CHAPTER 12

CONCESSIONARY ALLOWANCES

In this chapter we discuss the treatment that should be accorded the specific non-discretionary expenses listed in Chapter 7 (with the exception of the expenses of working mothers dealt with in Chapter 11) and the concessionary allowances that should be introduced to assist in the realization of certain social goals.

As explained in Chapter 7, our ability-to-pay principles require that tax units with specific non-discretionary expenses be granted a credit against their tax liabilities equal to the top marginal rate (the rate of tax on discretionary income) times the expense. Such a credit is equivalent to a reduction of the assumed discretionary income of the tax unit by the amount of the specific non-discretionary expense. For administrative and other reasons we have not been able to adhere to this rule completely.

Concessionary allowances to encourage socially desirable activities must be judged primarily in terms of their effectiveness in bringing about the desired result with the minimum departure from ability-to-pay principles.

MEDICAL AND RELATED EXPENSES

Medical Expenses

The medical expense allowance was introduced in Canada with little debate in 1942. In view of the heavy taxes imposed at the time, it was felt necessary to grant relief for "unusual" medical expenses. The Honourable Mr. Ilsley, then Minister of Finance, said in his Budget Address that studies of family expenditures on medical services had shown that the average expenditure was 4 per cent to 5 per cent of income annually and, "we desire only to provide exemption for those who have more than average expenditures of this kind" 1/. Accordingly, a "floor" of 5 per cent was set and only medical expenses as defined in excess of the "floor" were allowed. The "floor" was

subsequently lowered to 4 per cent in 1944, and to 3 per cent, the present figure, in 1953. 2/

Under the present Income Tax Act every taxpayer may, if he wishes, take the optional standard deduction of $100 in lieu of medical expenses and charitable donations. This administrative allowance and the 3 per cent "floor" replace what otherwise would be a very large number of small deductions for these items. If the taxpayer does not take the standard deduction of $100 he may claim the actual medical expenses (in excess of the 3 per cent "floor") if they are itemized.

We believe that, in the absence of universal and comprehensive medical and hospital insurance, a refundable tax credit equal to a substantial proportion (preferably 50 per cent-the top marginal rate) of the medical expenses in excess of a percentage of income would be the most equitable method of giving tax relief to individuals and families with heavy medical expenses. The "floor" would eliminate claims for small amounts and thus make the system administratively feasible; the large and refundable credit for medical expenditures in excess of the floor would substantially reduce tax liabilities or provide refunds, when catastrophic medical expenses were incurred. With refundable medical expense credits the tax system would, in effect, provide a form of partial medical and hospital insurance. Whether such provisions in the tax system would serve the desired social objectives as well as the present hospital insurance or the proposed medicare programme, we have not attempted to evaluate. Clearly, to recommend a completely new if partial system of medical-hospital insurance almost as an aside would be, to say the least, presumptuous. We have assumed that the present system of hospital insurance will be continued and that in the near future some form of universal and comprehensive medicare will be provided by government, as has been announced. When comprehensive medicare, including drug and dental costs, becomes a reality, special tax provisions for medical expenses probably would be unnecessary. The recommendations we make should be reconsidered in the

light of the system of medicare actually adopted. We look upon our recommendations with respect to medical expenses as interim measures.

We have not attempted to make recommendations about the appropriate definition of medical expenses. We can see no hope of formulating a definition that does not lead to borderline cases whose very existence would constitute a plausible argument for expansion of the definition. In the past the government has expanded the definition to remove anomalous situations when they arose; there seems no alternative to this *ad hoc* procedure.

We considered whether there should be some greater control over receipts for medical expenses, and in particular druggists' receipts. We concluded that this was basically a matter that could be left to the administration. Our recommendations would substantially reduce the number of receipts being filed. We suggest, however, that consideration be given to requiring a uniform type of medical receipt for tax purposes that could be readily handled with electronic data processing equipment.

However, we do make recommendations about the tax treatment of medical insurance. The present treatment of medical insurance is, we believe, both inconsistent and inappropriate. By medical insurance we mean insurance that has as its purpose the payment of the sorts of expenses covered by the definition of medical expenses in the Act. For many years the general rule has been that premiums or contributions for medical or hospitalization coverage were not deductible, but that medical expenses paid on behalf of the taxpayer by an insurer or through a medical or hospitalization plan were deductible. Thus, the latter have been treated as though they had been paid by the taxpayer for the purpose of computing his medical expense deduction 3/. Section 27(1)(c) has, in effect, been interpreted to permit the deduction of medical expenses paid on behalf of a taxpayer as well as "by the taxpayer or his legal personal representatives". However, premiums and contributions paid for protection against the contingency of medical expenses are not deductible,

even under a broad interpretation of the section.

An exception to the general rule is stipulated in section 27(4a), enacted in 1959, which prohibits the taxpayer from including in his deductible medical expenses those paid by him or on his behalf for which he is entitled to be reimbursed under the following legislation:

1. Legislation of a province which has a hospital care insurance plan to which the federal government makes contributions.

2. Federal legislation authorizing a hospital care insurance plan for employees of Canada and their dependants.

Justification for this provision rests on the ground that medical expenses paid by the federal government directly, or indirectly by means of subsidies to the provincial hospitalization plans, should not be deductible as though paid by the taxpayer or his personal representative as section 27(1)(c) contemplates. If the law were otherwise, the taxpayer would enjoy a double benefit at government expense.

There are three situations involving what we have called medical insurance. The following summary contrasts these situations and their tax consequences.

Situation	Tax Treatment of Premium	Tax Treatment of Benefit
1. Employer pays premium under group sickness, accident or medical services plan.	Premium not included in employee's income.	Medical expenses paid on insured's behalf not included in his income, but included in computing the medical deduction.
2. Taxpayer pays own medical insurance premium.	Premium not deductible.	Medical expenses paid on insured's behalf not included in his income, but included in computing the medical deduction.
3. Employer or taxpayer pays government hospital insurance premiums or taxes in lieu of premiums.	Employer-paid premium included in employee's income. Taxpayer paid premium not deductible.	Medical expenses paid on insured's behalf not included in his income or in computing the medical deduction.

The legislative sanction for the exclusion of the premium in situation 1 is section 5(1)(a), which excludes from taxable employee benefits the benefit the employee derives from his employer's contribution to a group sickness or accident insurance plan or medical services plan. The rationale for such exclusion presumably is to encourage group insurance plans to protect employees against illness, and to overcome the administrative difficulty of apportioning a group premium of this nature among individuals in the group because of age and insurability differences.

However, there is a fundamental inequity when we compare situation 1 with situation 2. In situation 1, not only is the employer-paid premium not included in the employee's income but the benefits paid on behalf of the employee are considered as though paid by him so that they come within the definition of medical expenses for deduction purposes. In situation 2, where the taxpayer provides his own insurance, he of course gets no deduction for his premium although the benefits paid out of the insurance are includible in computing the medical expense deduction.

Situation 3 is inconsistent with situation 1 with respect to employer-paid premiums, and inconsistent with situations 1 and 2 with respect to benefits. The reason advanced for the inconsistent treatment of benefits has already been given. The inconsistent treatment of premiums arises in part because of the different methods of financing hospital insurance in different provinces. Ontario, Manitoba and Saskatchewan charge a premium; the other provinces finance these hospital insurance plans from sales taxes or other tax revenues. Unless residents of the latter provinces were allowed to deduct a proportion of their sales taxes or other taxes paid, it would be unfair to allow taxpayers in the three provinces to deduct their premiums or to allow employers to pay premiums for employees without adding such premiums to the income of their employees.

The present treatment of medical insurance is not only inconsistent; it gives rise to the unreasonable result that a taxpayer covered by medical

insurance who has a large medical expense can actually be better off in the year of the illness; the insurance meets the expense but the expense, in excess of 3 per cent of income, is deductible to the taxpayer. We have come to the conclusion that consistency and reasonableness can both be improved by reversing the present approach. Ignoring the floor for the moment, taxpayers should only be allowed to deduct actual out-of-pocket expenses including medical insurance premiums or medical service plan contributions. The medical expenses paid under such plans should not be deductible. Thus, if a taxpayer paid a medical insurance premium of $150 and also paid medical expenses of $2,000, for which he was reimbursed under a medical insurance policy or plan to the extent of $1,000, the eligible expenses would be $1,150 not $2,000.

As more and more taxpayers are covered by some form of medical insurance policy or plan, and as the benefits under these policies or plans become more comprehensive, fewer and fewer taxpayers will have out-of-pocket medical expenses over and above their premiums or contributions. These premiums and contributions will be about the same for all individuals and for families of the same size.

To allow the deduction of all premiums and contributions would then be tantamount to allowing a standard deduction to all taxpayers. This would not only reduce the tax base, thereby requiring higher rates, it would also provide a more valuable concession to those with high marginal rates than to those with low rates, and such a result would not meet the objectives of the concession. We therefore recommend that the 3 per cent floor 4/ on the deduction of medical expenses should be retained and that the present standard deduction for medical expenses should be eliminated. Because the present standard deduction covers more than medical expenses, the current amount should be reduced. Because the 3 per cent floor is related to income, low income individuals and families would obtain some deduction from income with respect to medical premiums and contributions while middle and upper

income individuals would not. To be deductible, out-of-pocket costs other than premiums and contributions would have to be relatively greater for upper income taxpayers than for low income taxpayers.

We recommend, however, that the present treatment of government hospital insurance premiums should be retained. These premiums should be added to the incomes of employees when paid by an employer and should not be deducted when paid by an individual or family. This would be necessary to achieve consistency among taxpayers in all provinces.

Our recommendations would substantially reduce the number of taxpayers presently claiming medical expense deductions in excess of the 3 per cent floor without creating hardships. Catastrophic medical expenses not covered by insurance would continue to be deducted as at present. We think it will be recognized by most taxpayers that lower personal tax rates are preferable to standard deductions and to claims for medical expenses that were not actually paid by the taxpayer.

Blind or Confined to
Bed or Wheelchair

Section 27(1)(d) of the Income Tax Act provides for a special deduction from income of $500 which may be claimed by a taxpayer who:

1. Was at any time in the taxation year totally blind; or throughout the whole of the taxation year was necessarily confined to a bed or wheelchair, by reason of illness, injury, or affliction; and

2. Made no claim for medical expenses on account of remuneration for an attendant or care in a nursing home, by reason of his blindness, illness, or affliction.

Two points are apparent. First, the section only refers to a taxpayer so that the deduction is not available with respect to a dependant. Second, if the taxpayer is blind, he need only be blind for one day in the year to

qualify for the full deduction for the year. However, if the taxpayer is injured on the second day in the year and confined to bed for the rest of the year he does not qualify, because he was not "throughout the whole of the year, necessarily confined...." The logic escapes us.

Further, if the person confined to a bed or a wheelchair claims a deduction for actual medical expenses under section 27(1)(c)(iv) for remuneration for a full-time attendant, the special deduction of $500 is not available. Similarly, a blind person cannot claim both the special $500 deduction and expenses covered by section 27(1)(c)(v).

Because a deduction of actual expenses without ceiling is permissible, it is difficult to understand the need for the alternative treatment provided under section 27(1)(d), which is used only when the actual deductible expenses are less than $500.

Accordingly, it is our recommendation that section 27(1)(d) should be repealed.

The Aged

Special deductions from income are granted the aged in the Income Tax Act. Under section 26(1)(e), a deduction of $500 is granted to any taxpayer who has attained the age of 70 years. Under section 26(1)(f), a deduction of $500 is granted to any taxpayer who is between the ages of 65 and 70 years if a pension under the Old Age Security Act has not been authorized to be paid to him. This latter provision applies only to the 1966 to 1969 taxation years and was introduced to harmonize provisions of the Income Tax Act with respect to the aged, and the provisions of the Old Age Security Act.

These income tax provisions are not well suited to the provision of relief for aged persons with low incomes.

1. The most obvious problem is that the use of an exemption is of no benefit at all to those aged persons who are truly in need because they have little or no income.

2. It is sometimes argued that the very fact that a taxpayer has achieved the age of 65 (or 70) years means that his ability to pay has been reduced and therefore an additional exemption is justified. The information we have been able to gather does not support the contention that the economic circumstances of the aged justify a blanket exemption from income. One study indicates that a significant proportion of elderly persons and couples are wealthy, and a disproportionately high percentage of the wealthy are old people 5/. Another study showed that a couple over age 65 would ordinarily incur approximately 6 per cent less cost in maintaining a given standard of living than a couple between 35 and 65 years of age 6/. These studies relate to the United States but the same comparisons are probably generally true in Canada. We appreciate that retired people often have to live on less income than they had before retirement, but this fact is properly recognized by graduated personal tax rates.

3. There is reason to believe that the elderly are more prone than the average individual to unusual medical expenses, but we believe that our recommendations concerning medical expenses would be adequate to meet the needs of the elderly who had taxable income.

The basic problem, of course, is that an exemption is a very inadequate basis for a good welfare scheme. The way to help the most underprivileged is by positive assistance, not by income tax concessions that fail to discriminate between the needy and the affluent, that give no benefit where it is needed, but do give a benefit where it is not needed. We hope that a thorough review of Canadian welfare legislation will be undertaken. Until such a study is instituted, we recommend that section 26(1)(f) of the Income Tax Act should be retained, but that section 26(1)(e) should be repealed.

CHARITABLE DONATIONS

If equity were the only consideration, we would propose a system of tax credits for charitable donations. For example, under such a system a taxpayer who made charitable donations of $1,000 or more might receive a tax credit of $200. Taxpayers who donated less than $1,000 might receive a credit that was the same proportion of $200 that the actual donation bore to $1,000. The tax concession would thus be related only to the size of the donation and would not also depend upon the income of the taxpayer. The credit approach would, however, tend to stifle charitable giving by upper income individuals and families. Because we believe that private philanthropy performs a worthwhile social purpose 7/ we recommend that the fundamental feature of the present system, the deduction of charitable donations from income, should be continued.

Our recommendations as to the tax treatment of charitable organizations are set out in Chapter 20. We suggest there that their present tax-exempt status should continue, with exceptions for certain business and investment income.

The major practical problem relating to charitable donations is to ensure that the receipts issued by a charitable body are matched by actual contributions to it. A greater measure of control could be achieved if the following requirements were introduced:

1. Receipts should be in triplicate using forms supplied by the tax authorities, one copy to be given to the donor, one to the tax authorities, and one to be retained by the charity itself.

2. The charitable bodies should be required to maintain complete records of individual and total contributions received during the year, and to make such records available for inspection by the tax authorities.

3. The charitable bodies should be required to file annual returns of their gross receipts 8/.

It has been suggested that electronic data processing could be utilized to monitor charitable deductions. We agree that this could be done, but we are not certain that at the present time the expense of setting up a programme for this purpose would be justified.

The law to date, with two exceptions, requires that for charitable donations to be deductible the recipient charitable organization, trust, corporation, etc., must be in Canada 9/. By way of exception, a person resident in Canada whose chief source of income for the year is from an employment or business to which he commuted in the United States, may deduct his contributions to United States charitable organizations recognized as such under the United States Internal Revenue Code in the same manner as if he had contributed to a Canadian recognized charitable organization. Similarly, a Canadian taxpayer may claim a deduction not exceeding 10 per cent of his income from United States sources and taxable in Canada, for contributions to charitable organizations created under the laws of the United States as if the organizations were Canadian charitable organizations 10/. Thus, in these two exceptions the emphasis is on permitting charitable donations to organizations created in the United States out of income earned in the United States, presumably on the theory that some responsibility for good works lies in the jurisdiction whence the income flows.

We make recommendations in Chapter 20 that charitable bodies operating outside of Canada should be recognized and that deductions of contributions to a recognized charitable body should be permitted, whether or not the body operates in Canada.

At the present time the maximum charitable deduction is 10 per cent of the income of the taxpayer for the year with a one-year carry-over for amounts in excess of 10 per cent. We admire those who habitually make charitable donations in excess of 10 per cent of their income, and eloquent representations were made before us on their behalf. Nevertheless, we believe no change should be made until the administrative procedures recommended in

Chapter 20 with respect to charities have been implemented and have been found to be working satisfactorily. We recommend that at that time the limit on donations for individuals should be raised to 15 per cent of income. However, we recommend that no change should be made in the present 10 per cent limit for corporations 11/.

We have already recommended that the optional standard deduction should not be applicable to medical expenses. However, we believe that a good case can be made for an administrative concession in respect of charitable donations because there are so many small donations each with its own receipt. A limitation similar to that applicable to medical expenses, that is, restricting the deductibility of charitable donations to the amount exceeding 1 per cent of income, would appear to be preferable; but a limit of this nature might tend to restrain charitable giving by upper income taxpayers that the allowance is designed to encourage. A somewhat parallel problem could arise if an optional standard deduction, that is, a minimum amount that could be claimed instead of listing the actual donations and irrespective of the amount of actual donations, were too large, because it would then have a perverse incentive effect, discouraging those people from making moderate donations who could claim the standard deduction in any case. For these reasons, we recommend that an optional standard deduction should be retained for charitable donations, but that it should be limited in size to the minimum amount necessary to achieve the desired administrative savings. An amount of not more than $50 would appear to be appropriate for this purpose.

Section 27(1)(a) of the Income Tax Act provides that donations to Canadian provinces and municipalities may be included with charitable donations which are deductible for tax purposes, subject to the limit equal to 10 per cent of the taxpayer's income. Section 27(1)(b) provides that all gifts made to the Canadian government are deductible without limitation. We recommend that these provisions should be continued.

Gifts in Kind

Under the Income Tax Act charitable gifts in kind may be deducted provided they are supported by receipts from the donee charitable organization 12/. The one case that bears directly on the subject was decided on the ground that the transfer was not effected in the form of a gift 13/. In this instance a taxpayer sold a house to a church for use as a rectory for one half its value and claimed the other half as a charitable deduction. He lost his case. One wonders what the result would have been had he sold a one-half undivided interest in the house to the church and then followed this with a gift of the other half.

We see no reason why substantial gifts in kind should not be recognized. We have in mind the sort of thing the taxpayer was denied in the Gaudin case, as well as gifts of objets d'art to museums and similar institutions. Two points must be made clear. First, if a gift in kind were made, an unconditional and irrevocable transfer of ownership and possession to the donee must be effected before a donation is recognized for tax purposes. We do not believe that a deduction should be allowed of the value of a gift in kind which is made on condition that the subject of the gift, for example, a painting or a china collection, is to remain in the donor's possession for his enjoyment until some subsequent time.

On the other hand, we do not believe that small donations in kind of such things as old clothes and old furniture to charitable bazaars should be deductible, because of the administrative problems this would create. To minimize these administrative problems we would suggest that donations in kind should be deductible only to the extent that they exceed $500 in value in any year.

Second, there is a problem of valuation. Within the concept of the comprehensive tax base recommended in this Report, the transfer of an asset out of a tax unit would involve a deemed realization of the increase in the

value of the asset over the period of time for which the asset had been held. For example, if an individual purchased for $500 a painting which appreciated in value to $2,000, at which time he disposed of it through sale, the realized increase in value of $1,500 would be subject to tax in his hands. Suppose now that instead of selling the painting he donated it to a museum. In this case, he would add the gain of $1,500 to his income, but he could claim $1,500 ($2,000 less the $500 annual exclusion for gifts in kind) as a charitable donation if the amount did not exceed the limitation on charitable donations 14/.

Members of Religious
Orders and Postulants

Section 27(2) provides that where a member of a religious order has taken a vow of perpetual poverty and has in fact paid his earned income for the year to the order, he shall not be taxed on such income. We recommend that this provision should be repealed.

A different but related question arises with candidates for membership in religious orders, that is, postulants. They normally engage themselves in a trial period which may extend over several years, during which time they and the particular religious order seek the answer to the question "Is the postulant a suitable candidate for membership?" We recommend that one postulant under the age of 19 should be allowed as a dependant of each member of the religious order to which he seeks entrance, provided that the postulant has not been claimed as a dependant by parents or others.

Political Donations

Political donations at the present time are not deductible. However, there might be some merit in providing a 25 per cent tax credit for political donations of up to $50 per individual tax unit and $100 per family tax unit a year. It has been urged that such an approach would help ensure that political organizations, so vital to the maintenance of the parliamentary

system, have a broad base of financial support. This question is one which is not within our area of responsibilities, for the issues go far beyond taxation. However, we feel that it deserves public discussion, and implementation if it is as desirable as we are inclined to believe.

ANNUAL AND LIFETIME GIFT EXEMPTIONS

Under the comprehensive tax base, gifts would be brought into the income of the donee and would not be deductible in computing the income of the donor. However, under the family unit concept, gifts between members of a family unit, as we have defined it, would have no tax consequences. This would mean that a large proportion of all gifts would fall outside the purview of the tax system. Nevertheless, there are many small gifts of a "routine" nature between individuals and families that would be taxable under the proposed system unless some relieving provisions were available. Wedding gifts, birthday gifts and gifts made on religious holidays are obvious examples. It would be unreasonable to expect that donors would report to whom these small gifts were made and their value. Evasion would be rampant, because it would be unrealistic to expect that all donees would include them in income, and the administrative problems of valuation could be formidable. As a practical matter, we recommend in Chapter 17 certain annual and lifetime exemptions for gifts received that would mean that most people would not be taxed on the small gifts they received throughout their lives.

GIFTS IN SUPPORT OF DEPENDANTS

The present Act allows taxpayers certain deductions from income when they support close relatives who are dependent, usually wholly dependent upon them. The donor can support the dependant through gifts of as much as $1,000 a year without affecting the gift tax or the gift

tax exemptions of the donor. Adoption of our proposals would bring about a radical change. Gifts in support of wives, or husbands, or dependent children as we have defined them, would not be subject to tax to the donor or donee because wives, husbands and dependent children would all be members of the family unit and such transfers would not be subject to tax. However, without relieving provisions, gifts to parents of either spouse, aunts, uncles and children over 21 years of age who were not in full-time attendance at an institution of higher education or were not mentally or physically infirm, in excess of the annual and lifetime gift exemptions would be taxable to the donee and not deductible to the donor.

We considered but rejected the idea of allowing impecunious close relatives to become members of the family unit for tax purposes. To do so would unduly complicate the family unit concept because it would require elaborate provisions to prevent tax-free transfers between generations. However, there can be no doubt that individuals and families are often morally required to support, in whole or in part, aged or infirm relatives. These expenditures are non-discretionary and deserving of recognition. Without some form of concession the family tax unit would be too rigid; for aged and infirm parents and other close relatives are often thought of as members of the family. To accommodate the obligations of individuals and families to support close relatives, we recommend that a system of tax credits should be adopted as a concession to individuals and families making gifts to close relatives. The donor tax unit should be granted a tax credit of $100 for each close relative to whom $1,000 or more had been given in the taxation year. Smaller gifts to close relatives would entitle the donor to the appropriate proportion of the credit. Thus, a gift of $500 would entitle the donor to a credit of $50, a gift of $250 would entitle the donor to a credit of $25, and so on. We recommend that complete dependency snould not be a necessary condition for the tax credit. The donor should only have

to establish that the gift was actually made and that the donee was a close relative who was outside the donor's tax unit. This should facilitate administration of the tax credit. The close relative should not have to be a Canadian resident. A resident recipient of such a gift would have to bring it into income (to the extent that it exceeds his annual and lifetime exemptions), but if he had little other income and the gift was modest, the zero rate bracket applicable to all individuals and families should mean that there would be little or no tax on the gift.

A common method of assisting aged and infirm parents and other close relatives is for the taxpayer to provide them with free room and board in his home. The gift is in kind rather than cash. To avoid the valuation problem that would arise in these circumstances, we suggest that when a close relative is sharing the same domicile as an individual or family tax unit the tax unit should be deemed to have provided the close relative with a gift of $1,000 less any amount contributed by the relative toward expenses for clothing and shelter. If the relative had made no such contribution the donor tax unit would be entitled to the $100 credit. The relative would be required to take into income the $1,000 benefit in kind less any amounts falling within his annual or lifetime gift exemption. If this were the only income of the relative the zero rate bracket applicable to each individual tax unit would mean that there would be little or no tax on the gift.

POST-SECONDARY EDUCATION

We are concerned here with a student enrolled in an educational institution "that is a university, college or other educational institution providing courses at a post-secondary school level" 15/. Under the present law a student enrolled at a post-secondary educational institution in Canada may, in computing his income, deduct his fees as long as they exceed $25.

If the student is in full-time attendance at a university outside Canada in a course leading to a degree, he may deduct his fees in computing his income so long as the course is of not less than thirteen consecutive weeks' duration 16/. If the student relies on someone else for support, full-time attendance at university has a number of consequences, depending upon family status, degree of relationship and degree of support 17/.

We are fully in accord with the generally held belief that Canada should encourage a higher proportion of its citizens to improve their education. Despite the massive increases in government expenditures on post-secondary education in recent years, the proportion of Canadians proceeding to university still lags far behind the proportion in the United States. Because of the favourable effects of higher education on the growth of the economy and on the quality of our society, this gap should be closed. This could be achieved in a number of ways. Universities could be given increased grants so that fees could be reduced, and more students could be provided with more generous bursaries to meet their living costs. Loans and grants to students could be provided that would make it possible for more students to buy the higher education they want. Tax concessions could be provided that would make it easier for parents to finance the education of their children, or students to finance their own education.

We have not attempted to evaluate which technique or combination of techniques would be preferable. To have done so would have taken us far beyond our terms of reference. Our predilection is for increased government expenditure; but we thought it would be unwise for us to assume that government grants would increase so rapidly that other assistance would not be necessary. We therefore have made recommendations that we believe would encourage post-secondary education more equitably and effectively than the present tax provisions. By putting forth these recommendations we do not wish to imply that the tax concessions technique is the best technique, or that the proportions or dollar limits we suggest are in any sense firm recommendations. We are primarily interested in the method rather than the

amounts. The amounts should be determined in the light of the objectives and the expenditure decisions that are taken.

In Chapter 10 we recommend that a child, over the age of 21 but under 25, and in full-time attendance at an institution of post-secondary education, should be permitted to elect jointly with his parents, or parent where there is only one, to continue to be a member of the family unit. This would not only avoid the taxation of gifts from the parents to the child for the purposes of education in these circumstances, but would also facilitate the implementation of our recommendations with respect to tax credits.

In reaching our recommendations, we have tried to achieve a system with the features listed below:

1. We believe that the living costs of students should be recognized when they are not able to rely on their parents for support.

2. For reasons of equity we have repeatedly emphasized that relief for those incurring the costs of post-secondary education should be by way of tax credit rather than by deduction.

3. The tax relief should be available to the tax unit of which the student is a member.

4. Unused tax credits for post-secondary education should be carried forward to facilitate the repayment of loans when the graduate has income.

Our proposals as to post-secondary education allowances are:

1. A tax credit equal to one quarter of the fees paid by or on behalf of the student for post-secondary education should be provided. It would apply to the tax unit in which the person paying the fees was a member. It would be more valuable than a deduction for lower income tax units, and would be of relatively less importance to higher income tax units.

2. A further annual credit of up to $300 in recognition of living costs should be provided for a full-time student in an institution providing post-secondary education when the student is not a dependent child, as defined in Chapter 10. The credit for living costs would apply to the tax unit of the student.

3. Unclaimed credits should be carried forward and could be used to reduce tax liabilities at any time.

The concessions we suggest for full-time post-secondary education would provide a much greater incentive for the vast majority of taxpayers than the present system of deductions. The credit would provide the greatest relative assistance for low income parents and students with low incomes in their initial post-graduate years. We would expect that if the approach we recommend were implemented, the amounts we have suggested should be reviewed from time to time in the light of other policy decisions in the realm of higher education.

Further Training

Increasingly in the modern world, training and education continue throughout a person's working life and do not terminate with the attainment of a certificate or degree. Retraining and up-grading courses of various kinds are becoming an essential feature of many employments and professions. We assume that all of the costs of such courses, both fees and travelling and living expenses in excess of normal living expenses, would be reasonably related to the production of income and should therefore be deductible from income under the general rules for deductibility we recommend. Nevertheless, for greater certainty it might be useful to specify this in the Act. However, because we also recommend that full-time post-secondary education costs should be provided for by special tax credits, the costs of full-time post-secondary education would have to be specifically excluded as a deduction from income.

To permit the deduction of the costs of part-time or short-term training courses should remove a significant tax barrier to the maintenance of the skills and knowledge of both the employed and the self-employed. No concession would be required; only a less restrictive approach to the deductibility of the expenses of producing income. This more liberal approach can be justified on grounds of equity and neutrality.

CONCLUSIONS AND RECOMMENDATIONS

1. Some personal expenditures are made by individuals and families that are non-discretionary in whole or in part. There are other personal expenditures that serve a useful social purpose and, as a matter of public policy, should be encouraged. In equity, tax concessions should be granted to reflect the reduced ability to pay of those who have non-discretionary expenses and to provide an effective incentive to achieve a better realization of social goals.

2. Tax concessions designed to take into account non-discretionary expenses should, ideally, be of greater relative value to low income taxpayers. This principle follows because we believe that a given non-discretionary expenditure reduces ability to pay taxes relatively more when it is a large proportion of income than when it is a small proportion of income.

MEDICAL AND RELATED EXPENSES

3. The out-of-pocket medical expenses of taxpayers are non-discretionary expenses. While maximum equity might be achieved by providing for a refundable tax credit equal to a substantial proportion of the medical expenses in excess of modest limits, this would convert the income tax system into a medical insurance system; and such an approach may not be the most socially acceptable form of medical

insurance. We therefore recommend that the deduction approach should be continued.

4. The present approach, which prohibits the deduction of medical insurance premiums and contributions but allows the deduction of amounts paid under such policies and plans, leads to anomalous results.

5. Deductible medical expenses should include only amounts actually paid by individual and family tax units. The premiums or cost to a tax unit of medical insurance, the taxpayer's contributions to a medical services plan, and other out-of-pocket medical costs paid by the tax unit, should be treated as medical expenses. The benefits paid to or on behalf of a tax unit on account of medical expenses by insurers, medical services plans, etc., should not be treated as medical expenses of the tax unit because they are not paid by the members of the unit.

6. Premiums or other costs of governmental hospital service, as opposed to private hospital insurance or services, should not be treated as medical expenses of the tax unit because the provinces use different methods of financing hospitalization and no equitable pattern for federal income tax deductibility appears to be possible.

7. An optional standard deduction should not be available for medical expenses; the present standard deduction should therefore be reduced and used only for charitable donations.

8. In other respects the present rules with regard to medical expenses should be maintained. Thus, we have no specific recommendations for changes in the definition of medical expenses. In addition, the present restriction that only permits the deduction of expenses in excess of 3 per cent of income should be retained.

9. Our recommendations would substantially reduce the number of middle and upper income taxpayers claiming medical expenses.

10. The special deduction of $500 for taxpayers who are blind or confined to a bed or wheelchair and who do not claim certain defined medical expenses should be withdrawn. All the medical expenses of these illnesses in excess of 3 per cent of income would, of course, be deductible in the manner outlined above.

11. The special deduction from income of $500 for a taxpayer who has reached the age of 70, should be terminated.

CHARITABLE DONATIONS

12. To encourage charitable giving, a socially desirable objective, we recommend a continuation of the same basic system now in effect. However, some additional safeguards would be required.

13. Charities should file annual returns of their gross receipts.

14. The issuance of numbered charitable receipt forms should be controlled by the tax authorities.

15. The limit on charitable gifts should be increased to 15 per cent of income for individuals as soon as the administrative procedures we recommend have been implemented. The limit should be retained at 10 per cent for corporations.

16. Gifts to provinces and municipalities should be deductible in the same way as charitable donations and should be aggregated with charitable donations in determining the amount deductible. Gifts to the Canadian government should be deductible without limitation. In these respects the present law would remain unchanged.

17. The optional standard deduction should be set at an amount not exceeding $50 and should be restricted to charitable donations.

This deduction is recommended solely to reduce the administrative problem involved in processing a multitude of receipts for small amounts.

18. Outright gifts in kind to charitable organizations in excess of $500 in any year should qualify as charitable donations. On the making of such a gift the taxpayer would be deemed to have sold the property at the fair market value.

19. The special deduction from income of an amount equal to his earned income for the year, now available to a member of a religious order who has taken a vow of perpetual poverty,should be discontinued.

20. A member of a religious order should be able to claim as a dependant a postulant of that order under the age of 19, if the postulant is not being claimed as a dependant by another taxpayer.

POLITICAL DONATIONS

21. Consideration should be given to allowing a 25 per cent tax credit for political donations up to $50 per individual tax unit and $100 per family unit a year.

POST-SECONDARY EDUCATION

22. The present concession with respect to the expense of post-secondary school education, section 11(1)(qc)(i) of the Act, should be withdrawn and replaced by a tax credit system. This would provide a more effective and equitable concession. There should be a tax credit of one quarter of the fees paid by or on behalf of the student to the post-secondary educational institution. A further credit of up to $300 per annum should be allowed for the living costs of a student who is not a dependent child. The credit for fees should be available to the family unit of which the person paying the fee is a member; the credit for the living costs should only be available

to the student's tax unit. The credits should be cumulative, and to the extent not claimed should be carried forward indefinitely and be deductible at any time in the future.

23. The cost of part-time or short-term courses including fees and travelling and living expenses in excess of normal living expenses would be deductible under the general rules for deductibility we have recommended and tax credits should not be allowed in respect of such courses.

ANNUAL AND LIFETIME GIFT EXEMPTIONS

24. For administrative reasons, we recommend in Chapter 17 certain annual and lifetime gift exemptions.

GIFTS TO CLOSE RELATIVES

25. A tax credit of $100 should be provided to a tax unit making gifts of $1,000 or more in a year to a close relative outside the tax unit. The credit should be proportionately reduced for smaller gifts. When a close relative is provided with room and board in the home of the taxpayer throughout the year it would be deemed that the taxpayer had made a gift of $1,000 less any amount contributed by the relative toward the cost of room and board. The recipients of these gifts would be required to bring them into income. Because of the zero rate brackets and the annual and lifetime gift exemptions available to all tax units, the tax on modest gifts to close relatives with low incomes would be reduced or eliminated.

REFERENCES

1/ House of Commons Debates, June 23, 1942, p. 3580.

2/ The United States also initiated their medical expense deductions in 1942 and set the floor at 3 per cent, where it still is. The United Kingdom has no medical expense deduction. As originally enacted, the Canadian medical expense deduction was also subject to a "ceiling" which was removed in 1961. So far as we are aware, little difficulty has been experienced by the administration as the result of lifting the ceiling in 1961. In any event, it seems reasonable that very large medical expenses will be scrutinized by the Department and it does not seem that the Treasury will suffer if the burden of proof is on the taxpayer.

3/ This interpretation had its genesis when medical insurance was the exception rather than the rule and before the spread of government hospital and medical plans.

4/ The floor would be 3 per cent of income as determined before the deduction of medical expenses and charitable donations but after the deduction of all losses carried forward. Losses incurred in subsequent years would not be taken into account because of the complications this would cause in recalculating the medical expense allowance and in averaging income. The legislative technique to be followed would be a matter for the draftsman, but it would probably not be necessary to retain the present distinction between "income" and "taxable income".

5/ See Robert J. Lampman, The Share of Top Wealth-Holders in National Wealth, 1922-56, National Bureau of Economic Research, Princeton, N.J.: Princeton University Press, 1962, pp. 17-21.

6/ United States Department of Labour, Monthly Labor Review, November 1960, p. 1198. The study deals with "modest but adequate" budgets and covers the 20 largest United States cities.

7/ Our reasons are substantially the same as those in Gwyneth McGregor, "Charitable Contributions", Canadian Tax Journal, Vol. IX, 1961, p. 441.

8/ 1966 Budget Resolution No. 2 has proposed that, for the 1967 and subsequent taxation years, charitable gifts will be deductible only if the donee is a registered charitable organization which has been registered with the Minister and has filed a return in prescribed form. This Resolution has now been implemented by amendment of section 27.

9/ 1966 Budget Resolution No. 2 has proposed that, for the 1967 and subsequent taxation years, deductible charitable donations may include gifts to the United Nations or any agency thereof, to a prescribed university outside Canada which ordinarily has students from Canada, or to a charitable organization outside Canada to which the Canadian government has made a gift in the year. This Resolution has now been implemented by amendment of section 27.

10/ The authority for these two exceptions is found in section 27(3) of the Act and Article XIII D of the Canada-United States Reciprocal Tax Convention.

11/ The limit would be a percentage of income as determined before the deduction of medical expenses and charitable donations but after the deduction of all losses carried forward. It would seem unfair to take into account losses carried back because if they were deducted it would have the effect of disallowing donations which were properly deductible when made. See reference 4 above.

12/ Section 27(1) of the Act refers to the deduction of "such of the following amounts as are applicable: (a) the aggregate of gifts...." Section 139(1)(a) states that "(c) amount, means money, rights or things expressed in terms of the amount of money or the value in terms of money of the right or thing." It therefore appears that a gift of a thing is a gift of an "amount" within the meaning of the charitable deduction section.

Information Bulletin 17 published by the Taxation Division in Part I of the Canada Gazette, December 22, 1962, does not challenge the generality of this statement. It does state that donations of inventory that has been expensed and of second-hand goods will not be recognized.

13/ Gaudin v. M.N.R., 55 DTC 385.

14/ In the opposite case where a painting or other objet d'art was purchased by an individual for $2,000 but had a fair market value of $1,200 when donated to the museum, he would be permitted to claim a charitable donation of $700 ($1,200 less the sum of $500 which is the annual exclusion for gifts in kind). He would also be permitted to claim the $800 loss from realized property gains derived from the same type of property. See Chapter 15.

15/ Section 11(1)(qc)(i), Income Tax Act.

16/ Section 11(1)(qb).

17/ Section 26(1)(c), (ca) and (d).

CHAPTER 13

INCOME AVERAGING

We believe that taxes are fair when they are allocated according to ability to pay, and that this would be achieved by the application of a progressive rate structure to the annual tax base we have defined. One of the consequences of the adoption of a progressive rate schedule is that two individuals with the same average tax base may, over a period of years, pay substantially different taxes if the annual tax base of one fluctuates more than that of the other. The greater the fluctuation the greater the tax liability. This phenomenon poses several problems:

1. There is nothing sacrosanct about the measurement of income for tax purposes on an annual basis. The choice of the calendar year as the relevant time period is a matter of convention and convenience rather than principle. We can see no justification in equity for imposing substantially heavier taxes on those with fluctuating incomes, because there is no fundamental objection to the adoption of a longer time period and a longer time period would not produce this result. Some smoothing of income over a period of years would seem to us to be called for. We are not convinced, however, that equity demands income smoothing over a taxpayer's lifetime.

2. Without relief for irregular incomes the tax authorities would be drawn into an endless struggle to try to prevent taxpayers from manipulating the timing of their receipts or gains so as to minimize their tax liabilities. This struggle would produce ever greater complexities or arbitrariness in tax laws.

3. If there were no relieving provisions, those people who were able to manipulate the timing of their receipts or gains would, despite the efforts of the tax authorities, have an advantage relative to those who could not do so.

4. Unless there was some form of relief to those with irregular or fluctuating incomes, individuals might avoid occupations or businesses that were particularly subject to such variations.

These four points all seem to us to provide strong grounds for general relief from the tax consequences of lump sum or fluctuating incomes. In particular, the problem of taxpayer inequity is sufficient reason for providing relief even if it were possible to prevent the manipulation of income by taxpayers to avoid the full impact of progressive rates in each time period.

There is also a strong argument for the provision of some form of averaging because of the other recommendations made in this Report. Unless averaging provisions were available, the taxation of property gains at full progressive rates on a realized basis would, for example, be grossly unfair. It would be inequitable to tax realized gains as though they had arisen in the year realized. There are also other lump sum receipts that we recommend should be brought into tax, with the stipulation that the full impact of the progressive rates be softened by provisions that permit spreading of the receipts over a number of years. In particular, we believe that substantial gifts and inheritances, damage payments, and property gains realized or deemed to have been realized on death or cessation of Canadian residence all require relieving provisions.

Having acknowledged that relief should be granted on equity and other grounds, we hasten to add that this is not easily accomplished. All measures of relief for fluctuating and irregular income are relatively complex and create compliance and administrative problems. Many forms of relief have to be rejected simply because they would not be understood by many taxpayers or would require too much record keeping. As in so many other areas of the tax structure, what is required is a compromise between the desirable and the practical.

In Volume 2 of the Report we discuss at some length the importance of the built-in flexibility of the tax system. As the level of economic activity rises and falls, the rate structure automatically restrains expansions and contractions by increasing or reducing tax payments more than proportionately. This tends to stabilize the economy, although if the tax structure is too "tight" it can stabilize the economy at levels where labour, and other productive facilities and resources are not fully utilized. If substantial relief for fluctuating income were provided, the built-in flexibility of the system might be reduced. Whether it would be reduced, by how much it would be reduced, and under what conditions it would be reduced would depend, of course, on the particular form of relief provided and on changes in the other features of the tax structure. While built-in flexibility is not an unqualified advantage of a tax system, it should be recognized that some relief measures may make it more difficult to attain one of our economic objectives.

Little information is available in Canada with respect to the year-to-year fluctuations in the incomes of individual taxpayers. On the basis of two small and admittedly incomplete studies made by our research staff, we were surprised to find how general and substantial these changes apparently are. About 8 per cent of the sampled taxpayers in a number of Canadian metropolitan areas, with income below $10,000, reported year-to-year fluctuations of family income of more than 20 per cent from 1962 to 1963. 1/ In a survey of 450 taxpayers in two major Canadian cities, having income in 1962 in excess of $25,000, it was found that within the three-year period 1960-62, 20 per cent experienced fluctuations of more than 30 per cent in income for tax purposes from the highest to the lowest income year. This latter survey of upper income group individuals also showed that for these high income taxpayers, the higher the income the less on average were the percentage fluctuations in income in the period.

The tax impact of fluctuating income depends not only on the size of the fluctuations but on the rate structure. The width of the brackets, and the changes in rates from bracket to bracket, are obviously relevant. Analyses prepared by our research staff showed that the tax impact of a given degree of fluctuation under the existing rate structure is relatively modest at both the upper and lower ends of the income scale because the income brackets are relatively wide or the increases in tax rates from bracket to bracket are relatively small. It is the upper middle income group that has suffered most from fluctuating or irregular incomes.

The changes we recommend elsewhere in this Report would have two effects on the fluctuating income problem. Because of the widening of the tax base to include many non-recurring receipts that now are not taxed, the number of individuals who would experience year-to-year fluctuation in their tax bases would undoubtedly increase, and so would the extent of those fluctuations. On the other hand, the changes in the rate structure that we recommend would tend to reduce the tax consequences of these fluctuations, if only because we are suggesting a reduction in the top personal rates of tax.

