue guarantee to the provinces and the balance by an adjustment in equalization payments.

The reduction in federal revenues of $315 million fulfills the government's commitment concerning revenues from the reformed system in the first year. Had the present system been continued, but without the present 3-per-cent surtaxes on personal and corporate income, federal revenues in 1972 would have been reduced by $305 million, which is the yield of the surtaxes.

As the new system matures, it will generate more revenue annually than would the existing system had it continued to operate under current rules and rates. It is estimated that this additional amount will be about $850 million by the fifth year of the system. Reductions in tax rates designed to offset the revenue increase will be set out for the years 1973 to 1976 as part of the revenue commitment, and they are described in explanatory material accompanying the narrative description of transitional measures tabled budget night.

In brief, the reductions will be made both in the general rate of corporation income tax and in the federal rate on the first $500 of taxable personal income. The corporate rate will be reduced from 50 per cent in 1972 to 49 per cent in 1973, 48 per cent in 1974, 47 per cent in 1975 and 46 per cent in 1976. The 17-per-cent federal rate on the first $500 of taxable personal income will be reduced to 15 per cent in 1973, 12 per cent in 1974, 9 per cent in 1975 and 6 per cent in 1976.

Estimating Procedures

The estimates of the effect of the reform proposals on government revenues have been made by computer simulation, employing two samples of 1968 income tax returns-- one sample of the returns of individuals and the other of corporations. These samples, and the computer programs which permit alternative computations based upon the information in the samples, were designed and operated by officials of the Department of National Revenue after consultation with officials of the Department of Finance. This permitted the tax data to be used without jeopardizing the confidential nature of the information in the tax returns.

The sample of individual returns contained 100,000 returns, drawn from a larger sample used by the Department of National Revenue to produce its publication "Taxation Statistics", which analyzed 1968 T1 individual income tax returns. The sample was drawn to represent as closely as possible the entire tax-paying population.

Since it is proposed that the tax changes come into effect in 1972, it was necessary to estimate the revenue effects for 1972. To accomplish this, population and economic changes between 1968 and 1972 were estimated and the computer information modified to reflect the changes. The modifications were based upon the latest information available concerning trends and outlooks. Nevertheless it is important to caution that forecasting revenues entails risks. It is believed, however, that the forecast of over-all revenue effects is subject to only a modest margin of error. But even a 1-per-cent margin of error on an income tax base of $10 billion can result in a discrepancy of $100 million.

The statistical basis for developing corporate revenue yields has been the sample prepared by the Dominion Bureau of Statistics, working from financial statements filed under the Corporations and Labour Unions Returns Act. This sampling basis encompasses all taxable corporations with $5 million or more in assets, 50 per cent of taxable corporations with assets from $1 million to $5 million and 5 per cent of taxable corporations with less than $1 million in assets.

It has been possible to employ this sample of about 16,000 corporations to duplicate within less than one per cent the actual taxable income of the approximately 195,000 Canadian corporations in 1968.

Officials of National Revenue have coded the records so that it is possible to obtain sub-totals for all public corporations, for all corporations controlled directly by foreign corporations, and for the subsidiaries of those corporations. These sub-totals were essential to the estimates pertaining to some of the proposals.

In some instances the information necessary to estimate the 1968 revenue effect was in the 1968 tax returns, permitting a simple recomputation of tax due under the new rules. This was the case for personal exemption changes, the new rate schedule, the exemption of guaranteed income supplement payments, the deduction of unemployment insurance contributions, and the reform of the dividend tax credit.

In other instances, some of the information required was on computer, but it was necessary to supplement this information in some respects by estimates based on other data. For individuals, this procedure was used for calculating the tax effect of the increase in the limits on the deductibility of charitable donations and contributions to pension plans and retirement savings plans. This was also the case for the restriction on the deduction of depreciation on rented buildings. For corporations this procedure was used for the low corporate rate and the amount of net investment income, the flow of dividends between corporations, the deductibility of "nothings" and interest on money borrowed to buy shares, and capital gains realized.

For a third category of proposals very little or no information could be obtained from the 1968 returns. For those proposals, estimates were based upon information from other sources – U.S. studies, publications of the Department of Labour and the Unemployment Insurance Commission, and others – and the results were fed into the computer. This category included capital gains, moving and living-away-from-home expenses, child care allowances, the taxation of unemployment insurance benefits and the benefit received by an employee when part or all of his medicare premiums are paid for him by his employer, and several smaller items.

The most difficult item to estimate was capital gains. Capital gains on shares of corporations are by far the largest component of total gains. The amount of these gains likely to be realized by individuals was computed by two methods and the results were compared and analyzed. The first method was based upon the relationship between dividends paid and capital gains realized on Canadian corporate shares as determined in studies for the Royal Commission and 1971 studies for the Department of Finance. An adjustment was made with respect to corporations which do not pay regular dividends, since these corporations were under-represented in the corporate samples. The second method was based upon the relationships between share prices, undistributed corporate profits and capital gains reported for tax purposes in the United States, and between capital gains reported for tax purposes and gains accrued at the death of the holder.

Both methods have indicated that share gains realized and accrued by individual Canadians in Canadian corporations in 1968 were of the order of $2 billion. The taxable gains occurring in 1972 and for several subsequent years will, of course, be substantially less than these figures. No gains accruing prior to Valuation Day will be taxable, and the buildup of accrued but unrealized gains after the start of the system will initially be small, with a gradual increase occurring year by year. It is estimated, for example, that net revenues from capital gains in the first year will be an estimated $80 million. The calculation of the amount of gains realized in the early years of the new system has been based on U.S. data for the periods that assets are held by taxpayers, with an adjustment with respect to gains accrued at death.

Detailed estimates of the changes in corporate and personal income tax revenues are contained in the following tables.

Revenue Effect of Corporation Income Tax Changes
in the First Year of the New System

	On the Basis of 1968 Incomes	*On the Basis of 1972 Incomes*
	($ million)	
1. Change in the low rate of corporation income tax and reducing the amount of income taxed at the low rate	+ 75	+ 85
2. Reduction to 25% from 50% of the corporation tax rate applied to the investment income of private corporations that is distributed to shareholders	– 20	– 30
3. Net tax collected on portfolio dividends received by private corporations	+ 35	+ 50
4. End of the corporation surtax	– 80	– 90
5. Tax collected on capital gains of corporations	+ 40	+ 50
6. New deduction for "nothings" and for interest on money borrowed to buy shares	– 25	
7. New rules for deducting exploration and development expenditures by corporations whose principal business is not mining, petroleum or gas, and new rules for exploration and development outside Canada	– 10	– 35
8. Cancellation of deduction for club dues, yatchts, camps and lodges, etc.	+ 5	
	+ 20	+ 30

Revenue Effect of Personal Income Tax Changes
in the First Year of the New System

	On the Basis of 1968 Incomes	*On the Basis of 1972 Incomes*
	($ million)	
1. Increase in basic exemptions and rate schedule changes	– 190	– 120
2. Additional exemption for those over 65 and the exemption of GIS payments	– 55	– 90
3. Employment expense allowance, moving expenses and other deductions for expenses	– 205	– 285
4. Child care allowance	– 35	– 50
5. Inclusion in income of unemployment insurance benefits	+ 90	+ 130
6. Deduction of unemployment insurance premiums paid by employees	– 65	– 100
7. Increase in limits on deductions for contributions to pension and retirement savings plans	– 20	– 30
8. Increase in limit on deduction for charitable donations	– 10	– 10
9. Inclusion in income of medicare premiums paid on an employee's behalf by his employer	n/a	+ 80
10. Restriction on deduction for depreciation of rented buildings	+ 25	+ 45
11. Other expense deductions limited and other items included in income (see below)	+ 50	+ 65
12. Inclusion in income of one-half of net capital gains	+ 70	+ 80
13. Amendment to dividend tax credit formula	– 25	– 5
Total	– 370	– 290

The composition of Item 11 above is as follows:

	1968	*1972*
	($ million)	
Expense deductions limited:		
Restriction of deduction for club dues, etc.	4	6
Change in definition of deductible medical expenses	6	9
Other items included in income:		
Adult training allowances	15	20
Armed forces changes	10	15
Personal use of business cars	5	5
Additional interest paid by co-ops, caisses populaires and credit unions	5	5
Fellowships, scholarships, bursaries and grants	5	5
	50	65

Tax Reform Synopsis

ITEM	OLD LAW	NEW BILL
Single taxpayer – basic exemption	$1,000	$1,500
Married taxpayer – basic exemption	$2,000	$2,850
Spouse's income	Spouse's exemption of $1,000 reduced $1 for every $1 that income exceeds $250.	Spouse's exemption of $1,350 reduced $1 for every $1 that income exceeds $250.
Married exemption for supporting dependant	$2,000 when unmarried taxpayer supports dependent child or dependent relative.	$2,850 – Dependant must live with taxpayer. Exemption reduced where dependant has income over $250.
Children under 16	Parent deducts $300. If child's income is over $950, excess may be added to parent's tax (notch provision).	Parent deducts $300 which is reduced $1 for every $2 of child's income over $1,000.
Children over 16	Parent deducts $550. If child's income is over $950, excess may be added to parent's tax (notch provision).	Parent deducts $550 which is reduced $1 for every $1 of child's income over $1,050.
Other dependants	Taxpayer deducts $300 or $550, depending on dependant's age. If dependant's income is over $950, excess may be added to taxpayer's tax (notch provision).	Taxpayer deducts $300 or $550 depending on age of dependant, and reduces exemption as above if dependant's income exceeds $1,000 or $1,050.
Unmarried clergymen	Deduct $1,000 if fulltime servant employed in dwelling.	No deduction.
Elderly taxpayers	Additional $500 exemption if age 70 or over.	Exemption in creased to $650 and extended to taxpayers age 65 or over. Guaranteed income supplement made exempt.
Special deduction	Individuals who are blind or are confined to bed or wheel chair are allowed a special deduction of $500 a year.	Special deduction increased to $650 a year.
Child care expenses	No deductions.	Up to $500 per child under 14 or over 14 and infirm with a limit of $2,000 per family. Deductions may not exceed 2/3 of income of parent claiming deduction. Receipts needed. Deducted by mother unless unable to work. Payments to dependants or to relatives under 21 do not qualify.
Employment expenses	Very limited; e.g. union dues.	3% of gross employment income up to $150 deductible.
Expenses when working away from home	Amounts received from employer by construction workers for board, lodging and transportation at distant sites not taxable.	Old law extended to all employees.

INCOME

COMMONS REPORT	SENATE REPORT	WHITE PAPER
$1,400	$1,400 only if taxpayer's income does not exceed $3,000.	$1,400
$2,800	$2,800 only if taxpayer's income does not exceed $8,500.	$2,800
Same as White Paper.	Same as White Paper.	Spouse's exemption of $1,400 reduced $1 for every $1 that income exceeds $100.
Same as White Paper.	Same as White Paper.	Similar to bill but exemption $2,800.
Same as White Paper.	Same as White Paper.	Similar formula but reduction started at $900.
Same as White Paper.	Same as White Paper.	Similar formula but reduction started at $950.
Same as White Paper.	Same as White Paper.	Similar formula but reduction started at $900 or $950.
Same as bill.	Same as bill.	Same as bill.
No change from old law.	No change from old law.	No change from old law.
No change.	No change.	No change.
Similar to bill but deduction allowed only to parent with lower earned income. Would include care for incapacitated spouse.	Similar to bill.	Not allowed to father if mother unable to provide care or for children over age 14. Limited to 2/3 income of parent with lower income.
Similar to bill. Would allow alternative of itemized expenses.	Similar to bill.	Similar to bill.
No comment.	No comment.	Promised some tax relief.

ITEM	OLD LAW	NEW BILL
Moving expenses	Employer may deduct as business expense. No deduction by employee.	Employees and self-employed may deduct from income from new job with one year carry-over. Must move 25 miles closer to job. Special rules for students.
Medical expenses	Allowable expenses deductible to the extent they exceed 3% of net income.	List of allowable expenses increased to include training institutions for disabled persons and prescribed appliances and equipment.
	Insurance premiums not deductible.	Premiums to plans other than government are classed as medical expenses.
	Expenses reimbursed by government plans not deductible.	Expenses for which taxpayer has been reimbursed under a plan not classed as medical expenses.
	Employers' contributions to public hospital plans and some medical plans result in taxable benefit; contributions to private plans do not.	Employers' contributions to all government plans result in taxable benefit.
Unemployment insurance	Contributions not deductible; benefits not taxable.	Contributions deductible; benefits taxable.
Club fees, convention expenses, entertainment costs	Generally deductible by persons carrying on a business or profession.	Yachts, lodges and club dues disallowed; geographical restrictions placed on conventions.
Charitable donations	Donations to registered charitable institutions limited to 10% of net income.	Limit on donations 20% of net income. Donations to national amateur athletic associations qualify.
	Donations to federal and provincial governments deductible without limit.	Same provisions for donations to governments.
Pension plans, registered retirement savings plans and deferred profit-sharing plans	Limit on deductible contributions of $1,500 for pension plans and profit-sharing plans and $2,500 for retirement savings plans.	Limits increased to $2,500 for pension plans and profit-sharing plans and to $4,000 for retirement savings plans.
	Foreign-source income of pension plans and profit-sharing plans may not exceed 10% to qualify for tax-free status.	90% of assets of all plans must be Canadian. Penalties for having more than 10% foreign assets; not necessary to dispose of present excess foreign assets.
	Some restrictions on investments of pension plans and profit-sharing plans. No restrictions on investments of retirement savings plans.	Investments of retirement savings plans to be restricted on same basis as profit-sharing plans.
	Special rules for taxing lump-sum withdrawals from pension plans and profit-sharing plans.	Withdrawals taxed at ordinary rates (but may average or defer tax under new rules). Special rule for present accumulations in pension and profit-sharing plans.

COMMONS REPORT	SENATE REPORT	WHITE PAPER
Similar to bill. Recommended that certain time must be spent in new location.	Similar to bill.	Similar to bill but without one year carry-over or reference to students.
No comment.	No comment.	Did not increase list of eligible expenses.
Same as bill.	Same as bill.	Same as bill.
Same as bill.	Same as bill.	Same as bill.
Same as bill.	Same as bill.	Same as bill.
Same as bill.	Same as bill.	Same as bill.
Tighter enforcement of existing laws, continued deduction of proven entertainment expenses and geographical restrictions for conventions.	Retain old law with better enforcement to prevent abuse.	Similar to bill, but entertainment and convention costs not deductible.
No comment on limit except that it should be removed for gifts to Canadian public institutions. Suggested extension of list of registered organizations.	No comment on limit. Would enlarge list of registered organizations.	Did not increase limit on donations.
Recommended a switch to benefit based contributions as soon as feasible.	Recommended further study of benefit based contributions.	Did not increase contributions.
Similar to bill.	Similar to bill.	Similar to bill.
Similar to bill.	Similar to bill.	Similar to bill.
Special averaging for payments on death.	Under certain conditions withdrawals tax-free. Suggested more generous rules for taxing lump-sum withdrawals from plans.	Did not provide special rule for present accumulations or for income averaging annuities.

ITEM	OLD LAW	NEW BILL
Fellowships, scholarships, bursaries	Not taxable unless related to employment.	Taxable with an annual exemption of $500.
Training allowances	Not taxable.	Taxable except for living away from home allowance.
Research grants	Not taxable unless related to employment.	Taxable with deduction for research expenditures.
Benefit from personal use of automobile provided by employer or business	Taxed in some circumstances.	Minimum value set for personal use.
Income maintenance insurance	Not taxable if received from an insurance company.	Taxable if employer contributes to premiums, but with a deduction from benefits for premiums paid since 1967.
Income averaging	Special rules for special types of receipts. Five-year block averaging for farmers and fishermen.	General averaging for all taxpayers whose income in a year exceeds four-year average by 20% and immediately preceding year by 10%. Income of each preceding year deemed to be not less than $1,600. Also special forward averaging for certain receipts through the acquisition of an income-averaging annuity. Averaging for farmers and fishermen will continue as in the old law. Present special rules remain for three or five years.
Servicemen	Special rules – taxed on a monthly basis.	Treated as ordinary taxpayers.
Rate schedule	Rates (including provincial tax at 28%, old age security tax and other special taxes) from 14.8% to 82.4%. Surtax on foreign investment income – 4%.	Rates (including provincial tax at 30%) from 22.1% to 61.1% in 1972. In years 1973-76, federal rate of 17% on first $500 reduced in steps to 6%. Surtax on foreign investment income eliminated.

INCOME

COMMONS REPORT	SENATE REPORT	WHITE PAPER
Same as bill.	Should not be taxable.	Taxable, with no exemptions.
Same as bill.	Same as bill.	Same as bill.
Same as bill.	Should not be taxable.	Same as bill.
Similar to bill.	Retain old law with better enforcement to prevent abuse.	Similar to bill.
No comment.	No comment.	No provision.
Agreed with White Paper.	One type of averaging for general use, similar to that granted to farmers and fishermen under the old law; and a special formula for lump-sum receipts from plans. Retain present special averaging for lump-sum business receipts but restrict to small corporations.	Averaging if income exceeds four-year average by 33 1/3%. Restrictions for persons formerly dependent and for those under age 25. No provision for income-averaging annuities.
Same as bill.	Same as bill.	Same as bill.
Approved White Paper, but recommended top rate of 60% and no phase-in. The 50% rate to cut in at $30,000; the 60% rate at $60,000.	Reduce top rate to 50% for combined federal and provincial taxes. No increase in tax for middle income groups. Eliminate 4% surtax on foreign investment income.	Rates (including provincial tax at 28%) from 21.76% to 51.2%. Top rates to 81.92% in 1972 but reduced over five-year period.

ITEM	OLD LAW	NEW BILL
General rule	Not taxed.	One-half capital gains to be included in income. One-half losses deductible from gains. Losses not deducted in the year are carried back one year and forward indefinitely. Individuals may also deduct up to $1,000 of losses each year from other income.
Valuation Day		General rule: cost basis of asset to be higher of original cost or fair market value on V-Day in determining gains and lower of cost or market in determining losses. For bonds, etc., cost in these rules is amortized cost. Taxpayer may elect to use fair market value on V-Day for all assets.
Homes		No tax on sale of principal residence and one acre of land or additional land surrounding residence if proven necessary to enjoyment as residence. Farmer has alternative to deduct $1,000 per year on home and farm.
Works of art, jewellery, etc.		$1,000 minimum cost per item or set of items. Losses allowed against gains from similar assets and excess carried back one and forward five years with same restriction.
Other personal property		$1,000 minimum cost per item, or set of items. Losses not allowed.
Shares		Same as general rule.
Bonds, mortgages, agreements for sale, etc.		Same as general rule. Deep discounts half-deductible to issuer.
Windfall gains	Capital gains from gambling, sweepstakes and the like not taxable; losses not deductible.	No change.
Rollovers (carry-over of basis and deferral of gain)		Rollovers permitted for: – expropriation and destruction – transfers to an 80%-owned corporation – liquidation of a wholly-owned subsidiary – certain amalgamations and corporate reorganizations – transfers to a partnership – certain dissolutions of partnerships.
Gifts		No deemed realization for gifts to spouse; on subsequent sale, capital gains tax paid by donor. Deemed realization at time of other gifts.

GAINS

COMMONS REPORT	SENATE REPORT	WHITE PAPER
Similar to bill but more gains fully taxable.	Short-term (less than year) gains and losses treated as ordinary income. Long-term gains tax not to exceed the lower of 25% or rate of taxpayer. Long-term capital losses deductible only from long-term capital gains, subject to three-year carry-back and eight-year carry-forward	Capital gains to be brought into income and taxed at personal rates; losses to be deductible from any income. (See exceptions). One-year carry-back and five-year carry-forward.
Similar to bill. Suggested safe haven rules to reduce valuation problems.	Cost basis of asset to be higher of original cost or fair market value on V-Day for determining both gains and losses. Suggested safe haven rules to reduce valuation problem.	V-Day to be announced near commencement of new system. Fair market value on V-Day will be the basis for calculating subsequent gains and losses. Exceptions for bonds, mortgages and agreements for sale.
Same as bill without farmer's option.	Lifetime exemption of $50,000 for principal residences and $75,000 for farms and orchards owned by farmers.	$1,000 exemption per year plus $150 (or actual cost) annual improvement allowance. Rollover for one year where sold in connection with a change in job.
Same as bill.	$5,000 minimum cost per item.	$500 minimum cost per item. Losses restricted to prior, current and immediately subsequent year.
Same as bill.	$5,000 minimum cost per item.	$500 minimum cost per item.
Similar to bill.	Reject principle of distinguishing between closely-held and widely-held corporations. Gains and losses on both taxed as provided under general rule and only when an asset is sold.	Full gain taxable on shares of closely-held corporations; full loss deductible. Half gain taxable on shares of widely-held corporations; half loss deductible. Gains and losses on shares of widely-held corporations accrued every five years.
Full gain taxable on bonds, mortgages and agreements for sale; losses fully deductible. Transitional rules for recovery of cost.	Same as general rule.	Full gain taxable on bonds, mortgages, debentures, agreements for sale. If proceeds on disposal less than cost or amortized cost on V-Day, recovery not taxable.
No comment.	No comment.	No change.
Similar to bill.	Rollover provisions should be broadened.	Similar to bill.
Similar to bill.	No deemed realization. Cost basis to donor plus gift tax thereon flows through to recipient.	Deemed realization at fair market value at date of gift.

ITEM	OLD LAW	NEW BILL
Bequests		No deemed realization for bequests to spouse. Deemed realization at death for other bequests. Special rule for depreciable property.
Arrivals and departures		Taxpayers moving to Canada will value their assets at that time for the purpose of calculating subsequent gains or losses. On leaving Canada, deemed realization except for assets on which a non-resident is taxable by Canada. First $5,000 exempt. Alternatively, taxpayer may elect to be taxed as if resident of Canada in year of actual disposal, provided reasonable security given at time of departure.
Averaging		Capital gains subject to general averaging and forward averaging provisions.
Estate taxes	No tax on first $50,000. Maximum rate of 50% reached at $300,000. No tax on transfers to spouse.	Federal estate and gift taxes eliminated.

GAINS

COMMONS REPORT	SENATE REPORT	WHITE PAPER
Similar to bill.	No deemed realization. Cost basis to deceased plus estate tax thereon flows through to heirs.	Transferred to heirs at cost plus death duties applicable to any accrued gains.
Suspend tax for temporary residence (three years or less). Departures should have option of deemed realization or to continue to be taxed as residents of Canada, with security given to ensure payment of tax.	No deemed realization on leaving Canada.	Base value of assets for capital gains measurement will be fair market value on arrival day. Taxpayer leaving Canada deemed to have sold assets at fair market value.
Same as bill. Capital gains may be averaged.	Similar to bill. Capital gains may be averaged.	Same as bill. Capital gains may be averaged.
Exempt first $150,000. Broaden rate bracket so that 50% rate applies at $800,000.	Abandon estate tax field to provinces.	No changes proposed.

ITEM	OLD LAW	NEW BILL
Rates of tax	21% on first $35,000 and 50% on balance, (plus temporary 3% surtax).	General rate 50% in 1972 reduced by one percentage point annually to 46% in 1976. If eligible for small business incentive, 25% on first $50,000 of business income (see below).
Ordinary dividends paid by Canadian corporations to resident individuals	Individual shareholders can deduct a tax credit of 20% of dividends.	Dividend tax credit increased to 33 1/3% and included in income.
Ordinary dividends paid by Canadian corporations to resident corporations	Dividends from one "taxable Canadian corporation" to another one generally tax-exempt.	Dividends remain generally exempt. However, dividends received by private corporations from non-subsidiaries are subject to a special tax of 33 1/3% which is refunded when dividends are paid to shareholders. For every $3 of dividends, $1 of tax is refunded.
Investment income of private corporations (other than dividends)	No special rules, assuming corporation is not a "personal corporation".	Taxed at general rate. Refund of 25 percentage points when dividends are paid to shareholders. For every $3 of dividends paid, $1 of tax refunded.
Special dividends by private corporations out of capital gains	No provision.	One-half of capital gains taxed as investment income and rules for refund of one-half of tax will apply. The other half may be distributed tax-free to shareholders as a special dividend.
Small business incentive	Rate of 21% on first $35,000 available to all corporations.	Rate of 25% on the first $50,000 of business income available only to Canadian-controlled private corporations. Low rate not available to the extent funds used for non-business purposes and low rate ends once $400,000 of before-tax earnings have been accumulated after 1971.
Other special distributions	Corporations can pay special taxes, generally at 15%, on portions of their undistributed income, and thereafter distribute the remaining 85% to their shareholders tax-free.	Corporations can pay a special tax at 15% on all or any part of their undistributed income on hand at the start of the new system. The remaining 85% can then be distributed to shareholders tax-free. This distribution would reduce the opening value of the shares for capital-gains tax purposes. Once the 15% tax has been paid on all pre-1972 undistributed income, capital gains that relate to 1971 and before can also be distributed tax-free to shareholders. This distribution will similarly reduce the opening value of the shares. The special taxes would not apply to post-1971 earnings.

COMMONS REPORT	SENATE REPORT	WHITE PAPER
General rate 50%; low rate of tax should be replaced by new incentives for Canadian-controlled closely-held corporations.	General rate 50%, but the low rate of tax should be retained for the first $35,000 of business income of small business corporations.	All corporations pay tax at the rate of 50%.
Generally, all dividends would be subject to half integration.	Dividend tax credit retained, but modified. Credit would be 25% on the first $500 of dividends, 20% on the next $4,500 and 15% on the excess.	Shareholders would receive credit for all or half of corporation taxes paid, under a system of integrating the tax paid by corporations and shareholders.
General rule is that dividends between corporations should be taxable at the rate of 33 1/3% and should be subject to half integration. If a corporation has 25% or more ownership of another corporation, dividends should be tax-exempt.	Dividends from one corporation to another to be tax-exempt, with special rules to prevent undue accumulation of portfolio dividends.	Dividends from one corporation to another are taxable, and carry full or half credit for corporation taxes paid: full credit if the dividend is paid by a CHC and half credit if the dividend is paid by a WHC.
No special rules.	No special rules.	No special rules.
No special rules.	No special rules.	No special rules.
See rates of tax above.	See rates of tax above.	No special provisions.
Similar to bill.	Similar to bill.	Similar to bill.

ITEM	OLD LAW	NEW BILL
Exploration and Development		
Principal business taxpayers	Can deduct Canadian exploration and development expenses in the year incurred or in any subsequent year.	No change.
Non-principal business	Generally, are allowed to deduct exploration and development expenses only from mining and petroleum income, with an unlimited carry-forward.	These taxpayers will be allowed to accumulate Canadian exploration and development expenses in a separate asset class and to deduct annually the greater of: – income from mining or petroleum, including royalties and proceeds from mineral properties, or – 20% of the unclaimed balance.
Foreign exploration	Generally, no deduction for foreign exploration and development expenses, other than drilling expenses for certain foreign oil and gas wells.	Foreign exploration and development expenses will be accumulated in a separate asset class and all taxpayers will be able to deduct annually the greater of: – foreign income from mining or petroleum or – 10% of the unclaimed balance.
New mines		
Three-year tax exemption	Income exempt for first three years.	Existing exemption limited to income earned before Jan. 1, 1974.
Accelerated depreciation	No provision.	Assets related to a new mine (e.g. mine buildings, machinery and equipment, a refinery, and townsite facilities) may be included in a separate asset class and an annual deduction made equal to the greater of: – income from the new mine, or – 30% of unclaimed balance. This accelerated depreciation also applies to most assets related to the expansion of an existing mine where the milling capacity is increased by at least 25%.
Operators' Depletion	Most operators of mineral or petroleum resources are entitled to claim a depletion allowance of 33 1/3% of production profits. Special rates for coal and gold.	Present system of depletion continues until end of 1976. Thereafter, depletion will have to be earned at the rate of $1 for every $3 of eligible expenditures. Eligible expenditures include all Canadian exploration and development costs, capital assets (except townsite facilities) acquired after Nov. 7, 1969 related to a new mine or major expansion, new facilities acquired after Nov. 7, 1969 to process mineral ores to a stage beyond which they were previously processed in Canada. Depletion earned but unclaimed can be carried forward indefinitely in determining future depletion.

PETROLEUM

COMMONS REPORT	SENATE REPORT	WHITE PAPER
Same as bill.	Same as bill.	Same as bill.
Same as bill.	Recommended an increase in the rate to 30% from 20%.	Same as bill.
No comment.	No comment.	No comment.
Same as bill.	Retain exemption but reduce it to 75% of earnings of first three years.	Same as bill.
Similar to bill, but recommended that expenditures on new mine be deductible from any mining income, not just income from new mine.	Similar to bill.	Similar to bill, but did not provide for townsite assets or refineries or for expansion of an existing mine.
Similar to bill.	Present rules should apply for 10 years for properties now owned and operated. Thereafter taxpayers should be allowed a basic 20% depletion allowance and the earned depletion concept would only apply in calculating the maximum depletion of 33 1/3%.	Same as bill, but no automatic depletion for properties acquired after Nov. 7, 1969.
Similar to bill.		Eligible expenditures limited to exploration and development in Canada and new mine assets.
Taxpayers should be allowed to establish a bank of earned depletion at the start of the new system, calculated by reference to past exploration and development expenses less depletion allowed.	Same as bill.	Same as bill.

ITEM	OLD LAW	NEW BILL
Non-operators' depletion	Non-operators receiving royalties or rentals computed by reference to production from mining or petroleum properties are entitled to a 25% depletion allowance.	Non-operators depletion at the rate of 25% continues until the end of 1976. Thereafter such rentals and royalties will be treated as production income and be eligible for 33 1/3% depletion, subject to the earned depletion rules.
Shareholders' depletion	Shareholders of certain mining and petroleum companies are allowed to exclude from income 10%, 15% or 20% of dividends received.	Repealed.
Purchase of mineral rights	No deduction.	Included with exploration and development expenses, but do not earn depletion.
Sale of mineral rights	Generally tax-exempt.	Proceeds taxable. For rights held at start of new system, 60% of proceeds taxable if sold in first year, 65% in second year, and so on until the ninth and subsequent years when full proceeds are taxable.
Prospectors and Grubstakers	Proceeds on sale of mining properties are exempt from tax.	Exemption from tax is withdrawn. Where property is sold to a corporation in exchange for shares of that corporation, prospectors or grubstakers may elect to pay no tax at that time; they are deemed to have a zero cost basis for the shares and to pay capital gains tax on the proceeds of disposal. The corporation it then deemed to acquire property at no cost.
Provincial tax abatement	Provincial tax abatement is now 10% and provincial mining taxes are deductible in computing taxable income.	After 1976, an extra tax abatement of 15% on mining income, and mining taxes will not be deductible.

PETROLEUM

COMMONS REPORT	SENATE REPORT	WHITE PAPER
Same as White Paper.	Retain old law for interests held on Nov. 7, 1969.	Repealed.
Same as bill.	Same as bill.	Same as bill.
Same as bill except that these costs should earn depletion.	Same as bill except that properties acquired directly from the Crown should earn depletion.	Same as bill.
Same as bill except that certain tax-free transfers should be permitted between related companies.	All mineral rights owned on V-Day should be valued at that time and subsequent disposals subject to capital tax only.	Same as bill.
Continue exemption for prospectors.	Continue exemption for both.	Same as bill.
Same as bill.	No comment.	No comment.

ITEM	OLD LAW	NEW BILL
Interest on money borrowed to buy shares		
Corporations	Corporations are not allowed to deduct interest on money borrowed to buy shares in other corporations.	Corporations will be allowed full deduction for this interest.
Individuals	Individuals are allowed to deduct interest on money borrowed to buy shares in corporations.	Full deduction of interest is continued for individuals.
The "Nothings"	Certain expenditures, called "nothings" are not deductible in the year incurred because they are capital in nature; and they are not depreciable because they do not give rise to an asset that is listed in one of the capital cost allowance classes. Examples of these nothings are goodwill, franchises for unlimited periods and incorporation costs.	A new 10% capital cost allowance class is created for "nothings". One-half of the cost of these assets will be depreciable, in line with the one-half rule for taxing capital gains and deducting capital losses. This new class will only apply to costs incurred after the new system commences.
Sale of goodwill	Proceeds on sale of goodwill are generally tax-exempt.	Proceeds on sale of goodwill owned at the commencement of the new system will be included in income to the extent of 20% if sold in the first year, 22½% if sold in the second year, 25% if sold in the third year, and so on until the thirteenth and subsequent years when 50% of the proceeds will be included in income. One-half proceeds of sale of goodwill connected with a business acquired or commenced after start of new system credited to "nothings" class.
Entertainment and related expenses	Deduction allowed for reasonable entertainment expenses, membership costs and similar expenses provided they are incurred to earn income.	No deduction for social and recreational club fees, or costs of yachts, fishing camps and other recreational facilities. Deduction for entertainment and conventions similar to old law, except for geographical restriction on conventions.
Depreciation		
Gifts	A gift of depreciable property is deemed to be a sale at fair market value.	No change except that on gifts of depreciable property to a spouse, the spouse is deemed to acquire the property at its tax cost.
Bequests	On bequests of depreciable property, beneficiary is deemed to acquire property at fair market value for purposes of future depreciation. No recaptured depreciation to deceased.	On bequests to a spouse, beneficiary is deemed to acquire property at its tax basis. On bequests to other persons, deceased is deemed to have sold the property at tax basis plus one-half of any accrued gain and beneficiary to have acquired property for that amount.

PROPERTY INCOME

COMMONS REPORT	SENATE REPORT	WHITE PAPER
Approved White Paper.	Similar to bill.	Interest allowed as a deduction to the extent of dividends received.
Approved White Paper.	Approved White Paper.	Interest allowed as a deduction to the extent of dividends received.
Similar to bill, except that all of cost would be depreciable.	Similar to bill except that all cost would be depreciable, with the proviso that the legislation be broad enough to allow the inclusion of all "nothings". Also, goodwill should not be treated as a "nothing", but should be treated in the same manner as land which is not depreciable.	Similar to bill except that all cost would be depreciable.
Should be no retroactive taxation of goodwill owned at commencement of new system. Minister of National Revenue should be prepared to approve changes in the valuation of goodwill included in existing sale agreements.	Goodwill should be valued on V-Day and when sold the gain or loss would be subject to the normal capital gains tax rules.	Similar to bill except that all proceeds would be taxable after the transition period.
Similar to bill.	Similar to bill.	More restrictive than bill; would have denied a deduction for entertainment and convention expenses.
No change from old law.	Recipient of gift should acquire property at its tax basis to donor plus any gift taxes paid.	No change from old law.
Deemed realization at death. Beneficiary depreciates property based on fair market value.	Same as White Paper except that the depreciation base should be increased by estate taxes on the property.	Beneficiary is deemed to have acquired property at its tax basis.

ITEM	OLD LAW	NEW BILL
Rental property	All rental buildings are included in one of two capital cost allowance classes, depending on the type of construction.	A separate class is created for each rental building costing $50,000 or more.
Termination of class	A terminal loss is deducted only when all assets of a particular class have been sold.	No change from old law.
Losses from holding property	Losses from holding property are fully deductible as long as property is held for the purpose of earning income.	No deduction from other income for loss incurred on real property held primarily to earn rental income if the loss resulted from depreciation. Also no deduction from other income for loss incurred on holding undeveloped real property (e.g. vacant land) as a capital investment, if loss resulted from interest and property taxes. The interest and property taxes can be added to the cost of the property.
Consolidated returns	No provision for consolidated returns.	No provision for consolidated returns.
Taxpayers in the professions	Individuals and corporations earning professional income are entitled to compute income according to the "cash basis".	Professional income will be computed under the accrual basis, except that work in process may be excluded. There are transitional rules to cover the deferred income at the start of the new system.
Farmers and fishermen		
Cash basis	Farmers and fishermen are entitled to compute their income on a cash basis.	No change.
Averaging	Farmers and fishermen are entitled to special income-averaging provisions.	No change.
Basic herd	Farmers are entitled to classify a herd of animals as a capital asset, "basic herd", and gains and losses are treated as capital gains and capital losses and are therefore tax-exempt.	Farmers will have an opportunity to establish a basic herd as at December 31, 1971. Basic herds will be valued on V-Day and any proceeds of disposal up to this value will be exempt from tax. Proceeds in excess of this value will be treated as farming income and eligible for the special forward averaging.
Straight-line depreciation	Farmers and fishermen may use straight-line depreciation instead of diminishing balance depreciation and thereby avoid recaptured depreciation. Gains on disposal of depreciable assets are treated as capital gains.	Straight-line depreciation phased out.

PROPERTY INCOME

COMMONS REPORT	SENATE REPORT	WHITE PAPER
Increase limit from $50,000 to $100,000.	No change from old law.	Same as bill.
Similar to White Paper.	Similar to White Paper.	At any time taxpayers could write down the net book value of a class to the aggregate of the original costs of the assets on hand. This write down would have to be made in any year in which control of a corporation changes.
Similar to bill.	Similar to bill except that provisions should only apply to property acquired after new system starts and should then only apply to taxpayers who are not in the business of renting property.	No deductions from other income for a loss from holding property, if that loss resulted from deducting depreciation, interest or property taxes.
Consolidated returns should be permitted on payment of a tax premium.	Consolidated returns should be permitted without payment of a tax premium.	Partnership option permits consolidated returns in certain circumstances.
Similar to bill.	Cash basis should be retained.	Similar to bill except that work in process had to be included.
Same as bill.	Same as bill.	Same as bill.
Same as bill.	Same as bill.	Same as bill.
Retain "basic herd" provisions.	Approved White Paper.	Because of full taxation of capital gains, the "basic herd" provision is no longer required.
No comment.	Same as bill.	Same as bill.

ITEM	OLD LAW	NEW BILL
Hobby farmers	A taxpayer whose principal business is not farming may deduct only $5,000 of farming loss annually from other income.	Similar to old law except that property taxes and interest which are not allowed as operating losses can reduce subsequent capital gains on sale of farm, but would not be allowed to create a capital loss.
Trusts	Trusts taxed at same rates as individuals although no deductions allowed for personal exemptions.	No change for trusts created by will. For trusts established by living persons, retained income taxed at higher of 50% or personal rates. For trusts existing at start of system that do not receive additional property, retained investment income taxed at personal rates.
	Income received by a trust which is payable to beneficiaries in year received is taxable in the hands of the beneficiary, not the trust.	Former treatment continued, and certain beneficiaries may elect to treat a prescribed portion of the retained income as their personal income and not trusts' income.
	Income on which a trust has paid tax can usually be distributed to beneficiaries without additional tax.	No change.
		On trusts for spouse, deemed realization on death of spouse. Other trusts, deemed realization every 21 years. Special rules for valuing trust interests for capital gains tax purposes.
Partnerships		
Partnership income	Partner taxed on his share of partnership income.	Similar to old law, with changes in computing partner's share of depreciation.
Interest in a partnership		Sale of partnership interests will give rise to capital gains or losses; special rules for computing tax basis and V-Day value.
Investment corporations	Investment corporations pay 21% tax on all taxable income. Dividends paid to shareholders eligible for dividend tax credit.	Canadian dividends received are exempt. Investment income and full capital gains taxed at 25%. Dividends paid eligible for dividend tax credit. Special capital dividends occasion refund to corporation of capital gains tax paid and treated as capital gain to shareholders.
Incorporated open-end mutual funds	Can qualify as investment corporation, otherwise treated as ordinary corporation.	Can qualify as investment corporation. If not qualified, dividends received subject to 33 1/3% refundable tax; full capital gains taxed at 25%; other income taxed at 50%. Dividends paid eligible for dividend tax credit. Redemption of shares occasions refund to corporation of capital gains tax paid and treated as capital gains to shareholders.

PROPERTY INCOME

COMMONS REPORT	SENATE REPORT	WHITE PAPER
Same as bill.	Same as bill.	Same as bill.
No recommendations.	Retain old law.	Trusts which accumulate income taxed at a flat rate of 50% (with lower rates in special circumstances). Recommended further study.
No comment.	No comment.	No comment.
Similar to bill.	Similar to bill.	Most mutual funds will be WHCs and dividends received will be taxed in the same manner as receipts by other WHCs. Capital gains distributions will be permitted to shareholders to the extent of capital gains made by fund and these distributions will carry a 33 1/3% credit. This capital gain distribution would be half taxable to individual shareholders.
Similar to bill.	Similar to bill.	Taxed as above for investment corporations.

ITEM	OLD LAW	NEW BILL
Unincorporated mutual fund trusts	Same rules as for other trusts.	Similar to old law except realized capital gains may be allocated to unit holders. Unallocated capital gains taxed at 25%, tax refunded as units redeemed. Gains on redemption of units treated as capital gains to unit holders.
Co-operatives (including caisses populaires and credit unions)	New co-operatives exempt from tax for first three years.	Three-year tax exemption is withdrawn.
	Income for tax purposes reduced by patronage dividend with limit that taxable income must at least equal the excess of 3% of capital employed over interest paid, other than to banks or credit unions.	Patronage dividends can reduce income to 5%.
	Caisses populaires and credit unions are now exempt from tax.	Caisses populaires and credit unions to be taxed in way similar to co-operatives.
Investment income of clubs and other non-profit organizations	Certain non-profit organizations such as golf clubs, professional associations and trade and business associations, are now tax-exempt on all income.	Investment income in excess of $2,000 of certain social and recreational clubs will be taxable.

PROPERTY INCOME

COMMONS REPORT	SENATE REPORT	WHITE PAPER
Similar to bill.	Similar to bill.	Unincorporated mutual funds will be treated as CHCs or WHCs.
Approved White Paper proposal.	Recommended further study.	Withdraw three-year exemptions.
Half integration rules should apply to taxable patronage dividends paid out of taxed earnings. Small business incentives should apply to eligible co-operatives.		Increase interest rate to reasonable market level. Interest deductions for patronage dividend limitations include only interest on loans from members.
Similar to bill.		Caisses populaires and credit unions to be taxed as co-operatives.
Suggested further study.	Only net investment income in excess of $5,000 should be taxed. Complete exemption should be given for organizations that are better classified as charitable organizations.	Full taxation of investment income.

ITEM	OLD LAW	NEW BILL
FOREIGN-SOURCE INCOME OF CANADIANS		
Foreign tax credits	Foreign income taxes paid are deductible from Canadian tax up to the effective Canadian tax on the foreign income.	Similar to old law except that after 1975 foreign tax credit on investment income of individuals is limited to 15%. Excess over 15% will be a deductible expense.
	No provision.	If foreign taxes paid on business income exceed the foreign tax credit available, the excess can be carried forward for up to five years.
Taxes paid to political subdivisions	No provision.	Foreign income taxes paid to political subdivisions either deductible as an expense or included in foreign tax credit calculations, depending on circumstances.
Dividends from foreign affiliates	Dividends received by a Canadian corporation from a foreign affiliate are exempt from tax.	Dividends out of pre-1976 earnings exempt from tax.
		Dividends out of post-1975 earnings exempt if paid out of profits earned in a treaty country; if from non-treaty country, wholly or partially exempt depending on level of foreign taxes.
Grandfather clause		Non-exempt dividends received after 1975 may be treated as a return of capital to the extent of the cost basis of the shares of the foreign affiliate at the end of 1975.
		For projects undertaken by the end of 1975 relief will be given on dividends for taxes spared under incentive legislation of developing countries.
Passive income	No provision.	After 1972, Canadian shareholders of a foreign affiliate will be required to include in income their share of the affiliate's investment income and capital gains for the year.
Foreign business corporations	Exempt from tax.	Exemption reduced to 4/5 of taxable business income in 1972, 3/5 in 1973, and so on until eliminated in 1976 and subsequent years.
	Dividends paid by these corporations are not eligible for the dividend tax credit.	Dividends paid after 1971 are eligible for the revised dividend tax credit.
TAXATION OF NON-RESIDENTS		
Withholding Tax	Standard withholding tax on investment income paid to non-residents is 15%.	Beginning 1976 standard rate increased to 25%, lower rates by treaty.
	Dividends paid to non-residents by a corporation with a degree of Canadian ownership are subject to a 10% withholding tax.	Withholding tax rate continues to be 5% less than rate otherwise applicable.

COMMONS REPORT	SENATE REPORT	WHITE PAPER
Similar to White Paper.	Retain old law.	Similar to bill.
Similar to bill.	Similar to bill.	Similar to bill.
Same as White Paper.	Same as White Paper.	To be covered by tax treaties on a reciprocal basis.
Similar to bill.	No change from old law.	Similar to bill except that the date was the end of 1973.
Similar to bill.		Similar to bill.
No provision.	No provision.	No provision.
Similar to bill.	No provision.	No provision.
Restrict passive income rules to diverted income.	Rejected White Paper proposal, but recommended that old law be applied more strictly to curb abuses. Should help Canadian exporters.	Similar to bill except that passive income included "trans-shipment profits".
Similar to bill.	Similar to bill.	Similar to bill.
Similar to bill.	Retain old law and eliminate withholding taxes on interest payments to arms-length foreign lenders.	Similar to bill except that January 1, 1974 suggested date for increase.
No comment.	Similar to bill.	No comment.

