CANADA

REPORT

OF THE

ROYAL COMMISSION ON

TAXATION

VOLUME 4

TAXATION OF INCOME (continued)

Part B - Taxation of Income Flowing Through Intermediaries
Part C - Determination of Business Income
Part D - International

1966

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Catalogue No. Z1-1962/1-4ad

ROGER DUHAMEL, F.R.S.C.
Queen's Printer and Controller of Stationery
Ottawa, Canada
1967

CANADA

REPORT

of the

ROYAL COMMISSION ON TAXATION

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CONTENTS OF THE COMPLETE REPORT

ROYAL COMMISSION ON TAXATION

VOLUME 4

C O N T E N T S

Page

Page

PART B

TAXATION OF INCOME FLOWING THROUGH INTERMEDIARIES

CHAPTER 19

CORPORATIONS

Canada has levied a tax on corporate income since 1917. Although this tax has been productive of substantial revenue and has been relatively easy to administer, it does not necessarily follow that it is an efficient and equitable tax. In order to judge the efficiency and equity of the levy, it is first necessary to examine the incidence of the tax.

Because income tax is collected from corporations, trusts, and co-operatives, it does not mean that these organizations bear the burden of the tax. Ultimately, the burden of the tax on the organization is the relative reduction in the power of people to consume. This reduction can take the form of reduced payments to people who sell goods and services to the organization, increased prices for those who buy goods and services from the organization, reduced incomes to those who hold interests in the organization or reduced sale prices received for these interests by those who dispose of them. We recognize that it has been extremely useful to treat corporations as persons "in contemplation of law", and we agree that the shareholders of a large, widely held corporation usually do not have a major voice in the decisions of the corporation. But the rights and obligations of the corporation or the decision-making powers of those who control the corporation are irrelevant considerations from the viewpoint of deciding who bears the corporation income tax. The fact that an individual shareholder or a manager may be able to make the major decisions of the corporation does not mean that he bears any particular proportion of the burden of the tax on the corporation. His power to consume goods and services for personal use may be completely unaffected by the corporation income tax.

Taxing the income of organizations is an inexpensive method of collecting taxes, but unless the tax is integrated with the taxation of the incomes of the individuals or families who hold interests in these organizations, the tax system cannot be either equitable or neutral. When the income of organizations is taxed differently from other kinds of income, and the income of different kinds of organization is not taxed in a similar manner, avenues for tax minimization are created that are more readily available to some individuals than to others. As we explain later, to the extent that such taxes are not avoided they may be quickly shifted on to consumers and suppliers through prices and cost changes and thus become crude sales and cost-factor taxes. When these taxes on organizations are neither avoided nor shifted in this sense, they become capricious taxes on some kinds of wealth at the time they are imposed. Unless they are completely avoided, they distort the allocation of resources and reduce the value of our national output.

Equity and neutrality would best be achieved under a tax system in which there were no taxes on organizations as such, and all individuals and families holding interests in organizations were taxed on the accrued net gains from such interests on the same basis as all other net gains. Under such a system, shareholders of corporate organizations would be required to bring the following into their annual tax bases:

1. Dividends received during the year.

2. The gains or losses on shares disposed of during the year, that is, realized gains and losses.

3. The change in the value of the shares held over the year end, that is, accrued gains and losses.

The net gains from holding interests in other organizations would be treated in the same way.

Although we can see no grounds in principle for taxing corporations and other organizations, we have reluctantly reached the conclusion that there are good and sufficient reasons for continuing to collect a tax from them.

The main reason is the practical difficulty of taxing accrued share gains as required under the ideal approach we have just described. Another reason is the loss in economic benefit to Canada that would result if non-residents holding shares in Canadian corporations were not taxed by Canada on their share of corporate income at approximately the rates that now prevail.

Valuation problems preclude the annual taxation of share gains on an accrual basis, while to tax shareholders only on dividends received and gains realized without any tax on corporations, would permit massive and unwarranted postponement of personal income tax. In the absence of a tax on the undistributed earnings of corporations, those individuals who could arrange to receive income through corporations could retain their savings untaxed in the corporation. These untaxed savings would earn a return that would also escape taxation if the return was also retained and reinvested by the corporation. The result would be an inordinate tax advantage to those who could channel income through a corporation. Even if all of the shareholders of Canadian corporations were residents, it would still be essential to tax at the top personal rate that part of the current income of corporations that was not included in the tax bases of shareholders, in order to preclude tax postponement.

A substantial proportion of the shares of Canadian corporations is held by non-residents. As we emphasize in Chapter 5, the revenues derived from taxing the corporate source income attributable to non-residents provide a major economic benefit to Canada. If Canada did not tax corporate income on an annual basis at a rate roughly equal to the rate other countries impose on the foreign corporate income generated by their residents, we would simply be transferring substantial revenue from the Canadian treasury to foreign treasuries with little reduction in taxes to the non-resident shareholder. This would provide a substantial windfall benefit to foreign governments at Canada's expense, for foreign governments would be most unlikely to reciprocate. Imposing a high withholding tax on dividends paid to non-residents would not provide an adequate substitute for a corporation income tax. If this course was followed, non-residents could retain all of the income free of tax in a Canadian corporation and could then realize their gains by selling their shares. Such gains could not, as a practical matter, be taxed by the Canadian government. In any event, the existing tax treaties preclude an increase in the Canadian withholding tax to compensate for the reduction in corporation tax. If the treaties were amended to permit such an increase, foreign governments would probably retaliate by raising their withholding taxes on the foreign source income of Canadian residents. The importance of the Canadian corporation income tax revenue from foreign investment in Canada, and the need to avoid the foreign retaliation that would probably follow if Canada raised its withholding tax, dictate that corporate income should continue to be taxed at the corporate level at a rate of approximately 50 per cent.

After an exhaustive examination of the alternative methods of taxing corporate income, we have come to the conclusion that the method we recommend for the full integration of personal and corporation income taxes is without doubt the best system. It would achieve the greatest equity and neutrality consistent with the inescapable facts that accrued share gains cannot be brought initially into income each year and that Canada should tax the Canadian corporate income of non-residents at a rate of about 50 per cent.

The full-integration system is not an original idea 1/. What are original are our solutions to the practical problems that were thought to preclude the adoption of this method of taxing corporate source income. The following are the basic features of the full-integration system we recommend:

1. The income of Canadian corporations should be subject to a flat rate of tax of approximately 50 per cent.

2. Individuals and families should be subject to progressive rates of tax with a top marginal rate of 50 per cent.

3. The tax base of the resident shareholder should include the corporate income paid or allocated to him, "grossed-up" for the corporation tax paid 2/.

4. The resident shareholder should receive credit against his personal income tax liabilities for the full amount of the corporation tax paid in respect of the after-tax corporate income paid or allocated to him, with a refund if the credit exceeded the liability.

5. Realized gains or losses on corporate shares should be included in income and taxed at full progressive rates.

6. The corporation should be allowed to allocate after-tax corporate income to shareholders without having to pay cash dividends.

7. The cost basis of shares should be increased when the corporation allocated retained corporate earnings to shareholders, so that share gains resulting from the retention of earnings that had been taxed to the shareholder would not be taxed again to the shareholder when realized.

Under the system we propose, the receipt by a resident shareholder of a $50 cash dividend from a corporation which had been taxed at 50 per cent would be treated as shown in Table 19-1 which follows. As this table illustrates, each shareholder would ultimately pay only his personal tax on an original income of $100 at the corporate level.

TABLE 19-1

ILLUSTRATION OF THE
FULL-INTEGRATION SYSTEM

		Tax Bracket of the Shareholder		
		15 per cent	35 per cent	50 per cent
1.	Income (grossed-up dividend)	$100	$100	$100
2.	Personal tax	$ 15	$ 35	$ 50
3.	Minus: tax already paid by corporation	($50)	($50)	($50)
4.	Tax (refund)	($35)	($15)	(-)
5.	Plus: cash dividend	$ 50	$ 50	$ 50
6.	Total cash received by the shareholder	$ 85	$ 65	$ 50

The system of full integration that we propose has some features similar to those of the system recently abolished by the United Kingdom. There are, however, a number of crucial differences that are described later. In our opinion, these differences correct the principal defects in the previous United Kingdom system without losing its advantages.

We have already described the general equity and neutrality advantages of the full-integration system; we also draw attention to the following specific advantages it possesses:

1. The tax system would neither encourage nor discourage the retention of earnings by corporations, because the shareholder would be entitled to the same tax credit on an allocation by the corporation of its income as on the payment of a dividend.

2. Corporate cash retentions could be increased without worsening the cash position of most shareholders.

3. Corporations raising capital in Canada would be less affected by tax considerations in the choice between debt and equity financing.

4. To the extent that the reduction in the tax on corporate source income was not passed on in the form of lower prices or higher costs, the after-tax income from Canadian equities would be increased to most Canadians with the result that share prices would rise, the cost of equity capital would fall and the rate of capital formation by corporations would increase.

5. The increase in Canadian share prices should encourage non-residents holding shares in Canadian corporations to sell them to Canadians, and Canadian corporations wholly owned by non-residents would be encouraged to raise capital by issuing equities in Canada.

6. The advantages of, and facility for, tax avoidance by means of "surplus-stripping" that are inherent in the present tax structure would be removed.

7. Tax avoidance through the creation of associated companies to take advantage of the dual rate would be eliminated.

8. The tax treatment of corporations, trusts and mutual organizations would be put on substantially the same basis.

9. The allocation of resources would be improved with a resulting increase in the output of the goods and services that Canadians want.

10. All corporate source income (other than the income accruing for non-resident shareholders) would be taxed at the progressive rates applicable to the individual shareholder.