PRESENT LEGISLATION IN CANADA

The problem of the equitable treatment of lump sum and fluctuating income as it exists under the present system has been recognized in part in the legislation. There are a number of provisions in the Income Tax Act designed to alleviate this problem in certain special cases, and in respect of certain types of income. Following is a brief summary of the main provisions.

Farmers and Fishermen

A farmer or a fisherman is given the privilege of averaging his income over a five-year period, providing the taxpayer's chief source of income has been from farming or fishing during the current tax year, known as the

"year of averaging", and the four immediately preceding years for which he has filed returns of income as required by the Act 2/. The averaging method available to this group is an example of simple or block averaging. In effect, taxes are computed annually upon each year's income as determined in the normal fashion. At the end of a five-year period, income for that period is totalled and pro-rated equally over the five years and personal allowances are deducted for each year. Tax is then computed at the rates for each year on the amount of the resulting taxable income for that year and these taxes are totalled. This total is then subtracted from the total tax actually paid in respect of the five-year period and a refund may be claimed for the difference. There is no requirement that this difference must exceed a stated minimum and, because this type of averaging can never be disadvantageous to the taxpayer, taxpayers normally elect to average in the year in which they are eligible to do so. It is our understanding that the introduction of these averaging provisions has not added in any material way to the burden of administering the Income Tax Act.

Authors

The Income Tax Act permits the spreading back of income earned from the sale by an author of the copyright in a work which took him more than a year to produce 3/. The permissible spread-back period is related to the number of years it took to complete the work, but in no case is the period allowed to exceed three years. Thus, if an author sells the copyright to a literary work which took him five years to complete, he may elect to include one third of the proceeds in his income in the year of sale and one third in each of the two immediately preceding years.

Relief is provided for authors involved in literary, dramatic, musical or artistic work, but it does not apply to income realized as a result of scientific achievement after years of research; nor does it cover the income of inventors. It is interesting to note the words of the Minister of Finance when he appeared before the Standing Committee on Banking and Commerce in

1947: "We have had no representation from inventors. The authors asked for it and made what seemed to be a sound case." 4/ The restricted coverage of the provision appears, therefore, to have resulted largely from the absence of pressure from other occupational groups.

While no one would deny that some farmers, fishermen and authors are subject to extreme fluctuations in income, unquestionably there are taxpayers in other occupations who suffer as much from the same phenomenon. Actors, musicians, consulting engineers, architects, professional athletes, construction contractors, inventors, and so on, may, as groups, be less subject to variation in income than farmers, fishermen and authors, as groups, but undoubtedly there are members of the former groups that have variations that are as frequent and as wide as those of any member of the latter groups. Equity requires equal treatment of individuals in the same circumstances, not equal treatment of groups of individuals when there are significant intra-group differences.

The relief available to farmers, fishermen, and authors should either be withdrawn or made available to all.

Lump Sum Payments

The Income Tax Act at present provides special tax treatment for a variety of lump sum payments 5/. These payments may, at the option of the taxpayer, be excluded from ordinary income in the year of receipt and subjected to a special rate of tax. Briefly, the following income is eligible for such election:

1. A single payment made out of a pension fund upon the death, withdrawal or retirement of an employee, or on the winding-up or amendment of the pension plan.

2. A single payment in recognition of long service made to an employee on his retirement and not made out of a superannuation fund.

3. A single payment pursuant to an employee's profit sharing plan in satisfaction of all the payee's rights under the plan.

4. A single payment pursuant to a deferred profit sharing plan upon the death, withdrawal or retirement of an employee.

5. A payment or payments made by an employer to an employee or former employee on retirement in respect of loss of office.

6. A payment or payments made as a death benefit.

The amount on which the special tax can be paid is limited by reference to the number of years of service or the number of years in which the taxpayer was a member of a particular plan.

If the election is made, the taxpayer will pay, in addition to any other tax payable for the year, a special tax on the lump sum payments. This special tax will be equal to the proportion of those payments that the aggregate of the taxes otherwise payable by the employee for the three years immediately preceding the taxation year is of the aggregate of the employee's income for those three years. It will not always prove to be to the benefit of the taxpayer to make the election; and accordingly it is necessary to make the requisite calculations before deciding to elect.

Although the above types of lump sum payments are significantly different from one another, the legislation provides only one relief measure. This being so, arguments could be made for the extension of some type of relief for all forms of lump sum or fluctuating income. Indeed, as long as the piecemeal system of relief continues, there will justifiably be continuing pressure not only to provide more and varied relief but also to alter or add to the methods by which such relief is granted.

The major criticism of this relief measure is that the tax rate applicable to this type of income is determined by reference to other income without adding to the other income the lump sum income, which would

tend to increase the marginal rate. Moreover, the rate of tax to be applied is determined as a percentage of the income, not taxable income, thus affording further relief.

Business Losses

A taxpayer carrying on business is permitted to apply losses from the business against his other income in that year. To the extent that business losses exceed other income, they remain available to reduce business income of the immediately preceding year and the next five succeeding years 6/.

Stock Options

Where an employee of a limited company is given the right to acquire shares of the company at a price which is below the market value of such shares at the time of exercise, on exercising the option the employee is deemed to have received a benefit by virtue of his employment equal to the difference between the purchase price paid and the value of the shares at the time of acquisition. This benefit is treated as income in the hands of the employee, but is subject to tax at a special rate. The special rate of tax applicable to the benefit is the average rate that tax has borne to income (not taxable income) for the preceding three years, minus the lesser of 20 per cent of the benefit or $200. 7/

The criticism made in respect of the relief provisions for lump sum payments applied even more strongly here until recently, because the rate of tax payable on the benefit was reduced by 20 per cent (presumably in recognition of the fact that the cost of the benefit is not deductible from the company's taxable income). However, as a result of an amendment in 1966, the amount of the reduction from the average rate was limited to $200.

Recapture of Depreciation and
Revaluation of Inventory

Where a taxpayer is carrying on business, the sale of some or all of

the depreciable assets of the business may result in the recapture of a substantial amount of depreciation, which is income in the year of recapture. Similarly, if inventory is revalued in accordance with the requirements of section 14(2), an increase may be made in the income of a taxpayer under section 43A. The Income Tax Act provides a measure of relief from these rules by permitting tax to be paid on a special basis 8/. The effect is to allow a spreading of the income over a period of not more than five years immediately preceding the year in which the recapture or revaluation takes place. The period varies according to the length of time before the year of recapture or revaluation during which the taxpayer, if a corporation, has carried on business in Canada or, if an individual, has been resident in Canada. The tax payable is the tax that would be payable for the year in question if the income did not include any amount for recapture or in respect of a revaluation of inventory, plus a special tax equal to the aggregate of the amounts by which the taxes for the preceding years would have been increased if the recaptured amount or the amount added to income by a revaluation of inventory had been spread equally over those preceding years. In other words, the amounts in question will be spread, for tax purposes, over the number of years applicable.

Summary of Present Treatment

From this description of the main existing provisions, it can be seen that the present Canadian legislation recognizes the problem inherent in receipt by taxpayers of lump sum amounts or fluctuating income, and in some cases does attempt to provide alleviation. This is done through three distinct methods: the general averaging provision, restricted to income of farmers and fishermen; the special rates of tax applicable to income from exercising stock options and certain types of lump sum payments; and the spreading back of income over prior years, applicable to the income of authors from the sale of copyrights and to the income from recapture of depreciation or revaluation of inventory 9/. The treatment of business

losses does not fall into these categories and is dealt with in greater detail in Chapter 22.

It has been emphasized in submissions to this Commission that the present relief measures do not adequately meet the needs of the general body of Canadian taxpayers. In addition to a number of submissions calling for averaging relief in respect of specific kinds of income or of specific groups of taxpayers, a general averaging provision applicable to all individual taxpayers was suggested in several submissions.

TREATMENT IN OTHER COUNTRIES

Lump sum and fluctuating income is a problem in all countries where there is a steeply progressive personal tax rate structure. It is useful to consider the general methods of relief and the variations of these methods found in several countries.

Special Rates of Tax on Irregular Income

In Austria, a taxpayer's "extraordinary" income, such as a lump sum payment for work which has extended over a number of years, is, at the taxpayer's request, taxed at special rates ranging up to 25 per cent. Similar treatment is afforded the German taxpayer who has specified types of extraordinary income, such as damages in respect of services, indemnities, and so on. These types of income are taxed at special rates ranging between 10 per cent and 30 per cent, the exact rate being determined by the local finance office. Different treatment of other kinds of income in Germany is noted below.

In Australia, authors and inventors are granted a reduced rate of tax on "abnormal" income, which generally consists of lump sum or abnormal payments received for royalties, patents, prizes, inventions, and so on. Tax at a specially calculated rate is also available to certain taxpayers in receipt of premium income from a long-term lease.

In Japan, a special rate of tax is determined by excluding from income four fifths of "fluctuating income", determining the rate of tax on the balance of income, and then applying this rate to the balance of the fluctuating income, defined generally as fishery income, royalties, sale of copyrights and certain other lump sum payments.

Special Deductions from Income

In Denmark, a special "deduction for additional income" is permitted a taxpayer when his income exceeds the previous year's by more than 10 per cent. The rate of deduction ranges between 20 per cent and 50 per cent of income over 110 per cent of the previous year's income. In Italy, a lump sum payment on cessation of employment is exempt from tax up to a specified amount. In the United Kingdom, a "standard capital superannuation benefit" is deductible in some instances from lump sum payments in respect of an office or employment, but not in respect of the loss of such office or employment.

Spreading Income Back
Over Prior Years

In Germany, a taxpayer receiving in any tax year, for personal services rendered, compensation for work done over a period of years, may allocate the compensation to the years earned, but may not go back more than three years. This rule is subject to a number of provisos which result in a limited practical application.

Sweden permits individuals, including estates or trusts, to spread over a period of years income from a wide variety of sources, including disposition of machinery and lumber, and a lump sum payment in lieu of a retirement pension. The general rule is that amounts deemed to have been earned in at least two income years shall be taxed as if received in equal parts over as many years as it had been earned, not exceeding ten years. Such income, called "accumulated income", must total a specified minimum amount and must

constitute at least one third of the taxpayer's assessable income in the year of receipt. The tax rate applied to the additional income attributed to the prior years is the rate in force for the year of actual receipt.

In the United Kingdom, authors of literary, musical or artistic work can spread the proceeds of such work back over a maximum of three years; somewhat similar relief is provided for income from personal services earned abroad, and proceeds of sale or licence of a patent. There are slightly more generous provisions for the spreading back of lump sums received as termination pay. Australia has a special provision for spreading, generally over a five-year period, income received from the disposal of inventory not in the ordinary course of business. In India, authors may spread back over prior years income received from copyrights, royalties, etc., in a manner similar to that used in the United Kingdom.

Discretionary Relief

Indian tax law provides that in the case of certain types of income, such as lump sum receipts out of special funds or received on termination of employment or loss of office, the government may grant relief, but the granting of the relief and the mode of the relief are entirely at the discretion of the government. This is similar to the situation in Germany described above, where governmental discretion plays a part in the determination of the special rate of tax on extraordinary income.

General Averaging

In Switzerland, the federal defence tax, the basic income tax of the Confederation, is determined for two years at a time and is based on the average of the two accounting years preceding the year of assessment, with special commencement and cessation provisions. This averaging is available to all individual taxpayers.

In Australia, persons engaged in "primary production", that is, production resulting directly from the cultivation of land, may elect to average their entire taxable income over the base year and the four preceding years. A loss is treated as zero income, but may be carried forward to reduce income of a subsequent year.

In the United States, a general averaging provision was introduced in 1964. Because this is the most recent attempt on the part of any country to find a solution to the problem of fluctuating incomes, and because tax reforms in the United States are of particular interest to Canada, the scheme merits consideration in some detail.

The President of the United States in his 1963 Tax Message had the following to say about the proposed introduction of a general averaging provision:

> "I have instructed the Secretary of the Treasury to present to the Congress as part of this program an income averaging provision. It will provide fairer tax treatment for those who receive in a single taxable year unusually large amounts of income as compared to their average income for preceding years.
>
> "The proposal will go beyond the narrowly confined and complex averaging provisions of the present law and will permit their elimination from the Internal Revenue Code. It will provide one formula of general application to those with wide fluctuations in income. This means fairer treatment for authors, professional artists, actors and athletes, as well as farmers, ranchers, fishermen, attorneys, architects and others."

The averaging provision is available to a taxpayer whose ordinary income for the year, that is, exclusive of capital gains, wagering gains, gifts and bequests, etc., is more than one third higher than his average income for the prior four years 10/. The provision does not apply unless the excess amount is more than $3,000. This excess is taxed in an amount equal to five times the additional tax which would be payable on one fifth of the excess. The tax on the excess amount is then added to the tax on the balance of the taxpayer's current income to determine the total tax due for the year. This procedure, in general, results in slightly less

relief than an actual spreading of the excess income over a five-year period, and obviously still less relief than if all the income were averaged. Because it operates entirely in the current year, however, it does not require the amendment of tax returns or recomputation of tax for prior years. This greatly simplifies the administrative problem. The actual steps involved in the computation of tax in the applicable averaging year are as follows:

1. The average income for the prior four taxable years is determined.

2. The prior four-year average is increased by one third to produce a base income, the amount not subject to averaging.

3. The amount of base income is subtracted from current income to determine the excess amount which will be subject to averaging, that is, "averageable income", providing it exceeds $3,000.

4. The tax is computed for an amount of income equal to base income plus one fifth of the averageable income.

5. Tax is computed for the amount of base income alone and subtracted from the tax determined in step 4.

6. The difference between the two taxes determined in steps 4 and 5 is multiplied by five to provide the total tax on the averageable income.

7. The total tax on the averageable income computed under step 6 is added to the tax on the base income alone computed under step 5, to give total tax liability for the year.

An important feature of the United States averaging scheme is that it does not give relief to taxpayers who have experienced reductions in their incomes. While undoubtedly an administrative convenience, the requirement that "averageable income" exceed $3,000 seems to us to rule out averaging for the low income taxpayer.

ALTERNATIVES TO THE PRESENT POSITION

There are basically two approaches to the solution of the problem of lump sum and fluctuating income. First, there is the method of piecemeal relief, where the problem of fluctuating tax bases is, in effect, regarded as a series of separate problems, and specific and separate remedies are provided. This is the method now in effect in Canada. The second approach regards fluctuating and irregular incomes as a general problem to be solved by the application of a general remedy, applicable to all taxpayers. We favour the adoption of a combination of the two, with general but restricted provisions that would be available to all taxpayers, but with more generous provisions to deal with special hardship situations.

A piecemeal relief system has several advantages. The system can provide specific relief for specific problem areas, and in some respects achieves its limited purpose in a straightforward and administratively simple fashion. Further, a piecemeal system is already in existence in Canada and taxpayers are accustomed to it. Finally, the present system contains within it several useful devices that could be modified or applied more widely. But we believe the advantages of the piecemeal system are definitely outweighed by the following disadvantages:

1. There are many reasons for lump sum and fluctuating incomes, and it would be impossible to provide adequately for all these different circumstances in a system geared to a series of special relief measures.

2. The problem of fluctuating income is apparently fairly widespread, and the present system cannot provide general relief. With a great widening of the tax base this difficulty would be even greater.

3. The present measures provide different degrees of relief for different types of income and are therefore inequitable.

4. As long as there are separate relief measures for specific types of

income or specific vocations, there would be continuing pressure to have the law changed to include other types of income or vocations.

5. Special relief measures tend to complicate the tax legislation. This would give the well-to-do and informed taxpayer an advantage over other taxpayers.

For all these reasons, we believe that the Canadian tax system should have general averaging provisions available to all taxpayers.

In our investigation of the alternative relieving provisions that might be introduced, we have placed great emphasis on the need for methods that had the following characteristics:

1. They should be made available on an optional basis.
2. They should be neutral among types of gains.
3. They should be administered with relative ease.
4. They should allow forward as well as backward averaging.

Many methods of relief were considered in the light of these objectives. We examined the provisions now available in Canada, modifications of the existing provisions, the methods used in other countries, and a number of proposals that have been made by our research staff and by public finance authorities. Several of these alternatives, in addition to those already described, warrant a brief comment.

Progressive Averaging

Under a progressive averaging plan the total sum of taxes paid over the averaging period, which might be a lifetime, should equal the total taxes that would have been paid had the cumulative average income, including the current year's income, been received in equal instalments in each year of the averaging period. Taxes due under this plan could be computed by multiplying the tax due on the current year's cumulative average income by the number of years in the averaging period, and subtracting from this

amount the taxes already paid for earlier years of the averaging period computed in a similar manner 11/.

A variation of this system is to divide the life of a taxpayer into three or four periods, for example, from birth to majority, majority to age 35, age 36 to 65, and then age 66 to death. A progressive averaging system differs from the moving average system discussed below because it does not involve dropping an earlier year as each later year is added to the base.

We rejected progressive averaging not only because of its administrative complexity, but also because we could see no justification for using a lifetime, or the lengthy periods described above, as the interval over which income should be measured.

Moving Average

Under a moving average, tax for a given year is computed by reference to the average income for the current year and the preceding years of the averaging period. That is, tax on the income for the first year of the period would be paid. The tax for the second year would be based on the average taxable income for the two years, and that for the third year on the average taxable income for the three years. This procedure would be continued for the period of time established as the averaging period and, upon reaching the end of that period, the first year would be dropped and the current year added.

If it were made available on an optional basis we would have no fundamental objection to the use of a moving average as the method of relief. Indeed, because each year affects average income for the sequence of years of the averaging period, the moving average creates fewer uncertainties for the taxpayer than the block average approach. Under the latter approach the taxpayer has to decide whether or not he should "use up" a particular year, for each year can be included only once in the average. However, the

moving average is slightly more complicated than the block average, and the advantages do not seem great enough to warrant the change from the block approach which is now in use for farmers and fishermen.

Deferment of Tax

Under this option, the taxpayer would be permitted to spread his payment of taxes on lump sum payments forward over a period of years. This method was actually used in Canada in 1946, in respect of certain lump sum payments. It was abandoned after a very short experience, presumably on the grounds that there were too many circumstances, such as death or bankruptcy of the taxpayer, in which the government would be unable to collect the tax due. This difficulty would be avoided if the taxpayer were required to post a bond, or the government were provided with some other form of security. We recommend in Chapter 17 that taxpayers in receipt of non-cash gifts against which the donee cannot borrow should be given an extended period of time for the payment of the tax which is attributable to the gift; we also recommend that interest should be charged and safeguards adopted to ensure payment.

Carry-over of Unused Personal
Exemptions or Tax Credits

This method would permit a taxpayer who did not utilize his full personal exemptions or tax credits in a tax year to carry over to a subsequent year or years the unused portion of these exemptions or credits. Unused exemptions or credits are almost invariably applicable to taxpayers in the lower income tax brackets, and the introduction of such a measure might well mean that many such taxpayers would be relieved of all or a substantial portion of their taxes, perhaps for a period of years. The approach to block averaging that we recommend would, in effect, allow the carry-over of personal tax credits within the averaging period.

Income Adjustment Accounts

Some taxpayers have substantial income for a limited period relative to their probable future income, for example, some professional athletes or other entertainers in their peak years. Yet to offer special relief only to named occupations is clearly discriminatory; and to allow all taxpayers long averaging periods is not feasible on administrative grounds.

There is, we believe, a method of providing a form of long-term forward averaging that is administratively workable. The method would involve the use of what we have called Income Adjustment Accounts. These accounts, in the form of non-interest-bearing government deposits, would provide a method of granting relief to all taxpayers rather than to certain taxpayers for special circumstances. The Income Adjustment Accounts would permit a taxpayer to deposit part of his income with the government and deduct that amount from his income for the year in which the deposit was made. Withdrawals from these Accounts would be added to income in the year withdrawn. They would thus provide a form of "do it yourself" forward averaging without the drawbacks of most forward-averaging schemes. The taxpayer would surrender his economic power and postpone his tax liability, but he would "pay" for the postponement privilege by forfeiting the income that otherwise would be earned on the amount deposited. The system would therefore be self-policing. If future income did not fall, so that lower marginal rates could not be applied in the future, the depositor would have paid a postponement fee in the form of forgone income. It is this need for a postponement fee that has led to our recommendation that no interest should be paid on these deposits. In addition we feel that the payment of any interest, even at a nominal rate, would provide the Income Adjustment Accounts with an unfair competitive advantage over banks, trust companies or other institutions receiving deposits 12/.

These Accounts would not be without their limitations and problems.

There would have to be a minimum time period before a deposit could be withdrawn to prevent a short-term deposit over the year end being used to postpone tax for one year. It would be important to prevent taxpayers borrowing against their Income Adjustment Account deposits, and therefore deposits in the Accounts would have to be non-assignable. They would be of no assistance to those who receive income in the form of non-marketable assets. Although this form of averaging would therefore be inadequate as the only form of relief, we believe it would have many advantages as a supplement to the traditional averaging techniques if a few safeguards were applied.

Registered Retirement Income Plans

In Chapter 16 we recommend that contributions to defined Registered Retirement Income Plans should be deducted from current income within limits related to the annual income that could be obtained under such a plan from age 65. In addition, the investment income or property gains generated would not be taxed when received by the trustees of the plans. Payments from the plans would be brought into income when received. There would be few restrictions on the assets that could be held by the plans, and therefore it would be possible to contribute real property to them. The deferment of tax on the income generated by the assets held by such plans until received by the taxpayer, would continue to constitute an extremely important concession designed to encourage low and middle income individuals and families to provide for their retirement.

These Registered Retirement Income Plan provisions also provide a liberal and flexible method of averaging for low and middle income tax units that receive large lump sums, such as gifts, bequests or windfalls. If the individual or family had not already reached the limit imposed on contributions to such plans, and it is extremely unlikely that low income people would have done so, given the limits we suggest, a substantial contribution could be made in one year and the contribution deducted

from income. Any withdrawal would be brought into income, but the penalty which would normally apply on withdrawals before the age of 60 would not be applicable if the withdrawals did not increase total income for the year over $7,000. Further discussion of these plans is contained in Chapter 16.

Treatment of Losses

The carry-back and carry-forward of realized losses, in order to reduce net gains of earlier or subsequent years, provides a method of income averaging. Although we think it would be necessary to impose some restrictions on the deductibility of losses, primarily to ensure that personal consumption expenditures are not deducted, our basic proposal which is discussed in Chapter 9 would allow most losses (to the extent that they exceed other income for the current year) to be carried back for two years and forward indefinitely. These losses should be deductible from net gains of all kinds. Our proposed treatment of losses would make it possible to level out income more than has been possible under the present tax system.

Asset Revaluation

Permitting the revaluation of some assets to their demonstrated market value at the discretion of the taxpayer also provides a method of averaging. We recommend that a taxpayer should be permitted, without actually realizing gains or losses, to pay some of his potential tax liability on his unrealized property gains in low income years, and obtain relief by including unrealized losses in high income years. In Chapter 15, we discuss the optional revaluation provisions that we recommend.

RECOMMENDED TREATMENT OF LUMP SUM AND FLUCTUATING INCOMES

It should be made clear at the outset that the recommendations in this chapter should be applicable only to Canadian residents. To permit non-residents the relief contemplated for irregular income would raise serious administrative problems.

Block Averaging

The advantages of a general averaging provision over a piecemeal system of relief have been outlined. In the belief that the problem of lump sum and fluctuating incomes is sufficiently widespread to require a more adequate method of granting relief than now exists, we recommend that a block averaging provision should be introduced that would be available to all taxpayers. However, to reduce the administrative problems that such a provision would entail, there should be restrictions, at least initially, based on both a minimum fluctuation in income and the minimum tax saving that would have to be obtained before the block averaging provision could be employed by a taxpayer. We expect that it might be possible at some future time to remove these restrictions and to allow everyone to average regardless of the amounts involved. However, we suggest the use of limitations initially to ensure that the provision can be easily administered. Such a general block averaging provision would provide the same kind of treatment for all taxpayers whose incomes fluctuate frequently, or who move quickly from a low income bracket to a high income bracket or vice versa. It should be emphasized that our recommendation would allow averaging whether income was rising <u>or</u> falling. It would also provide a means of mitigating the severity of the tax burden in respect of lump sum income payments of any kind which are received by a taxpayer. In order to provide the taxpayer with an adequate period of time in which to determine his status in relation to any change in his tax unit, to carry back losses of subsequent years, if applicable, and to decide which years should be averaged, there should be an extended period for filing amended returns if the only change is to make an election to average and to claim a refund based on that election. However, in order to avoid undue deferment of election, no interest should be payable on such a refund.

The block averaging system has the advantage of already being an accepted part of Canadian tax legislation, and it appears to have operated to the reasonable satisfaction of both taxpayer and administrator. We do not think

that the advantages of the more complicated moving average system discussed above would justify its adoption at this time. As experience is gained by taxpayers and by the administration, adoption of more refined techniques should be considered.

We suggest that the block averaging provision be made available to all resident taxpayers. We believe it is desirable to have all tax units treated in a similar manner, and with a few exceptions that we deal with later in this chapter, to accord similar treatment to all kinds of fluctuating or lump sum income. Adoption of a general averaging provision would permit the repeal of all of the existing piecemeal provisions.

Period of Averaging. It is necessary in a block averaging system to specify over what term or period of years income can be averaged. The period must be long enough to level effectively the peaks of income, but not so long as to create an impossible administrative task in recomputing tax on many returns for many earlier years. Three-year averaging would appear to be the minimum that would take care of most income fluctuations; five-year averaging is probably the maximum administratively feasible period. At present, farmers and fishermen are entitled to use a five-year block average. In order to avoid worsening the position of these two groups and because we think it is practical, given the methods of data storage and handling now available, to treat all taxpayers in the same way, we recommend that a five-year rather than a three-year averaging period should be adopted. Only consecutive years, with no years omitted, should be included in an averaging period. No overlapping of years in different averaging periods should be allowed except upon death or on giving up Canadian residence, for the reasons given later in this chapter. Only years in which the taxpayer had been resident in Canada should be included in an averaging period.

The five-year period should be treated as the maximum number of years that could be averaged. Taxpayers should be permitted to average over shorter periods if they wished to do so.

Restriction Related to the Size of the Tax Saving. To keep the administrative problems of a general averaging scheme within bounds, relief in respect of lump sum and fluctuating incomes should be provided, at least initially, only where fluctuations in the tax liabilities are substantial. Therefore we recommend that the right to average should only be available when the income in the lowest income year of the averaging period is less than 75 per cent of the income in the highest income year of the period. In addition, tax relief should be allowed only to the extent that the reduction in tax resulting from the averaging procedure exceeded $50. These restrictions would eliminate small claims and would restrict the use of the provision to those with material fluctuations in income.

Method of Calculation. The calculation to determine the tax credit (or refund), for those with fluctuations of income in excess of the limit, should be as follows:

1. For the years being averaged, the incomes, tax credits, and tax payable would each be aggregated.

2. An appropriate special averaging rate schedule would be used to arrive at the tax payable before tax credits on the aggregate of the incomes after loss carry-over and charitable and medical deductions.

3. The total of the tax credits claimed in the years concerned would be deducted from the tax payable computed in 2.

4. The amount obtained in 3 would be compared to the total of the actual taxes paid for the years concerned. If the actual taxes paid were less than the amount in 3, then the fluctuation of income would not have been sufficient to produce a benefit under the averaging procedure. If the actual taxes paid exceeded the amount in 3, then the difference would be claimed as a tax credit from tax otherwise payable in the year or as a refund.

The use of the special averaging rate schedules would mean that only one computation of a new tax payable would be necessary, instead of a new computation for each year averaged. Changes in tax rates would be reflected in these schedules, so that a taxpayer would not have to refer back to the rate schedules of prior years. There would be separate individual and family rate schedules for the two-, three-, four- or five-year periods eligible for block averaging. The averaging schedules would represent an aggregation of the individual schedules for the years concerned. Thus, if for each of five successive years $10,000 of taxable income was subject of $2,260 in tax and the next $2,000 of taxable income was taxed at 35 per cent, the five-year rate schedule would show that $50,000 of taxable income was subject to $11,300 in tax with the next $10,000 of taxable income being taxable at 35 per cent. In addition, and to save a separate computation, the rate schedule would include in each of the income tax totals a further basic amount of $50, this being the amount of the reduction in tax that would not be refundable.

There are alternative methods of computing the tax adjustment under a block averaging procedure. For example, it would be possible to establish a minimum income fluctuation and to only allow the amount in excess of such fluctuation to be averaged. However, we feel that the procedure we have recommended would limit the election to those cases where it would be of some importance to the taxpayer and would reduce the necessary computations to a minimum.

Starting and Ending Points. The starting point for block averaging would be the first full year in which a particular tax unit came into being. In Chapter 10, we recommend that tax units would be formed at the beginning of the year in which any of the following circumstances occurred:

1. When an individual lost his or her dependant status otherwise than by marriage, an individual tax unit would be formed.

2. When a family tax unit was formed through marriage.

3. When a divorce or a legal separation took place and each spouse formed a new tax unit; if a spouse retained custody of a dependent child or dependent children this would be a new family unit; otherwise it would be a new individual unit.

4. When an unmarried woman had a child and retained custody of the child a new family unit would be formed.

5. When an unmarried individual adopted one or more children a new family unit would be formed.

6. When an individual or a family became resident in Canada an individual tax unit or a family unit would be formed.

The end of a period for block averaging should not be later than the termination of the taxable unit. In Chapter 10, we also recommend that a family unit would terminate when any of the following circumstances occurred:

1. The death of a surviving spouse who had no dependent children.

2. The remarriage of a surviving spouse.

3. The divorce or legal separation of spouses.

4. If all members of a tax unit ceased to be resident in Canada and did not elect to continue to be taxed as Canadian residents.

5. If the family unit consisted only of dependent children and the last of those children ceased to be dependent through marriage or otherwise, or died.

An individual tax unit would terminate in the event that the individual died, ceased to be resident in Canada, married or acquired a dependent child or dependent children through birth or adoption.

Because the first year of an averaging period could not be earlier than

the first year in which a particular tax unit came into being, newly independent individuals would not be entitled to include in the averaging period years when they were dependants and had no taxable income. Similarly, recently married couples would not be entitled to include in the computation years when they were single and taxable at higher rates.

Where one of the spouses in a family unit had filed separate returns for consecutive years, he or she should be entitled to make an election for the averaging of income for those years. However, a family unit as a whole should be entitled to average income only for consecutive years in which joint returns were filed.

When the family unit has been reduced to one member, the unit would continue but, as we have said, tax liabilities would be determined on the individual rate schedule. It should be provided that when block averaging has been applied under this circumstance the tax would be determined on the basis of the individual rate schedule for the whole averaging period. This would restrict the advantage that could be derived from averaging on the death of one spouse where there were no dependants.

We recommend that on the death of a taxpayer there should be realization of his property gains except for property transferred to members of his continuing family unit. We also recommend a deemed realization of property gains under certain other circumstances. This could result in substantial income in that year. To ensure that the income for the year in which such a realization or deemed realization took place could be averaged over five years, we suggest that, on the termination of a taxable unit because of death or ceasing to be resident in Canada, backward averaging should be permitted for the previous five-year period, even though one or more of those years had already been used in an earlier block averaging election. In this case the income to be taken into account for each year which was in the previous block averaging period would be the average income for that period and credit would be given for the tax calculated under the previous averaging which is attributable to that income.

It should be pointed out that by relating the block averaging period to the life of the taxable unit rather than to the sources of income of the members, there would frequently be large refunds in the early years of retirement. However, if averaging were limited to working years only, some taxpayers might be able to avoid the limitation because of the difficulties in defining retirement. We also believe a worth-while social purpose would be achieved by this form of relief to persons who experienced a sharp drop in income on retirement.

Moreover, our approach would permit families to average their incomes after the death of the income-earning spouse and, in effect, to obtain a tax rebate for earlier years of higher income.

Treatment of Losses. Where losses had been incurred by a tax unit prior to the commencement of the averaging period, these losses would be available to reduce income for one or more years in the averaging period. In this way such losses would be taken into account in the block averaging calculation. Similarly, if losses were incurred in one or both of the two years following the end of the averaging period, such losses would be eligible to be carried back so as to reduce the income for one or both of the last two years in the averaging period. We recommend that the time for making an election to average should be extended sufficiently to permit the carry-back of such losses.

If a loss occurred in a year which was within the averaging period, this loss could be applied in the usual way to reduce income for other years which may be prior to or within the averaging period or both. Any such loss, to the extent that it had not been fully used up by the end of the averaging period, should be allowed as a deduction in computing the aggregate income for the averaging period. The amount of the loss so deducted would not be eligible to be carried forward to subsequent years. It should be noted, however, that a taxpayer would not be required to make an election to average his income and if he did not do so the loss would continue to be available for carry-forward and application against income of subsequent years.

Comparison with United States Provision. Although we recognize that the United States approach has some administrative advantages over our block averaging proposal, we think that, on balance, our proposal is superior to the United States method. In particular, we think that there is as much, if not more, justification for giving relief when income declines sharply as when it rises sharply. The conditions under which the United States method bestows relief are exceedingly capricious. If the United States method were modified to provide relief when income changed in either direction, and if the tests of eligibility were reduced, we would consider it a satisfactory alternative to our proposal.

Administration. We do not wish to minimize the magnitude of the additional work that adoption of our proposal would create. It would mean an increase in the work load of the administration and more record keeping by taxpayers. We are convinced, however, that the additional cost would be fully justified.

Income Adjustment Accounts

On equity grounds we think there is as much reason to allow a taxpayer to take his expected future income into account in determining his current tax liability as to allow him to take his past income into consideration. This is in general ruled out under block averaging. Moreover, by restricting the block average to a five-year period, the longer swings in income, such as the substantial earnings of professional athletes, actors, and writers in their peak years, may be given inadequate relief. To overcome these two limitations of the block averaging scheme, we also recommend that a system of Income Adjustment Accounts be adopted. Like block averaging, these Accounts should be made available to all taxpayers on an optional basis. It should be noted that by combining both of these averaging devices it would be possible to average one year's income over a substantial period. Part of the income for the year could be deposited in an Income Adjustment Account and averaged forward for an indefinite number of years, while the other part of the income could be averaged back five years. Income Adjustment Accounts should be non-

transferable, non-negotiable and non-interest-bearing deposit Accounts administered by the government.

Deposits into Income Adjustment Accounts made during the calendar year, and within sixty days of the end of the calendar year, should be made deductible from income for that year for tax purposes.

Limitations of Reductions in Current Income. We would not limit the amounts of deposits in these non-interest-bearing Accounts. By allowing the deposit of all gains on disposition of property, the low or middle income taxpayer with infrequent gains could spread the gain over a number of years and reduce his tax accordingly, while the taxpayer who regularly received such gains would have no advantage. The same would be true of other lump sum receipts, such as gifts or gambling gains.

Speculation. Unless the use of the Income Adjustment Accounts was restricted, there would be some danger that taxpayers might use them when they expected that personal income tax rates might decline, or as a means of temporarily deferring payment of their tax liabilities. They could reduce their incomes by making deposits just before the end of the year, in the knowledge that they could withdraw the funds early in the subsequent year, and so use the Income Adjustment Accounts to speculate or to defer taxes at virtually no cost except the loss of interest on their funds over this short period. To reduce the profitability of such a procedure it would be necessary to require that the balance in a taxpayer's account could not be less than the sum of the deposits made within the previous twelve-month period.

The use of Income Adjustment Accounts would imply that all income was taxed at some point, but that the time pattern of income received and of income subjected to tax could be different. The taxpayer would not, however, gain by deferment of tax as such, because the provisions of such Accounts would be designed so that the taxpayer who made deposits when his marginal rate of tax was 50 per cent and made withdrawals when his marginal rate was

also 50 per cent would suffer a loss, because he would receive no income thereon, as compared with the taxpayer with the same income experience who made no deposits or withdrawals but paid his tax at the time he earned his income. The man with fluctuating income could, of course, gain by using the Accounts, although where small changes in marginal rates were involved, the gain would be at least partly offset by the lack of income from the funds deposited. The government would obtain the use of the money on an interest-free basis and accordingly would not suffer by deferment of the tax liability.

Withdrawals. Withdrawals from Income Adjustment Accounts should be added to taxable income in the year in which they were made. It would be prudent to provide that sums withdrawn should be subject to a withholding tax. The evasion problem should not be serious, because the administrator of the Accounts would report all withdrawals. A withholding rate of 30 per cent should be acceptable. Of course, the amount taken into income by the taxpayer should be the gross withdrawal before deduction of withholding tax, and credit would be given, if necessary in the form of a refund, for tax withheld at source by the administrator.

It must be borne in mind that the purpose of the Income Adjustment Accounts is to allow the taxpayer to spread his income more evenly to escape the high marginal rates that would apply in years of unusually high income. It is intended that taxpayers defer but not escape tax on the deposited income. Therefore, the general rule should be that funds deposited by a tax unit must eventually be taxed as the income of the same tax unit. In particular, the deposits should not be transferred to beneficiaries outside the unit without being subject to tax in the hands of the depositing unit. However, to avoid creating barriers to marriage and divorce, we would not require individuals to bring their Income Adjustment Account deposits into the income of the terminating individual tax unit before marriage, nor would we require spouses to bring such deposits into the income of the terminating family tax unit before divorce or legal separation.

When a taxpayer emigrated, any balance that remained in his account would have to be brought into income in the last year he filed a return as a Canadian resident. This procedure is discussed in more detail in Chapter 15. If he satisfied the administration that he would meet his tax liabilities, the taxpayer could withdraw the deposit in the usual manner whenever he chose to do so.

To limit the possibility of the pyramiding of tax liabilities at death, we believe it would be desirable to require that all individual tax units withdraw all deposits on or before reaching the age of 60 and that family units should withdraw all deposits on or before the date on which the youngest member of the unit reached the age of 60. Such a provision would prevent most units from postponing their tax liabilities until death.

Modification of Income Adjustment Accounts. A modification would be necessary to accomodate the aggregation of dependant and family income. The general rule should be that Income Adjustment Account deposits made by a tax unit must, on withdrawal, be brought into the income of the same tax unit, in order to prevent tax-free transfers of property between units. We recommend that a further exception should be made to this rule to provide some flexibility with respect to the aggregation of the dependant's income with family income.

As we pointed out in Chapter 10, we believe that the system should require dependants in receipt of gifts from outside the family, and in receipt of employment or business income earned at arm's length in excess of the $500 exemption, to aggregate all or part of this income with the income of the family for tax purposes. However, because the dependant and the family may not consider these receipts to be income available for current consumption, we suggest that the dependant should be able to deposit these amounts in special Income Adjustment Accounts in the year they were received. The deposits would be made in the name of the dependant and would be deductible from the income of the family. The family would not be required to bring these deposits into income at the time the dependant loses his or her dependant status, although withdrawals made while the dependant

is still a member of the unit would be included in the income of the family unit. Deposits could be withdrawn later and brought into the income of the tax unit of which the former dependant was then a member.

These deposits should earn interest for the period during which the depositor was dependent. Only a modest rate of interest should be paid to compensate for the fact that, in principle, the deposit should be subject to tax and only the after-tax deposit should earn a return.

Other Procedures

The two general relief measures we have advocated would meet the situations encountered by most taxpayers most of the time. But we recognize that it is important for acceptance of the comprehensive tax base that generous averaging be provided in all the circumstances which, although infrequent, can nevertheless produce hardship. We therefore suggest the adoption of a few special relief measures. What we have tried to do is to give special relief in special circumstances and not to special groups.

Deferment of Tax Payments. As we envisage the Income Adjustment Accounts, only cash deposits would be accepted. For those who received non-cash income, had no cash on hand and could not borrow, the Accounts obviously would not be helpful. Taxpayers would, of course, be able to utilize the block averaging provisions for this kind of income. However, a liquidity problem could still exist and for this reason we suggest that those in receipt of gifts or other income that is in a non-liquid form should be allowed, on the provision of adequate security, to pay the tax on this part of their income, with interest, over a period of, say, five years. This is discussed in Chapter 17.

Registered Retirement Income Plans. There are some other procedures, which we discuss in greater detail later in this *Report*, that will also serve to even out income fluctuations.

In Chapter 16 we discuss the details of our proposals for Registered Retirement Income Plans. The important aspect for averaging purposes is that the only limit on annual contributions we propose is one that would set the maximum amount that could be accumulated in the plan at any one time. Thus, a taxpayer who received a relatively large amount of income in one year and had not already made full use of his Registered Retirement Income Plan, could make a substantial contribution to such a plan and deduct the amount of such a contribution from income.

In Chapter 16 we also discuss the taxation of government and private insurance plans that provide for the continuance of income when unemployment or accident reduces or ends the earning capacity of the taxpayer. For these types of plans, such as workmen's compensation, unemployment insurance, supplementary unemployment insurance, and sickness and accident insurance of a salary continuance nature, we recommend that premiums should be deductible and benefits taxed in full when received.

Although these provisions are not averaging devices, they would encourage a form of income spreading to maintain a certain minimum level of income. Thus, they would encourage the individual himself to provide for periods when his income might otherwise be less than average.

<u>Property Revaluations</u>. In Chapter 15, we suggest that holders of property should be permitted to revalue such property, either up or down, to reflect current market prices. Although we would not expect many taxpayers to revalue their property upward, nevertheless such revaluations might be advantageous in years when income was relatively low.

<u>Registered Annuities</u>. We also recommend that the recipient of certain kinds of lump sum payments, such as damage awards related to the loss of future income, should be permitted to exclude such amounts from income if they were used to acquire government annuities registered for this purpose. Payments from the annuity would have to begin immediately and would be included in

income in the years received. This election would be of assistance in a limited number of cases.

Income Subject to Averaging

It is useful to distinguish four measures of income:

1. Net income for the year before the deduction of losses incurred in past years.

2. Net income for the year after the deduction of losses incurred in past years.

3. Income as defined in 2 minus charitable and medical deductions.

4. Income as defined in 3 minus losses incurred in subsequent years.

We recommend that the following rules should be introduced:

The allowable medical and charitable deductions should be computed by reference to 2.

Block averaging, or any special averaging provisions on death, should apply to 4; however, it could be elected initially on the bases of 3 and if losses are incurred in the subsequent two years an amended block averaging would be filed based on 4.

Reductions of income or additions to income resulting from the use of Income Adjustment Accounts, special deposits for dependants and registered annuities would be taken into account in the determination of 1.

By relating the medical and charitable deductions to the net income for the year before the deduction of losses incurred in subsequent years, these deductions would not have to be recomputed if losses were later carried back to reduce the net income for the year or if the income for the year was later included as one of a block of years for averaging purposes. This would be an important administrative advantage. It would also mean that tax credits

unused in low income years could be deducted against the higher taxes imposed on the average taxable incomes for the block averaging period. Unused tax credits could, in effect, be carried forward within that period.