ITEM	OLD LAW	NEW BILL
Pension and similar payments	No withholding tax.	Subject to withholding tax. Exemption for $960 of old age security payments and up to $1290 annually of Canada or Quebec Pension Plan payments. Alternatively, non-resident may elect to pay tax on his Canadian income, other than investment income.
Canadian branch of foreign corporation	Pays a special 15% tax on after-tax branch profits, to the extent these are not re-invested in capital assets.	Beginning 1976, rate of tax 25% subject to treaty reduction. Allowance for reinvestment extended to working capital, made cumulative and subject to recapture.
Thin capitalization	No provision.	If the ratio of shareholders' equity to debt due to non-resident shareholders who have a 25% interest in the corporation is less than 1:3, part of the interest paid is not allowed as a deduction.
Non-resident owned investment corporations (NROs)	Taxed at 15%.	Income includes full capital gains that are taxable to non-residents, but not other gains. Beginning in 1976 tax increases to 25%.
	No withholding tax on dividends.	Dividends out of post-1971 earnings subject to normal withholding tax. The income taxes paid on earnings (only one-half of tax on capital gains) refunded to the corporation.
Capital gains	Capital gains are not taxable.	Non-residents are taxable on gains from Canadian real property, Canadian business assets, shares of Canadian private corporations and substantial interests of Canadian public corporations.

INCOME

COMMONS REPORT	SENATE REPORT	WHITE PAPER
Similar to bill without exemption.	Rate should be 15%.	Similar to bill without exemption.
Similar to bill.	Similar to bill.	Similar to bill.
Similar to bill.	Rate should continue at 15%.	Similar to bill.
Similar to bill.	Similar to bill.	Similar to bill.
Taxation of NROs should be equivalent to the tax paid by corporation's sharehol-ders if they had personally received the income.	Retain old law.	Similar to bill except that increase in rate would take place in 1974. Same as old law.
Similar to bill.	Capital gains realized by non-residents should be exempt from tax, unless gain is related to a business carried on in Canada.	Similar to bill.

PART C

DETERMINATION OF BUSINESS INCOME

CHAPTER 22

GENERAL BUSINESS INCOME

We are concerned in this chapter with the measurement of business income. Individuals either own businesses directly as proprietors and partners, or own them indirectly by holding residual claims against intermediaries, such as corporations, co-operatives and trusts, that carry on business. We have already discussed the tax implications of carrying on business through these particular forms of intermediaries in Chapters 19, 20, and 21. The important conclusion was that the business income accruing to the benefit of an individual taxpayer should be measured by common standards regardless of the particular kind of business or the form of intermediary through which it passes. Therefore, in this chapter we are concerned with the determination of the income of a business without regard to the legal form under which it is conducted.

Succeeding chapters deal with the problems of measuring and taxing the business income of taxpayers in some industries that have unique characteristics. These are mining, petroleum, financial institutions (including life insurance), farming, forestry, fishing, general insurance, and construction. In seeking to resolve these problems our objective is to achieve neutrality in the treatment of business income arising from different kinds of businesses.

Although this chapter is concerned with the determination of business income, it is important to keep in mind that much of the significance attached to the source of income under the present legislation would disappear under our proposals. Of particular importance is the elimination of most of the tax consequences of the present distinction between income from business and income from property, a differentiation that is often difficult to make and has caused much of the uncertainty and inequity in the present tax system. Therefore, although it is useful for descriptive purposes to discuss our proposals as they apply to the various sources of income, we will suggest very few measures that are applicable to only one of the sources.

THE PRESENT SYSTEM IN GENERAL

Income from a business is brought into charge under sections 2 and 3 of the Income Tax Act, and section 4 provides that income from a business for a taxation year is the profit therefrom for the year. Section 139(1)(e) provides that business "includes a profession, calling, trade, manufacture or undertaking of any kind whatsoever and includes an adventure or concern in the nature of trade but does not include an office or employment".

The provision in section 4 that income from a business is the "profit" therefrom requires a determination of profit. That term is not defined in the Act but in practice the starting point for such determination is usually profit as established under recognized accounting practices 1/. Such practices must yield, however, both to express provisions of the Act and to decisions of the courts holding that in certain respects such practices are not applicable in the computation of income for tax purposes.

In calculating profit it is, of course, necessary to consider what is to be brought into income, when the income is to be brought into account, what expenditures are deductible and when such deductions can be made.

In determining what is to be brought into income, accretions to capital or property gains and other capital items are now excluded, in accordance with the established doctrine discussed in Chapter 9. There are also certain statutory exemptions which will be referred to later in this chapter.

Business income is ordinarily brought into account on the accrual basis, although farmers and members of professions may compute income on the cash method 2/.

The use of the word "profit" in the general definition of income from a business necessarily means that only net income is to be taxed, that is, gross revenue less the costs incurred in producing it. Such costs are, broadly speaking, of two kinds: those incurred in the day-to-day operation of the business, and an appropriate proportion of those costs incurred for the production (or preservation) of future revenue.

In determining whether particular expenses are deductible, account must be taken of recognized accounting practices, the express provisions of the Act and established legal doctrines. There are a number of provisions that limit the deductibility of certain expenditures. In Chapter 9 we discuss: section 12(1)(a) which prohibits the deduction of any outlay or expense except to the extent that it is made for the purpose of gaining or producing income; section 12(1)(b) which prohibits the deduction of capital expenditures or allowances for depreciation, obsolescence or depletion except to the extent that they are specifically permitted by the Act; section 12(1)(c) which prohibits the deduction of an outlay or expense if made to produce exempt income; section 12(1)(h) which prohibits the deduction of personal or living expenses of a taxpayer except for designated travelling expenses; and section 12(2) which prohibits a deduction in respect of an otherwise deductible expenditure except to the extent that it is reasonable in the circumstances.

The exclusion of capital receipts from income is based on legal decisions rather than any express provision of the legislation. The law contains a general prohibition against the deduction of capital expenditures 3/. Allowances for some capital expenditures, such as the cost of fixed assets, specified interest payments and certain costs of obtaining financing are expressly permitted 4/. Other capital expenditures, because the Act does not specifically permit their deduction, may not be deducted either currently or, because they do not fall within the capital cost allowance provisions, over a period of time, and are known for tax purposes as "nothings".

As to the timing of deductions, the ordinary rules of accrual or cash accounting, depending on the method followed by the taxpayer, will usually apply.

Income for the year is income from all sources, 5/ and a taxpayer is permitted to deduct a business loss from his other income in the year in which the loss was sustained. He may also carry business losses back one year and forward five years, but only against business income 6/. This is

subject to restrictions in the case of a corporate taxpayer if control of the corporation changes and the business in which the loss was incurred is discontinued 7/. The rule as to deduction of business losses from other income is subject to a limitation in the case of so-called "hobby farmers", as explained in Chapter 25 which deals in part with agriculture.

We also consider in this chapter the position of new and small businesses, which have a very important place in the Canadian economy.

Appraisal

We have reviewed briefly the present general rules for the taxation of business income relating to the revenues and gains which are brought into account, the expenditures and outlays which are deductible, and the time when the revenues and expenditures are taken into account. When viewed in the light of our comprehensive tax base it appears to us that the present rules are deficient in all three respects. Under our approach, all revenues and all expenditures must be taken into account in the computation of income and the principal problems remaining are those of timing.

The provisions of the present legislation with regard to the carry-over of business losses and their application against other income are in our opinion too restrictive, and we shall make suggestions as to ways in which they should be liberalized.

We have also considered the existing rules relating to the tax treatment of business transactions between persons who do not deal at arm's length, as in the case of parent and subsidiary companies. We think that these rules are inadequate and that more comprehensive regulation of such transactions is required.

MAIN PROBLEM AREAS

Application of Accounting Practices

We mentioned earlier in this chapter that under the present tax system the usual starting point for the determination of profit from a business is

the application of recognized accounting practices. We also pointed out that such practices are in some cases overridden by statutory provisions and legal decisions. The courts look to accounting practices in determining the meaning of profit, but have found that such practices are not always permissible for tax purposes.

The present statute does not expressly state that business income is to be computed according to recognized accounting practices. We have considered whether some such provision could now usefully be inserted in the tax legislation. Such a change might permit the elimination of a number of statutory rules and the simplification of the legislation generally. In Chapter 9 we pointed out that this same question was the subject of serious consideration at the time of the revision of the Canadian income tax legislation in 1948, and that it was then decided that the wide divergences in accounting practices were such that a provision of this kind was not practicable. The result was that the statute simply provided that income from a business was the "profit" therefrom.

In view of the many developments in the principles and practices of accountancy, we felt we should put to the accounting profession itself the question whether a specific reference in the legislation to accounting principles or practices would be desirable. The question was referred to a Special Tax Committee of the Canadian Institute of Chartered Accountants and referred by that Committee to the Institute's Accounting and Auditing Research Committee. In view of the importance of the matter, the full text of the reply of the latter Committee is given in Appendix A to this Volume. It states that the majority of the Committee reached the conclusion that a specific reference to accounting principles or practices in the income tax legislation would not be desirable.

We have concluded that the opinion expressed by the Canadian Institute of Chartered Accountants should prevail, and that the income tax legislation should not contain a provision prescribing the application of accounting principles and practices in the computation of profit. This conclusion does

not imply that accounting principles or practices are deficient, for indeed, we believe that recognized accounting practices should be taken into account, subject to the express provisions of the legislation and applicable court decisions as is now the case. Rather, it reflects our belief that the concept of income for tax purposes has unique characteristics which are frequently at variance with accounting concepts. In the detailed discussion below, we propose that some of the present statutory provisions affecting the computation of income from a business should be repealed, and we expect that if this were done the courts would look more to accounting and business practices in the future than they have in the past. However, in areas where these practices were not sufficiently precise for tax purposes some statutory rules would have to be used, and because such rules would doubtless have to cover many situations they might have to be arbitrary in order to avoid undue legislative complexity.

When we approached the Canadian Institute of Chartered Accountants, we were unable to tell them of the material changes in the computation of business income for tax purposes which the adoption of our comprehensive tax base would bring about. We believe it is unlikely, however, that the opinion they formed would be altered by our proposals.

Inclusions in the Tax Base

In determining the income of a business for tax purposes it is necessary at present to distinguish between gains of an income nature and those of a capital nature. Earlier in this Report we discussed the development of this concept in Canada and also summarized the treatment in the United States and United Kingdom. As far as a business is concerned, gains of an income nature are those arising in the ordinary course of the commercial activities which the business was formed to carry on, an obvious example being the revenue from the sale of inventory to customers. Gains of a capital nature may arise from the disposition of the business itself as a going concern or of all or part of what may be called the permanent structure of the business, an example being the gain on a disposition of the land,

buildings or equipment of the business. As such assets are regarded as capital assets, gains arising on their disposition are ordinarily regarded as accretions to capital and are not normally brought into income for tax purposes. In some of the legal decisions the distinction is drawn between receipts from the disposal of circulating capital, which are income, and those from the disposal of fixed capital, which normally are not.

There are some statutory exceptions to the rule that the proceeds of disposition of capital assets are not taxable. Under section 6(1)(j), amounts received which are dependent upon the use of, or production from, property are brought into income even if they are instalments of the sale price of property (other than agricultural land). This provision materially limits the forms in which a transaction may be cast without giving rise to tax liability by the vendors of properties such as patents, franchises and mineral rights. Under section 20, capital cost allowances taken on depreciable assets may be recaptured if the assets are sold for more than their undepreciated capital cost. On the sale of a business or part of a business, the consideration received for inventory must, under section 85E, be taken into account in determining income.

Other illustrations may readily be given of the distinction which has been drawn by the courts between gains of an income nature and gains of a capital nature. Thus,profits on foreign exchange will be taxable if they relate to inventory transactions, but not if they relate to the acquisition of capital assets. The proceeds of fire insurance will be treated as taxable if the property damaged or destroyed is circulating capital, but not if it is fixed capital (unless by way of recapture of depreciation). Compensation received for the failure of the other party to carry out a normal commercial contract will ordinarily be treated as income, but if the contract is one of major importance and forms part of the permanent structure of the business such compensation may be treated as capital. Government subsidies will be regarded as income if they are granted to supplement income, but as capital if their purpose is to assist in the acquisition of capital assets.

We have already referred to the difficulties under the existing system of determining whether a business is being carried on and whether particular income is from business or from property. Where it is plain that a business is being carried on, it may still frequently be difficult in practice to distinguish between gains of an income and those of a capital nature.

Because capital is invested in a business or property to gain an economic reward, we think it follows that any resulting gain of any kind should be taken into account in the determination of income for tax purposes. Accounting practices recognize that in the long run all revenue, as well as all expenditure, must be taken into account in measuring the income of a business. Because income is measured in annual periods, the main concern is to produce a record of annual earnings that indicates fairly the progress of the business. It is recognized that to a considerable extent the allocation of revenue and expenditure between annual periods is necessarily inexact, and that the inclusion in one year of miscellaneous amounts having to do with a different year is inevitable. The main concern of the accountant is to show such amounts separately if they would otherwise materially distort the income for the year concerned. But even though they are shown separately, they would usually be included in the calculation of total income for the year, and would certainly be included in arriving at income accumulated to date. On the sale of an asset, any costs applicable to it that have not been written off previously as an expense would be charged against the proceeds of the sale and, to the extent that such proceeds exceeded the unabsorbed cost, the excess would usually be regarded as income available for distribution.

Thus, the position under the present law is that a distinction of little significance to businessmen or accountants is of major importance for tax purposes. In the business world the question is not whether, but how or when, particular receipts or expenditures should be reflected in earnings. For tax purposes the segregation of capital and income items is now fundamental. This distinction is inequitable in our view, because any gain or loss changes the economic power of the taxpayer. In addition, the current tax treatment has

produced uncertainty and has given an exaggerated importance to the tax implications of many business transactions.

The present exemption of property gains from tax frequently leads to attempts to cast transactions in a form which minimizes tax. For example, on the sale of a business there may be considerable advantage to the purchaser, with no disadvantage to the vendor, if the consideration for goodwill is included in the price of a depreciable asset. As we shall see later in dealing with expenditures, there is also a significant anomaly within the tax system because the cost of developing a capital asset such as goodwill may be deductible, for example, the cost of advertising, whereas the proceeds of these assets when sold are non-taxable. The desire to realize non-taxable asset gains may also cause taxpayers to sell their businesses or business assets, rather than operate them to earn income that would be taxable.

At the present time, gifts received by a business are not ordinarily included in income for tax purposes. Cancellation of debt generally gives rise to income only when it is considered to be some kind of price rebate. Under the comprehensive tax base all such gains would be included in income. The implications of this change are discussed in Chapters 17, 18 and 20.

The comprehensive tax base that we recommend requires that all revenue be included in the tax base regardless of the way in which it arises or the source from which it comes. The adoption of this base would not only establish a common ground on which to measure the business income of all taxpayers but would also produce the following results:

1. Reduce uncertainty in the present tax system by removing the distinction between property gains and income.
2. Simplify the present legislation by permitting the elimination of provisions necessitated by such distinction.
3. Bring the tax treatment into closer touch with the realities of the business world and thereby reduce the effect of tax considerations on business transactions.

Timing of Revenue

The ideal method of determining the business income of all taxpayers would be to measure changes in economic power, including unrealized revenue. This approach would recognize that the creation of revenue is a gradual and continuous process, starting, for example, with the construction of production facilities and continuing through the development of a market, the taking of orders, the production of a commodity, and finally to the sale and delivery. Because all these steps are necessary in creating revenue, why should recognition of the revenue be delayed until the final moment of sale? We discuss in Chapter 8 the problems that would arise if income was recorded only when realized.

Completely objective measures of the potential revenue created at various stages in the process have not yet been developed, so that compromises are necessary. The determination of income is today a matter of recognizing revenue when the readily identifiable events of sale or disposition take place and of matching costs as accurately as is practicable against that revenue. In considering whether revenue should be recognized as arising at other times, it is important to bear in mind that objectivity, which is one of the prime considerations in accounting, is equally essential for tax purposes and therefore we cannot contemplate, at least for the present, a tax system based on rules less objective than those used in accounting.

Under accounting practice, revenue is not usually taken into account until goods or services have been provided to the customer and cash or a legal obligation convertible into cash has been received for them. Not infrequently, of course, amounts are received in advance of the provision of goods or services. Uncertainty as to the proper treatment of such amounts led to the enactment of section 85B of the Act, which deals in a comprehensive fashion with the timing of revenue. This section provides that "...every amount received in the year in the course of a business...that is on account of services not rendered or goods not delivered before the end of the year or that, for any other reason, may be regarded as not having been

earned in the year or a previous year" shall be included in income, but it also permits reserves to be established in respect of the portion of such amounts unearned during the year. The section also provides that (unless the taxpayer is on the cash basis) in computing income "...every amount receivable in respect of property sold or services rendered in the course of the business in the year shall be included notwithstanding that the amount is not receivable until a subsequent year...", and it permits certain reserves to be established in respect of amounts so receivable for property sold.

Because this section does not differ greatly from business practice and provides a legal framework within which to determine a taxpayer's liability, it may be thought to provide a satisfactory rule for tax purposes. We cannot, however, view the section with complete satisfaction. It is open to the objection that it requires amounts to be included in revenue that may not give rise to any net income at all, and the taxpayer is not assured that offsetting relief is afforded by the section. The provision, as it stands, is so complex that many of its implications are still not fully understood, even though it has been in the legislation since 1953. It is broad enough to deal with many of the situations which may arise in practice but there are still areas of uncertainty 8/. It appears to us that one of the key provisions that makes the section workable is that the reserves to be deducted must be reasonable, and yet this same test would be applied in any computation of profit according to recognized accounting practices. In their appearance at the public hearings of this Commission, representatives of the Canadian Institute of Chartered Accountants recommended the repeal of section 85B, subject to the retention of specific rules regarding instalment sales and the introduction of an allowance (which the section now denies) for guarantees, indemnities and warranties 9/. We agree with this proposal, because we have concluded that accounting and business practices have developed to a satisfactory degree.

Another problem with respect to the timing of revenue arises from the fact that, although revenue may be treated as realized when a sale is made

on credit, the receivable may turn out to be uncollectible. This possibility is recognized in the present legislation by paragraphs (e) and (f) of section 11(1) which permit, respectively, the deduction of a reasonable reserve for doubtful accounts and for accounts which turn out to be bad. In general, these provisions have proven satisfactory, although certain taxpayers have complained that the tax authorities place too much emphasis on an examination of specific accounts in determining what reserve is reasonable.

Under section 12(1)(e), no deduction of reserves is permissible in computing income unless such reserves are expressly provided for in the legislation. Apart from allowances for depreciation and depletion, this means that reserves for business generally are restricted to those permitted under sections 11(1)(e) and 85B. These provisions may have been necessary in the days when the businessman determined arbitrarily the amount set aside from profits for various purposes. However, we believe that the general prohibition of reserves has led to an over-emphasis by the tax authorities on the time at which revenues are recognized, and that in the present state of accounting and business practice such a provision is undesirable.

It also should be noted that the Canadian Institute of Chartered Accountants has recommended that the term "reserve" be applied only to a restricted number of items 10/. We suggest that in any future legislation the terminology suggested by the Institute should be taken into account.

In view of the foregoing considerations, we recommend the following:

1. The general disallowance of reserves should be deleted from the legislation.
2. The present specific provisions for reserves, namely, sections 85B and 11(1)(e), should also be repealed; with the result that the general statutory test of reasonableness would then apply to allowances for unearned income, to allowances for estimated losses in the value of accounts receivable, and to allowances in respect of the losses that could result from guarantees, indemnities and warranties.

3. In those cases where a test of reasonableness is difficult to apply and where it would be feasible to employ an arbitrary standard, the legislation should contain specific provisions with arbitrary rules to eliminate uncertainty. However, such rules should be framed so as to permit the most accurate estimate to be made of the average losses anticipated and should not make any allowance for contingencies. Thus, in Chapter 24, which deals with financial institutions, we recommend that specific arbitrary percentages should be established for the use of banks in valuing their loan accounts, and for all taxpayers in valuing real property mortgages receivable.

The implementation of these recommendations would be facilitated by consultations between the business and professional communities and the tax authorities, and we envisage that such consultations could take place through the informal advisory committees we recommend in Chapter 32.

This discussion concerning the timing of revenue for tax purposes has been in terms of the "accrual" basis of accounting, which we consider gives the best measurement of business income. The use for tax purposes of another common method of accounting referred to as the "cash" method is discussed later in this chapter.

Deductibility of Costs

Our affirmation of the general principle that all realized revenues of a business should be brought into income carries with it the further principle, to which we subscribe, that all reasonable business expenditures should be deductible at some time. However, we have also expressed support for the cardinal principle that in computing his taxable income no taxpayer should be permitted to deduct costs of a personal consumption nature. Thus, while we suggest that all costs related to the earning of income should be deductible at some time, we point out in Chapters 7 and 8 that expenditures which relate to personal enjoyment, use, or consumption cannot be allowed to reduce the comprehensive tax base. The problem in determining what costs

should be deductible is to ascertain whether an expenditure reasonably relates to the earning of income or is of a personal consumption nature. Most of the following discussion is concerned with establishing procedures for making this distinction in a feasible manner. We also consider the problem of determining the time at which a deductible expenditure should be allowed as a charge against income.

In Chapter 9 we discussed the deduction provisions contained in the present legislation, and the implications for these provisions of the adoption of the comprehensive tax base. We then suggested which sections of the Act could be eliminated and what general changes should be made in the remaining sections concerning the deductibility of expenditures. More important, we recommended that the sections remaining should be applicable to all income and should not be restricted in application to certain kinds of income. It is useful at this point to review the conclusions detailed in Chapter 9 and to point out their implications for the determination of income from a business. It is important to keep in mind that business income would continue to be determined for tax purposes in accordance with recognized accounting practices, but would be subject to the express provisions of the legislation and to any applicable legal decisions.

Section 12(1)(a) denies a deduction for an outlay or expense that was not made for the purpose of producing income. We believe that this limitation is unduly restrictive for there are expenditures, such as those which save costs, which may not be productive of income in a narrow sense but which should be allowed. Therefore, we suggest that the legislation should provide for the deduction of expenditures that are reasonably related to the gaining or producing of income. Such a provision should be expressed in wide, general terms.

Section 12(1)(b) provides that no deduction may be made in respect of capital expenditures or in respect of depreciation or depletion except as expressly permitted in the legislation. The general denial of a deduction of capital expenditures in computing income is simply another reflection of

the distinction between income and capital items for tax purposes which has existed in Canada since income tax legislation was first introduced. Accretions to capital have not been included in the computation of income, and expenditures for capital purposes have not been deductible. It is clear that the distinction between current and capital expenditures is frequently difficult to draw and has caused, and is continuing to cause, confusion and uncertainty among taxpayers and the tax authorities.

Some types of capital expenditure may qualify for capital cost allowance so that in some cases the question of whether an expenditure is a current or capital item simply affects the timing of the deduction. There are, however, a number of types of proper business expenditures, the so-called "nothings", which have been considered to be of a capital nature but for which no capital cost allowance is permitted. Examples of expenditures falling into this category include the cost of obtaining or terminating contracts of particular types, the cost of acquiring lists of customers, certain losses on advances to suppliers or customers, certain costs related to the issuance of securities, payments for goodwill, and certain expenditures for projects which are proposed but not consummated, for example, payments under options and architects' fees.

During our public hearings we received representations concerning the treatment of expenditures of this nature from a number of participants including the Canadian Bar Association and the Canadian Institute of Chartered Accountants. The 1965 amendments to the Income Tax Act provided relief in respect of a few such items. Under the comprehensive tax base all business expenditures would be allowable at some time, so that the problem would then become one of timing. Accordingly, we recommend that all expenditures that would be deductible under our test should be taken into account when incurred, unless they result in the acquisition of an asset which either falls within the definition of a specific capital cost allowance class, or is an asset, such as land or securities, which is not ordinarily expected to depreciate in value and the cost of which would be taken into account in computing the gain or loss when the asset was

disposed of. This would involve an extension of the present capital cost allowance system, and would mean that a particular business expenditure would be deductible when incurred unless it was the cost of an asset of the type referred to above or was an item that the legislation specifically required to be amortized over a period of time. Much of the present uncertainty would disappear, and the term "nothings" would become obsolete. This recommendation is discussed further in the next section on "Timing of Costs".

The deduction of expenditures for the purpose of producing exempt income is denied by section 12(1)(c). Under the comprehensive tax base, we anticipate that exempt income would be virtually eliminated, and that such a provision would cease to be necessary. We also propose that the present specific restrictions on the deduction of interest expense should be repealed.

Section 12(1)(h) denies a deduction for personal or living expenses except for certain travelling expenses. We have already emphasized that a very difficult and important distinction must be made between business and personal expenditures, for there can hardly be fair treatment of all taxpayers if some can charge personal expenses against taxable income and others cannot. The problem is broader than that already discussed in connection with employment income because it can also involve personal benefits provided to customers or suppliers of the business or to the owner of the business. In the last case, there is no natural constraint on the amount of the benefit because the payer and recipient are the same. We have already proposed a general rule that expenses be related in a general way to the earning of income. In addition, we recommend the retention of the present section 12(2) that limits deductions to an amount that is reasonable in the circumstances. We also agree that a provision is required to prohibit the deduction of expenditures that are of a personal nature. We have already discussed the current interpretation of section 12(1)(h) by the courts, and we have expressed the belief that, at least initially, it should continue to be left to the courts to establish the rules for border-line cases in this area. Some specific and arbitrary rules should, however, be included in the

Regulations to indicate the amounts to be deducted for specific kinds of expenditures where the uncertainty is great or where as a matter of policy a particular rule is to be adopted.

In Chapter 14, we suggested specific rules for travel and entertainment expenses, commuting expenses, club dues, etc. The guidelines we laid down there for identifying and valuing personal benefits should also apply to business income. The general approach for dealing with expenses that benefit employees should be applied to expenses that benefit customers, suppliers, or shareholders, that is, the expenditure involved should generally be deductible in determining the income of the business, and should be reported in the income of the individual who received the benefit. Failing such identification with the recipient, tax on a grossed-up basis at the top personal rate should be payable by the business whether or not the business was itself tax-exempt. The tax so paid by the business should be treated as an expense for tax purposes. Where the expenditure represented a gift conferred by an owner of the business, the amount thereof should be treated as income of the actual recipient, because it would represent a gift to him, and should also be taxed, on a grossed-up basis, to the owner of the business.

Section 12(2) denies the deduction of expenses to the extent that they are not reasonable in the circumstances. This provision, which has not been the subject of a great deal of litigation, permits the Department of National Revenue to disallow expenditures which could hardly be justified from a taxation point of view. Thus, it is a necessary part of the legislative measures that are required in order to differentiate between expenditures for the purpose of earning income and those that are of a personal nature. It is true that the test has given rise to some complaints because businessmen feel that they should be the best judge of what expenditures are reasonable for the purposes of their business, and we appreciate this point of view. However, it seems to us that this constraint on the principle that all business expenditures should be allowed is a fair one and should be retained. The question of reasonableness in particular circumstances would, of course,

continue to be left to the courts for ultimate determination in the event that the taxpayer and the tax authorities were unable to resolve a dispute.

Timing of Costs

If business income could be measured in terms of increments in economic power, whether realized or not, there would be no need to deal separately with expenditures. The result of operations would be shown by comparing the net change in economic power for any given period, thereby automatically allowing for both the incomings and the outgoings. Because it is not always possible to measure a change in economic power when it is not realized, and one is ordinarily forced to recognize revenue only when a transaction takes place, we have to deal separately with expenditures. Expenditures usually precede the realization of related revenue, so that the rules for measurement of business income must provide for the treatment of expenditures made in advance of the receipt of revenue.

One approach is often referred to as a process of matching costs against revenue. As we shall see in reviewing different types of costs, it is often difficult to identify specific costs with specific revenue, and, moreover, there is no certainty that any revenue will result from many types of expenditures.

Another approach is to treat expenditures as costs when incurred except when it is known they will bring future benefit. Under this approach, assets on a balance sheet, such as inventory and depreciable assets, can be viewed as residues of unabsorbed costs that are being carried forward against future periods.

Both these approaches raise the common problem that they require estimates to be made of the extent to which expenditures already made will produce a benefit in future periods. In other words, even though revenue is usually brought into account when realized, costs must frequently be carried forward beyond the period in which they were incurred. For this reason the treatment of costs is one of the most difficult problems in

accounting practice, and arbitrary rules may be necessary for tax purposes to provide certainty in the treatment of taxpayers in different businesses and to minimize differences in the treatment of their costs.

Inventory. The word "inventory" generally is used to describe goods which are purchased or manufactured for sale in the ordinary course of business. The purpose of inventory accounting is to bring certain costs into appropriate accounting periods. The determination of business income is then simply a matter of delaying the deduction of the costs of obtaining or creating the inventory until its sale. For a simple retailing operation in which goods are sold very soon after being purchased this is a fair statement, but for many business activities the matter is not simple. There are difficult problems in deciding which costs should not be written off as incurred but included in the inventory, and in determining by objective standards the extent to which the costs will benefit future periods 11/.

These difficulties are largely glossed over in the present provisions with respect to inventory valuation for tax purposes. Section 14(2) of the Act permits inventory to be valued at cost or market, whichever is lower, and section 1801 of the Regulations permits inventory to be valued all at cost or all at market. The terms "cost" and "market" are not defined. In practice, the various ways of determining "cost" and "market" under accounting methods are usually accepted, although there are some areas of dispute. For example, there may be difficulties regarding the amount of overhead to be included in cost, or regarding the valuation of second-hand items. In cases where the cost of inventory is written down to estimated market value, the tax authorities may contend that such an adjustment constitutes a "reserve" that is not allowed by the legislation.

It is evident that the rules regarding inventory valuation in the present legislation reflect the variety of methods used in practice, but they do little to help with the real problems, and should be removed. At the same time complex legislation would be necessary to provide satisfactory rules to ensure that taxpayers with businesses in different circumstances

would be treated fairly. Because the tax authorities are concerned with the degree of variation in inventory valuation found in businesses in similar circumstances, we considered the desirability of simple specific rules to ensure a minimum common standard in measuring business income. For example, one such rule would be to require that all businesses include in inventory the costs of the estimated variable and fixed overhead applicable to their inventory. We concluded, however, that specific rules should be introduced only if, after consultation between the tax authorities and the business and professional communities, there was little consensus on acceptable methods of valuation, and if the courts' interpretation of the word "profit" did not produce a satisfactory result.

Once the amount of cost embodied in an inventory has been determined, there remains the problem of matching that cost against the proceeds of sale. Such identification is often physically impossible, and a common assumption is that the items first purchased or manufactured are those which are first sold (first-in-first-out method), or alternatively that the cost of an item sold is represented by the average cost of items on hand at the time of the sale. In a period of rising prices the matching of costs in order of purchase or manufacture against the current selling price will result in higher recorded profits than with the average cost method. Conversely, in a period of falling prices, the recorded profits would be lower under the first-in-first-out method. Use of the average cost method accelerates the rate at which the recorded costs change after prices have risen or fallen. Another assumption used in certain businesses is that the last items of inventory purchased are sold first (last-in-first-out method). The emphasis in the last-in-first-out method is entirely on matching changing costs with revenues.

The present legislation offers no guidance on the appropriate method of matching costs of inventory against revenue. In the well-known Anaconda case 12/, however, it was held that this is one area where a practice that was acceptable for accounting and commercial use was not always acceptable for

tax purposes. The Supreme Court of Canada found that the last-in-first-out method of inventory valuation was an acceptable accounting method of determining profit for tax purposes in the circumstances of the particular business 13/. However, the Privy Council reversed this decision on the grounds that while the method might be acceptable for accounting or commercial purposes, it was not acceptable for tax purposes because, on the assumptions made, it disregarded ascertainable physical facts relating to the value of the remaining inventory, and permitted an increase in inventory values to be free of tax in a period of rising prices, and so was not appropriate to a tax system which measured income on a year-to-year basis 12/.

In this context, we believe that the tax purpose is at variance with the accounting purpose. Under the accounting purpose we can see that in certain circumstances there is some validity in using the last-in-first-out method of inventory valuation in measuring the annual income of a business as a going concern. Although accountants are somewhat concerned about the balance sheet inventory value that may result from this procedure, many accountants regard balance sheet considerations as secondary to those of the income statement. For tax purposes, we are of the opinion that the cost figure attributed to inventory on hand should be close to its most recent cost, and that the first-in-first-out method is generally preferable.

Although we have this important reservation about the use of the last-in-first-out method of inventory valuation for tax purposes, we recognize that in those circumstances where it is particularly appropriate, taxation based on other methods may cause a strain on cash resources for temporary periods. We have therefore given careful consideration to whether a means could be found to permit limited use of the last-in-first-out method for tax purposes, which would prevent it from being used as a protection against inflation and yet at the same time meet the requirements of these taxpayers. Such an approach would mean that the inventory value could not depart materially from current market value. If market values rose above cost as calculated under the last-in-first-out method, the inventory value should

be adjusted upwards so that it was no less than, say, 80 per cent of the average market value of the past three years, including the current year. If, on the other hand, market values fell below cost and the inventory value was therefore written down to market, it should be adjusted upward by any subsequent market recovery until its original cost value was reached. After that point, inventory values would be adjusted above cost only when cost was less than 80 per cent of average market value as already stated. In addition, we believe that any such provision should be limited to those industries where this method of inventory valuation is suitable to the circumstances of the industry and is actually used by businesses in their financial statements. As noted in the Exchequer Court decision in the Anaconda case, 14/ the last-in-first-out method is appropriate in circumstances where the sale price of the finished product closely reflects the current replacement cost of the materials content of the finished product, the inventory is large with a slow rate of turn-over, and the company does not speculate or trade in its materials. With these restrictions, it seems to us that only those taxpayers to whom the last-in-first-out method was particularly suited would make use of the provision, and that at the same time it would be useful to them. We have also given consideration to the economic implications of this method of inventory valuation. As we have already indicated in the discussion on economic stability in Chapter 3, investment in inventories is a source of short-run instability. Because the last-in-first-out method of inventory valuation tends to reduce profits in periods of rising prices, and to increase profits in periods of falling prices, its use might tend to stabilize business decisions. On the other hand, it would reduce the funds diverted to taxation in periods of upswing and would increase the diversion of funds in times of downswing with a destabilizing effect on the supply of funds to business.

In view of these considerations, we recommend that those businesses for whom the last-in-first-out method of inventory valuation is suited (as above set out) should be permitted to use that method, provided that they use it for their financial reporting and that, for tax purposes, the value

attributed to the inventory should not be permitted to fall below 80 per cent of the average market value. With the exception of these rules concerning the last-in-first-out method, we think that the valuation of inventories should not be subject to legislative rules.

Depreciable Assets. We now consider the timing of the deduction for expenditures on certain assets, such as buildings and equipment, which are useful over long periods and are commonly referred to as depreciable assets.

For tax purposes the most equitable method of deducting costs of depreciable assets would be one which matched the cost of such assets against the income arising from their use. Obviously to do this before their useful life had in fact expired would not be a simple task, because useful life might vary from one year to many years, and productivity would change from year to year. Yet, if the business income of all taxpayers is to be measured on the same basis, allowance must be made for these costs in a way which produces a reasonably accurate statement of income from year to year.

Under the Income War Tax Act depreciation on a straight-line basis was permitted on tangible assets, but only at the discretion of the Minister. Depreciation was considered to be essentially an allowance for wear and tear, so that it could apply only to tangible assets actually in use, and did not take into account the diminishing value due to obsolescence. There was dissatisfaction with the system because no official rates were ever published, and a taxpayer could never know whether he was receiving the same allowance as his competitors in the same business. Profits or losses on disposal of depreciable assets were considered capital in nature and were not taxable or deductible.

When the Income War Tax Act was replaced in 1948, and ministerial discretion was almost completely abandoned, "depreciation" gave way to the "capital cost allowance" concept for the amortization of the cost of assets. At the same time the allowance was extended to include certain intangible assets such as leasehold improvements, patents and certain franchises or concessions

for limited periods. Provision was also made on sale of assets for "recapture" of any excess capital cost allowance recovered through the sale. The use of the diminishing balance method, with its greater allowances in earlier years, in effect gave recognition, though in an indirect way, to obsolescence.

Under the present system the taxpayer has a statutory right to capital cost allowances. For simplicity, the so-called depreciable assets are grouped in the Regulations into a relatively small number of classes, for each of which a rate is prescribed. The maximum annual allowance is determined by applying the class rate to the unclaimed capital cost, that is, cost less capital cost allowance previously claimed, of assets in the class. Typical rates are 20 per cent for machinery and equipment, 5 per cent for buildings of concrete or steel construction, and 30 per cent for automobiles. When an asset is disposed of, the proceeds are deducted from the unclaimed costs of the class, thereby reducing allowances to be claimed in the future, or to the extent they exceed the unclaimed balance in the class, taken directly into income. Should the proceeds on disposal exceed the original cost of the particular asset concerned, such excess is not taxable. Taxpayers may claim capital cost allowance as soon as they own a particular asset, regardless of when it is put into use or whether construction is complete, and they have the privilege of claiming whatever amount of capital cost allowance they wish up to the maximum amount computed by using the specified rate.

Submissions to the Commission indicate that the present system has served its purposes well and has operated to the satisfaction of taxpayers. However, we think it pertinent to ask how closely it has enabled costs to be matched against resulting revenue, and whether it has placed the measurement of business income on as fair a basis as possible.

For guidance in this matter, we looked to the practice followed by business management in reporting income from operations. In a confidential survey of a number of corporations conducted by our research staff, it was found that most large business firms did not use the diminishing balance method of depreciation in their accounts. For the years 1955 to 1962, during which

time the 113 corporations surveyed accounted for 25 per cent to 30 per cent of the total capital expenditures of all corporations in Canada, capital cost allowances claimed exceeded depreciation recorded in the accounts of the corporations by approximately $1,200 million. The total deferment of tax resulting from these additional allowances is estimated to be almost $600 million and, when added to the deferred taxes of about $100 million recorded prior to 1955, a total cumulative deferment of tax of approximately $700 million to the end of 1962 results. These figures support the conclusion that the charges permitted under the present capital cost allowance system are, at least in the early years, in excess of what, in the view of management, is reasonably required to measure "actual depreciation".

Because the allowances under the present system appear to be generous in relation to a basis of determining business income that was free of tax considerations, we considered whether more reliance should be placed on accounting and business measurement of depreciation in order to reflect more accurately the individual circumstances of each business and thereby to achieve greater equity. However, we found that the accounting profession itself readily acknowledged that any particular method of depreciation was at best an estimate, and that it laid primary emphasis on some reasonable method of amortizing cost which would be adopted and applied consistently. Thus, an amortization of equal annual amounts over an estimated lifetime, the "straight-line" method, may be just as acceptable as a method under which the annual amounts continually diminish, as under the "diminishing balance" method. It therefore appears to us that reliance on accounting methods in this area would produce uncertainty, and would also have an unfortunate effect on business practices because the depreciation methods adopted would probably be adjusted to achieve the maximum tax advantage 15/.

We have therefore concluded that because of the uncertainty that could result from an attempt to match, on an annual basis, the costs of depreciable assets against resulting revenue, the use of simple and arbitrary tax rules is preferable. While such rules are unlikely to reflect accurately the annual loss in value of the assets, they at least ensure a minimum common standard

available to all taxpayers, and the ultimate allowance of all cost provides for a final reckoning. Liberal allowances are probably inherent in any simple system, and the present rates therefore appear generally to be satisfactory 16/. As we suggest in Chapter 4, a degree of liberality here can be accepted because it would probably assist in economic growth.

We therefore recommend that the basic system of capital cost allowances for depreciable assets and the general level of rates remain unchanged 17/.

Although the basic system of capital cost allowances is satisfactory, some technical modifications should be made in its structure. We comment on the more important of these below. Comments on other specific features of the system are contained in a separate study 18/.

As we have already noted, the present system permits a deduction to be claimed for assets even before they are put into use. This conflicts with the principle of matching costs against revenue, which we believe should govern. Therefore, we recommend that this feature should be deleted from the basic capital cost allowance system.

The permissive nature of the capital cost allowance system is such that the taxpayer is not required to claim any allowance if he does not wish to do so. This again is a departure from a measurement of business income that is free of tax considerations and has had undesirable side effects, the nature of which will become evident in the later discussions concerning business losses and incentives such as the three-year exemption for new mines. It would thus appear that some capital cost allowance should be required to be charged in arriving at a satisfactory measurement of business income. Because the rates under the present system tend to be on the liberal side, any mandatory deduction of capital cost allowances could hardly exceed 50 per cent of the permitted rates in any taxation year. The undesirable effects of the permissive nature of the capital cost allowances are, however, considerably reduced because of our recommendations for the more liberal treatment of losses and for the elimination of tax incentives in the form of

exemptions of certain income from taxation. Accordingly, we do not think the legislative complexity and record keeping which would be involved in requiring a deduction of capital cost allowance is warranted.

Under the present capital cost allowance system, proceeds in excess of the original cost of an asset are not taxable. In accordance with our proposals for a comprehensive tax base, the excess should be included in income. Generally, the excess should be taken directly into income, and should not be credited to the class in which the asset was included. To avoid compliance problems on small dispositions, taxpayers might be permitted to credit to the asset class any proceeds of less than, say, $5,000 from bona fide separate disposals, regardless of the original cost of such disposals.

At present, a terminal profit on disposal of all assets in a class can, on election, be taxed under section 43 as though it had been received over the five years ending in the year of disposal. No similar provision exists for terminal losses. In view of the expansion of the loss carry-over provisions and the averaging provisions which we recommend elsewhere, this special provision in respect of terminal profits on disposal of depreciable assets would no longer appear to be necessary. However, the present practice of deducting the amount of the proceeds of disposition of an asset, up to the amount of its capital cost, from the balance in its capital cost allowance class should be continued. This would appear to be a simpler procedure and, where gains arise, more favourable to the taxpayer than the alternative of computing the undepreciated capital cost of the assets sold, deducting this amount from the balance in the class, and using this figure as the cost basis in computing the taxable property gain.

The unclaimed cost of assets in a particular class cannot at present be deducted until all assets in the class have been disposed of. In certain cases, 19/ the rates of capital cost allowance may tend to be inadequate and there can be times when the unclaimed cost in any class may considerably exceed the original cost of the assets still on hand. We therefore recommend adoption of the suggestion made by the Canadian Institute of Chartered

Accountants that there should be a provision for an interim claiming of a terminal loss to the extent that the unclaimed cost in any class exceeded the original cost of the remaining assets.

The subject of capital cost allowance cannot be closed without considering leasing arrangements under which the lessee has some right to acquire the property. By renting a long-term asset instead of owning it, a taxpayer may enjoy most benefits of ownership and yet obtain a faster deduction of its cost for tax purposes in the form of rent than he would have obtained in the form of capital cost allowance had he owned the asset. If the lessor is subject to all the normal requirements of the capital cost allowance system in respect of the asset, this arrangement need not be of particular concern to the tax authorities. If, however, the lessor is able to accelerate the deduction of the cost of the asset, either by way of terminal loss upon disposal of the fixed asset, or as an inventory loss upon transfer of title to the lessee, the net effect is to achieve a faster write-off of the long-term asset and thereby to defeat the purpose of the capital cost allowance system.

Prior to 1963, there were provisions in a previous section 18 of the Act which were intended to prevent lessees under lease-option agreements from obtaining faster write-offs on capital assets covered by such agreements than would have been available if they had been purchased outright. In effect, the provision treated such agreements as agreements for sale of such assets, and treated payments thereunder as payments on account of the purchase price rather than as rental payments for the use of the property. The lessee's deductions from income in respect of such payments were limited to the equivalent of the capital cost allowances on the portion of the purchase price attributable to depreciable property. However, many shortcomings remained in the section despite various amendments and it was finally repealed in 1963. 20/

While the leasing business is based primarily on financial, rather than taxation, considerations, once a leasing arrangement is contemplated there is

an opportunity to obtain tax advantages. With the widespread use of leasing today, the treatment of such arrangements for tax purposes is a matter therefore of great concern if the capital cost allowance system is not to be undermined. In reviewing the problem, we realized that, with the great variety of terms on which leasing arrangements can be drawn, it would be impossible, as was found under the repealed provision, to provide detailed legislative rules to deal with the situation. This would be particularly true if the rules were based on possible events to take place in the future. At the same time, we believe that some specific provisions are required to control the tax postponement possibilities under this type of arrangement.

We recommend that a specific provision should be introduced into the legislation to allow deduction for rentals of long-term assets that the lessee has a right to acquire only to the extent that they are reasonable and that any excess be treated when paid as being on account of the purchase price of the asset. If the asset was a depreciable asset, this excess would be eligible for capital cost allowance when the asset was acquired, or would be deductible if the option lapsed. We also recommend that it should be specifically provided that where a lessee acquired, at less than its fair market value at the time of acquisition, an asset which he had been renting, such deficiency in the purchase price should be regarded as a reduction of rents previously claimed, except to the extent of the rents disallowed under the first part of our proposal, and the amount thereof should be brought into income immediately with an offsetting amount to be amortized in the future under the capital cost allowance regulations 21/.

"Nothings". There are certain expenditures that may be made for the long-run benefit of a business that are not now deductible for tax purposes as current expenses, and are not provided for in the capital cost allowance regulations. These are often referred to as "nothings".

The equitable treatment of business income requires that these expenditures should be allowed at some time. The problem of estimating the period over which benefits will result from the expenditures is, however, even more

difficult than in the case of depreciable assets. Evidence of this difficulty is seen in accounting practice under which costs incurred by a business in developing future markets are usually treated as current expenditures, and yet in special circumstances may be deferred 22/. Current write-off is usually recognized in practice by the tax authorities even though this treatment may be questionable. If, however, an item such as goodwill is purchased from another business its cost is disallowed as being of a capital nature, and no allowance is available either in the form of amortization of the cost over a period of years or as a final write-off when the goodwill no longer exists.