The balance of this chapter is devoted to a description of the present system, an appraisal of its defects, a review of alternative ways of overcoming these defects, a fuller exploration of the proposals we recommend and a consideration of transitional and other problems.

THE PRESENT SYSTEM

General

In very general terms, corporate source income in Canada is taxed in the following ways:

1. The corporation is taxed on its income computed in accordance with the ordinary rules for determining business or property income. It pays dividends out of after-tax income.

2. Corporations receiving dividends from other taxable Canadian corporations or from certain foreign companies may, with specified limitations, exclude such dividends from taxable income.

3. The individual resident shareholder includes dividends in income and is allowed a credit against his total tax liability equal to 20 per cent of the dividends paid to him by taxable resident corporations.

4. The individual shareholder ordinarily does not include in income gains on shares nor does he deduct losses on shares.

5. Dividends paid to non-residents are subject to a withholding tax at rates of either 10 per cent or 15 per cent (in specified circumstances).

Thus, the corporate flow of income is taxed at two levels and at two different times. The corporation tax is levied when the income is earned, and the shareholder is taxed when he receives a distribution from the corporation. The second event, if it occurs at all, may occur many years after the income is earned at the corporate level. Most of the problems in this area have arisen because the shareholder can delay the imposition of the second tax, and perhaps even arrange his affairs so that he need not pay it at all. We will describe some of these procedures and then will indicate how our proposals would eliminate these problems.

At present, the combined federal and provincial taxes on corporate income range from 21 per cent to 23 per cent on the first $35,000 of taxable income, and from 50 per cent to 52 per cent on the excess, the exact rates depending on the province involved 3/.

Current Distributions

Initially, dividends paid by Canadian companies were treated in a manner similar to that which was until recently followed in the United Kingdom, whereby a "normal" tax paid by the corporation entitled the dividend to be free of "normal" tax in the hands of the individual shareholder, although he might be liable to additional tax. In 1926 this concept changed, the corporation being thereafter regarded as a separate entity for tax purposes and the dividends becoming fully taxable to the shareholders. Dividends between resident companies were made exempt from tax.

The complete separation of corporate and personal taxation was modified in 1949 when resident shareholders became entitled to a tax credit of 10 per cent of dividends received from taxable Canadian corporations. The announced purpose of this change was to relieve the double taxation of corporate income, to provide some incentive for Canadians to invest in Canadian companies and to encourage equity rather than debt financing. In 1953 the dividend tax credit was increased to 20 per cent. These changes in the rate of tax credit corresponded closely to changes in the lower rate of corporation tax and provided almost complete relief for the corporation tax paid by corporations with small incomes.

Retained Earnings

With a dividend tax credit of 20 per cent and a top personal tax rate of 80 per cent, the additional tax to be paid on dividend distributions could be as high as 60 per cent. This taxation of dividend distributions has encouraged retentions by corporations 4/. Shareholders have enjoyed a considerable tax deferment advantage on these retentions, and some have also been able to realize the retentions free of tax through sales of shares. The accumulation of undistributed income led to a "bunching" of income when distribution finally occurred, and relief was sought by taxpayers from the attendant high rates of personal income tax. Some relief measures were provided by specific legislation, others by the ingenuity of taxpayers in the form of surplus-stripping.

The first legislative relief from the tax liability on accumulated income of corporations was for the years 1930-34, when free distribution was permitted of the income accumulated prior to 1930. The next step followed the proposals of the Ives Commission in 1945 and permitted the income accumulated in certain private companies up to 1939 to be distributed upon payment of a tax of between 15 per cent and 33 per cent, depending upon the amount of the distribution to each shareholder. In 1950, additional relief was introduced under which accumulated surplus at 1949 held by any company could be cleared of any further tax liability on the payment by the corporation of a 15 per cent tax. An amount of post-1949 surplus equal to dividends paid after 1949 could also be cleared of further tax liability by payment of a special tax at the same rate.

These measures provided substantial relief for the upper income shareholders of closely held corporations, and many such taxpayers took advantage of these relieving provisions shortly after they were introduced. However, these taxpayers and their advisers soon developed surplus-stripping techniques by which the retained earnings of closely held corporations could be distributed with the payment of even less, if any, personal tax.

Surplus-Stripping 5/

The term surplus-stripping is usually applied to situations where there is an actual distribution of accumulated corporate income and tax thereon is avoided by legal but artificial means. In the original version the shareholder realized on the accumulated income by a tax-free sale of shares, while the actual distribution went tax free to another corporation set up for the purpose and could be applied by it toward the purchase price of the shares. To block this device the government introduced the "designated surplus" provision, which provided that where control of one resident corporation was acquired by another, a dividend out of surplus existing when control changed, that is, designated surplus, would not qualify for the usual exemption from tax for intercorporate dividends 6/.

Other surplus-stripping procedures involved diversion of the distribution to parties which could receive distributions without substantial tax liability, such as an organization specifically exempt from tax, a non-resident corporation which could receive a distribution subject only to any applicable withholding tax, or to a dealer in securities which could offset dividend income by a loss on disposition of the shares. The legislative response to these practices came in 1955 and, in effect, gave them sanction by imposing a tax on them of 15 per cent or 20 per cent depending on the circumstances 7/. Further possibilities for stripping surplus free of tax emerged in the special rules for statutory amalgamations, and in 1959 a new section was introduced 8/ providing for a tax of 20 per cent on the portion of the undistributed income of the merging corporations that was no longer represented by assets of the continuing entity. This loophole never was successfully closed; even after subsequent amendments it continued to offer means of avoidance.

Over the years many more complex variations of surplus-stripping have been devised, all directed toward the extraction of undistributed income from a corporation without payment of substantial further tax. Many of these depend on the avenue of the intercorporate tax-free dividend, and nearly all would be discouraged by the taxation of share gains.

During the course of these complex and frustrating developments, the general anti-avoidance provisions of the legislation were not tested before the courts, nor was any attempt made to add to the law some basic guiding principle such as the United States "business purpose test". Rather, various attempts were made to control the techniques by specific legislation aimed at specific types of transactions. Experience has shown, however, that taxpayers and their advisers have been able to thwart such attempts by developing procedures falling outside the circumstances specified in the legislation.

In 1963 the government in effect admitted the lack of success of its specific measures and resorted to a general and arbitrary measure to deal with the problem when it enacted section 138A(1). Briefly, this provision permits the Minister to levy tax on certain amounts received by shareholders as a result of transactions which, in the opinion of the Minister, had as one of their purposes a substantial reduction or disappearance of the assets of the corporation in such a way as to avoid the tax that would otherwise have been payable on a distribution. A limited appeal is provided from the assessment made by the Minister. Although it appears that this was not intended as a permanent solution it has been effective. However, considerable dissatisfaction has been expressed by taxpayers with the uncertainty involved and with the impact on some ordinary business transactions.

Recently the Department has undertaken to attack many surplus-stripping transactions which were effected before the enactment of section 138A(1). At the time of writing it remains to be seen how much success this programme will have.

The realization of undistributed income by the types of technique described above has involved an actual distribution of retained earnings. What is not commonly appreciated, however, is that the advantages of tax deferment on retained earnings are such that a very substantial saving can be obtained without any distribution taking place. Where income is retained indefinitely the postponement of the tax due upon its eventual distribution is as good as a substantial tax reduction. With an interest assumption of 6 per cent, the present value of one dollar 25 years hence is 23 cents, of one dollar 50 years hence, 5 cents. Postponement of taxes for 25 years is thus equivalent to a 77 per cent tax reduction.

Furthermore, a shareholder in a public corporation can realize upon his share of the retained earnings by a tax-free sale of shares, thus effectively "stripping" his interest in the undistributed income without any distribution. In a closely held corporation, where the shareholders are more likely to be faced with an ultimate distribution of surplus, such indefinite postponement is not so readily available. In a real sense, surplus-stripping simply gave shareholders in closely held corporations the same advantage as was enjoyed by shareholders in those widely held corporations that retained a large part of their earnings. Both were able to avoid personal tax by the sale or liquidation of shares at prices unaffected by taxation.

Corporate Acquisitions and Reorganizations

Under the present system, tax considerations can be very material if one corporation wishes to acquire control of another. The applicable considerations and their relative importance will vary from case to case, but one or two general observations may illustrate the problem. From the point of view of the acquiring corporation, the acquisition of the controlling shares of the other corporation may lead to the creation of designated surplus in the latter corporation, while a purchase of assets will avoid this and may permit the taking of higher capital cost allowances on depreciable assets than would have been available to the vendor corporation. Moreover, interest paid on money borrowed to purchase shares is not deductible for tax purposes by an acquiring corporation (because dividends received on the shares would be exempt income), whereas interest paid on money borrowed to purchase assets is deductible. Thus, there will often be a distinct advantage to an acquiring corporation in purchasing assets rather than shares. From the point of view of the selling shareholders a sale of shares may lead to the realization of a tax-free gain; but a sale of assets of the company at a profit may lead to some corporation income tax, for example, on the recapture of depreciation and, if it leads to a winding-up of the company, could result in a further tax on the shareholders because of the distribution of any undistributed income which is deemed to occur on the winding-up. The controlling shareholders of a company may frequently, therefore, prefer to sell shares rather than assets.

The present system has also had an inhibiting effect on certain types of corporate reorganization. If a corporation, at a time when it has undistributed income, takes certain steps such as the redemption of common shares, the reduction of its common share capital, the conversion of common shares into preference shares or obligations, or the capitalization of undistributed income, the shareholders are deemed by section 81 of the Act to have received dividends out of undistributed income, and this has the usual consequences for the shareholders. When substantial undistributed income has been accumulated it may not be considered expedient to take steps of the nature indicated because of the tax impact on the shareholders.