CONCLUSIONS AND RECOMMENDATIONS

1. It would be unfair to impose substantially heavier taxes on those with imcomes that fluctuate from year to year. Equity requires that some form of income smoothing be permitted. Without this, taxpayers who were able to manipulate the timing of their receipts would have an advantage over other taxpayers.

2. For administrative reasons we could not recommend the full taxation of property gains on a realized basis unless liberal averaging provisions were available; the gains might have arisen over a period of years and it would be inequitable to tax them as though they arose in the year in which they were realized.

THE PRESENT SYSTEM

3. The present system of piecemeal relief is relatively simple to administer but affords special relief to some occupations and some kinds of receipts that are no more deserving than others. Some of the relief provisions have been too generous; the problems of other taxpayers, such as professional athletes and other entertainers, have been ignored. The present averaging provisions are extremely complicated and are inequitable.

DESIRABLE ATTRIBUTES OF AN AVERAGING PLAN

4. We believe that an averaging system should have the following attributes:
   a) It should be available to taxpayers on an optional basis.
   b) It should be neutral among kinds of gains.
   c) It should permit both forward and backward averaging.
   d) It should take into account relatively few earlier years to reduce the administrative problem.

We have developed our proposals in the light of these criteria.

BLOCK AVERAGING

5. We recommend the introduction of a block averaging system which would be available to all resident individual and family tax units. The averaging period should be five years, although taxpayers should be able to average fewer years if they wished to do so. Only consecutive years, with no years omitted, should be included in the block of years for averaging.

6. Except where there has been a realization or deemed realization of property gains upon the termination of a tax unit because of death, or on giving up Canadian residence, a year once used in a block of years for averaging purposes should not be included in another block of years.

7. There should be no restriction on the kinds of income that could be averaged or on the direction of the fluctuations in income.

8. The only restriction should be that the lowest income in the period must be less than 75 per cent of the highest income in the period, and that the tax saving brought about by block averaging would be reduced by $50. We suggest these restrictions to reduce administrative costs. With experience and increased mechanization, these restrictions might be dropped.

9. The first year that could be included in a block of years to be averaged should be the first full year in which a particular tax unit was in being. The last year that could be included in a block of years to be averaged should be the year in which the particular tax unit terminated. Generally speaking, this would result in refunds of tax after retirement, and after the death of the income-earning spouse.

10. Losses carried forward or back from years outside the averaging period could be taken into account in computing the income which was being averaged. Unused losses incurred in the averaging period would be deductible in computing the averaged income, but to the extent they were so used by reason of an election to average, they would not be available for future carry-forward.

INCOME ADJUSTMENT ACCOUNTS

11. We also recommend a system of Income Adjustment Accounts that would make it possible for taxpayers who expect reductions in future income to reduce their current income by making non-transferable, non-negotiable, non-interest-bearing deposits with the government.

12. When used in conjunction with the block averaging system, Income Adjustment Accounts would make it possible to spread income over many years.

13. There should be no restrictions on the amount of income that could be deposited in any one year. It would be necessary to impose a few restrictions on the timing of withdrawals to prevent speculation on changes in tax rates and postponement of tax through deposits made just before one year end and withdrawn early in the following year.

14. Because the Income Adjustment Accounts would be non-interest-bearing, taxpayers would pay a price for tax postponement. This would make the system self-policing.

15. A refundable withholding tax should be imposed on withdrawals, in order to prevent evasion.

16. To prevent a conjunction of taxes at death, the use of Income Adjustment Accounts should be denied to individuals of advanced years.

17. The funds deposited in an Income Adjustment Account by a tax unit should,

with certain exceptions, be taxed on withdrawal to the same tax unit to prevent tax-free transfers of property between tax units. These funds would be taxable in a year in which all members of the tax unit ceased to be resident in Canada.

MODIFICATION FOR DEPENDANTS

18. Dependants should be allowed to make Income Adjustment Account deposits not exceeding gifts received from outside the family and the annual employment or business income earned at arm's length by the dependant in excess of the $500 exemption. These deposits should bear a low rate of interest while the depositor remained a member of the family unit. Unlike the general treatment of Income Adjustment Accounts, the family should not have to bring the dependant's deposit into family income when the child ceased to be dependent. It should be taxed to the tax unit of which the former dependant was a member at the time of the withdrawal.

RETIREMENT INCOME PLANS

19. Under the proposed treatment of Registered Retirement Income Plans discussed in Chapter 16, we recommend that contributions to such plans should be deducted from current income within limits related to the annual income that could be obtained under such plans from age 65. Withdrawals could be made before age 60 without the usual penalty applying to such withdrawals if income, including the withdrawal, did not exceed $7,000 a year. The income earned by the assets of such plans would not be taxed until paid out. Because the recommended limits are high, it would be possible for most taxpayers in receipt of a substantial lump sum to make a large contribution in that year and defer tax until retirement or until annual income fell below $7,000.

PROPERTY REVALUATIONS

20. We propose that taxpayers be permitted to revalue their property up or down to reflect current market prices. Gains could thus be brought into income in low income years and taxed at lower marginal rates.

REGISTERED ANNUITIES

21. To put those in receipt of lump sum settlements for damages or compensation for accidents on the same basis as those who received monthly payments, we recommend that such sums should be deductible from income if used to purchase registered government annuities. Payments from such annuities would be brought into income when received.

REFERENCES

1/ From information collected by the Dominion Bureau of Statistics during a 1964 survey of consumer finances, and kindly loaned by them to the Commission.

2/ Section 42.

3/ Section 80. This provision was enacted as section 3(10) of the Income War Tax Act in 1946.

4/ House of Commons Standing Committee on Banking and Commerce 1947-48, Consideration of Bill 338, p. 673.

5/ Section 36.

6/ Sections 139(1)(x) and 27(1)(e). This subject is dealt with in detail in Chapter 22.

7/ Section 85A.

8/ Sections 43 and 43A.

9/ It will be noted that there are a number of other averaging provisions, such as sections 15(2), 15(3), 37(1), 37(3), 64(2) and 85E(4). Other methods of alleviation are provided for in some of these provisions.

10/ Internal Revenue Code, sections 1301-1305, applicable to taxable years beginning after December 31, 1963.

11/ For a detailed discussion of this complicated subject, see W. Vickrey, Agenda for Progressive Taxation, New York: The Ronald Press Company, 1947.

12/ If these accounts paid interest, even at a below-market rate, private financial institutions would be at a competitive disadvantage with the government because the combined value of the tax savings and interest could well exceed the return paid on private deposits.

CHAPTER 14

EMPLOYMENT INCOME

In this chapter we are primarily but not exclusively concerned with the taxation of employees. Many of the problems discussed here relate primarily to the taxation of employees but are not confined to them. The recommendations we make with respect to the taxation of non-cash benefits and the deduction of personal expenses apply also to other taxpayers.

Income and Deduction Problems

The comprehensive tax base, like the present Act, calls for the taxation of all net gains in cash or kind derived from the performance of personal services. There are three problems in achieving this result.

First, there is the problem of determining when the remuneration paid by the employer is to be included in the income of the employee. Although the present procedure of taxing an employee on the cash basis generally poses few difficulties, there are instances when an employer will deduct an amount that is set aside for the benefit of an employee, but, because it is not immediately paid to him, the employee does not include such amount in income until it is received in a later year. The effect is to defer the payment of the tax liability, a result which we believe is inequitable and should therefore be corrected.

Second, it is extremely difficult to determine when and to whom employers provide non-cash benefits and to value these benefits on a consistent basis. Failure to enforce a law that purports to tax non-cash benefits will inevitably result in a loss of respect for the tax system, while to change the law to exclude non-cash benefits from tax would provide some individuals with an inordinate tax advantage.

Third, while employees should be able to deduct the expenses they have incurred in the expectation of generating employment income, it is imperative

that the deduction of personal living expenses should be prevented. The distinction between the two kinds of expenses is often unclear. With a multitude of employees, each with many expenses, the application of the principle to the particular facts relevant to every expense of every employee is utterly impossible from an administrative point of view.

There is no denying that these difficulties are severe; there is also no denying that the present system falls far short of an adequate solution to any of them. The present system discriminates unfairly among different employees and between employees and the self-employed.

The major discrimination among employees arises because some can arrange to receive part of their remuneration in the form of untaxed "fringe" benefits while other employees cannot. The present law provides for the taxation of such benefits, but the administration has been unable to enforce the law effectively. The unequal application of the law means that some employees do not bear their fair share of the tax burden.

With literally millions of transactions taking place every month, general provisions such as those currently on the statute books are, to a substantial degree, an empty gesture. It would take an army of assessors and a battery of courts to apply the law effectively. A system consisting of a few general but unenforceable provisions inevitably degenerates into one where a few are capriciously taxed while the abuses of the many go untouched. We are reluctant to recommend arbitrary tax provisions, but we are convinced that arbitrary provisions that err on the side of liberality and are fully enforced would provide more real (if rough) justice than general provisions that are inconsistently enforced.

The unfair discrimination between employees and the self-employed arises primarily because the self-employed can, in computing their business or professional income, deduct all reasonable expenses incurred for the purpose of producing such income. Employees, in computing their income from employment,

can only claim a few specified deductions as set forth in sections 5 and 11 of the Income Tax Act and no other deductions whatsoever. Skilled manual workers and employed professionals are particularly affected by these stringent limitations on deductions 1/.

Before discussing the major features of the present system in Canada and other countries, and our specific recommendations, we wish to make a few remarks about the approach we have adopted.

Taxation of Benefits

The tax treatment that should be accorded most benefits from employment is usually perfectly obvious. When an employer makes a contribution to an employee retirement income plan or sets aside an amount that is to be paid to an employee at some later date or pays a life insurance premium for an employee or offers attractive stock option or profit sharing plans, it is clear that the employee is being remunerated by the employer and that the employee should pay tax on this remuneration when it is received or applied for his benefit or when he has a right to receive it or when the employer establishes a non-contingent liability to the employee. More difficult problems arise with respect to the element of remuneration that may be contained in the employee's expense account or in the consumer goods and services provided the employee by his employer while performing his duties.

The difficulties in taxing amounts that are set aside or put into trust for the benefit of employees are part of the overall problem of determining when an amount is to be included in income. In Chapter 9 we expressed our belief that although the employee should, in general, only be taxed when he actually received an amount, it is necessary to ensure that such an approach does not lead to deferment of tax liabilities. Because the employer will generally be in business and therefore will be recording his accounts on an accrual basis, it is necessary to ensure that a deduction is not claimed by the payer without the amount simultaneously becoming income to the beneficiary.

To do otherwise would be to invite taxpayers to make arrangements that result in tax deferment. Therefore, we recommend that the basic approach should be to deem that an employee had "received" a benefit at the time an amount paid or accrued by the employer was deducted in computing the income of the employer.

We have adopted four basic rules for the taxation of non-cash benefits:

1. Wherever possible the recipient of a non-cash benefit should bring into his tax base what the benefit would cost if he purchased it in the market and not the cost to or revenue forgone by the employer.

2. It must be assumed that the recipient of a non-cash benefit had a choice between the non-cash benefit and the receipt of a taxable cash payment equal to the cost which would be incurred if the benefit were purchased in the market.

3. When, in the course of carrying out his work, an employee is provided with consumer goods and services by his employer, there may be an element of personal benefit. Because the market value of the personal benefit in each case cannot be ascertained on a simple and consistent basis, there should be arbitrary limits on the costs of such goods and services which are regarded as expenses of earning income. A living expense of an employee paid by an employer in excess of these limits would be deemed to be a personal benefit to the employee. Expenses over these limits should be brought into the tax base of the employee.

4. Where a common facility provides benefits in kind to a number of individuals simultaneously, the market value of the benefit provided by the facility should be included in the incomes of those who enjoy it, according to their relative benefit.

We have tried to develop enforceable tax provisions consistent with these rules.

In order to perform their duties, some employees are required by their employers to travel (as distinct from commute), to live away from home and to entertain clients or staff. An employee required to do these things may be provided by the employer with food, drink, shelter and transportation or he may be reimbursed by the employer when he incurs these expenses 2/. There will be an element of personal benefit in the following circumstances:

1. When the employee is able to enjoy, at the expense of the employer, a style of life that is materially better than he provides for himself at home.

2. When the employee's personal living expenses are reduced.

3. When the purpose of the trip, dinner, party or entertainment is to satisfy (remunerate) the employee rather than to carry out the business of the employer.

There can be no doubt that the value of the personal benefit element in these employer expenses should be brought into the income of the employee. There is also no doubt that where employer and employee are dealing at arm's length the expense should not be disallowed to the employer 3/. Remunerating the employee by providing him with a holiday trip is no less an expense of generating business income than paying the employee's salary. Disallowance of the expense to the employer would be both inequitable and, under some circumstances, ineffectual. If the employer were a tax-exempt organization such as a charitable institution, disallowance of an employment expense that conferred a benefit on employees would be meaningless and the employees of tax-exempt institutions could enjoy an advantage compared with other employees.

To include all of the employee's travelling, living and entertainment expenses paid for by the employer in the income of the employee without any deductions to the employee would usually result in over-taxation of the employee. At the other extreme, to exclude all of these employer-paid expenses from the income of the employee, or to allow the employee to deduct all

expenses under all circumstances, would open a wide avenue for tax avoidance. Some middle ground must be found.

This problem of separating the element of personal benefit is difficult enough, but there is a complication that cannot be ignored. It is not unusual for several employees to enjoy simultaneously the same facility provided by an employer, and for employees to share the same facility with customers or clients. A company cafeteria providing free meals utilized both by employees and customers is not uncommon. Assuming that the market value of the meals provided by the employer is known, to whom and how is the benefit provided by the cafeteria to be allocated? Does the employer have to go to the trouble and expense of recording every meal taken by every employee? How could the company allocate part of the benefit to its guests? To allocate to the employees the benefits enjoyed by the guests would be quite unreasonable. To separate the element of personal benefit in employer-paid expenses, yet provide flexibility where the benefit cannot be readily allocated to specific employees, we recommend the following approach:

1. The Regulations should specify the upper limits for travelling and entertainment expenses that would be exempt where the travelling or entertainment had a bona fide business purpose. Where there was no business purpose, there would be no exemption.

2. The travelling and entertainment expenses of an employee in excess of these limits, if paid by the employer either directly or through reimbursing the employee, would be defined as a benefit and would be:
   a) added to the income of the employee, or
   b) subject to a tax levied on the employer.

3. Employers unable or unwilling to allocate a non-cash benefit to employees (or others) would be required to pay a special tax on the unallocated benefit. Thus, if the employer could not or would not allocate the value of the free meals in the cafeteria between employees and customers,

or to particular employees, the employer would be required to pay a special tax on the unallocated benefit.

The special tax on the employer would be designed to ensure that the cost to the employer would be the same whether the employer provided an employee with taxable income or a non-cash benefit that was not taxed to the employee. To illustrate what would be required, consider an employer who paid a taxable cash bonus of $200 to an employee who paid tax on this sum at the rate of 50 per cent. The employee could buy $100 worth of goods and services in the market from the bonus after tax. The tax on the employer must be such that if the employer gave the same employee a non-cash benefit with a market value of $100 that was not included in the income of the employee, the cost to the employer would also be $200. This could be achieved by taxing the employer at the top marginal personal rate on the before-tax income that an employee in the highest income bracket would have to receive in order to buy the benefit with after-tax income. The special tax paid by the employer on the non-cash benefit that was not taxed to the employee should be treated as an expense to the employer for tax purposes so that the cost to the employer would be exactly the same in both circumstances.

Deduction of Expenses

We now turn to consider the deduction of expenses by employees. The principle involved is clear enough. <u>All</u> of the expenses incurred in the expectation of generating net gains, other than personal living expenses, should be allowed as deductions from all actual gross gains. Distinctions between the kinds and forms of taxable gains, and considerations of whether a net gain actually resulted from the expenditures, are irrelevant. The major problem would be to allow the deduction of all expenses laid out to generate employment income and yet to prevent the deduction of personal living expenses. In most cases it would be obvious that a particular expense fell on one side of the line or the other, but one area of uncertainty would not be dealt with readily.

In our view the deduction of expenses by employees and self-employed persons should be treated in exactly the same way. The present unfair discrimination against employees should be removed. However, because a large number of employees would be involved, the task of assessment would be enormous if each employee submitted an itemized claim for his or her actual expenses. To reduce the administrative problem to manageable proportions we think it would be necessary to provide an optional deduction of a percentage of gross employment income, with a dollar limit, that could be taken by an employee in lieu of the deduction of actual expenses. Those employees with deductible expenses greater than the percentage deduction should be able to deduct their actual expenses. Because self-employed individuals would be expected to have expenses in excess of the optional deduction proposed, we do not feel that this proposal discriminates in favour of employees.

For greater certainty, and to ensure that some obvious personal living expenses would not be deducted, the Regulations should specify those expenses that could not be deducted from gross income by employees, or any other individual, under any circumstances. Such things as commuting expenses, the costs of child care, and recreational club memberships should be explicitly denied as deductions from income.

We now turn to a brief description of the present treatment of employment income in Canada, the United States and the United Kingdom.

THE PRESENT SYSTEM: CANADA

The word "employment" is defined in section 139(1)(m) of the Canadian Income Tax Act as "the position of an individual in the service of some other person (including Her Majesty or a foreign state or sovereign)". It is also provided in section 139(1)(la) that "employee" includes "officer", and in section 139(1)(ab) that "office" is the position of an individual entitling him to a fixed or ascertainable stipend or remuneration, and includes a

judicial office, the offices of a Minister of the Crown, and a member of the Senate or the House of Commons or of a provincial legislature. An office also includes the position of corporation director.

It follows that three types of persons are or may be classed as employees under the Act: persons who are employees in the usually understood sense, being in receipt of salaries and wages; officers, as defined, who receive payment for the offices they hold rather than for the specific work they do; and commission salesmen who are under contract to provide services to an employer.

If the same tax treatment were to be applied under our proposals to all kinds of income, it would be unnecessary to define employment or income from employment. However, because we propose to allow an optional percentage deduction with respect to income from employment in lieu of actual expenses, and because some other exemptions are related to employment income, for example, employment income of dependent children, a definition would have to remain in the Act, although the significance of the definition would be greatly reduced. The present definition appears to be adequate for this purpose.

Treatment of Benefits

Income from an office or employment is brought into charge, together with income from all other sources, under section 3 of the Income Tax Act. The components of employment income are then set out in detail in section 5 of the Act, and include not only wages and salaries and other remuneration, including gratuities, but also the value of "board, lodging and other benefits of any kind whatsoever....received or enjoyed...in the year", but with certain exemptions such as an employer's contributions to a pension plan and certain other employee benefit plans. All amounts received by an employee "as an allowance for personal or living expenses or as an allowance for any other purpose", again with certain exceptions, are also included in

his income. Allowances for board and lodging and travel expenses paid to construction workers in specified circumstances are excluded from their income. Special provisions cover allowances paid to certain other types of employees for travelling expenses.

In addition to section 5, there are other provisions of the Act which specifically bring into tax amounts related to employment, even though some of these would appear to fall within section 5. Section 6 brings into tax directors' or other fees and retiring allowances. The latter include amounts received in respect of loss of office as well as on or after retirement in recognition of long service. Section 25 brings into tax various payments made by an employer to an employee which in substance are from an office or employment but which, save for that section, might escape the tax net.

Excluded from income under section 10 of the Act are various receipts such as unemployment insurance benefits, workmen's compensation benefits, service pensions and expense allowances paid to members of provincial legislatures and municipal officers. Expense allowances paid to Members of Parliament are excluded under the Senate and House of Commons Act 4/.

There is nothing in the Act that would suggest that any distinction is to be made between benefits that come into the pocket and those that save the pocket. Indeed, the use of the words benefits "enjoyed" as well as those "received" seems clearly to include benefits that save the pocket. The meaning of the phrase "benefits of any kind whatsoever" has received little consideration in the courts. However, the administration appears to interpret the expression narrowly, thereby excluding many benefits that should be taxed. Excluded by departmental practice in specified cases are: discounts on merchandise, transportation passes, subsidized meals, special clothing, subsidized school services, transportation to the job, interest-free loans, free recreational facilities, removal expenses and tuition fees. On the other hand, rent-free or low rent housing, personal use of the employer's car, gifts and prizes are taxed at regular rates 5/.

Some employee benefits such as stock options, retiring allowances and death benefits are accorded preferential treatment under the Act 6/.

There is no apparent logic in the uneven treatment of these employee benefits. Because all of the benefits are not available to all employees, inequities between employees are both common and, in some circumstances, substantial.

Deductions

The few deductions from income permitted in computing income from employment are specifically set out in the Act. Some of these apply only to special classes of employees, such as the value of, or rent paid for, a clergyman's residence, certain expenses of railway workers and transport employees, and expenses of employed commission salesmen. Others are general, such as contributions to a pension fund, professional or union dues, and legal expenses incurred in collecting salary or wages due. Some are allowable only if the employee is required by his contract of employment to incur them, such as office rent, salary paid to an assistant or substitute, and the cost of supplies consumed directly in the performance of the duties of the employment. The permissive provision for deduction of these severely limited expenses closes with the words "but without any other deductions whatsoever". Nevertheless, an employee, in common with all other taxpayers, is allowed other deductions in computing "income", as distinct from "employment income". Examples are alimony and tuition fees in certain circumstances.

THE PRESENT SYSTEM: THE UNITED KINGDOM

Treatment of Benefits

The treatment of employee benefits in the United Kingdom is not entirely consistent. The basic principle, established by the decision of the House of Lords in Tennant v. Smith, 7/ is that fringe benefits are not taxable unless they can be turned into money at the employee's option. For example,

free meals provided by an employer would not be taxable because they would be available for the employee's consumption only. However, this principle has not always been consistently observed by the courts. For example, the discharge by an employer of an employee's pecuniary obligation not incurred in the course of employment gives rise to a benefit which the employee may have no option to convert into money but which is treated as part of the employee's income. Also, the principle that benefits not convertible into money are not taxable, has been narrowed by the Finance Act, 1963, which provides that an employee who occupies premises by reason of his employment is taxable on the difference between the rent he pays and the market rent of the premises.

An attempt was made to prevent tax avoidance occasioned by the granting of fringe benefits and allowances in kind, through legislation directed toward the class of employees who were thought to enjoy substantial benefits which escaped taxation. It applied to company directors and others whose salaries plus payments and benefits in kind amounted to £2,000 a year or more. Such people were required to bring into income all benefits in kind received as remuneration whether or not they were convertible into money. However, business entertainment expenses are now to be dealt with in a different way. Abuse in the deduction of these expenses led to the enactment of provisions in the Finance Act, 1965, prohibiting the deduction of all such expenses except those incurred in entertaining overseas customers if the entertainment is of a kind and on a scale which is reasonable in the circumstances.

The Royal Commission on the Taxation of Profits and Income stated: "Theoretically, all benefits in kind received in the course of employment and attributable to it are a form of remuneration and should rank as taxable income, since otherwise one taxpayer's income is not equitably balanced against another's" 8/. But in spite of this acknowledgment of the need to bring benefits into income, the Commission decided that "in practice the burden of administration would be so great that we do not regard an extension of the present law as justified unless the absolute loss of tax and the

relative irregularities between different taxpayers are greater than we believe them to be.... It is not possible to obtain any figures that really bear on the point" 9/.

Deductions

The United Kingdom Income Tax Act is very restrictive in the deductibility of employees' expenses. What is known as the "Schedule E rule" under which all employment income is charged is still in the same form as when it was enacted over a century ago, and states that if the holder of an office or employment

> "...is necessarily obliged to incur and defray out of the emoluments thereof the expenses of travelling in the performance of the duties of the office or employment, or of keeping and maintaining a horse to enable him to perform the same, or otherwise to expend money wholly, exclusively and necessarily in the performance of the said duties, there may be deducted from the emoluments to be assessed the expenses so necessarily incurred and defrayed."

When this rule was enacted, the only people assessed under Schedule E were the holders of certain public offices, such as Members of Parliament, all other employees being taxed under Schedule D. But in 1922 the vast army of salary and wage earners subject to "Pay As You Earn" was transferred from Schedule D to Schedule E.

The severity with which the Schedule E rule has been interpreted has caused such a volume of strong words from judges that the Royal Commission was moved to remark that "there can have been no part of the income tax code which has been so regularly the subject of unfavourable notice" 10/. The narrowness of the Schedule E rule can be seen if it is compared with the rule for deduction of business expenses under Schedule D, which is that no expenses may be deducted except those "wholly and exclusively laid out or expended for the purposes of trade...." There is no requirement under this test that there be an obligation to incur the expenses, as in the Schedule E rule, and no requirement that the expense must have been "necessarily" incurred; and

whereas under the Schedule E rule the expense must have been incurred "in the performance of the duties", that is, in the actual earning of the income, business expenses need be incurred only "for the purposes of" the trade. Furthermore, even if the other requirements of the Schedule E rule are met, the expense will not be allowed unless it is incurred by the holder of the office or employment as such.

The United Kingdom Royal Commission worded its conclusion on the question of deductions from employment income as follows:

> "Finally, we came to the conclusion that the best solution was to recommend a rewording of Rule 9 (the Schedule E rule) on less restricted lines. The wording that we propose would allow the deduction of 'all expenses reasonably incurred for the appropriate performance of the duties of the office or employment'. We have chosen this wording in order to bring the wording of Rule 9 into a closer conformity with the wording of the Schedule D rule and to remove the genuine cause of complaint that the Legislature deliberately imposes upon those in employment a narrower form of allowance for expenses than it accords to those who are deriving a profit (income) from their own efforts." 11/

Withholding of Tax

The United Kingdom system of withholding tax at source from employment income is known as Pay As You Earn. The amount of tax deducted from each payment of wages keeps in step with the employee's income, so that the total tax borne at any date in the year is related to the total earnings to date. A unique feature of the system is that if there has been any over-withholding, the employer must make the necessary refund to the employee and adjust his account with the Revenue. The system appears to be administratively more expensive and complex than the present Canadian system, but has advantages as a built-in stabilizer for the economy.

THE PRESENT SYSTEM: THE UNITED STATES

Treatment of Benefits

The general treatment in the United States of employee benefits in kind is succinctly described as follows:

"The use of benefits in kind as wage and salary supplements has become increasingly widespread in recent years, and has created a major issue of tax policy. These so-called fringe benefits may include meals and lodging furnished to employees at no cost, free medical services, health and accident insurance, discounts on merchandise purchased from the employer, recreational facilities, free parking spaces, bargain lunches, and in some instances free training and other educational opportunities.

"As a practical matter, this type of non-cash compensation has to a large extent escaped taxation. Although the scope of section 61 would appear to be broad enough to include most or all of such items in the tax base, and although the Regulations expressly state that 'if services are paid for other than in money, the fair market value of the property ... taken in payment must be included in income' ... the Internal Revenue Service has thus far made no full-scale effort to tax the value of fringe benefits to the employee-recipients." 12/

In Canada an employee may be taxed in respect of an allowance from which he derives no personal benefit but which he uses to meet certain business expenses for which he can claim no deduction 13/. However, the general rule in the United States appears to be that an employee is taxable only to the extent that he benefits personally from an allowance or reimbursement paid to him by his employer. While an employee is required to include an allowance or reimbursement in his gross income, he is entitled to deduct his operating expenses as an employee, since his employment is regarded as a trade or business.

Deductions

The treatment of an employee's expenses in the United States is quite different from that in Canada and the United Kingdom, and far more rational. There is some difference in the treatment of these expenses and the treatment of business expenses, but this seems to be more a matter of practice than of principle.

The main point of departure from the Canadian concept is that an employee is considered to be carrying on a trade or business and is entitled under section 162 of the Internal Revenue Code to the same "ordinary and necessary" business expenses as the self-employed business or professional man. The difference between the treatment of the expenses of a businessman and of an

employee is simply that the former may deduct all ordinary and necessary expenses and take the standard deduction 14/ as well, while an employee who wishes to take the standard deduction may claim only expenses falling within four specified categories: reimbursed expenses, travel expenses away from home; transportation expenses; and expenses of outside salesmen. However, other ordinary and necessary expenses may be deducted in lieu of the standard deduction. Reporting requirements are detailed and stringent.

Clearly the United States has gone a long way toward recognizing that businessmen and employees should be treated on the same basis in the matter of deductible expenses, in that employees are entitled to deduct ordinary and necessary expenses incurred in connection with their employment.

THE PROPOSED TREATMENT OF THE GROSS GAINS FROM EMPLOYMENT

We recommend that the Income Tax Act should include a general charging section that would bring into the personal tax base all receipts, gains and benefits. This would obviously cover wages, salaries, other forms of cash remuneration, including gratuities, and all non-cash benefits provided by an employer. For greater certainty, the Regulations should also specify certain expenditures, or revenues forgone, by employers that would be deemed to provide taxable benefits to employees (or others). Included in the specified expenditures should be amounts deducted by an employer in the computation of his income and set aside for future payment to the employee, rather than being paid to him in the year. The Regulations should then provide for the following alternative tax treatment of these benefits:

1. The value of these deemed benefits should be reported by the employer to the beneficiary and included in the tax base of the employee or other person who had received or had an opportunity to receive them, failing which,

2. The employer should be required to pay a special tax equal to the tax that would have been paid by an individual in the highest income tax

bracket on the before-tax income necessary to buy the benefit in the market with tax-paid income. The special tax would itself be deductible in computing the employer's income 15/.

The second alternative would be available to employers who were unable or unwilling to allocate benefits in kind to employees (and others). Under this alternative there would be no tax advantage to an employer or employee in remunerating an employee in non-cash benefits that were not taxed to the employee. For all employees except those in the highest income tax bracket, where there would be neither tax advantage nor disadvantage, the cost to the employer of providing a given after-tax benefit to the employee would be less if the benefit was reported as income of the employee than if the employer paid the special tax on it. Assuming the same total cost to the employer, the employee would benefit more from a cash payment than from a benefit in kind which is not reported as his income.

While the administration would have to be vigilant to ensure that all benefits provided by employers were subjected to one or the other of these tax treatments, the administration would not have to be concerned about the alternative selected by the employer. To keep costs down, employers would be most reluctant to provide non-cash benefits that could not be allocated to their employees.

Once the tax advantage derived from providing tax-free benefits to employees had been removed, we would expect that employers and their employees would be less interested in fringe benefits and more interested in cash remuneration. The present treatment encourages a substitution of tax-free fringe benefits for taxable benefits. Under our approach neutrality between the forms of remuneration would be restored.

Lump Sum Receipts

We now discuss the specific treatment we recommend for some of the more important forms of employment income. But before doing so we wish to point

out that the lump sum receipts of employees that would be brought into income under our approach would not require special alleviating provisions. We believe the proposed averaging provisions of general application, explained in Chapter 13, would be adequate. Among the lump sum receipts of employees that could be brought into income without special alleviation are: payments on loss of office, retiring allowances, death benefits, cash bonuses, current distributions from profit sharing plans, and stock option benefits.

Stock Options

The value of stock options for tax purposes should be defined as the difference between the option price of the shares to the employee and the market price at the time the option is exercised by him and this should be included in the employee's income 16/. The cost basis of the shares to the employee would then be the market price at the time they are acquired. Special rules will be necessary to deal with cases where stock options are assigned before they are exercised. The cost of an option is not imposed on a company but is borne by shareholders in a dilution in the value of their shares! Shares sold outright to employees below market price should be similarly treated in principle, but where the discount was small and the shares were available to all employees this benefit could probably be ignored, particularly because the value of the benefit would be picked up in the taxation of share gains.

Non-Accountable Allowances

All allowances that are at present non-taxable, such as those paid to Members of Parliament and provincial legislative bodies and to municipal officers, should be included in income in the ordinary way. Actual expenses, unless explicitly denied, would be deductible. The riding of an elected representative should be deemed to be his home, so that his actual living expenses while attending sessions of the legislature would be deductible, within limits to be specified, as travelling expenses. The only allowances

we would exclude from tax are those paid to direct representatives of the Crown, namely, the Governor General and the Lieutenant-Governors.

Deferred Compensation

Deferred compensation payments, other than those provided for under registered pension plans, should be included in the income of the employee when such amounts are paid into a trust fund or to an insurer by the employer for the benefit of the employee. This would mean that the income of the employee and the deduction for the employer would occur at the same time.

We recommend that amounts deducted by an employer in his computation of income, but not immediately paid to the employee, should be deemed to be an employee benefit. This provision should encompass the many kinds of arrangements that are entered into to postpone the time when an employee will have to bring an amount into income. However, the legislation should specifically exclude from the application of this provision amounts that are paid to the employee in the subsequent year.

Retirement Income Plans

We recommend in Chapter 16 that retirement income plans, including all types of plans that provide retirement income for the beneficiary, such as pension plans, profit sharing plans and retirement savings plans, should be either registered or non-registered plans. However, only one set of requirements would be applicable for Registered Retirement Income Plans, instead of the varying treatment that now applies to different kinds of plans. Contributions to registered plans would be deductible from current income, within limits, and the proceeds taxed in the hands of individuals when paid out. Contributions to non-registered plans would not be deductible in computing income.

There can be no doubt that the contributions of employers to employee pension plans constitute benefits to employees. However, there would be no

point in requiring employees to include in income employer contributions to registered plans because these contributions would be deductible by the employees in any event. Because the limits on the registered plans relate to what can be withdrawn rather than what can be put in, and because the limits would be enforced by the trustees of such plans nothing would be gained by adding employers' contributions to registered plans to the income of employees. However, employer contributions to a non-registered plan should be added to the income of the employee when the contributions were made, or should be subject to the special tax on unallocated benefits.

Insurance Premiums

Three kinds of insurance for employees can be distinguished:

1. Life insurance.
2. Hospital and medical insurance.
3. All other insurance, including unemployment insurance, workmen's compensation, supplementary unemployment insurance and group sickness and accident insurance.

Further discussion of 1 and 3 is contained in Chapters 16 and 18. Our recommendations are summarized below.

Life Insurance. Although our general recommendation is that initially life insurance premiums should not be deductible and that the proceeds on death or maturity should be excluded from income (although the investment income would be taxable), in the case of group life insurance we recommend that premiums should be deductible and that any benefits should be included in full in income. Thus, we propose that group insurance should be taxed in the same way as that recommended below for the various kinds of income insurance plans. This approach would simplify the administration of employee benefit plans because it would not be necessary for the employer to include in the income of the employee, premiums paid under group insurance plans. Employee contributions should also be deductible.

Hospital and Medical Insurance. Hospital insurance premiums paid by an employer should be included in the incomes of employees or should be subject to the tax on unallocated benefits, to provide a consistent treatment of taxpayers across Canada. Some provinces require individuals to pay premiums to finance hospital schemes, while others finance these schemes through a general sales tax. As we have indicated in Chapter 12, we cannot recommend that individuals and families be allowed to deduct hospital premiums because this would put taxpayers in provinces that finance hospital schemes from sales taxes at a disadvantage; they would have no identifiable amount to deduct. On the other hand, not to add the premiums paid by employers to the income of employees would be unfair to employees who had to pay them out of taxed income.

Only medical expenses, including medical insurance premiums, in excess of 3 per cent of income would be allowed as a deduction to a taxpayer. Therefore, in order to make the 3 per cent floor equally effective for all taxpayers, it would be necessary to include in employees' incomes the medical insurance premiums paid by their employers.

Other Insurance. When the proceeds from an insurance policy are taxable, the premiums should be deductible. Because we propose to tax the proceeds from insurance policies that maintain the income of the individual in the event of unemployment, illness and disability, premiums on such policies should be deductible to the employee, whether or not the employee claims the optional 3 per cent deduction referred to later in this chapter. There would be no point in requiring employers who paid the premiums on these kinds of policies on behalf of their employees, to add these premiums to the employees' incomes, because they would be deductible by the employees in any event. Therefore, we recommend that employer contributions to unemployment insurance and workmen's compensation, and premiums paid by employers on behalf of their employees for supplementary unemployment insurance and group disability insurance, that is, salary continuance insurance, should not be included in the incomes of employees nor taxed to the employer if unallocated to employees.

Free, Subsidized or Discounted
Goods and Services

When an employee is supplied by an employer with free goods and services, is allowed to buy goods and services subsidized by the employer or is allowed to buy the stock-in-trade of the employer at discount prices, a benefit should be deemed to have been conferred on the employee. The employee should be required to bring into income the difference between the value of the goods or services obtained from the employer and the cost to the employee 17/. If the employer is unable or unwilling to allocate these benefits to employees, the employer should be required to pay the special tax on unallocated benefits.

Among goods and services provided to employees (or others) by employers that should be subjected to this treatment the following may be noted:

1. Meals.

2. Housing.

3. Direct costs of schooling for the children of employees.

4. Loans.

5. Transportation passes.

6. Recreational facilities, including summer cottages, lodges, fishing and hunting camps, yachts, and golf courses.

Fees and Dues

All club, union or association fees or dues paid by an employer for an employee should be included in the income of the employee 18/. Expenses incurred by an employee in entertaining at a club for business purposes would be treated in the same way as entertainment expenses generally, as described below.

Costs Incurred by or on Behalf of an
Employee When Away from Home on Business

We recommend that the following expenses incurred by or for an employee while away from home on a bona fide business trip, and paid by the employer, should not be added to the employee's income for tax purposes:

1. Actual transportation expenses.
2. Actual expenses for meals and lodging within specified limits.
3. Expenses as aforesaid of attending a specified number of conferences a year, with a specified limit for registration fees.

The Regulations should specify the limits under 2 and 3. The limits might vary with the salary of the employee, to reflect the cost of obtaining comparable accommodation, and perhaps should take into account the size of the city or town visited by the employee, to reflect the fact that living expenses are usually higher in metropolitan areas than in small towns. The limit under 2 should not exceed $25 a day at current prices. Two conferences a year, with a maximum registration fee of $35 to $50 for each conference, probably would be sensible limits under 3. 19/ However, we state these limits only to give an indication of our thinking. We would suggest that the detailed limits should be determined after a careful review of living costs and in consultation with the informal advisory committee of non-governmental experts that we recommend in Chapter 32 should be established to aid the Department of Finance.

Expenses incurred by an employer on behalf of an employee in excess of the specified limits would be added to the income of the employee or taxed to the employer in the manner we have described. For pleasure trips the limits would, of course, be zero. All of the expense would be taxed to the employee or the employer. When the trip was partly for business and partly for pleasure, the transportation expenses would be apportioned.

The limits would apply to actual expenses. All expenses would have to

be supported by expense vouchers or other documents.

Entertainment Expenses

Where an employer reimbursed an employee for his bona fide business entertainment expenses, or paid bona fide business entertainment bills incurred by the employee, we recommend that actual expenses over limits specified in the Regulations should be added to the income of the employee or taxed to the employer in the prescribed manner. An upper limit of $5 to $10 per person entertained per day probably would be suitable at current prices, but here again we suggest consultation with the informal advisory committee. The limit on entertainment expenses that did not have a reasonable business purpose would, of course, be zero. The employer would be required to keep detailed records of who was entertained, where, at what cost, and why. Only actual expenses would be allowed and all expenses would have to be supported by expense accounts or other documents.

If experience showed that this procedure was being abused or was unenforceable, we recommend that all entertainment expenses be added to the income of the employee or taxed to the employer in the prescribed manner. This procedure would be similar to that in the United Kingdom where these expenses are disallowed.

We suggest arbitrary limits with respect to travelling and entertainment expense because we consider that assessors should not be required to judge what amounts are appropriate in each circumstance.

Automobiles and Aircraft

The value of the personal use by an employee of his employer's car or aircraft should be brought into the income of the employee or taxed to the employer in the prescribed manner. In the case of an aircraft a detailed log should be kept, showing for each trip the names of passengers carried, the points of departure and destination and the purpose of the trip. Unless

the log supported the claim that the trip had a business purpose, personal use should be assumed.

Miscellaneous

Fees paid by an employer for an educational course taken by an employee should be included in the employee's income; the employee should then be allowed to deduct the amounts specified in the general provisions for post-secondary educational expense discussed in Chapter 12. If not added to the income of the employee, the expense should be taxed to the employer in the manner we have described. The same treatment should apply to scholarships, fellowships, bursaries and awards to employees.

Strike pay should be included in the incomes of union members when received, or the union should pay the special tax in the manner described above. Since strike pay is a form of benefit under an informal income maintenance insurance scheme, there is no doubt that it is income to the recipient. This would not involve "double taxation" because union dues would be deductible to the members.

Exclusions

We recommend that the following items provided by employers be statutorily excluded from the employee's income, either because the amounts involved are too trifling to make it administratively worth while to include them, or because they cannot be said to confer a true benefit: employer subsidies to community schools; special clothing provided by employers; removal expenses paid by the employer where necessitated by the job; and tools and equipment for use in day-to-day work provided by an employer.

Summary

In our recommendations concerning employee benefits we have tried to treat all kinds of benefits obtained by all kinds of employees on the same basis. If our proposals were adopted, we think they would substantially

reduce the abuses of "expense account living". The tax revenues lost through expense account living may be relatively small, but to the few individuals involved it provides an advantage that is as important as it is unwarranted. These abuses should not be allowed to continue. The self-assessment system of taxation is only a viable system if taxpayers believe that everyone is bearing his fair share of the tax burden. This attitude can only prevail when all personal consumption expenditures are made from tax-paid income. We have tried to design a method of taxing non-cash benefits that would be both stringent and enforceable. The arbitrary features of the system we propose would be inevitable if the provisions were to be effectively and consistently enforced. It would be necessary for the tax authorities to continue to review expenditures that were not allocated to employees or taxed on the special basis. Possibly some detailed reporting of these expenditures would be required of employers in respect of amounts claimed to fall within the established limits.

Because all employees of all competing organizations would be subject to the same rigorous rules, we do not believe that the apparent harshness of the provisions we recommend would have a detrimental impact on business.

PROPOSED TREATMENT OF DEDUCTIONS IN COMPUTING EMPLOYMENT INCOME

The restrictive nature of the law on the question of employees' deductions has already been noted in our summary of the present Canadian system. In order to understand the present position and the problems arising out of it, it is necessary to trace briefly the history of the treatment of these expenses.

The Income War Tax Act defined income, in part, as "the annual net profit or gain", and allowed deductions from gross income of amounts "wholly, exclusively and necessarily" incurred in earning it. In theory, therefore, employment income was dealt with on the same basis as business income, and this concept was confirmed by the courts 20/. However, practice was quite

different from theory, and the words "wholly, exclusively and necessarily" were so stringently interpreted where employees were concerned as to result in the assessment of employment income virtually on the gross amounts received 21/.

In 1948, following the Bond case, 20/ a change was made in the law which gave with one hand while taking away with the other. Two minor concessions were made with regard to certain travelling expenses, but it was specifically stated that in computing employment income "no amount is deductible for a disbursement or expense laid out for the purpose of earning the income", a provision in direct contrast to the declared treatment of business expenses.