The most difficult of the "nothings" to deal with is goodwill. It is usually measured as the difference between the total value of a business as a going concern, equal to the expected annual level of earnings capitalized at the desired rate of return, and the value of its assets. The factors that might contribute to the creation of goodwill of a business are a particularly capable staff, established relationships with customers, "know-how" (including secret processes and technical data), a well-known company or product name with a good reputation, a franchise of indefinite life, or a special location. Some of these factors can be built up through good recruitment and training programmes, advertising campaigns, scientific research, or market research. The relative importance of the various factors is difficult to determine and will vary from one situation to another.

If income could be measured by changes in economic power, whether realized or not, then the goodwill arising because of certain expenditures incurred or actions taken would automatically be brought into account and there would be consistent treatment for all taxpayers. However, we have concluded that the measurement of income on the basis of the annual change in economic power would be generally impracticable, and we must deal with goodwill in the same manner as other factors contributing to business income, that is, recognizing revenue from it when realized and, in principle, deducting expenditures as incurred except to the extent that they benefit future periods.

In a continuing business it is almost impossible to identify the extent to which expenditures such as staff training, advertising, market research, and product development will benefit future periods. In practice, such expenditures are usually written off as incurred, both for purposes of the financial statements and under present tax treatment. It seems to us that this rather liberal treatment should continue, both as a practical matter and on the ground that it may have some economic advantages to the extent that it operates as an incentive to research and product development.

Where the ownership of a business changes, and part of the purchase price is for goodwill, the situation is different because a value has been placed on the goodwill factor as a result of bargaining between independent parties. Under the comprehensive tax base the proceeds of a disposition of goodwill would be subject to tax. There are arguments for permitting the purchaser some amortization of this value for tax purposes. The earning potential represented by the goodwill and created by the former owner will gradually disappear unless maintained by the new owner. It may therefore be reasonable to amortize this cost, while also permitting immediate deduction of the costs of maintenance under the new owner. An incidental effect of such a treatment would be to simplify some of the tax considerations in business take-overs, because it would mean that there would be few tax implications involved in the allocation of the purchase price between goodwill and other intangible assets of an indefinite life, which are not depreciable, on the one hand, and the tangible assets and intangible assets of limited life, the cost of which can be amortized, on the other.

To allow the amortization of purchased goodwill would be liberal because the value of goodwill generally does not depreciate. While immediate deduction of the costs of developing goodwill may be a necessary departure from an ideal tax system, the amortization of purchased goodwill would not be a necessary part of such a procedure, particularly as an independent value would have been placed on the goodwill. Furthermore, the costs to the new owner of maintaining or increasing the goodwill would still be deductible

when incurred. More important, if the purchased goodwill did in fact later decline in value or was sold, a deduction at that time should be permitted.

The treatment of goodwill must also take into account the relationship between the measurement of business income and the tax treatment of corporate source income under the comprehensive tax base. Share gains would be fully taxable and share losses fully deductible, and the tax paid by the corporation would be fully creditable on distribution or allocation to resident shareholders. The market value of shares would generally reflect the goodwill element in the business and, accordingly, once the proposed tax system was in effect, taxation of share gains would mean that gains or losses in goodwill, when realized in market transactions, would be taxed or allowed currently even though such gains or losses would not be reflected in the underlying financial statements of the business. To the extent that the value of the goodwill was thus reflected in the value of the shares, the sale of a corporation's business would not result in any additional tax to the shareholders, for any tax paid on that gain by the corporation would be creditable to the shareholders.

In addition, to permit goodwill to be amortized by the purchaser when there was no demonstrated decline in value would tend to create a tax incentive to business take-overs, because this portion of the purchase price could be recovered through tax write-offs. Furthermore, if all purchased goodwill could be amortized, and all our other proposals were accepted, the possibility of an additional tax advantage would be created because the value of the goodwill at the effective date of implementation would be included in the cost basis of the shares and would be free of tax upon realization by a vendor, but would be amortizable by a purchaser. It might be possible to eliminate this latter advantage by prohibiting the amortization of goodwill that existed at the effective date. However, it would become increasingly difficult to maintain the identity over time of this opening goodwill.

Therefore, we conclude that it would not be reasonable to permit the

amortization of goodwill and other intangible assets of indefinite duration purchased from another taxpayer, and that a deduction should only be permitted upon disposition or when it could be established that a significant loss in value had occurred.

In accordance with our recommendation that all expenditures that meet the three general tests enumerated (that they be related to the earning of income, not be of a personal nature, and be reasonable) should be deductible at some time, expenditures that fall into the classification of "nothings" should be deductible. The only question remaining is the time when such deductions should be permitted. In the same way that it is difficult to identify the extent to which expenditures contributing to goodwill in fact benefit future income, so it is often not possible to distinguish these other outlays as being costs of a current or of a longer term nature. Not only is the accuracy of any allocation doubtful, but uncertainty as to what allocation would be acceptable to the tax authorities complicates the determination of taxable income. For accounting purposes, it is usual to write off against income most of these expenditures when incurred.

We have thererore concluded that the preferable approach would be to permit the immediate deduction for tax purposes of all business expenditures unless the legislation specifically categorized the outlay as one that must be capitalized. This approach is liberal and would minimize uncertainty. These are advantages that should override the arbitrary nature of the designation of certain expenditures as being for the longer run benefit of the business, and therefore subject to amortization over a period of time. To implement this approach, we suggest that a new capital cost allowance class should be established. Initially, the regulations could define this class to include commissions 23/ and other costs of financing; costs of incorporation and other expenses of acquiring or establishing a business; legal and other expenses to defend successfully a franchise or copyright, to obtain long-term contracts, or long-term commercial advantages, for example, lower import duties; and such other similar costs as can be defined. It should not include the costs of investigations or plans that were not in fact proceeded with, because these expenditures do not directly lead to future income, and should be deductible immediately.

In summary, we recommend that the times at which reasonable business expenditures should be allowed are as follows:

1. All business expenditures should be allowed currently except certain designated expenditures that demonstrably benefit the business beyond the taxation year. We have pointed out that many expenditures that produce current revenue also benefit future periods, but are virtually impossible to allocate over appropriate periods. Other expenditures are clearly incurred to produce income for more than one period. We recommend that, on practical grounds, most expenditures should be written off as incurred regardless of the extent to which they provide some future benefit, unless they are specified by the Regulations as falling in one of the classes referred to below.
2. Expenditures that benefit the business beyond the taxation year and are not specifically permitted as a deduction in the year incurred should be segregated into:
   a) Those contributing to inventory value which would later become a cost of sale.
   b) Those attributable to long-term assets, such as equipment and buildings, and intangible assets of limited life, which would be subject to amortization on a prescribed basis.
   c) Others, such as purchased goodwill or other purchased intangible assets of indefinite life, securities, and land, where any loss would be eligible for deduction only on disposition or upon a proven significant loss in value.

   Where a deduction for loss in value of category (c) assets was made without a disposition, and the value of the asset subsequently increased, such recovery would have to be brought back into income to the extent of the amount deducted.
3. Long-term expenditures subject to amortization would include the cost of tangible assets and of certain intangible assets with limited life as currently set out in the Regulations. Any intangible property

not included in another class that had a period of existence reasonably measurable by law, agreement or nature, should be included in class 14.

4. A new class should be added, which would include defined expenditures, whether or not they resulted in the acquisition of property, and should be eligible for an allowance of 20 per cent of the original cost a year.

In view of the above recommendations and others made in this Report, the use of the term "capital" in differentiating expenditures of a current and long-term nature would no longer appear to serve any useful purpose, and we suggest that consideration should be given to discontinuing its use. This would emphasize that the distinction involved is one of timing and not of any inherent quality.

It will be noted that under our recommendations virtually all expenditures would be allowed at some time. The allowance of all business expenditures, even some that might have a long-term benefit, and the introduction of the new class for capital cost allowance would permit immediate deduction or amortization of many outlays that are not deductible under the present tax system. In effect, any business expenditure that did not fall within a capital cost allowance class, was not part of inventory, or was not part of the cost of acquiring an item of property of indefinite life, would be deductible when incurred. Purchased goodwill would not be amortizable, and, accordingly, in the purchase of a business as a whole, the allocation of price between goodwill and other assets would still be important and might cause difficulties. A deduction for purchased goodwill could be made on its eventual disposition or deemed disposition, or upon a proven loss in value, and in this way the existing difficulties should be reduced.

The "Cash" Method of Computing Income. The means we have discussed for placing the measurement of business income of all taxpayers on a common basis would involve recognizing income when it was realized. that is, when property was disposed of or services rendered, and allowing the deduction of costs either as incurred or as the benefits therefrom were used up. This approach

is substantially what is referred to in accounting terminology as the "accrual" method of computing income. Although the accrual method is generally required for computing business income on the grounds that it is the only method that gives a reasonably accurate measure of "profit", section 85F of the Act specifically permits a taxpayer engaged in farming or a profession to elect to use the "cash" method of computing business income.

Under the cash method, income is computed simply by deducting cash disbursements from cash receipts. Thus, sales are not taken into income until paid for in cash, and expenditures are not deducted until a cash payment has been made. Such a system ignores the fact that a sale may have resulted in a legal obligation readily convertible into cash, and that cash laid out may have been replaced by an asset of equal value. It also ignores expenses that have been incurred but not yet paid. Therefore, it is not a measurement of business income but tends to reflect cash flow. In some small businesses cash flow and income will be approximately the same, but this would not apply generally.

The cash method of computing income represents a significant departure from our concept of the best measurement of business income, and results in at least a temporary understatement of income for certain taxpayers. We therefore recommend that the right to use the cash method of computing business income should be restricted. In our view, it would create some hardship to require all farmers and professional individuals to adopt the accrual method because of the accounting and liquidity problems which this might involve for those with relatively small incomes. Accordingly, we recommend that any individual whose principal source of income is farming or a profession should be entitled to continue to use the cash method as long as his annual gross revenue from farming or the profession was less than a specified sum, say, $10,000. We also recommend that all other business income should be required to be computed on the accrual method. If an individual whose principal source of income was farming or a profession adopted the accrual method, either through choice or because his gross revenue exceeded the sum specified, he should not thereafter be entitled to revert to the cash method.

We are aware that the immediate implementation of this recommendation without some transitional provisions could cause hardship for those farming and professional businesses where the cash flow was inadequate to meet the unanticipated tax liability. In addition, there would be a problem where the accounting records were inadequate to compute income on the accrual basis. Therefore, our recommendations should be implemented in stages, starting first with those larger businesses where the cash flow was more substantial and where the records were adequate. The Department of National Revenue could provide standard forms to assist those businesses which required them to put their records in order. We do not feel that the burden of maintaining adequate records or of paying taxes on an accrual basis is unreasonable.

A problem lies in the appropriate treatment of the opening assets (accounts receivable and inventories less accounts payable) of businesses that are on a cash basis, which would be affected by transfer to an accrual basis. To bring such opening assets into income at the effective date would require payment of tax which the taxpayers concerned had expected to postpone until death, or sale, or discontinuance of the business. One possibility would be to exempt these opening assets from taxation, and to regard this as a necessary price of placing all taxpayers on an equal footing in the future. On the other hand, to exempt this income completely from tax would not give equal treatment with other taxpayers including those who, though eligible to use the cash basis, did not elect to take advantage of it and were therefore already "paid up".

Because many taxpayers would consider such a tax to be a special levy, and in many cases would be unable to make payment, equity could be served on transition by establishing for each taxpayer who converted to the accrual basis a contingent liability equal to the tax, which would become payable upon the reduction or ultimate liquidation of the opening assets. This might require a record to be maintained until the disposition of the business or until the taxpayer died or left the country which could be a substantial period of time. Another alternative would be to relate this problem to the determination of the cost basis of the business at the

effective date, for purposes of determining the eventual property gain or loss on final disposition. Thus, the estimated market value of the business at the effective date of the new legislation could be reduced by the excess of the assets over liabilities set up to convert the accounts from a cash to an accrual basis. Then, on ultimate disposition, this adjustment would be taken into income. This procedure would be substantially the same as at present, because a taxpayer is now required to bring into income the proceeds on disposition of certain assets, that is, accounts receivable and inventory. We recommend the adoption of the latter alternative because it would impose tax on the balances outstanding at the valuation date on the same basis as currently applies, because the taxpayer would not face an unexpected tax liability, because it would put the current records on an accrual basis, and because it would tax future profits in each year in which they accrued. When a farm or professional practice was acquired in the future the purchaser should be required to set up the appropriate portion of the purchase price as inventory and receivables, irrespective of the level of his gross revenue, a procedure that should not give rise to liquidity problems.

Business Losses

The proper treatment of business losses for tax purposes raises a number of issues.

The first question we shall consider is the extent to which the government should share in the losses as well as in the profits of business. Under the present system some sharing of losses takes place. If an individual with non-business income incurs a business loss, he may offset the one against the other in the year of loss, and to the extent that the tax otherwise payable on his other income is reduced, the government has shared in his business loss. Similarly, an individual or corporation engaged in several different lines of business at the same time may set off a loss in one business against income of the other.

There is no doubt that a full sharing of losses by the government, involving the payment of subsidies to a business to the extent of its business

loss multiplied by the going tax rate, would have some desirable results. The tax system would no longer make a distinction between businesses which can offset their losses against income and those which cannot, so that a disturbing effect on business activity would be eliminated and equity achieved between taxpayers. In particular, it would eliminate the tax disadvantage suffered by the small, risky business, which is already at a considerable disadvantage compared with the diversified, well-established business. In terms of stability, a sharing of business losses would provide funds in times of low economic activity and thereby act as an automatic stabilizer. Losses would no longer have any relevance for tax purposes beyond the year in which they were incurred or for any taxpayer other than the one incurring them, and the legislation would therefore be simplified.

Despite these attractions, we are convinced that a full sharing of losses by the government would be repugnant to most Canadians. We do not accept the argument that because the government shares in all income it should also share in all losses. Subject to this limitation, however, rules should be devised to place all taxpayers on as nearly equal a footing as possible.

The questions to be answered are when, and to what extent, business losses can reasonably be taken into account in determining income. We have no doubt that a business loss of any particular year should be applied to income from other sources in the same year as is now done. If a business loss is not completely offset by other income in the current year, however, to what extent should it be carried back against income of other years or carried forward against income of future years? Under the present tax legislation, an unabsorbed business loss in one year may, within certain limits, be carried back one year and forward five. In this respect Canada is not unlike many other countries, although the practice varies 24/.

The seven-year span covered by the present loss carry-over provisions might be considered satisfactory from the standpoint of measuring business income if the only cause of business losses was the ordinary fluctuations in business activity. However, the five-year carry-forward period is not

sufficient for a new business that requires a long development period, and the one-year carry-back is often not sufficient for a business that is winding up. As we noted earlier in this chapter, the period over which benefits are received from any given expenditure may be long, and a liberal carry-forward of losses is essential to overcome this limitation of the annual period of measurement. There is, however, an anomaly in the present tax system in that, because of the permissive nature of capital cost allowances, a taxpayer may fail to make any claim for capital cost allowances and thereby in effect carry losses forward indefinitely to the extent that they would have resulted if normal depreciation had been claimed.

The tax treatment of losses can also have either a stabilizing or destabilizing effect on the economy. For example, if losses occur to a greater extent during a downswing or a low level of business activity, tax refunds in respect of loss carry-backs could be helpful in encouraging business expenditure. On the other hand, a reduction in tax as a result of the application of losses against subsequent income could occur during an upswing, and thus encourage an increase in business expenditure when restraint would be more appropriate. Except in very major swings of the economy, however, the importance of the treatment of business losses for stabilization purposes may not be great because the bulk of business income is earned in large businesses which do not incur losses frequently, and because the timing of losses does not necessarily bear a direct relationship to the business cycle.

Apart from the proper determination of business income and the economic considerations which have been discussed above, there is an overriding consideration from the standpoint of equity. With the adoption of the comprehensive tax base a taxpayer should not be regarded as having any taxable capacity until such time as all his losses from any source have been recovered.

We have reached the conclusion that the present seven-year period over which losses may be spread is not adequate to place the measurement of the

business income of all taxpayers on the same basis. Therefore, we recommend that the period be extended to permit losses to be carried back two years and carried forward indefinitely 25/. We do not suggest a longer carry-back because it could lead to administrative difficulties. Furthermore, we do not feel it would improve equity, for shareholders could claim the loss on their shares even if the corporation was not able to carry back the full loss, and because our averaging proposals would provide the individual with a longer period of carry-back.

In general, under the present legislation, a business loss can be offset against any other income of the same year. The only limitation, which we discuss below, is in respect of farming carried on as a side-line activity 26/. To the extent that a business loss is unabsorbed in the current year, however, it can be applied only against business income in the previous year or in the succeeding five years. We think that this limitation is inequitable and that it should be permissible to apply most business losses against all other income during the carry-over period.

Losses of a Personal Expenditure Nature. In Chapter 9 it was pointed out that some "business" losses could in fact be items of personal expenditure, as when the taxpayer is not pursuing a business activity with a reasonable expectation of profit, but may be primarily engaged in a hobby or a form of recreational activity. The reasons for not allowing the deduction of personal expenditures have already been discussed. The problem is in distinguishing between the business that is pursued for profit and the one that is more of an avocation or recreational activity. The present legislation partially recognizes this problem in the case of farming carried on as a side-line activity. However, the question of "hobby businesses" is not limited to farming, and is of particular concern having regard to our proposals for the liberal treatment of business and property losses. Although our proposals would specifically preclude the deduction of personal expenditures, experience has indicated that it is difficult to apply such a provision to many of the expenditures of a "hobby" business, that is, expenditures that

are in fact related to a "business", but one which does not appear to be directed to a business purpose. We were unable to develop a definition of either a genuine business or a hobby business that could clarify this problem and that appeared to be capable of application in a manner that would produce certainty. We therefore recommend that an arbitrary restriction should be employed to ensure that taxpayers could readily determine which business losses were to be considered personal expenditures and therefore not deductible. The limitation should apply when a particular business sustained losses over a lengthy period.

It is our recommendation that losses of a business should be deductible from income from all sources in the year of loss, in the two preceding years, and in future years, unless and until losses have been sustained in three years which fall within a five-year period. However, once losses have been incurred in three such years, any further loss incurred following the third such loss year should not be deductible from any income of the taxpayer (either in the year of loss or any other year) from sources other than the loss business. Such subsequent losses could be carried back two years and forward indefinitely and applied against income of the same business. If, after sustaining such losses, the business then became profitable, and the profits realized in the years subsequent to the loss years exceeded all losses from the same business deducted in previous years (including the losses deducted from other income), such business would again become eligible to claim an unlimited write-off of losses against other income unless and until the three-year rule again became operative. The five-year period is suggested for ease of administration, but if the use of such a period permits some taxpayers to deduct recurring losses of a personal expenditure nature then it should be extended.

It might also be provided that any losses sustained subsequent to the three years would be deductible from all other income if the profits of the business during a period of, say, seven years beginning with the year of loss exceeded the losses during the same period. A provision of this nature would permit, for some businesses, the deduction of a loss from other income in the year of loss, rather than requiring it to be carried forward for deduction from income of the same business.

It is not our intent that our proposals should inequitably worsen the position of the bona fide farmer who needs to take off-farm employment to assist in maintaining and expanding his farm. If it is felt that our proposals would deter such farmers from taking off-farm employment, consideration should be given to a modification of the loss limitation. For example, it might be provided that where stipulated conditions exist income from part-time employment would be treated as farm income.

Because a new business would be permitted an unlimited loss deduction for the first three years, and would only become subject to the above procedure in the fourth year, the limitation should pose no difficulty for new businesses. In this way, the losses of a new business would be eligible for full deduction, without dollar limitation, from other income regardless of whether it was a "hobby" business. This procedure is quite liberal, because 100 per cent capital cost allowances could also be claimed by a qualified new business.

In addition, there are three points relating to the computation of a gain or loss from a business that should ensure that only "hobby" losses were disallowed. First, in Chapter 15 we recommend that certain expenditures relating to non-personal property, such as interest, property taxes, costs of establishing and defending a property right, and damage claims resulting from the holding of property, instead of being written off when incurred, should be permitted to be added to the cost basis of the property if the taxpayer so chose. Second, earlier in this chapter we pointed out that capital cost allowances should not have to be taken unless the taxpayer chose to do so. Both of these options would enable a taxpayer to reduce his losses for tax purposes and should mean that in most cases there would be sufficient taxable income that the three-year loss rule would not apply. The third factor would be a limitation on the taxpayer, for we recommend that in applying the three-year loss rule, gains from the holding or disposition of property of the business (other

than inventory) should be excluded from the computation as being income from property rather than from business.

The recommended provisions should not restrict the claiming of losses by bona fide businesses, but taxpayers engaging in an activity for personal enjoyment would find that the right to deduct any losses from such activity from income from other sources after an initial three-year loss period would be denied under the tests we have suggested. The present hobby farm provision should therefore be removed.

The disallowance of a loss to a corporation would be an idle gesture if the shareholders could then in effect claim the loss when they disposed of their shares at a price less than otherwise could have been realized. However, because the loss would be deemed a personal benefit, the amount would either have to be attributed to the shareholders or deducted from the cost basis of their shares. If this was not feasible, an amount equal to the loss would have to be subjected to the top rate of personal tax on a grossed-up basis. This is the procedure we recommend for other personal benefits which cannot be attributed to specific individuals.

Separate Businesses. Our recommendation for the treatment of losses of a personal nature has implications for the definition of a business. Although the current definition in section 139(1)(e) should be satisfactory for the purpose of determining whether a business exists, it is of little assistance in distinguishing between separate businesses, which would be necessary under our proposals because losses on some businesses would be subject to special limitations. This question has already been raised in Chapter 20, which deals with the taxation of clubs, charities, and certain tax-exempt entities. It would also be important in connection with our recommendations for new and small businesses later in this chapter.

The task of finding a suitable test for a "separate business" is not easy, considering how diverse the business operations of firms and individuals

are, and the degree to which essentially different operations may be integrated with one another.

Under the present <u>Income Tax Act</u> there are provisions which now require the identification and separation of the various businesses that a proprietor, partnership, or corporation might be operating. The most important examples concern the claiming of loss carry-forwards where there has been a change in control under sections 27(1)(e) and 27(5), and the requirement that separate businesses set up separate capital cost allowance schedules under Regulation 1101(1).

Although we do not propose a specific definition of what constitutes a separate business, we suggest that the legislation might contain some provisions on this matter for the guidance of the courts. Generally speaking, where business operations carried on by one taxpayer were interdependent they should be regarded as one business. The operations may be integrated vertically, like flour milling and the bakery business; mining iron ore and steel making; or producing, refining, and marketing petroleum products. Operations might also be integrated horizontally, as in the case of a chain of stores, hotels, or restaurants with central management and service functions. In these cases the operations should all be regarded as one business, even though it would have been possible to operate them separately. On the other hand, if two operations were of different kinds and neither contributed to the other by providing materials or services, promoting sales or sharing services, so that the only substantial connection between them was common ownership, they should be regarded as separate businesses. There would no doubt be many cases when one operation contributed in some way to the other operation. We do not think a token relationship should satisfy the test, but that there should be a genuine and substantial commercial integration.

The present jurisprudence suggests that businesses of an identical

nature may be separate if conducted in different locations. We do not agree that this treatment is fair, and we recommend that operations of a similar nature carried out by the same owner in one or more locations should not be considered as separate businesses.

Somewhat more difficult is the question of whether a business which has been discontinued is the same business once it recommences operations. We recommend that where a business had completely terminated and was recommenced, it should then be considered a separate business. However, this should not be the case if the cessation of operations was temporary and the facilities and basic organization were maintained during the period of cessation.

Consolidated Returns. It is convenient at this point to deal with the situation where a group of corporations is operated under common control. Because the present legislation does not permit the filing of consolidated returns, it is advantageous to conduct operations in one corporation rather than in a number of corporations, so that profits and losses can be immediately offset. The deficiency of the present legislation is evidenced by the fact that many groups of companies have been forced to adopt artificial means of offsetting losses against profits within the group 27/.

Consolidation is permitted in the United States without payment of any extra rate of tax. An 80 per cent degree of ownership is required, and there are a number of special rules, particularly in respect of corporations entering and leaving the consolidated group. In the United Kingdom, consolidation as such is not permitted, but companies with 75 per cent common ownership can in effect offset profits against losses within the group because a profitable company can deduct a payment (referred to as a "subvention payment") made to an associated company which would otherwise sustain a loss.

The failure of the present Canadian tax system to permit offsetting of profits and losses within a group of companies operated under common control does not arrive at a proper measure of the shareholders' ability to pay, and is not in accordance with our recommendations for a comprehensive tax base. It has led to artificial transactions in many cases. We therefore recommend

that the legislation should be amended to permit companies having common ownership to aggregate their incomes and losses for tax purposes. Of course, to the extent that a loss was set off against the income of another related company in the same year, it would not be available for carry-back or -forward. However, if there was an overall consolidated loss in any year, it should be available for carry-back or -forward against the consolidated income for other years of the same group of companies, or of a group which was eligible in the year of deduction to file consolidated returns and included the companies which sustained the loss. For practical reasons the privilege of filing consolidated returns should be limited to situations where there were no minority interests.

Transferability of Losses. We must now consider the treatment of business losses where the ownership of a loss business changes. Under the present tax system, the new owner of an unincorporated business does not obtain any deduction in respect of unabsorbed losses of the previous owner. The same position arises where assets of an incorporated company with unabsorbed losses are purchased. In each of these cases the purchaser is a different taxpayer from the vendor and is not permitted to utilize the losses of the vendor for tax purposes.

Where, however, shares rather than assets of a corporation with unabsorbed losses are purchased and the taxpayer that has sustained the losses, that is, the corporation, continues in existence, the question then arises whether the carry-forward of such losses should be restricted. The present rules 28/ are that losses sustained in an earlier year cannot be carried forward if (a) since the end of that year (or since the winding-up or discontinuance of the loss business in that year) control of the corporation has changed, and (b) during the current taxation year the corporation was not carrying on the business in which the loss was sustained. There is thus a somewhat limited restriction on the carry-forward of losses where control changes. As long as the original business is continued, which is not always easy to determine, the losses may be carried forward notwithstanding that the new owners may inject into the corporation new businesses which are productive of income against which the earlier losses may be offset.

We have stated our belief that a corporation should be regarded as an intermediary for the shareholders. The proposed liberal allowance of losses is not intended to be used in such a way that one taxpayer can deduct losses sustained by another and thereby defer or avoid tax liability. Accordingly, we recommend that losses should not be transferable from one taxpayer to another, and that the right to carry losses forward should be denied to a corporation where there is a change in control, either through a sale of its shares, through granting a right to acquire a controlling interest (unless the right is exercisable only on death or default of an obligation or under a first refusal arrangement) or through a statutory amalgamation. A vendor of the shares who was resident in Canada would, of course, be able to deduct from other income any loss on the disposition of his shares. However, if the change in ownership of the business or control of the corporation took place in a reorganization which was not regarded as resulting in a realization of a gain or loss by the shareholders or by any corporation, 29/ the carry-forward of the business loss should be permitted.

Reference should also be made to an anomaly in the present system, related to the transferability of losses, which arises from the permissive nature of capital cost allowances. A loss for tax purposes may be decreased or eliminated by reducing the claim for capital cost allowances, and some taxpayers are therefore able to transfer business losses freely in the form of unclaimed capital cost allowance on depreciable assets. This would be corrected to a great extent by requiring that all taxpayers claim at least 50 per cent of the statutory capital cost allowances. As already stated, we do not recommend this. Our recommendations would provide more liberal treatment of losses and would thereby reduce the need for a taxpayer to transfer unclaimed costs to another taxpayer.

Under our proposed tax system a shareholder of a corporation which incurred losses would have a much greater possibility of claiming them against his income from other sources. A loss on shares would be fully

deductible when they were sold or revalued, as set out in Chapter 15. In addition, share losses not absorbed against income from other sources in the current year, could be applied against such income in the two previous years or any succeeding year.

The revaluation of securities and the write-off of losses against any income would be particularly valuable in the first few years of a business, and should act as a stimulant to the risk taker. This result is consistent with one of our primary purposes, to assist new businesses.

Transactions Not at Arm's Length

If the business income of all taxpayers is to be measured by common standards, the basis on which transactions take place must be subject to common market forces. Where the two parties to a business transaction do not have opposing economic interests, the actual results of the transaction may not be a reliable basis for taxation because the parties are in a position to arrange the terms of the contract to produce the least amount of tax. Although separate legal entities, they have, by virtue of their particular relationship, a common economic interest, and persons in such circumstances are said not to deal with each other "at arm's length". Legislation has been enacted in many countries to prevent such a relationship between persons from distorting or reducing the tax effects of a transaction between them.

Under the detailed provisions of section 139(5) "related persons" are conclusively deemed not to deal at arm's length, and certain types of transactions between them are subject to provisions designed to adjust the transactions for tax purposes so as to reflect what would have occurred between independent persons. Related persons include individuals related to each other by blood, marriage or adoption, and corporations one of which controls the other or which are subject to common control 30/. It is provided in section 139(5) that it is a question of fact whether two parties not related to each other are dealing at arm's length. So far, however, case law has held that a mutual interest in keeping taxes to a minimum does not, by itself, constitute evidence that the parties are not dealing at arm's length.

In the determination of business income for tax purposes there are at least three factors which can be affected significantly by a relationship not at arm's length:

1. The level at which the price of a transaction is set.
2. The allocation of price between different assets.
3. The time within which the price is payable.

Level of Price. Generally speaking, transactions between parties not dealing at arm's length are subject for tax purposes to a fair market value test, which is applied in different ways to different circumstances. First, specific provision is made in certain cases for the adjustment of the taxpayers' accounts so as to give effect to the fair market value of such a transaction rather than the value attributed to it by the parties. Such provisions are contained in section 17. Second, the Act explicitly provides in section 137(2) for the taxation of "benefits" which are conferred by one party upon another in a transaction not at arm's length, regardless of the form or legal effect of the transaction. Certain other general provisions of the Act can also be invoked to frustrate the artificial effect of transactions not at arm's length as, for example, section 8(1) which is concerned with the conferment of a benefit by a corporation on a shareholder, and section 12(2) which prohibits the deduction of unreasonable outlays or expenses.

Special rules are contained in section 20(4) for determining the capital cost of depreciable property which is acquired by a taxpayer from a person with whom he does not deal at arm's length. The essential purpose and effect of these provisions is to prevent the inflation of the cost basis of depreciable assets upon which capital cost allowance may be claimed by means of artificial transactions between persons who do not act independently.

There is evidence that where corporations were subject to common control, artificial transactions have been used to offset the profits of one company against the losses of another. Common devices included transactions in services and fixed assets which are not subject to the fair market value adjustments provided for in section 17.

In our opinion, the general approach followed in determining the level of prices in transactions not at arm's length has been satisfactory, except for some points we will refer to specifically. Certain of the difficulties which arise under the present law would be removed if our principal recommendations were implemented. For example, the adoption of the comprehensive tax base would eliminate some of the problems relating to the disposition of depreciable assets at artificial prices, because the vendor would bring his entire gain into income and there would be no incentive to inflate the price. Similarly, our recommendation for the consolidation of profits and losses within a group of corporations would remove much of the incentive for artificial transactions within the group. Nevertheless, the need for provisions designed to prevent transactions not at arm's length from being effective for tax purposes would remain, particularly in respect of transactions with non-residents, and we recommend the following changes in the existing provisions:

1. Where a transaction between persons not dealing at arm's length is adjusted for tax purposes to reflect fair market values, such adjustments should be applied to the tax accounts of both parties and for all purposes of the legislation.

2. The fair market value test should be applied to all transactions not at arm's length, including transactions in depreciable assets, payments for services and the use of property, interest, and rent, except in cases where special rules were applicable that permitted transactions to be carried out at prices other than fair market value. These rules are discussed in Chapter 15.

3. As a result of recommendation 2 above, the special rules for depreciable assets which are now in the Act should be repealed.

<u>Allocation of Price</u>. Where different kinds of assets are sold in one business transaction it is possible that, after a total price has been tentatively agreed upon by the usual bargaining between the two parties, the allocation of the agreed value between the various assets may be artificially arranged

to achieve a reduction of tax that can be shared by the two parties. For example, under the present Act, if business assets are being sold and the vendor is faced with a full recapture of depreciation on his depreciable assets in any event, he would not object if some of the value reasonably attributable to goodwill and to land was included in the price allocated to the depreciable assets. Such a re-allocation would create a depreciable outlay to the purchaser and a non-taxable receipt to the vendor; the tax benefit could be shared with the vendor by an increase in the price for the business.

Section 20(6)(g) of the Act provides that where depreciable property and other property are sold together, the vendor's allocation of the proceeds between depreciable property and other assets must be reasonable, regardless of the form of the agreement, and the same allocation must apply to the purchaser. Under section 85E(2), and somewhat in conflict with the preceding provision, the two parties may agree upon the portion of the price that is to be allocated to inventory, and that portion is deemed to be the price for both vendor and purchaser. In the absence of an agreement, the Minister may fix the price 31/. These sections are not specifically concerned with transactions not at arm's length, but do compel both the vendor and purchaser to employ identical valuation procedures, regardless of what may appear to be reasonable for their own purposes.

Under the system of taxation which we propose, the allocation of the proceeds between various assets would no longer be so important, because all the proceeds would be taxable at some time. The time of taxation, however, would still be significant, and legislation along the present lines should probably be retained with modifications. We think it is inequitable and impracticable to require that the allocation of price between depreciable and other property should be the same to both parties. Therefore we recommend that the allocation for each party should be reasonable from his own standpoint, and that the present requirement placing them both on the same basis should be removed.

Time of Payment. At the present time, business income is ordinarily computed on an accrual basis, and other income, such as employment income, on a cash basis. Therefore, it is possible for salary expense to be accrued against a business without the corresponding income being reported by the employee until payment at a later date. Where an employee is in control of the corporation operating the business, he is in a position to use the different accounting methods as a device for delaying the payment of tax. To meet this situation, and possibly to counteract the introduction of fictitious charges by related non-resident persons, section 12(3) was introduced into the legislation many years ago, disallowing until the time of actual payment the deduction of items payable to persons not dealing with the taxpayer at arm's length, and not paid within a stipulated time 32/. In 1964 this provision was repealed and replaced by section 18(1), which is similar in effect to the former section 12(3), but also makes the disallowance permanent at the end of three years unless the parties file an agreement to the effect that the amount in question is deemed to have been received by the creditor and loaned back to the debtor.

Section 18(1) can result in certain anomalies and we suggest that these should be eliminated. For example, it should not apply if the creditor is on the accrual basis and has taken the amount into account in computing its income. Also, if no agreement is filed and the amount is paid subsequent to the three-year period, we think that the deduction should be allowed at the time of payment. Subject to these points, the section seems reasonable and we recommend that it be continued.

NEW AND SMALL BUSINESSES

Dual Corporate Rate

Until 1949 all corporate income was subject to the same rate of income tax. In that year the Minister of Finance introduced a dual rate of corporation

tax with the comment:

> "The House will at once recognize this as tax relief for small businesses and will, I trust, be heartily in accord with the policy. Our country as a whole owes a great deal to the small family type of business. They have to struggle along, grow and develop in competition with large and well financed corporations whose activities may be nation-wide. My own belief is that small businesses should be encouraged and it seems to me that a useful way to do this is to lower the tax and take less out of the funds they need for growth and expansion." 33/

The lower concessionary rate was thus introduced to encourage the growth of small businesses by leaving them with more funds for expansion. Subsequent changes in the concession, by increasing the amount of income taxable at the low rate, have been accompanied by similar statements pointing out the need to assist small businesses. Since 1961, the corporation income tax rates have been 21 per cent on the first $35,000 of income, and 50 per cent on the excess 34/.

Also in 1949 the dividend tax credit was introduced to remove "completely double taxation of small businesses" 35/. This credit now stands at 20 per cent, and, when used together with elections under section 105, has the effect of almost eliminating the "double" taxation for shareholders in low income corporations who have marginal personal income tax rates of 22 per cent or less, and of more than eliminating it for shareholders paying personal income tax at rates of 26 per cent or greater. This rather perverse impact is illustrated in Table 22-1, which shows that in the case of a shareholder in the 50 per cent tax bracket the total tax paid on distributed income would be 38.78 per cent. This latter effect is particularly significant as these tax concessions were only extended to businesses conducted by corporations and were not made applicable to proprietorships or partnerships.

TABLE 22-1

MAXIMUM TOTAL CORPORATION AND PERSONAL TAXES ON CORPORATE INCOME OF $100 TAXED AT 21 PER CENT a/

Marginal Rate of Share-holder %	Corporate Income $	Corporation Tax at 21 per cent $	After-Tax Corporate Income $	Net Personal Tax Rate b/ %	Personal Tax on $79 Dividend $	Total Corporation and Personal Tax %
(1)	(2)	(3)	(4)	(5)	(6)	(7)
10	100	21	79	-10	-7.90 c/	13.10
20	100	21	79	0	0.00	21.00
30	100	21	79	10	7.90	28.90
40	100	21	79	17.5	13.83	34.83
50	100	21	79	22.5	17.78	38.78
60	100	21	79	27.5	21.73	42.73
70	100	21	79	32.5	25.68	46.68
80	100	21	79	37.5	29.62	50.62

a/ Assuming no retention of after-tax corporate income and that the section 105 election is utilized.

b/ Marginal rate of shareholder less 20 per cent dividend tax credit on all of the dividend until the marginal personal rate exceeds 35 per cent, then only on one half the dividend with the flat 15 per cent tax under section 105 on the other half.

c/ Assuming the taxpayer has other income from which this can be deducted.

These figures must be qualified, however, to the extent that earnings are not paid out in the form of dividends. Many shareholders in corporations taxed at 21 per cent have not paid the personal taxes shown in column (6) of Table 22-1. Personal taxes on corporate source income have frequently been reduced or eliminated altogether. The sale of shares of corporations with retained earnings taxed at 21 per cent has made it possible for shareholders to realize all or part of the retained earnings as tax-free share gains. In the case of closely held corporations some relatively small costs have been involved in "surplus-stripping". We estimate that the top combined rate of corporation and personal income tax on low income corporations has been about 35 per cent when the optimum statutory provisions for special rates of tax on distributions have been followed.

This means that high income individuals whose income should be taxed at high marginal rates, have been able to reduce substantially their effective marginal rates of tax by holding the shares of corporations taxed at the low corporate rate. Far from suffering "double" taxation, these individuals have paid less tax on corporate source income than employees, proprietors, and partners have paid on incomes of the same size.

After carefully examining this low corporate rate concession we have come to the conclusion that, in addition to the above inequity, it has the following major defects:

1. The low corporate rate does not apply to unincorporated businesses, which may have just as much or more difficulty in raising funds.

2. An income of $35,000 or less does not mean that the corporation is owned by low income shareholders, that it has few assets or small gross sales, or that it is new. Using the low income criterion as a means of selecting the corporations eligible for the low rate results in a situation where the incentive has little if any relationship to the underlying problem which is the inadequacy of funds for expansion because of the imperfections in the capital market.

3. The low rate is inefficient as an incentive because it applies to the first $35,000 of corporate income regardless of the magnitude of the total income of the corporation. It thus reduces the average rate of tax for larger corporations which have no difficulty in raising capital in the market.

4. The concession is also inefficient because it applies whether the rate of return is high or low, or whether the assets or sales of the corporation are expanding or contracting. The concession has no time limit, so there is no inducement for the corporation to expand. Indeed, as its income expands its taxes increase more than proportionately.

5. By reducing the tax on low income corporations in perpetuity it tends to cushion the market pressures on inefficient and declining firms.

6. The concession also creates many potential avenues for abuse. To stop the worst loopholes it has been necessary to enact elaborate provisions designed to prevent the break-up of "large-income" companies into a number of "small-income" companies that would each enjoy the reduced rate of tax.

For all these reasons we recommend in Chapter 19 that the 21 per cent rate of tax on the first $35,000 of corporate income should be withdrawn, and that a uniform rate applicable to all corporate income should be substituted. We further recommend that this rate should be 50 per cent, including federal income taxes (before deducting the provincial tax abatement) and the old age security tax now levied against corporations. This 50 per cent rate is equal to the top marginal personal rate specified in our proposed rate structure. Because the provincial rates of corporation tax now differ slightly, a uniform 50 per cent rate could be achieved only by federal-provincial agreement. This matter is discussed in Chapter 38.

This does not mean that we believe the Income Tax Act should contain no special provisions for new businesses. On the contrary, we believe that the easy entry of new businesses can play an important role in the Canadian economy, and that preferential tax treatment is one of the ways in which they can be encouraged.

The easy entry of new firms can increase competition and hence bring about a more efficient allocation of resources. Moreover, new firms are frequently the vehicle by which new techniques and new products are introduced into the economy. In fact, an economy that actively encourages new enterprises will probably be one in which established large firms are active innovators as they seek to forestall the growth of competitors.

We are aware that easy entry is not an unmixed blessing in a world where many small investors have very imperfect knowledge. Some industries that are highly competitive with respect to price are characterized by a multitude of small proprietors, many of whom exist only long enough to use up their personal wealth. While this situation may be attractive to consumers, who can thus obtain goods and services below full cost, there is certainly no reason to introduce tax incentives that would encourage this uneconomic behaviour. Nevertheless, we believe that the advantages of fostering easy entry outweigh this disadvantage.

While many new businesses are small businesses at the outset, it is necessary to consider whether encouragement should be given to small businesses generally. It is important to distinguish between help for new businesses that are small because they are new, and help for small businesses _per se_. In some branches of retailing, for example, many proprietors receive low rates of return on their capital and below market wages for their time. There is chronic excess capacity.

Although directly or indirectly subsidizing small businesses is sometimes justified on political or social grounds, maintaining an environment characterized by countless numbers of small inefficient business units exacts a substantial cost in the long run in terms of a lower standard of living for Canadians.

We do not suggest that the tax system should be used to force a rationalization of industry, nor do we believe we can justify tax measures that have the effect of perpetuating businesses that cannot earn a competitive rate of return, whether they are large or small. Our objective is to

design a tax system that is neutral with respect to the size of the business and to restrict any concessions to new businesses that, because the owners may be relatively unknown or have relatively few assets, are forced to begin in a small way. This is where the capital market imperfections are probably greatest, as we have discussed in Chapter 4.

Investors discount expected rates of return on assets that are risky and for which there is no ready market. Therefore, the expected rate of return required to induce a flow of capital into a new business with untried management must be substantially higher than the expected rate of return required to induce the same flow into large established firms with a record of successful operations. Furthermore, the cost of underwriting small issues of securities adds considerably to the cost of financing new, small enterprises. Private sources of funds are often an expensive form of financing.

Canadian financial institutions have rarely invested in risky ventures. This may be entirely due to the high interest rates available on senior securities, but it could be also partly explained by legislation that restricts their portfolio selection, partly by the fact that they are not eligible for, or are unable to take advantage of, the dividend tax credit, partly by the rules of thumb used to select their portfolios, and partly by the fact that share losses have not been deductible for tax purposes.

There have been a number of important developments in recent years that have helped to reduce the financing problems of new and small businesses. Governments have played an increasingly important and valuable role in assisting them to finance their capital expenditures. The recent development of new financial institutions specializing in intermediate and long-term financing for new and small businesses is also encouraging. Implementation of the recommendations of the Royal Commission on Banking and Finance would go a considerable distance toward removing the remaining barriers faced by new and small businesses in raising funds for development and expansion. We therefore think that the problem of financing the entry of new firms is less pressing today than it was a decade or two ago.

Furthermore, a number of the recommendations we make elsewhere in this Report would help to reduce the barriers to investment in new and small businesses.

1. The liberal treatment of business and property losses would reduce the risk of investing in new ventures. We recommend that taxpayers should be permitted to carry business losses back two years and forward indefinitely, that such losses should be permitted as an offset against other income in any year, and that capital losses should be treated in the same way as business losses. The removal of most limitations on the timing and extent of the deductibility of losses would remove a major disincentive to investment in new and small businesses. The revaluation procedures discussed in Chapter 15 would also assist in this regard.

2. We recommend in Chapter 19 the complete integration of corporation and personal taxes, with a gross-up and credit for resident individual shareholders with respect to the Canadian corporation income tax. A comparison of the present system with the proposed full integration system is given in Table 22-2.

3. We recommend a new personal rate structure with a top marginal rate of 50 per cent.

4. We recommend that the shareholders of an incorporated business should, under certain circumstances, be permitted to file their tax returns as if the business were a partnership. Not only would such an election facilitate the claiming of losses by a shareholder against other income, but it would also enable him to avoid paying the flat rate 50 per cent corporation income tax and instead would allow him to pay his taxes at his own personal rate on a quarterly basis. This would ensure that his cash position was not temporarily worsened by the removal of the low rate of corporation income tax.

These reforms would substantially reduce the hardship that otherwise would be created by the removal of the lower corporate rate, and should to some extent provide an incentive to investment in new and small businesses.

TABLE 22-2

COMPARISON OF CORPORATION AND PERSONAL TAXES ON $100 OF CORPORATE INCOME UNDER THE PRESENT AND PROPOSED SYSTEMS

Present Marginal Rate of Share-holders (per cent)	Present System: Corporation Taxed at 21 per cent With Full Cash Dis-tribution a/	Present System: Corporation Taxed at 50 per cent With Full Cash Dis-tribution a/	Proposed System of Integration of Personal and Corporation Taxes With Top Personal Rate of 50 per cent b/ and With Full Allocation	Difference Between Present System and Proposed System (-) Reduction in Tax (+) Increase in Tax: Corporation Tax of 21 per cent	Difference Between Present System and Proposed System (-) Reduction in Tax (+) Increase in Tax: Corporation Tax of 50 per cent
	(dollars)				
	A	B	C	D(A-C)	E(B-C)
10	13.10	45.00	10.00	-3.10	-35.00
20	21.00	50.00	20.00	-1.00	-30.00
30	28.90	55.00	30.00	+1.10	-25.00
40	34.83	58.75	40.00	+5.17	-18.75
50	38.78	61.25	50.00	+11.22	-11.25
60	42.73	63.75	50.00	+7.27	-13.75
70	46.68	66.25	50.00	+3.32	-16.25
80	50.62	68.75	50.00	- .62	-18.75

a/ For illustrative purposes only. We do not wish to imply that full cash distributions would be usual. The table is for resident share-holders and follows the same assumption as in Table 22-1, where half the distribution was assumed to be under section 105 at a flat 15 per cent.

b/ It is assumed that the present marginal personal rates apply below 50 per cent, and that a 50 per cent rate applies to all taxpayers who previously had marginal rates over 50 per cent.