Personal Corporations

In essence, a personal corporation is a corporation used by individual taxpayers to hold their investments. Through this device they bring their assets together in one corporation for better management and convenience, not only during their lifetimes but also to facilitate management of their estates. However, this arrangement also has an ancillary advantage. Because intercorporate dividends are not taxed, an investor could accumulate his dividend income in a corporation without the payment of any personal tax until the corporation in turn distributed the income to him. In an attempt to prevent this deferment of personal tax on dividends, while not precluding the use of such a corporation for good business or personal reasons, the legislation introduced the concept of a "personal corporation" 9/. Companies falling within the definition are not subject to corporation tax on their income, but the shareholders pay tax as though the income was all distributed in the year received in the manner set out in the legislation. A company is a personal corporation if at least 25 per cent of its income is from investments, if control is held by or for a resident individual alone or with resident members of his family as defined and if no active business is carried on. However, the status of a personal corporation can easily be avoided by introducing some element of business activity or by exploiting weaknesses in the definition of control by an individual and members of his family.

Personal corporations have become increasingly popular for estate-planning and income-splitting purposes. Extensive amendments to the Act were introduced in 1961 in an attempt to correct some of the abuses, but were withdrawn following strong protests, the principal objection being that changes should await a general revision of the taxation of corporate distributions.

Investment Companies

The separate taxation of the corporation has also created problems for corporations which pool investment funds of the public at large and act as conduits between the source of the income and the investor.

Under the ordinary rules for taxation of corporate income and corporate distributions, some of the investment income, such as interest and foreign dividends flowing through such corporations, would be subjected to a higher rate of tax than if the individuals invested directly. Because of this, it is provided in section 69 that certain corporations that meet specified requirements as to shareholders, investments, income and dividends, may pay tax at a special rate of 21 per cent (including old age security tax) which, when combined with the 20 per cent dividend tax credit, virtually eliminates the extra tax arising from the existence of the investment corporations. Representations were received by us that these corporations should not have to meet specified requirements as to investment to obtain this treatment, and that the treatment should recognize completely the conduit nature of such corporations.

Mutual Organizations

An anomaly of the present system is that whereas it subjects the income of ordinary corporations to "double taxation", it has only limited impact on the income of mutual organizations. Some of them, such as co-operatives and mutual general insurance companies, are able to take full advantage of the provisions in the legislation which permit the deduction of patronage dividends in arriving at the taxable income of the organization. Others, such as mutual life insurance companies, credit unions and caisses populaires, are not taxed at all. Our recommendations for such organizations are set out in Chapter 20.

SOME DEFECTS OF THE PRESENT SYSTEM

Aside from the question of the double taxation of corporate source income that is dealt with later, the foregoing brief description of the present system clearly demonstrates that it has serious defects. These defects are summarized below:

1. The failure to tax share gains has made it possible for shareholders to avoid or reduce personal income tax while realizing the retained earnings of corporations through:

    a) the sale of the shares of widely held corporations at prices that capitalized the retained earnings, or by

    b) surplus-stripping, or by taking advantage of the relieving provisions introduced to assist shareholders of closely held corporations.

2. The tax system has been strongly biased toward the retention of earnings by corporations with the result that the Canadian capital market is thinner and less developed than would otherwise be the case.

3. A corporation that relies on the issuance of new shares to finance its expansion, and hence has to maintain an adequate cash dividend

to avoid a reduction in the price of its shares, has been at a distinct tax disadvantage.

4. Shareholders controlling closely held corporations have had a tax advantage over other shareholders because they could limit the dividends of the corporations so as to minimize personal taxes.

5. It has been extremely difficult to prevent the abuse of the low rate of tax on the first $35,000 of corporate income by the splitting of a high income corporation into a number of non-associated corporations each of which is taxed at the low rate. Section 138A(2) may be more effective than prior attempts to meet the problem, but it is arbitrary and is uncertain in its impact.

6. In an attempt to restrict the avoidance of personal tax on retained earnings, the legislation has become increasingly complex and arbitrary, with the result that some legitimate business transactions have been deterred.

7. In particular, section 138A creates uncertainty, and the "designated surplus" provisions are often a barrier to mergers and reorganizations that have a useful business purpose.

All of these specific defects are quite apart from the arguments made against the present corporation tax on the ground that it is inequitable because it represents double taxation. To this question we now turn.

THE DOUBLE TAXATION ARGUMENT 10/

Under a neutral tax system all kinds of net gains, both realized and accrued, would be brought into the base and all would be taxed in the same way. There would be no distinction between the net gains from employment, from operating a business, from membership in a co-operative, from holding shares, bonds or other property, or from being a beneficiary under a trust. To the extent that the net gains from different types of activities and from holding different kinds of property are subject to differences in tax treatment, the tax system distorts the allocation of resources.

As we have shown, the present tax system lacks neutrality in a multitude of respects. Nowhere is the lack of neutrality greater, however, than in the tax treatment of income from the corporate form of organization. Only corporate source income is subject to so-called "double" income taxes, under which income is taxed to the corporation and that part of corporate income distributed to shareholders is taxed again to them at personal rates without full credit for the corporation income tax. Examples of the effect of this double taxation are set out in Appendix E to this Volume. Other forms of organization, such as partnerships, proprietorships, co-operatives and trusts, are not faced with this double taxation (or can readily avoid it in the case of co-operatives).

The corporate form of organization offers some unique advantages. In particular, the corporate form has been found to be best suited for marshalling capital. Those economic activities that are dependent upon large pools of assets are unable to avoid double taxation by organizing as a partnership, proprietorship, trust or co-operative, except at the cost of paying a higher price for their capital.

To the extent that corporations pass on the corporation tax through higher prices for the goods and services they provide, or through lower prices for the goods and services they buy, consumers and suppliers buy fewer other things than they would otherwise be able to buy. This distorts the allocation of resources. To the extent that corporations do not pass on the tax through these price changes, their rate of return on investment is reduced and the allocation of resources to their economic activity is reduced (assuming that the shareholders could not avoid the extra tax by carrying out the activity through a non-corporate form). Thus, the tax on corporate income distorts the allocation of resources whether or not the tax is passed on 11/. Because of the corporation income tax, Canadians, as a group, are less well off than they would be in its absence, assuming total government revenue is unchanged, because fewer of the goods and services they want are produced. Removal of the distortions created by the corporation income tax would mean that output would be greater so that some Canadians could be made better off without causing others to be worse off.

This question of double taxation and the "passing on" of the corporation income tax is so important and so controversial that we think it is essential to make our point of view abundantly clear. While we focus attention on the corporation income tax, it must be borne in mind that virtually all taxes can be passed on under some circumstances.

Three terms have to be carefully distinguished:

1. Tax avoidance, that is, changing the form of an activity, of an organization or of an asset to escape the tax that otherwise would apply.

2. Tax shifting, that is, maintaining after-tax income from a fixed (tangible) asset in the face of a change in the tax on that income, either by changing the selling price of the goods and services produced by the asset or by changing the prices paid for goods and services used in conjunction with the asset to produce the goods sold.

3. Tax-induced changes in the supply and allocation of fixed (tangible) assets among alternative uses, that is, maintaining the expected after-tax rate of return on fixed assets used for certain purposes or held by certain organizations by an adjustment of the relative quantity of the assets available.

The extent to which taxes can be avoided depends upon the structure and language of the statutes, the interpretation of the statutes by the courts and the knowledge of the taxpayer and his advisors. The extent to which taxes can be shifted depends, among other things, upon the competitive position of the taxpayer and the state of the economy. The greater the degree of competition, whether from imported goods and services, from existing firms or from the possible entry of new firms, the more difficult it will be to shift tax increases forward through higher prices (or lower costs), or resist shifting tax reductions backward through lower prices (or higher costs).

The extent to which tax-induced changes occur in the amount of capital invested in a particular kind of fixed asset depends upon the nature of the asset and the speed with which the amount invested in the asset can be adjusted to changes in the expected rate of return. The supply of non-reproducible assets (such as a developed mineral deposit) obviously cannot readily be adjusted; on the other hand, the supply of some short-lived assets can quickly be adjusted simply by not replacing them. The adjustment can be rapid and complete or slow and incomplete, depending on the speed with which the total amount invested in an asset can be changed by changing the allocation of new savings among alternative investments.

When taxes are avoided by changing form without changing substance, tax shifting and tax-induced changes in the composition and amount of fixed assets do not occur. Similarly, when tax changes are not avoided, but after-tax income is maintained through shifting the tax, induced changes in the stock of fixed assets do not occur. However, when tax changes are not avoided and not shifted, the change in after-tax income from a particular kind of asset changes the expected after-tax rate of return on such assets. The search for the highest expected after-tax rate of return may induce a contraction or expansion in the amount invested in the particular kind of asset. Tax increases that lower expected after-tax rates of return on particular assets induce reductions in the amount invested in them. With the reduction in the amount of a particular kind of asset over what it would otherwise be, the supply of the goods or services produced by such assets is also reduced. This will usually increase the prices of the goods and services produced by such assets (we ignore here the international aspect of the problem). With higher prices for the goods and services produced by such assets, the after-tax income and expected rate of return on the assets rises, and thus eliminates part of the initial impact of the tax change on rates of return. Conversely, tax reductions that increase expected after-tax rates of return on a particular kind of asset induce increases in the supply of such assets that in turn tend to reduce the amount by which the expected rate of return is increased.