Until the two concessions were made in 1948, the only deduction allowed by statute in computing employment income was a contribution to a pension or superannuation fund. Since 1948 a few more concessions have been made, but the resulting hodge-podge does not change the basic principle that employment income for tax purposes is gross income; the few specified deductions emphasize rather than change that principle.

The treatment of employment income must be compared with that given to business income, which includes income from a profession. The Act specifically states that income from a business is the "profit" therefrom for the year, and in effect allows the deduction of all reasonable expenses incurred "for the purpose of gaining or producing income", without any specific mention of what may be deducted. The basic principle is therefore quite different from that underlying the treatment of employment income.

The inequity of the law in general, as applied to employees, has shown up strongly in the few appeals taken by employees to the Tax Appeal Board. The small number of such appeals is not a measure of the discontent felt with the legislation but rather an indication of its efficiency; any appeal for deduction of an expense not specifically allowed, even where it is admitted by everyone that it was incurred for the purpose of earning the income, is

doomed from the start. One public-spirited taxpayer, a journalist, took to the Board an appeal which he stated he knew he had no chance of winning, but which he hoped might help to draw the attention of the authorities to the plight of people who had to incur certain expenses in earning their salaries but for whom no relief was available. He himself was both salaried and free-lance, and the lack of logic in the law's treatment of his expenses was emphasized by the fact that he was allowed to deduct in his capacity as free-lance the selfsame expenses he was prohibited from deducting from his salary. The same situation prevailed in another case, involving a member of the Toronto Symphony Orchestra 22/.

For many employees this stringent treatment may cause little or no hardship but, regardless of the number of taxpayers involved, the legislation is unfair and should be changed.

The main problems in removing this discrimination are administrative. First, there is the question of distinguishing the personal and business elements in many of these expenses, such as those on travel, entertainment, attending conventions, and so on. But this problem exists just as much in the area of business income. Second, there is the problem of numbers. There are about nine times as many employed taxpayers in Canada as there are self-employed taxpayers, or over 4.5 million employees to about 0.5 million self-employed 23/. The Department of National Revenue admits that it has difficulty checking the expense claims of even 0.5 million; it would find it quite impossible to handle expense claims for all employees as well without an enormous increase in staff.

Possible Alternatives

We considered a number of alternatives as possible remedies for the present unsatisfactory situation.

One was to maintain the present general system of permitting only

specified deductions, but to give additional deductions to employees. Although such an approach would relieve some of the inequities, it would still not be in accord with the general principle that it is net income that should be taxed and that therefore all costs related to the earning of income should be deductible. It would also still be discriminatory as between employees and others.

We also considered the possibility of adopting the "earned income allowance" which is part of the United Kingdom structure. There it is applied not only to employment income but to all earned income. It is a fixed percentage of that income and is allowed regardless of the amounts actually spent. If this provision were applied to all earned income in Canada, it would merely perpetuate the discrimination between employees and others; and if it were applied to employment income only, it would seem to contravene the original justification for its being granted in the United Kingdom, which was that earned income was more "precarious" than other income. There seems to be no more precariousness attached to employment income than to other types of income. In fact, one of the basic principles underlying our recommendations is that all income increases the economic power of the recipient in the same way, regardless of the kind or source, and therefore all income should be taxed in the same manner.

Another alternative would be to change the basic wording of the present rules regarding employees' deductions, and to adopt a rule something like that suggested by the United Kingdom Royal Commission on the Taxation of Profits and Income, that is, to allow deduction of "all expenses reasonably incurred for the appropriate performance of the duties of the office or employment". Such a rule would certainly permit more liberal allowances than the present system, but would still retain the inherent difference between employment and other income. Furthermore, it would not solve the administrative problem of reaching conclusions of fact in a very large number of cases.

Proposed Rules for Deductibility

We came to the conclusion that the most equitable course would be to treat employment income on the same basis as income from a business or profession. Expenses would then be deductible if reasonably related to the earning of income. The prohibition against the deduction of personal and living expenses as set out in section 12(1)(h) of the Income Tax Act would, of course, be applicable, as would the provision in section 12(2) that expenses must be reasonable in the circumstances.

The adoption of such a course would remove the unfair discrimination between the two kinds of income and should not lead to much additional litigation. As we have already stated, the United States does place employment income on the same basis as business income, and all "ordinary and necessary" expenses are deductible for both kinds of income.

However, because of the great numbers of taxpayers in receipt of employment income in Canada, and to obviate the need for processing numerous claims for relatively small items, we recommend an optional deduction of 3 per cent of gross employment income, up to a maximum deduction of $500. Any employee whose deductible expenses exceeded this figure would be at liberty to claim them in lieu of the optional 3 per cent deduction, provided they were itemized and substantiated. The deductibility of particular itemized expenses would then be determined in accordance with the rules to be applied to business expenses. Employees, like the self-employed, would not be permitted to deduct travelling and entertainment expenses in excess of the limits discussed earlier in this chapter.

It might be argued that such a blanket deduction would provide a concession to employees that would not be available to the self-employed. However, it would be expected that most self-employed individuals would have expenses in excess of the 3 per cent limit and that therefore such an option would be of little significance to them.

Although we recommend that in general all expenses reasonably related to the earning of employment income should be deductible, we also recommend that certain expenditures should be deemed to be of a personal nature regardless of their relationship to the earning of income and hence not deductible. We have made this recommendation because there are certain expenditures that are virtually impossible to classify as being either of a personal nature or for the purpose of earning income. In addition, certain expenditures have come to be regarded as a means of conveying personal benefits to employees. Thus, because the administrative problems in separating the "legitimate" expense from the personal expenditure would be great, and because we have concluded that a substantial proportion of such expenditures are in fact of a personal nature, we recommend that items of this kind should be arbitrarily deemed to be personal benefits and not deductible. We have listed commuting expenses, fees or dues to social or recreational clubs, and the cost of social or recreational facilities, including the expenses of pleasure boats, as items that should initially be included in such a list. Similarly, we suggest that all entertainment and travelling expenses in excess of specified arbitrary limits should in effect be deemed to be personal expenditures. We appreciate that some will regard this treatment to be unnecessarily harsh. However, we have considered a number of alternatives and found this to be the only solution that would provide some equity while being administratively feasible. In fact, we consider that these arbitrary rules would have to be amended and extended as experience was gained in administering the general allowance that we suggest. Nevertheless, such a result would be more equitable than the alternative of disallowing all the expenses of individuals related to the earning of income except those specifically permitted by the legislation.

In recommending a deduction of 3 per cent of employment income up to a maximum deduction of $500, we intend to provide an option that would be chosen by the vast majority of employees and yet would not provide an inordinate

concession to any. Should it be found on the basis of experience that a very high proportion of employees were claiming actual expenses, the terms of the optional blanket deduction should be made more attractive. In order to avoid a misconception, it should perhaps be pointed out that the 3 per cent deduction is for expenses incurred in earning income, and is entirely separate from, and does not cover, deductions made from net income for such things as charitable contributions and medical expenses, which are dealt with in Chapter 12, or the tax credit for working mothers which is dealt with in Chapter 11. Unemployment insurance contributions of employees, and the premiums paid by employees on Registered Retirement Income Plans and other income maintenance insurance policies would also be deductible whether or not the 3 per cent optional deduction were taken.

While they are not a perfect solution, we are convinced that our recommendations for the deduction of expenses for the earning of employment income would be substantially more equitable than the present system and would be administratively feasible.

WITHHOLDING OF TAX

The problem in this area is relatively small but present methods could be improved.

There is room for abuse in the taxation of income from casual labour where regular employers are involved. There is no requirement for individual reporting of earnings under $250. This permits workers to move from job to job and, as long as their earnings are less than $250 at any one job, there is no reporting or deduction at the source.

We recommend that a flat rate of tax of 15 per cent should be withheld from wages paid for casual labour, up to a maximum wage or a maximum period of days, after which the regular procedure for reporting and withholding tax from salaries or wages should be applied. This would apply to any employer who employed casual labour in the course of earning income.

Another aspect of the present withholding system that causes concern is the over-withholding of tax. Under the present somewhat rough and ready system, excessive tax can be and frequently is deducted. This occurs, for example, when an employee in the course of the year becomes entitled to additional exemptions or has periods of unemployment or periods of lower than average earnings, and may affect both taxable persons and persons who are non-taxable because their earnings do not exceed their exemptions. For example, in 1964, of the 5.3 million taxable individuals, 3.1 million, or over 58 per cent, received refunds; and of the 1.4 million non-taxable individuals who filed returns, 0.9 million, or over 64 per cent, received refunds. Because over-withholding usually is not rectified until after the end of the year, the deductions at source may work hardship in some cases. Some relief is available under Regulations 102(5) and 106, but to obtain the relief involves ministerial approval and the Regulations are apparently rarely used, possibly because most employees are unaware of their existence.

We believe that a cumulative system of tax deduction, similar to the pay-as-you-earn system used in the United Kingdom, may be preferable to the present Canadian system of withholding. However, in view of the fact that very few complaints were made to us about over-withholding we do not feel that we can recommend the adoption of a new, complicated system, particularly because it would involve considerable extra compliance costs to employers. As the use of electronic equipment by employers and in tax administration becomes more general, the adoption of a more accurate withholding method should be seriously considered.

CONCLUSIONS AND RECOMMENDATIONS

1. The comprehensive tax base, like the present law, requires the taxation of all net gains in cash or in kind from the performance of personal services. One problem is to enforce the taxation of non-cash benefits from employment while allowing the deduction of reasonable non-personal expenses in a way that does not create impossible administrative problems.

2. Because the present law is not effectively enforced, some employees receive non-cash benefits from their employers that are not taxed. This provides a tax advantage not available to taxpayers generally.

3. Because of the stringent limitations in the present law, employees are unable to deduct many expenses that are deductible by the self-employed. Skilled manual workers and employed professionals in particular are unfairly treated relative to the self-employed.

4. Equity requires that both types of unfair discrimination be eliminated from the tax system by effectively bringing all significant non-cash benefits into tax and by putting the deduction of expenses on the same basis for employees and the self-employed.

5. Travelling expenses and entertainment expenses pose a particularly difficult problem. When an employer pays these expenses for an employee or reimburses an employee for travelling and entertainment expenses, there may be a substantial element of personal benefit to the employee. To ignore this benefit would be to create a gaping loophole; to treat all of these expenses as personal benefits would be to penalize employees, or their employers, who incur such expenses for legitimate business purposes.

6. Where there are facilities of employers that could yield a benefit to many employees and to non-employees simultaneously, this compounds the problem because it is difficult to allocate the benefit.

7. Disallowing the travelling and entertaining expenses of employees would be inappropriate and in some cases ineffective: inappropriate because paying an employee by providing a non-cash benefit is just as much a cost of doing business as paying wages or salaries; ineffective because disallowance would not impose a restraint on tax-exempt employers.

8. An attempt to meet the problem only through the inclusion of some general rules in the law would, we believe, be doomed to failure. There are too many transactions and too many fine judgments required for effective enforcement of general rules. We believe there is no workable alternative to having some detailed and specific rules that give rough but effective justice.

GROSS GAINS

9. The Act should include a general charging provision that would bring all receipts, gains and benefits into the tax base of the individual or family. This would bring into tax all forms of employment income, including wages, salaries, bonuses and gratuities. For greater certainty, the Regulations should also specify certain expenditures, or revenues forgone by employers, that would be deemed to provide a benefit to employees (or others).

10. The value of these deemed benefits should be reported by the employer to the employees (or others), and included in their incomes, or the employer should be required to pay a special tax on them.

11. The special tax on the employer would apply when the employer was unable or unwilling to allocate benefits to individuals. The tax would be imposed at the top personal rate on the before-tax income that an individual paying tax at that rate would have to receive in order to buy the benefit in the market with after-tax income. The special tax would itself be deductible in computing the employer's income. There would therefore be no tax saving, and possibly an increase in the tax cost, if the employer provided non-cash benefits that were not taxed to the employee (or others).

RELIEVING PROVISIONS FOR
LUMP SUM BENEFITS

12. Because we recommend liberal averaging provisions of general application, no special relieving provisions would be necessary for lump sum receipts such as payments for loss of office, retiring allowances, death benefits, bonuses, distributions from profit sharing plans and stock option benefits.

STOCK OPTION BENEFITS

13. A stock option benefit should be taxable in full when the stock is acquired by the employee.

NON-ACCOUNTABLE ALLOWANCES

14. Allowances which are now tax free should be brought into income in the regular way. This should apply to allowances paid to members of the federal and provincial legislatures and to municipal officers.

RETIREMENT INCOME

15. Employer contributions to the Registered Retirement Income Plans of employees need not be brought into the incomes of the employees because these contributions would be deductible by them, together with the employees' own contributions, in any event. However, employer contributions to non-registered pension plans should be brought into the incomes of the employees.

INSURANCE PREMIUMS

16. Hospital insurance and medical insurance premiums paid by employers on behalf of employees should be brought into the income of the employees or taxed to the employer in the prescribed manner. This would be necessary because these premiums would be either not deductible, or would only be deductible by the employee under some

circumstances. Premiums on group life insurance policies and on policies of the income maintenance type, where the benefits would be taxable when received by the employee, should be deductible by the employee if paid by him. Thus, there would be no point in requiring the employer to add them to the income of the employee.

FREE, SUBSIDIZED OR DISCOUNTED GOODS AND SERVICES

17. Free, subsidized or discounted goods and services provided to employees should be taxable as benefits to them or subject to the special tax on the employer as described above. When the good or service is of a kind sold by the employer, the value of the benefit should be based on the market value of the good or service. In all other cases, the value of the benefit should be the full cost to the employer. Among the more obvious goods and services provided by employers that should be treated in this way are: meals, housing, schools for children of employees, loans, transportation passes and recreational facilities including summer cottages, lodges, fishing and hunting camps, yachts and golf courses.

FEES AND DUES

18. All club, union and association fees or dues paid by an employer for an employee should be included in the income of the employee or taxed to the employer in the prescribed manner. Union and association fees or dues would normally be deductible by the employee, however, if he did not claim the optional 3 per cent deduction referred to below.

TRAVELLING AND ENTERTAINMENT EXPENSES

19. Travelling and entertainment expenses paid by an employer in excess of stipulated limits should be included in the income of the employee or taxed to the employer in the prescribed manner. Some limits are suggested in the chapter to give an indication of the orders of magnitude

we have in mind. We recommend that the limits be established after consultation with the informal advisory committee discussed in Chapter 32.

20. If experience showed that the provisions for entertainment expenses we recommend were being abused, then all entertainment expenses paid by an employer should be included in the income of the employee or taxed to the employer.

MISCELLANEOUS

21. The following benefits should be taxed to the employee or taxed to the employer in the prescribed manner:

   a) The value of the personal use by an employee of his employer's automobile or aircraft.

   b) Fees for educational courses paid by an employer.

   c) Scholarships, fellowships, bursaries and awards to employees.

22. Strike pay should be included in the income of the union member or taxed to the union in the prescribed manner.

DEDUCTIONS

23. The same rules with respect to deductibility of expenses should apply to employees and to the self-employed. Expenses reasonably related to the earning of income should be deductible. There should be a general prohibition against the deduction of personal living expenses. For greater certainty, deductibility should be explicitly denied to such expenses as commuting expenses, fees or dues for social or recreational clubs and expenses related to the use of recreational facilities or pleasure boats. Also, travelling and entertainment costs in excess of the designated limits should be deemed to be personal expenditures.

24. To reduce the administrative burden, there should be an optional deduction of 3 per cent of employment income up to a maximum deduction of $500. This could be taken in lieu of the deduction of actual expenses.

WITHHOLDING OF TAX

25. As data handling and storage techniques improve and more employers become equipped to handle more elaborate tax withholding procedures, the present system should be refined. The pay-as-you-earn procedure now in effect in the United Kingdom may be preferable to the rough and ready Canadian system.

26. Regular employers should be required to withhold tax at a rate of 15 per cent on casual labour hired in the course of earning the employer's income.

REFERENCES

1/ See Gwyneth McGregor, Employees Deductions under the Income Tax, Canadian Tax Paper No. 21, Toronto: Canadian Tax Foundation, 1960.

2/ An employee may be required to pay travelling and entertainment expenses out of his salary or commission. The problem then is to ascertain the appropriate deduction from gross income. This side of the coin is dealt with later in this chapter. Obviously the personal benefit element in a living expense paid for by an employer that should be added to the income of the employee is the same element that should not be deducted by the employee who has met the expense out of wages, salary or commission.

3/ Disallowance would be appropriate, however, if the benefit provided was a gift from the employer to the employee.

4/ R.S.C. 1952, Chapter 249.

5/ See Department of National Revenue, Information Bulletins, Numbers 24 and 25, of February 15, 1964 and June 13, 1964, respectively.

6/ For an outline of this preferential treatment see Chapter 13.

7/ [1892] A.C. 150. For a detailed description of the United Kingdom treatment, see D.J. Sherbaniuk, Specific Types of Personal Income, a study published by the Commission.

8/ Royal Commission on the Taxation of Profits and Income, Final Report, Cmd. 9474, London: H.M.S.O., 1955, paragraph 211.

9/ Ibid., para. 215.

10/ Ibid., para. 129.

11/ Ibid., para. 140.

12/ Harvard Law School, International Program in Taxation, Taxation in the United States, World Tax Series, Boston: Little, Brown and Company, 1963, p. 538.

13/ For example, automobile allowances received by a public health nurse and by a hospital nurse for the use of their cars in transporting patients, were held to be part of their employment income, in Hawkins v. M.N.R., 50 DTC 472, and Campbell v. M.N.R., 55 DTC 434, respectively. A yearly travelling allowance paid to a county assessor was likewise held to be income from employment in Quance v. M.N.R., 52 DTC 237. An entertainment allowance paid to an insurance agent to be used when seeking insurance contracts was held part of his remuneration in Mr. S. v. M.N.R., 50 DTC 390.

14/ The lesser of $1,000 or 10 per cent of "adjusted gross income" (gross income less allowable expenses).

15/ Assume that the top personal rate of personal income tax is 50 per cent and the non-cash benefit has a market value of $100. In order to purchase from tax-paid income a benefit with a market value of $100, the employee would have to receive $200 from his employer and pay $100 in personal income tax. If the benefit were not brought into the employee's income, our proposal would require the employer to pay a special tax of $100 (50 per cent of $200). The employer's deductible expense would be $200 ($100 cost of the benefit plus $100 special tax), the same as it would have been if the employer had paid additional salary or a bonus of $200.

To be more precise, the employer would pay a special tax equal to $\frac{R \times B}{(100-R)}$, where R is the top marginal rate expressed as a percentage, and B is the cost of the benefit.

16/ Stock options are now dealt with in section 85A of the Income Tax Act.

17/ Where goods and services are of a kind sold by the employer, their market value should be used in valuing the benefit. For all other goods and services the full cost to the employer should be used for valuation purposes.

18/ Fees or dues to social or recreational clubs would not be deductible by the employee. However, employees should be able to deduct union dues or association fees (unless the optional percentage deduction is taken).

19/ It might also be reasonable to exclude conferences outside Canada unless they were sponsored by an international organization.

20/ Samson v. M.N.R., [1943] Ex. C.R. 17, and Bond v. M.N.R., [1946] Ex. C.R. 577.

21/ J.G. McDonald, Canadian Income Tax, Toronto: Butterworth, 1963, p. 171.

22/ Harbron v. M.N.R., 58 DTC 110; MacKay v. M.N.R., 58 DTC 447. A similar result was reached by the English courts in Mitchell and Edon v. Ross (1960) 40 T.C. 11.

23/ Information based on 1964 tax returns and supplied to us by the Department of National Revenue.

CHAPTER 15

PROPERTY INCOME

Rights to and interests in property can produce increases in economic power, whether held or disposed of. These increases take two basic forms: rents, dividends, royalties, interest, and other returns 1/ derived from holding property rights; and gains derived from increases in the market value of property rights.

The first form is already taxed as income in Canada, while the second is normally exempt as a "capital gain". While the changes we propose in the taxation of returns from holding property are minor, we suggest a major change in the tax treatment of gains on disposal of property.

We have emphasized in this Report that the only equitable basis for taxation is to include in the comprehensive tax base the value of all additions to economic power, including so-called capital gains. It may have been appropriate in years past to distinguish, for tax purposes, between gains flowing from property and those resulting from the acquisition and disposition of property, but in the current business and investment environment such a distinction has little if any significance. We are convinced that the failure to tax capital gains in Canada has no basis in principle; that it has led, and will continue to lead, to uncertainty as to which gains on the disposition of property are taxable and which are not; and that it affronts all the standards of equity and neutrality which we feel should characterize a tax system. In our view the exclusion of capital gains is no longer defensible, if it ever was. We are convinced that the time has come to abandon this exclusion and to replace it with a more logical, certain and equitable basis of taxation.

The inclusion in income of all gains from transactions in property is not without problems. In this chapter we describe the problems and suggest solutions. We consider whether and to what extent there should be allowances

for losses on such transactions; whether such gains and losses should be brought into income as they accrue or only when they are realized; whether and how these gains should be taxed when a taxpayer dies or ceases to be a resident of Canada; whether gains from property transactions should be taxed in the same way as other forms of gain, or whether they should receive preferential treatment; and how the receipt of lump sums from such transactions should be treated in order to avoid the application of unduly high marginal rates.

THE PRESENT POSITION

An extensive description and analysis of the Canadian treatment for tax purposes of gains on the disposition of property is given in three supporting studies, and the following discussion is therefore only a brief outline 2/. The basic approaches followed in the United Kingdom and in the United States have already been briefly discussed in Chapter 9.

The present position in Canada is that some receipts from the disposition of property are regarded as being of an income nature, and any gain arising therefrom is regarded as income subject to tax. Other such receipts are regarded as being of a capital nature, and the gain therefrom is regarded as an accretion to capital, or a capital gain, which is not subject to tax. None of the terms "income", "capital", or "capital gain" is defined in the legislation, and hence it is necessary to determine into which category a particular gain falls by having regard to the principles established in decisions of the courts.

The Distinction Between Income and Capital Gains—Business or Investment. The basic distinction drawn in the legal decisions is between a gain on the realization of an investment, which is capital, and a gain derived from the carrying on of a business, which is income 3/. In the _Californian Copper Syndicate_ case, a leading United Kingdom decision on this branch of the law which has been followed in Canada, this distinction was expressed as follows:

"It is quite a well-settled principle in dealing with questions of assessment of Income Tax, that where the owner of an ordinary investment chooses to realize it, and obtains a greater price for it than he originally acquired it at, the enhanced price is not profit...assessable to Income Tax. But it is equally well established that enhanced values obtained from realization or conversion of securities may be so assessable, where what is done is not merely a realization or change of investment, but an act done in what is truly the carrying on, or carrying out, of a business. The simplest case is that of a person or association of persons buying and selling lands or securities speculatively, in order to make gain, dealing in such investments as a business, and thereby seeking to make profits. There are many companies which in their very inception are formed for such a purpose, and in these cases it is not doubtful that, where they make a gain by a realization, the gain they make is liable to be assessed for Income Tax.

"What is the line which separates the two classes of cases may be difficult to define, and each case must be considered according to its facts; the question to be determined being—is the sum of gain that has been made a mere enhancement of value by realizing a security, or is it a gain made in an operation of business in carrying out a scheme for profit-making?" 4/

The Income Tax Act does not define "investment" but does contain a definition of "business". That term includes "a profession, calling, trade, manufacture or undertaking of any kind whatsoever and includes an adventure or concern in the nature of trade". Ordinarily, where a business is carried on there would be a series of transactions of a particular kind. However, the inclusion of the words "adventure or concern in the nature of trade" in the definition in the Act has been interpreted by the courts to mean that an isolated transaction which has other characteristics of a business operation can also be treated as a business, and that any gain therefrom will be taxable.

In some cases, where the disposition of property results in a profit, there will be no real difficulty in determining whether that profit constitutes a capital gain or income. In recent years there have been a great many cases, however, in which the tax authorities have contended that a profit was taxable and a considerable amount of litigation has resulted. In cases of this kind, the courts, in deciding whether a particular gain arose from carrying on business or realizing an investment, consider the whole course of conduct of the taxpayer in connection with the matter,

including the circumstances in which the property was acquired, what was done with the property while it was held, and the circumstances in which the disposition took place. While they decide each case on its own facts, they have treated a number of factors as material in determining whether or not there was liability to tax.

Criteria of Business or Investment. One of the factors is the nature of the property involved in the case. If the property sold is itself productive of income, such as where a business is sold as a going concern, the transaction is probably the realization of an investment. If, on the other hand, an individual buys and resells articles which are ordinarily not held for investment but are bought and sold by commercial concerns, he may well have engaged in a scheme of a business nature.

Another factor to be considered is the frequency of transactions of a similar type in which the taxpayer has taken part. The more frequent such transactions are, the more likely it is that any profit will be regarded as income. Furthermore, the fact that a particular transaction is in a field related to the normal business of a taxpayer, or even in a business in which he was formerly engaged, would be an additional factor leading to a finding that it constitutes a business venture.

What the taxpayer has done with the property during his period of ownership will also be material. If, for example, land is purchased, an apartment building is built thereon, the apartments are leased over a period of years, and the building is then sold, the sale may constitute the realization of an investment. On the other hand, if the purchaser of land proceeds to sub-divide it and sells building lots, he may well be held to be carrying on the business of dealing in land and to be taxable on his gain.

The length of time an asset has been held may be significant. Ownership of an asset for a lengthy period is consistent with, but by no means conclusive, evidence of an investment. Ownership for a short time is more likely to be treated as pointing to a business operation.

A further and a very important factor is the intention the taxpayer had with regard to the property both at the time he acquired it and subsequently. The application of this very subjective test has not been entirely consistent and as a result has led to much of the uncertainty in the capital gains area. In particular, the attempts to ascertain a "secondary" or "alternative" intention of the taxpayer have increased the general uncertainty of taxpayers about the tax consequences of property transactions. At one extreme, an intention to retain indefinitely property that regularly produces income in the form of rents, interests or dividends would presumably indicate that the profit is of an investment nature. At the other extreme, the purchase of a perishable commodity with the expectation and intention of reselling it immediately at a profit would presumably mark the commencement of a trading operation. There can, however, be an infinite variety of cases falling between such extremes.

It often happens that the intention with which a particular property is acquired is not carried out. A taxpayer may, for a wide variety of reasons, change or abandon his original plan with regard to the property and take alternative action. He may also be prevented by circumstances beyond his control from carrying out his original intention. In such cases it is necessary for the courts, having regard to the altered circumstances, to determine whether a profit on disposition should be treated as capital or income. Added complexity has arisen in cases in which the courts have found that a taxpayer had primary and secondary intentions at the outset, and that if the primary intention was not or could not be carried out his course of action should be judged on the basis of his alternative or secondary intention.

The expectation of capital appreciation and ultimate sale at a profit and the absence of an immediate income return may not be inconsistent with investment. On the other hand, if organized activity of a business nature is devoted to a project, the resulting profit may be a business profit, but

the lack of such activity or any substantial amount of such activity need not rule out a scheme of profit making.

In any given case, the basic question for determination is whether the taxpayer's whole course of conduct is consistent with investment on the one hand or a scheme of profit making on the other. The application of readily stated principles to the facts of particular cases has often proved to be extremely difficult. The Canadian decisions in cases relating to alleged capital gains in recent years have more than borne out the observation in the Californian Copper Syndicate decision of 1904 that the line between investment and carrying on business is difficult to draw. Unfortunately these decisions and the reasons given therefor are not easily reconciled and seem far from consistent. The result is that doubt and uncertainty have existed for some years, and seem likely to continue, as to the circumstances in which the proceeds of disposition of property will be regarded as capital gains or taxable income.

It may be that such uncertainty is inherent in a system which distinguishes between capital and income but fails to define these terms so that it becomes necessary to consider such broad questions as what constitutes investment on the one hand, and carrying on business or an adventure in the nature of trade on the other. In any event, we do not consider that the distinction currently drawn between the two types of increment to economic power is warranted. Our proposal that all gains on the disposition of property should be treated as income would, of course, eliminate the problem of distinguishing between the two types of cases.

Under the present system, losses realized on the disposition of property are not deductible from income unless they constitute business losses, in which event they are deductible within prescribed limits. As will appear in what follows, we consider that the taxation of property gains should in general be accompanied by the allowance of property losses as a deduction from any income, a procedure similar to that we propose for business losses.

The uncertainty of the present position is a serious enough defect, and we shall speak of it further. A far more important defect is the lack of equity.

Equity

A tax, if it is to be imposed equitably, should satisfy two requirements. It should provide for horizontal equity, the equal tax treatment of persons in the same circumstances, that is, with similar claims on resources; and for vertical equity, a "fair" allocation of the total tax burden between those in different circumstances.

The first requirement would call for the same tax treatment for the wage earner who pays for his car by working overtime and his fellow worker who uses his net gains from the stock market to acquire a car. Today one acquires the car out of taxed income; the other out of a non-taxable gain. Another inequity arises because in recent years there appears to have developed a marked tendency to seek to tax gains made on the purchase and sale of real estate, but not to assess gains of a similar nature made on the purchase and sale of marketable securities. In theory both types of transaction should be subject to the same tax treatment, and there appears to be neither logic nor equity in taxing the gains on one type of asset and not on the other.

Because property gains generally become proportionately larger as income increases, vertical equity is particularly lacking under the present tax system. If property gains are exempt from tax, those members of the upper income groups who derive a major part of their revenue from property gains would pay a lower average rate of tax on their comprehensive tax bases than persons in lower income groups. Because property gains are part of the United States tax base, it is possible to be somewhat more exact about the distribution of

property gains by income class for that country. Table 15-1 shows that average capital gains, as defined in the United States, for taxpayers with incomes in excess of $200,000 exceed income from other sources, and are a large part of income in the $100,000 to $200,000 bracket.

TABLE 15-1

UNITED STATES INDIVIDUAL TAX STATISTICS, 1963

Adjusted Gross Income Class (including net capital gains) (dollars)	Percentage of Total Taxpayers Reporting Net Gains (per cent)	Percentage of Capital Gains to all Other Income a/ (per cent)
0 - 1,000	3	4
1,000 - 3,000	5	3
3,000 - 5,000	6	2
5,000 - 10,000	7	1
10,000 - 25,000	18	3
25,000 - 50,000	45	11
50,000 - 100,000	58	20
100,000 - 200,000	72	48
200,000 +	82	128
All taxpayers	8	4

a/ Gross net gains as a percentage of adjusted gross income before capital gains and losses for taxable and non-taxable returns with net gains. Gross net gains refer to the excess of gains over losses before deduction of the 50 per cent exclusion for long-term gains on capital assets.

Source: Prepared by the Commission staff from figures contained in United States Treasury Department, Statistics of Income— 1963, Individual Income Tax Returns, Washington: United States Government Printing Office, 1966.

For several reasons, these figures are not wholly applicable to Canada, but they do make it clear that the exemption of property gains from income has a significant effect on the tax base of the upper income groups. It should also be remembered that, because the percentages shown in the table are averages, there will be individual taxpayers in each group whose proportion of capital gains is even larger.

An even more striking compilation has been made by our research staff from United States data to demonstrate the effect on the progressive tax burden of the exemption or partial taxation of capital gains. Table 15-2, based on a year when the rates of United States personal income tax rose to over 90 per cent in the top bracket, shows that with taxation of capital gains at special rates, the progression flattened out after $50,000 of income at just over 30 per cent, and with no tax on capital gains the average effective rate would have dropped from 26 per cent for persons in the $50,000 to $100,000 bracket, to 20 per cent for persons in the bracket of $100,000 and over. It was assumed in each case that income other than capital gains was taxed at full rates. Although the data are by no means capable of exact application to Canada, this second comparison could well be typical of the Canadian curve of progression, because of the complete exemption here of capital gains. At least it can be taken for granted that the progression in the statutory personal income tax rates in Canada, as in the United States, bears no resemblance to the true progression that would result if capital gains and taxable income were added together. At some level, progression would very likely cease and the curve decline.

There is no doubt in our minds that as long as capital gains are excluded from income the present system will fall short of achieving the standards of horizontal and vertical equity that we recommend should be established for the Canadian tax system.

TABLE 15-2

THE EFFECTIVE AVERAGE RATE OF INCOME TAX PAYABLE
UNDER VARIOUS ASSUMPTIONS, UNITED STATES, 1962 a/

Adjusted Gross Income Class b/ (dollars)	Assuming Capital Gains Subject to Full Rates of Tax (per cent)	Assuming One Half of Capital Gains Subject to Tax c/ (per cent)	Assuming Capital Gains Exempt from Tax (per cent)
0 to 5,000	10	8	5
5,000 to 10,000	13	11	10
10,000 to 25,000	18	16	14
25,000 to 50,000	26	23	20
50,000 to 100,000	36	31	26
100,000 +	45	33	20

a/ Information only for taxable returns having capital gains or losses, but the computations exclude the amounts of net losses.

b/ Adjusted gross income for the purposes of determining the average rate of tax payable is before the deduction of the 50 per cent exclusion for long-term gains on capital assets, although the division by adjusted gross income class is based upon the amount after this deduction.

c/ These rates are imposed on the basis actually used in the United States. One half of the excess of net long-term capital gains over net short-term capital losses is included in income, but the maximum tax is 25 per cent of the total of this excess.

Source: Prepared by the Commission staff from figures contained in United States Treasury Department, Statistics of Income—1962, Individual Income Tax Returns, Washington: United States Government Printing Office, 1965.

Neutrality

In several areas grievous problems of taxation are attributable to the fact that a transaction carried through in one way results in taxable income, whereas if it is conducted in another way the gain is totally exempt or taxed at materially lower rates. One striking example of this lack of neutrality relates to the current method of taxing the income earned by corporations. If declared each year as a dividend, it attracts personal income tax; if allowed to accumulate in the corporation, it is likely to increase the value

of the capital stock of the corporation. This increase in value in excess of the earnings retained, when realized by disposition of the stock, is generally free of tax. Another example concerns the disparity in the tax treatment of the proceeds derived from the exploitation of intangible property, such as patents, copyrights, or even business goodwill. If property of this nature is retained by the owner, he pays income tax on the annual returns, but if he sells the property to someone else at a price that represents the capitalized expected return, the proceeds are often exempt from taxation. Because this type of property generally has a limited life, in both cases the taxpayer would at some time lose this source of income, so the tax differential can have a major impact on the decision to retain or sell the property. The taxation of increments in property values is essential for more equitable and neutral treatment of income from property.

It is probably safe to say that the fact that income from a transaction will be exempt from tax, if realized through the disposition of an investment or a capital asset, is at the root of much of the very considerable effort directed to tax avoidance under our present system. A long list of additional examples could easily be given to substantiate this statement further. Also, it is amply evident from the background of the capital gains tax in the United Kingdom, that the growing sophistication of taxpayers in devising means for achieving tax exemption through the capital gains route had a very substantial influence on the final adoption of the tax. We are convinced that much would be gained in Canada by bringing an end to a situation in which a tax advantage of very substantial proportions may rest on the mere form in which a transaction is carried out.

Certainty

As we observed earlier, the taxpayer is in the hands of the courts in the determination of the tax results of a transaction, and in the particular area of capital gains the courts have been unable in the past to evolve a set of tests that can be applied with certainty to many situations that arise,

and in our view they will be unable to do so in the future. The present basic concept of income is so obscure that the tax administration and the courts are required to make distinctions where no real distinctions exist. They are required to judge the motivation that guided a taxpayer to a certain result when frequently all the evidence of intention, both primary and secondary, could as easily be interpreted to indicate one intention as the opposite. In our view the present system requires both the administration and the courts to spend excessive amounts of time and skill in the making of hairline distinctions which are inevitably arbitrary, capricious and inequitable.

By what process of reasoning can it ever be decided with certainty whether it requires one, three, five, ten or fifty transactions in an article of trade to constitute carrying on a business? What ultimate test could ever be applied to determine absolutely whether a person fully intended to make a gain through the sale of property, or had only the purpose of holding an investment? By what rule of logic are gains on land suspect and those on securities inviolate? Merely to state these questions, and they are relatively straightforward by comparison with some that could be set down, is enough to show the refinements of hair splitting in which taxpayers, tax administrators and the courts are now required to indulge as a regular exercise. The only full solution to the dilemma that we can see is to adopt the comprehensive tax base and to tax in full all gains. Thus, the issue of motivation would no longer be a criterion, for a person's capacity to consume would be increased regardless of whether the gain resulted from a profit-seeking transaction or was of a windfall nature. The proposition is simple, but it would render obsolete the many guidelines that have been established over the years for determining what was in a taxpayer's mind, an exercise which was at its best unsatisfactory, and at its worst an arbitrary, inequitable and capricious way to determine tax liability.

COMPREHENSIVE TAX BASE

We have concluded that taxation at progressive rates of increments in economic power represents the fairest measure of ability to pay, and is the only means of achieving an equitable and neutral tax system. Gains realized on dispositions of property come within this concept naturally and logically. Such gains increase the taxpayer's economic power and thus enhance his ability to pay. We see no escape from the quandary in which the Canadian tax system finds itself except by the adoption of a concept under which the taxability of property gains is made clear and certain.

It appears to us, moreover, that property gains should be taxed in full as ordinary income. This proposal may seem extreme, particularly when in countries like the United States and the United Kingdom at least some such gains are taxed at reduced or preferential rates. However, we think that such preferential rates may be attributable in whole or in part to the existence of very high progressive rates of tax, or to the lack of comprehensive averaging provisions in the countries concerned. In addition, concern with the economic impact of taxation on investment may have been a major influence in the determination of the level of taxation that should apply. Unquestionably, preferential rates and the arbitrary time periods which are sometimes used for the purpose of determining whether a particular gain should be taxed as income or on a preferential basis, can add greatly, as in the United States, to the complexity of the tax legislation and to the uncertainty of its application. Tax differentials can also produce a considerable distortion in the manner in which taxpayers organize and conduct their activities. Thus, preferential rates produce complexity and a lack of neutrality and moreover, as we discuss later, they are not necessarily the most efficient way to encourage investment and to relieve inequities. With an overall concept of income, it seems to us that it is neither feasible nor desirable to distinguish between types of increments to economic power.

We shall examine these questions, and the economic impact of taxing capital gains, more fully later. We would anticipate some of the discussion that will arise regarding our proposal by pointing out the following:

1. We believe that our proposal for the integration of the corporate income tax with the individual income tax should eliminate the double taxation of corporate source income that could otherwise exist with the taxation of share gains.

2. Our proposed personal income tax schedule has a top marginal rate of 50 per cent, and the taxation in full of capital gains under such a schedule should not be considered in the same light as taxation under a schedule, such as is now applicable, with a top marginal rate of 80 per cent.

3. We propose several averaging devices in respect of lump sum receipts of income that would also apply to the disposition of capital assets.

Making allowance for the fact that a tax on property gains would exempt gains that had accrued prior to the date of its coming into force, we believe that the proposals we set forth in this chapter represent a fair and workable system that would help greatly to achieve the objectives we have established for a revised Canadian tax structure.

FURTHER CONSIDERATIONS

Before discussing the proposals in greater detail, it is desirable to give further attention to some of the aspects of a tax on property gains that are a cause of concern to many persons.

Economic Implications

We discuss the economic effects of the taxation of property gains in greater detail in Chapter 37 as part of the discussion of the economic impact of all our tax proposals. In this chapter we limit ourselves to a

discussion of some of the specific economic problems that might arise if our proposals for the taxation of property gains were implemented.

The taxation of property gains is clearly called for on grounds of equity. However, if such an extension of the tax base would have adverse economic effects that were not offset by other measures, it would not be an unequivocal improvement.

We agree with the opinion expressed by many economists in the United States that the taxation of property gains has had very little effect on the level of investment in that country.

Effect on Savings. It is sometimes argued that the taxation of property gains would both reduce the rate of saving and make risky investments less attractive and that the reduction in the rate of economic growth is more significant than the resulting improvement in equity.

Assuming the same total tax revenue was raised, the taxation of property gains could reduce the rate of saving in two ways:

1. Personal saving would decline if those with increased tax liabilities reduced their saving by more than those with reduced tax liabilities increased their saving.
2. Corporate saving would be reduced if the taxation of property gains resulted in increased corporate cash distributions and shareholders did not increase their savings by the amount of the additional dividends.

We are satisfied that the first argument does not warrant concern. Taxing property gains, together with all other reforms, would increase the taxes borne by most taxpayers. The individuals and families in these classes undoubtedly save a higher proportion of their incomes than those in the lower income groups for whom we propose tax reductions. This means a substantial proportion of the increased taxes on the well-to-do would be financed through reduced personal saving. Only a small fraction of the reduced taxes on lower and middle income taxpayers would be saved. The net effect on personal saving would be almost certainly negative. But while the direction of the effect would be unfavourable to domestic saving, the magnitudes involved would not be substantial. It must

be constantly kept in kind that, while we propose to tax capital gains in full, we are also proposing other changes, in particular personal and corporate integration and lower rates of personal income tax, that would tend to reduce the taxes paid by middle and upper income tax units. Also, it must be recognized that the taxes paid by these tax units are a relatively small proportion of total revenue. All of our proposals taken together, including the higher initial taxes necessary to cover transitional costs, would probably not increase the personal tax liabilities of tax units with incomes of over $15,000 a year (defined in accordance with the comprehensive tax base) by more than $150 million. Even if the whole of this tax increase was financed by reduced personal saving, total personal saving (currently about $3 billion) would only be reduced by about 5 per cent. There would be no appreciable impact on total domestic saving of approximately $11 billion.

The second argument would concern us if the proposal to tax property gains was made in isolation. There can be no doubt that the failure to tax share gains biases the system in favour of corporate retentions. If this bias were not only removed but was reversed, corporate savings could be significantly reduced. The adoption of our integration proposal (Chapter 19) would, however, ensure that there was no double taxation of retained earnings and would also reduce the pressure on management to increase cash dividends.

The integration system requires the allocation of corporate earnings to shareholders and does not require the distribution of cash in order to give the shareholders the right to credit for the underlying corporate tax. Management could, in effect, substitute tax credits for increased cash dividends. Because the interest of management is almost always to retain cash within the corporation, we are convinced that the net effect of the taxation of share gains and corporate-personal integration would not be to increase total corporate cash distributions. Indeed it is more likely that some reduction in corporate cash distributions would occur. Despite the full taxation of share gains and despite the removal of special industry concessions and despite the withdrawal of the lower rate of corporate tax, we estimate that adoption of our integration proposal would reduce the tax revenue derived from Canadian corporate source

income of residents by more than $100 million. We are convinced that some of this tax reduction at the personal level would be offset by a slower rate of increase of cash dividends and a correspondingly greater increase in corporate saving.