This is shown by the calculations given in Table 22-2. These calculations assume corporate income of $100 per share and include personal and corporation income taxes with full distribution (or allocation) of all after-tax corporate profits. It will be seen that removal of the low corporate rate, without integration and without the new personal rate structure, would substantially raise the taxes borne by that portion of the corporate stream of income now being taxed at 21 per cent, particularly for the low income shareholder. Under the proposed integration system, however, the increase in tax burden would be moderate and would be confined to the middle and upper income groups. Most shareholders with marginal rates of less than 30 per cent would have a reduction in tax.

However, here, too, this comparison requires careful qualifications. As we have pointed out, there have been a variety of techniques by which middle and upper income shareholders have been able to avoid some or all personal taxes on corporate source income. We have estimated that the top combined rate of tax on low rate corporate source income probably has not exceeded 35 per cent. Therefore, even with integration, the effective marginal rate of tax on high income shareholders in what have been low rate corporations would probably be raised by about 15 per cent.

With abolition of the low corporate rate, full integration of corporation and personal income taxes, and full taxation of share gains, shareholders in corporations that previously enjoyed the low rate would pay exactly the same taxes as individuals earning comparable incomes from employment and from operating unincorporated businesses. This would provide tax relief for the low income shareholder but would generally involve an increase in taxes for other shareholders, because under the present system these individuals are not subject to full progressive rates of tax on all their income (as we define income).

Rapid Write-off of Capital Cost

Despite our great reluctance to recommend the complex tax provisions that are inevitable when the tax structure is used to achieve specific

economic purposes, we believe it would be unwise to recommend withdrawal of the low corporate rate without making some adjustment within the tax system designed specifically to assist new and small businesses. We are concerned that if we did not propose a technique of assistance within the tax system, either our major reforms would be rejected because aid to new and small businesses outside the tax system might be thought to be impractical, or they would be implemented without the adoption of compensating policies outside the tax system, to the detriment of new and small businesses. We have decided that a concession to such businesses within the tax system that would assist in the financing of capital expenditures would reduce the major difficulty that confronts many of these businesses.

The concession we envisage should be designed to accomplish the following objectives:

1. To reduce the cost of capital to new businesses or rapidly expanding small businesses where those who control the business are not in a position either to put up much capital themselves or to raise capital cheaply because of their lack of an established financial position or an established reputation as successful managers.

2. To help fill the gap in the present capital market with respect to longer term financing of capital investment. We think that, in general, the regular sources of financing should provide the required funds for financing accounts receivable and inventory.

3. To avoid creating pressure on taxpayers to change the way they conduct their affairs in order to secure a tax advantage.

4. To promote the expansion of businesses rather than to perpetuate stagnating or declining businesses.

To accomplish these ends, we recommend a system of accelerated capital cost allowances with the following provisions:

1. The concession should be available to all qualified businesses, including farming, without regard to the legal form under which the

business was carried out, that is, corporation, trust, co-operative, proprietorship or partnership.

2. In order to qualify, the business should have to meet three tests for each year in which the accelerated capital cost allowances were claimed:

   a) The assets, after capital cost allowances, of the business and of other businesses controlled by the same shareholders should be less than $1 million <u>and</u> gross revenues should be less than $10 million.

   b) At least 70 per cent of the beneficial interest, defined as either the right to control or to receive income, in the business should be held by Canadian residents.

   c) At least 70 per cent of the beneficial interest, either direct or indirect, in the business should be held by one or more resident individuals, no one of whom:

      i) had a beneficial interest of more than 30 per cent in another business that was qualified or had been qualified for the accelerated write-off of capital costs, or

      ii) had, within the previous ten years, owned a beneficial interest of greater than 30 per cent in another business that was qualified for the accelerated capital cost allowance at the time the interest was held.

   In determining whether a 30 per cent beneficial interest was held or had previously been held by an individual in another business, the interests of members of his family unit should be included.

3. The business should be required to apply to the tax authorities for status as a qualified business. The applicant would have to satisfy the authorities that the business met all the statutory conditions in order to qualify. This would be done by an application setting forth the relevant facts of the business. Refusal of the authorities to

qualify a business would be subject to appeal to the courts. If an application or appeal was successful, the qualifications would be effective as of the date on which the original application was made. The procedure would be optional to the taxpayer, and he would not have to qualify an eligible business unless it was advantageous for him to do so.

4. Qualified businesses should be permitted to claim capital cost allowances up to the full actual capital costs in computing taxable income in any one year, or over a period of years, to a total value of $250,000, without regard to the maximum capital cost allowance rates specified in the Regulations.

5. Capital costs incurred before qualification would not be deductible after qualification, except at normal capital cost allowance rates.

6. Having once been deducted, capital costs should not be claimed again under any circumstances. If the assets were sold for more than their undepreciated capital cost the excess would be brought into income in the usual fashion.

7. Businesses in existence at the effective date of the legislation should be permitted to apply for qualification for capital costs incurred subsequent to the effective date of qualification.

8. The definition of a separate business has been discussed earlier in this chapter.

9. If a business had qualified for the rapid write-off in one year, and was subsequently disqualified because of the growth of its assets or sales, the unused part of the $250,000 should be deductible in later years if, through a decline in assets or sales, it subsequently qualified. Ten years after qualifying, the business should be automatically disqualified even if part of the $250,000 accelerated capital cost allowance had not been deducted.

10. A business that exhausted its $250,000 of accelerated capital cost allowances, or became disqualified by the passage of the ten-year period, would not again become qualified.

We are under no illusions that this rapid write-off of capital costs for new and small businesses would be simple to administer. Despite these administrative difficulties, we believe that our proposals would not create the complexities that now exist in the present "associated corporations" provisions of the Act.

When the split corporate rate was introduced in 1949, it was made applicable to all corporations, with the exception that those subject to common control were required to share the low rate of tax. Presumably, it was considered that, even though the existence of separate corporate entities had a sound business reason, they should be regarded as a unit for purposes of the tax relief to small businesses. At the same time, the associated corporations rule was an anti-avoidance measure intended to restrain the the proliferation of corporations purely for the purpose of obtaining additional low rates of tax.

The concept of control in determining association was immediately viewed by taxpayers as too stringent, 36/ and, in 1950, retroactive to 1949, the test of control was replaced by that of a 70 per cent degree of ownership. This basic test was supported by other rules, one of the main objectives of which was to treat individuals not dealing at arm's length as a common group. These rules became more complex and difficult to interpret, and, at the same time, the ingenuity of taxpayers was such that the intent of the legislation was being thwarted. In 1960, the legislation was substantially amended to abandon the 70 per cent ownership test and revert to the test of control. This still proved insufficient to prevent undue advantage being taken of the low rate, and in 1963 the government added the present overriding section 138A(2) under which the Minister may deem corporations to be associated if their separate existence is not solely for the purpose of carrying out their business in the most effective manner,

and if one of the main reasons for such separate existence is to reduce the amounts of taxes otherwise payable. Such ministerial action can be appealed, but will be set aside only if it is determined that none of the main reasons for the separate existence is to reduce the taxes otherwise payable. This last change has probably checked the undue proliferation of corporate entities for tax minimization, but it is based on determining the intention of the taxpayer, which is always difficult, and the appeal provisions seem to be slanted in favour of the Minister.

Our proposal should, if implemented, lead to fewer avoidance problems than the split corporate rate for three reasons:

1. The relief would be available only to qualified businesses and, in order to qualify, the business would have to make an application to the tax authorities. In this way the authorities could obtain all the information necessary to trigger quick action to close loopholes.

2. The rapid write-off of capital costs would be, in effect, an interest-free loan to those small businesses that were acquiring fixed assets within a relatively short period. Because the relief would take the form of a deferment of tax, rather than a permanent remission of tax, this should reduce the lengths to which taxpayers would go to obtain qualification.

3. By restricting the provisions to businesses controlled by Canadian residents, the proposed concession should be more easily policed than the present low rate provision.

It is quite true that we have not defined a new business but only a small business, and so it might be argued that our proposal is no great improvement over the present system. However, it should be noted that after a transitional period of about ten years, during which time all the qualified small businesses would have used up their accelerated depreciation or their qualifications would have expired, the concession would apply only to new businesses. We assume that all small businesses that could qualify would do so as quickly as possible after the provision was introduced.

We emphasize the liberality of the transitional provisions we recommend. Because most existing small businesses would be able to qualify if our proposal was introduced, those that undertook substantial capital expenditures after qualification could probably avoid payment of corporation taxes for several years. If the total income of the business before depreciation did not exceed $250,000 over a ten-year period, and if it acquired depreciable assets to a value at least equal to its income before depreciation, no income tax would be payable for the ten years. Moreover, at the expiration of the qualification period, or on the exhaustion of the $250,000 allowance, the tax burden would not be unduly harsh. Because the tax on business income would then be levied at personal rates, low income individuals who owned or controlled small businesses would ordinarily pay lower taxes than at present, even with the split rate. Upper income individuals in receipt of income from small businesses would pay higher taxes on this income than at present, but this would only bring them into line with other individuals with the same level of income from other sources. The reduction in the top marginal personal rate would ensure that no individual was faced with a marginal rate of over 50 per cent on his business income.

CONCLUSIONS AND RECOMMENDATIONS

COMPUTATION OF BUSINESS INCOME

1. Business income for tax purposes should continue to be based on "profit" as a starting point.

2. Some of the present statutory provisions for computing income should be repealed, as indicated below, to permit the tax authorities and the courts to look more to accounting and business practice in determining profit.

3. The legislation should be amended to ensure that all types of revenues were included in business income, including property gains, gifts, windfalls, and the forgiveness or cancellation of debt.

4. The present provisions for a general disallowance of "reserves", and for the specific allowance of "reserves" in respect of unearned income and doubtful accounts should be repealed. The general statutory test of reasonableness should apply to allowances for unearned income, to estimated losses in value of accounts receivable, and to allowances in respect of losses that could result from guarantees, warranties, and indemnities.

DEDUCTIBILITY OF EXPENSES

5. All expenditures reasonably related to the gaining or producing of income should be deductible at some time. They should be deductible when incurred unless they were applicable to inventory, to an item defined in a capital cost allowance schedule, or to property of an indefinite life such as purchased goodwill, land, and securities. Costs allocated to the first group should be deductible from the proceeds of sales, those of the second group should be amortized as permitted by the schedules, and for the last group, losses should be deductible on disposition or when there was a proven significant loss in value.

6. Any element of personal benefit in business expenditures may generally be allowed in arriving at business income, but should be reported as income of the recipient. If such allocation to the recipient is not possible, the business should be subject to a special tax on such personal benefits on their grossed-up amount at the top personal rate, and this special tax should be allowed as a deduction.

7. The general test of reasonableness should continue to apply to all business expenditures. Where individuals carry on business directly, personal or living expenses of the indiviuals should not be deductible. However, the disallowance of expenditures for the purpose of producing exempt income should be deleted.

8. The present rules regarding inventory valuation should be deleted, and more reliance should be placed on accounting and business practice, with satisfactory guidelines developed by the business and professional community and the tax authorities. The use of the last-in-first-out method of inventory valuation should be allowed on a restricted basis.

9. The amortization of costs provided under the present capital cost allowance system should be continued with the present general level of rates unchanged, but the system should be broadened to cover certain defined outlays now known as "nothings" that are at present non-deductible. The following modifications should be made to the system:

   a) There should be no allowance until an asset has been put into use.

   b) In accordance with our recommendation for a comprehensive tax base, the proceeds from disposal of a depreciable asset in excess of its original cost should be taxable.

   c) A deduction should be permitted to the extent that the unclaimed cost in any class exceeded the original cost of the remaining assets.

   d) Rentals for long-term assets with a purchase option should be allowed only to the extent that they were reasonable and any excess should be treated as being on account of the purchase price of the asset. In addition, there should be a specific provision requiring an amount to be brought into income and capitalized where a lessee acquires, at less than fair market value, an asset which he has been renting.

10. The cost of purchased goodwill, or other intangible assets of indefinite life, would be deductible upon disposition or upon an established, significant loss in value in the same manner as recommended for land and securities in Chapter 15.

ACCRUAL BASIS

11. All businesses should compute income on the accrual basis, including farming and professions, except that an individual whose principal source of income was farming or a profession, and whose annual gross revenue from that source was less than a specified sum, say, $10,000, would be entitled to continue on the cash basis. A transitional provision would defer payment of any tax liability on the initial accounts receivable and inventory until final disposition of the business.

BUSINESS LOSSES

12. Business losses should be subject to the following treatment:

    a) The present provisions for applying losses against other income should be broadened by allowing most losses to be carried back against any income of the two previous years, and carried forward indefinitely against any income of future years.

    b) Some form of consolidation for tax purposes should be permitted for groups of corporations under the same ownership.

    c) Transfer of losses between taxpayers should be prohibited, except on certain tax-free reorganizations.

    d) Certain losses, determined by an arbitrary formula, should be deemed to be of a personal nature and should only be deductible from gains from the same business in the two previous years or in any succeeding year.

TRANSACTIONS NOT AT ARM'S LENGTH

13. The rules applied to transactions between parties who do not deal at arm's length should be amended as follows:

    a) The test of fair market value should be applied to all transactions between parties not dealing with each other at arm's

length, except where special rules are applicable.

b) Where the purchase price of property has to be allocated among more than one type of property, such as inventory, depreciable assets, and goodwill, each party should be permitted to make a reasonable allocation from his own point of view.

NEW AND SMALL BUSINESSES

14. The dual rate of corporation tax should be replaced by a single rate of 50 per cent which would include the old age security tax.

15. New and small businesses should be allowed to write off expenditures for assets eligible for capital cost allowances at any time, if they so elect, subject to the following restrictions:

a) The privilege would be available only to those businesses, whether incorporated or not, that had gross revenues of under $10 million in the tax year and total assets, net of capital cost allowances, of less than $1 million book value.

b) The privilege would be available only to those businesses that made application to the tax authorities, and would apply only to the cost of assets acquired after the application.

c) The privilege would be available only to those businesses in which at least 70 per cent of the beneficial interest in voting power or profits was owned directly or indirectly by Canadian resident individuals who, together with members of their family units:

i) did not hold a beneficial interest of more than 30 per cent in another business that was qualified, and

ii) had not held, within the previous ten years, a beneficial interest of more than 30 per cent in a business that was qualified at the time the interest was held.

d) The value of depreciable assets the cost of which would be eligible for the accelerated write-off would be limited to $250,000.

e) A business that had ceased to qualify, either because it had used up its $250,000 allowance or because it had failed to use up the allowance within a ten-year period, could not again become qualified.

f) As soon as the business ceased to meet either of the restrictions on gross revenue or asset value, any additional capital assets would be subject to the regular capital cost allowance regulations.

g) All assets of such a qualifying business should be subject to the regular provisions applying on disposition of depreciable assets.

REFERENCES

1/ As used in this Report, the expression "accounting practices" may be taken to include not only the practices of accounting but also the underlying principles on which the practices are based.

2/ Section 85F.

3/ Section 12(1)(b).

4/ Section 11.

5/ Section 3.

6/ Section 27(1)(e).

7/ Sections 27(5) and 27(5a).

8/ As shown, for example, in the case of Atlantic Engine Rebuilders Ltd. v. M.N.R., 64 DTC 5178, where the Exchequer Court expressed doubt as to whether section 85B applied to certain deposits.

9/ See the brief submitted to this Commission by the Canadian Institute of Chartered Accountants, pp. 12-13.

10/ Canadian Institute of Chartered Accountants, Committee on Accounting and Auditing Research, Bulletin No. 9, January 1953.

11/ While it is fairly obvious that material and labour directly used in the production of a product should be included in its value, the inclusion of variable overhead, such as a foreman's salary, is less obvious, and the inclusion of fixed overhead, such as depreciation and property taxes on a factory building, is still more questionable. The general practice varies from including an estimated amount for all the overhead to that of including no overhead, depending on the particular circumstances involved and the theory adopted. (The first approach is commonly referred to as "absorption costing" and the second as "direct costing".) The reason for a variation in practice

is that a business is viewed as a going concern, and consistency in the treatment of inventory is considered more important than accurate reflection of the historical position of the business at a given date. The English courts have held that a taxpayer who has consistently employed direct costing cannot be required to depart from it (Duple Motor Bodies Ltd. v. Ostime (1961), 39 T.C. 537).

In estimating the extent to which the cost of the inventory will benefit future periods, market value is often available as an objective measure. The market value, depending on the type of inventory, may be determined in terms of replacement cost or net realizable value upon sale. If the market value is higher than the cost of the inventory, the full amount of the cost can be deferred, whereas if the market value is lower the usual practice would be to carry costs forward only to the extent of that market value. However, there is some lack of agreement on whether market value should be based on replacement cost or net realizable value, and in determining net realizable value there is dispute as to whether cost should be written down to permit realization of a reasonable profit in the subsequent period.

12/ M.N.R. v. Anaconda American Brass Limited, [1956] A.C. 85.

13/ M.N.R. v. Anaconda American Brass Limited, [1954] S.C.R. 737.

14/ [1952] Ex. C.R. 297.

15/ Striking evidence of this was the change in business practice after the present system of capital cost allowances was introduced in 1949. It was initially provided, until the 1954 taxation year, that a taxpayer could not claim the capital cost allowances unless he entered an equivalent amount of depreciation in his accounts. To obtain the benefit of the more generous tax allowances, many taxpayers changed the amount of depreciation charged in the accounts.

16/ We did receive representations that some of the rates were not adequate, for example, in respect of heavy construction equipment, building equipment, certain hotel equipment, and electronic equipment. We note, however, that the Regulations were recently amended to provide a higher rate for heavy construction equipment. Occasional adjustments of rates are appropriate, although it must be kept in mind that the simplicity of the system arises from the grouping of a multitude of types of assets into a relatively few classes, and the rate for a specific type of asset may well not be accurate.

17/ Recommendations are made elsewhere in this chapter to expand the capital cost allowance system to cover certain "nothings".

18/ R. W. Davis et al., Capital Cost Allowances, a study published by the Commission.

19/ One of which was presented to the Commission by International Business Machines Ltd.

20/ The terms of the legislation appeared to be such that in the case of long-term leases very substantial annual capital cost allowances could be claimed by regarding the purchase price for the property as the aggregate of the annual rentals payable plus the option price. In two recent Exchequer Court decisions, however, the purchase price has been treated as being the final option price: Louis J. Harris v. M.N.R., 64 DTC 5332; Consolidated Building Corporation Limited v. M.N.R., 65 DTC 5211. The taxpayer's appeal in the former case was dismissed by the Supreme Court of Canada (66 DTC 5189) on the ground that the arrangement violated the rule against perpetuities, and that in any event, (a) the final option price was the purchase price on which capital cost allowances should be calculated, and (b) the allowance claimed would artificially reduce the taxpayer's income and should be disallowed under section 137(1).

21/ This discussion of leasing has been in terms of depreciable assets. If land is involved the potential tax reduction is even greater, and similar rules should apply. The offsetting amount would be added to the cost basis of the land.

22/ If a business goes through a lengthy period of development, the costs of development may be amortized over an arbitrary period of operations. Or again, where a business incurs extensive advertising or promotional expenses toward the end of a year, some or all of the costs may be deferred and applied against income of the following year. The problem, of course, is in forecasting the future benefits of such expenditure.

23/ Some controlling provisions might be required because of the possibility of inflating share values and overstating these expenditures.

24/ In the United States a loss may be carried back three years and forward five. The United Kingdom permits an indefinite carry-forward and, on cessation of business only, a three-year carry-back. The Netherlands permits a one-year carry-back, but there is no provision for carrying back losses in France, Germany or Sweden. A carry-forward period of five years is common, although Norway permits a carry-forward of ten years; and, in The Netherlands, where the standard period of carry-forward is six years, a new business may carry forward indefinitely losses incurred in the first six years.

25/ We have proposed that this same carry-over should also apply to most other losses, including losses from the disposition of property (including shares). These loss carry-over rules would be in addition to the methods of income averaging which we recommend in Chapter 13. In the case of corporations, however, the carry-back would be limited to the amount of the income for the years in question which had not been distributed or allocated to the shareholders.

26/ Further discussion of the deduction for farm losses is contained in Chapter 25.

27/ This point was emphasized by the Canadian Bar Association in its appearance before this Commission. Under the present legislation transactions at other than market value are possible in respect of such items as fixed assets, service, and interest, as explained in the discussion later in this chapter of transactions not at arm's length. In addition, the tax authorities do not always insist on the application of the fair market value rule in transactions between Canadian companies.

28/ Sections 27(5) and 27(5a).

29/ For example, by a transfer of assets or shares from one wholly owned subsidiary to another wholly owned subsidiary of the same parent corporation. Tax-free reorganizations and transfers are discussed in Chapter 15.

30/ A modification to this rule is suggested in Appendix A to Volume 3, which deals with tax avoidance.

31/ Where this price is not the fair market value, the question arises whether section 17 overrides section 85E when the parties are not at arm's length. It has generally been departmental policy not to apply section 17 where section 85E applies.

32/ We understand that there was also concern that a Canadian corporation might claim deductions for merchandise purchased from a non-resident parent, and then subsequently receive a non-taxable forgiveness of the liability for the purchases. This possibility would no longer exist under our comprehensive tax base because forgiveness of debt would be income to the debtor.

33/ Budget Speech, Ottawa: Queen's Printer, 1949, p. 14.

34/ This rate includes the 3 per cent old age security tax and is calculated before deduction of the provincial tax abatement. The rate is higher in those provinces where the provincial tax levied exceeds the abatement. See Appendix I to this Volume for a discussion of the dual rate of corporation income tax.

35/ Budget Speech, op. cit., p. 15.

36/ The major complaint is said to have been that the test of control discouraged the formation of new corporations that depended upon capital furnished by existing corporations, or by individuals who already controlled one or more corporations; Report of Proceedings of the Fourteenth Annual Tax Conference, Toronto: Canadian Tax Foundation, 1960, pp. 43-44.

CHAPTER 23

MINING AND PETROLEUM

The *Income Tax Act* has a number of special provisions relating to the mining and petroleum industries. A detailed examination of their effects can be found in studies published by the Commission 1/. Several participants in our public hearings also submitted extensive studies of the tax provisions together with illustrations of their application under different circumstances. The most significant of the tax provisions from the point of view of revenue loss are outlined briefly below:

1. In general, qualifying corporations 2/ can claim immediately the costs of exploration and development as deductions from income from any source 3/. Any portion of these costs not absorbed against current income may be carried forward indefinitely. Depreciation on plant and equipment is not allowed as an exploration or development cost as such assets are subject to regular capital cost allowance.

2. The income of new mines is exempt from tax for a period of three years 4/. Because a taxpayer may defer deduction of any capital cost allowance or development costs until after this period of exemption, income tax is unlikely to be paid for some additional years after this initial three years.

3. Taxpayers who operate oil or gas wells or mines 5/ (with the exception of gold 6/ and coal 7/ mines, which are given special allowances) are permitted to claim a depletion allowance equal to one third of their taxable income from petroleum production or mining operations. (The term "petroleum" when used in this chapter should be taken to include natural gas.) In general, this provision can be said to reduce the effective rate of corporation tax by one third. Non-operators are entitled to a depletion allowance of 25 per cent 8/ of their gross income from the mining or petroleum operation. In addition, shareholders are permitted to deduct 10 per cent, 15 per cent or 20 per cent

of the amount of dividends paid by certain corporations resident in Canada if the income of the corporation which was derived directly or indirectly from the operation of a mine, oil or gas well meets the prescribed tests 9/.

These provisions of the Income Tax Act and the Regulations have been subject to controversy over the years between those who have argued that they reflect only the necessary distinction that should be made to take account of the peculiar characteristics of these extractive industries, and those who argue that the provisions result in an unwarranted tax concession to a particular type of economic activity.

The present tax treatment of business income has several major defects as discussed in Chapters 9 and 22. In particular, because of the exclusion of capital items from income, some costs are not deductible at any time. The limitations on the carry-forward, carry-back, deductibility against other income and transferability of losses mean that the present system is seriously biased against risk taking by new and small businesses. The low rate of corporation tax on the first $35,000 of corporate income appears to be a relatively inefficient and ineffective method of compensating for the apparent bias of the capital market against risk taking by small firms.

With the adoption of the recommendations made elsewhere in this Report these defects would be virtually eliminated for all businesses. To the extent that the mining and petroleum industries have been particularly penalized by these deficiencies in the present system, these industries would obtain a greater benefit than other industries from the general reforms which we propose.

The defects in the present system are of omission as well as commission. If all costs are made fully deductible, all gains should be made fully taxable. The recommendations made elsewhere would bring into tax all property and other gains at full rates and would subject all corporate income to a

flat rate of tax of 50 per cent. The question is therefore whether the present special tax concessions to the mining and petroleum industries would have any place in a reformed tax system that eliminated some of the defects in the existing system that perhaps justified granting the concessions in the first instance. The great emphasis that has been placed throughout this Report on the paramount importance of horizontal equity and neutrality of tax treatment among different activities means that deviation from the full taxation of all income is only acceptable if there is an overwhelming reason for doing so.

After carefully analyzing the many arguments advanced in support of special concessions to the mining and petroleum industries, we have concluded that, in general, adoption of the reforms recommended for the taxation of businesses and corporations would make the special tax concessions to these industries unnecessary and unacceptable. Percentage depletion and the three-year exemption for new mines are extremely costly in terms of revenue, and the available evidence suggests that these concessions are inefficient (i.e., that they have a relatively small effect on mineral and petroleum exploration and production per dollar of tax revenue forgone).

It is estimated that in 1964 the three-year exemption for new mines and the depletion allowances reduced tax revenues by over $150 million. It is true that in the absence of these concessions the income generated by mining and petroleum almost certainly would have been less, but the increased investment in other industries of funds which were invested in mining and petroleum would have increased taxable revenues from these other industries. Hence, if the concessions are as inefficient as we believe them to be, any overstatement of the revenue loss is relatively small. When it is recognized that $150 million is almost equal to the revenue raised by four percentage points of the corporation income tax, it is apparent that a significant reduction in the taxes levied on other businesses would be possible if the concessions were removed.

There is no doubt that these concessions encourage the mining and petroleum industries. As a result of the concessions, Canada has more investment in these activities, more people are employed in them, and the volume of our exports of minerals and petroleum is no doubt greater and the volume of our imports of minerals and petroleum is no doubt smaller than otherwise would be the case. In addition Canada's known mineral and petroleum reserves are probably somewhat greater than they otherwise would be.

The issue is not the direction of the effects of the concessions but rather:

1. Have the effects been significant?

2. To the extent they have been significant, did the diversion of labour and capital from other uses to the mining and petroleum industries increase or decrease the total output of the goods and services that Canadians want (or that could be traded for such things)?

3. To the extent that the diversion increased the economic welfare of Canadians, could it have been achieved at lower cost?

In our opinion, the concessions probably brought about an increase in the allocation of capital and labour to mineral and petroleum extraction; but there is no presumption that this had a beneficial effect on the overall economic well-being of Canadians. Even if the re-allocation did improve general economic well-being, the concessions were an unnecessarily costly method of achieving this result.

THE DETERMINATION OF INCOME FROM MINERAL AND PETROLEUM EXTRACTION

Discovery Value

The "discovery value" of a mineral or petroleum deposit—the value of a deposit in excess of its cost of discovery—is the net gain in the value of a right to or interest in property resulting from the discovery of a

mineral or petroleum deposit. To maintain equity in the tax system it is necessary that those who realize such net gains, either through the disposition of the interests or rights in the property or through the sale of the minerals or petroleum extracted from the deposits, should be taxed in full on the net gains. It is impractical to tax most property gains on an accrual basis because of valuation problems. This is certainly the case with respect to discovery value. To tax discovery value at the time of the discovery (i.e., on an accrual basis) would be virtually impossible because of the difficulty of estimating the quantity of reserves, the costs of extraction and the trend of future market prices for the product.

Discovery value is, in essence, a capital gain. Because the present tax system does not bring capital gains into tax, it is sometimes argued that to define income from the extraction and sale of minerals or petroleum as the difference between gross revenues and the actual costs of generating those revenues would overstate "true" income because the capital gain element would not be deducted from gross revenues. This overlooks the fact that those who are in the business of making capital gains are subject to tax on those gains, and those who hold rights to or interests in mineral or petroleum properties usually are in the business of making discoveries. In any event, whatever the merits of this argument in the context of the present system, under the system which we have proposed, discovery value would be taxed on the same basis as other kinds of gains and a reduction in income from mineral or petroleum extraction to reflect discovery value would be inconsistent with the treatment accorded other kinds of net gains.

Percentage depletion allowances are also advocated as a method of compensating for the exhaustion of the deposit. In manufacturing, for example, the cost of the machine used up in producing the goods that are sold is deducted from revenues in determining income. It is argued that similarly mineral and petroleum deposits, being wasting assets, are used up by extraction and a similar deduction for the cost of acquiring the asset

is appropriate. This point of view is valid and leads to the conclusion that all of the costs incurred in acquiring mineral and petroleum rights and in discovering and developing the deposits should be deductible from revenue at some time 10/. However, it does not justify the writing-off of discovery values. The discovery value of a deposit is, by definition, the gain in value of a right to or interest in property after deducting all costs of discovery. Discovery value should not be deducted from the revenues from the sale of minerals or petroleum any more than revenues from the sale of manufactured goods out of inventory should be reduced if these revenues exceed the cost of producing the goods sold.

As in the case of other businesses, the income from mineral and petroleum extraction should be determined by including in income all revenues and by deducting from income all of the costs actually incurred in earning that income. There is little if any problem in determining what should be included and deducted in computing income. There is a problem in determining the time at which costs should be deducted in order to measure income from mineral and petroleum extraction in a manner that is comparable with measures of income from other kinds of business.

Exploration Costs Generally

The more uncertain the value of the asset created by a particular expenditure, the more rapidly the cost should be written off. Because the probability of success for a particular exploration venture is usually low, it is reasonable to deduct exploration costs immediately in determining income. The immediate write-off of these costs would be an effective form of tax incentive to new mineral and petroleum discovery and would also be consistent with the recommended treatment of research and product development costs for businesses generally.

Development Costs Generally

Development costs in mineral and petroleum extraction are comparable to inventory costs in, say, a manufacturing business, although the value of the asset created by the latter expenditures is more certain than is the case with exploration costs. Development costs are much more directly related to the earning of future income. In principle, therefore, if the method of measuring income from mineral and petroleum extraction is to correspond with the method of measuring income from other industries, development expenses should be deferred and written off against the revenue received from disposing of the minerals or petroleum in the developed deposit or well.

In order to match development expenses against the revenues from the extraction of minerals and petroleum it would be necessary to segregate exploration and development costs. The dividing line is uncertain in the mining industry and even less clear in the oil industry. But it should not prove impossible to draw up arbitrary but reasonable rules that would separate the two kinds of costs. Ultimately an attempt should be made to do so. The Canadian Petroleum Association has already agreed on some division for statistical purposes. We believe that regulations could be written after discussion between the tax authorities and industry representatives that would provide adequate guidelines for the allocation.

The accounting practices followed in financial statements would not provide a suitable basis for segregating exploration and development costs. Not only is there considerable variation in the practices now followed by companies, but also accounting practices would be adversely influenced if they became significant in the determination of the tax liability.

There are three general ways of determining the write-off of development costs once these costs have been segregated. The first would be to relate amortization to the rate of extraction of the mineral or petroleum. This would match costs against revenue, but it is usually impossible to obtain a reliable

estimate of the total expected production. A second method would be to write off development costs on the basis of the life of the mine or well, subject to an arbitrary maximum period to avoid severe administrative difficulties. The difficulty of obtaining a reliable estimate of the amortization period would remain. The third alternative would be to have arbitrary rates of write-off regardless of the life of the mine or well.

The third alternative would be the most workable and would not unduly depart from the principle of matching revenues and expenses. Accordingly, it would be preferable to establish some general arbitrary rate at which development costs could be written off—as is done for capital assets generally. Depending on the dividing line eventually established between exploration and development costs, the rate of amortization on a diminishing balance basis that would treat the mining and petroleum industries in a manner similar to other industries would be approximately 20 per cent.

Costs other than those related to exploration and development would be deductible from income in the way already recommended for business costs in general.

Exploration and Development Costs in Mining

Development expenses in mining are approximately four times as great as exploration expenses. The Dominion Bureau of Statistics reported that prospecting and exploration costs were about $45 million in 1960. The costs incurred after the decisions are made to develop the mines average about $200 million a year. Our survey of the mining industry 11/ showed that the development period is usually from one to four years in length but may run over seven years. The same survey suggested that of the total expenditures on depreciable assets and development, depreciable assets constituted between 25 per cent and 90 per cent and averaged about 75 per cent. Most of the responding companies in their accounts wrote off their exploration expenses in the year incurred but wrote off development costs against subsequent income from production.

Depreciable Assets Used in Mining

As already indicated, in the mining industry a substantial investment in depreciable assets is required in the development period. Most of these assets are used for purposes of production. While the physical characteristics of the depreciable assets themselves are similar to those used in business generally, the unique feature of mining assets is that they are of little commercial use if the mine is abandoned. It would therefore be appropriate, for the matching of costs against revenue, that the method of writing off the depreciable assets should reflect the life of the mine. Accordingly, to the extent that depreciable assets were used in the development period, depreciation thereof should be treated as part of the development costs and written off in the same manner as other development costs. However, certain depreciable assets, such as a smelter or a refinery, may not be dependent upon one mine for usefulness. In addition, certain associated facilities such as townsites, railways and airports may be constructed primarily for purposes of the mine, but may have other possible uses to the taxpayer in the future. In neither of these cases would a write-off of cost over the life of one mine (or at the arbitrary rates used for administrative reasons in the case of development costs) necessarily be the most appropriate procedure.

The Mining Survey indicated that in the mining industry a great variety of depreciation methods are used for corporation accounting purposes. The straight-line method is frequently adopted, with rates varying from 4 per cent to 15 per cent; but both the unit-of-production method and the diminishing balance method are also employed.

Exploration and Development Costs in Petroleum

Although the breakdown between exploration and development costs in the petroleum industry cannot be determined exactly, the statistics provided

by the Canadian Petroleum Association suggest that expenditures in each of these activities are about $100 million to $200 million annually.

While only a small proportion of exploratory drilling has resulted in productive wells, 80 per cent to 90 per cent of development drilling has been successful.

The appropriate treatment of exploration and development costs for petroleum has raised considerable controversy in accounting circles in Canada and the United States in recent years. Some argue that anyone embarking on an oil exploration programme accepts the fact that a certain amount of drilling will be unsuccessful, and that therefore the cost of the unsuccessful drilling should be treated as part of the cost of the oil reserves resulting from successful drilling. This "full costing" approach would have the deduction of all exploration and development costs deferred in some manner and amortized against subsequent production of oil; it has been gaining some support recently and has been adopted by some Canadian companies. Many, however, object to this method on the grounds that the hope of eventual success may never be realized and that it is not realistic to bring together costs of operation and revenues in unrelated geographic areas 12/.

PRESENT TAX TREATMENT

All prospecting, exploration and development costs, including the costs of oil rights and properties purchased from others, but excluding mining rights, 13/ are generally deductible immediately to the extent of the taxpayer's income from all sources (excluding exempt dividends and before deducting the depletion allowance). Any costs not deducted in the year may be carried forward indefinitely against income of future years.

Once a mine has commenced production, the cost of any further development work (referred to as "forward development") is usually regarded as a current operating expense except to the extent that it relates to underground work designed for continuing use, such as a mine shaft, a main haulage way

or an extension thereof. The treatment of the latter type of expense is set out below.

As already indicated, there are also special provisions permitting depletion allowances to be deducted in arriving at income for tax purposes.

Equipment and structures acquired for use in the production of petroleum are generally entitled, under the present legislation, to be written off on the diminishing balance basis at the rate of 30 per cent 14/.

Mining machinery and equipment and buildings acquired for the purpose of gaining or producing income from a mine (except office buildings that are not situated on the mine property and refineries) are subject to capital cost allowance at 30 per cent on the diminishing balance basis 14/. Mine shafts, main haulage ways and other similar underground work designed for continuing use and constructed after the mine came into production are permitted an annual write-off of up to 100 per cent 15/. This permits the taxpayer to treat them as expenses when he chooses. Associated facilities such as roads, railways, airports and wharfs are subject to the ordinary capital cost allowance rates for such assets, which range from 4 per cent to 10 per cent on the diminishing balance basis 16/. Under the present capital cost allowance system the allowance is dependent upon ownership, and accordingly commences upon acquisition rather than use 17/. No recognition is given for tax purposes to the cost of facilities, such as developed sites and buildings, which are donated by the taxpayer to the local authorities 18/.

In addition to the above provisions concerning the treatment of costs, there are other special provisions, one of the most important of which is the exemption from tax for three years of the income of a new mine. This exemption is rendered more significant by the fact that a taxpayer may defer claiming any capital cost allowance on depreciable assets and any pre-production costs until after the three-year period.

ARGUMENTS FOR SPECIAL TAX PROVISIONS

Based on a review of published material, the briefs presented to us, the views expressed at the hearings and interviews conducted by members of our staff, we found that most of the arguments advanced in support of special tax provisions for the resource industries fell into one or another of five general categories. These categories are briefly described below:

1. The "accounting neutrality" argument: in determining taxable income, all costs of generating income should be deductible at some time; and because of the uncertainty of the return from outlays incurred in the extraction of minerals and petroleum these costs should be deducted quickly. Thus, early write-offs are advocated as a means of achieving inter-industry neutrality.

2. The tax system bias against risk-taking argument: mineral and petroleum extraction is particularly risky; tax systems that lack complete loss-offsets discriminate against risk taking; the present tax system does not provide complete loss-offsets; the present tax system therefore discriminates against mineral and petroleum extraction. Special tax concessions to the extractive industries are therefore required to compensate for this feature of the tax system in order to achieve inter-industry tax neutrality.

3. The capital market bias against risk-taking argument: mineral and petroleum extraction is particularly risky; the capital market discriminates against risky ventures; the capital market therefore discriminates against mineral and petroleum extraction. Special tax concessions to the extractive industries are required to compensate for this market bias.

4. The corporation tax discrimination against mineral and petroleum extraction argument: the corporation tax falls on one factor of production—equity capital; the extractive industries are equity

capital intensive and rely relatively little on debt financing; following imposition of a corporation tax the resource industries either have to raise their prices more in the short run or reduce investment more in the long run than other industries in order to restore inter-industry equilibrium in after-tax rates of return. If the adjustment is through reduced investment, the corporation tax reduces investment in the mining and petroleum industries more than in other industries. Tax concessions to mineral and petroleum extraction are required to compensate for this non-neutral feature of the corporation tax.

5. Expanded investment in the extractive industries confers social and economic benefits argument: expanded resource industries provide benefits to the economy that individual investors do not take into account. Consequently, without tax incentives (or subsidies) there would be too little investment in the resource industries from the point of view of society as a whole. In particular, without tax concessions foreign direct investment in Canada would be reduced and Canadian capital destined for the extractive industries would be invested abroad to the detriment of Canadians. This argument can be broken down into a number of more specific contentions which are listed and discussed later in this chapter.

Some of these arguments are complex, and many of them (particularly the last one) involve issues that go beyond the immediate subject matter of this Report. In the balance of this section we attempt to appraise the principal issues and set forth our views on them. More detailed discussion is contained in the study previously cited 19/.

Accounting Neutrality

Because of the low probability of generating any revenue as a result of an outlay for mineral or petroleum exploration, and because of the long and variable time lags between search and discovery and between

discovery and production, it is argued that all costs should be written off and that they should be written off rapidly in order to achieve a measurement of income from mineral or petroleum extraction that is comparable with the measurement of income from other industries. The rapid write-off of costs that may not be matched by revenues is therefore advocated, in this case not as a concession to mineral or petroleum extraction but as a necessity for inter-industry neutrality in the determination of income. While it is difficult to determine just how rapid the write-off should be to achieve neutrality, we believe that the treatment recommended later in this chapter is liberal. This treatment is basically that the cost of exploration and development should initially be allowed in full as claimed by the taxpayer. After a transitional period the rate of write-off of development costs should be reduced.

The Tax System Bias Against Risk Taking

There are, unfortunately, no accurate and reliable measures of the relative degrees of risk attached to investments in different industries 20/. No one can doubt that the probability of loss on a single exploratory venture in the extractive industries is very high indeed 21/. Whether the probability of loss from such an isolated venture is greater than the probability of loss from a single research experiment by a manufacturing firm, say, in the chemical or electronics industry, is a moot point.

The diversification of risks is an important consideration. Many firms engaged in mineral and petroleum extraction are large enough to be able to undertake many exploratory ventures themselves. Both in mining and petroleum, joint ventures or syndicates are often formed, and through them smaller firms can hold small partial interests in many exploratory ventures. The greater the diversification, the more stable and predictable the percentage of successful ventures. The large manufacturing corporation also can undertake many pieces of research and thus reduce its risk. However, the smaller manufacturing concern usually does not have the opportunity to

participate in syndicate arrangements by which it could have a small share in a multitude of research projects as does a small mining or petroleum company in the case of exploration projects.

Because the joint venture arrangements for the pooling of risks in the extractive industries are more fully developed than in most other industries, to focus attention on the undeniably high risk attached to a particular exploratory venture grossly overstates the degree of risk of investments in the mining and petroleum industries relative to other industries. This is not to deny that the new small mining company or the new small petroleum company is subject to great risk if it cannot enter into joint ventures with other companies or that it is subject to substantial risk even if it can enter into such arrangements. We are not convinced, however, that even these firms are subject to greater risks than small firms in some other industries characterized by rapid technological and product change.

Nevertheless, it is clear that, to the extent that a tax system fails to fully recognize losses through tax refunds, it is biased against risk taking—whether by a small or large manufacturing firm, or a small or large mining or oil company. However, as part of our general reform proposals we recommend a much more liberal treatment of business losses than at present. We also recommend a liberal treatment of property losses to match the full taxation of property gains. Together, these provisions would come close to the perfect neutrality which can only be reached by payment of subsidies on losses. If the tax system accorded similar treatment to gains and losses, so that risk taking was not penalized by the tax system, there would be little need for any special concessions to the mining and petroleum industries even if it was felt that they were characterized by greater risk than other industries.

The Capital Market Bias Against Risk Taking

On the assumption that investment in the extractive industries is

subject to greater risk than investment in other industries, it is also argued that, because the market discriminates against risky ventures, concessionary tax provisions are necessary to compensate for the market bias. A market bias would raise the cost of capital to the mining and petroleum industries. It is argued that, in the absence of concessionary tax provisions, the higher cost of capital would result in too little investment in the extractive industries relative to other industries. Tax concessions that overcame this bias would be efficient in the sense that the additional resources devoted to mining and petroleum as a result of the concessions would yield a more valuable output than if the resources were put to alternative uses.

We are sceptical that investment in the extractive industries is more risky than investment in other industries, given prevailing institutional arrangements. But to the extent that the diversification of risk is not achieved, it is conceded that if investors demand a risk premium to compensate for the uncertainty of the expected returns from exploration there may be some under-investment in the extractive industries—and in other industries with the same characteristics 22/. To compensate for any possible market bias against the mining and petroleum industries we will recommend a special provision that would permit the immediate write down of shares when funds were raised for exploration and development, rather than restrict the write-down to whatever losses were accrued or realized.

Corporation Tax Discrimination Against
Mineral and Petroleum Extraction

It can be argued that the corporation tax discriminates against mineral and petroleum extraction. If the production of the mining and petroleum industries was sold in world markets at prices that were unaffected by the Canadian output, the Canadian corporation tax could not be shifted in the short run through higher prices. Imposition of the corporation tax would necessarily be followed by reduced investment in the

future. Moreover, where Canadian output does affect world prices, to the extent that the extractive industries are more capital intensive than other industries (that is, if they have high physical capital/output ratios) and have lower than average debt/equity ratios, a greater investment adjustment would be necessary for the extractive industries than for other industries to restore equilibrium among after-tax rates of return.

There are five points to be made in responding to this argument:

1. While some Canadian-produced minerals are sold at prices unaffected by Canadian output (notably gold) there are many that are not (notably nickel).

2. Even when the world price is unaffected by Canadian production many other countries that produce minerals and petroleum also impose corporation taxes and these taxes may affect quantities produced and world prices.

3. It would be inconceivable to grant tax concessions to all corporations that are unable to shift the corporation tax through short-run price increases.

4. There are other industries in Canada that are more capital intensive than the extractive industries and some that rely as heavily on equity financing.

5. The proposed integration of personal and corporation income taxes removes any tax discrimination against equity investment that might exist.

We therefore reject this argument for tax concessions for the extractive industries.