While the present method of taxing corporate source income involves double taxation in the sense that the same dollars of income are taxed twice without full credit to the shareholder for the tax levied at the corporate level, the before-tax income of the corporation may have adjusted to the tax in one of several ways. The corporation income tax may have been shifted forward when it was imposed or increased. In that event shareholders would have been unaffected by the tax change, but consumers would have been subjected to a crude sales tax on goods and services. This sales tax would have reduced consumption or saving or both, and probably would have changed the pattern of consumption and hence the allocation of resources in a deleterious way. Because low income individuals and families consume a larger proportion of their income than others, a corporation tax, to the extent that it is shifted forward, is a regressive tax.

To the extent that the corporation tax or an increase in the corporation tax was not shifted, it must have changed expected after-tax rates of return to shareholders. The market value of the shares in corporations that were unable to shift the tax must have fallen. Those who held such shares at the time the tax was imposed, or increased, and sold them after they fell in price, would have suffered a capital loss at that time, and so in effect would have been subjected to a tax on their wealth. Those who purchased the shares subsequent to the tax change would have bought them at a price that capitalized the tax on the anticipated earnings of the corporation. Those who held shares at the time the tax was imposed, or increased, and held them since that time, would also have suffered a capital loss because the after-tax income from their shares would have been reduced following the imposition or increase of the tax.

When a corporation income tax is imposed or increased, the cost of equity capital to corporations that are unable to shift the tax is raised (because of the decline in share prices) and the rate of investment by such corporations is lowered relative to what it otherwise would have been. With less investment and less output, the prices charged by non-shifting corporations tend to rise more rapidly, thus, over a period of time, bringing about a relatively greater increase in after-tax income and a corresponding recovery in the prices of the shares 12/. Other things being equal, when the adjustment to the corporation tax was complete, the relationship between the rates of return on all corporate shares and other assets, such as bonds, would be approximately what it was prior to the imposition of the corporation income tax 13/. The original equilibrium would thus be restored. If the adjustment was complete but the imposition of the tax changed rates of saving, risk preferences and other fundamental features of the economy, a different equilibrium would be reached, in which asset prices would bear a new, but stable, relationship to one another.

The main point, and it is an extremely important point, is that if the corporation income tax was not shifted, it was inequitable to those who held shares at the time the tax was imposed or increased, whether or not they subsequently held their shares or sold them. Those who bought shares following the imposition or increase of the tax did so at prices that capitalized the tax. The recovery in after-tax income that would generally follow the imposition of the tax would in many cases generate capital gains for those who accepted the uncertainty of the extent and timing of the adjustment and purchased shares at low prices soon after the tax was imposed. However, Canadians generally have lost through the taxation of corporate income at higher average rates than other income, even if the tax was not immediately shifted, for the reduced investment in corporations that could not shift the tax distorted the allocation of resources. The stock of assets of the non-shifting corporations is less than it otherwise would have been. As a result, fewer goods and services of the kinds that Canadians want are being produced than would have been produced had there been no "double" taxation of corporate source income.

It is, of course, utterly impossible to rectify the inequitable consequences flowing from the "double" taxation of corporate income. The tax was first imposed in 1917, and the rates have been substantial for 25 years. No one knows who held particular shares at the time each increase in the tax took place, much less the extent to which particular shareholders in the past suffered capital losses because the tax was not shifted. Certainly it is impossible to compensate all consumers and suppliers for the corporation income taxes that were shifted at the time, and to compensate all Canadians for the reduction in the value of national output that has resulted from the lower rates of investment that subsequently have ensued. What we wish to emphasize is first, that the double taxation of corporate source income does not mean that present shareholders are being unfairly treated, and secondly, that the only relevance of the shifting question is in deciding to what extent the corporation income tax has been a crude sales tax and to what extent a crude tax on wealth.

This leads to the question of what would happen if the present system of taxing corporate source income was changed and the double tax effect removed. The converse of the previous analysis applies. To the extent that the reduction in the tax on corporate source income was shifted, consumers would be better off because the prices of some goods and services would decline, and suppliers (including employees) would be better off because the prices paid for some goods and services would increase. To the extent that the tax reduction was not shifted, some shareholders at the time of the reduction would obtain capital gains. Shareholders in corporations that did not shift the tax reduction but which were not expected to be able to maintain prices for many years because of the entry of new firms, or because of the more rapid expansion of existing firms attracted by the higher after-tax rate of return, would have small capital gains. Shareholders in corporations that did not shift the tax reduction and were not expected to face strong competition from other corporations would have larger capital gains. These capital gains would be "unfair" in the same way that the capital losses created by the imposition or increase of the tax were "unfair". It is in this sense that the adage "an old tax is a good tax" is valid: even though it has had effects on the allocation of resources, the market has capitalized these effects, and removing the tax would give rise to unfair gains for existing shareholders.

Under our proposals the taxation of capital gains would to some extent offset the tax reduction and would mitigate the amount of the net gains after tax which the integration proposal in itself would produce.

Where increases in share prices occurred, however, the cost of capital to the corporation would be reduced and an expansion in the rate of capital formation for those corporations would be encouraged. This in turn would increase the future output of the goods and services produced by the affected corporations, would tend to reduce the prices of these goods and services and, over time, would bring about a relative reduction in expected after-tax corporate income toward its original levels, with a consequent reduction in the prices of the shares of these corporations relative to what they otherwise would have been. (It is not suggested that an absolute reduction in share prices would occur.) This reduction in share prices is the converse of the situation described above of the decline in price of a premium bond as it approaches maturity. The expansion in the output of these corporations would benefit all Canadians.

We recommend the abolition of the double taxation of corporate income, not to help existing shareholders, but primarily to obtain this additional output and to eliminate differences in tax treatment between different kinds of organizations that inevitably provide opportunities for tax avoidance. The capital gains that some shareholders would obtain on the abolition of the double taxation of corporate income would be an undesirable, but inescapable, consequence of the proposal. In equity, these capital gains should be taxed at 100 per cent. In practice, it is not possible to distinguish these capital gains from other capital gains. However, it would be grossly unfair to allow the gains resulting from the integration proposal to escape being taxed at anything less than full rates.

Even with the taxation of capital gains at full rates, implementation of our integration proposal would probably give rise to gains to some shareholders. Since the overall net reduction in taxation of corporate source income would be offset by increases in taxation of income from other sources, these gains would in effect be financed by those whose taxes would be increased under our proposals. We believe that the financing of such gains to shareholders as may occur should be regarded as an investment by other sectors of the economy which would more than pay for itself as a result of the gains in future output that the implementation of our integration proposal should produce.

If the tax system is to be neutral, persons who carry on an activity through one form of organization should be subject to tax on the same basis and at the same rates as persons who carry on the same activity through another form of organization. As we have indicated, the corporation tax is probably shifted to an undetermined extent to consumers and suppliers. By the same token the tax imposed on an individual proprietor or on members of a partnership or syndicate may be shifted. The income taxes imposed on employees may be shifted, to some degree, to employers, and possibly by the employers to consumers and suppliers. There is no certainty that taxes are borne by the persons on whom they are imposed or that they are borne to the same degree by all persons on whom they are imposed. It is obviously impossible to measure the ultimate impact of a tax on all members of the community.

INTEGRATION AND CAPITAL GAINS

Although we do not wish to dwell upon the matter here, the relationship between the taxation of corporate income and the taxation of the gains or losses on corporate shares is very important. The failure to tax share gains in the past has undoubtedly reduced the adverse impact of the double taxation of corporate income. Without a tax on share gains, it frequently has been possible to arrange the form of transactions to avoid the full impact of the double tax. The earnings of the corporation generally could not escape the tax net, but by retaining the earnings in the corporation and selling the shares of the corporation at a price that reflected the additional assets of the corporation, the personal tax on retained corporate income could be avoided. To this extent the pressure to shift the tax was reduced, or the capital losses imposed on shareholders at the time the tax was imposed on the corporation were less. By the same token, removing the double taxation of corporate income would result in less reverse shifting or smaller capital gains to those who held shares at the time, if share gains were subject to full personal income tax. This is one of the reasons why we advocate **both the full taxation of property gains and the full integration of personal and corporation income taxes. We could not countenance the unwarranted benefits that some shareholders would obtain from full integration if share gains were not taxed in full; similarly, we could not accept the adverse effects of taxing share gains in full without removing the double** taxation of corporate source income. The two proposals are part of a package. Neither can be recommended in isolation.

THE EFFECTS OF THE INTEGRATION PROPOSAL

The proposed full integration of personal and corporation income taxes and the proposed full taxation of realized share gains would mean that residents would be taxed at progressive rates on the realized net gains from the ownership of shares in Canadian corporations. The net gains from the ownership of these shares would be taxed neither more nor less than the net gains from employment, from operating a business as a partner or proprietor, from holding real property, from holding bonds or from membership in a mutual organization. The system would be neutral with respect to the retention of corporate earnings, and there would be neither tax advantages nor disadvantages as between equity financing and debt financing. The opportunities for tax postponement and avoidance would be reduced, for the form of a transaction would have much less tax significance. Several parts of the present law could be eliminated, while the uncertainty and complexity of other parts would be reduced. No other method of taxing corporate source income which we have considered has these desirable attributes.

Shifting

On the basis of the evidence we discuss in Chapter 4, we are doubtful that the implementation of the full integration proposal would result in substantial price reductions or cost increases in the short run. The evidence available suggests that Canadian corporation income tax changes have not been quickly and fully shifted even when they occurred at the same time as similar changes in the United States. Because implementation of the integration method would be unique to Canada, and because Canadian changes not matched by United States changes are less likely to be shifted, we do not expect that prices would fall or costs would rise sharply. As our earlier discussion suggests, increases in the prices of many shares would therefore be likely to occur, although the full taxation of share gains would substantially reduce the increase in share prices that would otherwise take place. This potential increase in share prices would also be restrained by the fact that a substantial proportion of Canadian equities is held by non-residents and our proposal for integration would have no direct effect on this group of shareholders.