Taxing property gains would undoubtedly change the relative attractiveness of different kinds of investments. Other things unchanged, assets that provide a return with a high property gain component, not now taxed, would be relatively less attractive. Here again, for some assets we are recommending other changes in the tax system that would offset this effect. The integration proposal, when combined with the taxation of share gains, would reduce the marginal rates of tax on the total return from most corporate shares for most Canadian shareholders. Low and middle income shareholders in particular (and the institutions that make investments on their behalf) would find holding corporate shares more attractive relative to other assets than at present. The cost of equity capital to Canadian corporations would be reduced, thus encouraging an increase in the rate of investment by most corporations.

Our proposal to allow accelerated depreciation to new and small businesses, coupled with the treatment of losses we also recommend, would provide an added incentive to invest in new, risky ventures.

Our recommendations to tax property gains would undoubtedly make investment in some assets less attractive. For example, investments in real property and speculative mining and petroleum shares would be relatively less attractive because after-tax expected rates of return would be reduced. But we have no doubt that by inducing more new investment in other corporate shares and in new and small businesses, the rate of increase of future output in Canada would be enhanced despite these negative effects.

If after our recommended system was implemented the rates of national saving and investment were not adequate, there are a number of methods of increasing the growth rate that would be more efficient and more equitable than the preferential tax treatment of property gains. These methods are discussed in Chapter 4.

<u>Effect on the Rate of Turn-Over of Security Holdings</u>. Another question raised by the taxation of property gains, when it is limited to a realization basis

as we recommend, is the effect on the rate of turn-over of security holdings. Because our proposed method of taxation would have the same effect on security transactions as a transactions tax of the same magnitude, obviously it must to some extent restrict the turn-over of assets. Therefore, it is necessary to examine whether this effect would be so great as to have a disruptive influence on Canadian security markets. Because publicly traded securities are the most widely held form of investment, it is with these assets that our concern is greatest.

To the extent that our proposal for the full taxation of share gains has an impact on publicly traded share turn-over, it will primarily affect transactions by individuals who have acquired the shares as a long-term investment. Stock exchange members and other individuals engaged in trading activities acquire shares in anticipation of an early change in the market price and generally dispose of the shares after a short time (say, less than six months) regardless of what happens to the price. These persons are already taxed on their gains or, if not, are generally engaged in short-term buying and selling activities which would be relatively unaffected by the measures we propose. Pension funds and other intermediaries dealing in shares for Registered Retirement Income Plans will not be taxable so that their trading would not be affected by our proposal.

According to surveys conducted by the two major stock exchanges in Canada, individuals acquiring shares with the intention of retaining them for more than six months make up less than one half the trading activity. Of the business conducted on the Toronto Stock Exchange on the days selected, less than one half was for the account of such individuals, while the percentage for the Montreal Exchange was under 20 per cent 5/. Thus, the potential impact on mobility of the full taxation of capital gains is limited to something less than one half the trading activity.

We attempted to ascertain what the influence on these investors of

our proposal would be by reviewing a number of studies that had been completed in the United States and by conducting our own survey of share transactions by taxpayers with incomes exceeding $25,000.

The various studies in the United States have attributed different degrees of mobility effect to the taxation of share gains. Unfortunately, the most ambitious study in this regard concentrated the analysis on the level of taxation of realized gains, and ignored the effect of the United States tax exemption on gains accrued at death 6/. Therefore, the view stated in the study that a reduction in the level of taxation on capital gains would substantially increase the turn-over of securities is not conclusive. Other studies have indicated that the tax exemption on gains accrued at death does reduce mobility, while concluding that the taxation of realized gains, at the United States preferential rates of tax, has only a limited influence on security transactions. The sharp declines in the general level of stock market prices which occur from time to time probably have a much greater effect on the mobility of capital than would any reduction in the taxation of share gains.

Our research staff reviewed the number of securities sold in 1961 and 1962 by a sample of high income Canadian taxpayers 7/. Unfortunately, we were unable to conclude whether the mobility of securities in Canada was greater or less than that in the United States, because the United States studies do not give enough information to provide a comparison with the data gathered for Canada. However, our survey does indicate that for most Canadian taxpayers in the upper income groups the proportion of their total portfolio that was disposed of in these years was relatively small, despite the fact that this country does not generally tax the profit from stock transactions. We did not collect data on taxpayers with incomes of under $25,000, but for them the proposed level of tax on property gains would be much less significant.

Even though the present rate of turn-over of security holdings appears to be low in Canada, the taxation of gains at full personal rates of tax could well reduce it further. This pressure toward a reduction in mobility is, however, at least partially offset by two other influences. The investor who held a stock selling at more than his cost would supposedly weigh the immediate tax cost of a disposition against a potential fall in market price, as well as compare the prospective yield from the net after-tax proceeds to the current yield being obtained. To cause immobility, the known tax cost would have to exceed the possible decline in the share price, and exceed it by a sufficient margin to reduce the yield on the prospective investment below that expected on the current investment. In addition, because every Canadian taxpayer would know that at his death or that of his spouse tax would have to be paid on accrued property gains, the value of tax postponement would be reduced. Regardless of the amount of tax, it would, of course, generally be most profitable to dispose of a stock holding when its price was at its highest level.

Later in this chapter we suggest that, some time after the adoption of a comprehensive tax base, provision should be made for the periodic revaluation of publicly traded securities by taxpayers, who would take any changes in value into account in computing their incomes. Such a measure would substantially eliminate whatever immobility was occasioned by the taxation of property gains on a realization basis only.

Preferential Treatment

<u>Lower Tax Rate</u>. Although property gains are generally taxed at preferential rates in other countries, we have concluded that because taxable capacity depends on the amount of a receipt, and not at all on its source, equity requires that all receipts, including property gains, should be taxed at full rates.

It may be argued that, when increases in the price of shares are a reflection of the growth in the retained earnings of a corporation, the taxation of share gains would mean that part of the earnings of the corporation had been taxed twice.

It should be recognized, however, that on average the prices of corporate stocks in the postwar period have increased more rapidly than retained earnings. The additional increase in prices during this period is a reflection of a more optimistic current estimate of anticipated future after-tax earnings than was made earlier; and therefore some part of the increase is not, in the first instance, a gain that has already been subject to income tax in the underlying corporation. However, we think that the question of double taxation of retained earnings would be of little significance if the corporate tax were integrated with the individual tax, as we recommend in Chapter 19. We anticipate that if our recommendations were adopted most corporate income would be distributed to shareholders in one way or another for tax purposes. That part which was distributed in cash would not be subject to double taxation. That part which was allocated to shareholders for tax purposes in the other ways contemplated under our integration proposals would increase the cost basis 8/ of the shares to the shareholder so that he would not be subject to double taxation on earnings retained in the company if he sold his shares.

Substantial administrative problems would be attached to any differentiation in rates. Just as exclusions and exemptions from income lead to administrative complexities, so would the preferential treatment of any type of income also increase administrative difficulties. The complexities of the United States Internal Revenue Code could be greatly reduced if all property gains were taxed at full rates; the major complexities are not the result of taxing such gains, but of taxing them at preferential rates.

For these reasons and because we recommend suitable averaging provisions, we believe that the only grounds on which we could justify preferential rates of tax for a particular type of income would be as an economic incentive. Therefore, it is important to discuss again the relationship between dividends and gains on capital stock. We believe that investors would be generally indifferent as to whether they received their return from capital stock in the form of dividends or gains, as long as their total after-tax income is the same. At the present time in Canada, dividends usually attract some tax liability while gains are generally free of tax, a situation that tends to encourage corporate retentions and is therefore the basic cause of the surplus-stripping problems, that is, the realization of cash from a corporation with retained earnings in such a manner as to reduce or eliminate the tax liability of the shareholder. However, it would be just as undesirable to reverse the situation so that dividend pay-outs would be encouraged. Therefore, for reasons of tax neutrality, we regard it as a matter of some importance that both forms of yield on capital stock should be taxed at approximately the same levels—an objective that would be attained if our proposals were implemented.

The taxation of gains on corporate stock need not depress security prices. In fact, an overall rational approach to the taxation of corporate source income that considered taxation at the corporate level, in the hands of intermediaries, and when ultimately received by the individual, could result in a substantial rise in stock prices. The effect of taxation on the stock market depends upon the taxation of income in general, and corporate source income in particular, and not merely on the taxation of gains on corporate stock. Thus, the increase in demand for securities that we anticipate would follow from the implementation of our proposal for the taxation of corporate source

income and from our suggested procedures for taxing financial institutions should offset any adverse influence that might be expected to result from the taxation of gains on corporate stock. The reduction in the net cost to a taxpayer of incurring losses, because they would become deductible, should also have a favourable effect.

There is little to be said for the view that an exemption from tax for property gains or the taxation of such gains at preferential rates would act as a stimulus for an expanding economy. Further discussion of the effects of our proposals on equity prices is contained in Chapter 37.

We have not suggested that preferential treatment should even be considered for other forms of property gains. None of the reasons that might suggest a preference for capital stock gains appears to apply in a material way to other forms of property. In addition, the more extensive the preference, the greater the complexity and uncertainty that would result. In particular, even if a preference were granted, it would be imperative that it be related to the substance and not to the form of a transaction. There is little economic advantage in granting incentives only to those who are able to arrange their affairs in the appropriate manner.

Holding Period. A number of other jurisdictions vary the tax rates applicable to property gains according to the length of time a property was held. Arguments have been advanced that a reduced rate of tax for the gain on long-term assets gives recognition to the fact that a gain when realized may represent a value that has accrued over a long period of time.

We reject this line of reasoning. The phenomenon of a large amount of income being realized in one year after accruing for many years is

not an unusual one, and there are a variety of ways of averaging income to ensure that progressive tax rates do not unduly erode such a receipt. We propose in this Report the adoption of several methods of averaging, but we reject the principle that a substantial part of any income should be exempted from tax simply because the time over which it accrued exceeded six months or one year or some other arbitrary period. We see nothing to distinguish the realization of such a gain on property from a lump sum receipt of income in any other form, and our proposal therefore is that no concession should be granted for realized property gains beyond the averaging devices we propose in Chapter 13. In any case, we are satisfied that the combination of the averaging proposals with the proposed rate schedule would ensure that no taxpayer would incur a substantial increase in progressive rates because of a large lump sum receipt. Thus, with a maximum rate of personal income tax of 50 per cent, and the opportunity to average a gain over an extended period by combining our block averaging proposal with the temporary use of the Income Adjustment Account, the taxpayer should be able to alleviate any potential hardship of applying progressive rates to a substantial gain.

Another argument that has been advanced in favour of holding periods is that they could be used as devices for determining eligibility for preferential treatment, the intention being to deny the preference to the so-called speculator. The speculator is arbitrarily deemed to be the person who completes his transaction within a specified period, six months in the case of the United States, and therefore preferential treatment is extended only to those who delay disposition beyond such a time period. In this sense the United States has perpetuated the distinction between "carrying on business" and "investing" which we find so unpalatable in the present Canadian position. In addition, the test is one that even the so-called speculator can satisfy with little difficulty. The distinction is not only artificial and arbitrary, but also ineffective if the criterion for the

preference is such that virtually any shareholder can readily qualify for the benefit. We have concluded that the holding period approach would introduce complexities into the legislation without achieving its intention.

In any case, the significant consideration is that in equity we see no justification for preferential treatment for any form of gain on transactions in property. We have set out how problems of lump sum receipts can be dealt with adequately, and in our view all realized increases in economic power, regardless of their source, should be equally a subject of taxation.

Inflation and Interest
Rate Effects

Another question that is often raised relates to the equity of taxing gains accrued over a period of time during which there has been inflation or a fall in interest rates.

It has been argued that it would be inequitable to tax a gain that resulted from a general increase in the price level. The point is made that such a gain is illusory because it does not represent any real increase in purchasing power. This argument, when used to support the exemption of stock market gains, appears over-emphasized if the substantial increases in the stock market averages are compared with the rather smaller increase in the cost-of-living index. In addition, we cannot overlook the fact that there are many members of society with fixed incomes who suffer losses in economic power because of inflation and are unable to protect themselves against it. This is in contrast to the equity holder who, during a period of inflation, will generally experience some growth in the dollar value of his assets. Because it is not possible to make provision for complete recognition of declines in purchasing power brought about by inflation, we have concluded that it should not be the function of the tax system to attempt to relieve only some segments of the population from the effects of inflation. The tax system should therefore, in our opinion, continue to be based on current dollars and not on constant dollars.

Fluctuations in interest rates necessarily bring about inverse changes in bond prices. It is sometimes argued that the gains and losses from buying and selling bonds are therefore illusory in some sense and should not be subject to tax like gains and losses on other assets. It cannot be denied that taxing realized gains on any asset can have a deleterious effect on the mobility of capital. This "locking in" effect is not unique to bonds and we can see no reason to differentiate gains and losses on bonds, from gains and losses brought about by changes in rents, dividends, and other returns on other assets. Increases in bond prices relative to other prices increase the economic power of the bondholder and should be taxed; and conversely for reductions in bond prices.

Roll-Over Privilege

Another issue concerning taxpayer equity is the proposition that, if property gains in general are to be taxable, there should be an exemption to the extent that the proceeds received on a sale are reinvested in other investment property. This "roll-over" procedure has an apparent attraction in its encouragement of reinvestment by postponing taxation of realized property gains that are reinvested. However, we find the proposition to be a serious violation of equity. In effect, the suggestion is that those who accumulate saving from realized but reinvested property gains shall be free of immediate tax, while those who save from other income must pay full rates of income tax at the time the income is received. We are unable to find any rationale for a system that would enable some property owners to save from pre-tax dollars, while others must save from after-tax dollars. If such a substantial incentive to investment and saving is considered to be desirable, we discuss in Chapter 4 a number of alternative ways to provide it without discriminating among any of the sources of saving. The proposals outlined in Chapter 16 for Registered Retirement Income Plans do not discriminate between sources of income and would be a strong inducement to saving.

In addition to the serious inequities that would be produced by a roll-over provision, there would also be major administrative problems in determining what income should be eligible for such a provision and to what extent. We examined in detail a number of alternative methods of providing for a roll-over and found them all to be subject to major complexities and serious definitional problems.

Revenue

It has been argued strongly that there should be no change in the tax base unless the additional revenue to be produced were substantial. This proposition is unacceptable to us, because we believe that a fair sharing of the total tax burden would be a goal to be pursued even if it resulted in no change in total revenue. Naturally, any proposed alteration in the tax base would be warranted only if it were administratively feasible. We are satisfied that the comprehensive tax base would, after the initial transition period, have administrative advantages which would far outweigh short-run difficulties. We reject any policy under which any form of income would be relieved of taxation on the ground that it contributed little to total revenue, or that the cost of collection exceeded a nominal percentage of the revenue collected.

It is not possible to estimate with any degree of accuracy what the net revenue effects of the taxation of property gains and the allowance of property losses would be in any one year. Because such gains are now tax free, there are no figures available to indicate their magnitude. Moreover, even if such figures were available, any projection would be questionable because of the variations in this type of accretion to wealth. However, there are statistics available on the United States experience and it is possible to arrive at a general estimate of Canadian revenues based on these figures. It has been possible to adjust this estimate fairly readily to take account of a number of our proposals, because of the statistical material that is available. Thus, adjustments were made to reflect the taxation in

full of all property gains, the full allowance for all property losses, the inclusion as a disposition of a gift or bequest, and the lowering of the top marginal rate of personal tax to 50 per cent. However, the impact of our proposals for the integration of the corporate tax on the revenue to be derived from the taxation of property gains is much more difficult to estimate. Ignoring the effect of the integration proposals, we are satisfied that in the long run the revenue from the full taxation of property gains of resident individuals would exceed 10 per cent of personal income tax revenue, or something less than what the United States percentage would be for similar gains if they adopted the same procedures 9/. Based upon the average rate of tax in Canada in 1964, this would have amounted to about $300 million, while the taxation of corporate property gains would have resulted in about another $80 million of revenue. It has also been assumed that the proportions of income derived from each of the general sources of income would remain unchanged, with total property gains realized by Canadians forming a lower proportion of their total income than they do for United States taxpayers. Because these assumptions are conservative, and because property gains tend to be concentrated in the growing middle and upper income groups, we expect that the percentage would increase over time. In the short run, however, the revenues would be nominal, because only gains accruing subsequent to the change in legislation would be affected, and because the other transitional provisions we recommend would temporarily reduce the potential revenue.

The net effect of taxing corporate source income on an integrated basis would be to eliminate most of the retained earnings element in share gains 10/. However, the goodwill element in share gains would remain and might well increase because of improved after-tax rates of return from integration, and because the resulting increase in the rate of fixed capital formation should stimulate share prices. On the basis of experience in the United States, where stock gains make up over one half of the total reported property gains, the potential revenue from the taxation of property gains in Canada, based upon average rates of tax, would probably be considerably less than the figures given above. Detailed estimates of the overall revenue implications of the taxation of corporate source income are contained in Chapter 35.

THE PROPOSAL IN OUTLINE

The following summary gives a general outline of the main principles we think should apply in the tax treatment of property gains and losses. In subsequent pages some of the major questions which arise will be discussed.

Gains should be included in income when they are realized, that is, on the disposition or deemed disposition of property. The concept of realization or receipt of income was discussed in Chapter 9 and the difficulties of defining these terms were outlined there. In the case of property gains we are suggesting that a realization should be deemed to have occurred when there has been a disposition, as we employ the term, even if the disposition does not in itself result in the receipt of cash. We have already discussed the major problems that an approach of this nature can produce: the breach of the ability-to-pay principle if gains are not taxed as they accrue to the benefit of the taxpayer, and the problem of lump sum income receipts if gains accruing over many years are taxed at progressive rates in one year. Taxation on an accrual basis will be discussed later in this chapter, while several income-averaging proposals are described in Chapter 13.

1. Persons taxable should include residents, both individual and corporate, and they should be taxed on their world gains, just as they are now taxed on their world income. The foreign tax credit should therefore extend to foreign taxes on property gains.

   A non-resident carrying on business through a permanent establishment in Canada should be taxed on gains on property employed in that business, but should not be taxed on gains on the disposition of other property until a satisfactory means can be developed of assessing the tax and enforcing its collection.

2. Gains on all forms of property should be included in computing income, subject to a limited exception for certain residential, including farm, properties.

3. While all losses should also be taken into account in computing income, no deduction should be permitted for losses that are in effect items of personal consumption. To accomplish this objective, all losses should be deductible except to the extent that they resulted from the disposition of property that has been held for personal use or consumption, or resulted from an activity that could not be reasonably related to the earning of income.

   Although, in general, a loss should be allowed as a deduction only if a disposition has taken place, we also suggest that a deduction should be permitted when there has been no disposition, provided that a loss could be shown to have actually occurred. It would not be necessary to show that the loss was of a permanent nature.

4. The term "disposition" should be used in the broadest sense. It should include voluntary dispositions, such as sales or exchanges of property, and involuntary dispositions, such as occur on the loss of property. It should also include most changes in the form of property, even if one person held ownership throughout the transaction. In addition, the termination of a contingent interest in property or of an option to acquire property should be treated as a disposition.

   These rules would mean that gifts and bequests, which are voluntary dispositions of property, would be treated as dispositions for tax purposes at the fair market value, as we think they should be. Moreover, certain events should be deemed to result in dispositions. Thus, whenever an individual or a corporation becomes or ceases to be resident in Canada, there should be a deemed disposition of the property of that person, while on a person becoming resident in Canada there should be a deemed acquisition by him of his property at the fair market value.

However, certain events affecting property should not be treated as dispositions, so that their occurrence should not give rise to a gain or loss. Among these events, if they qualified in the prescribed manner, we would include the following:

a) A loss or destruction of property that gave rise to payment of insurance or damages if such proceeds were reinvested in similar property within a reasonable time.

b) The expropriation of property if the proceeds were reinvested in similar property within a reasonable time.

c) The transfer of property to a corporation when a business was incorporated.

d) Exchanges of shares and transfers of property on certain corporate reorganizations.

e) The pledging of property by way of security for an obligation.

5. When a disposition occurred, the gain or loss should be determined by deducting the cost basis of the property from the net proceeds of disposition.

The net proceeds of disposition should be the consideration received, less any expense of the disposition. On gifts or deemed dispositions, the proceeds should be taken to be the fair market value. The cost basis should include the original cost of the property and most costs incurred to enhance or to protect its value. In particular, it should include any interest and property taxes which the taxpayer elected to add to his cost basis rather than to deduct as a current expense. There would also be other adjustments to the cost basis in certain events.

Partial disposals would require an apportionment of the cost basis,

using either an average cost, first-in-first-out, or some other reasonable basis of allocation.

6. Annual tax returns should include appropriate information as to all securities and real property owned. Particulars of all property gains and all deductible property losses would also be required.

7. The taxation of property gains should not be retroactive. Gains on property held on the transitional date should be taxable only to the extent that the proceeds of ultimate disposition exceeded the fair market value at the transitional date.

   Publicly traded securities should in most cases be valued at their market value as at the transitional date. For other property the taxpayer should be allowed to value his property as at the transitional date, or alternatively to wait until disposition and then to apportion any gain or loss, on a time basis, between the periods before and after the transitional date. A partial exemption for gains determined under the second alternative would make this alternative attractive and should reduce the number of detailed valuations required.

Persons Taxable

The taxation of residents poses few difficulties in determining who would be taxable, beyond those difficulties already encountered under the present law. However, the situation would be more complex where non-residents were concerned.

The general approach to the taxation of non-residents, that we develop in Chapter 26, is that income derived from Canada should be subject to some Canadian income tax. Accordingly, the levying by Canada of some tax on gains realized by non-residents on the disposition of Canadian property would appear to be in order. However, the administration and collection of such

a tax would in many cases be difficult, if not impossible, because of the problem of determining when a disposition by a non-resident had taken place, and the further problem of enforcing the collection of any tax imposed. Therefore, we do not propose that property gains of non-residents should immediately become taxable in Canada, unless a non-resident carried on business in this country through a permanent establishment and the gain was on property employed in that business. However, if procedures could be developed that would make it feasible to tax other gains of non-residents, Canadian tax should be assessed on this type of income in the same way as on other income derived from Canada.

We also recommend that the definition of "permanent establishment" should include real property and mining and petroleum rights owned in Canada by a non-resident, who would therefore be taxable on gains on the disposition of such property. This would require that non-residents also be taxable on the disposition of shares of closely held companies used to hold real property. If these measures were not adopted, the non-resident owner of real property would have a competitive advantage over the resident.

Gains for Tax Purposes

We propose that gains on all forms of property should be taxed, property being broadly defined as in the present Act, subject to the exclusion provided for below. We do not believe that any other form of gain should be excluded on the grounds of equity or administrative complexity. However, if some other specific item should be excluded, it would have to be defined. We do not suggest that the Act should specify all items to be included in income, but rather that it specify any items that are to be excluded. The latter approach minimizes taxpayer uncertainty and the inequities that could otherwise arise.

We recommend an exception for property gains realized on the sale of residential (including farm) properties up to a lifetime total of $25,000

of such gains for a family unit or an individual. Although the reasons for this exclusion are largely administrative, there are also social implications. The complexities in maintaining adequate cost records over the periods involved if gains on residential properties were taxed would be considerably greater than would be involved for other types of property. In addition, the taxation of gains on such properties would give rise to pressure to have losses of a similar kind allowed, even though the losses might reflect in large measure costs of a personal consumption nature such as depreciation of a dwelling. Also, some form of roll-over provision, despite all its attendant complexities, might be demanded. We therefore recommend an exclusion, but an exclusion limited in some important respects.

Residential properties and adjacent lands used by the taxpayer as a residence should be eligible for the exemption. All property owned and operated by bona fide farmers should also be eligible, provided it had been worked as a farm unit by the owner for not less than two years. At least for a transitional period, the trade or business test should continue to apply in order to tax gains arising from trading in such real property. The lifetime dollar limit would reduce the significance of the trade or business test, and also would make it unnecessary to impose an acreage limitation on the exemption as was done in the United Kingdom. To relieve most taxpayers, other than qualified farmers, from the necessity of maintaining detailed records of improvements, we suggest that the cost basis of residential property could be determined, by election, either on an actual basis or by adding to the original cost basis 1 per cent of the cost of the buildings for each year the property had been held. If the actual basis were used, then the same considerations would apply as at present in determining whether an expenditure was a repair item or an addition to the capital cost. In addition, as we indicate later in this chapter, it should be possible to add to the cost basis property taxes and interest, except to the extent they were disallowed as personal expenditures. These latter expenditures would therefore be available for deduction by qualified farmers, but generally not by the

holders of residential real property. Property held at the effective date of the new legislation could be valued at either cost or the appraised market value at that date. A taxpayer using property jointly for personal living and business would be required to allocate his costs and expenses between the two. There would be pressures to make a reasonable allocation, because only business depreciation would be deductible, while only personal gains on the sale of residential property would be exempt. If members of a family unit filed separate returns and each had eligible gains, the exemption would be apportioned between them.

Losses for Tax Purposes

Deductible Losses. Because we recommend that all realized gains should be brought into the tax base, equity requires that all realized losses should be applied to reduce the tax base. Subject to what follows concerning property employed in personal use, we recommend that losses realized from dealings in property should be deductible in full from all other forms of income. This deduction would be considerably more liberal than that existing in other countries, 11/ and parallels our recommendations elsewhere in this *Report* for the treatment of business losses. Although this proposal might prove expensive to tax revenues in years of declining asset values, we feel that not only would it result in a tax base that would be a better reflection of taxable capacity, but that it should provide an incentive for risk investment. It also has other very desirable economic implications, in particular for stabilization policy. Further discussion of the economic effects is included in Chapter 37. It should also be noted that our studies of the taxation statistics for the United States suggest that the loss limitation there places little restriction on the higher income groups, who soon realize compensating gains, while many in the lower income brackets appear to have to carry forward a loss which in effect becomes non-deductible.

We therefore recommend that the loss carry-over provisions that we suggest for business losses in Chapter 22, a carry-back of two years and an

unlimited carry-forward with the loss being deductible from all other kinds of income, should also apply to losses on the disposition of property.

Non-Deductible Losses. The general proposition for the deduction of losses has, however, serious implications as regards principle and administration. We do not intend to recommend the deduction from the tax base of items of personal consumption; thus, for example, depreciation or losses on assets employed for personal use should not be deductible. The primary obstacle to an allowance for a capital loss realized when a consumption asset is lost through damage, destruction or theft is one of determining the depreciated value of an asset at the time of loss. There would also be a problem of enforcement under a tax system which would disallow a deduction for partial losses, through depreciation, but would permit a deduction of a complete loss, through destruction. In addition, a tax system that permitted the deduction of such losses should logically allow the deduction of expenses incurred to reduce the amount of these losses. Any listing of such expenses would be lengthy, and the administration of such an allowance would be complex and uncertain. Therefore, the inability of the taxpayer, and even more the inability of the tax administration, to ascertain accurately the gain or loss from the depreciated value arising on the disposition of personal assets, as well as the additional administrative difficulties involved, have led us to the conclusion that it would be necessary to disallow all losses on property held for personal use, including losses arising on the disposition of a residence.

Losses on the Disposition of Property. The above conclusion in turn leads to the question of how best to determine whether property has been held for personal use. The recent legislation in the United Kingdom speaks of "tangible movable property", and exempts gains and losses that are within a prescribed monetary limit. It is difficult to assess, at least until some experience has been obtained, whether such a provision is the best way to meet the problem. We have already recommended that the deductibility of expenditures

should be limited to those outlays that are reasonable, are related to the earning of income, and are not for personal use or consumption. The jurisprudence on the last test has already established a number of limitations on deductibility, and we expect that the courts would continue to develop the necessary concepts to determine those expenditures that were a proper charge against income. It therefore appears reasonable to apply the same tests to losses in order to establish their deductibility. Thus, for property losses a deduction should be permitted if at the time of disposition the purchase of the same property for the same use would be deductible at some time, under the statutory rules that we recommend. An approach of this nature would unfortunately produce some uncertainty, but after examining a number of alternatives we are satisfied that it would be the only way to ensure that all reasonable property losses would be deductible. Nevertheless, we shall describe later an alternative approach that might be applied if the definitional problems become excessive.

The proposed allowance of losses on the disposition of property parallels that recommended for business losses, and therefore means that in most circumstances there would be no significant difference between business gains or losses and property gains or losses; an approach that would have the obvious advantage of eliminating much of the existing uncertainty in the Canadian tax system. Therefore, we recommend that all gains should be included in income, including any gain on the disposition of an item of personal property, but we recommend that the general allowance of all losses should be restricted by denying a deduction for losses of a personal nature.

In relation to business losses we have proposed an arbitrary rule to the effect that, if such losses have been incurred in three years during a five-year period, and, if subsequent gains from the same business do not exceed these initial losses, then subsequent losses would be regarded as losses of a personal expenditure nature and could be applied only against income from the same business for other years. This rule is obviously not applicable

to losses incurred on the disposition of property (unless it is property employed in such a business) since various types of properties might be disposed of during a period of years and the fact that net losses were incurred would not lead to any implication that any particular property was acquired or used for personal consumption. The question of whether property losses are of a personal nature, so that their deduction would be restricted, would have to be determined on the facts of each case unless it should be found necessary to adopt the alternative approach which we will refer to later.

The possible inequity of taxing gains on some transactions, for example, on property for personal use, while disallowing losses on similar transactions, is more apparent than real. Only where the sale price of property held for personal use exceeded the original cost, rather than the depreciated value, would the excess be subject to tax. It is unlikely that there would be many items of this nature, and if they were material, the possibility would exist that they were acquired with a business motive. The possible inequity of not allowing a deduction for the loss or destruction of personal property that might result in a substantial reduction in taxable capacity is not great, because most consumer durables can be easily insured to provide sufficient protection against such an eventuality.

The major potential inequity in the above approach relates to gains and losses on certain kinds of property that are of a personal nature but that are not actually consumed. The chief examples are works of art and jewellery. It seems to us to be equitable to make some provision for any losses on such property that might arise. Therefore, we recommend that the legislation specifically permit the deduction of most losses on the disposition of property that would otherwise be disallowed from gains realized on the disposition of similar kinds of property in the preceding two years, in the same year, or in any succeeding year. This provision matches the one we recommend for "business" losses that were or were deemed to be of a personal nature.

Losses on the disposition of residential real property, which are losses on property held for personal use and not therefore deductible, should not be eligible for this carry-over. Losses on the disposition of personal property result mainly from two processes: the "using up" or depreciation of the property, and the gain or loss in the value of the property caused by external influences unrelated to wear and tear. The latter process would usually result in a gain, unless a loss of a casualty nature had occurred, for example, a fire. Losses resulting from depreciation should clearly be excluded from the tax base as being of a personal nature, while gains or losses of the second kind are similar to those arising from the disposition of other kinds of property and should, in principle, be included in the tax base. As already pointed out, it is difficult, if not impossible, to segregate a gain or loss on the disposition of personal property into these two elements. As a result we recommend that in the case of property held for personal use only the net gain, that is, the excess over the depreciation loss, should be taxable and that no loss should be deductible, even if no part of the loss was attributable to depreciation. We have suggested that, to relieve the inequity that such a provision might cause to a taxpayer who disposed of a number of items of the same kind of property, any losses should be deductible from gains on the disposition of similar property. However, the extension of this concession to residential property would not be warranted. If a taxpayer has a number of transactions in this kind of property he might well be engaging in a form of business or investment. In addition, the depreciation element in residential property is substantial, and a loss carry-over would only benefit those who are in a position to derive substantial speculative gains on an increase in land values. Furthermore, any potential inequity in the procedure we recommend should be more than compensated for by our recommendation that there should be a lifetime exemption of $25,000 in residential property gains for each tax unit.

The farm property of a bona fide farmer should not be classed as personal property for this purpose, and therefore losses incurred on the disposition

of such property would be allowed as a deduction from any income. However, it would be reasonable to provide that, before a property gain could qualify for exemption under the $25,000 allowance, it would be necessary to "recapture" any property losses on farm property which had previously been claimed as deductions from other income.

Operating Losses on the Holding of Property. In Chapter 9 we recommend that while business losses and losses incurred on the disposition of property should be deductible from other income, subject to certain limitations, operating losses arising from the holding of property should not be deductible from income arising from other sources. We recommend this treatment because we believe it would be the most appropriate way to match income and expenses for tax purposes. The difficulty in matching income and related expenses arises because property is often held with a view to eventual disposal at a profit. Because the increment in property value is not brought into account until it is realized, it would not be reasonable to permit the annual deduction of operating losses that represented the carrying costs associated with such ultimate gain. An additional consideration is that it would often be difficult to determine to what extent a property was held in anticipation of a gain, and to what extent it provided the taxpayer with a personal benefit. By not allowing these losses to be deducted from other income, but rather permitting them to be carried back two years and forward indefinitely for deduction from operating income (but not gains on disposition) from the same property, the desired objective should be attained. To alleviate the difficulties which such a limitation might otherwise cause, we recommend that certain expenditures that are commonly thought of as being a cost of current operations, but that are also costs of "carrying" the property, should be permitted to be capitalized. Thus, costs that were primarily related to the holding of property, with a view to its later disposal at a gain, could be added to the cost basis of that property. This would reduce the current operating expenditures, and therefore the current losses, and would match the expenses more closely to the expected revenue, that is, the property gain. The capitalization of these expenditures would be optional to the taxpayer.

Although there are a number of kinds of expenditures that might be eligible for capitalization, we consider the prime examples to be interest and property taxes. The costs of establishing or defending title to the property, and damage costs related to the ownership of the property are also items which should reasonably be eligible for capitalization. Where property is clearly of a personal consumption nature, such as residential property or consumer durables, carrying charges such as interest and property taxes should not be deductible, and the taxpayer should not be able to capitalize them or add them to the cost basis of the property.

Alternative Treatment of Losses. In the event that the procedure we recommend for limiting the deduction of losses of a personal nature proved difficult to administer, we suggest as an alternative that the Act permit only the deduction of losses that were specifically defined, and that items of property employed in personal use should not be included in the list of allowable losses. The list, apart from business losses, should include losses suffered on the disposition of: securities; real property, except for residential property as already defined; machinery and equipment used in a business; intangible property as defined in Classes 13 and 14 of the capital cost allowance regulations (as expanded); purchased goodwill; interests in trusts, non-registered pension plans, etc.; and such other kinds of property as could be specifically defined and were not generally employed in personal use. Other property losses would not be deductible from other income, but would be deductible from gains realized on the disposition of similar kinds of property in the preceding two years, in the same year, or in succeeding years. The word "securities", in this context, would mean capital stock and obligations such as bonds, debentures, notes, mortgages, and other funded indebtedness.

To include in the tax base all gains other than those specifically excluded, and to deny a deduction from the tax base of all losses other than those specifically allowed, has obvious advantages in certainty and administrative feasibility. However, it does not explicitly permit all losses that

are not of a personal consumption nature, and therefore we suggest it only as an alternative.

Determination of When a Loss Should be Deductible. In the above discussion the word "loss" has been employed, and the precise meaning of the word therefore becomes significant. Basically, a loss should be defined to occur when there has been a disposition of property at a price that is less than the cost basis, when the property has ceased to have any significant value, or when the value of the property is shown to have declined to a point from which there would be no further fluctuation in value 12/. Although a definition of this nature would permit the claiming of a loss when a disposition had not taken place, ordinarily it would be difficult to do so.

In order to serve as an incentive to risk taking, and to reduce the need for regulations to prevent abuses in this area, we wish to provide additional means of claiming losses. We suggest that a taxpayer should be permitted to value all of his publicly traded securities, or any of them he may select, at either cost or market (or possibly at a price between cost and market). Although the option of valuing securities at a price other than cost would primarily be utilized by taxpayers who wished to claim a loss, in some cases a taxpayer might find it appropriate to accrue an unrealized gain. In this case the taxpayer would compute his income as if he had sold the securities at the year end at the adjusted price, and had reacquired them at the same price. However, in the case of a reduction in market below cost, if later the price of the security recovers, the taxpayer's cost basis should be increased up to the market value but not to an amount exceeding the original cost basis to bring such increase into income. The fact that the taxpayer could use this option for only some of his securities, and need not claim the full write-down to market, should reduce the number of instances when this upward revaluation would be required. This proposal would also considerably reduce the use of the so-called "wash sale" 13/ procedure to recognize a loss or gain, and would therefore avoid some artificial stock market transactions and

fluctuations. However, if the required upward revaluation on a subsequent recovery of prices encouraged taxpayers to engage in "wash sales", consideration should be given to dropping the required revaluation. Experience in the United States has shown that regulations to prevent this type of artificial realization only lead to more complex manipulations.

We also suggest that taxpayers should be allowed to revalue their holdings in a private corporation by following certain procedures. We think that such revaluations should be settled with the tax authorities and that the private companies concerned, rather than individual shareholders, should be responsible for the negotiations. They should be permitted to undertake such negotiations only if formally instructed to do so by the holders of a majority of the voting shares of the company. Individual shareholders would not be required to utilize the valuation so arrived at, but if they did, the tax authorities would retain the right to revalue to not more than original cost if the securities concerned subsequently appreciated in value. This procedure would make investment in risk enterprise more attractive and should reduce the attraction of trading in loss companies. It might become necessary, because of the difficulties of supporting a revaluation of a private share, to introduce regulations permitting the use of stated valuation procedures. In any event, we hope that the tax authorities would establish the procedures to be followed in a manner that would minimize uncertainty for the taxpayers concerned.

Individual taxpayers might also be permitted to revalue other property that was not employed in a business, if they were able to demonstrate that there had been a loss in value. Again, upward revaluation should be required in the event that the property regained its value. Thus, an individual could be permitted to revalue an interest in a trust or a similar intangible property interest. This provision should not be extended to property employed in a business, because the ordinary rules applicable to the determination of property losses in a business, and the amortization of depreciable property

should be satisfactory. In any case, a loss suffered by a company could be claimed by a shareholder through the disposition or revaluation of his shares.

Dispositions for Tax Purposes

The principle of recognizing only realized gains on property may generally be accepted on grounds of administrative convenience, but the principle of taxpayer equity would be violated if it were possible for taxpayers to postpone indefinitely, or to escape permanently, their underlying tax liability. The comprehensive tax base that we recommend includes all a taxpayer's increments in wealth, whether realized or not. Any variation from the procedure of computing tax liability on the basis of an annual accrual of property increments would be a violation of equity, even though administrative considerations may make such a variation necessary.

It would be possible to accept the postponement of taxes inherent in the realization principle only if it were temporary. We have therefore said that the term "disposition" should be used in the broadest sense. It should include any form of transfer or alienation of title to property, including sales, exchanges, gifts and bequests of property, except transfers from one member of a family unit to another. It should include the termination of a contingent interest in property, and extend to involuntary disposals of property arising, for example, through expropriation, theft, damage or destruction; in such cases any compensation recovered whether by insurance, damages or otherwise should be treated as proceeds of disposition. While in the case of bona fide transactions at arm's length the actual proceeds should be included in computing income, in the case of gifts, bequests and transactions not at arm's length, the disposition should be deemed to take place at the fair market value. However, we suggest that, under certain circumstances discussed below, some of these involuntary disposals should not be regarded as dispositions for tax purposes.

Exchanges of Property. The exchange of one property for another could raise difficulties, because the parties would not realize cash with which to pay any tax liability that may accrue. In the case of voluntary dispositions there generally should be little hardship because the parties would supposedly have foreseen the situation and have taken steps to meet their tax liabilities. Because an individual taxpayer would be required to pay tax on his accrued gains at the latest upon his death or that of his spouse, the hardships would be mainly a question of timing, because an exchange would attract tax at an earlier date than would otherwise have been the case. To exempt voluntary exchanges of property for the corporation would be especially unreasonable, for it could result in a permanent deferment of tax liability. However, certain specified types of exchanges, especially those occurring in connection with certain corporate reorganizations, should not constitute realizations. These are discussed below.

Disposition on Death. We do not suggest that a transfer on death should be excluded from being a disposition for tax purposes. Although the United States does make such an exclusion, and although the United Kingdom has a substantial monetary exclusion, we consider that it would be a serious breach of taxpayer equity to grant such an exclusion from the comprehensive tax base. For example, one could compare the lifetime tax burden of two taxpayers with identical lifetime economic incomes, on the assumptions that one taxpayer died the day after liquidating all his assets, while the second taxpayer died before any such liquidation. The tax capacity of the two taxpayers would be identical, but their tax liabilities could be drastically different, and would be equalized only if there were a deemed disposition for tax purposes on the death of the second taxpayer. The economic implications of deemed dispositions in such cases are also considerable for, as has already been discussed, to the extent that immobility of capital investment does exist in the United States, it would appear to be largely the result of the tax deferment and exemption extended to accrued gains on property transferred by gifts and bequests. Basically, we consider it would be intolerable

to permit some taxpayers to escape their "accrued" tax liability by merely reducing the number of dispositions that they made during their lifetime.

There are two potential inequities that could result from the taxation of a disposition on death. The first concerns the availability of cash to meet the tax liability. The second results from the possible application at one time of steeply progressive rates of tax to an amount of income that had accrued over a number of years. We feel that taxpayers are capable of planning their affairs to meet the first situation, but that payment of certain tax liabilities should be permitted over time with an appropriate rate of interest. The problem would be substantially alleviated by our recommendation that under the family unit approach there should not be a disposition for tax purposes on the death of one spouse, but only when the family unit terminated. The averaging provisions we recommend in Chapter 13 should be adequate to relieve most problems resulting from the bunching of income.

Excluded Transactions. In addition to recommending that there should be no disposition for tax purposes on a transfer between members of a family unit, there are other cases in which we recommend that a disposal should not be considered to have taken place. Transactions of this nature should be specifically excluded from being dispositions for tax purposes. Generally these are cases where there has been no change in the essential continuity of an investment, although there may have been some alteration in the form of the investment.

In the event of certain involuntary disposals of business property, any proceeds received may be required to be reinvested in replacement property to ensure continuity of the business. The present legislation with regard to the recapture of depreciation recognizes this situation, by providing that insurance proceeds payable in respect of loss or destruction of property need not be brought into income if reinvested in similar property within a limited period. We recommend that such a provision should be retained and extended to apply to gains in excess of the cost basis. It should also

cover damages or other compensation for loss or destruction of property, and the proceeds resulting from an actual or threatened expropriation or compulsory taking of property, but only to the extent that the proceeds are reinvested in property of a similar nature within a reasonable period. In such cases, the cost basis of the new property would be related to the cost basis of the original property.

It is also necessary to consider the extent to which corporate reorganizations, amalgamations and other inter-company transactions should attract tax. We recognize that it is often necessary to change the form of ownership of a business or property, or to rearrange or reorganize the affairs of corporations for business reasons. If every such change or reorganization were to result in a disposition for tax purposes by the shareholders, or the corporation, or both, this could have an inhibiting effect and could tend to produce undesirable rigidity in corporate structures. Because we regard a corporation as an intermediary, and individuals as the persons who ultimately bear the taxes, we consider that certain corporate reorganizations and transfers which change the form of ownership, but do not effect a change in the ultimate beneficial ownership of a business or property, should not result in a tax liability.