Social and Economic Benefits

Finally, tax incentives to the resource industries are advocated on the grounds that they achieve one or more of the following results:

1. Provide employment.
2. Maintain Canada's resource base.
3. Maintain Canada's position as a world producer of minerals and petroleum.
4. Increase Canada's exports.
5. Make Canada more self-sufficient.
6. Encourage direct investment in mining and petroleum in Canada by non-residents and discourage direct investment in mining and petroleum in other countries by residents.
7. Encourage industrial development generally by providing important energy sources (e.g., oil and uranium).
8. Foster regional development, particularly in the far North.
9. Encourage domestic ownership in the mining and petroleum industries.

Needless to say, those who advocate the tax concessions believe all of these alleged results to be desirable. They also assume that:

1. Either the benefits can be achieved without cost; or
2. The benefits outweigh the costs; and
3. To the extent that there are costs, the same benefits could not be achieved at a lower cost.

Since all of these alleged benefits from tax concessions to the extractive industries are dealt with at some length in the studies prepared for us and cited above, we shall discuss none of them extensively, although we shall consider most of them briefly.

Providing Employment. To provide employment when there is unemployment is clearly an advantage. It is not necessarily an advantage, however, if increased employment in the extractive industries means less employment elsewhere. There are more effective methods of preventing unemployment than the provision of industry incentives, as discussed in Chapter 3.

Maintaining the Resource Base. No one would dispute the proposition that, if natural resources could be discovered without cost, then the more natural resources that were discovered the better. But the discovering of additional natural resources is far from costless, and the relevant question is whether the additional discoveries warrant the additional cost in terms of the output forgone when labour and capital are devoted to this use rather than alternative uses. Only if the long-run cost of the new reserves was less than the cost of substitute materials (including foreign supplies) would special tax incentives be warranted. Even then, if the objective was to increase reserves, to be efficient the incentive should apply to exploration and not to development and production. This question is considered again later in the chapter.

Encouraging the Production of Exports and Import-Competing Goods. Minerals and petroleum constitute important exports for Canada and Canadian-produced minerals and petroleum displace commodities that otherwise would be imported. It does not follow, however, that these facts justify special tax concessions to encourage the mining and petroleum industries. To take the view that exports and import-competing industries should be given tax incentives implicitly assumes that, if capital and labour were not producing exports or import-replacing goods, they would not be producing anything else. Over the long run (and that is the relevant period) this assumption is invalid.

Canadians should specialize in producing the goods and services in which they have a comparative advantage and not necessarily the goods that have been exported or that have displaced imports in the past. This can be illustrated in a simple way by supposing that, unknown to anyone, there were no undiscovered mineral deposits or petroleum reserves in Canada, and that the government adopted a policy of subsidizing the production of minerals and petroleum for export. As a result of the subsidy more resources would be devoted to exploration and marginal mines and wells would be brought into

production. By increasing the subsidy, more resources would be devoted to searching for reserves and producing minerals from fewer and fewer productive mines and wells. Less and less of other things would be produced. Canadians would become less and less well off. We do not for a moment wish to suggest that the return from exploration is, in fact, zero. We do wish to suggest that the policy of encouraging a particular kind of export is probably not consistent with the overall economic well-being of all Canadians.

Furthermore, the effect on the balance of payments of increasing the volume of minerals and petroleum exported and the domestic production of import-competing minerals and petroleum is most uncertain. It depends on, among other things, the foreign demand for these products and the changes in the volume and composition of Canadian imports which result from the diversion of resources to the production of more minerals and petroleum. If the foreign demand for minerals and petroleum is inelastic (i.e., small increases in the volume of exports bring about large reductions in price) and resources are taken from other export or import-competing industries to produce more minerals and petroleum, it is conceivable that Canada would weaken rather than strengthen her balance-of-payments position.

Encouraging Foreign Investment in Canada. Many nations, in particular the United States, offer substantial tax concessions to the extractive industries. It is urged that Canada must offer equivalent tax concessions to the extractive industries if the rate of foreign investment in these industries is to be maintained.

The question of foreign investment in Canada is, as the discussion in Chapter 5 points out, extremely complex. Little can be done in a brief review except to call attention to some relevant points:

1. A substantial proportion of foreign direct investment in Canada is probably related to considerations other than the after-tax rate of return to parent corporations. The securing of sources of supply,

investment in a politically stable country near the United States market and the maintenance of a share of the market are clearly significant factors in the decision to invest in Canada. It is impossible to determine with any certainty the sensitivity of foreign direct investment to changes in after-tax rates of return. From what our staff has been able to ascertain about many, if not most corporations, the expected after-tax rates of return are either not computed with sufficient precision to reflect many of the tax concessions now offered to the mining and petroleum industries, or these concessions are not a significant factor in the decision whether or not to invest. Hence, changing the tax system might be of greater significance in the assessment of factors other than the rate of return, such as those mentioned.

2. If it is true, as some persons contend, that international "mineral" capital is exclusively devoted to mineral and petroleum extraction and is seldom available for other forms of investment, there is a strong presumption that it is invested where the probability of finding ore or oil is greatest—and is insensitive to after-tax rates of return.

3. A principal benefit—but not the only benefit—that Canada obtains from foreign investment in Canada is the revenue from taxing the income generated by such investment. To determine the rate of tax on the income from foreign investment in Canada which would maximize the net benefit to Canada would require a knowledge of the sensitivity of foreign investors to changes in after-tax rates of return and a knowledge of the indirect benefits from foreign investment. Neither of these crucial facts is known. If, as we suspect, much foreign investment in the Canadian mining and petroleum industries is insensitive to changes in after-tax rates of return, the net benefit to Canada could be increased by raising Canadian taxes on the income.

4. Undoubtedly, the optimum taxes that Canada should impose on the resource industries are not entirely independent of the foreign tax

treatment of these industries. If foreign governments grant larger concessions to the resource industries than Canada does, the weight of tax that Canada can impose without having some adverse influence on foreign direct investment in these industries is less than it would otherwise be. On the other hand, if foreign governments grant foreign tax credits that exceed current Canadian taxes, the latter can be raised without reducing such investment.

5. How high the Canadian tax on the income of Canadian mining and petroleum corporations could be raised without reducing the net benefit from foreign direct investment in these industries is impossible to say with certainty. It can be argued that higher Canadian taxes on such income would reduce investment in these industries. In some circumstances this would undoubtedly be the case. It is also necessary for Canadians to bear in mind that some investments made in Canada by non-residents could not be made by Canadians because they are only profitable when a market for the output is assured. In some circumstances, only a foreign parent company can provide such a guaranteed market, as was the case in the development of most of the Canadian iron ore mines.

6. The only way to maximize the net benefit for Canada would be to treat each foreign-financed Canadian venture separately, taking into account the sensitivity to differences in tax treatment and the net benefit to Canada that would be provided. This venture-by-venture discrimination is both impractical and unacceptable. Consequently, any uniform treatment applied will result in some instances in less than the optimum net benefit for Canada—because some foreign direct investment that would have provided a net benefit will be kept out by Canadian taxes, and because some foreign direct investment in Canada will obtain a greater after-tax return than the minimum it would have been willing to accept.

7. Adoption of our mining and petroleum recommendations would undoubtedly make foreign direct investment in these industries less attractive than

it is now. Some foreign investment that would have provided a net benefit would be lost, while Canada would obtain a greater net benefit from some foreign investment than it does now.

8. We are also satisfied that it would be a grave error to adopt the approach that, whenever a foreign country adopted a tax concession for a particular industry, an equivalent tax concession should be provided in Canada for that industry so that foreign investment in the Canadian industry would remain equally attractive. Often the best Canadian policy to pursue when foreign governments give large concessions to particular industries would be to import the subsidized goods from the foreign country and devote Canadian resources to producing other goods, or to establish foreign subsidiaries of Canadian corporations in the foreign industry with the concessions to take advantage of the higher after-tax returns.

When there is full employment in Canada we may need net foreign investment to maintain the rate of capital formation without reducing domestic consumption. But usually what is required is access to foreign goods and services in general, not access to foreign dollars destined for a particular use in Canada. If Canada can call upon foreign savings for investment in other industries, Canadian labour and capital can be employed in the resource industries (or any other industry) and foreign goods and services can be substituted for domestically produced goods that are forgone because of the increased investment in the resource industries. Aside from the instances where assured foreign markets or specialized foreign technology are involved, Canada can and should adopt general policies to control the inflow of foreign capital and should eschew industry concessions that could substantially reduce the net benefits from such foreign investments.

Discouraging Foreign Direct Investment by Canadians. If Canada does not match the concessions to the extractive industries given by other countries, Canadian capital destined for these industries may be invested abroad. This

point of view is often expressed by those interested in the Canadian mining industry 23/. It is an argument for maintaining the concessions now given the Canadian mining industry—concessions that are admittedly liberal relative to those offered by most other countries 24/.

With full employment in Canada, increased investment abroad by Canadians, unless offset by increased foreign investment in Canada, would require either a reduction in current domestic consumption or a reduction in domestic investment. If there was no offsetting increase in foreign investment in Canada and the increased investment abroad by Canadians was accompanied by a reduction in current domestic consumption, then Canadian savings would have increased and the national income of Canada would grow more rapidly in the future by the additional income earned abroad by Canadians.

If there was no offsetting increase in foreign investment in Canada and the increased investment abroad by Canadians was at the expense of domestic investment, the national income would grow more or less rapidly depending upon the after-foreign-tax return earned on the additional foreign investment by Canadians, the before-tax return that would have been earned on the forgone domestic investment, and the indirect effects of the two kinds of investments.

Ignoring these indirect costs and benefits, 25/ under the conditions assumed in the preceding paragraph, if Canada gave credit for the foreign taxes paid on the income from such investments, it is possible that a foreign investment that was profitable to the Canadian investor would result in a net economic loss to Canada. The investor presumably is indifferent as to whether he pays taxes to one government or another. However, the net benefit to Canada from the investment would be reduced to the extent that, by investing abroad, revenues were transferred to a foreign treasury. If, as seems probable, the net indirect benefits from investment abroad were less than from domestic investment, the higher the foreign taxes imposed on such

investments and the more generous the foreign tax credits provided by Canada, the more likely that it would be that increased investment abroad would result in a net economic loss to Canada.

The situation would be different, however, if increased investment abroad by Canadians was offset by increased investment in Canada by non-residents. Even if the before-tax rate of return on direct investment abroad was no higher than it was in Canada, Canada could obtain a net benefit from increased Canadian direct investment abroad under some conditions. The conditions would be:

1. Foreign direct investment in Canada was as productive as the Canadian investment it replaced; and

2. Canada taxed the income from foreign direct investment in Canada at a rate higher than other countries taxed the income from Canadian direct investment abroad.

To be more explicit: (a) if the removal of the tax concessions to mining in Canada resulted in increased investment abroad to take advantage of the tax concessions other countries gave to mining; and (b) if non-residents increased their investment in Canada (presumably not in mining) by a corresponding amount; and (c) if Canada was able to tax the income from increased foreign investment in Canada at a higher rate than other countries taxed the increased foreign investment of Canadians, Canada would obtain a net economic benefit from the change.

Enough has been said about the complex issues involved to establish that it is impossible to make any unequivocal statements about the net economic gains and losses from increased direct investment abroad in mining by Canadians.

This leads to the second aspect of the problem. Would a removal of the Canadian tax concessions in fact lead to increased investment by

Canadians in mining in other countries? There can be little doubt that, if the Canadian tax concessions to mineral extraction were removed, foreign direct investment in mining would be relatively more attractive to Canadians than it is now. But the proposals for mining are not made in isolation. The integration proposal, as will be illustrated later in this chapter, would partly compensate resident shareholders for the removal of the concessions, although the after-tax rate of return from Canadian mining corporations would be reduced for many shareholders. However, because we propose in Chapter 26 that the credit for foreign taxes should be restricted to 30 per cent and that the income of foreign subsidiaries of Canadian corporations should be taxed on an accrual basis at a rate of 30 per cent, foreign direct investment by Canadians would also, in some circumstances, be less attractive than it is now.

With offsetting pulls toward other kinds of domestic investment and offsetting pushes away from foreign investment, we are satisfied that a large increase in Canadian investment in foreign mining ventures would be unlikely to occur as a result of removing the special concessions to mining in Canada. To the extent that an increase did occur, it could not be presumed to be against the national interest.

<u>Energy as a Leading Factor for Growth</u>. It may be contended that the growth of the economy is particularly dependent on sources of abundant energy. The implication is that the oil and gas industries merit favoured treatment. The comments made above apply also in relation to this argument. Specifically, if supplies of oil and gas could only be produced domestically at a higher real cost than the cost of importing them, Canada would obtain a net economic benefit if they were imported.

<u>Regional Development</u>. The pioneering role of mineral extraction in the remote areas of Canada is often stressed, particularly in reference to populating the far North. But, as direct employers, mining and petroleum companies do not rank high, and their indirect employment effects in the immediate region of their

mining and producing operations are relatively low. It should also be observed that a forced pace of settlement has certain social costs (i.e., the provision of transportation, housing and associated services) that could exceed the costs to the industry. There is no economic reason why the pace of development of raw materials with higher real costs should be forced before supplies available in more accessible regions have been fully exploited. Nonetheless, many of Canada's remote regions are ill-suited to economic pursuits other than mining and there are non-economic reasons for encouraging the population of some areas.

If settlement subsidies for particular regions are required in the light of national policy, they should not be confined to one type of industry but rather to specified areas. Provision of transportation facilities and social capital are much more effective in partially redressing the problems of high costs and below-standard living conditions than are tax concessions to one type of industry. Nevertheless, if specific encouragement to the extractive industries to develop particular areas is deemed to be desirable, the recently introduced loan fund for exploration in the North is clearly a much more efficient device than general tax concessions to these industries.

A variant of the regional development argument supports aid to sectors of the industry in the interests of slowing or halting the decline of communities. Such is the rationale for the direct subsidies paid to coal mines and gold mines and for the more favourable depletion allowance accorded to these industries. Mining, being regionally specialized, is particularly prone to this "ghost town" problem; but it is not unique. Such subsidization is justified as a short-run measure on the grounds of social cost in terms of human dislocation. In the interest of administrative efficiency, the direct subsidy should be made adequate to the task, and the hidden subsidy, in the form of a more generous depletion allowance, should be abandoned.

But long-run solutions demand a shift of resources from declining industries. In this task government aid should play a role, most obviously in

subsidizing the movement of and retraining of displaced workers, but also, where such movement is not possible or desirable, in the form of incentives to new industry to enter the area. Such a policy of encouraging new industry in declining mining regions need not exclude other branches of mining, which might be given assistance on a regional basis in finding and developing new minerals, without being permanently subsidized.

Encouraging Domestic Ownership in the Extractive Industries. It is argued by Canadian petroleum companies that the present Canadian treatment of the extractive industries is not generous enough because the combined impact of United States and Canadian tax laws favours the operations of United States residents (individual and corporate) over those of Canadian residents. This viewpoint was adopted by the Royal Commission on Canada's Economic Prospects. As a counter measure, that Commission advocated a form of depletion for Canada based on gross earnings.

Given the situation of an independent Canadian petroleum producer, the argument is not without merit. It has, however, also been taken up by the major integrated oil companies, who are currently in the most advantageous position of all, as is shown later in this chapter in Table 23-3.

Such advantages as exist for non-residents apply to Canadian branches of United States companies before their production income in Canada exceeds the cost of their current exploration and development programmes. Prior to reaching this point, these branches can carry forward their pre-production expenses for write-off against future taxable income in Canada. At the same time they can obtain an immediate recovery for intangible drilling costs and the cost of unproductive acreage against income otherwise subject to United States tax, without affecting the size of their concurrent depletion allowances in the United States. A Canadian company, on the other hand, gets no depletion so long as its write-offs exceed its production income. However, once the United States company attains a tax-paying position in Canada it loses this advantage. It has, in addition, to contend

with the 15 per cent non-resident withholding tax. The effective rate of tax on its Canadian operations then becomes the higher of the Canadian and United States rates that apply to that part of its total operations.

The major international integrated oil companies with Canadian affiliates incorporated in Canada, and which account for the major proportion of the impressive statistics on United States ownership of Canadian petroleum resources, do not have any advantage in Canada that stems from United States tax law. Integrated oil companies, whether they be Canadian or non-resident-owned, do have some advantages under Canadian law. The chief advantage is that, if their write-offs of exploration and development costs exceed their production income, the excess may be written off against refining and marketing income.

A liberalization of the Canadian depletion allowance would, of course, apply to the previously mentioned United States subsidiaries as well as to Canadian-owned corporations, thus reducing the claims for Canadian tax paid that the former would make on their United States returns. The net effect, then, could well be a transfer of revenues from the Canadian treasury to the United States treasury.

It is probable that the dominance of United States-controlled companies in the Canadian oil industry is an episode in the world-wide integration of the industry and does not stem from the application of tax laws. Furthermore, the very success of Canadian crude in penetrating the United States market may in part be a result of that dominance.

We are satisfied that a further tax concession to the resource industries in the form of gross depletion would not, if it had any effect, produce more than a minor increase in Canadian ownership. The adoption of our integration proposal should be more effective for this purpose and would not involve a transfer of revenues from the Canadian to foreign treasuries.

As we will show later in this chapter (see Tables 23-4, 23-5 and 23-6), although our proposals would increase the after-tax rate of return to Canadian shareholders, the taxation of share gains would mean that the total after-tax return to a substantial proportion of the Canadian shareholders in Canadian mining and petroleum corporations probably would decline. To the extent that this reduction was not shifted through higher mineral and petroleum prices, it would be capitalized in lower share prices. The total after-tax return on most shares of corporations not in the extractive industries would probably rise as the net benefits of integration not lost through short-run shifting were capitalized. Most resident shareholders, then, would generally realize windfall losses on shares in Canadian mining and oil companies and windfall gains on the shares of other Canadian corporations.

The after-tax return on Canadian mining and petroleum shares would be reduced more for non-residents than for residents because the former would not obtain the benefits of integration. Non-resident portfolio investors would therefore generally find it to their advantage to sell their shares to residents.

The after-tax rate of return to non-resident direct investors in Canadian mining and petroleum would also be reduced. However, because the price that could be obtained for the shares of most large Canadian mining and petroleum companies would likely be less than at present, there would be no incentive to non-resident parent corporations either to sell the outstanding shares of these subsidiaries to Canadians or to offer them new equity issues.

Foreign-controlled companies raising funds for exploration and development might find that new issues commanded higher prices because of the special write-off that we will propose for such issues. This write-off would reduce the cost of Canadian equity capital to these companies, and more new issues for this purpose by foreign-controlled corporations might occur.

A SUMMARY OF OUR VIEWS

After reviewing all of these arguments we have reached the conclusion that:

1. if all costs were deducted at some time in the determination of business income from the extraction of minerals and petroleum,
2. if these costs were written off rapidly to reflect the uncertainty of the return that would be generated by these outlays, and
3. if the tax treatment of losses was such that risk taking was not discriminated against by the tax system,

the only ground for special tax concessions to the extractive industries would be to compensate for the possible discrimination against risk taking in the Canadian capital market. In other words, to the extent that there was a bias in the capital market against risk taking, and to the extent that mineral and petroleum extraction was unusually risky, a deviation from a neutral tax system would be justified to compensate for this bias, assuming that more efficient methods of compensation were not available.

It has already been pointed out that the large corporations in the extractive industries can spread the risks of exploration by undertaking either several ventures at once or a series of ventures and by participating in syndicates which take a partial interest in several ventures in order to pool risks. The large and established companies can also offset the costs of unsuccessful exploration ventures against production income. These companies, in effect, obtain refunds of taxes on their exploration losses.

There is no question of capital market bias against these large companies in the extractive industries. They are able to raise capital in the market at costs that are no higher than those incurred by corporations of comparable size in other industries, as their price/earnings ratios attest. To the extent that it exists, the capital market problem is confined to the financing of mineral and petroleum exploration by small, recently established

corporations that do not have the financial resources needed to spread the risks by carrying out many ventures simultaneously, cannot join syndicates (or enough syndicates) to pool risks, and do not have income from mineral or petroleum extraction or refining against which the costs of unsuccessful exploration ventures can be offset. Under these conditions the cost of capital for mineral and petroleum exploration is probably high. However, it is difficult to say whether the cost of capital is higher for such exploration than for research by small manufacturing companies.

While the capital market may be biased against exploration under some conditions, there is little if any evidence that known mineral and petroleum reserves are inadequate. Present reserves are adequate for current requirements, and for most minerals the reserves are growing rather than declining relative to current output. The question of oil reserves requires specific attention. Although the market bias against risk taking may adversely affect independent oil companies, the seriousness of the problem should be judged in terms of Canada's oil reserves.

We have been told that there are no insurmountable technical obstacles to the commercial production of oil from the Athabasca tar sands. The principal problem is that, if oil from the tar sands is to be competitive with conventional crude oil, large scale productive facilities are required and these must operate near rated capacity. With the output of conventional crude oil substantially below 50 per cent of capacity, the Province of Alberta has been reluctant to grant permission to the industry to proceed with the exploitation of the tar sands on an adequate scale because this would entail a cut-back in the production of conventional crude. But if costs of conventional oil exploration continue to rise it is apparent that, if the tar sands are not now competitive with conventional crude, they will be competitive in the near future, and Canada's oil reserves, for all practical purposes, will be limitless. Devoting resources to the search for conventional oil is, or will become, unnecessary. Hence, to grant

increasingly generous tax concessions to encourage the discovery, at higher and higher costs, of more conventional oil when tar sands crude was available in limitless quantities but could not be exploited because of the limited market, would be perverse.

We have generally adopted the view that wherever possible, when incentives are needed, subsidies rather than tax concessions should be granted. The cost of subsidies is apparent and they can be equally efficient as, or more efficient than, tax concessions. If public policy dictates that mineral exploration should receive greater encouragement than would be provided by the tax treatment that we recommend, any or all of the following measures would be effective:

1. The recently announced government loan programme for exploration in the North could be expanded.

2. Increased subsidies for transportation, communication and geological surveys could be made.

3. A subsidy equal to a fraction of additional exploration expenses could be provided.

We have therefore come to the conclusion that the need for special encouragement to mineral and petroleum exploration to compensate for a capital market bias against risky ventures is small, if it exists at all. We are also convinced that there are fiscal methods available that would be as efficient as, or more efficient than, tax concessions in encouraging exploration if this was deemed to be in the public interest. It is against this background that the efficiency of the present concessions will be analyzed.

EFFICIENCY OF THE PRESENT MAJOR TAX CONCESSIONS

The purpose of tax concessions to the extractive (or any other) industries is to make additional activity more attractive. This can be done by increasing the after-tax net return on investment in an attempt to expand

investment, and thus lead to increased exploration, discovery, development and output. But concessions related to current profit, such as percentage depletion and the three-year exemption, are inefficient devices for increasing the long-run supply of minerals and petroleum because they apply to the output that would have occurred without the incentive as well as to additional output. From this starting point the effect of the present concessions may be reviewed briefly assuming that the tax reduction resulting from the incentive is not shifted in the short run through lower prices or higher costs.

By increasing immediate profits, the tax concessions increase the capitalized market value of existing assets in the industry, including the equity shares of existing corporations and the value of proven or potential reserves. However, if the establishment of new mines or new petroleum wells is barred, either through monopoly control or through the prohibitive cost of new discoveries, such tax concessions are pointless.

If the opportunity to open up new deposits is relatively unrestricted and if long-run costs do not rise sharply, higher current profits resulting from the introduction of tax concessions will induce a shift of resources into the industry. If this happens, and if the country's increased output of the given mineral can be sold with no appreciable reduction in price, windfall gains to owners of existing assets will be at a minimum. The tax concessions will be as efficient as possible. An allocation of resources that is different from what it would have been under free market conditions will have been achieved.

However, if the price is maintained by effective control of total output and if there is freedom to open up new deposits, new investment will indeed be attracted by the tax concessions but it will result in idle capacity. There will be no increase in the output of the industry in question and less of other commodities will be produced. In this sense the re-allocation of society's resources will have been wasteful.

On the other hand, if output is permitted to rise but prices are highly sensitive to the country's output, the additional output resulting from a net increment in investment will quickly reduce profit expectations from further increments. The sensitivity of price to output will depend, in particular, on the size of Canada's output in relation to world demand for a given product. If small increases in output lead to large price reductions, there will be little impact on the country's final output as a result of the concessions.

Depletion Allowance to Operators. Percentage depletion is an extremely expensive incentive for encouraging mineral and petroleum exploration for the following reasons:

1. The incentive is related to current profit and not to costs. The impact of the incentive is therefore indirect—the after-tax rate of return on production is increased and this increases the value of mineral and petroleum resources, and hence encourages exploration. More exploration could be encouraged at the same revenue cost, or the same exploration at a lower revenue cost, by relating the incentive to additional exploration, so that exploration that would have taken place without the incentive would not be unduly rewarded.

2. Because exploration expenses must be deducted before depletion can be claimed, the more a corporation spends on exploration the less it benefits from depletion. This objection could be removed by the adoption of gross depletion; but as already stated, the additional revenue cost would be substantial and the incentive would still be less efficient than a direct subsidy to exploration.

3. The depletion allowance provides a benefit only to established corporations with operating income. Both in mining and oil a few corporations (eight in all) claimed substantially over three quarters of the more than $150 million claimed in depletion by mining and petroleum

companies in 1964. The smaller corporations obtain little if any direct benefit from this concession, which favours most those corporations which need it least, because the cost of capital to the largest mining and petroleum corporations is comparable with that of corporations of similar size in other industries.

Deduction of Exploration and Development Costs

The rapid write-off of exploration and development expenses yields an imputed interest saving. As a device intended to cause the re-allocation of resources, this concession is the most efficient of those under consideration. It has the great virtue that there is a direct relationship between the stimulus and the desired response.

The present deduction provisions can, however, be subjected to two major criticisms. First, they are more advantageous to those corporations which have operating income and so can immediately utilize the rapid write-off, than to those that do not. Second, the privilege applies to all stages of pre-production activity—from primary reconnaissance through to final development. Given that the risks of failure have been greatly reduced by the development stage, the direct effect of the rapid write-off provisions for development costs is likely to be a more rapid development of known mineral deposits and petroleum reserves rather than a search for new deposits and reserves.

The Three-Year Exemption for New Mines

Where the three-year exemption is an alternative to the write-off provisions, as it is in the case of a short-lived mine operated by a corporation without operating income, this exemption adds little to the profitability of a mine. However, where it is applied in addition to the write-off it may add substantially to the profitability of a mine, especially where the write-off is obtained immediately against other income. Thus, it is relatively advantageous in the case of a short-term project that is associated with an existing mining organization.

As an incentive device the three-year exemption is more efficient than the depletion allowance. Its impact is related only to the early productive period of a mine and not to its lifetime income, so that the primary influence of the three-year exemption is not on asset values in the entire industry but only on those mines that are in the development phase. Since it is more selective, it may be less costly for each unit of additional activity induced than the depletion allowance; but even so it involves large elements of waste. The exemption is applied to all new mines whether or not their development would have taken place in its absence. In terms of benefits, the additional production with which it can be credited is only from those properties which would otherwise have been expected to return less than the minimum acceptable profit.

Here too the incentive provides the greatest benefit to those who need it least. During the period 1955 to 1964, five large mining companies reported about 70 per cent of the income exempted under the new mine provisions. These corporations had operating income against which exploration and development expenses could have been immediately offset, and they operate on such a large scale that they are quite capable of spreading their risks. There is no evidence of a capital market bias against their shares. Three of these companies claimed $117 million in tax-free income in 1964 alone—at a tax revenue loss of nearly $60 million. It is open to question whether this tax saving had a major impact on the investment expenditures made by these companies. Even if it did, it is most unlikely that the benefits obtained exceeded the lost tax revenue.

THE PROPOSED TAX TREATMENT

If we were recommending a tax system that accorded only such concessions to the mining or petroleum industry as are recommended for industry in general, the depletion allowances would obviously be eliminated as would the three-year exemption for new mines. All costs, including property costs, would be deductible at some time and at the following rates:

1. Exploration costs would be written off immediately. Depreciable property which was useful only in connection with one exploration project would be included in this classification. If there was insufficient income to absorb such costs currently, they would be carried over for deduction from income in a subsequent year.

2. Development costs (excluding the cost of acquiring properties or property rights) would be amortized on the diminishing balance basis at a rate of, say, 20 per cent.

3. Equipment, buildings and other facilities used in the development and production phases would be amortized on the diminishing balance basis at the same rate of 20 per cent, as their usefulness would be closely related to the life of a particular mine or well. A smelter or refinery should be permitted only the regular rates of capital cost allowance applicable to buildings and machinery generally.

4. The 100 per cent capital cost allowance for small and new businesses would also apply to mining and petroleum.

5. The cost of purchasing a mining or petroleum property would be amortized on a time or a production basis where the property had an ascertainable useful life or where the amount of reserves was determinable. On the other hand, if both the useful life and the quantity of reserves of the property were indefinite in duration and amount, the cost would be written off only to the extent that a loss in value could be shown to have occurred.

6. The write-off of development costs and depreciable assets used in development and production would not be permitted until production commenced, consistent with the proposed general rule that, in the absence of a concession, capital cost allowance should not be claimed until the assets are put to use.

7. Capital outlays which did not result in the acquisition of property would be deductible either directly or by way of capital cost allowance in the manner recommended in Chapter 22 for "nothings" generally.

The Proposal

It is our view that this method of determining business income should not be immediately applied to income from mining and petroleum operations. While it represents the same tax treatment as would be applicable to other industries, its immediate adoption might well have major adverse effects. However, the present depletion allowance for both mining and petroleum and the three-year exemption for new mines appear to us to be not only more generous than is necessary to compensate for any risk factor but are, in addition, inappropriate and inefficient incentives. In our view, to the extent that there is to be a divergence from a neutral tax treatment, it would be better to permit an accelerated write-off of all costs, including the cost of properties, development costs and the cost of depreciable assets which are useful only for a particular exploration or development project or for production from a particular mine or oil or gas well (but not the cost of smelters and refineries). When combined with the deductibility of share losses and the more liberal treatment of business losses, such treatment should be quite adequate to offset any bias in the capital markets that might exist against the mining and petroleum industries. The operator of a mine or oil well would therefore pay little tax until he had recovered all of his costs. After that point, there is no reason why his income should not be taxed in full.

However, it must be emphasized that a tax treatment incorporating these special write-offs would be considerably more liberal than the treatment recommended for industry generally and need not be extended indefinitely to all mining and petroleum companies. We will therefore propose the gradual restriction of some of these write-offs to rates of capital cost allowance that would be closer to those provided for industry.

We have agreed that there may be some capital market bias against small and medium-sized mining and petroleum companies, although smaller companies in these industries probably do not face financing problems significantly more difficult than those encountered by manufacturing concerns of the same size. On the other hand, we were unable to find any evidence that the larger companies in these industries were subject to any capital market bias. Therefore, to achieve inter-industry neutrality, any special write-offs for the extractive industries should, in the long run, be limited in amount. They should also be restricted to the smaller companies. We considered whether the provision already outlined in Chapter 22 for new and small businesses would be satisfactory in this regard. The allowance of 100 per cent capital cost allowance is quite sufficient as a concession, but there remains the question of what size of operation should qualify for this treatment. The limits suggested in Chapter 22 refer to assets (net of capital cost allowance) of under $1 million and to annual gross revenues of less than $10 million. Of these two limits, the one applying to assets would be more significant for the mining and petroleum industries. Thus, although the new and small business provision would be of assistance to a new mining or petroleum company, it would not assist a medium-sized company that had accumulated assets in excess of the stipulated limit. We therefore examined alternatives that would have some effect on medium-sized companies, as well as on smaller companies which had used up the $250,000 of accelerated capital cost allowance permitted under the new and small business provision. We rejected an expansion of the limits on the size of assets or revenues that would be applicable only to mining and petroleum companies, as this would increase the administrative difficulties to which the new and small business provision would give rise. At some future date such a special provision might be a useful means of extending accelerated capital cost allowances to more mining and petroleum companies.

We believe that another proposal we make later in this chapter for a special write-off for shareholders who acquire newly issued shares of mining

or petroleum companies would be of greater direct benefit to these companies. This latter provision would not be restricted to companies of any particular size, but we would expect that it would primarily be utilized by small and medium-sized companies undertaking an exploration or development programme.

Our specific proposals, which we discuss in more detail in the following pages, are these:

1. The present depletion allowance for the mining and petroleum industries and the three-year exemption for new mines should be withdrawn.

2. Exploration costs (including the cost of depreciable assets that can be used only in connection with a specific exploration project) should be included in a separate capital cost allowance class with a rate of write-off of 100 per cent.

3. Development costs (including the cost of depreciable assets which can be used only for production from a particular mine or oil or gas well) should be included in the same capital cost allowance class with exploration expenses during a transitional period of five to ten years. Thereafter they should be segregated in a separate capital cost allowance class and subject to write-off at a rate of 20 per cent to 30 per cent on a diminishing balance basis.

4. The cost of mining and petroleum properties should be capitalized in a separate capital cost allowance class for each property. The costs should then be amortized by the write-off of amounts related to the operating revenues derived from the same property. The capital cost allowance rate should be substantial (say, up to 50 per cent) in the transitional period, but thereafter should be set at 10 per cent to 20 per cent of the operating revenue from the property. In addition, if the property is disposed of, abandoned or becomes valueless, the unamortized balance should be written off.

5. Losses in the mining and petroleum industries (whether they result from the write-offs referred to above or otherwise) should be available in the same way as other business losses for carry-back two years and forward indefinitely. They should also be subject to the rules we have proposed to restrict the transferability of losses, but Canadian resident shareholders would be entitled to deduct losses on shares.

6. All profits made on the disposition of mining and petroleum properties should be included in income, in accordance with the comprehensive tax base. The full gain should be included in income, even if some portion of that gain accrued prior to the effective date of the legislation implementing our proposals. However, where shares are disposed of by persons who are not in the business of dealing in securities, only the profit accruing after the date of the legislation would be included in income.

Three-Year Exemption and the
Depletion Allowance

Our reasons for recommending the withdrawal of these concessions will be apparent from the discussion earlier in this chapter. We have concluded that they are more liberal than is justified by any disadvantage of the petroleum and mining industries in obtaining capital and, furthermore, are inappropriate and inefficient incentives. Our recommendation for withdrawal extends to all the depletion allowances—for operators, non-operators and shareholders.

As we have said, we recognize that the withdrawal of these depletion allowances and the three-year exemption and the simultaneous imposition of a restriction on write-offs to regular capital cost allowance and amortization procedures could result in a serious impact on the larger integrated companies in the mining and petroleum industries. While most of the benefit of these concessions (particularly of depletion) accrues to the larger and better financed companies, nevertheless the smaller companies plan their affairs

in anticipation of being in a position to benefit from the concessions, and certainly the three-year exemption has benefited some smaller mining companies. Therefore, while we recommend the immediate withdrawal of percentage depletion, we suggest that provision be made for transitional periods for both the withdrawal of some of the more liberal write-off provisions and the withdrawal of the three-year exemption for new mines. We recommend that the exemption continue to apply to new mines brought into production during a five-year period, but that for this period the amount of exempt income for any one mine should be limited to $1 million.

We will also propose a further measure that will reduce the impact of the withdrawal of percentage depletion by permitting the deduction, over a transitional period, of a portion of those property costs that were not deductible in previous years. This deduction is discussed in greater detail later in relation to the treatment of property costs.

Withdrawal of percentage depletion and the three-year exemption would be major changes in the tax structure and would greatly increase the future tax liabilities of the few large integrated mining and petroleum corporations. It would undoubtedly make capital formation by these corporations less attractive than it has been in the past. However, it would be a mistake to over-emphasize the magnitude of the negative effects. The rate of capital formation by some of the largest companies probably would not be greatly affected because they enjoy a substantial degree of market power and only increase capacity to meet increasing demand or to maintain a share of the market.

The after-tax rate of return to many Canadian shareholders on investments made by many of the smaller companies that have relatively little operating income would be materially improved. (See Tables 23-3 and 23-6.) However, the benefit to Canadian shareholders of our proposal for the integration of corporation and personal income taxes would in many cases be offset by the full taxation of share gains.

If percentage depletion is regarded as compensation for the present limitation on the deduction of costs, the justification for such depletion would disappear under the proposed tax system. If percentage depletion and the three-year exemption for new mines are looked upon as compensation for the bias against risk taking in the present system because of the restricted treatment of losses, adoption of the proposed reforms would eliminate the need for such compensation. If the bias in the capital market against risk taking or the indirect economic and social benefits of mineral and petroleum extraction are thought to warrant an incentive for mining and petroleum, then our recommendations embody such an incentive. Because the recommended treatment satisfies all of these requirements, we have no hesitation in recommending the abolition of percentage depletion and the three-year mining exemption.

Exploration Costs

We propose that the costs of exploration, including the cost of depreciable property which can be used only in connection with a specific exploration project, should be included in a new capital cost allowance class which could be written off at the rate of 100 per cent. If the amount claimed in any year exceeded the income of the taxpayer, the deduction would result in a loss which, under our general proposals, would be available for carry-back two years or forward indefinitely against income. If the taxpayer was a member of a group of companies which filed consolidated returns, the loss could be offset against the income of other companies in the group in accordance with our recommendation.

The immediate write-off of exploration costs is a concession that is similar to the proposed write-off of all costs of research and product development for industry generally, and is an incentive that can be supported on general economic grounds.

Development Costs

We recommend that initially development costs, including the cost of depreciable assets which can be used only for production from a particular

mine or a particular oil or gas well, should be treated in the same way as exploration costs and should be included in the same capital cost allowance class—although we have indicated that such development costs should in principle be deductible only over a period of years. We recommend that after a reasonable transitional period of, say, five to ten years, these development costs should be segregated in a separate capital cost allowance class and should be subject to write-off at a rate of, say, 20 per cent to 30 per cent on a diminishing balance basis. When this separation between exploration and development costs becomes effective, the regulations should specify what items are to be included in the development cost class and which in the exploration cost class. Any other expenditures not included in these classes should be deducted currently.

In the transitional period a 100 per cent rate of capital cost allowance would be applicable for both exploration and development costs so that there would be no need to distinguish immediately between such costs, which could be grouped into a single new capital cost allowance class that would be subject to a rate of 100 per cent. Unclaimed costs of exploration and development as at the effective date of the new legislation should also be included in this new capital cost allowance class. In the event of a reorganization under which all the underlying properties of a corporation were transferred, the undepreciated balance would likewise be transferred and the present limitations on the sale of unamortized costs should no longer apply. On the other hand, the taxation of property gains would mean that any gain on disposition would be taxable.

The above treatment should not apply to depreciable assets used in smelting and refining. These should continue to be subject to capital cost allowance at the regular rates for buildings and equipment.

Property Costs

Mining and petroleum properties are wasting assets which often have an indeterminate life. To be consistent with our recommendations for industry

generally, the costs of finding and maintaining mineral and petroleum reserves should be allowed as a deduction when incurred, while the cost of purchasing a property should be amortized over the life of the property if this is determinable or, if it is not determinable, the cost should only be deducted when a loss in value can be shown to have taken place. In the case of mining and petroleum properties it should usually be easy to demonstrate such a loss, for when a property proves unproductive or is closed down a loss in value would be established.

Because of the difficulties in estimating the amount of mineral and petroleum reserves with any degree of accuracy, it would not be feasible for tax purposes to attempt to match all of the costs of the property against the revenue produced. Rather, the exploration costs should be immediately deductible and the development costs should be amortized at an arbitrary rate, a procedure which would generally result in a faster write-off of costs than would otherwise be the case. In addition, the proposed rapid write-off provisions should also apply to the costs of acquiring property rights, even if subsequent exploration and development work was successful.

Accelerated write-offs assist the taxpayer to conserve internal sources of funds by deferring his tax liabilities, and therefore reduce the need for outside capital. However, in the case of the purchase cost of mining and petroleum properties an unlimited write-off, even for a transitional period, could have undesirable consequences. Not only would such a write-off be unduly liberal for the larger concerns, but it could well become a tax incentive to the larger companies to take over the smaller operations. If companies that were in a taxable position could immediately write off the full costs of acquiring a developed property, they would have a substantial advantage in the market for properties as compared to companies that were not yet taxable. Such an incentive would be particularly attractive to non-resident-owned companies, as integration would not apply to reduce the relative value of the immediate write-off.

In Chapter 22 we discuss a problem of a similar nature that is applicable to business in general. Although purchased goodwill and trade marks are intangible assets, while mining and petroleum properties are tangible assets, the problem of matching the revenue and related expenses is similar where the useful life and the quantity of reserves are indefinite in duration and amount. In principle, all the costs of developing or acquiring these items should be capitalized and then amortized so as to be matched with the revenue produced from the exploitation of the property. It is often difficult, if not impossible, to ascertain the useful life of each asset, for this depends upon the revenues that can be derived from it. The level of such revenues will be affected by many factors, usually beyond the control of the taxpayer. In Chapter 22 we recommend that all the costs of developing and maintaining such assets as goodwill and trade marks should be deductible in the year incurred, despite the fact that such costs should in principle be capitalized and amortized, but that the cost of purchased goodwill or trade marks should only be deducted when it could be demonstrated that a loss had occurred.

We will recommend a procedure for the mining and petroleum industries that will allow them to continue to receive more liberal treatment than other industries. Our proposals are as follows:

1. For companies qualifying under the new and small business provision the cost of mining and petroleum properties should be treated in the same way as is recommended for exploration and development costs, that is, allowed as a deduction when incurred up to a maximum of $250,000.

2. For other taxpayers the purchase cost of mining and petroleum properties should be capitalized in a separate capital cost allowance class for each property. The cost should then be amortized by the write-off of amounts related to the operating revenues derived from the same property. While in the transitional period the proportion

might be up to 50 per cent, after a period of five to ten years it should be set at, say, 10 per cent to 20 per cent of the operating revenue from the property. A provision of this nature should not be difficult to administer as it should be possible to develop administratively feasible regulations defining what property costs were to be capitalized and how operating revenues were to be determined.

Any unamortized balance of the property cost should, of course, be allowed on the disposal or abandonment of the property or when it could be demonstrated that the property was valueless.

As a transitional measure, it perhaps should also be provided that the restriction on the write-off of property costs should not immediately apply to purchases of property rights from a government. The petroleum industry has had the right to an immediate write-off of the cost of such property rights since 1962 and to defer the deduction of these costs, while simultaneously withdrawing depletion, might be too great an adjustment for the larger integrated companies to make at one time. However, after, say, five years the limitations outlined above should be extended to all purchased properties.

Deduction of the costs of mining and petroleum property rights should differ in one respect from the usual procedures applicable to other costs included in capital cost allowance classes. A taxpayer acquiring a mining or petroleum property directly would capitalize the full costs, which would be amortized or written off as described above. A taxpayer acquiring a company that held such properties should not be permitted to adjust upward to market value the depreciable capital cost of the properties, as we have suggested he could do with other depreciable assets of the purchased company. Rather, the company should continue to claim capital cost allowance on the same basis as before the change in control and the excess of the purchase price of the shares over the undepreciated capital cost of the mining or petroleum property, if any, should in effect be regarded as goodwill. This procedure would create a bias between the purchase of shares and

the purchase of assets, but nevertheless would be necessary because of the difficulty of differentiating between the value of the properties and other intangibles such as goodwill.

Property Gains

We have recommended that property gains should be taxed in full (a procedure that is already applicable to petroleum properties), and that gains accrued prior to the date of implementation of our proposals should be excluded from income. However, in the case of mining and petroleum firms, we do not recommend that this exclusion should apply.

Our rejection of an exemption for gains unrealized at the transition date is dictated partly by tax avoidance considerations and partly by practical considerations. Experience at the time of the change in treatment of petroleum rights in 1962 indicated that, if petroleum properties could be sold tax free while the cost to the purchaser could be written off, many sales would probably take place for tax reasons and there would be an unacceptable loss in tax revenues. As a practical matter, it would be extremely difficult, if not impossible, to value many mineral properties. The allocation procedure suggested in Chapter 15 would be inappropriate because of the extreme fluctuations in the value of these properties over time, and because of the inhibiting effect that such a procedure would have on mobility. We discuss these difficulties later in this chapter.

In any event, the hardship which would result from the denial of the exemption is limited. For one thing, the general exclusion of gains accrued prior to the transition date should not apply to those taxpayers whose business included the realization of such gains. Also, all gains realized on the disposition of petroleum properties are already subject to tax. More important, the shareholders of a company holding property rights would not be subject to tax on the accrued property gains to the extent that such gains were reflected in the value of their shares at the transition date. Thus,

what would appear to be harsh treatment at the corporate level would be fully compensated for at the shareholder level as far as resident shareholders were concerned. Furthermore, in the case of prospectors, we recommend that some recognition should be given to the fact that their property gains are now tax free. In view of the difficulties in valuing mineral properties, the transitional provision for prospectors should provide for the taxation of such gains in stages.

We have recommended that all property gains should be taxed in full when realized. Thus, the disposal of any mining or petroleum property would be a taxable transaction; and the amount that would be amortizable to the purchaser would be an amount equal to the proceeds of disposition included in the income of the vendor. The taxation of the vendor's gains should produce much of the revenue to offset the write-off claimed by the purchaser. However, if the vendor was a non-resident while the purchaser was a resident, the liability to Canadian tax is not assured. We have expressed our belief that all gains realized on the disposition of Canadian property are a reasonable subject of Canadian tax. We have also stated that at the present time it is administratively impracticable or, in some cases, impossible to collect a tax on many such property gains—the prime example being the gains of non-residents on dealings in Canadian securities. On the other hand, we have recommended that gains and losses on the disposition of real property by non-residents should be included in income. Not only do we believe it is possible to administer such a provision, but also it is necessary to levy tax in these circumstances to avoid putting the Canadian holder of real property at a competitive disadvantage. These same considerations apply to mineral and petroleum rights and we therefore recommend that they be treated in the same manner as other interests in real property. Thus, the ownership in Canada of real property, or of an interest in real property, should be deemed to be a permanent establishment in Canada, with the result that any gain or loss on the disposition of such property or property interest would be taken into account in computing Canadian source business income.