As we will demonstrate later, the combination of our integration and full capital gains tax proposals would result in little if any tax relief for upper income shareholders, but would provide substantial tax relief for low and middle income shareholders. Upper income shareholders would benefit from the reduction in the top personal rate and from the fact they would pay no further tax on dividends when received. But bringing capital gains in full into tax could more than offset these benefits, for it has been estimated that even after the exclusion of the portion of capital gains attributable to retained earnings, the capital gains that now escape tax are at least as large as the taxable dividends now received by those with large incomes. Therefore, the imposition of full personal taxes on such gains would, for the upper income shareholder, generally offset the effect of eliminating double taxation of corporate income.

Should the adoption of integration be followed by price reductions or wage and other cost increases, the after-tax income (broadly defined) of upper income shareholders would be further reduced as a result of our proposals. However, it is extremely unlikely that reverse shifting would occur to the point where low and middle income shareholders would not have a material net benefit. For low and middle income shareholders to be worse off, the tax reductions would have to be substantially over-shifted, that is, the average rate of return on shares would have to be sharply reduced. If this improbable event occurred it would not be permanent, for there would be a long-run adjustment through a reduction in the rate of investment that would gradually increase the expected after-tax rate of return on the shares of corporations where over-shifting had occurred.

The Demand for Canadian Equities

Low and middle income resident individuals would find the holding of Canadian equities under our proposal much more attractive than they do now. At the present time, $100 of corporate income bears a tax of approximately $50 in the corporation and no further tax if the remaining $50 is retained. The increase in share prices resulting from the retention is realized without tax to the shareholders except to the extent that the price has been discounted for the tax that will be payable on eventual distribution. The return to the shareholders is approximately $50, whatever the income bracket of the shareholders. Under integration, the corporate income retained would be allocated to shareholders and the cost basis of the shares held by them would be increased by the $50, so that the sale of the shares that had risen by $50 because of the retention would not produce a taxable gain. If the shares increased in price by more than $50, the excess would be the "goodwill" appreciation which would be subject to tax on the sale of the shares.

Because the resident shareholder in the top marginal rate bracket would be subject to tax on the allocation of $50, he would not have any additional tax to pay, nor would he receive any refund of tax paid. Thus, his after-tax return would still be $50. The low and middle income resident shareholder, on the other hand, would receive a rebate equal to the difference between the corporate rate of 50 per cent and his personal rate of tax at the time the retained earnings were allocated to him. Thus, a shareholder with a marginal rate of 20 per cent would receive an after-tax return of $80, rather than the current $50, that is, a $30 rebate of tax plus a $50 gain on the sale of the share. This gain would not be taxed because of the tax-basis adjustment already described. This great reduction in the weight of tax on corporate source income paid or allocated to low and middle income shareholders is one of the great advantages of our proposal. The reader is referred to Table 19-2 and Appendices M and N to this Volume for calculations of the differences in tax under alternative systems for shareholders in different income classes.

We propose that all intermediaries, including pension and other retirement income plans and life insurance companies, should be given full credit for the applicable corporation tax in respect of distributions or allocations on the shares of Canadian corporations that they hold. They do not now benefit from the dividend tax credit. This would be particularly important for Registered Retirement Income Plans, because we recommend elsewhere that these plans should not be taxed on their investment income or share gains but that the beneficiaries should be taxed on the full amount of any withdrawals. Such plans would therefore be entitled to a full refund of the corporation tax credited to them. Canadian equities, therefore, would be much more attractive to these plans than they now are. Individuals whose principal form of saving was through Registered Retirement Income Plans would not be denied the advantages of integration.

The benefits of integration would not be available to non-residents, except to the extent that they realized share gains that were a result of the capitalization of the expected benefits of integration. The tax position of non-resident shareholders of Canadian corporations would, in general, be unchanged except to the extent that it would be affected by the recommended changes in the corporation tax base. However, the increase in Canadian share prices that should result from an increased demand for Canadian shares by Canadians could cause the dividend rate of return on Canadian equities to decline for non-residents relative to the dividend rate of return on non-Canadian shares. However, this does not necessarily mean that the total rate of return (gains plus dividends) on Canadian shares would decline, because the stimulus to capital investment might well cause Canadian share prices to increase more rapidly than the prices of non-Canadian shares. Also, the after-tax rate of return to non-residents would not necessarily be reduced. If Canadian corporations reduced their cash payouts in favour of non-cash distributions this would probably result in an increase in share prices as a reflection of the higher retained earnings, and would therefore result in the non-resident receiving a greater proportion of his income in the form of share gains, a change that could reduce his domestic tax liabilities. Although we would not expect non-residents to sell their Canadian shares quickly, because if they were subject to capital gains tax in their country of residence they would wish to postpone their tax on the share gain, nevertheless, over time a repatriation of Canadian shares would be likely to take place. This repatriation would probably not be sufficiently rapid to hold down the prices of Canadian equities.

The Supply of Canadian Equities

An increase in the price of Canadian equities, as a result of integration, would consequently reduce the cost of equity capital to Canadian corporations. Moreover, because the ultimate tax on residents would be the same on interest and dividends, the present tax bias in favour of debt financing would be substantially reduced. On both grounds, the attractiveness of equity financing to corporations would be increased and we would expect some increase in the supply of Canadian equities. The amount of the increase would, of course, also depend on other factors, such as the availability of alternative sources of financing and the attitudes of those who control companies toward the dilution of equity and the possible effect on control.

There is, however, one feature of our proposal that would moderate this heavier reliance on the issuance of shares. Resident shareholders would be given full credit for the tax imposed at the corporate level on all corporate income allocated to them. As is indicated later, cash dividends would be only one of the methods available for the distribution of corporate income to shareholders for tax purposes. Because the allocation would not have to be by way of a cash dividend, the corporation could retain more cash without reducing the cash position of low and middle income shareholders, for these shareholders would obtain a rebate of part of the corporation income tax. In other words, the government would return part of the corporation income tax to those shareholders whose personal rates were less than the corporation income tax rate. Not only would this approach have the great virtue of making the tax system neutral with respect to the corporate decision of whether or not to retain income, but we expect that many public corporations could reduce their cash dividends without bringing about a reduction in the prices of their shares. These corporations would be forced into the equity market less frequently than at present to finance their present rate of capital formation. Generally speaking, we would expect the stimulus to capital formation to be sufficiently great to readily utilize the additional retentions and still make the raising of additional capital attractive.

The lower cost of equity capital in Canada which would be brought about by the implementation of the integration proposal should encourage Canadian corporations which were controlled by non-residents to issue shares in Canada. It is difficult to estimate the impact of this encouragement, for if the non-resident parent company was in no need of additional capital it would be indifferent to the attractive price obtainable on the sale of equities in Canada. Nevertheless, our proposal should have an effect similar to that sought by the Budget of 1963 without being open to the charge that the position of non-resident direct investors had been adversely affected. The rules of the game would be changed, but in a way that would benefit the resident investor without harming the non-resident investor.

The Rate of Investment

To the extent that the reduction in the tax on corporate source income was not shifted backward through lower prices for goods and services or through higher costs for such things as labour, the reduction in the cost of capital would increase the rate of capital formation. This additional investment should in turn increase productivity, and thus bring about an increase in national output. Therefore, whether the reduction in tax was shifted backward or resulted in an increase in capital formation, Canadians as a group would be better off. This would be the principal benefit from integration.

Financing Integration

A reduction in the taxes on corporate income as currently defined would have a stimulating effect on investment and on the economy. However, to arrive at the net effect on the economy it is necessary to consider both the positive effects of the tax reduction and the negative effects of the tax increases that must be made elsewhere if revenues were to be maintained. This question is discussed later in this chapter and is explored more fully in Chapter 37. We can anticipate the results of those discussions by pointing out that we believe that the revenue cost of integration could be more than offset by taxing capital gains, by removing certain industry concessions and, in particular, the concessions to the life insurance and natural resource industries, by removing the dual rate of corporation tax and replacing it with a more efficient incentive for new and small businesses, and by reducing tax avoidance and evasion.

Our proposals for the taxation of corporate source income, taken as a package, do not involve reducing taxes on investors and increasing taxes on non-investors. Rather, they involve a complex re-allocation of taxes among investors. Non-resident investors in small income corporations and in Canadian mining and oil corporations, upper income shareholders in small income corporations and speculators with gains in non-dividend paying shares would all be worse off. Low and middle income resident shareholders, particularly those holding shares in large income, dividend-paying Canadian corporations, would be better off.

The Dual Rate of Tax

We discuss in Chapter 22 and in Appendix I to this Volume the administration problems and the opportunities for tax avoidance that have abounded under the complex provisions related to the reduced rate of corporation income tax on the first $35,000 of corporate income. We believe that equity, neutrality and respect for the tax laws would be improved by ending this feature of the corporation income tax, and we are persuaded that our recommendation for the full integration of corporation and personal income tax would make this possible and desirable. Under our proposal, the ultimate tax on corporate income would be the personal income tax, and a flat-rate tax could therefore be imposed on all corporations with the assurance that resident shareholders would bear no more tax on corporate income than on any other income that they received. As we have explained, a flat-rate tax of 50 per cent, the same rate as the highest marginal rate of income tax under our proposed personal income tax rate schedule, would be necessary to avoid the tax deferment through corporate retentions which would be possible if the corporate rate were materially lower than the personal income tax. Small corporations having low income shareholders could distribute or allocate all of their income or, in order to avoid the need to remit tax at 50 per cent and then to have the shareholders claim a refund, a closely held corporation could take advantage of the option proposed elsewhere in this chapter of being taxed as a partnership. We propose other incentives (in Chapter 22) of a different character to encourage the growth of new and small businesses. Implementation of all these proposals would provide more efficient incentives to new and small businesses, and would remove a concession that has often been abused. In any event, our proposal would ensure that no shareholder in a small income corporation would pay tax at a rate in excess of his own personal income tax rate. Because there could be no "double" taxation of corporate income, there could be no inequity.