A type of transaction which does not involve a change in the essential continuity of an investment can occur when a business is incorporated. Accordingly, where property other than securities is transferred by an individual or individuals to a new company in exchange for common shares of the company, we consider that the disposition of each asset or class of assets should generally be regarded as having taken place at its cost basis to the transferors as adjusted by capital cost allowances and otherwise to the date of transfer (which is referred to below as the adjusted cost basis). However, the parties should also have the right to elect that the disposition would take place at a price which was specified as being the fair market value of the assets transferred. If this election was made, and if the price specified

for all the property transferred and for each asset or class of assets should be shown not to be the fair market value, the administration would be entitled to require that this price be adjusted to the fair market value.

In the event that the property was transferred by an individual to a new company in exchange for common shares of the company which were publicly traded and which represented less than, say, a 25 per cent interest in the outstanding common shares of the company, the disposition should not be permitted to take place at the adjusted cost basis of the property to the transferor, but rather should be at the fair market value of the property transferred. Otherwise, an individual selling property to the company would be able to unduly defer taxation on the profit realized on the exchange. If the transfer was made at the cost basis of the property rather than the fair market value in consideration for common shares which were not publicly traded, or which were publicly traded but represented more than 25 per cent of the outstanding common shares of the company, and these shares subsequently became publicly traded or became less than 25 per cent of the outstanding common shares of the company, the individual should be deemed at that time to have disposed of the shares at their fair market value and to have reacquired them at the same price.

The procedure outlined above for the transfer of property to a new company should apply equally to a transfer of assets to an existing company in exchange for common shares by the individual who owned all of its common shares, or by several individuals who owned all the common shares if the transfer was made by the individuals in proportion to their shareholdings and this proportion did not change on the carrying out of the transaction.

It may be that the procedures we suggest could be made available where the property was exchanged for redeemable preference shares or other securities, as well as when it was exchanged for common shares, but it would be necessary to regulate such a procedure to ensure that it was not utilized as a device for tax deferment.

Another type of transaction which does not involve any change in the continuity of investment is a transfer between a company and its wholly owned subsidiary or sub-subsidiary, or between companies which are wholly owned directly or indirectly by the same shareholder (or by the same shareholders in the same proportions). This would include a liquidation of a wholly owned subsidiary corporation. The legislation should provide that any such transfer of an asset or class of assets may be made at its adjusted cost basis to the transferor, or at the fair market value, or at any price between these two figures. In the case of each such transfer, including a transfer on a liquidation of a wholly owned subsidiary, the transfer price, or the basis of computing the transfer price should be specified by the parties. If it was lower than both the cost basis to the transferor and the fair market value, or if it was higher than both of these amounts, the administration should be entitled to require that the price should be adjusted accordingly.

We must also consider the treatment of a statutory amalgamation of two or more companies. In this case there should not be a deemed disposition of the assets of the companies, but there should be a deemed disposition by the shareholders (except an amalgamating company) of their shares at the fair market value. The same treatment should apply if a corporation transferred all its assets to another corporation in consideration for securities of the other, provided the transferor corporation was then liquidated immediately. In this case, as on any liquidation, the shareholders of the transferor corporation would be regarded as having disposed of their shares for a consideration equal to the value of what they received on the liquidation. This value would then be the cost basis of the securities received on the liquidation. The cost basis of the assets to the transferor company, and the tax treatment of the assets transferred, would be carried over to the continuing corporation. This would also apply in the case of an amalgamation. The provisions contained in section 85I of the Income Tax Act could be used as a guide in this connection.

As far as other corporate transactions are concerned, our general approach is that transfers and exchanges of assets and securities in such cases should constitute dispositions for tax purposes. However, while it may be reasonable to tax share exchanges of capital stock in two unrelated corporations, primarily to ensure tax neutrality between the various forms of purchase offers, and because of the complexity and tax avoidance that could arise if any exemption were permitted, exchanges of capital stock in the same or related corporations are in many cases a reasonable subject for exemption. The interest of the shareholder may not be materially altered in substance, although it may be in form. It is possible to define a restricted exemption in this case in a manner that should preclude most uncertainty and most possibilities of utilizing the exclusion as a tax postponement device. We suggest that an exchange of shares of capital stock should not be a disposition if immediately after the exchange the taxpayer had the same proportionate participation in votes, in distribution of income and on liquidation that he had immediately prior to the exchange. This rule should apply to the subdivision or consolidation of the shares of a company, to the splitting of shares of a particular class into two or more classes of shares, to the variation of some rights attaching to shares, and to similar kinds of recapitalizations. The cost basis of the securities exchanged should apply to the new securities received. We do not suggest any other exemption on an exchange of securities, although we do not rule out the possibility that others could be developed that would not invite exploitation for tax avoidance purposes.

The disposition of an asset by way of security for an obligation should not be treated as a disposition for tax purposes. The same rule should apply to the re-transfer of the asset on the discharge of the obligation. Although a taxpayer could in this manner obtain cash in excess of the cost basis of property without any tax liability, we feel that it would be exceedingly difficult to enforce any provision that deemed a loan on a security to be a disposition for tax purposes.

The United States Internal Revenue Code contains various provisions which allow a tax deferment for certain kinds of corporate reorganizations and share exchanges. These provisions, by and large, are complex and have led to problems of tax avoidance. Apart from this, certain of the reorganizations permitted in the United States would not be feasible in Canada because of differences between the corporate laws of the two countries. We have also considered the fact that the United Kingdom provisions in this general area, including those relating to take-over bids, are more liberal than those we have suggested. These provisions are also somewhat complex, and it is not yet clear how they will work in practice.

Our general approach is partly influenced by our proposal for the integration of the corporate and the individual tax, a procedure that is not now followed by either the United States or the United Kingdom. We think that under our integration proposals, capital gains on shares arising from an accumulation of underlying corporate earnings would not be the problem that they would be if integration were not introduced. We also think that a tax-free investment roll-over would in most cases lead to more inequities than it would alleviate. Although problems of liquidity could arise under our approach because the shareholder might not have the cash available with which to pay the tax, we do not believe that this problem would be sufficiently serious to warrant introducing complex measures that could lead to uncertainty and to tax avoidance. Moreover, reorganizations often take place in times of corporate difficulty when it is unlikely that a gain would result. This may not ordinarily be the case where corporate amalgamations or take-overs are involved, but in these circumstances there is usually a material change in corporate structure or control, and the gain involved is to a large extent the result of such change. In such circumstances it appears reasonable to impose the tax at the time the gain arises.

We appreciate that our list of exempt dispositions is limited and perhaps should be extended. We think, however, that additions should be made

only after careful consideration of the problems of administrative complexity, uncertainty, and possibilities for tax avoidance which may be involved.

Deemed Disposition on Change of Residence. Apart from the cases of voluntary or involuntary dispositions already mentioned, we recommend that a disposition should be deemed to have occurred when a taxpayer, individual or corporate, gives up Canadian residence.

The same equity considerations already discussed in connection with a disposition on death apply to the question of deeming a disposition to have taken place when a taxpayer gives up his Canadian residence. We do not think it should be possible for a taxpayer to escape tax on property gains that have accrued during his residence in Canada simply by becoming resident in another country. Our recommendations for general averaging provisions, and for spreading the payments on the tax liability should be sufficient to meet the major difficulties of liquidity and lump sum income that could arise.

The deemed disposition on a change of residence would also be significant for a taxpayer who became resident in Canada. Because the disposition would be deemed to take place immediately prior to the change in residence, such a taxpayer would value all his property at market value when he became resident, and would be subject to tax only on subsequent gains.

There are administrative problems in connection with deemed dispositions on a change of residence. We recommend that in general individuals leaving Canada should either be asked if they are giving up their Canadian resident status or should be required to sign a simple declaration indicating whether they are emigrating or only planning a temporary absence. Those who were emigrating should be required to show evidence

of a tax clearance, which would be obtainable only after the filing of a final tax return that brought accrued property gains into taxable income. It would be essential to have procedures under which clearance for emigration would be issued expeditiously on the posting of adequate security or on the giving of adequate undertakings without awaiting assessment of the final return. Also, if suitable arrangements to ensure payment of future tax liabilities could be made, the taxpayer should be permitted to elect to continue to be taxed as a Canadian resident by filing returns on a world income basis, so that a disposition would not have to be deemed to have occurred.

We appreciate that at the present time questions are only asked of, or forms required from, persons entering the country, so that additional staff would be required to implement this recommendation. However, to accomplish the desired objective the procedures would not have to be complex. Initially the question need only be asked and a form required from those who indicate they are giving up their resident status. In some cases (e.g., commuter crossing points) it would not even be necessary to ask any questions. Eventually the carriers (airline, railway or bus line) might be asked to have their passengers complete a simple form which the carrier would then turn over to the border official.

The enforceability of provisions such as these would to a great extent be dependent upon taxpayer honesty, which fortunately has been sufficient in Canada for the operation of a self-assessment system. Most taxpayers would be unwilling to sign a false declaration and, more important, would be reluctant to be labelled as tax evaders who could not re-enter the country because of the threat of prosecution. The tax authorities would have no difficulty in determining who had not made an accurate declaration, for the fact that annual tax returns ceased to be filed would raise questions as to why the taxpayer was not reporting his

income. Although it would be necessary, in order to maintain the equity of the tax system, that action should be taken to collect tax at the time of a change of residence, we have not recommended more stringent procedures because it is also important that regular business activity and ordinary travel should not be inhibited or restricted. It may be that some individuals would avoid their liability, but under our suggested procedure it would be clear in such cases that an illegal act had taken place.

Assuming that the present basic rule remains that companies incorporated in Canada shall be deemed resident here, we are concerned simply with companies formed abroad which have become resident in Canada and then cease to be so resident. The number of such corporations is likely to be small, but we think it appropriate that a disposition of their assets should be deemed to take place for Canadian tax purposes when they ceased to be resident here. Enforcement measures where necessary could be directed against the individuals who were directors or officers at the time of the change of residence.

Because it would be possible that a taxpayer, after a change of residence, might also become subject to tax in another jurisdiction when the accrued gain was realized, it would be necessary to allow a full foreign tax credit with respect to such gains, even if this involved a refund at a later date when the foreign tax was paid.

Accrual of Gains or Losses. The final question we wish to discuss in the context of dispositions is whether there should be at least a modified form of taxation of property gains on an accrual basis. We have emphasized in a number of places in this Report that income arises when there is an increase in economic power, and that economic power increases when the market value of property increases. We have also pointed out

the inequity inherent in the realization approach, in that taxpayers who retain investments which have appreciated in value are, in effect, allowed a tax-free investment of the accumulated gains that are built up free of tax, while others, who turn over their investments, are denied this privilege. Nevertheless, we have suggested that other considerations, for example, the administrative difficulties involved, require that, in general, the theoretically correct accrual approach must give way to a realization basis for determining income.

On the other hand, in a number of places in this chapter we have pointed out cases where the realization basis in itself would lead to administrative difficulties and inequities. Most important, we have emphasized that under the comprehensive tax base, which would require that all income would be taxed at full progressive rates, there could be some reduction in the mobility of capital if property gains were taxed on a realized basis only. An accrual approach would also assist in reducing the problems associated with deemed dispositions, corporate reorganizations, and other situations where the build-up of gains over a number of years created difficulties, not only because of the liquidity problems, but because the large potential tax liability would increase the risk of attempts at tax evasion. Also, any reduction in the volume of untaxed accrued gains would lessen the significance of the arbitrary rules for determining when a disposition had taken place.

If the accrual requirement was made applicable only to assets that could be readily valued and was not required annually, then difficult administrative problems should not arise. In particular, because the number of securities involved for most taxpayers would not be large, it would be a relatively simple matter to value publicly traded securities every five years. Such a procedure would be applied to each holding of a publicly traded security once it had been retained for five years. This

would mean that the accrual requirement would be applicable only in a limited area, but would have the desired effect of reducing substantially the long-term accumulation of untaxed gains.

We have considered the problem of the ability of the taxpayers to meet such tax liabilities, and have concluded that even if a taxpayer were forced to liquidate some part of his holdings it would not generally lead to hardship, but rather would be a necessity for overall taxpayer equity in order to ensure that taxpayers were not allowed to defer payment of their income taxes. It is unlikely that many investors would experience any difficulty in meeting such tax liabilities, particularly because our integration proposal should increase the total cash flow to most shareholders, but hardship could arise where there was a thin market for the securities. Therefore, if some consideration were to be given to the liquidity problem it should be in the form of allowing a time period for the payment of taxes on accrued gains that exceeded a certain proportion of total income. Interest should be payable on such deferred taxes.

After some experience had been gained and after certain valuation procedures had become more widely accepted, it seems likely that such a requirement for periodic accruals could be extended to other forms of property. For private companies, the use of the same valuation procedures as those employed for the optional revaluations we have suggested earlier would appear to remove undue difficulties. In fact, after some experience had been gained in this area, it should be possible to formulate a number of rules that would greatly facilitate the valuation process.

Nevertheless, despite our concern with the inequity, complexity, and the other problems of the realization approach, we do not recommend the immediate enactment of provisions taxing accrued gains.

Computation of Gain or Loss

When a disposition for tax purposes took place, it would be necessary to determine the amount of the resultant gain or loss. In most cases the computation would be relatively simple, with the cost basis of the property being deducted from the net proceeds on disposition. The net proceeds would be the balance of the consideration for the property that remained after all the expenses of disposing of the property had been deducted. In the case of non-cash gifts, or deemed dispositions on death or change of residence, the proceeds would be based on the fair market value of the property. The cost basis would include all acquisitions and improvements and certain other adjustments that we have already discussed.

The receipt of stock dividends, or other forms of non-cash distributions or allocations on shares which we describe in Chapter 19, would increase the cost basis. Similarly, the attribution or allocation for tax purposes by an intermediary of a property interest, such as a share in a trust or an interest in an unregistered pension plan, would increase the cost basis of the property interest. If the holders of securities of a company were issued rights to take up additional securities, the cost basis of their original holdings would be increased by the amounts paid to exercise the rights. In addition, we have suggested that a taxpayer should be permitted to add to the cost basis of property, other than property of a personal expenditure nature, certain expenditures attributable to the holding of the property.

A partial disposition of property would involve a reduction in the cost basis. In determining the cost basis when only a portion of the holding was disposed of, either a first-in-first-out or an average cost basis would appear to be reasonable for identifiable interchangeable

pieces of property. In instances where only a portion of a particular property was disposed of a reasonable allocation of cost would be acceptable.

Administration

To bring property gains and losses into account for tax purposes should not unduly increase the administrative difficulties of the tax system and, in fact, for reasons already given, should substantially ease administration in the long run. However, because enforcement of the law primarily rests upon taxpayer compliance, an annual reporting of holdings of securities and real property should be required. Although such a listing is not required in the United States or the United Kindgom, it would greatly assist the tax authorities in their verification procedures, and would enable the taxpayer to maintain an adequate and up-to-date record of the cost basis of his investments. We have reviewed information supplied by the Department of National Revenue and have concluded that the number of items of property to be listed would not be large except for much less than 1 per cent of taxpayers.

The tax return should include a space for a declaration by the taxpayer that he did not own at any time during the year, directly or indirectly, a beneficial interest in any securities or real property. If this declaration were not completed, the taxpayer should be required to furnish a schedule listing the following: his holdings and their cost basis at the beginning of the year; acquisitions, dispositions, and any other changes in the cost basis during the year; and the cost basis of holdings at the end of the year. In addition, the gain or loss on disposition and other property income received would be listed and totalled to provide the necessary income figures. The return should also include a question as to whether any other forms of

property were sold during the year at a price in excess of cost, and whether certain types of property were disposed of during the year at a price less than cost. An affirmative answer to this question would necessitate the provision of particulars which would establish the gain or loss.

Transitional Provisions

To include property gains and losses in the tax base would raise a number of problems which, although initially significant, would gradually fade in importance. We think that those problems, even at the outset, would be eased by the transitional provisions we propose.

We do not intend, of course, that the taxation of property gains should be retroactive. Where gains on the disposition of property held at the effective date of the legislation would be tax free under the present law, the gains accrued to that date should continue to be free of tax. Gains ultimately realized on the disposition of such property should be taxed only to the extent that the proceeds of disposition exceeded fair market value at the effective date as revised by any subsequent adjustments to the cost basis.

Property included in the inventory of a business is subject to tax on disposition under the present law. Accordingly, there would be no need to revalue such property at the effective date of the legislation. This would also apply in the case of property which was held for disposal as part of an adventure or concern in the nature of trade. Because a profit or loss realized on the disposition of such property is taken into account in computing income under the present law, its value at the effective date would have no significance. The principal type of property in this category is probably land, because under the present law and Department of National Revenue practice, securities are normally regarded as investments unless held by a security dealer. We recommend that where there is doubt as to whether the disposal of an asset would result in taxable income under the present law, the tax authorities should be willing to give a ruling on this

point to assist the taxpayer in deciding whether a valuation would be necessary. We also recommend that in order to ease the problems of transition, the tax authorities should adopt a liberal approach in giving such rulings. If a taxpayer received an adverse ruling on this question he would, of course, be entitled to obtain a valuation of the property at the effective date and, when he disposed of the property, to have its status under the present law determined by the courts.

Because capital cost allowances are subject to recapture under the present law, such allowances which had been deducted before the effective date should continue to be subject to recapture. However, if at the effective date depreciable property had a value in excess of its original capital cost, this excess should not be taxable in the event of a subsequent disposition. If such property were sold following the effective date, the undepreciated capital cost of property in the class would be adjusted as under the present law, and if the present law would result in recapture of depreciation, this would be taxable. In addition, if the sale price exceeded the capital cost, this excess would be taxable only to the extent that the sale price exceeded the value of the property at the effective date or the capital cost of the property, whichever was greater. This treatment should result in complicated calculations in only a few cases, because depreciable property would not ordinarily have a value in excess of its capital cost. Valuation of such property at the effective date would be necessary only where the value was likely to exceed capital cost and when the taxpayer did not wish to utilize the optional procedure described below.

The major property owned by most taxpayers is residential real estate, but the $25,000 exemption we recommend for gains on such property should mean that few home owners would be concerned with a potential tax liability on this type of property. In any case, the alternative to a detailed valuation described below should be acceptable for most home owners who were uncertain as to whether they would be exempt from tax under the prescribed dollar

exemption. Publicly traded securities are held relatively widely but, because of their marketability, there would be little difficulty in determining their values at the effective date. Non-residential real estate would pose some valuation problems, although appraisals would not be difficult to obtain in most instances. The major area of uncertainty as regards valuations would be unincorporated businesses and private companies. Valuations of these types of property are usually made only at the time of sale, or when a gift or estate tax valuation is required. However, an alternative is suggested below which should be more attractive to most taxpayers than a detailed valuation.

To ease the difficulties that could arise in establishing fair market values at the effective date, it is suggested that the taxpayer should be given the option, except as regards publicly traded securities, of either obtaining departmental approval of a detailed valuation of some of his property as at the effective date in a manner similar to an estate tax valuation, or of computing an arbitrary value when the property has been ultimately disposed of based upon the following procedure. The difference between the net proceeds of disposition and the cost basis of the property, that is, the original cost of the property, regardless of when it was acquired, plus additions and less disposals, would be apportioned over the total time the property had been held or was deemed to have been held. For this purpose it should be assumed that the period of time that the property had been held prior to the effective date would be the lesser of the actual time held or, say, ten years. An arbitrary limit on this aspect of the computation should eliminate most of the difficulties of determining exactly when property was acquired. It would also reduce the unfavourable effect on equity and mobility that such a transitional provision would otherwise have, because of the potential tax exemption for gains accruing after the effective date on property that had been held for a substantial period of time. In the case of net gains, the portion attributable to the period subsequent to the effective date would be reduced by an arbitrary percentage, say, 25 per cent,

while in the case of net losses this portion would not be adjusted. These balances would then be brought into the computation of income for tax purposes.

We expect that this simple and liberal procedure would discourage detailed valuations. Its adoption would be encouraged by limiting to two years the period during which the taxpayer could elect to make a detailed valuation, and by stipulating that if approval of a detailed valuation were requested, the right to elect the arbitrary procedure would be lost. If the taxpayer and the tax authorities were unable to agree on the detailed valuation, either should have the right to refer the matter to the court. It should also be provided that the same guidelines accepted for a detailed valuation would be applied to any later valuations of the same item of property. Thus, the taxpayer who obtained an unduly high detailed valuation at the transitional date would find that the same basis would be used by the tax authorities at a later date when there was a gift or bequest.

In respect of publicly traded securities a taxpayer might be permitted, in the case of a gain, to employ as his cost basis the higher of the original cost or the actual valuation. If implemented, this procedure should only be available where the property was disposed of within a limited period of three to five years. In the case of a loss, the actual valuation would be employed. This would exempt from tax those gains that represented a recovery of a loss that had accrued prior to the effective date of the legislation.

The adjustments to the cost basis of capital stock necessitated by distributions from undistributed income on hand at the effective date are discussed in Chapter 19. The cost basis of proprietorships and partnerships which were on a cash basis as at the effective date would have to be reduced from market value by the amount of any adjustment resulting from the conversion of the accounts from a cash to an accrual basis. Because the valuation of corporate shares would take into account the market value of the underlying assets, including goodwill, the valuation of these assets would

have to be adjusted to reflect the market value of the shares in order to ensure a proper computation of subsequent gains or losses on any disposition of the underlying assets.

The tax authorities would have to provide for a substantial temporary increase in staff. If a number of special officers (with specialized training in the valuation of companies and real property) were appointed to assist the proposed new Tax Court, disputes should be settled equitably and fairly rapidly.

INCOME FROM HOLDING PROPERTY

Interest

There are no major problems in connection with the inclusion in income of interest received. However, some minor difficulties arise in determining the time of receipt.

In general, the rules of constructive receipt are interpreted to bring an amount into income when it is made available to a person unconditionally, so that it could have been received in cash or its equivalent. However, under present practice there is a general exception to this rule in the case of matured bond coupons, which are usually not included until they are cashed. In the United Kingdom this same procedure is followed, while in the United States the courts have applied the doctrine of constructive receipt to include uncashed matured coupons in income. We recommend that such coupons should be treated as income when they become due, subject to a deduction for bad debts, even if they were not cashed.

A similar problem concerns interest accrued by the borrower, but not payable to the investor until some future time. An example is an investment certificate which provides for the retention and reinvestment of the annual interest until a future date. Generally, under present practice, the tax liability does not arise until such interest is received by the investor in cash.

We are not in favour of attaching such importance to the form of a transaction when, in substance, the investor enjoys the benefits of the interest through reinvestment, once it has been credited to him. In our opinion, amounts credited directly or indirectly to the account of the taxpayer, or held on his behalf, should be regarded as realized by him, whether or not he was entitled to receive possession. Therefore, we recommend that all taxpayers be required to report interest income when it has been credited directly or indirectly to them. For administrative convenience, the inclusion of amounts less than $10 in the case of each taxpayer should not be required. In addition, a taxpayer who was not in the business of lending money should be permitted the option of excluding from income interest that, in the usual course of events, would be received in cash in the subsequent taxation year, because little postponement would be involved and it would be simpler to record such income on a cash basis. Non-collectible interest which had been reported as income would be deductible as a bad debt, and if payment is doubtful, the taxpayer should be entitled to a reserve.

In the case of an amount that was made up of blended principal and interest, for example, payments under a mortgage, the payee should be required to make a reasonable allocation. If he did not do so, the tax authorities should have a right to allocate under a provision similar to section 7(1) of the present Act.

We recommend that the reporting requirements for payors of interest should be altered to apply to interest credited directly or indirectly to the benefit of the investor, as well as to interest paid. If a payor of interest which is deductible was either unable or unwilling to credit interest to the ultimate beneficiary, a withholding tax of 50 per cent should be collected and held by the government until such time as the interest was paid or credited to the payee.

One difficulty in the taxation of interest has been that taxpayers do not always report interest paid as they are required to do. It is difficult

to enforce this requirement, because in many instances taxpayers who pay interest do so on their personal account and are not entitled to a deduction. Thus, recipients of interest know that it is virtually impossible for the Department of National Revenue to trace interest, and sometimes fail to report it.

The personal tax return should be expanded to require a taxpayer to report both the amount of all interest, or interest and principal, paid in the year and the name of the recipient. This would serve as a cross-check and would to a very large degree cut down avoidance through non-declaration.

We have reviewed the question of withholding tax at source on payments of interest. In the case of individuals paying interest, we think that a withholding requirement would be an idle one. Such a law would be completely unenforceable and we do not recommend it.

On the other hand, it seems reasonable to require financial institutions to withhold at source and remit tax on interest paid and accrued. Institutions of this nature possess the necessary accounting records and procedures. Also, the various governments and corporate borrowers should withhold tax when paying interest on their obligations. Therefore, we recommend that all corporations, governments and government organizations be required to withhold tax at a rate of 15 per cent on all interest paid or credited. This requirement should also apply to bearer bonds, but should pose no difficulty, because the coupon would be redeemed at its face value less the amount of the tax.

Where interest was paid to a tax-exempt entity, there would be little value in withholding tax. Therefore, we recommend that a tax-exempt entity, as opposed to a person who is non-taxable because of low income, should be entitled to apply to the tax authorities for an exemption certificate which when delivered to the payor would relieve him of the obligation to withhold. This provision could apply equally to non-resident and resident tax-exempt entities.

The problems currently arising because of the difficulty of determining whether discounts or premiums are taxable would be eliminated by the full taxation of all gains or losses on securities. The amortization procedure should follow accepted practice.

Dividends

The taxation of dividends is discussed in Chapter 19, where the wider use of reporting forms and the question of withholding at source are considered.

Royalties

The present legislation is inconsistent, in that amounts received "that were dependent upon use of or production from" property are included in income under section 6(1)(j) of the Act, while the outright sale of a property right may yield a tax-free gain. This anomaly would be taken care of by our all-inclusive concept of income. The problem of "bunched" income that might otherwise result would be met by the averaging provisions detailed elsewhere in this Report. If it were felt that some special consideration should be given to the proceeds of sale of a patent or copyright, such proceeds might be made eligible for a special averaging provision. However, we do not believe that such a provision would be necessary.

Rental Income

Rent should be included in income and the recipient required to pay tax on it in the same way as at present. Premiums for the granting or cancellation of leases would be income to the recipient and deductible to the payor, except where they were a personal expense, as part of the comprehensive tax base. There are cases, however, when it would be difficult to determine whether an amount was rent, which is basically a payment for the use of property for a term certain, or whether it was a payment on account of the purchase price. In a lease-option arrangement the lessee ordinarily has a right to lease a property and then to purchase it at a specified price. It

can be argued that the "rental" payments are really payments on account of the purchase price. The subject of lease options is dealt with in Chapter 22.

The personal tax return should be expanded to require a taxpayer to report both the amount of all payments of rent in the year and the name of the recipient. This would serve as a cross-check, and to a large degree cut down avoidance problems caused by non-declaration.

Deductions from Property Income

We make the general recommendation that all expenses reasonably related to the earning of income should be deductible in computing that income. We have concluded that allowances of an arbitrary nature such as percentage depletion allowances should be replaced by the write-off of actual expenses, or at least should be restricted to amounts that are a reasonable approximation of the actual expense. Also, we recommend that special incentives should be examined to determine whether they are effective or whether a direct form of subsidy would be more effective. These general observations should also apply to the expenses of earning property income.

At the present time, taxpayers may deduct half the fees paid to an investment counsel and all interest paid on funds borrowed to gain or produce taxable income 14/. The latter allowance, in effect, has permitted the deduction of interest from personal dividend income, even though ownership of the security may also have resulted in tax-free gains. Because all property income, including gains, would be taxable under our proposals, investment counsel fees should be deductible in full. In effect, commissions and transfer taxes would also become deductible, because they either reduce the gross sale price or increase the cost basis.

The requirement that interest, to be deductible, must be paid on funds specifically borrowed to gain income has led to some apparent anomalies, because individuals paying mortgage and similar interest, and who also have property income, have not been able to claim such interest as a deduction

unless they could specifically relate the borrowing of the money to the earning of income. We do not recommend that all interest should be deductible regardless of the purpose for which the funds were borrowed, because this would in many cases amount to the allowance of an expenditure of a personal consumption nature. However, the suggested general provision, that expenditures should be deductible where they are reasonably related to the earning of income, should reduce the problem created by the disallowance of interest in some circumstances.

At the present time the Act permits a deduction of a depletion allowance by the shareholders of certain companies 15/. Under our proposals these companies would be permitted to write off in full their capital investment; dividends paid out of capital (if permitted by law) would not in themselves be subject to tax, and any losses in capital reflected in the prices of the shares would be deductible. There does not appear to remain any reasonable justification for the continuation of this measure, either as an expense allowance or as compensation for loss of capital. As an incentive measure, the provision is a form of industry favouritism that does not appear to be warranted. Therefore, we recommend in Chapter 23 that the shareholder's depletion allowance be withdrawn.

Investment Income Surtax

The present legislation levies a special tax of 4 per cent on the total of the taxpayer's investment income "from sources outside Canada" in excess of the greater of $2,400 or the aggregate of the taxpayer's personal deductions 16/. Until 1961 this surtax applied to all investment income, but apparently it gave rise to objections that it was an inequitable burden on many retired taxpayers. In that year its application was limited to income from foreign investments, partially in an attempt to remove any discouragement of investment by Canadians in Canadian securities. We suggest that such a "disincentive" to foreign investments is more punitive than effective, and that in any case our proposals for integration of corporate and

personal taxes are a much more potent incentive to Canadians in this regard. Therefore, we recommend that this surtax should be abolished.

CONCLUSIONS AND RECOMMENDATIONS

TAXATION OF GAINS AND LOSSES

1. All realized gains on the disposition of property, with the exceptions noted in Recommendations 8 to 14 below, should be included in full in income and taxed at full progressive rates, subject to the averaging provisions we recommend in Chapter 13. Residents should be taxed on world gains; non-residents only on gains attributable to permanent establishments in Canada.

2. All losses on the disposition of property, other than those arising on the disposition of property used for personal consumption, should be deductible in full from any other income and should be eligible for the same carry-over provisions as business losses. Property losses of a personal nature, except those incurred on disposal of a residential property, should be deductible from gains on similar property realized in the preceding two years, in the same year, or in succeeding years.

3. The taxable gain or loss would be determined by deducting the cost basis from the proceeds of disposition. In the case of a bona fide disposition in a transaction at arm's length, the actual proceeds of disposition would be taken into account. In the case of most other dispositions, the proceeds would be deemed to be the fair market value of the property disposed of.

4. Losses incurred on the holding of property should not be deductible from other income, but should be available for carry-back two years and forward indefinitely for deduction from operating income from the same property. A taxpayer should be entitled at his option not

to deduct certain carrying expenses such as interest and municipal taxes but to capitalize them and add them to his cost basis, so that they would be taken into account in computing the ultimate gain or loss on disposition of the property.

5. Taxpayers should be permitted to revalue certain property up or down to market, or possibly to a price between cost and market, and to report the loss or gain as if a disposition had taken place. This value would then become the cost basis. Where there had been a write-down and the market value recovered, it would be necessary to write the property up to market, but not to an amount exceeding the original cost basis. Property qualifying for this treatment would include publicly traded securities, shares of a private company if authorized by the company, interests in trusts, and possibly other assets not used in a business.

DISPOSITIONS

6. A disposition should include all sales, exchanges, transfers, gifts, bequests and losses through theft, damage, or expropriation, except for certain specifically excluded transactions referred to below. In the case of bona fide arm's length transactions the actual proceeds would be included in income and in the case of other dispositions the fair market value of the property would be deemed to be received. There should be a deemed disposition at the fair market value of a taxpayer's property when he ceased to be resident in Canada, unless he elected to continue to be taxed as a Canadian resident on his world income. There should also be a deemed acquisition on the same basis when a non-resident becomes a Canadian resident.

7. There should be a disposition of a taxpayer's property at the fair market value at death, unless the property passed to a member of the

same family unit. Ordinarily, on a transfer from one member of a family unit to another, no disposition would be considered to occur.

EXCLUDED TRANSACTIONS

8. Gains on residential and farm real property should be excluded from income up to a lifetime total of $25,000. To determine the cost basis of residential property, the original cost should be increased by the cost of actual improvements or, at the option of the taxpayer, by 1 per cent of the cost of the building for each year the property had been held.

9. In the case of an involuntary disposition occurring on a loss or destruction of property, or on an expropriation, to the extent that the proceeds were reinvested in similar property within a stipulated time there should be deemed to be no disposition.

10. Special rules should apply where individuals transfer property other than securities to a company in exchange for common shares, provided the company has been newly formed or was an existing company whose shares were owned by the transferors in the same proportion in which they were transferring the property. Generally, each asset (or class of assets) should be regarded as having been transferred at its cost basis to the transferors, unless the parties elected to transfer it at its fair market value. However, if the common shares received by a transferor were or became publicly traded and represent less than 25 per cent of all the common shares of the company, the transferor should be regarded as having made a realization at the fair market value.

11. Where property is transferred between a company and its wholly owned subsidiary or sub-subsidiary, or between companies wholly owned by the same shareholder (or the same shareholders in the same proportions), the disposition of each asset or class of assets should be

at the cost basis to the transferor, or at the fair market value, or at any price between those amounts which was specified by the parties.

12. In the event of an amalgamation there should be a deemed disposition at the fair market value by the shareholders of the amalgamating companies, but not by the corporations. This should also be true in the case of a transfer by one company of all its assets to another in exchange for securities of the transferee, followed by an immediate liquidation of the transferor. The cost basis and tax treatment of the assets would be carried over to the continuing company.

13. A subdivision, consolidation, conversion, or exchange of shares in the same corporation (or possibly a related corporation) should not be regarded as a disposition if after the transaction each shareholder had the same proportionate participation in votes and in distributions of income and on liquidation as he had before.

14. The transfer of an asset as security for an obligation or its retransfer on the termination of the security should not be treated as a disposition.

TRANSITIONAL PROVISIONS

15. Only gains that accrued after the effective date of the legislation should be taxable, and liberal procedures should apply to determine the value of assets held as at the effective date, which would be the cost basis to the taxpayer. Gains ultimately realized would be taxable only to the extent that the proceeds of disposition exceeded the value at the effective date. This would not apply to inventory or property held for disposal as part of an adventure in the nature of trade, and depreciation taken prior to the effective date would continue to be subject to recapture.

16. Publicly traded securities should be valued at their market value at the effective date. However, if the original cost of such securities exceeded this value, and the securities were disposed of within a period of 3 to 5 years, the original cost would be taken into account in computing a taxable gain, but not a loss.

17. A taxpayer should be entitled to elect, within two years from the effective date, to make a detailed valuation of assets other than publicly traded securities, and to agree on the value with the tax authorities, or have it determined by the courts. As an alternative, if no such election is made with respect to such an asset, the taxpayer should be entitled to apportion the total gain over the time the asset was held or deemed to have been held and to take into account in computing his income only the portion of the gain or loss attributable to the period subsequent to the effective date. For this purpose the period of asset holding prior to the effective date should be the lesser of the actual time held or, say, 10 years. This taxable portion of the gain should be reduced by, say, 25 per cent but no such adjustment should be made for losses.

INCOME FROM HOLDING PROPERTY

18. Interest should generally be brought into income at the time it has been credited directly or indirectly to the taxpayer even though it may not be payable at that time. If the taxpayer is not in the lending business, and in the usual course of events the interest would not be received until the following year, he should have the option of including it in income when received.

19. The reporting of interest paid or credited (as defined) should be required for amounts of $10 or more.

20. Financial institutions, governments, and corporate borrowers should be required to withhold tax at the rate of 15 per cent on interest paid or credited, unless the recipient is a tax-exempt entity which presents an exemption certificate.

21. The reporting of amounts paid as rent should be required.

22. All expenses of earning income, including investment counsel fees, commissions, transfer taxes, and interest on money borrowed to buy income-earning property should be allowed as deductions. Shareholder depletion should be withdrawn.

23. The investment income surtax should be removed.

REFERENCES

1/ The personal enjoyment derived from the use of one's own property, which necessitates forgoing the return that could be obtained from renting the property to others, constitutes a return too; but, as we indicate in Chapter 8, valuation problems preclude including these imputed rents in the tax base.

2/ D.J. Sherbaniuk, The Concept of Income—The Receipts Side, and G.R. Conway, The Taxation of Capital Gains, and, G. R. Conway and J. G. Smith, The Law Concerning Capital Gains, studies published by the Commission.

3/ As we note in Chapter 22, even where an established business is carried on, the gain resulting from the disposition of an asset will be treated as capital if the asset disposed of is part of the permanent structure of the business, for example, a fixed asset.

4/ Californian Copper Syndicate v. Harris (1904) 5 T.C. 159, p. 165.

5/ Toronto Stock Exchange, Origin of Business Study for 1965; Montreal Stock Exchange, Transactions Studies for 1964 and 1965.

6/ Lou Harris and Associates, On the Effects of Reducing the Capital Gains Tax Rate, New York: The New York Stock Exchange, 1960.

7/ G.R. Conway, The Taxation of Capital Gains, a study published by the Commission.

8/ The term "cost basis" should have specific meaning in the Act and would, in some cases, involve certain computations. Basically, it should represent the accumulated cost (including acquisitions and improvements) of the property involved, disregarding any capital cost allowance. In the case of depreciable property, "cost basis" would therefore have the same meaning as "capital cost" in the present legislation. The treatment of recaptured depreciation would continue as under the present legislation.

9/ For details concerning this estimate, see G.R. Conway, The Taxation of Capital Gains, op. cit.

10/ If cash pay-out values remain unchanged, share prices should continue to be influenced by the retention of earnings and the capitalization rate applied to these earnings. However, because under our proposals the cost basis of shares held would be increased by allocations and capitalizations, the taxable gains (net proceeds less cost basis) would be reduced.

11/ For example, in the United States individuals are permitted the deduction of property losses from other kinds of income only up to $1,000 a year.

12/ Mr. Justice Abbott regarded similar events as giving rise to a capital loss in M.N.R. v. Consolidated Glass Company, Ltd., 1957 S.C.R. 167, p. 183. We do not think that the present definition of the word "loss" in section 139(1)(x) of the Act need be retained for this purpose.

13/ We regard a "wash sale" in this context as involving the disposition of property, and the early reacquisition of the same, or similar, property.

14/ Sections 11(13) and 11(1)(c) respectively.

15/ Section 11(2).

16/ Section 32(3).

CHAPTER 16

DEFERRED INCOME

In this chapter we deal with the tax implications of deferring the use of income. The most common deferment is the organized provision for retirement by means of a contractual arrangement which requires the setting aside of income for later use. The principal examples are pensions, profit sharing plans, annuities and similar forms of saving. For our present purposes we shall refer to such arrangements as "retirement income plans". In addition, most permanent life insurance has a substantial saving element.

There is also a second general kind of contractual payment plan in which the saving element, if any, is nominal. This is primarily a means of protection against the immediate loss of income from an unexpected adversity and is not intended as a form of saving. Examples are unemployment insurance, supplementary unemployment insurance, workmen's compensation, weekly indemnity and group life insurance, sickness and accident and other income protection insurance, all of which provide a substitute for the regular income stream when for some reason it ceases. Group life insurance is included in this classification because of the administrative advantages of treating it in a similar fashion to the other kinds of employee benefit plans. We shall refer to such plans as "income insurance plans". Although arbitrary distinctions of this nature are imperfect and certain plans would contain elements of each, retirement income plans are concerned primarily with long-term income maintenance, while the second type of plan is designed to provide shorter term income protection or lump sum payments in the event of income ceasing unexpectedly. Because of the low element of saving in the latter type of plan the income deferment is relatively less important.

In examining various aspects of income taxation, we have been very critical of devices and arrangements that would permit some individuals to postpone tax liability on amounts which are immediately taxable to others. We must therefore face up squarely to an examination of the various issues involved.

In the following pages we review the present tax treatment to appraise the pattern that has already been established. We examine the social and economic implications of encouragement of personal saving. We finally recommend changes to bring taxation in this area more closely into harmony with our concepts of equity and neutrality.

THE PRESENT TAX TREATMENT

We are concerned with the tax treatment of three elements of all plans of the types we have mentioned: (1) payments into the plan; (2) investment earnings or other gains arising from such payments while held for final disbursement; and (3) disbursements from the plan.

Registered Pension Plans

In general, where a superannuation or pension fund or similar plan has been registered with the Department of National Revenue, both the employer under sections 11(1)(g), 11(1)(h), and 76, and the employee under section 11(1)(i) are able to deduct their contributions in computing income in the year they are made, and the earnings of the fund are exempt from tax when earned 1/. The employee does not pay tax on the employer contributions when they are paid into the plan for his benefit, 2/ but all payments from the plan are taxable in full to the recipient 3/. Thus, the beneficiary will include in his income when received, all amounts derived from the following:

1. His own contributions, which he will have earlier deducted in computing income.

2. His employer's contributions which will have been deducted earlier by the employer.

3. The earnings of the fund, which will not have been subject to tax earlier.

Limits are imposed for both the employee and employer deductions. In respect of current services the employee may not deduct more than $1,500.

Contributions by the employee for past service, both while he was a contributor and while he was not, are also subject to limitations 4/. For the employer the maximum deduction in respect of current services is $1,500 for any one employee, but alternatively there is a prescribed formula to limit the deduction where one contribution is made for all employees 5/. On the recommendation of an actuary, the employer may deduct, without specified limit, payments made in respect of an employee's past service in order to fund the plan more fully 6/.

The earnings of a registered pension fund are tax-exempt if it is administered by a separate trust or corporation established solely for that purpose, provided that not less than 90 per cent of the income arises from sources in Canada 1/.

Normally all payments received from a pension fund are taxed at the ordinary rates of the recipient. However, where a lump sum has been paid out, the recipient may elect to be taxed at the average effective rate of tax on his net income before deducting tax credits over the previous three years 7/. Transfers from a pension fund (including retiring allowances) to another pension fund, registered retirement savings plan or deferred profit sharing plan 6/ within the year or within 60 days thereafter are excluded from income 8/.

Although the Canada and Quebec Pension Plans are not registered, their tax position is identical to that of registered plans; contributions of employer and employee are deductible, 9/ income is free of tax when received by the plan, and all benefits are taxed in full when received by the beneficiary.

Registered Retirement Savings Plans

Provision is made for the registration of annuity contracts issued to individuals by certain authorized persons 10/. The purchaser of such a contract may deduct payments up to the lesser of 20 per cent of earned

income or $2,500, unless his employer contributes to a registered pension plan for him, in which case his combined current service contributions under the registered pension plan and the registered retirement savings plans may not exceed the lesser of $1,500 or 20 per cent of earned income. Income of any trust established for such contracts is exempt when earned. Where premiums are refunded on death, a special tax of 15 per cent applies instead of the personal rate. Where a payment is made from a plan which has lost its registration privilege, a minimum tax of 15 per cent is imposed, to be withheld from the distribution. Otherwise, payments of benefits from the plan are taxed at the ordinary rates of the recipient.