Deduction for Shareholders

In order to ensure that the benefits of the proposed rapid write-offs accrue to the small and medium-sized companies as well as to the integrated operations, we recommend that an option be available to mining and petroleum companies to pass on to the purchasers of new shares the right to the immediate deduction of exploration and development costs. This transfer would be accomplished by permitting the purchasers of the newly issued shares to write down the cost basis of such new shares to the extent that the proceeds of the issue were to be spent on exploration and development. This reduction in the cost basis, which would produce a "loss" that could be deducted from other income, would be allowed at the time of the investment even though the costs would not then have been incurred by the mining or petroleum company. When the company did incur the costs they would not, of course, be available as a deduction to the company and as a result corporation income tax would become payable at an earlier date. The tax authorities should establish certain controls to ensure that the company did in fact expend the funds on exploration and development. For example, a trust account might be required and a special tax might be imposed on any part of the designated funds that had not been spent on exploration and development within the period specified. It is not intended that costs of financing or administration would be included in this special write-off, but only the direct costs of exploration and development. This provision should be applicable to new share issues only, and not to outstanding shares. It should greatly facilitate the raising of risk capital by independent exploration companies and put them on essentially the same basis as the larger integrated corporations. Also, it should help to equalize the positions of the large and small companies as regards their ability to utilize the liberal write-off provisions that we have proposed.

Taken together, these proposals would virtually preclude the possibility of incomplete loss-offsets for expenditures in mining and petroleum exploration

and development. The large successful companies would deduct their costs of unsuccessful ventures from other business income. The newly issued shares of corporations that did not have operating income would, if the corporation made the election outlined above, immediately be eligible for a write-down to the extent of exploration and development expenses. The shareholders could immediately offset these expenditures against other income. The shares of corporations with inadequate operating income that for some reason did not follow the immediate write-down procedure would decline in price if the market judged the venture to be unsuccessful. The shareholder could then write down the value of his shares to market value. With all of these methods available for deducting losses from other income, we are satisfied that the tax system would not be biased against risk taking in the mining and petroleum industries.

Undeducted Property Costs

Although we have proposed some measures to reduce the impact of withdrawing percentage depletion, we believe that an additional transitional provision is required. As depletion was at least in part intended to compensate for non-deductible costs, and as substantial costs have been incurred in the expectation that any income would be eligible for a depletion allowance, some recognition should be given to costs that have not yet been absorbed. Therefore, we recommend that mining and petroleum operations that are now eligible to claim depletion should be able to deduct (over, say, a three- or five-year period) all costs of exploration and development which were not deductible in the past, including the cost of mining and petroleum properties, leases and licences, to the extent that such costs exceeded the amount of depletion claimed. This provision should only apply to costs incurred in Canada and depletion claimed over a certain number of years. As the deductibility of exploration and development costs was considerably expanded in 1948, this might be an appropriate year from which to begin the determination. The computation should be applied to associated companies on a consolidated basis.

The unclaimed costs of properties for petroleum companies are probably between $500 million and $750 million 26/. These companies claimed depletion between 1947 and 1964 of over $350 million, so that a provision of this nature would probably result in an amount of about $300 million becoming deductible by petroleum companies. The amounts of unclaimed costs would not be as large for mining companies, which have claimed depletion over this period in excess of $1,000 million. Thus, most of the benefit of such a write-off would accrue to those mining companies that had claimed little or no depletion.

Prospector and Grubstaker Exemption

There remains no justification for exempting the profits of prospectors and grubstakers from full rates of personal income tax. With the full deductibility of costs, with the averaging provisions recommended elsewhere in the Report, and with the provisions suggested later in this chapter to ameliorate any liquidity problems that would arise when property rights were exchanged for a non-cash consideration, the exemption can be withdrawn without hardship. However, the withdrawal should perhaps be implemented in stages over a transitional period, because we recommend that any properties held at the transition date by an individual prospector should be valued at his cost so as to obviate the problem of determining a market value.

Shareholder Depletion

With the full deduction of all costs, it would not be necessary to provide shareholders with an allowance for the depletion of their "capital". Accordingly, the provision for shareholder depletion should be repealed.

Special Aspects of the
Proposed Tax Treatment

We now turn to certain special aspects of mineral and petroleum operations: the treatment of costs of exploration outside Canada, payments to the provinces for petroleum rights and mining taxes, the purchase and sale of

mining and petroleum rights and properties, and the application of the proposed incentives to particular types of taxpayers.

Exploration Outside Canada. Under the present legislation, the costs of exploring for minerals and petroleum outside Canada are generally not deductible. This disallowance was probably adopted in the past to encourage the development of Canadian resources and to obviate any tax avoidance opportunities which their deduction might have created. Such an opportunity might have arisen, for example, in circumstances where a taxpayer resident in Canada deducted the costs of foreign exploration and then, in order to escape Canadian tax on any resulting profits, transferred the income-producing property to a company in a low tax jurisdiction.

The allowance of these costs is a desirable step if the measurement of income from mineral and petroleum extraction is to be improved, and we therefore recommend that these expenses be made deductible. It may be necessary to enact provisions which would require a resident company which transfers a property to a non-resident to include in its income at least the fair market value of the property transferred. Having regard to the provisions we recommend for deemed dispositions and the taxation of income from direct investment abroad, we are of the opinion that the problem of avoidance should not be a serious barrier to the allowance of these costs.

Payments to the Provinces. A continuing problem over the years has been the determination of what is a reasonable allowance under federal taxation for the various levies on natural resources imposed by the provinces. Where a province has retained proprietary rights in natural resources under the British North America Act, it may levy a charge in compensation for relinquishing those rights. In effect, it may sell its natural resources at a reasonable price. Any province may also exercise its constitutional powers to impose a direct tax on the exploitation of any natural resource, whether or not the province retains a proprietary interest in the resource. Such a direct tax may be imposed in addition to the natural resource charge, because

the legislative powers of the provinces in respect of property and taxation are not mutually exclusive.

Normally, the proprietary cost is recognized through a charge based on the quantity and quality of the resource depleted; typical examples are the stumpage charges in the forestry industry and the royalty charges for petroleum. These are normally recognized without question by the federal authorities as being allowable expenses of the taxpayer.

The provinces, particularly Alberta, have obtained substantial revenues from their oil resources by charging operators, by way of initial payments and annual charges and royalties, for rights to take oil 27/.

Royalties have always been allowable as a deduction in computing income for tax purposes, but payments for rights to take the oil were deductible only to a limited extent prior to 1962. When the cost of these rights became fully deductible in 1962, oil producers could afford to pay higher prices for the rights; consequently, a major effect of the change was to increase the prices of such rights and thereby transfer from the federal to the provincial treasury some of the government revenues from oil resources.

The provinces have had little difficulty in exercising their right to revenue from petroleum, probably because of such inherent characteristics as its homogeneous nature and the fact that the market value is relatively easy to establish. Because petroleum has an established value at the well-head, it would be somewhat easier than in the mining industry to determine the income from the actual extraction of petroleum and to levy a tax thereon. The provinces, however, have not thought it desirable to apply to the petroleum industry an income tax comparable to the mining tax, but rely on a royalty based on barrels of production.

Originally, the provinces derived revenue from mining by levying a flat charge per ton of ore removed. Most provinces now obtain their main revenues from mining through a tax on mining income—although the

provincial revenues from mining are much less than one half of those derived from petroleum. While simple in theory, the determination of the meaning of mining income for tax purposes has given rise to certain complications. Elaborate definitions have been devised to formulate a method of determining such income, the general purpose being to establish a concept of income earned in extracting the ore and raising it to the surface. In some cases this is done by direct computation; in others by a calculation to eliminate from the total profits of the operation the profit made on milling and processing. The federal government has its own definition governing the sort of tax it will recognize as being deductible and, while most of the provinces adhere fairly closely to this definition in levying their charges, there are some troublesome differences in the treatment of certain factors in the computation. The most serious differences arise in the case of the Quebec tax which is levied on a broader base than is contemplated in the federal definition.

Whether the provincial governments derive revenues from natural resources through lease payments, royalties, or a tax on income, the charges are nevertheless a cost of acquiring a supply of the mineral or petroleum concerned. Therefore, such charges, regardless of their form, should be deductible in full in the computation of income in the same way as any other cost of doing business. However, as they are a cost of earning income, they should not be eligible for any form of tax credit.

Purchase and Sale of Mineral and Petroleum Rights and Properties. A mining or petroleum property may pass through many hands before being developed. In the case of mining property, a typical chain of events for a discovery not made by a major mining company is that a prospector first stakes a property and, having done some work on it, enters into an agreement with an exploration company under which the company, in consideration for an interest in the property, undertakes to investigate the property. If the investigation warrants it, the exploration company does some development work on the property and interests a major mining company in financing it to a producing

state. At this stage a new company is formed in which the prospector, the exploration company and the mining company each have an interest. Usually, throughout this chain of events, little or no cash changes hands between the parties and frequently no price is stipulated when the property passes from one owner to another. Each party takes or retains an interest in the property either in the form of rights to participate in net income from production or shares in a company controlling the property.

Transactions also occur in mining properties that have been fully developed or are in production, but these are not nearly as common as transactions in proven or producing oil properties.

In general, the proceeds from the sale of mining properties by prospectors or grubstakers would probably be considered taxable, but specific exemption is at present provided in section 83(2) of the Income Tax Act. Mining properties that have been developed or are in production are normally considered capital assets, and any proceeds from their sale are non-taxable except to the extent of recaptured depreciation unless the vendor is found to be dealing in mining properties. There is no recapture of exploration and development costs that have been claimed and are subsequently recovered upon sale of the mining property. Circumstances in which pre-production expenditures can be transferred between taxpayers are referred to below.

Thus, while the present system ignores purchases and sales of mining properties, the actual costs of exploration for and development of mining properties are generally recognized, either as deductions against other income of the taxpayer incurring the costs or, under certain conditions which will be discussed in more detail below, by transfer to other taxpayers. The important exceptions to this general statement are prospectors and grubstakers and the exploration companies and mining companies that themselves have insufficient income to absorb such costs and are unable to enter into transactions that would enable the costs to be transferred to other taxpayers.

The present system is inequitable and contrasts sharply with our recommended basis for determining business income. Certain anomalies and loopholes have incidentally been created. In this connection, we have already proposed that all the costs of acquisition and development of mining rights should be allowable, and it would follow that any proceeds attributable to these activities should be included in income.

The main difficulty in introducing a system under which the purchase and sale of mining properties would be taxable transactions lies in placing a value on the consideration, most of which would usually be in the form of shares. There are several alternative methods of valuation:

1. Fair market value might be adopted as the measure of the consideration. In some cases information would be available as to the value of the shares, but often there would be no adequate indication of value for several years. It does not seem practicable to wait a number of years to establish the value.

2. Only the cash consideration might be recognized for tax purposes. This would make for greater certainty, but would be inequitable when so little of the consideration would usually be paid in the form of cash. It would also invite artificial avoidance procedures.

3. Only the costs related to the property that were not yet claimed by the vendor might be regarded as consideration for tax purposes. This treatment would give recognition to the fact that many transactions in mining properties are steps in a continuous chain of events resulting in the emergence of operating income. It would not serve equity, however, where the fair market value was considerably in excess of the cost.

Despite the practical difficulties involved, we recommend, with the exception noted below, that the purchase and sale of mining properties be treated as taxable transactions. It follows that the present exemption of amounts realized by prospectors and grubstakers from the sale of mining

properties should be discontinued and that any costs which they have incurred should be allowed. The general basis of valuing transactions in mining properties should be fair market value, although in certain circumstances the use of the unclaimed costs of the vendor would be acceptable. Where a mining property was exchanged for shares in a new company that were not publicly traded or for shares that were publicly traded but represented an interest in a company of more than 25 per cent, we recommend that the vendor of the property should be permitted to adopt as the cost basis of the shares an amount equal to his unclaimed costs. This would mean that no profit would be recognized for tax purposes at the time of transfer. Under our proposed treatment of losses, any decline in the value of the property or shares could be taken into account whenever such loss could be established. In Chapter 15 it is also recommended that a disposition of the shares received in exchange for property should be deemed to take place when the shares satisfy two conditions: they represent an interest in the company of 25 per cent or less, and are publicly traded.

We have already noted that in 1962 fundamental changes were enacted in the tax laws applicable to the petroleum industry. The cost of oil rights and properties became a deductible expenditure, and the proceeds from disposal of all petroleum properties, regardless of their date of acquisition, became taxable. However, the costs of properties acquired prior to the effective date were not deductible. Representations have been made to us concerning this anomalous result, and accordingly further comment is appropriate.

Originally, it was proposed that the proceeds from the sale of any property acquired prior to April 11, 1962, would not be taxable, a procedure that would have followed the more or less traditional approach of avoiding retroactive taxation of amounts that were previously exempt. However, since the cost of any property acquired after that date was to be immediately deductible, there arose the possibility that taxpayers would exchange

properties at high prices to their mutual tax advantage, creating capital gains for the vendors and deductible costs for the purchasers. Because of the way in which oil fields are shared by companies, it soon became evident that this potential avoidance technique was an actual one. Accordingly, when the changes were finally enacted it was provided that the proceeds of the disposal of all oil properties not acquired by inheritance would be included in income unless they were acquired before April 11, 1962, and disposed of before November 9, 1962. 28/

Actually, the taxation of proceeds from the disposition of properties acquired prior to April 11, 1962, has probably had a limited retroactive effect as the purchaser, now that the cost of acquisition is deductible at some time, can afford to pay a much higher price and thereby leave the vendor in almost the same net position as before. It has also been contended that the impact of tax on the profit from dispositions of oil properties has been such as to discourage transactions from actually taking place. However, the size of the tax impact is a reflection of the fact that a property may be carried at a much lower tax value than its real value. When a taxpayer actually realizes this difference, the government must collect the full tax at that time. It is the consequence of taxing income on a realized basis and allowing accelerated write-off of costs.

The denial of a deduction for the cost of properties acquired prior to April 11, 1962, is of more concern. However, as part of our recommended transitional provisions we have suggested that the excess of these unclaimed costs over depletion claimed should become deductible, and therefore in effect all costs would be deducted in one manner or another.

Application of Mining and Petroleum Provisions to Particular Types of Taxpayers. Under the present legislation considerable complexity is caused by the fact that provisions for the taxation of mining and petroleum income apply to different taxpayers in different ways, primarily according to the principal business conducted by the taxpayer, but also according to whether the taxpayer is an

individual or a corporation. Many of the provisions presumably were intended as incentives available only to persons in mining and petroleum. This policy does not generally appear to be valid. It is therefore recommended that the limitations on the availability of the special provisions be removed. An incidental and important effect of this change should be to encourage wider participation by Canadians in the mining and petroleum industries.

Proposed Tax Treatment of the Mining and Petroleum Industries Compared with the Proposed Tax Treatment of Other Industries

The effects of our proposals on the mining and petroleum industries, relative to the present treatment of these industries and relative to the proposed treatment of other industries, can be shown in tabular form. Table 23-1 deals with the treatment of costs; Table 23-2 deals with the treatment of losses.

The outstanding features of the recommended changes in the treatment of costs can be briefly stated:

1. All costs would be deductible at some time for all industries.

2. The mining and petroleum industries would be allowed an immediate write-off of all exploration costs and initially of all development costs, with the exception of depreciable assets used in smelting and refining (although the new and small business provision applicable to all industries would also apply to mining and petroleum).

3. The purchase cost of mining and petroleum properties and property rights could be amortized, initially at a rapid rate and later at a more moderate rate. The cost of abandoned or valueless properties could, of course, be written off when the loss in value was shown to have occurred.

TABLE 23-1

COMPARISON OF PRESENT AND PROPOSED TREATMENT OF COSTS FOR MINING AND PETROLEUM WITH COMPARABLE COSTS OF OTHER INDUSTRIES

Type of Cost		Present Treatment		Proposed Treatment	
Industry Generally	Mining and Petroleum	Industry Generally	Mining and Petroleum	Industry Generally	Mining and Petroleum
Research and product development	Prospecting and exploration	Current and capital costs for scientific research—immediate write-off a/ Other current costs—immediate write-off Other capital costs—no write-off unless under capital cost allowance provisions	Immediate write-off	Immediate write-off	Immediate write-off including special write-off for holders of newly issued shares
Inventory	Development costs (including forward development)	Charged against income when goods sold or on a loss in value	Generally immediate write-off	Charged against income when goods sold or on a loss in value	Immediate write-off during initial period—capital cost allowance at 20 per cent to 30 per cent thereafter, also special write-off for holders of newly issued shares
Patents copyrights and goodwill	Property rights	Fixed life—amortized over life Other—not deductible	Petroleum—immediate write-off Mining—not deductible b/	Fixed life amortized over life Other—deductible when lost or reduced in value	Amortized as a percentage of revenues from the property or written-off on a proven loss in value
Depreciable assets	Depreciable assets: a) used in prospecting, exploration, extraction and reduction b) used in smelting and refining c) unclaimed capital costs on effective date	Immediate write-off for assets used in scientific research—otherwise capital cost allowance rates	Capital cost allowance rates	Immediate write-off for assets used in scientific research. On other assets capital cost allowance rates unchanged except for small and new businesses	a) Immediate write-off b) Unchanged except for small and new businesses c) Unchanged

Notes:

a/ Until the end of the 1966 year an additional 50 per cent is also deductible.

b/ Depletion is sometimes regarded as a roughly equivalent deduction.

TABLE 23-2

COMPARISON OF PRESENT AND PROPOSED TREATMENT OF LOSSES
FOR MINING AND PETROLEUM WITH OTHER INDUSTRIES

Type of Loss	Principal Features of Treatment	Present Treatment: Industry Generally	Present Treatment: Mining and Petroleum	Proposed Treatment: Industry Generally	Proposed Treatment: Mining and Petroleum
Business losses	Carry-back	1 year	Same as industry generally	2 years	Same as industry generally
	Carry-forward	5 years		No limit	
	Deductible from other kinds of income	All income in year of loss—business income in other years		No limit a/	
	Transferability	Restricted		Restricted but this is largely irrelevant because losses on shares deductible as described below	
Losses on shares	Carry-back Carry-forward Deductible from other kinds of income	Not deductible	Not deductible	Same as treatment of business losses	Same as industry generally
	Write-down to market without realization	Not deductible	Not deductible	Deductible	Deductible

Note:

a/ Except for limitations to preclude deduction of personal expenditures.

4. The mining and petroleum industries would therefore be allowed to write off the following kinds of costs more rapidly than industry generally would be allowed to write off costs of a comparable type:

    a) pre-production and development costs;
    b) the cost of depreciable assets used in exploration and development; and
    c) the purchase cost of mining and petroleum properties and property rights.

5. The mining and petroleum industries would be better off under our proposals than they are at present so far as the treatment of costs is concerned; the major advantage would be enjoyed during the initial period when development costs could be written off when incurred.

6. New mining and petroleum companies that met the asset and sales qualifications for new and small businesses would be entitled to an immediate write-off of all depreciable assets within liberal limits. In addition, the newly issued shares of mining and petroleum companies would be eligible for a special write-off to the extent that the proceeds of the share issue were to be expended on exploration and development.

The outstanding features of the recommended changes in the treatment of business and property losses are set forth in Table 23-2.

1. The treatment of business losses would be liberalized for all industries in the following respects:

    a) the carry-back of losses would be extended from one to two years;
    b) the five-year limit on the carry-forward of losses would be removed;
    c) business losses could be used to offset other income of the individual in any year of loss or any other year in which the loss could be carried back or forward;

d) limitations on the transferability of losses would remain, but because property losses would be deductible to shareholders the significance of the restriction would be much reduced.

2. Share losses for all industries would be treated in the same way as other property losses; under the present system share losses are not deductible because the gains are not taxed.

Effect of the Proposed Tax Treatment

It is difficult to make precise estimates of the overall effects of our proposals on the after-tax rate of return from mining and petroleum companies. The impact of the recommended changes would depend upon many circumstances that would differ substantially from company to company. It is useful, however, to cite the following estimates from a study prepared for us 29/. These estimates, as given in Table 23-3, are based on simplified assumptions that are set forth in the study and do not purport to represent any particular company. Rather, they show the position of a "typical" company under hypothetical but reasonable conditions. Estimates have been prepared for both hypothetical mining companies and hypothetical petroleum companies. Because of the different assumptions made for the two industries, estimates of the rates of return are not comparable between the two, but are comparable within each industry.

Although we freely acknowledge that these indices are subject to severe limitations and must be interpreted with caution, they reflect the general orders of magnitude involved. The data in Table 23-3 suggest that:

1. Because of the incentive element built into the capital cost allowance rates generally, corporations in all industries have a higher after-tax cash flow rate of return than they would have with a "pure" accounting concept of income (Index 2 compared to Index 1).

2. The proposed treatment of mining and petroleum companies would provide a substantially higher after-tax cash flow rate of return than that proposed for other industries (Index 3 compared to Index 2).

TABLE 23-3

INDICES OF THE AFTER-TAX CASH FLOW RATE OF RETURN TO A CORPORATION ON INVESTMENTS IN PETROLEUM AND MINING UNDER HYPOTHETICAL CONDITIONS AND ALTERNATIVE TAX TREATMENTS

Tax Treatment	Petroleum	Mining
1. Complete matching of costs and revenues over a period of time, with no percentage depletion or three-year exemption. This is a "pure" accounting concept of income.	100.0	100.0
2. Exploration and development expenses in a 30 per cent capital cost allowance class.	119.0	121.4
3. Proposed initial treatment for mining and petroleum a/.	151.6	147.5
4. Present treatment b/		
a) integrated company—i.e., one with operating income to offset all exploration and development costs.	196.7	165.9
b) non-integrated company—i.e., one without operating income other than from the particular mine or oil well.	141.0	150.5

Notes:

a/ The index for petroleum is higher than that for mining because of the relatively greater importance in petroleum of the cost of property rights. Thus, an accelerated write-off of such costs is of more value to petroleum companies. The indices for both petroleum and mining reflect our proposals for the transitional period, and therefore are slightly higher than what might be expected when the costs of development and of property rights are not written off immediately or at a 50 per cent rate but are amortized over a period of years.

b/ In Bucovetsky's study a period of 25 years was employed for the petroleum and 15 years for the mining examples. Because the depletion allowance becomes more valuable once all the costs of exploration and development have been written off, a longer time period increases the relative value of the present concessions. Thus, the index of 165.9 for mining would be an understatement of the position of a mine with a longer life.

Source: Bucovetsky, The Taxation of Mineral Extraction, Appendices E and F.

1. Petroleum Case 12; Mining Case 14.
2. Petroleum Case 15; Mining Case 17.
3. Petroleum Case 14; Mining Case 13.
4. Petroleum Case 3; Mining Case 2.
5. Petroleum Case 1; Mining Case 1.

3. The after-tax cash flow rate of return to petroleum companies with operating income would be reduced by our proposals by about 23 per cent; 30/ the cash flow rate of return to petroleum companies that now cannot offset exploration and development expenses would be raised by 5 per cent to 10 per cent (Index 3 compared to Indices 4 and 5).

4. The after-tax cash flow rate of return to mining companies with operating income would be reduced by about 11 per cent; the after-tax cash flow rate of return to mining companies without adequate operating income to provide a full offset would decline about 2 per cent (Index 3 compared to Indices 4 and 5).

The integrated company would be subject to the most unfavourable change at the corporate level, as shown by the indices of after-tax cash flow of rates of return in Table 23-3. Despite the substantial reduction in after-tax corporate income for integrated petroleum companies that would follow from the implementation of the recommended tax treatment for the petroleum industry, the compensating effects of integration at the shareholder level would largely offset, for Canadian shareholders receiving dividends, the increased burden at the corporate level. This is demonstrated in the example given in Table 23-4 which compares the respective positions of Canadian shareholders who receive dividend income from an integrated company and who are subject to tax at marginal rates of 50 per cent and 30 per cent under the present and proposed systems. Clearly, shareholders at the higher income levels are not absolutely worse off and at the lower income levels are absolutely better off.

However, the hypothetical example given in Table 23-5 illustrates that the favourable effects of integration do not offset, for resident shareholders in integrated companies, the negative effects of both the corporation tax changes with respect to petroleum companies and the full taxation of share gains. On the other hand, Table 23-6 illustrates that low and middle income resident shareholders in non-integrated companies would have their

TABLE 23-4

AFTER-TAX DIVIDEND INCOME OF A CANADIAN SHAREHOLDER IN AN INTEGRATED PETROLEUM CORPORATION—COMBINED EFFECT OF PROPOSED CHANGES IN TAX TREATMENT AT THE CORPORATE LEVEL AND INTEGRATION OF CORPORATION AND PERSONAL TAX

	Present Treatment	Proposed Treatment
Corporation		
Assumed after-tax corporate income based upon the indices in Table 23-3 a/	$100.00	$ 77.00
Shareholder with a 50 per cent marginal rate		
Dividend (assuming 100 per cent distribution)	$100.00	$ 77.00
Personal Tax at 50 per cent	-40.00 b/	-77.00 c/
Tax Credit d/	+16.00	+77.00
After-tax dividend income to shareholder	$ 76.00	$ 77.00
Shareholder with a 30 per cent marginal rate		
Dividend (assuming 100 per cent distribution)	$100.00	$ 77.00
Personal tax at 30 per cent	-24.00 b/	-46.20 c/
Tax credit d/	+16.00	+77.00
After-tax dividend income to shareholder	$ 92.00	$ 107.80

Notes:

a/ If an index of 196.7 equals $100.00, then the index of 151.6 equals $77.00. The difference in the income figures reflects the removal of the depletion allowance but does not take into consideration any write-off of old exploration and development costs that would be deductible under the proposed transitional provisions.

b/ Personal tax computed as follows:

Dividend	$100.00
Less shareholder's depletion at 20 per cent	-20.00
Net dividend taxable	$ 80.00
Personal tax at 50 per cent	$ 40.00
Personal tax at 30 per cent	$ 24.00

c/ Personal tax is levied on the grossed-up amount

$$\left(\text{i.e.}\quad \$77.00 \times \frac{100}{100 \text{ minus corporation tax rate}}\right)$$

d/ The tax credit at present is the dividend tax credit of 20 per cent of the net dividend after depletion, while under the proposal it would be the credit for the corporation tax paid.

TABLE 23-5

EFFECT OF THE PROPOSED TAX CHANGES—BOTH CORPORATE AND PERSONAL AND INCLUDING TAXATION OF SHARE GAINS—ON THE AFTER-TAX RATE OF RETURN FROM A HYPOTHETICAL INTEGRATED PETROLEUM CORPORATION TO A CANADIAN SHAREHOLDER WITH A MARGINAL PERSONAL TAX RATE OF 30 PER CENT

		Present		Proposed
Corporate after-tax income per share		$100.00		$ 77.00 a/
Cash retained by corporation b/		50.00		38.50
Dividend to shareholder		$ 50.00		$ 38.50
Personal tax at 30 per cent		-12.00 c/		-46.20 d/
Dividend tax credit (present) or tax rebate (proposed)		8.00 c/		77.00 e/
After-tax cash income to shareholder		$ 46.00		$ 69.30
Assumed share gain: f/				
from retention	$50.00		$38.50	
from goodwill	50.00	100.00	38.50	77.00
Personal tax on share gains		-		-11.55 g/
Total after-tax return to shareholder h/		$146.00		$134.75

Notes:

a/ It is assumed that changes in the tax treatment at the corporate level reduce after-tax corporate income by 23 per cent. (See Table 23-4.)

b/ It is assumed that retained earnings are one half of after-tax corporate earnings.

c/ Personal tax is computed as follows:

Dividend	$ 50.00
Less shareholder depletion at 20 per cent	10.00
Net dividend taxable	$ 40.00
Personal tax at 30 per cent	-$ 12.00
The dividend tax credit is 20 per cent of $40.	-$ 8.00

d/ It is assumed that all corporate income is allocated to the shareholder so that the shareholder would bring into income $154.00 (the grossed-up figure for $77.00 of after-tax income) and would be subject to a 30 per cent tax on this amount.

e/ Full credit for the corporation tax paid.

f/ It is assumed that share gains are double retained earnings per share (and therefore that "goodwill" capital gains are equal to retained earnings). A higher ratio of goodwill gains to retained earnings would further improve the relative after-tax return of the present system as compared to our proposals.

g/ Because of the upward adjustment of the cost basis by the amount of the retention, the share gain resulting from the retention would not be subject to tax to the shareholder. It is assumed that the goodwill property gain is realized.

h/ For a shareholder subject to a personal rate of tax of 50 per cent the comparable figures would be $138.00 at present and $96.25 under the proposal.

TABLE 23-6

EFFECT OF THE PROPOSED TAX CHANGES—BOTH CORPORATE AND PERSONAL AND INCLUDING TAXATION OF SHARE GAINS—ON THE AFTER-TAX RATE OF RETURN FROM A HYPOTHETICAL NON-INTEGRATED PETROLEUM CORPORATION TO A CANADIAN SHAREHOLDER WITH A MARGINAL PERSONAL TAX RATE OF 30 PER CENT

		Present		Proposed
Corporate after-tax income per share		$100.00		$100.00 a/
Cash retained by corporation b/		50.00		50.00
Dividend to shareholder		$ 50.00		$ 50.00
Personal tax at 30 per cent		-12.00 c/		-60.00 d/
Dividend tax credit (present) or tax rebate (proposed)		8.00 c/		100.00 e/
After-tax cash income to shareholder		$ 46.00		$ 90.00
Assumed share gain: f/				
from retention	$50.00		$50.00	
from goodwill	50.00	100.00	50.00	100.00
Personal tax on share gains		-		-15.00 g/
Total after-tax return to shareholder h/		$146.00		$175.00

Notes:

a/ It is assumed that changes in the tax treatment at the corporate level do not have any net effect on after-tax corporate income. Table 23-3 indicates that the proposed treatment would not vary greatly from the present situation. As depletion is of little value to the non-integrated company, the improvement in write-offs is sufficient to offset its removal. On the other hand, for those companies that permitted their shareholders to take advantage of the special write-off on newly issued shares, the proposed tax treatment would improve their position over what presently exists. For these companies the assumption of an unchanged corporate after-tax income would be conservative.

b/ It is assumed that retained earnings are one half of after-tax corporate earnings.

c/ Personal tax is computed as follows:

Dividend	$ 50.00
Less shareholder depletion at 20 per cent	10.00
Net dividend taxable	$ 40.00
Personal tax at 30 per cent	-$ 12.00
The dividend tax credit is 20 per cent of $40.	-$ 8.00

d/ It is assumed that all corporate income is allocated to the shareholder so that the shareholder would bring into income $200.00 (the grossed-up figure for $100.00 of after-tax income) and would be subject to a 30 per cent tax on this amount.

e/ Full credit for the corporation tax paid.

f/ It is assumed that share gains are double retained earnings per share (and therefore that "goodwill" capital gains are equal to retained earnings). A higher ratio of goodwill gains to retained earnings would improve the relative after-tax return of the present system as compared to our proposals.

g/ Because of the upward adjustment of the cost basis by the amount of the retention, the share gain resulting from the retention would not be subject to tax to the shareholder. It is assumed that the goodwill property gain is realized.

h/ For a shareholder subject to a personal rate of tax of 50 per cent the comparable figures would be $138.00 at present and $125.00 under the proposal.

positions improved by our proposals, unless the capital gain element was a substantial proportion of their total investment return.

While the negative effects of the proposed tax treatment of companies with operating or refining income would be greater than for other companies in the extractive industries, we acknowledge that the position of a substantial proportion of resident shareholders of Canadian mining and petroleum corporations would be less favourable than it is now. Non-resident shareholders would not benefit from the integration proposal, and therefore to the extent that the additional Canadian tax was not eligible for foreign tax credit their position would be worsened even more substantially. This is an unfortunate but inescapable result of removing an inefficient concession. Unless we are willing to accept the existing tax system as immutable, we must also accept undesired windfall gains and losses. They are the inescapable concomitants of change.

Our recommendations would have a greater revenue impact on the mining industry than on the petroleum industry. The amount of depletion claimed by the mining industry is more than double that claimed by the petroleum companies, although three petroleum companies are included in the eight companies that, in 1964, together accounted for about 85 per cent of the total depletion claimed by all mining and petroleum companies. In addition, the removal of the three-year exemption for new mines would be applicable only to the mining industry and would produce about the same increase in tax revenues as the elimination of depletion. Again, the largest companies would be subject to the greatest impact, as is demonstrated by the fact that, in 1964, four mining companies accounted for over three quarters of the exempt income under this provision.

The question that then arises is whether the removal of the major concessions would have a serious impact on the activities of the larger companies. In seeking the answer, we reviewed the operating figures of a number of companies to compare their position with what it would have been

if our proposals had been in effect. A review of four large iron ore mining companies, which together have claimed approximately $250 million in exempt income under the three-year provision, indicated that under our recommended procedures they would on average still not pay any income taxes until they had been producing for over ten years. This is somewhat more than a year earlier than would have been the case under the present system. The major difference is that under our proposals it would have been necessary to claim substantially all of the capital cost allowance available in order to eliminate their taxable income. In any case, the accelerated write-offs would mean that tax liabilities could be deferred for a considerable period of time, and certainly could be deferred until the total financing obtained to put the mines into production had been repaid. We do not believe that a procedure for computing taxable income that would have deferred the payment of income taxes for over ten years would have prevented the development of an economically feasible project.

Another interesting example of the impact of the present concessions is provided by some of the uranium mining companies. The major uranium producers up to 1964 had produced and sold over one billion dollars worth of ore from mines that represented a capital investment of under a quarter of a billion dollars. After retiring all debts and writing off the whole investment, they realized about a quarter of a billion dollars of which somewhat less than one half was paid out in dividends. After deducting exempt income and depletion, the total income tax liability (including taxes paid by shareholders) was under $30 million, or about 10 per cent of the profits. Under our proposals the tax liability would have been about the same, but all of their capital cost allowances would have been claimed. Thus, their future taxes would be substantially higher, but this fact would not have precluded the development of any of these mines.

Finally, we reviewed the operating figures for the past three to ten years for a number of large integrated mining and oil companies. The average

total taxes paid on income before tax and before depletion, including an estimate of the income taxes paid by shareholders on dividends received, was just over 40 per cent. The mining companies were taxed at less than this rate because of the three-year exemption (one large mining company in particular paid taxes at a substantially lower rate). We estimate that under our proposals the average tax rate applicable to all corporate source income attributable to Canadian residents would be substantially less than 40 per cent. Therefore, the Canadian shareholders in mining and petroleum companies would experience a reduction in the total income tax liability on their portion of the corporate profits of these companies. Non-resident shareholders in these companies would experience an increase in the Canadian tax on their portion of the profits. Canadian shareholders would, however, also be subject to a tax on share gains at full personal rates and so would pay tax on gains at a level that would be higher than that faced by non-residents. Consequently, the total taxes paid by a substantial proportion of the Canadian investors in mining and petroleum companies would be increased.

We have emphasized that the small and medium-sized mining and petroleum companies obtain very little direct benefit from these two major tax concessions. We have pointed out that a major purpose of such special tax concessions is to offset a capital market bias that is presumed to exist. However, we do not believe that the larger companies experience any unusual difficulties in financing their operations and therefore, from this point of view, the concessions are misdirected. For the small and medium-sized companies, we feel that the proposed rapid write-offs of exploration and development costs, and the special write-off for new shares issued to finance exploration and development, would be at least as beneficial as the present concessions. Further assistance to such companies, if it is required, would be best directed to them in the form of exploration subsidies and assistance in meeting transportation and other special costs.

CONCLUSIONS AND RECOMMENDATIONS

1. The present Income Tax Act contains special provisions for the mining and petroleum industries. The most important of these provisions are:

   a) the immediate deduction of exploration and development costs by qualified corporations against income from any source with an indefinite carry-forward of such costs not written off;
   b) the three-year exemption of income from new mines;
   c) the deduction of a proportion of the income from oil, gas and mining operations as an allowance for depletion, which is permitted to oil, gas and mining companies and their shareholders.

2. These special provisions have probably brought about an increase in the allocation of labour and capital to mineral and petroleum extraction in Canada. Whether there is a net gain in economic well-being from this diversion of labour and capital from other uses to mineral and petroleum extraction, and whether the same result could be achieved at lower revenue cost, are the crucial questions.

3. The treatment of business income generally in the present Act is seriously deficient in three respects that are relevant for the taxation of the mining and petroleum industries:

   a) some costs laid out to earn income are not deductible at any time;
   b) restrictions on the deduction and transferability of business losses create a bias against risk taking; and
   c) some net gains are excluded from business income.

   To the extent that the mining and petroleum industries are more adversely affected by (a) and (b) than industry in general, and to the extent that (c) is less advantageous for the extractive industries than for industry generally, the special provisions for mining and petroleum have some justification in the context of the present tax system.

4. The adoption of the recommended changes in the treatment of business income generally would virtually eliminate all of the features of the present system that justify special concessions to the extractive industries either through percentage depletion or the three-year exemption for new mines. Specifically:

   a) all costs of earning income would be deductible;
   b) the limitations on the carry-forward, carry-back, deductibility and transferability of losses would be either substantially reduced or made much less important; and
   c) virtually all net gains would be taxed on the same basis.

ARGUMENTS FOR SPECIAL TAX CONCESSIONS

5. We accept the argument that, because of the uncertainty of the return on outlays for mineral and petroleum discovery and extraction, a more rapid write-off of costs is required to achieve tax neutrality between the mining and petroleum industries and other industries. The recommended changes in the provisions for the mining and petroleum industries reflect this acceptance.

6. We accept the view that, unless losses are accorded treatment that is similar to that given to gains, the tax system is biased against risk taking. (Equality of treatment could be achieved only with unlimited tax refunds on business losses.) The proposed treatment of business and property losses would virtually eliminate this bias for all businesses.

7. We doubt that the capital market bias against risk taking adversely affects the mining and petroleum industries more than other industries. Large mining and petroleum companies can diversify their risks by undertaking many exploration ventures; both large and small companies can form syndicates and pool their risks. Small manufacturing companies usually are unable to spread the risks involved in research and

product development. To the extent that there is a problem, it is a problem mainly for the small mining and petroleum companies which have operating income less than their exploration and development expenses and which do not participate in sufficient joint ventures with other companies to spread the risk sufficiently. However, to remove any possible doubt, some concessionary provisions for exploration and development costs are embodied in our recommendations for the extractive industries.

8. The extractive industries are highly capital intensive and rely on equity financing to a greater extent than many other industries. The argument has been advanced that the adjustment to the imposition of the corporation tax—a tax on the return on equity capital—must therefore be more onerous to the mining and petroleum industries than to other industries; and that more shifting through price changes or larger reductions in investment must be required to restore after-tax rates of return on investment in mineral and petroleum extraction following imposition of the corporation tax. There are, in fact, other industries that rely as heavily or more heavily on equity financing and there are other industries as capital intensive as the mining and petroleum industries. The problem is therefore not unique to these industries. It would not be feasible to reduce the corporation tax for those corporations that shift the tax least—for there are no unequivocal measures of the extent to which the tax is shifted. In any event, the adoption of our integration proposal would remove any tax discrimination against equity financing. This argument is therefore rejected.

9. Tax concessions to the resource industries increase the allocation of labour and capital to these industries and hence to the known reserves and the production of minerals and petroleum. It is alleged that many economic and social benefits result, including increased employment,

domestic investment, exports, industrial development in general and regional development in particular. It is by no means obvious that some of the alleged benefits are, in fact, net benefits. Frequently, it is assumed that the additional employment, investment and output of the mining and petroleum industries are achieved without cost in the form of reduced employment, investment and output elsewhere in the economy.

10. A careful review of the many arguments advanced in support of the present concessions to the mining and petroleum industries does not suggest that the economy would be adversely affected by their removal. Indeed, because of the probable insensitivity of foreign direct investment in the Canadian mining and petroleum industries to changes in after-tax rates of return, the net economic benefit to Canada from such investments could be increased by the withdrawal of the concessions. With the adoption of the proposed treatment of foreign source income of Canadians, substantial increases in foreign direct investment in mining by Canadians are unlikely to occur and such increases, if they did occur, would not necessarily be against the national interest.

11. Canadian mineral and petroleum reserves apparently are not declining relative to rates of utilization. In particular, methods of extracting oil in commercial quantities from the almost inexhaustible Athabasca tar sands have been developed; the costs of discovering conventional crude oil are apparently rising; and the exploitation of the tar sands is being held back because of the limited market for oil. All of these factors suggest that there is no obvious need for special incentives to encourage oil exploration.

12. If, as a matter of public policy, mining and oil exploration is to be encouraged there are several methods of doing so that would be equally effective and much less costly in terms of tax revenue than the present percentage depletion and the three-year new mine allowances.

13. Similarly, if development of the far North is to be encouraged as a matter of public policy, specific incentives for that purpose should be adopted rather than inefficient incentives to particular industries.

EFFICIENCY OF THE PRESENT
MAJOR TAX CONCESSIONS

14. The present incentives to the mining and petroleum industries are relatively inefficient as an encouragement to additional exploration because they increase current after-tax operating income and thus provide only an indirect stimulus to exploration.

15. Percentage depletion is a particularly inefficient incentive because:

a) the more that a company spends on exploration the less its relative benefit from percentage depletion; and
b) percentage depletion appears to have been of little benefit except to the larger companies, which have no need for the incentive to offset any market bias against risk taking.

16. The three-year exemption for new mines is a more efficient incentive than percentage depletion but benefits most the companies that need it least.

17. The rapid write-off of exploration and development costs is the most efficient of the three incentives now available in the mining and petroleum industries.

18. Under the proposed treatment of business income generally, research and product development costs would be written off immediately, inventory costs would be written off against sales or on a loss in value, depreciable assets would be written off at capital cost allowance rates and purchased goodwill either would be amortized over the life of the asset (where the life was fixed) or would be deductible when lost or reduced in value. The application of the same approach

to the costs of mineral and petroleum extraction would therefore call for the following treatment:

a) exploration costs - immediately written off;

b) development costs - deferred and written off against revenue, or written off if the property was abandoned;

c) cost of depreciable assets - amortized through capital cost allowance classes;

d) cost of property rights - amortized on a time or production basis where the useful life or amount of reserves was determinable, or otherwise deducted when a loss in value occurred.

19. It is recommended that exploration costs, including the cost of depreciable assets that could be used only in connection with a specific exploration project, should be included in a separate capital cost allowance class which would be subject to write-off at the rate of 100 per cent.

20. It is recommended that development costs, including the cost of depreciable assets which could only be used for production from a particular mine or oil or gas well, should be included in the same capital cost allowance class with exploration expenses during a transitional period of five to ten years. Thereafter they should be segregated in a separate capital cost allowance class and subject to write-off at a rate of, say, 20 per cent to 30 per cent on a diminishing balance basis.

21. It is recommended that the cost of mining and petroleum properties should be capitalized in a separate capital cost allowance class for each property. The costs should then be amortized by the write-off of amounts related to the operating revenues derived from the same property. The capital cost allowance rate should be substantial, say, up to 50 per cent, in the transitional period, but thereafter

should be set at 10 per cent to 20 per cent of the operating revenue from the property. If the property was disposed of, abandoned or became valueless, the unamortized balance should be written off. During a transitional period of, say, five years an immediate write-off should be allowed for the cost of property rights acquired from a government.

22. Exploration and development expenses which are presently available for deduction but had not been claimed at the effective date of the legislation should be included in the same capital cost allowance class with exploration costs.

23. Losses in the mining and petroleum industries should be available in the same way as other business losses for carry-back two years and forward indefinitely.

24. Consistent with the comprehensive tax base, all profits made on the disposition of mining and petroleum properties should be included in income. Non-residents should be subject to tax on the disposal of Canadian mineral and petroleum properties. The full gain should be included in income, even if some portion of that gain had accrued prior to the effective date. Shareholders would in effect be exempt from tax on the gain accrued to the transition date because of the transitional provision applying to the valuation of shares.

25. It is further recommended that mining and petroleum companies intending to sell shares to finance exploration and development should be entitled to apply for special tax treatment. Under this concession, the purchasers of newly issued shares would be entitled to write down the value of the new shares for tax purposes to the extent that the proceeds of the issue were to be used for exploration and development. This would ensure that the shareholders of such companies would be able to deduct immediately from other income any potential losses from exploration

and development and would reduce the cost of equity capital to mining and petroleum companies undertaking exploration and development projects.

26. Depletion allowances for the mining and petroleum industries should be withdrawn immediately. This includes the percentage depletion for operators, non-operators and shareholders.

27. The three-year tax-exempt period for new mines should be withdrawn. Complete withdrawal should be delayed for five years, but in the interim the amount of tax exemption that could be claimed for any one mine should be limited to $1 million.

28. As an additional transitional measure, taxpayers in the mining and petroleum industries should be permitted to deduct, over three or five years, the excess of formerly non-deductible costs of mining and petroleum properties over depletion claimed.

29. The cost of exploring for minerals outside Canada should be deductible.

30. Payments to the provinces for natural resources should be deductible. Similarly, the mining taxes paid to the provinces should be allowed as a cost of earning income and not as a tax credit.

31. Prospectors and grubstakers should be taxable on their profits. However, any such person who transferred mining properties to a newly formed company in consideration for shares should record the sale at a price equal to his unclaimed costs. He should bring any increment in value into income when the shares became publicly traded if they represented a 25 per cent interest in the company or less.