Tax Avoidance Generally

Opportunities for tax avoidance usually arise where income derived through one kind of organization or in one form is given a different tax treatment than income derived through another kind of organization or in another form. This encourages taxpayers to change the organization through which income is earned or arrange transactions so as to obtain income in one form rather than another. Under the system we propose, income of a resident individual would be taxed in substantially the same way whether it was earned by him directly or was derived by him through a corporation, a trust, a partnership, a syndicate or otherwise. It would receive substantially the same tax treatment whether it was obtained in the form of employment income, dividends, partnership income or property gains. The possibilities of obtaining any substantial reductions or deferment of tax liability through changing the organization or the form of payment should be largely eliminated. We believe that the basic neutrality and equity of the system we propose would go a long way toward removing the problems of tax avoidance which have existed under the present system.

It would be naive to claim that our proposals would eliminate tax avoidance. Only in a country completely isolated from the rest of the world, with a tax system in which all accrued gains, imputed gains, and benefits in kind were brought into the tax base on the same basis as net gains realized in cash, would all avenues for tax avoidance be closed (assuming also that the deduction of personal expenses could be precluded). We obviously cannot create these conditions. Our proposals would, however, greatly reduce tax avoidance. Bringing the top personal rate into line with the corporate rate would preclude the postponement of tax on retained earnings. This, plus the full taxation of share gains, would prevent surplus-stripping by resident shareholders and would obviate the need for many of the anti-avoidance provisions in the present legislation. The abolition of the dual rate of corporation tax would prevent the major abuses related to associated corporations. Full integration, the taxation of share gains and the proposed tax treatment of transfers of wealth would remove the differences in tax treatment which now exist between a non-personal corporation and a personal corporation, so that the latter status could be abolished.

Not only would implementation of our proposals eliminate the advantages of many present tax avoidance techniques, it would also make it possible to remove most of the barriers now in the Act that are designed to prevent avoidance of the double tax on corporate income. For example, the designated surplus provisions contained in section 28 which now impede legitimate mergers and amalgamations could be removed; and sections 105, 105A, 105B, 105C, and 138A could be withdrawn.

Equity and Neutrality
Between Organizations

Implementation of our proposed system of taxing corporate income would make it possible to remove the disparities in tax treatment between different forms of organization. Corporations would be treated as favourably as co-operatives, trusts, partnerships and proprietorships. After hearing and examining the protracted "corporation—co-operative" debate, we believe this to be a very important advantage of the system we propose.

Committee-of-Four Proposal

Both the Canadian Institute of Chartered Accountants and the Canadian Bar Association suggested in their briefs to us a modified version of the proposal submitted to the government by the Special Committee on Corporation Taxation in 1961, hereinafter called the Committee-of-Four proposal 14/.

We therefore gave this method, and the proposed modifications, a thorough examination and careful consideration 15/. We recognize that adoption of the Committee-of-Four proposal would substantially reduce the surplus-stripping problem without resort to ministerial discretion—the problem with which the Committee was particularly concerned—within the context of the present statute. However, it would not resolve a number of the problems we have described and would not remove the inequities of the present system.

Fundamentally, the Committee of Four proposed that all corporate distributions should be subject to a tax at a flat rate of 15 per cent, with dividends tax free in the hands of shareholders. There would be no dividend tax credit. To reduce the impact on lower income shareholders, the Committee recommended that the 15 per cent tax collected at the corporate level on distribution should be refunded to shareholders with taxable incomes (including dividends) of less than $10,000. This, of course, would set up a sharp distinction between those with taxable incomes just under and those with taxable incomes just over $10,000, and would encourage the manipulation of income between years. However, our major objection to this proposal is that it fails to apply the same schedule of progressive rates of tax to corporate source income as to other income 16/. In terms of our criteria, the proposal would tax shareholders in different income groups unfairly relative to one another. The double taxation of corporate income is an undesirable feature of the present system and one that the Committee could not have been expected to correct within their terms of reference.

The Committee of Four also proposed that as an incentive to certain Canadian corporations to distribute their earnings to Canadian resident shareholders, a special tax abatement should be allowed to such corporations equal to a percentage of dividends paid to Canadian shareholders out of earnings after December 31, 1960. It was suggested that the rate of abatement should be reviewed annually, with an initial suggested rate of 10 per cent.

This would have the effect of reducing the overall taxes on amounts distributed to resident shareholders. However, since the tax abatement would be allowed to the corporation it would benefit non-resident shareholders as well as resident shareholders. The greater the percentage of non-resident shareholders in a corporation, the less would be the percentage benefit obtained by the resident shareholders.

We considered how the Committee-of-Four proposal might fit into a structure that taxed capital gains and had a lower top personal income tax rate. We explored a number of alternative methods of combining this approach to the taxation of corporate income with different approaches to the taxation of capital gains.

It was apparent that if the Committee-of-Four method of taxing corporate income was adopted, the full taxation of share gains would be completely unacceptable. Unless corporations capitalized their retained earnings through the issuance of stock dividends (with an appropriate increase in the cost basis of shares to avoid taxing both the retained earnings and the share gains attributable to those earnings), the weight of tax on corporate source income with the full taxation of capital gains would be increased inordinately. After-tax rates of return on shares would be depressed and the cost of equity capital would be increased, with a consequent depressing effect on capital formation by corporations. Such a system would be both unfair and incompatible with economic growth.

The obvious alternative was to combine the Committee-of-Four proposal with something similar to the United States approach to capital gains: the taxation of the full amount of share gains at one-half personal rates up to a maximum rate of tax of 25 per cent, although with a top personal rate of 50 per cent this upper limit would not have to be explicit. We have not included in this alternative the special tax abatement for distributions to Canadian resident shareholders which was recommended by the Committee of Four, particularly since it was not recommended by either the Canadian

Institute of Chartered Accountants or the Canadian Bar Association. This is termed the "alternative" system in the balance of this section of this chapter. We rejected this alternative on the grounds discussed below.

In our evaluation of the alternative system, we assumed that to minimize the taxes payable by shareholders, most corporations would capitalize their retained earnings by the issuance of stock dividends, and that the cost basis of shares would be increased accordingly. We also assumed, following approximately the recommendations of the Committee of Four, that shareholders with marginal rates below, say, 35 per cent would be refunded the 15 per cent tax on corporate distributions, whether the distribution was in stock or cash.

The impact of this alternative approach relative to the present system and the system we propose for shareholders with different marginal rates can be readily demonstrated. A recent United States study found that over the period 1926 to 1960 an equal investment in every company with shares listed on the New York Stock Exchange would have yielded an average before-tax return of 9 per cent compounded annually 17/. It is reasonable to assume that dividends accounted for about one third of this return, share gains resulting from retained earnings accounted for another one third, that is, that dividends averaged one half of net profits, and the remaining one third arose from what might be called a "goodwill" capital gain 18/. The period covered by the study included the depression of the 1930's and post-World War II experience; if the postwar period alone were considered, the return would be substantially higher and the proportion of the total gain arising from goodwill gains would be substantially greater.

Assuming that the cash pay-out policies of corporations would not change and that the estimates given above would hold, the tax on the $9 annual return to the shareholder from a share costing $100 is shown in Table 19-2 under the three alternative procedures for taxing corporate source income.

TABLE 19-2

PERSONAL AND CORPORATION TAXES PAID ON AN ANNUAL NET GAIN OF $9.00 PER SHARE UNDER THREE TAX SYSTEMS, FOR SHAREHOLDERS WITH DIFFERENT MARGINAL RATES

	Marginal Rate of Shareholder					
	20 Per Cent			50 Per Cent		
	Corporate Level	Personal Level	Total Tax	Corporate Level	Personal Level	Total Tax
Present System	$	$	$	$	$	$
$3.00 dividend ($6.00 corporate income before tax)	3.00	0.00 a/	3.00	3.00	0.90 a/	3.90
$6.00 share gain arising from:						
$3.00 after-tax corporate income retained ($6.00 before tax)	3.00	0.00	3.00	3.00	0.00	3.00
$3.00 "goodwill" capital gain	0.00	0.00	0.00	0.00	0.00	0.00
Total tax	6.00	0.00	6.00	6.00	0.90	6.90
Alternative System Including Tax at One-Half Rate on Capital Gains						
$3.00 dividend ($6.00 corporate income before tax)	3.00	0.00 b/	3.00	3.00	0.45	3.45
$6.00 share gain arising from:						
$3.00 after-tax corporate income retained ($6.00 before tax) c/	3.00	0.00 b/	3.00	3.00	0.45	3.45
$3.00 "goodwill" capital gain	0.00	0.30	0.30	0.00	0.75	0.75
Total tax	6.00	0.30	6.30	6.00	1.65	7.65
Integration and Full Taxation of Share Gains						
$3.00 dividend ($6.00 corporate income before tax)	3.00	-1.80	1.20	3.00	0.00	3.00
$6.00 share gain arising from:						
$3.00 after-tax corporate income retained but allocated ($6.00 before tax)	3.00	-1.80	1.20	3.00	0.00	3.00
$3.00 "goodwill" capital gain	0.00	0.60	0.60	0.00	1.50	1.50
Total tax	6.00	-3.00	3.00	6.00	1.50	7.50

The following assumptions were made in constructing this table:

1. Before-tax corporate income of $12.00 per share.
2. Corporation income tax of 50 per cent.
3. Dividend of $3.00 per share.
4. "Goodwill" capital gain of $3.00 per share.
5. The capital gain is realized.