Profit Sharing Plans

Profit sharing plans fall into two categories: "employees profit sharing plans" and "deferred profit sharing plans" 11/. They differ from pension plans in that lump sum settlements of the benefits payable under the plan may be made at any time. No tax is levied on the trustee administering the plan in respect of the income of the fund under either type of profit sharing plan 12/.

Under an employees profit sharing plan the employer may deduct his contribution in full in the year it is made, and it must be allocated to the employees, contingently or absolutely. The employee must include his allocation in his income for the same year and pay tax on it whether he eventually receives it or not. Employee contributions, where called for, are not deductible to the employee. The investment income earned is not taxed in the hands of the trustee, but must be allocated to the employees either contingently or absolutely and are taxable to them on such allocation. Therefore, when payments are made out of the plan to the employee ordinarily they are exempt from tax. Provision is made for a tax credit to an employee on withdrawal from the plan at a flat rate of 15 per cent on all amounts which have been allocated to him on a contingent basis but not received by him.

Under a deferred profit sharing plan the employer is allowed a deduction which, when aggregated with his current service contributions under a pension plan, does not exceed $1,500 for each employee. The employee is not allowed to deduct his contributions, but is not required to pay tax on the employer's contribution until a payment is actually received by him from the fund, when tax is payable on all amounts received, including capital gains realized in the fund, less the employee's own contributions and certain other amounts if the plan had previously been a profit sharing plan. Income of the trust is tax-exempt if 90 per cent of the income is from sources in Canada.

In general the taxation of a deferred profit sharing plan is very similar to that of a registered pension plan, the main difference lying in the denial of a deduction to the employee for any contribution he may make. There are also special provisions dealing with the revocation of the registration of a plan and with the appropriation of funds or property of a deferred profit sharing trust to an employer.

Individual Annuities

Each annuity payment is included in income when received, 13/ but a deduction is permitted for the capital element as defined 14/. The definition of "capital element" differs as between contractual annuities and those paid under a will or trust. Under a contractual annuity the capital element in each annuity payment is the proportion thereof that the purchase price for the annuity is of the total payments to be made or expected to be made under the annuity which are calculated on a prescribed mortality basis where life expectancies are involved. Under a will or trust the capital element is the amount which can be established not to have been paid out of the income of the estate or trust.

The general effect of this arrangement is that no deduction is allowed for premiums to purchase a contractual annuity, and no taxable income is imputed to the annuitant for the investment income accumulated on his premiums

prior to payment of the annuity to him. All amounts accumulated up to the date annuity payments commence, either from premiums or from earnings, are considered to constitute capital and therefore are not taxable to the annuitant.

Non-Registered Pension Plans

There are very few pension plans which do not satisfy the registration requirements of the Act. Such a plan is generally based on a contract between employer and employee whereby a portion of the remuneration earned is paid by the employer to fund a plan to make future payments to the employee, either before or after retirement, and is commonly funded by the purchase of an annuity 15/.

In such a plan the employee generally has no right to deduct any of his contributions, and he may also be required to pay tax on the amounts set aside by the employer. Although the practice of the Department is not to allow a deduction for an employer contribution to a non-registered pension plan, the employer may be able to deduct reasonable contributions to some kinds of non-registered plans 16/. Investment income attributable to the beneficiary is generally not taxable until it is paid out to him. When payments are made to the employee under the contract or arrangement, departmental practice is to tax the whole amount received, even though all or some part of the contributions may already have been included in his income. However, if the payment is funded by the purchase of an annuity which is vested in the employee, the employer's contributions would be included in the employee's income when made, and when each annuity payment is received by the employee the capital element would be deductible by him 17/.

Life Insurance

No deduction is allowed to an individual taxpayer for premiums paid on a life insurance policy, and no income tax is imposed on policy dividends

or on the proceeds of a policy when paid out either on maturity or in the event of death. Where the proceeds are paid in the form of an annuity, the tax treatment is that described above for contractual annuities, the capital element being determined at the time the annuity commences.

In most permanent life insurance there is a substantial element of saving, arising primarily from the fact that life insurance policies generally call for the payment of equal premiums over a substantial number of years. This level premium plan results in substantial saving, and therefore significant investment income. The early premiums exceed the real cost of the protection, and the excess is in effect saved to make up the deficiency when the insured is older and the higher cost of protection exceeds the premium. The proportion of the investment income of the insurance company attributable to the policies is not identified with individual policyholders, and is not taxed as being attributable to them. Thus, although there is no specific exclusion in the legislation, property income received by a policyholder through life insurance has not been taxed, either when earned or when received by the beneficiary.

Income Insurance Plans

There are a number of arrangements that fall within the classification we have referred to as income insurance plans. Under the government unemployment insurance plan the employer is allowed a deduction for his contributions, the employees' contributions are not deductible, and benefits are tax free to the recipient under section 10(1)(h) 18/. For workmen's compensation, group accident and sickness insurance and group life insurance the same procedure applies, with the employer receiving a deduction for the premiums paid and the employee generally receiving any benefits free of income tax. There is one case of this kind in which a payment by the employer is taxable to the employee. Premiums paid by an employer for group life insurance in excess of $25,000 on the life of an employee are to be treated as an employment benefit and added to the

employee's income when paid 19/. An individual who is covered by any of these plans is not able to claim a deduction for premiums paid and is not subject to income tax on any benefits received under the plan. The element of investment income in all of these arrangements is also free of income tax but is minor because the premiums are usually relatively small, and total benefits are generally designed to match total premiums over a short period of years. It should be noted that in all of these arrangements income tax is not merely deferred but in fact never imposed.

Summary

The most obvious characteristics to be noted in regard to the present tax treatment of all these arrangements are not only that the treatment is varied, but also that there is extensive tax deferment or exemption. For registered pension plans, deferment is granted for the contributions, both of employer and employee, and for the earnings of the fund; registered retirement savings plans carry deferment benefits for the payments into and the earnings of the fund; in the case of employees profit sharing plans there is no deferment of tax, while under deferred profit sharing plans tax deferment is granted for employer contributions and earnings of the fund. Where contractual annuities are acquired the interest accrued until annuity payments commence is free of tax, while in the case of life insurance none of the profits are subject to taxation. This is also true in the case of income insurance plans which in most cases are ignored for tax purposes.

Another inconsistency in the present system can be found in the treatment of mortality gains and losses 20/. In the case of registered plans these gains or losses are brought into income because the full amount of the proceeds is taxable. The same applies to some extent to non-registered plans, while in the case of income insurance and life insurance the mortality gain or loss is not included in income.

EQUITY AND NEUTRALITY

Under the comprehensive tax base the objectives of equity and neutrality have very great relevance to the tax treatment of retirement income plans and income insurance plans. The attainment of these objectives would imply the following:

1. Tax deferment related to the deduction in computing income of payments into such plans should, in general, be eliminated. If retained for reasons of social and economic policy, deferment should be granted on a uniform basis for competitive types of plans and should be carefully defined. In addition, any deferment should not be in a form that would create a lack of neutrality between businesses because it was available only through some of a number of competing organizations.

2. Any investment income received or accrued through a retirement income plan or an income insurance plan should bear the same tax as if the income had been received directly; also, this tax liability should arise each year and not be deferred. If tax is deferred for reasons of social and economic policy, the tests set out in 1 above should apply. One need only examine Table 16-1 to see that tax deferment can be tantamount to tax forgone.

TAX DEFERMENT APPRAISED

We shall consider the justification for tax deferment, involving as it does a departure from our basic goals of equity and neutrality, under three main headings: social goals, administrative implications, and economic considerations.

Social Goals

It seems to be generally agreed that individuals should set aside a portion of their income in their working years to ensure an adequate command over goods and services in their retirement years. Such private provisions

TABLE 16-1

NET ANNUAL AFTER-TAX RETIREMENT INCOME FOR FIFTEEN YEARS TO BE DERIVED FROM RETIREMENT SAVINGS

Marginal Tax Rate Before and After Retirement (per cent)		Annual After-Tax Retirement Income for Each $1,000 of Annual Before-Tax Income			
		From 20 Years of Saving with Investment Yield of:		From 40 Years of Saving with Investment Yield of:	
		5%	7%	5%	7%
20	N.R.	2,145	2,820	6,840	11,245
	R.	2,550	3,600	9,310	17,535
30	N.R.	1,720	2,190	5,140	7,905
	R.	2,230	3,150	8,145	15,345
40	N.R.	1,350	1,565	3,790	5,135
	R.	1,910	2,700	6,985	13,150
50	N.R.	1,030	1,230	2,720	3,670
	R.	1,595	2,250	5,820	10,960

Notes:

N.R. - Non-registered savings plan: the annual contribution is not deductible because the plan is not registered, and therefore the amount saved would be the balance after the applicable tax liability had been paid. The tax on the investment income is deducted each year and the benefits are not taxable when received.

R. - Registered plan: the annual contribution is deductible for tax purposes so the full amount of income available is paid into the retirement income plan. The investment income is exempt from tax when earned. Benefits are taxable when received.

The following assumptions were made in preparing this table:

1. The before-tax income available for saving each year is $1,000.

2. The before-tax net investment income yields of 5 per cent and 7 per cent a year include property gains and tax refunds on dividends received, but are after expenses. Thus, the effects of our recommendations for the integration of personal and corporate income taxes and the full taxation of capital gains are incorporated into these figures.

3. Average marginal tax rates of individuals were assumed to be the same after retirement as during the years when contributions were made. It is likely that there would be a lower marginal rate of tax after retirement and accordingly the figures would in general understate the value of registration.

4. The retirement income is payable over 15 years in equal monthly instalments and the taxpayer has other retirement income sufficient to make the above-mentioned marginal rates applicable to this retirement income.

5. Any employer contributions are included in before-tax income of the employee and the amounts available for saving include all contributions whether made by employers or employees.

for retirement are thought to foster self-reliance and to reduce the need for the state to provide relief. If in fact this is a desirable social goal, the tax system is one tool available to government to influence retirement saving. Less positively, the government might wish to avoid tax procedures that would discourage such saving. Because Parliament has introduced legislative measures which favour retirement income plans and has broadened them over the years, it can be assumed that this social goal is generally accepted, at least within certain limits. Also, because this legislation has been in existence for a number of years, the concept of tax deferment on this type of individual saving is well imbedded in our system.

Administrative Implications

The administrative problems that would arise in preventing the deferment of tax in connection with pension and insurance plans are also important. In the case of a pension plan, for example, both the employer's contribution and the earnings of the fund would have to be attributed to the employees. The use of arbitrary techniques to meet this requirement in an administratively feasible manner would lead to a number of inequities between employees. However, if a tax procedure were adopted under which most of the members of pension plans remained unaffected by any general requirement to attribute income, the difficulties and inequities would not be so serious. Therefore, a general approach somewhat similar to the present one has definite administrative advantages.

Economic Considerations

Under an expenditure tax an individual would ordinarily be taxed on what he spent in the year and not, as under an income tax, on what he could spend in the year without a reduction in net worth. By allowing taxpayers to deduct their contributions to pension plans from other income, and by taxing them only on what they take out of such plans, thus deferring the imposition of tax on both the contributions and the current income earned

on the assets of such plans, an income tax system is converted into a modified form of expenditure tax. An income tax system is prevented from being transformed by registered retirement income provisions into an expenditure tax system only by setting limits on the amounts that can be deducted from income and by imposing penalties on withdrawals prior to retirement.

This raises three questions:

1. Should the tax system be consciously structured to encourage increased personal saving on economic grounds?

2. Would removal or reduction of the limitations that now distinguish the income tax system from an expenditure tax system serve to increase personal saving?

3. Would this have adverse effects on the allocation of saving?

We will consider each of these questions briefly.

The Need for Additional Personal Saving. As we explain in Chapters 4 and 5, we take the position that until Canada has realized its potential growth rate through the continued maintenance of full employment it would be premature to take steps to increase the growth rate by increasing the rate of domestic saving and investment. To achieve a higher growth rate by maintaining full employment would be economically costless and socially desirable. To achieve a higher growth rate through increased saving would impose a cost in terms of reduced current consumption. It seems to us that it is only reasonable to take costless steps before taking painful steps. Should it be found that the full-employment growth rate was inadequate, then and only then would it make sense to adopt policies to increase the rate of domestic saving.

It is sometimes argued that the rate of domestic saving should be increased to reduce our reliance on foreign saving without reducing the Canadian growth rate. Whether Canadians should or should not reduce their current consumption in order to reduce their reliance on foreign saving is a matter

of preference. The current rate of saving in Canada is high relative to other countries, and we can see no great merit in raising it still further to reduce Canada's reliance on foreign saving. Nevertheless, we acknowledge that increasing the Canadian saving rate to reduce dependence on foreign saving, while maintaining the growth rate, is a perfectly legitimate preference that is commonly held.

Assuming that it was decided as a matter of public policy that the rate of domestic saving should be increased, either to increase the full-employment growth rate or to reduce Canada's reliance on foreign saving, it does not follow that personal saving, rather than the saving of some other economic sector, should be increased. As we indicate in Chapter 4, there are a number of alternative policies that could be adopted to increase the rate of domestic saving. A restrictive fiscal policy to generate a government surplus accompanied by an expansionary monetary policy to encourage investment would be a relatively simple and effective method of increasing the rate of domestic saving and investment without creating inflationary pressures. Accelerated depreciation would probably be a relatively effective method of increasing corporate saving, and should be considered as a viable alternative to a policy designed to increase personal saving. Thus, it is by no means obvious that the rate of domestic saving should be increased or, if it is to be increased, that attempts to increase personal saving would be as effective or equitable as the alternative methods.

There are at least three methods that might be adopted to increase the rate of personal saving if this were thought desirable.

1. Increase the weight of sales taxes relative to personal income taxes.

2. Reduce the degree of progressiveness of the personal income tax rate structure.

3. Liberalize the retirement income provisions so as to bring the income tax system closer to an expenditure tax system.

The less restrictive the provisions under 3 the smaller would be the differences between 1 and 3.

Effects of Concessions for Retirement Saving. In Appendix F to Volume 2, we demonstrate that a partial shift from income to sales taxes, which is what the adoption of method 3 above fundamentally involves, would be equivalent to an increase in the interest rate on retirement saving. There is no conclusive evidence one way or the other that changes in interest rates of the magnitudes that would be involved for low and middle income individuals would have any effect on their rates of personal saving. Allowing high income individuals to deduct their retirement saving from income, and postponing the taxation of the income earned by the assets acquired with this saving, would be equivalent to an extremely large increase in the interest rates on their retirement saving. There can be no doubt that this would encourage upper income individuals to change the form of their saving. However, there is no way of knowing whether they would save the tax reduction or spend it. Probably they would do some of both.

We are inclined to believe that, in the past, liberal retirement saving provisions have had indirect positive effects on saving by low and middle income individuals that probably were as important as, or more important than, the direct effect on the rate of return from such saving. These provisions have encouraged the establishment of pension plans, perhaps to a great extent as a substitute for other kinds of saving that are less generously treated under the tax system. But when pension plans are set up, individuals also become much more "pension" conscious. Because they are forced to consider their lifetime income patterns, there is a change in the evaluation of their future requirements. The discount on future income is reduced, and retirement saving therefore becomes more attractive.

There are two other influences at work. First, participation in a pension plan is often a condition of employment. Those who are not much concerned about the level of their retirement income are often forced to

save for the future or find another job. This element of compulsion probably increases personal saving. Second, because retirement saving cannot be withdrawn at will without limit, low income individuals cannot completely substitute retirement saving for other kinds of saving that are accumulated to meet emergencies, although the introduction of compulsory unemployment, hospital and medical insurance removes some of the major reasons for precautionary saving. All of these factors would seem to suggest that tax provisions that grant a concession to retirement saving probably have encouraged an increase in total saving by low and middle income individuals, although not because of the tax provisions per se 21/.

The introduction of the Canada Pension Plan, which occurred at the beginning of 1966, will result to some unknown extent in a reduction in saving through some registered employer plans. We doubt that the substitution will be complete. If we treat the compulsory Canada Pension Plan contributions as equivalent to private saving, the plan will probably increase total saving 22/.

The benefits under the various government plans, when combined with the benefits under employer pension plans, could well mean that the point is being reached where many couples will have a retirement income as great as or greater than their income before retirement. Unless people put a premium rather than a discount on future income, we doubt that more generous tax provisions would induce low and middle income people in such a position to increase their retirement saving, unless the withdrawal privileges were relaxed to the point where retirement saving and precautionary saving merged. In our view it is likely that over the next few decades those who now have "full" pensions, that is, pensions which equal earnings in the last years of employment, would not increase their retirement saving in response to more favourable tax provisions. Indeed, the reverse is more likely to occur to the extent that the Canada Pension Plan is substituted in part for employer pension plans. However, in those cases where the individual does not have

a "full" pension, employer pension plans will probably improve so that not only will the level of pension benefits grow, but the proportion of the labour force covered by employer pension plans will probably increase. The increase in the labour force will also have an expansionary effect. On balance, we expect that after a temporary setback to adjust to the Canada Pension Plan, the number of members, annual contributions and assets of employer pension plans will all continue to increase about as rapidly in the future as in the past even without a greater concession. As Appendix B to this Volume indicates, this would involve an extremely large tax deferment by 1970. We also believe that for low and middle income groups a greater tax concession would not materially increase the rate of private saving, although the substitution of registered retirement saving for other kinds of saving would be induced if the restrictions on withdrawals were liberalized.

To the upper income groups, retirement saving concessions have greater value because their higher marginal rates of tax mean that the amount of tax deferment is greater; but there is no *a priori* reason to assume that the tax reductions are saved rather than spent. Two things are clear, however. First, the higher the limits on the retirement saving contributions that can be deducted from income, the more certain it will be that upper income individuals will substitute registered retirement saving for other kinds of saving. Second, the higher the limits, the more the system will depart from ability-to-pay taxation. This results from the inability of all taxpayers to utilize the full amount of a large exclusion, and also reflects the fact that the income deferment is a more valuable privilege the higher is the marginal tax rate of the beneficiary.

Institutionalization of Personal Saving. If an individual establishes a one-man registered plan by transferring personal investments into such a plan and he determines the investment policy of the plan, there are no implications for the control of investment capital. However, if the same process is applied to group pension plans it might well shift control of

resources from the individual members of the plans to those managing the funds, depending upon the degree to which investment management is so delegated. To the extent that the investment policies of the institution or the professional management differ from those of the individual, the flow of investment funds would be affected. If institutions are less inclined than individuals toward equity investment, there could be a misallocation of capital growth. However, the shift of voting power in the corporate sector from individuals to institutions is not necessarily an unfavourable trend; corporate management is already to a great extent isolated from individual investors, and knowledgeable share ownership by institutional investors probably has a favourable influence.

The attitude of institutional investors toward risk investments is, however, of significance. Certainly the figures available on investment in Canada indicate that the proportion of trusteed pension savings invested in equity securities is not large, although it is growing rapidly. The Dominion Bureau of Statistics reports show that of over $6.1 billion (market value) invested in trusteed pension plans at the end of 1964, almost one half was invested in federal, provincial and municipal government bonds, and only some 20 per cent was invested in common stocks 23/. This latter percentage is considerably larger, however, than the over 7 per cent at the end of 1952. 24/ Nevertheless, the proportion invested in common stocks by industrial trusteed plans, about 27 per cent, is considerably less than the approximately 50 per cent invested in common stocks by United States corporate pension funds.

Although the reason for this apparent conservatism of Canadian pension plans is not clear, the current tax treatment of such plans, which involves full taxation of the benefit regardless of the underlying source of income, could well be a factor. Thus, the pension fund manager who wants to maximize benefits must compare the high guaranteed yields of a bond or mortgage with the riskier dividend and capital gain yield of a common stock, without the benefit of the dividend tax credit and exemption of capital gains that the

ordinary investor will take into account. A 5 per cent to 7 per cent guaranteed interest rate might therefore compare favourably with a probable 3 per cent to 4 per cent dividend rate plus a possible capital increment. It would still be expected that an overall average long-term yield on common stocks of approximately 9 per cent 25/ should have attracted considerably more interest by financial institutions than it apparently has, particularly in the case of pension funds and insurance companies, where investment decisions should of necessity be based upon long-term factors. Nevertheless, it is clear that equities have been relatively less attractive to pension funds than to middle and upper income individual investors.

The point at issue, however, is whether the proportions of savings invested in equities would have been any greater if individuals had saved directly instead of assigning their funds to institutional management. Any conclusion must obviously be one of conjecture, but if the present trend to increased investment in equities by pension plans continues, it would be questionable to assert that more equity capital would have been available if individuals had managed the assets acquired with their savings. In any event, there is little doubt that the growth of pension funds is contributing to an institutionalization of saving, a trend that is causing considerable discussion because of its uncertain implications for the capital markets.

General Conclusions

Table 16-1 indicates that the value of the tax postponement involved in the tax concessions for pension and retirement savings plans is substantial. For example, if over a period of 40 years an individual has available for investment in a registered pension plan, an annual before-tax income of $1,000 a year, if it can earn a rate of return of 5 per cent, and if he is in a 30 per cent tax bracket, he can build up an after-tax retirement income of $8,145 a year for a period of 15 years, compared with only $5,140 if he saved in the ordinary manner. This is an increase in annual income of almost 60 per cent, a substantial amount. The postponement becomes even

more valuable if the rate of return is higher or if the marginal rate of tax is less after retirement than when contributions were made.

The relatively greater value of this deferment where one's marginal rate of tax is higher is perhaps best indicated by the fact that to put registered plans in exactly the same position as non-registered plans it would be necessary to impose a postponement fee on the investment income of registered plans at a rate equal to the marginal rate of tax of the beneficiary. All payments from the plan would continue to be taxed in full as at present. Even under this approach, saving through a registered plan would be advantageous if the marginal tax rate on retirement were less than when deductible contributions were made, because the tax relief on the capital invested would be greater than the tax paid on the capital element of the annuity payments. Therefore, an individual in a 50 per cent bracket in his working years and a 40 per cent bracket on retirement would still benefit if he saved through a registered plan, even if the registered plan were charged a special, non-creditable, tax of 50 per cent of all investment income earned.

Moreover, and more important, the relative value of the present tax inducement for registered plans would be considerably increased under the recommendations put forward elsewhere in this <u>Report</u>. At the present time, the use of registered plans by those who otherwise would invest directly in common shares is restrained. The full taxation of all benefits paid out of a plan means that any capital gains on common shares held by the plan are taxed and that the dividend tax credit is lost. Under the comprehensive tax base all gains realized by individuals would be taxed, while gains realized in registered plans would be taxed only when eventually paid out in benefits. Integration of the corporate and personal income taxes would result in a refund of the corporate tax to registered plans, the beneficiaries not paying personal tax until the benefits were received. The tax deferment aspect of registered plans would thus become more valuable. Neither of these specific changes should be offset or reduced

by any measure that is applicable only to dividends or property gains. To do so would not only continue the present disincentive to investment by registered plans in Canadian equities, a disincentive that is somewhat in conflict with the declared government intention to encourage Canadian participation in equity investment, but it would also be in conflict with our declared objective of maintaining tax neutrality between various investment forms, for example, bonds and stocks. If any reduction in the tax deferment advantage is contemplated, it should apply equally to all forms of investment income received by registered plans.

We conclude that, in general, tax inducements to encourage retirement income plans should be retained, primarily on the social ground that plans by individuals for income maintenance during periods of adversity or retirement should be encouraged. However, our consideration of the above factors has also led to the conclusion that deferment of income for tax purposes is a very valuable concession, and has sufficiently important implications to warrant placing greater restrictions on its utilization than now exist. In particular, if the justification for tax concessions is primarily social, the value of such benefits should be designed primarily for the low and middle income groups where encouragement of saving is more socially desirable. To the extent that the tax incentive does have an impact on the level of saving, it is largely manifested in the low and middle income groups. We also believe that it is possible to achieve a less complex and more rational approach to the taxation of savings plans of all types.

We shall discuss the implications of these conclusions in detail, first for pension and other retirement income plans, and then for life insurance.

Any type of plan meeting the requirements set out below, whether on an individual or group basis, whether the contributions are a fixed percentage of income, salary or wages, or whether they are on a profit sharing basis, should be eligible for registration. The important restrictions should relate to the provisions for pay-out in the form of pensions, with limitations

on cash settlements, the time of withdrawal and the investment of the funds.

Any unregistered plan should be regarded as a conduit to the beneficiaries. Contributions by an employer and property income that are not distributed or allocated to beneficiaries should therefore, in theory, be taxed at the top personal rate of tax.

RETIREMENT INCOME PLANS

For retirement income plans which can meet the stipulated conditions for registration, we are in favour of continuing to permit the contributor to deduct from income for tax purposes certain contributions to such plans in the year paid, of exempting from immediate tax the annual income on the amounts invested and of including all benefits in the tax base in the year or years in which they are received. The questions to be examined are: first, what types of arrangements should be permitted to qualify for this preferential tax treatment; and second, what specific provisions are required for restricting the deduction of contributions, for the taxation of the income on the savings, and for the taxation of the ultimate benefits. As our proposals concern the limits to be placed on tax deferment, there will continue to be many retirement plans that will not qualify for preferential tax treatment. We also propose specific measures for these non-registered retirement income plans.

Registered Retirement Income Plans

The Canada Pension Plan, and alternative provincial pension plans with equivalent provisions, should be deemed to be registered plans and should therefore be taxed in a manner similar to other registered plans. We recommend that there should be specific rules for the registration of other plans, some of the more important of which are mentioned below. Detailed regulations would be required; but although we have examined such requirements and the overall impact of our proposals in sufficient detail to satisfy ourselves that our recommendations are practical, we only include in this chapter a general discussion of the more important aspects of our proposals. We contemplate that there would be only <u>one</u> set of requirements for all registered plans and that the different rules now applicable to pension

plans, profit sharing plans, and registered retirement savings plans would be eliminated.

1. Contributions by employers and employees should be fully deductible from their incomes until the maximum allowable benefit, as set out in 5 below, had been achieved. There should be no annual limitation, as at present, based upon a percentage of earned income of the employee or on an amount for each employee. This would end the problem of how to limit past service contributions and substantial employer contributions to plans for executives. The procedure would also eliminate the problem for registered plans of how to attribute all the employer contributions to employees, a procedure that would be necessary to enforce a limitation based on annual contributions.

2. Income received by the administrator of the plan should be exempt from tax as long as the plan was registered. Where dividends were received from Canadian corporations, the administrator would be entitled to claim for the plan a refund of corporate income tax paid on the underlying earnings of the corporation.

3. The tax concessions attached to registration should, in principle, be limited to Canadian residents and taxpayers who were permitted to elect to be taxed as a resident. The latter election is discussed in Chapter 26 and essentially is designed to allow Canadian residents who temporarily become non-resident to continue to be taxed as if they had remained resident. However, limiting membership in a registered group plan to Canadian residents would involve the employer and administrator in complex pension arrangements and might become a barrier to labour mobility. Accordingly, while membership prior to retirement in individual registered plans should be limited to persons taxable as residents, there should be no residence limitation for registered group plans, although certain limitations might become necessary if group plans were used as a device for tax avoidance.

4. To be registered, a plan should be administered by a separate trust or corporation in Canada.

5. The maximum allowable benefits for all registered income plans for any tax unit, except as indicated below, should be the equivalent of a single life annuity, with a guaranteed term of ten years, of $12,000 a year for an individual, payable from age 65. This limitation would only apply to establish a common basis of valuation, because benefits could be payable in any one of a number of ways. It must also be emphasized that this is not a limit on what people can save for retirement, but rather a limit on the amount of such savings that would be eligible for preferential tax treatment.

   This formula for determining the maximum amount of deductible contributions, which we refer to as the "basic maximum", appears to be administratively feasible. For administrative reasons we recommend that it should be the maximum for any pension under a group plan. We also recommend that it should be the maximum for all retirement income benefits of each tax unit. However, it would seem reasonable that a family unit which included a married couple should have a higher overall maximum benefit than an individual unit. Such a higher maximum benefit could be acquired under a retirement savings plan, under such a plan together with a group plan, or under a combination of two or more plans, but not under any one group plan. The overall maximum benefit for such a family unit might be the equivalent of a joint and survivor life annuity of $12,000 per annum for the two spouses without a guaranteed period, commencing when the older spouse attained age 65. The younger spouse, if more than ten years younger than the other, would be deemed for this purpose to be only ten years younger than the other. If a family unit acquired more benefits than the basic maximum and then terminated through divorce or legal separation or on the death of one spouse so that one of the former spouses then became the sole beneficiary of the benefit, he or she would be required to bring into income the value of the benefits in excess of the basic maximum, and this amount would presumably be paid out at that time, unless there was a relieving provision which made this

unnecessary where the marriage had lasted a specified number of years at the time the family unit terminated.

The above limitations would apply to the whole family unit and not to each member of the unit. The limits might be lower but should not be higher. However, for convenience these amounts are used in the balance of this chapter. We suggest these amounts, even though they are higher than would be required to meet the social goal of encouraging every taxpayer to provide for a reasonable retirement income, in order to reduce the transitional difficulties which would arise with a lower limit that would affect many of the plans currently in existence. It would allow a margin for individual plans set up with lower benefits in the event that market fluctuations lead to property gains that would provide for larger benefits than had been planned. To facilitate application of the benefit limit, Canada Pension Plan benefits and benefits under any alternative provincial pension plan with equivalent provisions, should be in addition to and not included in this amount. Therefore, total benefits from all registered plans could amount to over $13,000 a year, excluding old age security benefits, without losing the tax deferment privilege.

Such a limit should not pose administrative problems for group plans, because we propose that no plan that provided for or permitted payments to members in excess of this amount would be registered; therefore there would be no point in any beneficiary making contributions in excess of those required to provide such benefits. However, the limit could raise complications in individual plans. For these plans the limit on the balance accumulated in the plan at any time could be a dollar amount based on a standard mortality table used to ascertain the expected life of the taxpayer or spouse and on a stipulated interest rate of, say, 5 per cent. These two factors would be employed to determine the present value of a single life annuity of $12,000 guaranteed for ten years, or

of a joint survivor annuity of the kind described above, payable from age 65 to the taxpayer or his spouse. This present value would be the maximum aggregate market value of assets that would be permitted to accumulate for an individual or family tax unit under all plans. If the market value increased to an amount in excess of this amount, the excess would be included in the taxpayer's income, and in practice would presumably be paid out to him. Market value for publicly traded securities would be readily determinable. For other property the market value would have to be determined in a manner acceptable to the tax authorities.

If a taxpayer who was a member of one group plan joined a further group plan, perhaps as a condition of employment, he would have to attach to his tax return the same certificate (discussed below) as the taxpayer with one or more individual plans. The benefits under each of the plans would be estimated to determine if in total they were within the prescribed limit 26/.

6. Any individual or corporation operating a plan, and desiring to issue the certificates described below, would have to register with the tax authorities and would become a registered administrator. It would be expected that these persons would generally be the same as those authorized to provide certificates under the legislation of the various provinces. To be registered a plan would have to be under the supervision of a registered administrator.

If a taxpayer had an interest in more than one registered plan, he would annually be required to attach to his tax return a certificate signed by the registered administrator of each plan of which he was a member showing the level of the retirement benefits which had been accumulated to that date under that plan. The taxpayer would be required to list in his return all the registered plans of which he was a member. As long as the taxpayer had a beneficial interest in more than one plan, he

would be required to file a certificate annually in respect of each plan, even if he were only contributing at that time to one of the plans. He would not be required to file a certificate if he were a member of only one plan.

7. For a plan to continue to be registered, the administrator would have to comply with certain regulations. For example, he should be required to do the following:

   a) To file an annual statement with the government in respect of each fund under his supervision showing details of investments held, their cost and market value, income during the year, and contributions received during the year.

   b) On the request of a beneficiary, to provide him with an annual certificate stating the level of his retirement benefits accumulated to that date, based where necessary on a number of assumptions that would be set out in the Regulations.

   c) To certify that to the best of his knowledge all the requirements of the legislation had been complied with.

   d) To withhold tax from all disbursements from the fund to non-residents at a rate of at least 30 per cent. A withholding tax at the same rate or a lower rate on payments made to residents might be imposed if required for purposes of enforcement.

8. All payments received from the registered plan or plans would be included in full in the income of the taxpayer in the year received. Withdrawals prior to retirement would therefore be taxed at full progressive rates, although the regular averaging procedures described in Chapter 13 would be available. In addition, the taxpayer could transfer any portion of the proceeds into another registered plan as long as the permitted limit was not exceeded. The present provision for

averaging over three years should be removed. There should also be a special tax of at least 15 per cent levied on all withdrawals prior to age 60 otherwise than on death 27/. This tax should be refundable on any amounts put into another registered plan in respect of the same taxation year, and on that portion of the withdrawal that did not increase the total income of the tax unit for the year over a specified amount of, say, $7,000. A provision of this nature would be necessary to discourage early withdrawals while still allowing the withdrawal of a reasonable amount in an emergency. If the social goal is to provide for retirement, funds generally should be left in the plan except in the case of an earlier emergency.

9. Benefits under a registered plan should be payable to a member of the family unit which made the contributions, or in respect of which they were made by an employer. However, the family unit may terminate with benefits still being payable under the plan. In general this should result in a deemed realization to the family unit as well as being income to the new family unit. However, if such benefits were payable to the taxpayer or his spouse and a new unit was formed, for example, through divorce, separation or remarriage, there should not be a deemed realization. In any such case a gift should not be deemed to have been made, because the beneficiary would be one of the spouses who were members of the family unit when the contributions were made. However, the application of the limitation to the new family unit might result in an amount being brought into income.

   If the beneficiary was not the taxpayer or his spouse and was not a member of the family unit, then it should be deemed that there had been a disposition by the family unit of the benefits at a price equal to their value, at the earliest of the following dates:

   a) when the benefits become payable,

   b) when the beneficiary was not or had ceased to be a member of the family unit and the benefits became fully vested in him, or

   c) when the family unit terminated.

This value would be included in the income of the contributors' family unit. It would also be regarded as a gift to the beneficiary, and would be included in his income unless he were eligible himself to qualify the benefits to which he was entitled under a Registered Retirement Income Plan.

10. Payments should begin no later than the seventy-first birthday of the taxpayer or, in the case of a family unit, the seventy-first birthday of the elder of the spouses, and should generally have to be at a level to provide for the complete disbursement of the fund by the time payments to the taxpayer or his spouse would be expected to cease (under standard mortality tables). This would permit the benefits to be taken in the form of an individual annuity or a joint and survivor annuity with or without a guaranteed term. As an individual need not purchase an annuity, it would be necessary for the Regulations to specify the required levels of payments, so that it could reasonably be expected that the fund would be eliminated within the life expectancy of the taxpayer or his spouse. To prevent undue deferment of tax, payments after age 70 should be permitted to accelerate with age only if this is specifically approved by the tax authorities. For example, acceleration should be permitted for increases related to changes in the cost of living or for increases resulting from higher than expected post-retirement earnings of the fund.

11. There should be a requirement for registration with the tax authorities. The conditions for registration should be given legislative sanction in the statute or Regulations thereunder and should set out clearly the requirements for a registered plan. The constitutional power of the federal government to legislate controls of pension plans has been questioned, but there is no doubt that it can and does establish many rules and classifications for income tax purposes which indirectly influence the development of financial arrangements. We think it

important that if the federal government is to extend a tax concession it must retain ultimate control over the application of such a concession. However, to the extent that the provincial governments have enacted acceptable restrictions, detailed federal regulations would not be required.

When an employer contributed to the plan, in order to protect the employees' interests it would be necessary to issue regulations similar to, but more comprehensive than, the booklet (since withdrawn) issued by the Department of National Revenue regarding pension plans (commonly called the Blue Book) 28/. The present rules for registered retirement saving plans under section 79B should form the basis of the regulations for plans established by individuals for themselves or to which the employee alone contributed. However, the permitted investments in the case of individual plans should not be restricted.

To qualify for registration, a group plan should be a bona fide arrangement to provide retirement income for employees, not a disguised form of temporary savings plan. Therefore, the right to convert the benefit into a lump sum by surrender, commutation, or assignment should be strictly limited. The plan should also meet standards of solvency and the investments should be restricted in order to ensure proper diversification. The employee should at all times have a vested right to his own contributions, and there should be reasonable conditions for vesting of employers' contributions, together with safeguards to members if the plan was wound up.

In the case of pension plans regulated by provincial statutes, it would be convenient if provincial registration could be made a condition for income tax relief. However, the provincial acts do not apply to employees profit sharing or deferred profit sharing plans, to individual arrangements or to other types of plans that might seek federal registration. Moreover, it may be many years before all provinces adopt

the uniform Pension Benefits Act now in force in Ontario, Quebec and Alberta. This being so, the whole burden could not be passed to the provinces and it would be necessary for the federal government to set out the rules for registration. If uniform regulations are not implemented by all provinces, the federal government would have to ensure that the regulations adopted by one or more provinces did not have the effect of providing the residents of those provinces with a tax concession unavailable to the residents of the other provinces.

12. The de-registration of any plan for reasons spelled out in the Regulations should cause the full balance to become income of the beneficiary or beneficiaries in the year of de-registration, unless registration were restored within a stipulated period of time. On de-registration a withholding tax of 50 per cent should be remitted by the administrator or trustee and allocated to the beneficiaries of the plan.

13. A taxpayer should have to declare his interest in all plans if he had an interest in more than one plan. Contributions to registered plans should be deductible until such time as the market value of all investments held by all plans for the account of one taxpayer reached the amount required, based upon the standard mortality table and stipulated interest rate, to provide the designated retirement income. If the market value of the investments exceeded this limit for two successive years, any excess existing at the end of the third year should be brought into income. Once one such two-year period had occurred, subsequent excesses should be permitted only for a single year. This provision should not affect a taxpayer who had an interest in a single registered group plan because, regardless of the increment in market values, such a plan would not be permitted to provide for benefits in excess of the limit. Any excess funds in a group plan would probably be distributed by the trustee as a form of return of premium (and

would be taxable income). However, a taxpayer might be a member of more than one group plan, in which case he would have to bring into income each year any excess benefits accruing to him. If this amount was not then paid out to him, an appropriate part of his subsequent pension payments would then be non-taxable as a return of capital.

14. In the case of existing plans, the requirement that any excess benefit should be brought into income should not apply to any amount in the plan as at the effective date. However, further property income of the plan should be brought into income of a taxpayer if the assets in the plan were already in excess of the defined limits. It would be expected that some present group plans would be split in two, with one plan being registered and the other non-registered. The latter would provide for benefits in excess of $12,000 a year. Alternatively, the taxpayer who is in a group plan could, if the plan so provided, be permitted to elect what proportion of his interest in the plan is to be de-registered and in that case he would subsequently bring that proportion of the employer's contributions and of the earnings of the fund into his own income.

In essence, then, our recommendations do not involve any material change for the great majority of existing retirement income plans, but do include a substantial alteration in the method of determining limits for tax deductible contributions. At the present time deductible contributions by an individual taxpayer in any year are limited, either to a percentage of his earned income or to a dollar amount. This procedure is unsatisfactory because it does not adequately take into consideration employer contributions, so that the limitation is unevenly applied to different persons. A better approach would be to allocate the employer contributions to the employees, and then to require that these benefits be included in the income of the employees. However, such an allocation would in many cases be difficult if not impossible. Another difficulty with the present limitation is that it

ignores investment income and therefore confers a relatively greater benefit, in the form of tax deferment on investment income, on those plans that earn a high rate of income.

Therefore, we have recommended that the limitations on tax deductions be shifted from annual contributions to the amount of the benefits that could be obtained from registered plans. Because no beneficiary of a group plan could receive more than $12,000 a year, the use of benefits as a limit would mean that employer contributions would not have to be allocated and that the amount of income accumulated would become a factor in determining when employee and employer contributions were no longer required. The amount of the maximum benefit permitted is a question for arbitrary determination. However, it should be high enough to ensure that the present registered group plans would easily qualify in respect of substantially all of their members, and yet not so high as to extend the privilege of the extremely valuable tax deferment to a level where the social goals are no longer of significance. The amount should also be high enough to allow even major fluctuations in the values of a substantial proportion of individual plans to be encompassed within the limit.

We have pointed out that both the deductibility of contributions to, and the exemption from current taxation of income earned in, a Registered Retirement Income Plan would be extremely valuable concessions. Therefore, it may be thought necessary, now or at some future time, to reduce the value of this incentive. Certainly the loss in tax revenues is immense, and we cannot be at all sure that the same or almost the same level of retirement saving would not be attained without such a substantial incentive.

Any method of reducing the incentive should apply equally to all forms of property income received by any plan, and should not reduce the net rate of return on only one kind of income. We have proposed a limit on ultimate benefits to restrict the use by higher income groups of this valuable deferment. This limit could be reduced, but not substantially, or it would affect

a number of employees in plans that are presently registered. In addition, an upward fluctuation in the market value of the assets held in group plans could have unfavourable tax implications for many taxpayers if the upper limit were greatly reduced. Therefore, if the value of the tax concession were to be reduced, a postponement fee or tax on the total annual income of registered plans would appear to be more appropriate. We think that basically there are two kinds of tax which could be applied to the annual income of the plan, a postponement fee or a withholding tax. Such a fee or tax could be levied on the total income of the plan, including contributions, or on the property income only. Because both of these elements involve tax deferment, a tax on the total income would appear to be the more appropriate.

A postponement fee would be an annual levy on the income of the plan that would not be creditable to the beneficiary. This would amount to a form of interest on deferred tax. The fee should be 10 per cent or less, and would be simple to administer. However, it would be regressive in impact, because it would apply to the amount of income on which tax is deferred and not to the amount of tax deferred.

A withholding tax at a flat rate has undoubted appeal in that the beneficiary would be able to claim a credit for tax paid when the benefits ultimately were paid to him. A flat rate of withholding tax on the total income, that is, on contributions and property income, would be required so that there would be no need to account accurately each year for the proportion of employer contributions and property income attributable to each beneficiary, an accounting that would be virtually impossible to do accurately except in the case of money purchase plans, because of the many actuarial factors involved. However, a flat rate withholding tax would be inequitable as between individuals in different income brackets. A withholding tax would also involve reporting to beneficiaries the amount of tax withheld at the time benefits were paid. To have the same impact on the ultimate level of benefits received after tax, the rate of withholding tax would have to be almost double the level of a postponement fee.

Further discussion of the difficulties encountered with each of these alternatives is contained in our later discussion on the taxation of the proceeds from life insurance. Both procedures would have a relatively greater impact on taxpayers at lower income levels, so that if the intention were to reduce the attractiveness for tax reasons of Registered Retirement Income Plans, the preferable alternative would be to reduce the permitted level of retirement income.