32. The provisions recommended should apply to all taxpayers, whether individuals or corporations, and should not be limited by reference to the taxpayer's principal business.

33. Adoption of these recommendations would accord more favourable tax treatment to the mining and petroleum industries than to industry generally, particularly with respect to the treatment of costs.

34. These tax concessions to the mining and petroleum industries would more than compensate for any possible capital market bias against risk taking that might, in the absence of the concessions, reduce investment in these industries below the levels required for an efficient allocation of resources.

35. Withdrawal of depletion and the three-year exemption for new mines, coupled with the recommended changes in the treatment of costs described above, would reduce the after-tax cash flow rate of return to integrated petroleum companies and, to a lesser extent, to those mining companies that had operating income after deduction of exploration and development costs. The after-tax cash flow rate of return to non-integrated mining and petroleum companies that had insufficient operating income to offset exploration and development expenses should, however, be improved. The present concessions are greatest for the largest companies, which are the most unlikely to be subject to higher costs of equity capital as a result of a capital market bias. The recommended changes would ensure that the full value of the concessions was available where it was most likely to be needed.

36. Removal of percentage depletion and the three-year exemption for new mines and the full taxation of share gains would be offset to a large extent by the recommended treatment of costs and, for resident shareholders, by the integration of personal and corporation taxes. Nevertheless, a substantial proportion of resident shareholders of mining and petroleum corporations would be worse off than at present. Because most non-resident shareholders of such corporations would not benefit from integration, they would suffer a greater reduction in after-tax income.

REFERENCES

1/ M. Bucovetsky, The Taxation of Mineral Extraction; D.Y. Timbrell, Taxation of the Mining Industry in Canada; C.G. Burton, Tax Treatment of the Oil Industry, studies published by the Commission.

2/ In general, corporations which qualify to use the special tax provisions are those whose principal business activity is in petroleum or mining, although there have been some extensions to corporations in related activities. It is assumed in most of the discussions in this chapter that the corporation concerned does qualify. The implications of limiting the qualification are discussed under the heading "Application of Mining and Petroleum Provisions to Particular Types of Taxpayers".

3/ Section 83A.

4/ Section 83(5).

5/ Regulation 1201(2).

6/ Regulation 1201(3).

7/ Regulation 1203.

8/ Regulation 1202.

9/ Regulations 1300-1303.

10/ For a discussion of the historical justifications for percentage depletion see Appendix K to this Volume.

11/ This survey of large Canadian mining companies was conducted by us in conjunction with the Canadian Metal Mining Association. We shall refer to it hereafter as the Mining Survey. The results are published as an appendix to the study by D.Y. Timbrell cited earlier.

12/ In a recent research study prepared for the Canadian Institute of Chartered Accountants, entitled Accounting Problems in the Oil and Gas Industry, by W.B. Coutts, F.C.A., it was advocated that costs should be accumulated by "area of interest". Such a procedure requires that costs be accumulated for exploration in any particular area while exploration is in process, and that such costs be deferred against production revenue from the area if the project is successful, or be written off immediately if it is unsuccessful. This approach would be supported on a theoretical basis by many practising accountants, but it is beset with practical difficulties. For example, an evaluation of the results of exploring in a particular area could be very much a matter of personal opinion, and management might be inclined to defer a distasteful decision if it meant writing off in one year costs that had accumulated over several years. Furthermore, because an individual project may not be successful, it may be wise to write off arbitrarily a certain percentage of costs while the project is still under way. Thus, while something like the "area of interest" concept would most adequately portray the actual results of operation over a period of time, it is followed in practice by only a relatively few companies. The general procedure is rather to defer costs only in respect of known assets; thus the drilling cost and sometimes the land cost of productive wells may be deferred over their productive lives.

13/ Section 83A.

14/ Regulations, Schedule B, Class 10.

15/ Ibid., Class 12.

16/ Ibid., Classes 1, 3, 4 and 6.

17/ Section 11(1)(a).

18/ Except under section 27(1)(a) which permits, inter alia, a deduction of up to 10 per cent of income for gifts to municipalities.

19/ M. Bucovetsky, The Taxation of Mineral Extraction.

20/ Because of differences in accounting treatment and because they provide no information about unsuccessful companies, price/earnings ratios are an inadequate measure of relative risk among industries.

21/ A study prepared for the Royal Commission on Banking and Finance by E.K. Cork, Finance in the Mining Industry, states at p. 37 that from 1907 to 1953 there were over 400,000 claims recorded in Ontario and 6,679 metal-mining companies formed, of which 348 went into production and only 54 paid dividends. In a supplementary submission to us, the Canadian Petroleum Association cited an average success ratio of 7.4 per cent in exploratory drilling for the period 1947 to 1962, after eliminating from the calculation wells which were initially successful but which later proved unsuccessful.

22/ When investors demand a risk premium, this may reduce the investment in the industry relative to the social optimum because the risk to the individual investor on a particular venture is greater than the risk on all similar ventures taken as a group. Risks can be reduced through pooling.

23/ Because most Canadian corporations in the petroleum industry are subsidiaries of international companies this discussion is less relevant to that industry. There are, however, some Canadian petroleum companies that would be affected.

24/ See the study by Bucovetsky, previously cited, for a comparison of the Canadian and United States provisions.

25/ The indirect costs and benefits are extremely difficult to determine because they depend upon the particular circumstances. See Chapters 5 and 26.

26/ For the period from 1949 to 1962 the amounts paid to provinces for oil rights and rentals amounted to something in excess of $1 billion and, after allowing for deduction of rentals not exceeding $1 per acre and lease costs of abandoned properties (both of which are already deductible under section 83A), possibly $500 million to $750 million would not have been allowed for tax purposes. Various estimates of the amount of such costs were supplied to us by industry representatives, and an amount within this range would appear to be a reasonable estimate.

27/ The amounts of these provincial revenues are indicated by the following figures for Alberta for the sixteen-year period 1947-62 as quoted in Oil and Gas Bulletin of the Royal Bank, No. 17, August 31, 1963:

	(Millions of dollars)
Sale of Crown reserves	653.8
Rental from leases	333.2
Royalties from oil and gas	329.3
	1,316.3

28/ Section 83A(5b).

29/ M. Bucovetsky, The Taxation of Mineral Extraction.

30/ The transitional provision proposed (the allowance of all development costs not already recovered through depletion) would result in a smaller reduction for many companies for a certain number of years.

CHAPTER 24

FINANCIAL INSTITUTIONS

For purposes of this Report any institution that forms a link between those who are savers of money and those who are borrowers of money will be termed a financial institution. The rapid growth that has taken place in the use of credit, and the impracticability of its being provided substantially by direct dealings between borrowers and savers, has led to a considerable increase in the business conducted by financial institutions. Table 24-1 lists the principal financial institutions and, as a rough measure of their size and importance, shows their total assets at the end of 1962.

TABLE 24-1

ASSETS OF PRINCIPAL FINANCIAL INSTITUTIONS, 1962

Institution	Assets (millions of dollars)
Bank of Canada	3,231
Chartered Banks	14,848
Quebec Savings Banks	357
Trust Companies	1,877
Mortgage Loan Companies	1,286
Caisses Populaires and Credit Unions	1,666
Finance and Consumer Loan Companies	2,689
Industrial Development Bank	181
Life Insurance Assets in Canada	9,950
Fire and Casualty Insurance Assets in Canada	1,585
Mutual Funds	710
Pension Funds	4,572
TOTAL	42,952

Source: Royal Commission on Banking and Finance, Report, Ottawa: Queen's Printer, 1964, p. 106.

The Bank of Canada and the Industrial Development Bank, agencies of the Government of Canada, are not discussed in this Report. Credit unions and caisses populaires are discussed in Chapter 20, fire and casualty insurance companies in Chapter 25, and mutual and pension funds in Chapter 16. In this chapter we deal with banks, trust companies, mortgage loan companies, finance and consumer loan companies, and life insurance companies.

BANKS, TRUST COMPANIES, MORTGAGE LOAN COMPANIES, AND FINANCE AND CONSUMER LOAN COMPANIES

All these financial institutions, directly or indirectly, collect the savings of individuals and corporations and lend them. They differ in the forms they utilize to accumulate savings and again in the arrangements by which they lend the funds at their disposal. Some of them concentrate their lending activities primarily in short-term loans, others in long-term mortgages. The types of borrowing which they traditionally use range from demand deposits to long-term debt. The variety is not haphazard or simply a matter of choice, but is closely related to the uses to which each institution expects to put the money in attempting to relate maturities of assets and liabilities. Some of them perform other important services in fiduciary and agency capacities. However, all have the common characteristic of being dealers in financial claims. There has been a noticeable trend toward diversification of activity, with an overlapping of functions, so that many institutions now find themselves competing with others that are essentially known for their activities in other parts of the financial field. Therefore, many of the differences are blurred as the various types of institutions compete with each other on both sides of the borrowing-lending process.

Another general characteristic of these financial institutions is the magnitude of assets under their control in comparison with the equity capital of the companies concerned. This is because they rely so heavily on borrowed funds as an integral part of their method of doing business, a hardly surprising result for institutions that specialize in money. On average, they

derive about 90 per cent of their funds from borrowing, while equity accounts for less than 7 per cent. This may be compared with industrial companies that on average obtain over one half of their total funds from equity sources.

Most types of financial institutions are subject to extensive government supervision and control. Again, this is not surprising in view of the extent to which they are heavily indebted to the public. Questions concerning government regulation are beyond the terms of reference of this Commission. However, we take the position that it is the responsibility of the supervisory authorities and regulatory legislation to see that financial institutions conduct their activities in a way that ensures their solvency; these businesses should not be granted tax concessions to induce them to do so, or to compensate them for doing so.

Main Tax Considerations

Generally speaking, the determination of the income of financial institutions for tax purposes is relatively straightforward. While it is not suggested that the determination of their income presents no problems, the tax problems are, for the most part, common to other industries as well. Furthermore, a number of these problems would disappear with, or be mitigated by, the implementation of certain of our recommendations. For example, under existing tax law, security gains earned as a result of trading activities are taxable, but if derived from investment activities they are not subject to tax. Some financial institutions find themselves in the peculiar position of being taxed on some of those gains but not on others. However, the treatment we recommend for security gains in Chapter 15 would eliminate these discrepancies by subjecting all such gains to tax. As a further example, while interest and general expenses incurred to earn non-taxable dividend income are currently disallowed, the integration of personal and corporation income tax described in Chapter 19 and our recommendations in respect of business income in Chapter 22 would generally result in the allowance of these expenses.

Financial institutions generally account for their revenues and expenses on an accrual basis. Estate, trust and agency fees are exceptions. Estate fees require court approval and are not legally collectible until so approved. It is common practice for trust companies to account for them on a cash basis, and in some cases all estate, trust and agency fee income is accounted for on a cash basis for the sake of internal consistency in dealing with these activities. In addition, some consumer loan companies account for their interest income on a cash basis as permitted by section 6(1)(b) of the Income Tax Act. In line with our general recommendations for the expanded use of the accrual basis, we suggest that it should be required that these forms of income also be recorded on an accrual basis. We believe that acceptable techniques can be readily developed to accomplish this result.

The only problem in the determination of income of financial institutions that is both significant and of particular applicability to them alone arises in the estimation of losses on loans. Loans and other investments provide the major source of income of these institutions and, because of their magnitude relative to equity capital, a small percentage difference in the losses that are incurred on them will have a significant impact on income. For example, a loss of 1 per cent on these investments can be the equivalent of as much as a year's income.

The problem stems from the impossibility of determining accurately in advance what losses will occur on existing accounts. Differences of opinion between the taxpayer and the tax administration as to what is a reasonable provision for losses are not easily reconciled. Apart from the recognized measures of doubtful collectibility such as overdue accounts, management decisions as to provision for losses will be based on other less well-defined, but valid, criteria such as general business conditions, a knowledge of the particular industry, familiarity with the affairs of debtors, and past loss experience.

While the problem of evaluating receivables is faced by all businesses, where the amount invested in them is small relative to total assets their valuation is not likely to bear significantly on the determination of income. In the case of financial institutions, however, materiality and volume combine to make the problem both more significant and more difficult. Financial institutions ordinarily have large numbers of loans and other receivables outstanding 1/. Neither the taxpayer nor the tax assessor can review individually a significant proportion of the accounts within the bounds of reasonable time. Moreover, even if the time were available, it would not be possible in the case of certain secured transactions, for example, those involving mortgages and conditional sale agreements, to complete a useful review of individual accounts, because there will seldom be any data available on the underlying security other than that collected at the time the loan was made.

Present Tax Treatment
of Reserves

The income tax treatment of banks differs in one respect only from that accorded to corporations generally and that is in the treatment of valuation reserves. Banks are permitted to deduct reserves "not in excess of the reasonable requirements of the bank" without having to substantiate them on the basis of losses expected at the end of the fiscal year 2/. In other words, in addition to providing for "specific" or anticipated losses, banks are permitted, within certain limits, to provide reserves for contingencies that cannot be foreseen at the time.

It is the Minister of Finance, not the Minister of National Revenue, who determines the reasonable requirements of banks with respect to contingency reserves. At least once each year the Inspector General of Banks must inquire into the affairs of each bank and report to the Minister of Finance. This examination is made "for the purpose of satisfying himself that the provisions of this Act having reference to the safety of the

creditors and shareholders of the bank are being duly observed and that the bank is in a sound financial condition" 3/. This responsibility includes ensuring that the banks maintain adequate reserves.

At the present time the maximum reserves that a chartered bank can claim for income tax purposes are prescribed in rules issued by the Minister of Finance, which set out the procedure for determining tax-free inner reserves. This maximum is based on a percentage of certain of the assets of banks and in 1963 was 3.504 per cent of eligible assets 4/. This ratio is adjusted annually by a formula that takes into account the change in the average loss experience over successive 25-year periods, and has been declining because of the relatively favourable loss experience of recent years. The Quebec savings banks are permitted reserves up to a fixed percentage of 5 per cent of eligible assets.

The United Kingdom permits banks to make specific provision for bad and doubtful debts, but has never permitted banks to deduct contingency reserves in the determination of taxable income. In the United States, a bank has the option of creating a contingency reserve for loans or of charging annual losses directly against income. Until recently the allowance permitted to each bank for contingencies was based on the bank's own loss experience, the maximum being three times its ratio of annual loss experience to eligible loans for any twenty consecutive years starting not earlier than 1927. However, beginning with the 1965 taxation year, the procedure has been changed to allow a flat 2.4 per cent of outstanding loans. The definition of eligible loans excludes those guaranteed by the federal or state governments or their agencies, but is generally broader than the Canadian definition. It should be noted that this reserve applies to loans only.

The Income Tax Act also permits taxpayers, whose business includes lending money on the security of mortgages, to deduct, in computing taxable income, amounts sufficient to provide up to 3 per cent of their mortgage loans outstanding as a reserve in lieu of the general provisions for doubtful debts otherwise permitted 5/.

The above-mentioned tax provisions are the major ones having specific applicability to financial institutions. It will be appreciated that they go only part of the way in dealing with allowances for losses on the multifarious investments in which financial institutions engage. For loans that are not made by banks or are not in the form of mortgage loans, the taxpayer can invoke the provision that is available to taxpayers generally for valuing receivables 6/. This provision permits a taxpayer to deduct a reasonable reserve for doubtful debts. The most satisfactory method of ascertaining the amount of such a reserve is on the basis of a valuation of specific accounts. Alternative methods are to base the reserve on bad debt experience in recent years and the relative delinquency position (accounts outstanding more than 60 days, 90 days, etc.) of current portfolios of accounts. The valuation of other investments of financial institutions is subject to the same general rules that are applicable to other taxpayers; rules that would become more certain with the inclusion of all gains and losses in the computation of income.

The statutory provision in the United Kingdom is somewhat more stringent than in Canada, and the tax authorities do not accept allowances calculated as a percentage of total receivables. However, as in Canada, they will accept allowances calculated with reference to total amounts delinquent for various periods of time. The statutory position in the United States is more flexible and we understand that allowances are permitted there that are somewhat more favourable than those allowed in Canada but, nevertheless, protracted negotiation is often required.

Evaluation of Present Tax
Treatment of Reserves

Before commenting on the present tax treatment of financial institutions, it will be useful to make a brief reference to certain general conclusions that we reached earlier in the Report.

First, the importance of tax neutrality has been emphasized. Although

different financial institutions bear different designations and are governed under different statutes, their functions overlap and they are competing with one another increasingly. In these circumstances, it would be inequitable to apply different tax rules to different institutions, except where necessary for administrative reasons, and even then material differences in tax impact should be avoided.

Secondly, general or contingency reserves should not be recognized for tax purposes. Only those losses in asset values and those liabilities that can reasonably be expected to occur should be allowed. All business is subject to some risk and uncertainty in the ascertainment of income on an annual basis. We believe that the general recommendations we make for the treatment of annual losses would provide sufficient recognition of these factors for taxation purposes.

Thirdly, where it is extremely difficult to determine reasonable annual allowances, we have acknowledged that it may be necessary to adopt rather arbitrary procedures. For example, we conclude in Chapter 22 that the use of simple, and arbitrary rules would be appropriate in the case of depreciation provisions, because of the high degree of uncertainty in matching this kind of cost against revenues 7/.

Finally, we have said that where certain actions are deemed to be necessary or desirable as a matter of public policy, taxation should not be the vehicle for regulating the actions where other more direct measures are available.

Allowances for Doubtful Accounts. The valuation of receivables under the existing general tax provision presents difficult assessment problems. Even though the tax authorities are willing to accept arbitrary procedures for determining the allowance for doubtful accounts which might result in an amount liberal to the taxpayer, there continue to be many disputes as to the reasonableness of the loss allowances that are claimed 8/.

We recommend in Chapter 22 the withdrawal of the existing general provision in respect of doubtful debts, on the grounds that it appears to rely primarily upon what is "reasonable", that the test of reasonableness should be found in the application of accepted accounting and business practice, and that the provision is therefore unnecessary. Where amounts claimed appear to be reasonable and are not significant determinants of income, there would seem to be little call for disturbing them on assessment.

It must be conceded, however, that repeal of the provision would not solve the basic problem. Where an allowance for losses is a significant determinant of income, and where objective evaluation of specific accounts is not possible, allowances that are claimed by taxpayers cannot be accepted for assessment purposes without careful review. Inasmuch as we recommend that all business costs be allowed, including accounts that ultimately proved to be uncollectible, the application of arbitrary rates of provision against such accounts to determine the amount of an allowance may be appropriate where the problem was significant and undue difficulties of compliance and administration could be mitigated. In the interests of administrative simplicity and consistency, these arbitrary rates might be applied in all cases if practical means could be found for doing so. The alternative to arbitrary rates would be the application of criteria which would be more contentious and more difficult to administer, but which would still not reflect accurately in advance what losses were likely to arise, and therefore might well be inferior to well-chosen arbitrary rates.

It is apparent that to be administratively most effective, optional arbitrary allowances would have to be based on rates that were sufficiently generous to ensure that most taxpayers would elect to use them rather than make detailed estimates. If the taxpayer was not allowed the option of either using the arbitrary rates or making detailed estimates, the arbitrary rates would still have to be sufficiently generous to ensure that few, if any, taxpayers suffered because of the requirement. Nevertheless, rates should not consciously provide a margin for contingencies.

Trade accounts receivable will ordinarily result from a sale that has been reflected in income. The most accurate matching of revenues and expenses in terms of timing would call for accounts that proved to be uncollectible to be matched against the revenue recorded at the time of sale, rather than at the time the account was determined to be uncollectible. Because this would usually involve reopening the accounts of a past year whenever an uncollectible account was written off, practical considerations call for making allowances in the year of sale on an estimated basis to the exclusion of making any retroactive adjustment on the basis of subsequent events. Indeed, it is the necessity of having a practical basis for matching revenues and expenses that constitutes the justification for doubtful account provisions in general and, in the case of financial institutions in particular, for permitting allowances for losses in advance of the determination that a debt is uncollectible. There is, however, one important respect in which the opening of a loan account receivable differs from an ordinary trade account. The loan is not always a reflection of income that has already been taken into account, but is usually evidence of an investment, the income from which will accrue subsequently. We do not suggest that this distinction is of much assistance in determining the loss provisions that should be allowed to financial institutions 9/. However, it should be appreciated that to make full allowance against losses as loans were granted would not necessarily represent a more accurate matching of revenues and expenses than would the claiming of the expenses only as accounts proved to be uncollectible.

The problem of estimating the ultimate collectibility of a long-term real estate mortgage will ordinarily be greater than in the case of a short-term loan or of a trade account receivable. It does not follow, however, that the allowance for loss should be higher. The type of security held is of basic relevance, and a real estate mortgage ordinarily has greater protection against loss than an unsecured trade account receivable.

It also should be emphasized that no allowance should be made for an untoward economic trend that cannot be foreseen. Such a provision would be carrying the principle of providing for losses beyond what appears to be reasonable, that is, beyond losses and into the area of possible losses. Moreover, commercial businesses are subject to this risk, many of them to a much greater degree than financial institutions, and it is difficult to contemplate how such a provision could be applied generally in a reasonable fashion. This general economic risk is just one of the risks of being in business that should not, and cannot, be the basis of a tax allowance.

The matter of reserves for financial institutions was reviewed by the Royal Commission on Banking and Finance and that Commission recommended the continuation of an allowance at a level somewhat higher than the allowance now granted to the chartered banks. The emphasis of our consideration has been primarily on the tax implications of the present treatment, and we have made it amply clear that we are averse to the use of the tax system for objectives other than those we have referred to frequently in this Report. We have expressed our understanding of the need for reserves against possible losses on loans and investments within the dictates of ordinary commercial and accounting practice, and for administrative reasons we see considerable advantage in the use of an established rate. However, we find ourselves unable to accept the view that an allowance larger than is justified on these grounds should be granted in order to assist in preserving the liquidity and soundness of a financial institution. We are much more inclined to agree with the Banking Commission in its general approach that the public benefit will best be served by institutions whose strength rests to some extent on public inspection and supervision, but primarily is based on the ability of the institutions to meet competition in a financial market which has been freed of some of the artificial impediments which now exist in Canada.

We stated earlier that taxpayers should not be permitted to claim general or contingency reserves for tax purposes, but rather that they should be

restricted to making a reasonable provision for expected losses. If certain institutions need to be regulated to ensure their continued solvency and liquidity, we do not believe that such regulation calls for any departure from the general rules for determining their actual income for tax purposes. Indeed, we do not believe that tax legislation should be designed to assist in ensuring solvency and liquidity. Such policy goals can be provided for adequately only by specific legislation, and there is legislation in force that specifically provides for the regulation of such institutions. However, we have pointed out that it can be extremely difficult to value a large number of receivables in a manner that is acceptable both to the taxation authorities and to the taxpayer. For the same reason that arbitrary depreciation allowances have proved to be a relatively efficient and mutually satisfactory way of allocating costs for tax purposes, so have the arbitrary reserves for banks and mortgage lenders proved to be attractive from the administrative point of view. It should be noted, however, that an arbitrary allowance provided for a type of institution, rather than for a type of loan, has the weakness of allowing the same loss provision against relatively secure loans (other than those that may be specifically excluded from any loss provisions) as against relatively high risk loans, and is unfair as between competing types of institutions.

In the case of banks and on the basis of long-term loss experience, the permitted ratio of valuation reserves to eligible assets appears to exceed greatly the rate that would be employed to reflect an allowance for bad debt losses only. While an allowance based on previous loss experience could be unrealistic, we believe that past experience is the best single criterion on which to establish an arbitrary rate of provision against bad debts. Although during one five-year period in the 1930's losses averaged 1.25 per cent of loans, over the twenty-five-year period from 1940 to 1964 the annual average loss experience was about one seventh of 1 per cent 10/. While the annual loss experience is only one factor in determining a reasonable loss allowance, a reserve exceeding twenty times the average loss experience over the last twenty-five years would appear to be excessive.

Unfortunately there is no meaningful breakdown of the present inner reserve figures into their two components, specific and contingency reserves, the former reflecting expected losses, and the latter possible losses. The Royal Commission on Banking and Finance pointed out that specific reserves were about three quarters of 1 per cent of eligible assets, 11/ but since at present little significance is attached to the division between specific and contingency reserves, this percentage is unlikely to represent what the specific reserves would be if computed carefully.

One other percentage that is of interest because it reflects the position of a competing institution that specializes in higher risk loans, is the allowance for doubtful accounts established by those companies in the small loan business. At the end of 1963, their allowance for doubtful loans was 2 per cent of outstanding accounts 12/.

Another consideration is whether one arbitrary rate should apply to all loans, or whether there should be a number of rates to reflect the varying loss experience on different kinds of loans. Certainly a single average rate would tend to be relatively less favourable for the bank that accepted a greater degree of risk. Although it would obviously be difficult to define the kinds of loans in a manner that would segregate them into risk classes, the present arbitrary allowance is already selective to some extent, because it applies only to certain assets. However, some of the assets included would virtually never be realized at a loss, while other assets involve a certain amount of risk. In addition, it would be expected that on average the losses would be relatively higher for the smaller loans than for the larger ones.

A final consideration relates to the administrative problem of determining the loss provisions for a large number of accounts. Because the taxpayer should always be given the option of claiming specific reserves if he found the arbitrary allowance to be deficient, it is desirable that there should be a liberal arbitrary allowance applicable to those accounts where the determination of specific allowances would be unreasonably time consuming.

Because over 99 per cent in number and 50 per cent in amount of the bank loans outstanding are under $100,000, 13/ the need for arbitrary provisions is greatest for these accounts.

As in the case of allowances for loan losses of banks, some arbitrary rule for determining allowances for losses on real property mortgage loans could produce administrative simplicity and taxpayer equity, while providing a degree of certainty. The present provision for real property mortgages appears to do these things, while having the additional desirable feature of relating the allowance to a type of asset, rather than restricting it to a kind of business. However, in line with our other recommendations that reduce the importance of the distinction between operating a business and holding an investment, it would appear more reasonable to extend this allowance to all taxpayers rather than only to those who are in the business of lending on this type of security. In addition, a review of the actual mortgage loss experience over the past thirty years leads to the conclusion that the present arbitrary rate of 3 per cent on these relatively secure investments is excessive 14/.

We question also whether a single arbitrary rate should apply to all mortgages. Obviously the degree of risk is not uniform as between, say, first and third mortgages. There already exists a generally acknowledged test for distinguishing between secure and hazardous loans in the laws which prohibit federally or provincially incorporated trust and loan companies from acquiring mortgages with a face value exceeding 75 per cent of the fair market value of the real property. Although there are no accepted standards of valuation that would ensure that this rule is applied uniformly across the country, it is important that the group of companies under federal and provincial trust, loan and insurance legislation, which hold the major proportion of the outstanding real property mortgages, are limited to loans of up to 75 per cent of the fair market value of the security. Therefore, to distinguish between mortgages on the basis of whether they were more or less

than 75 per cent of the value of the property is an arbitrary distinction that could be readily applied, because most of the companies concerned would only qualify for a single arbitrary reserve rate. It thus would be practical to have two rates for determining allowances, one for mortgages (whether first, second or third) that in total did not exceed 75 per cent of the value of the property and a second, and higher rate for other mortgages. There obviously would be administrative difficulties for those companies with a mixed portfolio of mortgages that qualified for both rates, but we do not think these problems would be insoluble, and we feel that the advantages of arbitrary rates would outweigh the problems involved, particularly because most of the problems would be of a transitional nature in establishing the procedures to be followed. The legislation should probably specify that all companies regulated by specific federal or provincial legislation (relating to trust and loan companies and insurance companies) would be eligible only for the low rate, while all other taxpayers could split their portfolios into the two classes of mortgages.

The present tax legislation does not contain any arbitrary allowances for doubtful accounts other than those already mentioned. However, the problems of compliance and assessment that we have discussed in connection with banks and mortgage lenders are also encountered by other financial institutions. This is true of those institutions that have a large number of accounts making up a substantial proportion of their assets and who experience some difficulty in determining an appropriate reserve on an account-by-account basis, or even in negotiating some arbitrary rates that are acceptable to the Department of National Revenue. We have stressed the importance of neutrality of treatment of competing organizations, but have also stated that arbitrary rates should be applied only in cases where it was not administratively practical to do otherwise. The two arbitrary provisions discussed above are readily applied because there is little difficulty in determining what qualifies as a bank, or what qualifies as a real property mortgage. While some of the other financial institutions are

as easily defined because they also are incorporated under special legislation, the allowance of arbitrary provisions to trust companies, credit unions, and small loan companies, for example, would to some extent increase the competitive inequities unless such provisions were also extended to finance and other companies of a similar nature. Unfortunately, the latter companies cannot be so easily defined. If it should be decided that an extension of the arbitrary provisions was warranted, the preferable method would appear to be an expansion of the allowance for mortgages. For example, if the mortgage provision were expanded to include mortgages and conditional sales agreements on chattels, most of the loans of financial institutions would become eligible for arbitrary provisions. There would be some difficulty in administering such an extension, because it would encourage some taxpayers to rearrange their loans so as to qualify, but at least such an approach would not extend a preference to only some kinds of businesses.

Deduction of Bad Debts. Ranking equally in importance with the control of provisions for doubtful accounts, is the exercise of control over the circumstances under which bad debts may be written off against income for tax purposes or against accumulated provisions for doubtful accounts. Rules respecting provisions for doubtful accounts are of little consequence, particularly in the case of arbitrary provisions, if debts may be written off by the taxpayer at will 15/. We believe that this control is best established for taxpayers who claim the arbitrary reserves by limiting the write-off of bad debts to accounts in respect of which it can be proved that a "loss" has occurred. The term "loss" would continue to have the meaning ascribed to it in current jurisprudence 16/.

Appraisal

Our basic conclusion is that there is little reason not to tax financial institutions in the same way as other taxpayers. Therefore, not only should all our general recommendations apply equally to these institutions but, in particular, the treatment of their reserves should be altered to conform to

general practice. The allowances for expected losses should be computed on the basis of accounting and business principles. No contingency element should be included. The term "reserve" should no longer be used in this context; the word "provision" or "allowance" or some similar term is a more appropriate designation.

Because the application of accounting and business principles in this area cannot always be easily and equitably administered, we conclude that financial institutions are a reasonable subject for the greater use of arbitrary allowances. Nevertheless, the use of such arbitrary allowances should not become a means of claiming contingency reserves. Although it would be desirable to make arbitrary rates and their attendant advantages available to other taxpayers concerned with the valuation of receivables, the difficulty of determining percentages that would be a reasonable reflection of expected losses for the full range of business receivables seems insurmountable.

Banks. In the case of banks, it would appear that the best way to give effect to our conclusions would be to vary the arbitrary rates by the size of the loans outstanding, and to further restrict the assets that would be eligible for such allowances. Specifically, we recommend that banks should continue to be allowed to employ an arbitrary provision for certain kinds of loans; that the list of eligible loans should be further limited so as to remove loans to municipalities and school boards, call loans, guarantees and acceptances, letters of credit, foreign exchange provisions, and any publicly traded securities not already excluded; that the allowable provision should vary in relation to the size of the loan balance outstanding; that there should be two arbitrary procedures which are optionally available; and that the overall level of the permitted reserves for tax purposes should be substantially reduced. Each bank would then be able to elect one of three general methods of determining its loss allowance for loans, depending upon which of the following procedures appeared most appropriate in the circumstances:

1. A specific reserve arrived at by valuing each loan.

2. An arbitrary allowance based on the outstanding balances of eligible loans. Rates of something less than 2 per cent for balances of up to $100,000, and of one half of 1 per cent for balances of between $100,000 and $500,000 would appear to be reasonable. The suggestion of something less than 2 per cent is based largely upon the experience of small loan companies which would probably have higher losses than banks and have found that a provision of 2 per cent is adequate. This allowance would also be based on the expectation that on average the larger loans would show an even lower loss experience. The percentages chosen should represent an average of what would be reasonable for the smaller loans and the larger balances.

3. An arbitrary allowance for eligible loans that were under the defined limit of $500,000 of up to seven times the average loss experience for the previous five years. The loss experience for each of those years would be defined as the net write-offs for the year expressed as a percentage of the eligible loans outstanding at the end of the year. Because different banks specialize in different kinds of loans, some probably experience more losses than others. A single arbitrary rate for all loans of the same general size might tend to discourage entry into less secure loans, and therefore we suggest this alternative to take such loss experience into consideration.

Loans in excess of $500,000, although numerous, should nevertheless not greatly exceed 2,000 in number for any one bank. These larger loans can reasonably be reviewed individually in the regular manner applicable to other taxpayers (which might well include the development of arbitrary procedures based upon past experience) to establish a reasonable provision for expected losses in the near term.

Federal and provincial securities with maturities in excess of one year from the date of issue which are held by financial institutions should

be valued on an amortized basis rather than at the lower of cost or market. This method of valuation is preferable for these companies because the securities are usually held for longer periods as an investment. Accordingly it provides a better matching of revenue and expenses than a valuation at the lower of cost or market. However, in order to provide for the substantial losses that may occur on disposal of the securities, it would appear reasonable to allow these institutions an arbitrary allowance of one half of 1 per cent of the amortized value.

We can see no justification for allowing a provision for tax purposes that was greatly in excess of that required to provide for reasonably expected losses. Therefore, the arbitrary rates to be employed should reflect the expected losses, and should bear a reasonable relationship to the provisions claimed by competing institutions. The actual rates to be employed should be designated only after more detailed analytical work had been completed on the actual loss experience of the various financial institutions.

We do not believe that the deductible allowances should be in any way related to what the banks record in their fiscal accounts.

Because these proposals involve a substantial adjustment in the existing tax allowances, special transitional provisions in the Act would be required. Therefore, a period of not more than ten years should be allowed for the gradual adjustment of the present tax allowances to the proposed amounts. It should be emphasized that the banks would not have to maintain their accounts on the same basis as the proposed tax allowance, and would be permitted to claim specific allowances if they did not elect to use the arbitrary percentages.

The savings banks should be subject to the same arbitrary provisions as other banks.

Mortgages. Section 85G which contains the loss provisions for real property mortgages should be amended to apply to all taxpayers (except banks) whether or not they are in the mortgage business, to exclude all insured mortgages (not only National Housing Act mortgages), and to differentiate in general between mortgages that are for less than 75 per cent of the fair market value of the real property and those that are for amounts exceeding this limit. The present allowance of 3 per cent should be substantially reduced to something close to 1 per cent for those better secured mortgages under the 75 per cent limit, and to something less than 2 per cent for the other mortgages on real property. A size limitation of $500,000 should also apply, because a very large mortgage should be capable of periodic review and assessment.

This arbitrary provision should not apply to any insured mortgage loans, including National Housing Act loans, because the risk of loss has been transferred, in whole or in part, to the insuring organization. The insuring organization should be permitted to base its allowance for tax purposes on these same arbitrary rates. In addition, the banks should be excluded from the application of this provision, not only because of certain arbitrary allowances already proposed for the banks, but because of the difficulty of differentiating between ordinary loans and loans secured by mortgages. However, the proposed arbitrary rates should generally be such that mortgage companies and banks would be claiming similar allowances.

The present limitation on the annual increase in the allowance for mortgage losses contained in Section 85G does not appear to be consistent with the concept of providing for expected losses, and therefore should be removed.

Taxpayers should be able to elect to set up their loss allowances on the basis of an appraisal of individual loans. There should be no requirement that the tax allowance and the books of account be in agreement. Again, it would be necessary to provide for the gradual adjustment of the present tax allowances to the proposed amounts. However, the adjustments would be

relatively smaller in this case, 17/ and a period of five years would appear to be reasonable.

While, in general we have concluded that loans and mortgages on which arbitrary allowances have been claimed should be written off (for tax purposes) only when an actual loss has taken place, we appreciate that such a procedure can also be administratively difficult. Therefore, we recommend that the write-offs for banks should be accepted without dispute so long as the recoveries did not exceed 10 per cent of write-offs. Any recoveries exceeding the designated percentage should be carried back to the earliest years of write-off for the accounts recovered, tax should be assessed on such increment in income, and interest charged for the number of years involved. Alternatively, it could be provided that in the case of small balances of under $10,000, a bad account would be eligible for write-off if no payment on account had been received for two years.

Other Financial Institutions and Other Accounts. We considered the extension of arbitrary allowances to other financial institutions as well as banks and to other accounts receivable as well as mortgages. In some cases, the use of general accounting and business practices could be just as inequitable and administratively complex for other taxpayers as for banks and for other accounts as for mortgages. Therefore such an extension might seem warranted. If this were to be done, the preferable method would appear to be an expansion of the mortgage allowance to include chattel mortgages and conditional sales agreements. The percentage used should be the same as the highest rate applicable to real property mortgages, which in turn should be equal to the arbitrary rate allowed to banks for the smaller accounts. This would ensure that only a minimum of account analysis would be necessary, and that most of the competing businesses would be on the same basis regardless of the form in which the loans were made. However, for various reasons we are unable to recommend the immediate implementation of such a measure, which would be significant for credit unions and caisses populaires, small loan

companies, and finance companies. For one thing, arbitrary rates should be sanctioned only when required as a matter of administrative convenience, as we explained earlier. Also, the use of flat rates, regardless of risk of loss, would give a greater benefit to some taxpayers than to others 18/. Finally, we cannot be sure that there would be a sufficient reduction in administrative complexity and improvement in taxpayer equity to warrant the revenue cost that could result.

Although the adjustments to the reserves of banks and mortgage lenders that we recommend are substantial, the liberal transitional provisions would spread out the tax impact over a number of years. In addition, since we recommend that the mortgage allowance be granted to all taxpayers, we would not expect the increase in tax revenues to be large.

LIFE INSURANCE COMPANIES

Characteristics of These Companies

The principal business of life insurance companies is entering into contracts to provide life insurance and life annuities. Some companies also write personal accident and sickness insurance.

The importance of the life insurance business is indicated by the fact that the total assets employed by Canadian life insurance companies in Canada and elsewhere at the end of 1964 amounted to over $11 billion, primarily in mortgage loans and bonds. The net investment earnings for that year from assets in Canada amounted to approximately $410 million for Canadian companies, and approximately $140 million for non-resident companies.

Life insurance exists because of the desire of individuals to provide for their financial responsibilities upon death. Because of the unpredictability of the time of this event for any one individual, and the problem of ensuring that he will have accumulated sufficient assets before that time to meet these requirements, the practical way to provide protection against

"mortality risk" is to share it with others so that its cost becomes predictable. There is a problem involved in this sharing, because the mortality risk, and therefore the cost of insurance, increases with age. This has been solved by the introduction of the level premium method under which premiums are greater in relation to the mortality risk in earlier years, and less in later years. The excess portion of the premiums in early years enables funds to be built up, the income from which reduces the cost of the insurance to the policyholder 19/.

Saving Aspects. The level premium method creates a form of saving. The individual could, instead of purchasing level premium life insurance, even out his total insurance costs by purchasing term insurance on a year-to-year basis. The funds which he would otherwise pay for a premium in excess of the mortality risk would be used to buy investments which, with the accumulated income thereon, would offset the higher cost of term insurance at a later date.

In addition, many insurance policies are available with various saving elements in addition to the provision for mortality risk. Most policies other than pure term insurance have a cash surrender value which ensures some return of amounts paid in premiums in the event of surrender before death occurs. Endowment policies provide for payment of a lump sum amount provided the policyholder survives to a specified age. Endowment policies may also have options under which the policyholder can convert the lump sum into an annuity and in this way provide for additional income upon retirement.

Role of the Insurer. Although the insurance business may be considered in a very broad way as pooling of mortality risk and saving, its wide-scale operation depends upon the introduction of an important intermediary, the insurer. This organization, which is a separate legal entity, contracts to provide a given amount of protection in the future for a given cost, 20/ subject to certain participating elements which will be referred to later.

The business of the life insurer is unique in certain respects when compared with other types of business. In most businesses the capital is primarily provided by the shareholders or investors who bear no relationship to the customers of the business. Commitments to customers are usually short term, and even when they are long term, as for example, in guaranteeing products sold to customers, they are not the dominant feature of the business. The general situation in life insurance is quite different. As an insurer grows in size, its principal customers—the policyholders—become the main source of funds, with the participating surplus and the actuarial reserves representing the policyholder's substantial interest in it. The important feature of the business is that the insurer commits himself contractually to meeting certain obligations to these customers over very long periods of time.

The main problems of income determination for the insurer are therefore in estimating the amount of the liability for future payments which will arise out of commitments already made, and in estimating its future investment income and expenses. In setting the premiums which it charges to the policyholders, assumptions must be made regarding future "experience" in respect of the three main elements, mortality, investment income, and expenses. The provision for the liability in respect of business which has been written is commonly referred to as a "policy reserve" or "actuarial reserve", but might more accurately be described as a "provision for future policy claims". In estimating this provision, the amount of policy benefits that are expected to be paid in future years based on established mortality tables, and the premiums yet to be received, are discounted to the present year by the application of a rate of expected investment yield. Thus, the current policy reserve, future premiums, and the investment income on such funds should accumulate to an amount sufficient to meet the expected claims. Expenses are usually covered by a "loading charge" included in the premiums.

Because of the uncertainty of long-term projections, the assumptions made regarding investment earnings and mortality and expense experience

tend to be conservative, and surpluses are often created as the actual results prove more favourable than those anticipated in setting the premiums.

Investment Policy. Commitments being of fixed amounts, insurance companies invest primarily in securities which involve little risk to capital, yield a fixed return and are of a long-term nature. In 1964 the market value of common shares in Canadian and foreign corporations represented about 8 per cent, and the book value about 4 per cent, of the assets held by all federally registered life insurance companies, although by legislation they were each permitted to hold up to 15 per cent in such shares. In 1965, this limit was extended to 25 per cent.

Participating and Non-Participating Insurance. In participating insurance, which represents about 70 per cent of the insurance in force today, the pooling aspect of insurance is emphasized, and the fixed commitments of the insurance company modified. The premiums for participating insurance are as much as 20 per cent to 30 per cent higher than for non-participating insurance, but the policyholder is given the opportunity of sharing in the favourable experience of the insurance company and presumably he hopes that such participation, in the form of policy dividends, will result in a net insurance cost lower than that for a non-participating policy. Competition between insurance companies provides some assurance to the policyholder that policy dividends will be forthcoming. However, the participating policyholder has no contractual right to share in favourable results, and there is no guarantee that policy dividends will be paid. Under non-participating insurance the commitment of the insurance company is fixed, and competition tends to produce premiums that do not vary widely from company to company.

Stock and Mutual Life Insurance Companies. The distinction between stock and mutual life insurance companies is not as clear as the distinction between ordinary corporations and co-operatives. The stock life insurance company may do a considerable amount of participating insurance business, and in respect of this business is in effect operating a co-operative enterprise.

In the accounts of a life insurance company the participating and non-participating operations are clearly segregated. As far as possible the segregation is applied to premiums, claims, actuarial provisions, salesmen's commissions, etc. For investment income, however, an arbitrary method of apportionment has to be adopted, because the assets are not split into separate funds. While the method of apportionment varies among companies, it is usually based on the average amount of assets in the two lines of business for the year. The method of allocation is closely supervised by the Department of Insurance to safeguard the interests of the participating policyholders.

In a stock company the shareholders are limited in the extent to which they can share in the surplus arising from the participating business. They are entitled to a maximum of 2.5 per cent to 10 per cent (depending on the size of the participating fund) of the amount of participating dividends that are distributed from the surplus earnings of the participating business. All the surplus arising from the non-participating business is for the account of the shareholders. However, no income tax is paid on either of these surpluses until such time as they are formally allocated to the credit of the shareholders. In practice, only sufficient surplus is allocated to cover dividend requirements and to provide a small margin. Thus, basically the stock companies pay income taxes only on dividends paid.

In a mutual life insurance company the ultimate owners of the company are the participating policyholders. Accordingly, they are entitled to surplus earnings created from all the business, non-participating as well as participating. However, because there are no shareholders, there is no income for tax purposes and no income tax is paid. Since 1958, five large Canadian life insurance companies have "mutualized", a procedure under which the policyholders in effect buy out the shareholders. The primary reason for this change was to keep control of the companies in Canada, and it was financially possible because of the magnitude of policyholders' capital in an insurance company. By special statutory provisions the amounts paid for the shares were entirely tax free to the recipients.

<u>International Aspects</u>. The international aspects of the life insurance business are important because about 30 per cent of the life insurance in force in Canada is placed with non-resident companies, and about 30 per cent of the insurance carried by Canadian companies is on non-residents, most of whom live in the United States.

<u>Public Interest</u>. The provision of funds to indemnify the estate of an individual, his dependants, or both, in the event of death has long been considered important from a social standpoint. Practices of the industry are supervised by the Department of Insurance, and no policyholder in a regulated Canadian life insurance company has ever lost a dollar through non-payment of the amount guaranteed under his policy. Under federal legislation governing the insurance industry, the investment yield assumptions in setting actuarial reserves cannot exceed 3.5 per cent for insurance, or 4 per cent for annuities. Recently, however, this has been modified to permit higher interest assumptions if special permission is given by the Department of Insurance.

Main Tax Considerations

<u>Life Insurance as a Business</u>. Life insurance has grown into a highly complex business employing large amounts of capital. In a society in which business income is taxed either to a corporate entity or to an individual, it is appropriate that the business income of a life insurance corporation should be taxed in a manner similar to the income of other businesses, after taking into account its special features. That surplus earnings do emerge beyond those needed for the protection of policyholders was clearly shown in the prices paid to shareholders upon mutualization of certain Canadian companies in recent years 21/.