Notes: a/ After deduction of 20 per cent dividend tax credit.
b/ It is assumed that the 15 per cent tax on distributed earnings is refunded to shareholders with marginal rates below 35 per cent.
c/ To avoid taxing share gains arising from retained earnings that have borne tax at the corporate level, it is assumed that corporations issue stock dividends that have the same tax consequence as cash dividends. This minimizes the tax burden under this alternative.

Under the foregoing assumptions, the alternative system and the proposal we recommend would have virtually the same effects on the tax position of shareholders with marginal rates of 50 per cent. In both cases, taxes would be raised by about the same amount relative to the present system. However, it should be pointed out that if, as we believe, the foregoing estimate of the proportion of goodwill gains to total gains understates the "true" picture, the difference between our proposal and the alternative approach for upper income shareholders would narrow and possibly be reversed. The greater the goodwill gain in proportion to the total gain, the less would be the tax levied under the alternative, while the tax under our proposal would remain unchanged.

Under our proposal, the increase in tax would be the net result of a reduction in the tax on corporate earnings and an increase in the tax on the goodwill gain. Under the alternative system, the tax on corporate earnings would be unchanged relative to the present system, but the goodwill gain would be taxed less heavily than under our proposal.

The major difference between the two methods is the treatment of the low and middle income shareholder. The present system greatly overtaxes the low and middle income shareholder relative to the upper income shareholder if the progressive rate schedule is used as the standard. The alternative approach reduces this vertical inequity. Our proposal removes it entirely. Another difference is that our proposal would make holding Canadian equities more attractive to low and middle income resident individuals and less attractive to upper income resident individuals. The alternative approach would make holding Canadian equities less attractive for all but those upper income individuals who are now paying extremely high marginal rates on their cash dividends. The alternative system might therefore tend to depress share prices and discourage capital expenditures by corporations. Certainly it would perpetuate the adverse effects on resource allocation that characterize the present system.

We are convinced, therefore, that our proposal is more equitable than the alternative approach. The alternative approach would lead to inequities because most dividends would be taxed at flat rates and capital gains at half rates. Low and middle income shareholders would be overtaxed relative to upper income shareholders, and all would pay too little tax on goodwill gains relative to a neutral system. In addition, we have the following objections to the alternative system:

1. With the alternative system, it would be difficult to abolish the dual rate of corporation tax, for, to the extent that small income corporations had low income shareholders, it would be inequitable to levy a tax of 50 per cent on corporate income at the corporate level with no subsequent credit to the shareholder for this tax. On the other hand, to maintain the dual rate would permit some upper income shareholders to derive corporate source income with the payment of tax at less than personal rates and would leave in existence the associated-company problems Canada now has.

2. Taxing capital gains at one half the regular rates would perpetuate the present difficulties involved in trying to separate capital gains from income gains. As we point out in Chapter 15, as long as this distinction remains the law will be both uncertain and complex and will place a premium on the adjustment of form to avoid taxes.

3. The lack of neutrality in the tax treatment of different forms of organization would remain.

4. Unless the "one-half tax rate on capital gains" approach were confined to corporate securities, gains on real property and other capital assets would be taxed at one-half rates only. We see no justification for this concession to other property gains.

5. It would leave opportunities for tax avoidance.

In the light of these findings, we concluded that the Committee-of-Four approach to the taxation of corporate source income, even with the partial taxation of property gains, is irreconcilable with our basic concept of equity, would be administratively complex when combined with the partial taxation of share gains and would lack neutrality.

OTHER ALTERNATIVES

We propose now to examine some other alternatives to our proposal and our reasons for rejecting them. This is done only briefly here; an analysis of these alternatives is given in Appendix F to this Volume.

Allow Dividends as a Deduction

The allowance of dividends paid as a deduction from corporate income seems a reasonable alternative. It would partially meet some of the defects of the present system, mainly by encouraging distributions and thus limiting the attractiveness of surplus-stripping. Its main drawback, however, would arise from the deduction of dividends paid to non-residents. The allowance of such deductions would result in unwarranted revenue costs and would serve to increase the amount collected by foreign treasuries. We reject the possibility of overcoming this by a withholding tax equivalent to a combination of the present corporation income and withholding taxes, for such a substantial withholding tax, regardless of the underlying circumstances, would obviously be unacceptable to some of the countries with which it would be necessary to renegotiate tax treaties. Restricting the deduction to dividends paid to residents would be imperfect in impact because the benefit of the deduction would flow to all shareholders, both resident and non-resident. In addition it would pose administrative problems.

Treat Corporations as Partnerships

An alternative at the other extreme would be to deem that all corporate earnings were distributed to shareholders and therefore were subject to personal income tax as earned. This proposal is in many ways similar to the approach we recommend and would end all problems arising from the retention of earnings such as tax deferment and surplus-stripping, but it would create other problems. A complete and theoretically consistent allocation of the year's income would require that the various persons who had held the shares of the company for varying periods during the year would be allocated their share of the year's income. This would be extremely difficult. In addition, the final order or priority of the rights of individual shareholders would have to be settled every year for the sharing of the year's income among them. This might be contrary to contractual arrangements already in existence. Liquidity problems would be created for shareholders deemed to have received substantial amounts of income in a year in which it was not possible for the corporation to pay out cash. The latter difficulty could be avoided by levying a substantial withholding tax, but again this would probably be unacceptable to other countries. In any event, this alternative would not provide an acceptable basis for the taxation of income flowing to non-residents.

We do recommend later in this chapter that in some cases an election could be made that a corporation be taxed as if it were a partnership. However, we suggest that the right to make this election should be subject to restrictions which should overcome the difficulties referred to above in cases where the election was made.

Exempt Distributions from Further Tax

Another alternative would be to continue the corporation income tax but to exempt distributions from any further tax when received by shareholders, that is, to apply only the corporation income tax to corporate earnings. This solution is wholly inconsistent with our view that equity requires that progressive rates of tax be applied to a comprehensive income base that includes income from corporations, and it cannot be entertained for that reason.

Increase the Dividend Tax Credit

The dividend tax credit could be increased to reflect more closely the rate of corporation tax. With a refund of tax to the lower income groups, a tax credit equal to the corporation income tax would achieve reasonably close integration, but would not produce the same adherence to progressive tax principles as the system we recommend. The main defect of such a system would be that it would fail to achieve the complete identity of the income of the corporation in the hands of the shareholder that would result from including in the shareholder's income the grossed-up amount of the dividend before corporation income tax was paid. By including only the dividend in the income of the individual, an amount of corporation income equal to the tax paid by the corporation would be excluded from personal income, an exclusion that would increase in value as the income of the shareholder increased. Thus, the dividend tax credit approach is essentially more valuable to upper income than to lower income shareholders.

Levy a Special Tax on Retained Earnings

Finally, we considered levying additional taxes on retained earnings in lieu of, or in addition to, corporation income tax. A variety of schemes is possible, including a flat-rate corporation tax and additional rates of tax of, say, 5 per cent to 20 per cent on undistributed earnings of the corporation. A flat-rate tax is inequitable because it is not progressive. It would meet the requirement of reducing the advantage of tax deferment through retention, but it would require the more general use of stock dividends or it would run the grave risk of creating tax pressure for the increased distribution of cash to the detriment of capital investment. We favour a tax system which is neutral between retention and distribution of cash. A tax on undistributed earnings, if it exceeded the tax on distributions, would create a bias in favour of distributions. The proposal we recommend would remove existing impediments to distribution rather than impose a tax penalty on retentions.

TREATMENT IN OTHER COUNTRIES

Appendix G to this Volume contains a summary of the tax treatment of corporate source income in the United Kingdom, France, Germany, and the United States. Although we also examined the treatment in other countries, we have referred specifically to these four because their systems are representative of the general approaches being followed in industrial countries. The United Kingdom and France are of particular interest because they have recently adopted major changes in this area, each country moving in essentially the opposite direction to the other.

In the United States the corporation is taxed as a separate entity, with a dual rate of tax similar to that presently existing in Canada. All corporate profits are taxed whether distributed or retained. Since 1964 no credit for the corporation tax has been extended to the shareholder. Prior to that time the shareholder was entitled to a 4 per cent dividend tax credit, which was reduced to 2 per cent for 1964 and thereafter eliminated.

In Germany, a distinction is made between distributed and retained earnings, with the former subject to a tax of 15 per cent at the corporate level while retained corporate profits are taxed at 51 per cent. Resident shareholders are not eligible for a tax credit for any part of the tax paid by the corporation.

Prior to 1965 France taxed all corporate profits, whether distributed or retained, at 50 per cent, and taxed dividends received by individuals at full personal rates without any credit for any part of this corporation tax. Then in 1965, to encourage economic growth by stimulating private investment and saving, the government introduced legislation, to become fully effective as of January 1, 1967, to extend to resident shareholders a gross-up and credit for one half of the corporation tax paid. The corporation tax is to remain at 50 per cent; but the amount to be included in the income of shareholders for dividends received is to be 150 per cent of the dividend, with the extra 50 per cent to be claimed as a tax credit. This credit is to be refundable to the extent that it exceeds the tax liability of the shareholder. Thus, in effect one half of the corporation tax paid will be deemed to have been paid on behalf of resident shareholders. This contrasts with our proposal to treat the full amount of the corporation tax in this fashion. In addition, corporations are to be encouraged to distribute profits within five years of the year earned by a provision that requires them to pay an additional tax equal to this 50 per cent credit on any distributions from profits earned more than five years prior to the year of distribution.