Non-Registered Retirement Income Plans
(Including Ordinary Annuities)

Our proposals are not intended to restrict retirement savings, but rather to limit the amount of retirement savings that is eligible for preferential tax treatment. Plans that could not qualify for registration would not be eligible for the deferment privilege, and no deduction from income for tax purposes would be allowed to the taxpayer for his contributions. An employer would be able to deduct his contributions if they were a reasonable business expense. Consideration must be given to the tax treatment of employer contributions and of income received by the trustee or other administrator, that is, property income earned on contributions while retained in the plan and any other income received, such as gifts and bequests. The ultimate tax treatment of total benefits received from the plan must also be considered. Non-registered plans would include profit sharing plans and any other similar form of savings plan that did not meet the requirements for registration. Individual annuities that were not registered would also fall into this classification.

Annuities which were provided by way of gift present special problems and we deal with the treatment of such annuities in Chapter 17. An annuity which was payable out of a trust should be dealt with in accordance with our recommendations in Chapter 21.

Our concept of an equitable tax system requires that income should be taxed when earned, and taxed in a uniform manner regardless of the form in which it was accumulated or received. In a retirement plan, income is set aside for future use, but when the plan is non-registered, the income should be taxed when first credited to the account of the beneficiary. The intermediary should be regarded as a conduit

through which the cash will flow and anything received by the intermediary, for example, employer contributions and property income, would be received for the account of the beneficiary. Income should therefore be taxable when received by the intermediary, just as if it had been received directly. This tax-paid income would then in effect become capital. Under our recommendation for integration of the corporate and personal income taxes, the procedure for grossing-up and crediting the corporate tax paid to those receiving corporate distributions should apply to non-registered plans in the same way as it would have applied had the beneficiary received the distributions directly.

Because there would be no tax deferment in such a plan, benefits would be regarded as a non-taxable return of investment. If the ultimate benefits received were less than the cost basis of the taxpayer's interest in the plan, that is, the contributions made by the taxpayer and the employer contributions and income which have been attributed to him, there would be a property loss which would be deductible from other income. Over his lifetime a taxpayer would include in income the full realized increase in his economic power, but would not be taxed on any amount that he did not ultimately receive.

We expect that the trustees or administrators of such plans would maintain records of the contributions and investment income attributed, so that when the benefits were paid it would be possible to supply the taxpayer with a statement of his cost basis, that is, original contribution plus attributed income. Any difference between this amount and the ultimate proceeds would be a gain or loss that should be included in the comprehensive tax base.

Although this procedure appears to be relatively simple, in practice it would be complicated by the fact that in many cases it would be very difficult to allocate the employer's contributions or the property income to the beneficiaries. In such an event, a flat-rate withholding tax should be charged against all such unallocated amounts, and later credited on a grossed-up basis to the beneficiary when these amounts were allocated. Thus, on

retirement, the beneficiary of a non-registered plan would receive his pension net of tax withheld. Alternatively, the tax withheld could be refunded to the trustee or administrator so that the beneficiary would receive his full pension, which would be taxable to the extent it exceeded the beneficiary's own contributions and amounts previously allocated to him. Computation of the tax withheld should not be difficult, because a record of the employee contributions and amounts previously allocated to the employee would have been maintained, and any excess of benefits paid over such amounts would in effect represent the amount on which tax had been withheld. To prevent manipulation, the withholding rate should ideally be equal to the highest rate of individual tax, but a rate of 40 per cent would probably be sufficient. Such a rate would cause most employers or individuals to establish their non-registered retirement saving plans in a manner that would permit attribution, even if the allocation rules had to be rather arbitrary. Records would be maintained showing for each beneficiary the total of his own contributions plus the portion of the employer's contributions and income attributed to him. When an amount ultimately vests in the beneficiary, any excess or deficiency of such amount over or under his cost basis would be included in or deducted from income.

INCOME INSURANCE PLANS

Although plans falling within this general classification, for example, unemployment insurance, supplementary unemployment insurance, workmen's compensation, sickness and accident insurance and group life insurance, do not contain a large saving element, so that the relative size of the property income involved is small, the insured does benefit from lower premiums because of the existence of some investment income. Also, there is a mortality or risk element involved and beneficiaries realize a gain or loss because of the sharing of risks through insurance. The major questions for consideration are whether premium payments should be deductible and whether benefits that are ultimately received should be included in income.

The allowance of premium payments as a deduction from income would facilitate the bringing into the tax base of the property income and the mortality gain or loss. As in the case of group pension plans, it is difficult to allocate fairly to each beneficiary his share of both the employer's contribution and the property income, and such allocation should be avoided if at all possible. A procedure that permitted the deduction of all contributions and then brought into income all benefits received would ensure that each beneficiary was taxed only on the net increment in his tax base, regardless of the extent to which the increase in economic capacity was derived from the employer contribution, the property income, or the mortality gain or loss. However, such an approach would also result in the deferment of tax liabilities, with both the premium contributions and the property income accumulating free of tax until eventually paid out in the form of a benefit.

We believe that the deferment of income for tax purposes, at least initially, should be limited to Registered Retirement Income Plans. Ultimately the social advantages of a comprehensive scheme of income deferment might well lead to a "registered deferred income plan" which permitted the deduction of contributions for plans that would provide for benefits in the event that disability, unemployment or death caused the income of the family to decline below a certain level. The proposal for Registered Retirement Income Plans provides only for retirement, although we have suggested a relieving provision which would permit the payment of benefits without penalty prior to retirement to the extent that income of the tax unit in the year, including the amount of the withdrawal from the plan, did not exceed $7,000. We have not suggested the immediate implementation of a more comprehensive income maintenance plan because we believe it would be advisable to obtain first some experience in the operation of our recommended limitation on the deductibility of contributions to Registered Retirement Income Plans. Once the procedures for administering this limitation had been worked out in detail, the registration of more comprehensive plans could be considered.

To obtain the desired administrative advantages without the inequities of a tax deferment, the premium payments to income insurance plans should be deductible and some form of tax should be levied on the total amounts accumulating in the plan. Such a levy, as already discussed, could take the form of either a postponement fee or a withholding tax, but it would have to be applied to both contributions received and property income earned by the plan.

Therefore, we recommend that premium contributions to income insurance plans of both employers and employees should be deductible in computing income in the year paid and that all benefits should be included in full in income in the year received. Because the premiums would be deductible in full by the individual, there would be no need for the employer to allocate his share of the premiums to individual employees. In addition, to reduce the advantages of income deferment that this procedure would encompass, the total income of the plan, that is, premium contributions and property income, should be subject to either a small postponement fee of up to 10 per cent or to a withholding tax of up to 20 per cent.

The postponement fee or withholding tax recommended should not, however, be applied to government unemployment insurance and workmen's compensation. Because the terms of these plans are not established by individuals, and because the plans are not fully funded so that the tax deferment element is not serious, the application of such a tax is not warranted.

Therefore, the full amount of all proceeds received from such income insurance plans as unemployment insurance, workmen's compensation, sickness and accident insurance and group life insurance should be included in full in income in the year received. We recognize that transitional arrangements would be required, and under the heading "Life Insurance" we mention some of the alternatives.

The averaging arrangements proposed in Chapter 13, including the option of converting certain kinds of insurance benefits into registered annuities,

and the proposed treatment of Registered Retirement Income Plans under which substantial single contributions would be deductible in the year of contribution, should remove the hardship that could otherwise result from including substantial lump sum benefits from these plans in income in one year.

FOREIGN SOURCE PENSIONS AND CANADIAN PENSIONS PAID TO NON-RESIDENTS

Pensions received by Canadian residents from foreign sources should be treated as receipts from a non-registered plan. Thus, any benefits received in excess of the taxpayer's own contributions should be taxable in full subject to a credit for foreign withholding taxes on the benefits. One question is whether employer contributions and investment income accumulated prior to the taxpayer becoming a Canadian resident should be deemed to be contributions by the taxpayer. We recommend that this should be the case, because in Chapter 15 we recommend that all new residents should be entitled to assign as a cost basis of their property the market value of the property as at the date they became resident. Membership by a Canadian resident in a non-resident plan should be treated in a similar fashion to membership in any non-registered plan, with the investment earnings of the plan as well as an employer's contributions being included each year in the member's income. The employee would be required to make an estimate of the applicable amounts if he were unable to obtain the detailed figures from the employer.

The Canadian employer contributing to a registered or non-registered pension plan for a non-resident employee would be able to deduct his contributions from income, as he would for any form of employee remuneration. In the case of a non-registered plan, the annual investment earnings attributable to a non-resident should be subject to the non-resident withholding tax, and the dividends or other distributions from Canadian corporations which are applicable to the non-resident interest should not qualify for the refund of underlying corporate income tax. The employer contributions into a non-registered plan would be a taxable benefit, and should be subject to

withholding tax in a manner similar to any other employment income. Payments from such a plan would be a return of capital, and therefore should be free of any Canadian tax.

In the case of a registered group plan (a person taxed as a non-resident should not be permitted to have an individual plan), no tax should be imposed on the fund because the contributions and investment earnings would be accumulated. The non-resident should not be allowed to deduct his employee contributions unless he was eligible to be taxed as a resident. The withholding tax discussed below should be applied to all disbursements from the plan.

Should a Canadian resident become a non-resident, what tax could reasonably be collected by Canada on pensions accumulated for him or subsequently paid to him? We do not think that the deemed realization provisions applicable to other property of a person who ceased to be resident in Canada should apply in this case because of the liquidity problem. Some might suggest that, because these pensions would be received by a non-resident who would be subject to a foreign tax jurisdiction, the basic right to tax should belong to the foreign jurisdiction. However, because the pension benefits would have been built up while the beneficiary was resident in Canada, and in the case of registered plans he would have received special tax concessions while accumulating them and because Canada would be the source of the payment, Canada would have every right to levy tax. In the case of registered plans, part of the payment would represent income earned while the recipient was resident in Canada, but on which payment of the Canadian tax liability had been deferred until retirement. It is therefore reasonable that Canada should collect the deferred tax. It would probably also be necessary to collect this tax to prevent the emigration of Canadians as a result of tax considerations. We therefore recommend that a tax of perhaps 40 per cent or of at least 30 per cent, the general withholding rate for payments to non-residents, should be withheld from the income portion of pension payments to such non-residents. By income portion we mean that

portion of the payment that would have been income for tax purposes if received in Canada. This would exclude that which was deemed to be a return of the investment, that is, the employer and employee contributions and income of non-registered plans that had been attributed to the beneficiary. In the case of withdrawals from a registered plan prior to age 60, the rate of withholding tax should be at the maximum 50 per cent rate to prevent the use of these plans as a tax avoidance device.

Some tax conventions would have to be renegotiated to permit this withholding tax.

The level of the proposed withholding tax raises the question of whether refunds should be allowed. The amounts concerned could be significant for some individuals, so we recommend that such non-residents should be allowed to file Canadian income tax returns as if they were resident in Canada, that is, on a world-income basis. The non-resident could then claim a refund of any tax withheld in excess of the tax that would have been payable if he were resident in Canada. Alternatively, he would be entitled to file an undertaking to submit a return so that the full withholding would not be required. To ensure that there would be no double taxation, it would be necessary to allow a credit for all foreign taxes which were attributable to income from foreign sources. The effect of this proposal would be that the total tax burden on the taxpayer would, in many cases, be substantially the same whether he resided in Canada or abroad.

LIFE INSURANCE

Life insurance is an important feature of the social and economic environment of most Canadians. Approximately three quarters of the families in Canada have acquired life insurance to provide funds in the event of death or in anticipation of some event which would require financial resources 29/. A further indication of the extensive use made of this form of saving is the fact that almost 30 per cent of personal saving is put into life insurance.

An individual who takes out a life insurance policy pays single or periodic premiums and in due course may receive a benefit upon the death of the life insured or upon the maturity of the policy. In addition, the policyholder may receive policy dividends during the life of a policy. The policy may be surrendered for cash before death or maturity.

The amount received from a life insurance policy may be determined by several elements or factors:

1. The return of premiums paid, which is in effect a return of capital,
2. Minus, the expense loading to cover the commissions and other costs involved in issuing and servicing the policy,
3. Plus, the income earned on the investment of these net premiums,
4. Plus or minus, the mortality gain or loss.

Over the whole insured population there should not be a net mortality gain or loss, because the concept of insurance involves the complete offset of individual gains and losses, but individual policyholders will receive either more or less than they contribute.

At the present time no part of the proceeds of a life insurance policy is included in income. The exclusion is not the result of any specific legislative provision but appears to be, to a considerable extent, a matter of administrative practice. Thus,the investment income that is accrued each year to the benefit of policyholders, the policy dividends and the mortality gain or loss are all excluded from income for income tax purposes. The rationale behind this exclusion is not clear, but probably a major reason for the special treatment has been the difficulty of determining how a tax could be levied in an equitable and administratively feasible fashion.

However, life insurance is an important element in the Canadian economy. In 1964, Canadians contributed over $1,300 million in premiums, received over

$800 million in policyholder dividends and other benefits and about $600 million in net investment income flowed to insurers. Amounts of these magnitudes cannot be ignored when determining what is to be included in the tax base. It is inappropriate that one source of property income should have the competitive advantage of offering a complete tax exemption on all investment income derived through that source, particularly in view of our recommendations concerning property income contained elsewhere in this Report. For not only do we recommend that all forms of property income should be taxed in full, but we also recommend that it should be taxed when it is earned regardless of the fact that receipt of the income might be deferred to a subsequent year. Thus, we recommend in Chapter 15 that interest income should be included in the payee's income each year, even if receipt were postponed by the terms under which the investment was made. We believe that a similar approach should be applied to the investment earnings derived through life insurance, and therefore property income accruing to the benefit of individuals through life insurance should be taxed.

Tables 16-2 and 16-3 provide some indication of the relative size of the amounts involved for some standard kinds of life insurance policy. All of the examples are for $10,000 policies and all computations are based upon the requirements for the federal government minimum statutory reserves. In fact, most policy premiums are now based on an assumed interest rate higher than the 3.5 per cent used in these tables together with an allowance for expenses. In addition, in Chapter 24 we recommend that life insurers should pay the full rate of corporate income tax on business income when earned and that policy reserves for tax purposes should be based on an investment yield of at least 4 per cent. Policy reserves represent the accumulated amount provided out of premiums and investment income to meet the estimated future liabilities, based upon actuarial considerations, for policy claims. Thus, one element of this liability account represents the accumulation of investment earnings for eventual

TABLE 16-2

SOURCE OF POLICY RESERVES FOR A WHOLE LIFE POLICY
PAID UP AT AGE 85 FOR $10,000 TAKEN OUT AT AGES 35 AND 50

Year of Age	Net Premium Added in Year (1)	Investment Income Credited in Year (2)	Mortality Loss Debited in Year (3)	Policy Reserve at End of Year (4)
Taken out at age 35 (approximate non-participating annual premium of $175)				
35	$ 25.06	$ .84	$ 25.10	$ .80
45	157.67	52.91	45.38	1,517.20
55	157.67	114.17	87.24	3,288.90
65	157.67	179.21	154.11	5,146.10
75	157.67	239.76	230.53	6,858.00
84	157.67	295.70	221.37	8,524.30
Total for 50 years	7,750.89	7,204.91	6,431.50	
99	—	339.78	—	10,000.00
Taken out at age 50 (approximate non-participating annual premium of $330)				
50	$ 84.10	$ 2.97	$ 83.17	$ 3.90
55	313.69	44.65	114.34	1,204.50
65	313.69	130.79	201.08	3,666.90
75	313.69	212.41	294.50	5,986.10
84	313.69	295.68	221.37	8,524.30
Total for 35 years	10,749.56	5,126.79	7,352.05	
99	—	339.78	—	10,000.00

Notes:

Column (1) The net premium is calculated according to the mortality and interest basis prescribed by the federal government for the minimum statutory reserve, without loading for expenses. This basis is not necessarily the same as the mortality and interest basis used by the insurance company in computing the premium rates it charges to policyholders. The first year net premium is modified to allow for the initial expenses.

Column (2) The investment income for the year is 3.5 per cent (the rate used in arriving at the statutory minimum reserve) of the reserve at the beginning of the year plus the net premium for the year, since premiums are assumed to be payable annually in advance.

Column (3) The mortality loss for the year is the amount chargeable to those that survive in order that the expected claims of those that die in that year may be paid in full. Should death occur at any age, a mortality profit arises in the year of death, equal to the sum assured of $10,000 less the year-end reserve held for the policy.

Column (4) The policy reserve at the end of the year is the total of the policy reserve at the beginning of the year plus the net premium added and the investment income credited and less the mortality loss debited. This amount could be taken to be the "value" of the policy at the year end.

TABLE 16-3

SOURCE OF POLICY RESERVES FOR AN ENDOWMENT, WHOLE LIFE, AND TERM INSURANCE POLICY FOR $10,000 TAKEN OUT AT AGE 40 AND WITH 20 YEARS OF PREMIUMS

Year of Age	Net Premium Added in Year (1)	Investment Income Credited in Year (2)	Mortality Loss Debited in Year (3)	Policy Reserve at End of Year (4)
20 Year Endowment (approximate non-participating annual premium of $425)				
40	$224.71	$ 7.89	$ 34.60	$ 198.00
45	388.85	75.26	41.81	2,184.20
50	388.85	154.10	45.65	4,513.20
55	388.85	248.00	35.15	7,296.40
59	388.85	338.15	-	10,000.00
Totals for 20 years	7,612.86	3,110.45	723.31	
20 Payment Whole Life (approximate non-participating annual premium of $310)				
40	101.86	3.59	35.05	70.40
45	266.00	46.75	46.35	1,337.10
50	266.00	95.82	60.12	2,773.50
55	266.00	151.52	72.72	4,406.20
59	266.00	202.06	76.26	5,897.60
Totals for 20 years	5,155.86	1,900.74	1,159.00	
99	-	339.78	-	10,000.00
20 Year Term (approximate non-participating annual premium of $97)				
40	34.11	1.19	35.30	-
45	81.00	8.88	52.38	209.60
50	81.00	14.01	80.41	335.80
55	81.00	13.83	126.33	282.40
59	81.00	6.30	185.90	-
Totals for 20 years	1,573.11	203.89	1,777.00	

Notes:

Column (1) The net premium is calculated according to the mortality and interest basis prescribed by the federal government for the minimum statutory reserve, without loading for expenses. This basis is not necessarily the same as the mortality and interest basis used by the insurance company in computing the premium rates it charges to policyholders. The first year net premium is modified to allow for the initial expenses.

Column (2) The investment income for the year is 3.5 per cent (the rate used in arriving at the statutory minimum reserve) of the reserve at the beginning of the year plus the net premium for the year, since premiums are assumed to be payable annually in advance.

Column (3) The mortality loss for the year is the amount chargeable to those that survive in order that the expected claims of those that die in that year may be paid in full. Should death occur at any age, a mortality profit arises in the year of death, equal to the sum assured of $10,000 less the year-end reserve held for the policy.

Column (4) The policy reserve at the end of the year is the total of the policy reserve at the beginning of the year plus the net premium added and the investment income credited and less the mortality loss debited. This amount could be taken to be the "value" of the policy at the year end.

payment to the policyholders. Because the stipulated investment yield rate would be employed for computing the allowable deduction to the insurance companies for transfers to policy reserves for tax purposes, it would also establish the amount of investment income that would be deemed to have been accrued to the benefit of policyholders. Thus, the actual amounts of investment income that would be allocated to a policyholder for tax purposes under our proposals might differ from the amounts shown under the column "Investment Income Credited". Nevertheless, the tables give some idea of the relative size of the amounts that under our proposals would have to be included in income for these various policies.

Participating Dividends

The holder of a participating policy is entitled to dividends in addition to the contractual benefits payable on maturity or death or on surrender of the policy. Policyholder dividends are a form of distribution similar to ordinary dividends and to patronage dividends of co-operatives and, like these other distributions, should be included in the tax base of the insured when credited to him. Policyholder dividends may be to some extent a return of premiums paid, but they also represent a distribution of a share of the property income earned and may also be derived from favourable overall mortality experience or from a favourable expense record. In our view, all of the latter three items should be treated as income to the policyholder and taxed as such. The problem is whether all, or only a portion, of the policyholder dividend should be brought into the income of the policyholder. The proportion chosen would not affect the taxable income of the insurer because it would deduct the full amount of such dividends.

Mortality Gains and Losses

We must also consider whether mortality gains and losses should be taken into account in computing income. There can be no doubt that ability to pay is increased or reduced by this gain or loss and that therefore under

our definition of the comprehensive tax base mortality gains and losses should be part of taxable income. In our view, the co-operative nature or mutuality of the arrangement by which individuals, through insurance, decide to pool their risk does not of itself justify special tax consideration. A change in capacity to pay is important, and certain classes of transactions cannot be accorded special treatment without creating inequities. On the other hand, the social argument that individuals should be encouraged to provide for their own protection is significant. Also, because the greatest gains occur as a result of early death, it is apparent that taxing mortality gains may mean the imposition of tax at an inappropriate time, a time when it would be difficult for the beneficiary to understand why a tax liability had arisen. Moreover, the allowance of mortality losses would give a tax refund at a time and for a reason that would be equally difficult to understand.

While the difficulty of explaining the rationale of such taxation concerns us, the argument that gains realized because of the loss of life are not a reasonable subject of taxation cannot be accepted. If it is felt that loss of life warrants some special tax considerations, a special tax allowance or tax credit related to this occurrence should be made available to all taxpayers and not just to those taxpayers who are fortunate enough to be recipients of insurance benefits. Special treatment of insurance benefits compounds the inequities arising on death by assisting only those who are already receiving some compensation.

Another concern is the lump sum nature of this type of income, with a relatively large benefit being received in one year. However, the beneficiary would be eligible for the averaging procedures suggested in Chapter 13, or he could exclude the benefit from current income by making a lump sum contribution to a Registered Retirement Income Plan or to an interest-bearing registered government annuity. The latter two alternatives are extremely important because they would permit a lifetime averaging of insurance benefits in many cases; and in those cases where the benefits were only of moderate

size and were payable to a beneficiary who had little other income, they would result in the payment of little or no tax.

One must also consider the administrative difficulties arising from the inclusion or exclusion of mortality gains and losses in determining the tax base. An apportionment of the proceeds of a life insurance policy, even on an approximate basis, between the various sources of the funds (premiums, investment earnings, and mortality gain or loss), in an attempt to arrive at a specific amount that was to be either included in, or excluded from, the tax base would be a difficult task. If all the proceeds were to be included in income there would be no need to make such an allocation. Another aspect of the administrative question is whether the tax revenues to be gained warrant the effort involved. Mortality gains and losses should compensate over the whole insured population if computed without recognition of the expense element, and there should not be a net revenue gain or loss. Even though the revenue gains and losses might balance out over all taxpayers, the amounts for individual taxpayers would be significant and should be taken into account in determining their ability to pay. Only in this way can equity be attained.

If mortality gains and losses were to be taken into account in the computation of income, and if property gains and losses were to be taken into account on an accrual basis, theoretically the applicable mortality loss should be deductible each year the policy is in effect. This is indicated by Tables 16-2 and 16-3 which appear earlier in this chapter. In other words, the amount to be included in the policyholder's income each year would be the investment income accumulated for his benefit less the mortality loss. The result of this procedure would be to tax the policyholder each year on the increase in his policy reserve less that portion contributed by the taxpayer in the form of the net premium. Thus, the balance of policy reserve in effect becomes the cost basis of the taxpayer's interest in the life insurance policy. On maturity of the policy the mortality gain (or loss) would then be the policy proceeds less the reserve then held by

the insurer in respect of the policy, and possibly less any difference between the gross premiums and the net premiums paid. However, for practical purposes it would probably be more satisfactory to calculate the net mortality gain or loss, that is, the policy proceeds less premiums paid and less investment income credited, at the time the policy matured, and to include it in income at that time. This would avoid the bringing of a large sum into income in one year, as the accumulated mortality losses would reduce or offset the ultimate mortality gain. Alternative approaches to the inclusion in income of mortality gains and losses are discussed in Appendix C to this Volume.

If the policyholder had to pay tax on some portion of his benefits, his insurance would be of less value to him. If mortality gains and losses were to be taken into account, it might be necessary to have special relieving provisions applicable to benefits received during the first five years on policies in existence at the effective date of the legislation, and perhaps it would be necessary to provide an exemption from tax up to a certain amount of policy proceeds. In addition, the cost basis of all policies as at the effective date would have to be determined, because the values built up in the past should not be taxed. For practical purposes the value could be taken as the greater of premiums paid or the cash surrender value as at that time. In any case, this determination could be made by the insurer on the basis of procedures worked out by the industry and the government departments concerned.

Property Income

To tax the investment income earned through life insurance would not constitute the removal of a specifically granted exemption, but rather would be the taxation of gains that have been excluded in practice because of the difficulties of levying tax in an equitable fashion. Taxpayers are taxed generally on investment income and therefore it is not unreasonable to subject to tax immediately investment earnings received or accrued through life insurance. The total amount of investment income accruing each year to

the benefit of Canadian policyholders is substantial, amounting to almost $500 million in 1964, and to continue to exempt an amount of this magnitude from income tax would be most inequitable. In addition, a tax exemption of these proportions may have had a distorting effect on the efficient allocation of saving.

However, not all the investment income earned each year is immediately paid out to the policyholders. A portion will be distributed in the form of policy dividends, but most of the property income is accumulated in the policy reserves until paid out in the form of claims or on cancellation. Elsewhere in the Report we recommend that although most income of the individual should be taxed only when received, it would be necessary to account for many items of property income on a form of accrual basis. We have pointed out the value of tax deferment, and have stated that as a result it would be necessary to regard certain items that are set up as liabilities by the payer, such as interest, to be income to the beneficiary even if payment were deferred until some future date. This approach should also be followed in the case of life insurance to maintain neutrality of tax treatment between various kinds of saving arrangements, and to preclude the use of life insurance as a tax deferment device. Property income accumulated in policy reserves should be taxed in much the same manner as if it had been paid out to the policyholder and paid back by him to the insurer in the form of higher premiums. It will be observed, however, that in many cases the policyholder may be able to arrange with the insurance company for such variations in his policy as would be necessary in order to qualify it for registration as a Registered Retirement Income Plan.

Life Insurance as a Registered
Retirement Income Plan

One proposal for the taxation of life insurance benefits that we rejected was the treatment of most life insurance as a form of Registered Retirement Income Plan. Although life insurance plans are not entirely

comparable to other plans included in this designation, they provide alternative media for the savings of individuals. For registered plans the premiums would be deductible, the investment earnings would be free of tax until paid out to beneficiaries, and the full amount of all benefits would be taxable. Because mortality gains or losses and investment earnings would all be included in the tax base, it would not be necessary to divide the proceeds into their relative components. To ensure equality of treatment between competing forms of saving, registered life insurance contracts would have to be subject to the same requirements for registration that were imposed upon other registered plans, including a limit on the amount of eligible benefits.

Although we considered a number of alternatives, we were unable to develop rules that met both the criteria for registration already discussed and that were capable of encompassing life insurance without leading to unacceptable administrative complexities. The method proposed for the more effective regulation of retirement income plans involves a limit on benefits, a technique that becomes more difficult to administer if a large proportion of the beneficiaries have more than one registered plan. Also, even if most life insurance contracts were registered, there would remain a number of unregistered plans where the sum assured exceeded the prescribed limits for registered plans, and therefore it would still be necessary to provide for the allocation of some investment income.

We therefore concluded that life insurance should, in general, be treated in a manner similar to non-registered retirement income plans.

It should, of course, continue to be possible for life insurers to register and sell life insurance contracts that meet the requirements for retirement benefits already suggested, as they now do under section 79B plans. It should also be possible to vary existing policies so that they would meet the criteria for registration and to register such policies if they comply with the requirements. Thus, competitive neutrality could be maintained between the various savings media.

The Proposal

Our recommendations for life insurance are that:

1. Premiums paid for a life insurance policy, other than for group life insurance which we discussed under the heading of income insurance plans, should not be deductible in computing income unless the policy was registered as a Registered Retirement Income Plan in the manner already specified.

2. In general, the property income accumulated for the benefit of the policyholder should be included in his income in the year it was accumulated in the hands of the insurer. This procedure would be consistent with that recommended for investment income accrued by other financial intermediaries and not immediately paid to the beneficiary. Alternative procedures by which the property income would be subject to a postponement fee or withholding tax when accrued by the insurer, are discussed in Appendix C to this Volume.

3. The entire policy dividend should be included in the income of the recipient, a procedure similar to that recommended for patronage dividends of co-operatives. A withholding tax of 15 per cent, as recommended for interest and certain other payments, should be deducted.

4. Mortality gains and losses should eventually be included in the computation of the income of policyholders. In the case of the other contractual arrangements that give rise to mortality gains or losses, such as, annuities, some pension plans and income insurance plans, we have recommended that such a gain or loss should immediately be included in the comprehensive tax base. However, we do not recommend the immediate inclusion of mortality gains and losses from life insurance, other than from group life insurance, unless their inclusion would be essential to an administratively feasible system of taxing the other income elements of life insurance. The exclusion of mortality gains

and losses would omit life insurance proceeds from income and disallow the deduction of premium payments 30/. We recommend that the inclusion of mortality gains and losses in the tax base should be postponed, because our other recommendations involve a substantial change in the tax treatment of life insurance and we would prefer that the impact of including mortality gains and losses in the computation of income should not arise at the same time.

The taxation of policy dividends would pose few administrative difficulties because the amount of such dividends is already reported annually to policyholders. As in the case of the patronage dividends of co-operatives, we recommend that the full amount of policy dividends should be included in income because of the futility of attempting to designate a reasonable amount that could be considered to be a return of premium. Although such an arbitrary procedure may appear inequitable when mortality gains and losses are excluded from income, the eventual taxation of the excess of policy proceeds over premiums paid would remove any possible inequity because the gross premiums would be taken into consideration when determining the final tax liability.

In the case of the property income accrued as part of the policy reserves of the insurer, an allocation to individual policyholders would be a new procedure. However, the reporting of such income to policyholders should be relatively straightforward, particularly because well over one half of the holders of policies outstanding are already receiving notices concerning annual distributions, that is, the participating dividends. Also the determination of the amount of the allocation should not be unduly complex because the insurer must maintain, as a necessary basis for his statutory valuations, detailed records of the reserves held under each kind of policy. Because it is the investment income credited each year to the policy reserves for tax purposes that is deducted in computing the taxable income of the insurer and is accumulated for the benefit of the policyholder, it is this amount that should be allocated annually to the policyholders. Any amount that the insurer does not allocate should be subject to a substantial withholding tax, a tax that should subsequently be refunded to the insurer when the applicable investment income has been allocated to a policyholder. Although the

allocation would not provide the policyholder with cash from which to meet this tax liability, we do not feel that the liquidity problem would be particularly serious, because the amounts involved each year would usually be relatively small in comparison with the other income of the policyholder. In any event, the policyholder who was concerned with liquidity could qualify his policy as a Registered Retirement Income Plan and thereby defer payment of tax until he received the policy proceeds.

A major advantage of the recommended allocation is that the policyholder would pay the full tax liability and the cash flow of the insurer would therefore not be reduced. Thus, the insurer could continue to provide for its contractual liabilities in the same manner as at present. This effect, when combined with the initial exemption for mortality gains and losses, means that the initial proposal could be implemented with very few transitional provisions. For example, there would be no need to value the policies outstanding as at the effective date.

However, we suggest one exception to the general requirement that investment income be allocated. There are some kinds of policies, which would be specifically defined and would include most term insurance, that have relatively small reserves and thus little investment income. In such cases a detailed allocation would not appear to be warranted and the application of a substantial withholding tax would not be reasonable. We therefore recommend that the insurer should be permitted, at his option, to pay a flat-rate tax of, say, 20 per cent on the investment income credited to the reserves held for such policies. This tax would be in lieu of any personal income tax on such investment income, so that allocation to policyholders would not be required. Although the application of progressive rates of tax would be forgone, the saving element is small and the inequity would be minor, while the reduction in administrative complexity would be significant.

The recommendations we have made in this chapter are stated in general terms. It would be necessary for the tax authorities to work out, in association with representatives of the life insurers and the Department of Insurance, the detailed regulations that would apply. Although we believe that the detailed procedures for implementing our proposal for the allocation of investment income to policyholders can be developed with the co-operation of these three groups, it is possible that such an approach would place too great an administrative burden on the insurer. We have therefore set out, in Appendix C to this Volume, two alternatives that should be considered if our primary proposal for the allocation of investment income proves unacceptable. As we have mentioned, one of these alternatives involves the immediate inclusion in the computation of income of mortality gains and losses realized through life insurance, a proposal that we would endorse if it was a necessary part of the taxation of accrued property income.

CONCLUSIONS AND RECOMMENDATIONS

REGISTERED RETIREMENT INCOME PLANS

1. The Canada Pension Plan and alternative provincial pension plans with equivalent provisions should be deemed to be Registered Retirement Income Plans so that contributions would continue to be deductible, earnings of the fund would continue to be exempt from tax, and benefits would continue to be taxed in full.

2. The extent to which contributions to other Registered Retirement Income Plans (to include pension plans, retirement savings plans, profit sharing plans and life insurance) are deductible from income should be based upon benefits. There should be only one set of requirements applicable equally to all registered plans, with no distinction by kind of saving plan. There should be no annual limit on deductions, but contributions by both employer and employee should be deductible from income only as long as the retirement benefits to the taxpayer from plans other than the Canada Pension Plan (or an alternative provincial

pension plan with equivalent provisions), calculated on specified assumptions, does not exceed the equivalent of a single life annuity of $12,000 a year, payable at age 65 with a ten-year guarantee. A family unit which includes a married couple should be permitted to make additional contributions to an individual plan or to any second plan, subject to certain restrictions, to provide total retirement benefits equivalent to a joint and survivor life annuity of $12,000 per annum for the two spouses without a guaranteed period, commencing when the older spouse attained age 65. Benefits could be paid in the form of an individual annuity or a joint and survivor annuity commencing not later than age 71 with or without a guaranteed term.

3. In the case of existing plans that have accumulated assets in excess of those required to provide the maximum benefit, contributions and property income should no longer be treated as income of a registered plan. Thus, such contributions would not be deductible and the property income would have to be included immediately in the income of the beneficiary. However, the "excess" assets accumulated to date should be permitted to remain in the plan and should not be brought into the income of the beneficiary until distributed.

4. The trustee or administrator of a Registered Retirement Income Plan should continue as at present to be exempt from tax on the property income received. Dividends from Canadian companies received by the plan should qualify for a refund of the 50 per cent corporate income tax paid on the underlying earnings.

5. Membership in a registered individual plan prior to retirement should be limited to Canadian residents or former Canadian residents who elect to continue to be taxed as such. Membership in a registered group plan should not be limited by residence.

6. There should be a requirement that employer's contributions and property

income in excess of an amount required to provide the $12,000-a-year benefit mentioned above must be distributed or attributed to the beneficiary. This requirement should apply to all registered plans other than those referred to in 1 above, including those at present outstanding. Amounts so paid or attributed would be taxable in the hands of the beneficiary.

7. All withdrawals and benefits received from registered plans should be taxable at full progressive rates. There should also be a special 15 per cent tax on withdrawals prior to age 60 otherwise than on death. This tax should be refundable only to the extent that the withdrawal does not increase the income of the tax unit over $7,000 for the year.

8. The present requirements for registration should be strengthened. Annual reporting to the tax authorities should be required, and every such plan should be under the supervision of a registered administrator. To maintain his registration, an administrator should have to comply with certain regulations.

NON-REGISTERED PLANS

9. Non-registered plans, including ordinary annuities, should be treated as conduits for the individual beneficiaries. Contributions by the beneficiaries should not be deductible. Any property income or employer contribution not attributed to an individual, and included in his income, should be subject to withholding tax at a rate close to the maximum individual rate of 50 per cent. Such plans which receive distributions from Canadian companies should be entitled to credit for the underlying corporate tax in the same manner as we recommend for other taxpayers. Any foreign plan would be treated as a non-registered plan.

10. The cost basis of a non-registered plan would consist of all amounts contributed by the tax unit and all amounts attributed to that tax unit and included in its income. The difference between what was received

out of the plan and the cost basis would be a gain or loss that should be taken into account in computing income.

INCOME INSURANCE PLANS

11. All benefits received from income insurance plans (unemployment insurance, supplementary unemployment insurance, workmen's compensation, sickness and accident insurance and group life insurance) should be included in income. Contributions of employers and employees should be deductible in computing their income. To reduce the value of the tax deferment involved in this procedure, the total receipts (contributions and property income) of the plan for the year should be subjected to a small postponement fee or to a withholding tax. Government unemployment insurance and workmen's compensation plans should be exempt from this fee or tax.

PENSION PAYMENTS TO NON-RESIDENTS

12. The income portion of pension payments made to non-residents should be subject to a withholding tax of at least 30 per cent. However, a non-resident should be entitled to elect to file a return as a Canadian resident, reporting his world income including the pension payment and claiming a credit for foreign tax on his income from foreign sources.

LIFE INSURANCE

13. Premiums paid (with the exception noted below) should not be deductible and the investment income attributable to the policyholder, that is, the investment income credited to the reserve held for his policy, should be allocated to him each year and included in his income for that year. Initially the proceeds of a Canadian life insurance policy received by the tax unit that made the premium payments should be excluded from its income. Policy proceeds received by other tax units are in effect gifts and should therefore be included in full in their

incomes. Policy dividends should be subject to a 15 per cent withholding tax, and should be included in full in the income of the policyholder. If a life insurance policy was registered as a Registered Retirement Income Plan, it should be treated in the same manner as other such plans. Mortality gains or losses from life insurance should eventually be included in income.

REFERENCES

1/ Section 62(1)(q).

2/ Section 5(1)(a).

3/ Section 6(1)(a)(iv).

4/ Section 11(1)(i).

5/ Section 11(1)(g) and Regulations, section 2700.

6/ Section 76.

7/ Section 36(1). Since April 26, 1965, a limit on the amounts eligible for this special rate of tax has been imposed by sections 36(5) and 36(6) to prevent abuse.

8/ Section 11(1)(u).

9/ Section 11(1)(x).

10/ To qualify under section 79B, the annuity must mature by the time the annuitant attains age 71, be for life or for the joint lives of an annuitant and his spouse or the life of the survivor, and may have a guaranteed period not exceeding 15 years. The plan must provide that there shall be no realization or commutation of an annuity or benefit before maturity except by way of refund of premiums on death. Section 79B applies not only to contracts for the purchase of an annuity, but also to arrangements whereby payments to a corporation in trust are to be made for the purpose of providing an annuity at a fixed maturity date. The same tax consequences follow as set out in the text.

11/ Section 79 and section 79C respectively.

12/ A deferred profit sharing plan, like a pension plan but unlike an employees profit sharing plan, must be registered. In order that it

be registered, amounts paid in must be allocable to employees, the employees must not be able to surrender, assign or borrow on their interest in the plan, and direct investment must not be made in the employer's obligations directly or through a company.

13/ Section 6(1)(aa).

14/ Section 11(1)(k) and Regulations, section 300.

15/ Plans which provide future payment for present services should be distinguished from plans which, at least ostensibly, provide future payment for future services. Deferred compensation plans which contemplate future services, such as consulting services by executives, are dealt with in Chapter 14.

16/ There is British judicial authority which suggests that such payments are deductible. See J. S. Hausman, "Non-statutory Deferred Compensation Plans", Canadian Tax Journal, Vol. XIII, 1965, p. 402.

17/ Section 11(1)(k).

18/ For supplementary unemployment benefit plans authorized by section 79A, amounts paid by the employer are deductible and no tax is paid by a trust while governed by such a plan. However, amounts received from such a plan are taxable.

19/ Section 6(1)(db).

20/ The mortality gain or loss is the difference between what each person having an interest in an annuity, pension plan, life insurance policy or similar form of contract receives and what he contributes directly (by contribution or premium) or indirectly (by reinvested property income). Whether this difference amounts to a gain or loss will depend upon whether (and when) the insured-against event occurs within the term of the plan or policy.

21/ A detailed discussion of the effect of the growth of pension plans on the rate of individual saving is contained in Philip Cagan, Effects of Pension Plans on Aggregate Saving, Occasional Paper No. 95, New York: National Bureau of Economic Research, 1965. A less detailed analysis, but one concerned particularly with Canadian Registered Retirement Savings Plans, is contained in Robert N. Schoeplein, Taxpayer Participation Under the Registered Retirement Savings Program, Canadian Journal of Economics and Political Science, May 1966.

22/ This depends on the uses to which governments put the funds raised, and what would have happened to government revenues in the absence of the plan.

23/ Trusteed Pension Plans, Financial Statistics, Ottawa: Queen's Printer, 1964, Dominion Bureau of Statistics, Table C.

24/ Survey of Canadian Trusteed Pension Funds, 1953—a much smaller survey than that conducted in 1963.

25/ This figure is an estimate made of the average compounded annual before-tax rate of return (with dividends reinvested plus gains and less losses) of all common stocks listed on the New York Stock Exchange for the 35 years from 1926 through 1960, a period that included the Depression and World War II. L. Fisher and J.H. Lorie, "Rates of Return on Investments in Common Stocks", Journal of Business, Vol. XXXVII, 1964, p. 9. Although the yield on Canadian equities has not necessarily been the same, the performance of the Canadian stock market has not differed materially from the United States record.

26/ Where the pension rights accumulated to date were related to future income, the assumption would be that the taxpayer's income would continue at current levels, unless there was evidence to the contrary.

27/ While we have suggested a limitation on withdrawals by reference to a

stated age, it might be considered desirable as an alternative to provide for withdrawals prior to this age, subject to suitable restrictions which would permit the retirement income to be payable in monthly instalments from maturity which would be equal except to the extent necessary for integration with the Canada Pension Plan and old age security payments.

28/ Department of National Revenue, Statement of Principles and Rules Regarding Pension Plans, Ottawa: Queen's Printer, 1959.

29/ Canadian Life Insurance Association, Canadian Life Insurance Facts, 1964, Toronto: Canadian Life Insurance Association, 1964.

30/ The exclusion would be accomplished by specifically excluding from income the proceeds received from a Canadian life insurance policy on death, maturity and cancellation. In addition, the mortality gain or loss attributable to a policy that was qualified as a Registered Retirement Income Plan should be excluded from the income of the tax unit that paid the premiums. However, we are also recommending that the comprehensive tax base should include gifts and bequests received by a taxpayer. As the receipt of the proceeds of a life insurance policy by a tax unit other than the unit that paid the premiums (and was credited with the investment income) amounts to a gift, then the exclusion would have to be limited to the Canadian life insurance proceeds received by the same tax unit that paid the premiums and was credited with the investment income.