<u>Measurement of Income</u>. Ignoring for the moment the problems presented by participating insurance, the major difficulty in measuring the income of a life insurance business results from the long-term nature of its commitments. Because of this it is contended by some that an annual measurement

is futile and that any surpluses indicated in an annual measurement are needed to provide for unforeseen contingencies which may produce unfavourable experience in the future. When viewed in relation to other businesses, however, this contention is not convincing. The problems of annual measurement are not unique to the life insurance industry. There are other kinds of businesses in which the income may not finally be established for many years. For example, in the oil and forestry industries it is not unusual for capital to be commited for periods of 50 years, from which the final income to be derived cannot be forecast with any degree of accuracy.

The fact that the long-term nature of the life insurance business lies in its commitment to customers in the future is unique, but this does not mean that for tax purposes future contingencies should be provided for as the management sees fit. In the same way that there must be a limit on the rates at which depreciable assets can be written off, provisions for future liabilities should be subject to reasonable limitations.

The degree of latitude in providing for future liabilities of the life insurance business should be governed by the degree of uncertainty involved. This uncertainty centres primarily upon the possible future changes in mortality, expenses, and investment yield. With respect to mortality, the use of any of the accepted tables appears to be conservative, and accordingly, the only major mortality hazard would appear to lie in events such as war or epidemics. Except in case of violent inflation, the expense variations do not seem to be serious. Fluctuations in investment income are certainly an important element, but through its investment policy an insurance company can level out short-run fluctuations to a considerable degree. Most investments are of a long-term nature with a fixed return, some of which are uncallable, and most of those callable are subject to a premium. The investment yield assumptions used in calculating the policy reserves are usually quite conservative. At the present time, we understand that the typical assumption would be 3 per cent to 3.5 per cent, 22/ and yet the average net

yields for the insurance industry have not fallen below 3.5 per cent since 1900, and were almost 5.5 per cent in 1964. Since 1931, when the average annual yield fell below 6 per cent, there was only the seven-year period of 1945 to 1951 when the average annual yield was under 4 per cent, and it has increased every year but one from the 1948 low of 3.57 per cent. (See Chart 24-1.)

Furthermore, any adequate system of taxing income from life insurance must recognize that income may arise from favourable mortality and expense experience, as well as from an investment yield in excess of that required to meet obligations.

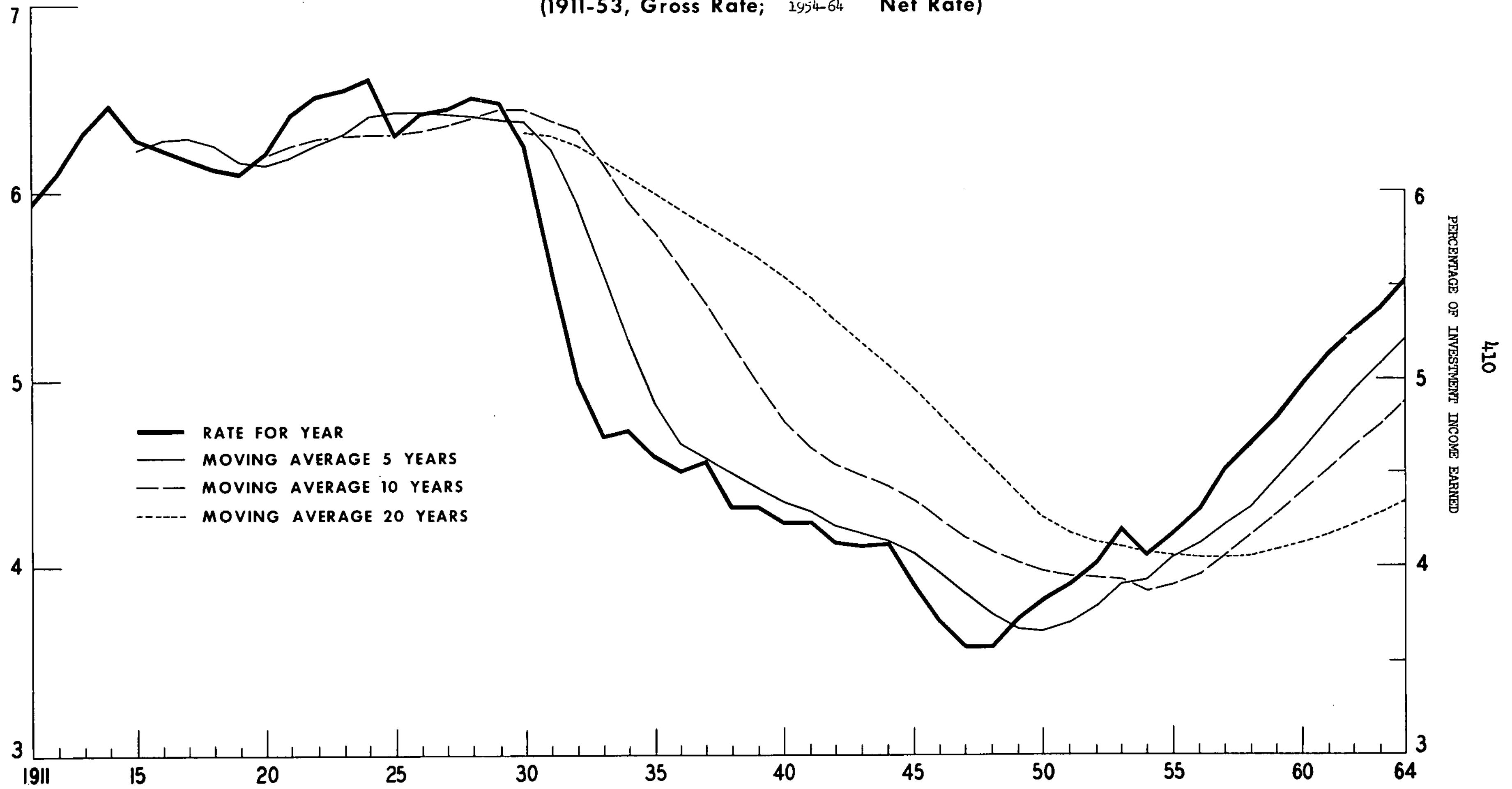
Mutual Aspect. Participating insurance, written by either joint stock or mutual life insurance companies, presents further problems in measuring the amount of the business income. The tax treatment is best explored by considering first the basis on which participating premiums are charged and the components of a policy dividend.

The premium for participating insurance is higher than that for non-participating insurance to allow for experience in investment yield, mortality and expenses that is less favourable than can reasonably be expected (and less favourable than that assumed for non-participating insurance). Thus, the policy dividend may be viewed as arising from experience more favourable than that assumed in setting the premium for the participating policy. It has been argued by some that the policy dividend therefore merely reduces the insurance coverage to cost. To the extent that the policy dividend represents results better than those assumed for non-participating insurance, that is, to the extent that policy dividends exceed the difference between participating premiums and non-participating premiums, this argument is unacceptable, because the ensuing income would normally accrue to the owner of the business. To the extent that the policy dividend arises from experience no better than that assumed for non-participating insurance, the policy dividend could be said to be merely a return of "excess premium" which

Chart 24-1

AVERAGE RATE OF INVESTMENT INCOME EARNED BY CANADIAN LIFE INSURANCE COMPANIES

(1911-53, Gross Rate; 1954-64 Net Rate)



would not be required from a policyholder such as a non-participating policyholder who had no participation in the income of the company. On the other hand, the participating policyholder has no contractual right entitling him to any dividend.

However, in our discussion of the taxation of payments received from life insurance in Chapter 16, and in our discussion of co-operatives and other forms of mutual enterprise in Chapter 20, we emphasize that the only consistent and reasonable way to tax distributions by the organization to the shareholder, member, or policyholder is to regard such a distribution as a distribution of income and therefore to tax it in full in the hands of the recipient. We reached this conclusion largely because of the administrative problems of determining what proportion of the distribution, if any, is a return of capital, that is, the "excess premium" paid. The policy dividend therefore should be deductible to the company and taxable to the policyholder in somewhat the same manner as business income earned in a co-operative and distributed to its members 23/. However, to the extent that dividends are paid out of surplus existing at the effective date of the legislation, they should not be taxable to the policyholders and therefore should not be deductible to the company. The rules for determining what dividends would be considered to have been paid out of this surplus should be consistent with the rules relating to corporate distributions and would be worked out in co-operation with the insurance industry. We recommend that a 15 per cent withholding tax should be deducted by the company from taxable dividends paid or credited to policyholders. As is the case with co-operative enterprise generally, it is possible to "price out" participating insurance by lowering the original premium, although this possibility would be limited by the need for financial stability.

Investment Conduit Aspect. The main tax considerations we have discussed so far have dealt with the surplus earnings created in a life insurance business. The surplus earnings arise when the experience in respect of investment yield, mortality, and expenses is found to be better than that

required to meet the liabilities of the business. It must not be overlooked, however, that at least 80 per cent of the investment income of the insurance business is required to meet its liabilities, and, accordingly, even if included in the measurement of business income, it would not be taxed because liabilities incurred in operations are deductible.

Some would argue that the investment income is merely incidental to the insurance business, and to the extent it is required to meet the liabilities it should not be taxed. Viewed broadly, however, all the investments of an insurance company which produce income necessary to meet liabilities represent an alternative form of saving for the individual, and in this context the life insurance company is an investment conduit.

The avenues for investment now available are such that individuals have a practical alternative to saving through life insurance by combining personal investment with renewable term insurance, and the tax system should not discriminate between the two approaches.

The appropriate tax treatment of this aspect of life insurance therefore depends primarily on the treatment of the individual in respect of other forms of saving through pension plans, mutual funds, etc., which are dealt with elsewhere in the Report.

Effect of Tax Treatment on Industry Practice. Because the solvency of life insurance companies is important to the public interest, any method of taxing them that incidentally encouraged practices that tended to impair the solvency of companies could lead to difficulties. However we emphasized earlier that protecting the solvency of financial institutions is a matter for the applicable regulatory legislation and should not be regarded as a function of taxation. The impact of taxation should fall as evenly as possible on participating and non-participating business, and on stock and mutual companies.

Present Tax Treatment

Income Tax: Canadian Companies. The ordinary provisions concerning business income do not apply to a life insurance company. Rather, the income of

a company, by a special provision, is deemed to equal the amount credited to shareholders' account 24/. The amount so taxed does not include amounts credited to the non-participating fund contingency reserves, such as investment reserves or surplus, both of which are available to shareholders. In practice, the amount credited to shareholders' account is usually little more than that required to pay dividends on the shares. For example, while in 1964 revenues of Canadian insurance companies exceeded expenditures, including policy dividends and a normal increase in actuarial reserves, by $90 million, income taxes were paid on an amount of less than $5 million.

A deduction from taxable income is allowed to the company for the portion of the amount credited to shareholders' account that is considered to represent (on a pro rata basis) dividends received from taxable Canadian corporations and charitable donations made by the company. A pro rata share of profits and losses on investments is included in arriving at the taxable amount. In the same manner, a Canadian life insurance company includes in its taxable income a portion of the income from foreign operations. However, a tax credit is granted in respect of foreign income taxes, 25/ and, because the latter are usually much higher than the corresponding Canadian income tax, there is little or no Canadian income tax on foreign operations.

As mutual life insurance companies and fraternal benefit societies do not have shareholders' accounts, they are in effect exempt from income tax. Where a stock company is given permission to mutualize, the payments to shareholders to buy them out are specifically exempted from income tax under the Canadian and British Insurance Companies Act in the case of a federal insurance company, and under section 68B of the Income Tax Act in the case of a provincial company.

Income Tax: Foreign Companies Operating in Canada. There are no special provisions concerning Canadian branches of foreign companies, and, because foreign companies are considered to have no shareholders' accounts in Canada, they are not subject to Canadian tax on the business income from their Canadian

operations. The foreign companies are subject to non-resident withholding tax of 15 per cent on the portion of Canadian investment income which relates to assets in excess of 110 per cent of the Canadian liabilities 26/.

Premium Tax. A provincial premium tax of 2 per cent is levied on all insurance premiums less policy dividends.

Summary of Present Tax Revenue. Table 24-2 presents information on the income tax revenues in respect of life insurance business in 1964.

TABLE 24-2

INCOME TAXES ON CANADIAN LIFE INSURANCE COMPANIES

Canadian Income Taxes		
Federal	$1,631,557	
Provincial	295,217	$ 1,926,774
Foreign Income Taxes		$13,819,168

Note: In addition, Canadian companies paid premium taxes of $9,905,387 to Canadian provinces and $5,018,419 in foreign countries. Foreign companies paid provincial premium taxes in Canada of $4,966,705 and Canadian and non-resident shareholders paid about $300,000 in Canadian taxes on share dividends received from Canadian insurance companies.

Source: Department of Insurance.

With only about 30 per cent of the life insurance carried by Canadian companies being placed abroad, the $13.8 million paid by them in foreign income tax offers strange comparison with the mere $1.9 million paid in Canadian income tax. The foreign income taxes paid by Canadian companies may also be noted relative to the fact that foreign companies paid no income tax to Canada on a comparable amount of insurance placed by them in Canada.

Evaluation of Present
Tax Treatment

In view of the main tax considerations discussed above, the present tax treatment of the life insurance business must be considered inappropriate and unsatisfactory for the following reasons:

1. The business income of a joint stock company is untaxed except for the portion which is credited to the shareholders' account in the financial statements.

2. There is no tax on the business income from mutual life insurance conducted by a joint stock company, except for a small percentage which may be withdrawn by the shareholders, nor on any of the business income of a mutual company.

3. The investment income generated in the life insurance business is considerable, and yet most of it is untaxed. This gives the holder of life insurance a tax preference over individuals who choose to save through some other investment form.

4. Because life insurance companies are virtually untaxed, the dividend tax credit is ineffective as an incentive to investment by them in Canadian equities. In fact, the existence of this credit tends to lower the rate of return before tax on equity shares and therefore to reduce their attractiveness for insurance companies as compared with other investments.

5. The business income of a Canadian branch of a non-resident insurance company is not subject to Canadian tax. Substantial tax may be levied on it in the country of residence.

6. While the mutualization of a life insurance company is permitted primarily to enable its control to remain in Canada, the procedure does enable surplus accumulated in a life insurance business to be distributed tax free.

7. Because the business income of life insurance companies is virtually untaxed, the other sections of the income tax legislation which impose restrictions on deductions are relatively ineffective. Primary examples are those relating to employer contributions to registered pension and other plans, charitable donations, and the rate of write-off of capital assets.

At the public hearings of this Commission it was suggested by the Canadian Life Insurance Officers Association that the present provincial premium tax serves as a substitute for income tax, but this does not appear valid either in principle or in terms of tax revenue. A tax on life insurance premiums is both a tax on saving and a tax on services. It is not a tax on income, and it is not a satisfactory substitute for an income tax.

It is not uncommon to tax both the income and sales of a business. Canada's present income and federal sales taxes do exactly this, and we recommend that services should be taxed in the same way as goods. The provinces have applied the premium tax to fire and casualty insurance premiums, even though these companies are also subject to income taxation. It may also be pointed out that in the United States the life insurance business is subject to premium taxes as well as to a comprehensive form of income tax. However, we have also advocated neutrality in tax treatment between competing organizations. Thus, it would not be equitable to continue a tax on life insurance premiums when savings invested through competing organizations are not subject to such a tax. Because the provinces would share in the tax revenues from life insurance profits, they might well decide to forgo the revenue from the tax on life insurance premiums. If not, then it would be hoped that the premium tax would be extended to apply to all forms of contributions to saving plans.

It has also been mentioned that income generated by insurance is taxed eventually because insurance proceeds are subjected to estate tax. The same could be said, however, of any form of income which is subjected to

tax and of which the unexpended amount is later subjected to estate tax. In any case, while insurance proceeds paid to Canadians in 1963 exceeded $600 million, only $50 million were included in assets on taxable estate tax returns.

Foreign Methods of Taxation

United States. Legislation which became effective on January 1, 1958 was the first attempt in the United States to tax the life insurance industry in a comprehensive fashion. Its provisions were designed to subject to tax the surplus which emerges each year in the same manner as corporate earnings generally. Under this legislation insurance companies are subject to tax on the following:

1. Taxable investment income, determined in the manner outlined below.

2. One half of the "underwriting gains", that is, of the excess of net income from all sources over taxable investment income.

3. Amounts distributed to shareholders or transferred to the shareholders' surplus account out of the policyholders' surplus account which arises from accumulations of the other half of the underwriting gains and of some other amounts which are deductible in computing underwriting gains.

In the event of an "underwriting loss", this is deductible in full from taxable investment income.

Taxable investment income is the insurance company's share of the investment income less investment expenses. This excludes the policyholders' share of investment income which is determined by applying to life insurance reserves an interest rate equal to the average earning rate of a company on all its assets for the five years ending in the taxation year.

In determining underwriting gains, an insurance company is entitled to deduct dividends to policyholders, except that if there is an underwriting

loss, policyholder dividends are deductible only to the extent of $250,000. In computing underwriting gains a company may also deduct 10 per cent of the increase in reserves for non-participating contracts or 3 per cent of the premiums for non-participating contracts, whichever is greater, and 2 per cent of the premiums for accident and health insurance contracts and group life insurance contracts.

Discussions with people familiar with the life insurance industry in the United States indicate that there are a number of technical difficulties in the legislation which have not yet been resolved. In view of the sudden increase in the tax burden on the industry, however, these technical difficulties are not surprising. What is more disturbing is that the industry is apparently having great difficulty in determining the tax implications of different management actions. Part of this difficulty arises from the fact that a sharp distinction is drawn between underwriting gains and taxable investment income. We understand that most of the present revenue is derived from taxable investment income.

In addition to the federal income tax, insurance companies are subject to premium taxes levied by the states, the most common rate being 2 per cent.

United Kingdom. In the United Kingdom the life insurance business is regarded primarily as an investment operation, and all the investment income, net of management expenses, but including the portion required for actuarial reserves, is taxed. The Revenue authorities have an option to tax an insurance business on its trading profit which is measured in a manner somewhat similar to that at present used in Canada, but apparently this is almost always lower than the investment income and is seldom used. Insurance premiums paid by individual taxpayers in specified circumstances are allowed to them as deductions from income for tax purposes.

Alternatives to Present
Tax Treatment

The main requirement of any alternative system of measuring the income from a life insurance business for tax purposes would be to impose some reasonable limit on the amount which could be set aside for future obligations, that is, the actuarial liabilities for future claims under outstanding policies. There is also a question of how the heavy initial expenses incurred in selling and writing an insurance policy should be treated.

Industry Practice. The simplest and most flexible approach would be to accept for tax purposes the provisions and write-offs established in the financial accounts of an insurance company. The amounts carried to surplus 27/ in the statements filed with the Department of Insurance could then form a basis for a regular tax on business income. This would amount to accepting for tax purposes procedures that have been developed for regulatory purposes. These purposes are usually in conflict because, while the first looks to the proper reporting of annual income, the second is concerned with protecting the policyholder. We have already stated our conclusion that regulatory goals can best be attained by direct legislation and that tax measures should not be used for this purpose, unless no other measure is available, because of the inequity that would result. Accepting the company statements would mean that the expenses of selling and writing insurance would be written off when incurred, a more liberal treatment than is now generally permitted to other taxpayers earning income under long-term contracts. Such a system would also create an inducement to defer tax by strengthening actuarial reserves by the use of lower interest rate assumptions. Such a deferment could have serious effects on tax revenue, because a conservative interest assumption in respect of amounts held for up to fifty years could prevent the emergence of surplus for a very long time. There would be some limit on the extent of such deferment because the Department of Insurance would discourage improper increases in reserves,

and competition in participating insurance requires the emergence of surplus for policy dividends. It is unlikely, however, that these influences would be sufficient to avoid undue deferment of taxation. There would be some discrimination as between different companies, because the large and well-established companies could more easily afford to strengthen their provisions for future liabilities without disrupting their financial positions than could their new and smaller competitors, but this discriminatory feature would not be unique to the life insurance industry. Because the liabilities recorded in each company's own records would determine its tax liabilities, there would be pressure on the companies to over-estimate their liabilities, an unfortunate result in view of the flexibility now enjoyed in this respect. In addition, such a procedure would allow the life insurance industry a degree of flexibility in computing tax liabilities that would not be available to other industries.

Arbitrary Assumptions for Tax Purposes. A second alternative for determining the amount of the actuarial provision that could be deducted in computing income for tax purposes would be to establish an arbitrary rate of investment yield. This rate might be struck as being reasonable for the long run and, for tax purposes only, all insurance companies would be required to adjust their actuarial provisions to reflect this factor. Alternatively, the arbitrary yield rate could be the maximum rate permitted under insurance legislation, this rate presumably being sufficiently conservative to protect solvency. Or again, the arbitrary yield percentage could be based on actual investment earnings of the individual company over an extended period of time. From the inquiries we have made, and from experience under the former methods of United States taxation, it appears that the use of a similar rate for all companies might not be entirely equitable because it would not reflect the individual circumstances of each company in relation to the nature of its investments and its policies.

On the other hand, there is evidence that any attempt to use different rates for different companies might lead to inequities and would certainly

cause administrative complexity. We regard this latter factor as extremely important, for if no system will produce complete equity because of the necessity for arbitrary guidelines, it is preferable to employ an approach that is readily understandable and can be administered with relative ease by both the taxpayer and the government. An arbitrary rate also makes clear beyond all doubt that, while fixed standards may be required for the practical necessities of taxation, for other purposes the evaluation of policy reserves by the management of individual companies should be undisturbed by tax considerations.

Excess Investment Yield as a Minimum. Because a substantial portion of the profit of an insurance operation usually arises from favourable investment experience, another alternative would be to ensure that the taxable business income was no less than the "excess" investment yield. This is an important feature in the United States method of taxing life insurance companies, and the formula is intended to identify the excess of the actual investment yield over that which would be needed if reserves (or accumulated assets) were limited to those needed under current yields. It appears, however, that this method might leave substantial profits untaxed, and involves an artificial segregation of investment and underwriting profits, which has proved to be one of the troublesome features of the United States system.

Annuities, and Accident
and Sickness Insurance

The principal type of annuity written by insurance companies is the life annuity, the payment of which begins either immediately upon purchase or at some date in the future if the policyholder survives it. Insurance policies do not specifically provide for annuities, although such policies may provide for a lump sum convertible into an annuity at maturity. About 90 per cent of the total annuities now in force are group annuities, which are usually carried by employers for the benefit of employees.

The income of a life insurance company which is generated from its

annuity business is taxed in the same manner as the rest of its income. Therefore, the treatment of income from the annuity business must also be considered and co-ordinated with the tax treatment of the life insurance business. Annuity premiums are not subject to the provincial premium tax. Within limits, an individual may deduct contributions for annuities registered for tax purposes, the proceeds from which are fully taxable. Contributions by an individual for annuities that are not registered for tax purposes are not deductible, and only the interest element in the proceeds is taxable. The appropriate tax treatment of annuities from the annuitant's standpoint is discussed more fully in Chapter 16.

In general, the income of life insurance companies from accident and sickness insurance is taxed in the same manner as their income from life insurance. Because of the freedom which this procedure provides in setting up liabilities allowable for tax purposes, the life insurance companies have a competitive advantage over general insurance companies in the same field.

Proposed Tax Treatment

Our primary conclusion is that the present system of taxing life insurance business in Canada is quite inadequate 28/. A more appropriate tax system would recognize the emergence of annual income which accrues to the shareholders of the stock companies, to the participating policyholders of the mutual companies and the stock companies, or to the members of the fraternal benefit societies. We recommend that each of these groups should be taxed in a similar fashion. Experience in the United States suggests that the system should be as simple as possible and designed in such a way that its effect on business transactions will be predictable. Also, it should not be discriminatory between different types of business or different forms of organization.

Business Income. The computation of the business income of life insurance companies for tax purposes should be based on procedures which permit the

deduction of reasonable provisions for future liabilities; that is, of reasonable actuarial reserves. Such reserves for tax purposes should be calculated using an assumed arbitrary rate of investment yield, rather than actual investment yields. The use of an arbitrary and uniform rate would reduce complexity to a minimum. The rate to be employed should ensure that virtually all companies would deduct reserves which were not less favourable to them than would result from the use of their expected long-term investment yield. The arbitrary rate is recommended for administrative simplicity in determining income and is not intended as a means of accumulating contingency reserves. The provisions for future policy claims that are required to ensure solvency under the worst of conditions are not necessarily those that provide a reasonable reflection of income for tax purposes.

We believe that the above requirements dictate an arbitrary yield rate at the present time for Canadian life insurance actuarial liabilities of more than 4 per cent. The actual rate to be employed should be determined after discussions between the government and representatives of the industry. Our reason for suggesting a rate of more than 4 per cent is that the 20-year moving average of the actual investment yields earned on Canadian investments by federally incorporated life insurance companies has not dropped below 4 per cent in the 1900's 29/. We appreciate that the conservative investment valuation procedures employed by these companies tend to increase the yield rates. However, this overstatement is probably more than compensated by the omission of property gains from the computations. Therefore, a rate of over 4 per cent would permit the companies to report their provisions for tax purposes on a very favourable basis. The arbitrary rates could be changed if a long-term trend in investment yields warranted an adjustment. However, we would not expect such adjustments to be frequent.

The rate suggested above refers specifically to Canadian business. Because the yield on foreign investments acquired to provide for foreign liabilities is unlikely to be the same as for Canadian business, it would

not be equitable to apply the Canadian rate to all business. If our recommendations in Chapter 26 are accepted, there would be little difficulty in this regard because foreign source direct investment income from designated countries would then be eligible for an arbitrary foreign tax credit when received, regardless of the actual level of underlying tax. Nevertheless, some foreign source income would not qualify for such treatment, and in this case a different arbitrary rate should be determined, based upon the relative investment yields in Canada and the foreign jurisdiction.

Actuarial liabilities for tax purposes should be established on the net level premium basis.

In Chapter 22 we suggest that expenses which contribute to earning income over a number of years should either be written off as incurred or should be capitalized and amortized through capital cost allowances. The expenses of obtaining new insurance business should receive the same treatment as would be accorded to similar expenses by other businesses, namely, an immediate write-off of most expenses.

As in all businesses, gains or losses on investments should be included in business income.

The above recommendations concern the computation of tax liability only. The provisions for tax purposes should not depend in any way on what the companies record in their fiscal accounts.

All the above provisions are liberal when compared with our recommendations for industry generally. Under these provisions, a new life insurance business would not pay any income tax for a number of years, although most existing life insurance companies would immediately begin to pay substantial income tax. However, the impact on the shareholders of insurance companies of taxing life insurers on the full amount of their earnings would not be as substantial under our proposals as it would have been if the companies were subject to the full rates of tax under the present system, because the

integration of corporation and personal income tax would permit the tax burden to be limited to the personal rates of the resident individual shareholders.

However, in the case of a mutual life insurance company there would be no shareholders to whom undistributed earnings could be attributed, while in the case of a stock company most of the undistributed earnings from the participating business would be allocated to the policyholders and not to the shareholders. We have indicated in this Report that a corporation or other organization should not in itself be regarded as having a tax-paying capacity but as being an intermediary for the "owners", or the persons who have residual claims against it.

We have proposed that when the 50 per cent tax was levied on a corporation it should be entitled to allocate to its shareholders the earnings which had been subject to tax in the hands of the intermediary but had not been distributed in cash. Canadian residents would then include the amounts allocated to them in income, grossed-up to include the tax paid by the intermediary, and would obtain a credit for this tax. This procedure, if adopted, would apply to the shareholders of stock life insurance companies. A treatment which would be consistent in principle would be to permit stock companies to allocate to participating policyholders the earnings which arose from participating insurance (other than the shareholders' proportion of those earnings) and to permit mutual insurers to allocate to their participating policyholders all of the income which arose from their life insurance business. Canadian resident policyholders would then include in income the amounts allocated to them, grossed-up to include the tax paid by the insurer, and would receive a credit for that tax. However, in the case of income allocated to participating policyholders the situation would not be exactly parallel to that existing for shareholders. There would be the question of when, if ever, the accumulated income might be distributed to the policyholders. Also, as we recommended in Chapter 16 that mortality gains should not initially be subject to tax and as the policyholder interest in a life insurance policy is not readily marketable, there would be a question

of how the policyholder should record for tax purposes the amounts allocated to him. It would therefore be necessary for detailed regulations to be developed after discussions between industry and Department officials.

Policy Dividends. Consistent with our recommendations for other forms of mutual and co-operative activity which are contained in Chapter 20, policy dividends should be deducted in arriving at the business income taxable to the insurance company. The policy dividend should be treated as a distribution of business income and should be subject to a withholding tax of 15 per cent.

Investment Income. Discussion of the tax treatment of the investment income credited to policy reserves is contained in Chapter 16. The investment income in excess of that portion credited to policy reserves would, under the procedures discussed above, be included in income and taxed in the same manner as income of other corporations. Thus, the life insurance company would include dividends received from Canadian companies in its income on a grossed-up basis, and would obtain credit for the corporation income tax. This should prove to be a substantial incentive toward investment in Canadian equities.

Branches of Non-Resident Companies. Branches of non-resident companies should be taxed in the manner set out above for Canadian companies. Because non-resident companies do not ordinarily file operating statements with the Department of Insurance, a special calculation would be required, based on a proration of the results of the entire operations of each non-resident company. This would involve an allocation of head office expenses to the Canadian business and of a portion of policyholders' surpluses to Canada. To the extent that assets were held in Canada in excess of the actuarial reserves, the investment income on that excess could be taxed at the ordinary non-resident withholding tax rates as at the present time. In addition, it would be necessary to extend to life insurance companies the special tax on branch profits that is applicable to other businesses.

Administration. Under a comprehensive method of taxing life insurance companies, it does not seem reasonable to expect the Department of Insurance, which has responsibility for supervising industry practices, to ensure that policy liabilities will be met and also to determine whether the tax liability has been correctly calculated. Therefore, we suggest that certain members of the tax administration should become sufficiently familiar with the industry to be able to assess its taxation and that they should work in conjunction with the Department of Insurance.

Accident and Sickness Insurance. Income of a life insurance company from accident and sickness insurance should be taxed in the same manner as that recommended for the general insurance business in Chapter 25.

Interest on Funds Left on Deposit. Insurance companies pay interest on policy dividends and other policy proceeds that are left with them by policyholders. We understand that this interest is not always reported as income by the policyholder. Because the assets held on deposit are substantial, over $900 million in Canadian companies at the end of 1964, the requirements for reporting this income to the government and to the policyholder should correspond to those for investment income generally. Thus, the companies should be required to report the income and withhold tax of 15 per cent.

Effect on Tax Revenue. The revenue which would be produced by taxing income of insurance companies in the manner outlined above, based on its full application to 1964, is indicated in Table 24-3.

TABLE 24-3

APPROXIMATE TAX ON THE BUSINESS INCOME OF LIFE INSURANCE CORPORATIONS
(millions of dollars)

Canadian Federal Companies—amount carried to surplus (less net losses on investments) plus the estimated adjustment resulting from the use of a 4 per cent rate to provide actuarial liabilities	$143 a/		
Less—Foreign portion, say, 30 per cent b/	44		
		$99	
Foreign Companies, say, two sevenths of the income of Canadian companies		41	
Total taxable business income		$140	
Corporation tax thereon at 50 per cent			$70 c/
Additional 15 per cent non-resident tax on branch income and on dividends paid to non-residents			5
Provincial companies and fraternal benefit societies			5
			$80 d/

a/ Amount carried to surplus, less loss on investments, per Report of the Superintendent of Insurance. — $90 million
Adjustment of actuarial provision for year to reflect an interest rate assumption of 4 per cent instead of the existing rates which appear to average out to approximately 3 per cent — 53
— $143 million

b/ It was assumed that after allowing for foreign taxes on the foreign income of Canadian companies there was no additional Canadian tax to be paid.

c/ The tax paid at the corporate level would be offset by credits to resident shareholders of approximately $15 million and might also be offset by credits of most of the balance to resident policyholders if allocations to them were provided for.

d/ Subject to the effect of integrating corporation and personal income tax, this figure can be compared with estimated revenue of $2 million under the present system of taxation as detailed earlier in this chapter.

Transitional Provisions

Taxation of Business Income. Because the measurement of business income is based on earnings in excess of those required to meet liabilities, implementation of our proposals should not cause financial difficulties. The effect of our proposals on stock companies would be to levy income tax on the income as it was earned, rather than to wait until it was eventually distributed. Although this would only bring the taxation of shareholders of companies in the insurance business into line with the treatment of other shareholders, it would change what has amounted to a permanent tax deferral into an immediate tax liability. It should also be noted that under our proposals the burden of tax on income allocated to shareholders or participating policyholders would be limited to the rate of individual income tax applicable to the shareholders or participating policyholders. Nevertheless, our proposals would reduce substantially the future retained earnings and the cash flow of stock life insurance companies. It is possible that some portion of the taxes paid might be passed on in the form of higher premiums on new policies, and in the form of reduced dividends on existing and future participating policies.

The position for mutual life insurance companies would be somewhat different from that outlined for stock companies. Because the income of a life insurance company is at present only taxed when transferred to a shareholder's account, and because a mutual company has no shareholders, the mutual life companies are at present effectively exempt from taxation. In the case of both stock companies and mutual companies, the burden of tax on income attributable to resident policyholders might be limited to the rate of individual tax of those policyholders. The comments made above concerning the impact of these proposals on policyholders apply equally to policyholders of a mutual life company 30/.

Therefore, we recommend that our proposals should be implemented in full

immediately, with no provisions for a transitional period. We also recommend that all business income should be taxed, including the income derived from policies issued prior to the date of the implementation of our proposals.

Surpluses Accumulated Tax Free in the Past. A tax on the annual earnings of life insurance companies should take into account the treatment of surpluses accumulated tax free in the past. For Canadian insurance companies, such surpluses, including special contingency reserves, amounted to over $900 million at the end of 1964. 31/

It would be virtually impossible to impose taxation on surpluses accumulated in the past by foreign companies.

Surpluses accumulated in the past by mutual companies on all their business, and by stock companies on their participating business (other than the 2.5 per cent to 10 per cent share of participating business profits that could eventually be credited to the shareholders), are exempt from tax under the present legislation, and accordingly tax should not be imposed on them. The surpluses remaining, mainly from the non-participating business of Canadian stock companies, are taxable under the present legislation upon transfer to shareholders, and, accordingly, provision might be made to tax them under new legislation. The amount of such surpluses relating to Canadian business, including the recommended adjustment of actuarial liabilities, would amount to almost $300 million. Alternatively, it could be argued that in the ordinary course of events the tax on surpluses accumulated in the past would have been postponed indefinitely under the existing legislation, and that to tax them now would discriminate against the stock companies. It should also be noted that most of the surplus retained by the insurance companies has not yet borne any corporation tax.

We recommend that the surplus on hand at the effective date should continue to be subject to the 50 per cent corporation income tax if and when

it is credited to shareholders' accounts, but when paid out in the form of dividends it should be treated in the same manner as for other corporations, that is, as a reduction in the cost basis of the shares.

Another transitional problem concerns the opening balance, for tax purposes, in the provision for actuarial liabilities. At present, all companies use an investment yield rate of 3.5 per cent, or less, for determining their life insurance liabilities, while we recommend that a rate higher than 4 per cent should be employed. We recommend that, for tax purposes, the surplus accounts at the effective date should be increased by the amount required to reduce the provision for actuarial liabilities to the amount determined under the new rate to be employed.

CONCLUSIONS AND RECOMMENDATIONS

BANKS, TRUST COMPANIES, MORTGAGE AND LOAN COMPANIES, AND FINANCE AND CONSUMER LOAN COMPANIES

1. Financial institutions should, in general, be taxed in the same way as other taxpayers. Federal and provincial legislation provides for the solvency and liquidity of most of these institutions, and we do not feel that income tax legislation should be made to help serve the same purpose.

2. The treatment of the reserves of financial institutions should be altered to conform to general practice as followed in determining taxable income of other taxpayers, and should not provide for contingencies. However, to reduce complexity and uncertainty these institutions should be allowed to provide for losses on designated kinds of loans on an arbitrary basis, as an alternative to the specific valuation of individual loans. The present use of arbitrary allowances for banks and mortgage lenders should therefore be continued, but, the level of rates should be considerably reduced. In the case of banks the rate should be reduced from approximately 3.5

per cent to variable rates, applicable to fewer assets, of something less than 2 per cent, and, in the case of mortgage lenders, from 3 per cent to about 1 per cent on most mortgages and to something less than 2 per cent on the riskier mortgages. In the case of banks only, an alternative arbitrary allowance against loans of up to seven times the average loss experience for the previous five years should also be available on an optional basis.

3. Federal and provincial securities with maturities exceeding one year which are held by financial institutions should be valued on an amortized basis, and should be eligible for an arbitrary allowance of one half of 1 per cent of the amortized value.

4. The special provisions with respect to mortgages contained in section 85G of the Income Tax Act should be extended to all taxpayers (except banks), whether or not they are in the mortgage business. The exclusion of insured mortgages should be extended to privately insured mortgages, and the percentage rates should be reduced as indicated above.

LIFE INSURANCE COMPANIES

5. The business income of resident insurance companies, whether organized as stock or mutual companies or as fraternal benefit societies, should, in general, be determined and taxed in the same way as the business income of companies in other industries.

6. An arbitrary investment yield assumption should be specified for use in estimating the actuarial liabilities for tax purposes. A rate exceeding 4 per cent would appear to be appropriate for determining life insurance liabilities.

7. Policy dividends (except those paid out of surplus existing at the effective date of the legislation) should be deductible in computing the income of the paying company and should be included in the incomes

of the recipients. They should be subject to a withholding tax of 15 per cent.

8. The business income of Canadian branches of non-resident insurance companies should be taxed in the same manner as the business income of resident companies. They should also be subject to the same tax on branch income as is applicable to other non-resident companies with branches in Canada.

9. Resident insurance corporations should be entitled to follow the gross-up and credit procedure in respect of dividends from resident companies that we recommend in Chapter 19.

10. Stock companies should be entitled to allocate to shareholders the income which is attributable to them in the same manner as any other corporation. It would also be desirable for both stock and mutual companies to allocate to participating policyholders the income which is attributable to them. The amounts allocated to resident shareholders and policyholders would be included in their incomes, grossed-up to include the corporation tax, and they would be entitled to credit for the corporation tax.

11. Interest on funds left on deposit with insurance companies should be reported to the tax authorities and should be subject to a 15 per cent withholding tax.

12. Surplus at the effective date of the legislation should be adjusted for tax purposes to reflect the revision of actuarial liabilities. Such surplus would continue to be taxable if credited to shareholders' account.

REFERENCES

1/ The chartered banks, for example, had over two and a half million individual loans outstanding at June 30, 1965, amounting to $10.5 billion. A few large retail organizations have this problem in common with the financial institutions, but their income is derived primarily from trade rather than from the business of lending money and provision for losses on receivables therefore is not as significant in income determination.

2/ This deduction is allowed under section 11(4) of the Income Tax Act. The deduction in computing income is permitted only of "such amount as is set aside or reserved", so that banks are limited to the lower of the maximum permitted reserves or the amount set up in their books as valuation reserves. Notwithstanding section 11(4) of the Income Tax Act, it would appear possible for a bank to claim a deduction alternatively under section 11(1)(e) and this conceivably could exceed the amount allowable under section 11(4). However, it is extremely unlikely that a bank would do so.

3/ Bank Act, S.C. 1953-54, Chapter 48, section 63(1).

4/ Royal Commission on Banking and Finance, Report. Ottawa: Queen's Printer, 1964, p. 386.

5/ Section 85G of the Act deals with loans "made...on the security of a mortgage, hypothec, or agreement of sale of real property". However, mortgages or hypothecs under the National Housing Act, 1954 or any of the Housing Acts as defined in paragraph (e) of section 2 of the Central Mortgage and Housing Corporation Act are excluded. The section was introduced in 1955 and was designed to permit, over a period of time, a maximum reserve of 3 per cent of the principal amount of mortgage loans outstanding plus interest due and unpaid on those loans. The rate of accumulation of the reserve was limited to

one quarter of 1 per cent a year, but was changed in 1965 to one half of 1 per cent a year. The Trust Companies Association of Canada in their submission to the Commission, pointed out that the former limitation was such that a company with annual increases in mortgage loans outstanding would not reach the 3 per cent maximum at any time in the future. However, the change in the limitation should ease this problem and the percentage reserved should move toward the maximum.

6/ Section 11(1)(e).

7/ Depreciation provisions constitute an important determinant of income for many businesses.

8/ Disputes may also arise over the right to make deductions. For example, the right of acceptance companies to claim losses in respect of wholesale or retail "paper" purchased has never been clearly established, but by departmental practice such claims have been allowed because the finance contracts have been regarded as "accounts receivable" or "inventory". In Ted Davey Finance Co. Ltd. v. M.N.R., [1965] Ex. C.R. 20, the Exchequer Court threw some doubt on this practice by finding that (1) a sale of such commercial paper was not a sale in the course of trade, (2) section 85D dealing with the sale of accounts receivable did not apply, and (3) the commercial paper was not "inventory".

9/ The fact that the anticipated income has not been earned, of course, does not affect the loss potential.

10/ Bank of Canada, Statistical Summary, February 1965, p. 90.

11/ Royal Commission on Banking and Finance, Report, op. cit., p. 386.

12/ Computed from Superintendent of Insurance, Report on Small Loan Companies and Money Lenders Licensed Under the Small Loans Act, Ottawa: Queen's Printer, 1963.

13/ The following percentage distribution of loan accounts outstanding by size at September 30, 1962, was prepared from figures in Royal Commission on Banking and Finance, Report, op. cit., pp. 132 and 134.

Category	Under authorization of:		No. of Accounts (per cent)	Outstanding Amounts (per cent)
1	Less than $10,000		96.3	30.9
2	$10,000 to $100,000		3.1 a/	19.4
3	$100,000 to $1,000,000			23.6
4	$1,000,000 or more		.6	26.1
			100.0	100.0
Number and Amount		2,068,105	$7,033,000,000	

a/ This figure pertains to categories 2 and 3.

14/ There are few published data on mortgage losses. Information concerning a major mortgage company and information supplied by the Department of Insurance relative to Canadian life insurance companies suggest that the average annual net losses over this period have been approximately one fifth of 1 per cent. When a mortgage is foreclosed, the eventual loss is usually only a small proportion of the amount defaulted.

The Dominion Mortgage Association has completed a survey of its members for the 1929 to 1948 period that shows an average annual loss allowance of just over two thirds of 1 per cent. However, representatives of the Trust Companies Association pointed out that losses since 1948 have been virtually non-existent. The annual average loss experience is only significant in indicating the magnitude of the losses that will be chargeable against the allowance. Therefore, perhaps a more useful comparison is the insurance fee of 2 per cent charged on the initial value of National Housing Act mortgages. In this case, it would appear that the allowance built up with these fees will be quite sufficient to take care of expected losses, even though the risk of loss on such mortgages is considerably greater than on most conventional first mortgages.

15/ The write-off for tax purposes itself does not affect the taxpayer's right of collection.

16/ See Chapter 22 for further discussion on the meaning of "loss".

17/ Figures supplied by the Department of National Revenue for nine companies in the mortgage business indicate a tax allowance at the end of 1963 of under 2 per cent in all cases. Three companies had an allowance of under 1 per cent, and all but one were under 1.5 per cent. However, the 1965 legislative amendment permitting a larger annual provision will have caused some increase in the percentages.

18/ Figures supplied by the Department of National Revenue for six finance companies indicate that the tax provision at the end of 1963 ranged from one quarter of 1 per cent to 2 per cent of outstanding accounts.

19/ The cost of protection and the benefits derived therefrom affect the taxable capacity of the individual. The appropriate tax treatment of the individual is considered in Chapter 16.

20/ Fraternal benefit societies may alter the terms of their contracts by by-law, but rarely if ever do so in practice.

21/ Summary for the five companies which mutualized (thousands of dollars).

Companies	Total Amount Paid for Shares	Capital Account	Surplus in Share-holders' Fund	Excess (Paid out of Policy-holders' Surpluses)	Policyholders' Surpluses as at December 31 of Year Prior to Start of Mutualization	
					Non-Participating	Participating
Canada Life Assurance Co.	$22,000	1,000	1,208	19,792	9,224	20,882
Confederation Life Assoc.	18,000	1,000	719	16,281	13,402	16,548
Equitable Life Insurance Co.	4,253	327	400	3,526	2,488	(1,077)
Manufacturers' Life Insurance Co.	41,250	1,500	2,234	37,516	14,736	23,812
Sun Life Assurance Co. of Canada	65,000	2,000	2,426	60,574	21,338	129,019

Source: Information supplied by the Department of Insurance.

22/ It should be noted that the investment yield assumption employed in setting premiums might be slightly higher than that used in calculating policy reserves.

23/ Although the participating policyholder, unlike the co-operative member, has no contractual right to share in surplus earnings, nevertheless the participating policyholders as a group have ultimate ownership of the surplus earnings of the participating business, and the suggested treatment would reflect the extent to which this participation takes place.

24/ Section 30.

25/ Income Tax Act, section 41(3) and Regulations, Part XXIV.

26/ Regulations, sections 802, 803.

27/ The amount carried to surplus does not include the regular actuarial provisions for future policy claims and policy dividends; it does include an adjustment for profits and losses on disposal of investments, special increases in provisions for future policy claims, changes in special reserves, and dividends to shareholders.

28/ We discuss the treatment of policyholders in Chapter 16.

29/ See Chart 24-1.

30/ Our recommendations concerning policyholders, including those who receive policy dividends, are given in Chapter 16.

31/ Adjustment of accumulated policy reserves to reflect the proposed arbitrary rate would increase this amount by over $800 million.