In contrast to the French approach, the United Kingdom in 1965 moved away from their system of a substantial integration of the corporation and personal income taxes to a system involving a flat rate, non-creditable tax on the corporation. In essence, this ended the procedure of collecting the standard rate of tax of approximately 40 per cent at the corporate level and then requiring the shareholder to gross-up his income to include this tax paid on his behalf. The corporate profits tax, which was in general levied at a rate of 15 per cent, was also eliminated, and instead a flat-rate corporation tax of 40 per cent was imposed, with no credit being allowed to shareholders on dividends received. Thus, while the tax liabilities of the corporation have been reduced from about 55 per cent to 40 per cent, resident shareholders have lost the credit for tax at the standard rate which was formerly paid on their behalf by the corporation. The declared primary purpose of this change was to encourage corporations to reduce distributions and to invest the funds retained in capital expansion. In addition, the Chancellor of the Exchequer criticized the previous system as being unnecessarily complex, awkward to vary for economic purposes and subject to abuses and anomalies.

Thus, both the United Kingdom and France have introduced major changes in the taxation of corporate source income essentially to encourage private investment. In both cases the goal is to provide additional funds for corporate expansion, but the methods employed are diametrically opposite to one another. In France, the incentive is extended to the shareholder; in the United Kingdom, to the company. Before the effects of any shifting or reverse shifting, after-tax rates of return are to be increased in France and lowered in the United Kingdom. However, the cash flow of the corporation will initially be increased in the United Kingdom, while it will remain unchanged in France.

The criticism levelled by the Chancellor of the Exchequer at the former system in the United Kingdom has significance for our recommendations. We have examined in detail the avoidance and administrative problems encountered under the former United Kingdom system, and are satisfied that our proposals encompass solutions for these problems. In particular, our proposal would only permit a tax credit to the shareholder for taxes actually paid or deemed to have been paid by the company. Our recommendations are sufficiently flexible to permit the use of any kind of tax incentive or disincentive. In addition, we feel that our proposed single flat-rate tax at the corporate level, when accompanied by the full taxation of share gains, would be relatively simple to administer when compared to a multi-tax approach with preferential rates for different kinds of income. Our proposal would limit the top personal rate to approximately the corporate rate and so would not be subject to the anomalies and complications which have resulted from the United Kingdom surtax. Finally, we believe that the best encouragement to economic growth in Canada would be to facilitate the most efficient allocation of resources and that this would be accomplished by levying taxes on corporate source income that were as neutral as possible in their effects.

SOME FURTHER ASPECTS OF OUR PROPOSAL

At the beginning of this chapter we described briefly the essential features of our integration proposal and the relationship between that proposal and the taxation of all property gains at full rates. The purpose of this section of the chapter is to explain some of the major technical attributes of the proposal in greater detail. For still further information about its technical features, the reader is referred to Appendix H to this Volume.

Essentially our integration proposal is a method of collecting from the corporation the corporation tax on all corporate income at the top personal rate, and then providing full credit to resident shareholders for the portion of this corporation tax applicable to the corporate income paid or allocated to shareholders. Because most resident shareholders would obtain a refund, because no resident shareholder would pay additional tax at the personal level and because the credit also would apply on a non-cash allocation to shareholders, we believe that virtually all corporate earnings of companies controlled by Canadians would be paid or allocated to shareholders on an approximately current basis.

To keep the gross-up and credit procedure simple and understandable for shareholders, it is suggested that in any special cases where corporate income is taxed at less than 50 per cent, the corporation should be required to pay additional taxes or withholding taxes in order to bring the total tax paid or deemed to be paid by the corporation on all distributions of income to resident shareholders up to 50 per cent, so that the gross-up and credit on all distributions from the corporation would be at the same rate for the shareholder. The shareholder, either corporate or individual, would therefore always receive credit for the full rate of corporation tax, and this would keep the complexities involved in ensuring that the proper tax had been paid within the corporation where they could be handled most readily. In particular, this approach would facilitate the accounting for intercorporate dividends. This approach is not a necessary feature of the full integration system, but it is one that we recommend because we believe it would be feasible and preferable to the alternative techniques.

Another important feature of the integration system is the adjustment of the cost basis of shares. Corporate income which is allocated to shareholders (by one of several methods described later) would be brought into income like a cash dividend, but the shareholder's cost basis of his shares would be increased by the amount of the earnings retained. Therefore, increases in share prices resulting from the retention of earnings would not be subject to tax on realization.

It should be kept in mind that the integration proposal relates to resident shareholders only. Non-resident shareholders would not receive any credit for the corporation tax and would be subject to withholding tax on distributions (but not on allocations) on much the same basis as at present.

Various Forms of Eligible Distribution

We have reviewed a variety of means by which a resident shareholder could become entitled to a gross-up and credit. We contemplate that there could be four principal methods, three of them not requiring the distribution of cash. We emphasize that each method would have the effect of allowing a full credit to the shareholder for the corporation income tax. Some of the methods would require an adjustment of the cost basis on the relevant shares. The methods we recommend are as follows:

1. Cash dividend (including a dividend in kind): full gross-up and credit; no adjustment in the cost basis of shares.

2. Stock dividend: full gross-up and credit; increase in the cost basis of the shares, including the shares issued as the stock dividend, by the amount capitalized in the corporation's accounts.

3. Other procedures involving a capitalization of surplus: same treatment as stock dividend.

4. Allocation of taxed income without capitalization: same treatment as stock dividend except that in the corporate accounts the amount distributed would not be capitalized and there would be no increase in the number of shares outstanding. We discuss later the reasons for this procedure and its technical aspects.

These methods of distributing or allocating corporate income that has borne tax are all discussed in detail in Appendix H to this Volume. By way of further brief explanation here, it may be said that under method 3 above, we would include the payment of dividends in debentures or other obligations of the company. Also, under this method, where shares without par value were outstanding, any effective transfer of income to capital stock account would be regarded as a capitalization. Under this procedure no new shares or obligations would be issued, but the company would notify the shareholders as to the action taken. The possibility we have in mind under method 4 is simply the transfer of income to an appropriately designated account which might be called "allocated surplus". This would result in a deemed dividend for tax purposes. Under this last method, no new shares or obligations would be issued but the shareholders would be notified of the action taken.

It will be apparent that the proposals just made would have implications for corporate accounting, as would the proposals which we will later put forward for the treatment of foreign income, corporation tax incentives and transitional undistributed surplus. Some types of distributions would result in the resident recipient being entitled to the gross-up and credit for tax purposes; others would not. Implementation of our overall proposals would imply allocation of corporate surplus among accounts according to the tax consequences for the shareholder of a distribution from those accounts. We have set forth explanations of these matters in Appendix H to this Volume.

One aspect of corporate distributions that merits special comment is the order of pay-out of the various categories of corporate surplus and capital. Under the present law most distributions, except those made on the retirement of redeemable preferred shares, are deemed to be made out of undistributed income as long as there is any undistributed income on hand. Such a requirement is a necessary protective feature of a tax system which attempts to levy both a corporation tax and a personal income tax on corporate earnings. Under the system we propose, however, the corporation tax would be analogous to a prepayment of personal income tax and, because a distribution would usually result in a tax credit to the resident shareholder, it would be in his interest to have a distribution deemed to be taxable. Nevertheless, it would be useful to have a stipulated order of priority in which corporate distributions are to be made, as is discussed in Appendix H to this Volume. It should be provided, for example, that distributions and allocations would be made out of taxed income to the extent of such income and that further distributions would be by way of return of capital.

We also believe it would be desirable that so far as shareholders were concerned there should only be two types of distributions, those made out of taxed income which would be grossed-up at the corporate rate and on which credit would be allowed at the corporate rate, and those made as a return of capital which would not be included in the shareholder's income but rather would reduce the cost basis of his shares.

Distributions out of taxed income would include all dividends, capitalizations and allocations made out of income which had been subject, or was deemed to have been subject, to corporation income tax but had not previously been distributed. Distributions not made out of taxed income, but which represented a return of capital, would include distributions made out of income previously allocated, distributions made out of surplus existing at the transitional date on which the legislation came into effect and distributions made out of other financial surplus which was not subject to corporation income tax.

Because some types of corporate income, such as income from foreign sources and possibly income which was treated in a special way under incentive legislation, may be taxed at less than the normal corporate rate, the corporation should be required to pay sufficient additional tax on making a distribution out of such income so that all of the income being distributed would have borne tax at the full corporate rate. The shareholders would then gross-up the distribution and would obtain credit on that basis. It would also be possible to provide that corporation income tax would be deemed to have been paid on particular kinds of income so that the shareholder would be entitled to gross-up a distribution and obtain credit for the corporation tax as if it had been paid. This may apply in cases where a credit was given for foreign tax paid or where an incentive was granted to corporations in the form of an exemption from tax which the government wished them to be able to pass on to their shareholders. Procedures for accomplishing these objectives are discussed in Appendix H to this Volume.

It would be necessary to make provisions with respect to various types of distributions other than those referred to above. This would be a matter for the legislators, but we suggest that some types of distributions should be dealt with along the following lines:

1. A distribution on liquidation should be treated as a distribution out of taxed income of the corporation to the extent of such income, and the balance should be treated as a return or realization of capital.

2. A distribution on the redemption or purchase for cancellation of shares or on a reduction of share capital should be treated as a return or realization of capital to the extent of the amount paid up on the shares; any excess over that amount should be regarded as a distribution of taxed income to the extent of the shareholder's portion of the corporation's taxed income; and the balance, if any, should be treated as the proceeds of a realization of the shares.

3. A conversion of shares into another class of shares should not be treated as a distribution unless it resulted in a capitalization of surplus, in which case its treatment would be as outlined above. A conversion of shares into obligations of the corporation should be treated in the same way as a redemption.

4. No special provisions would appear to be required for loans to shareholders, since there would be no tax advantage in making such loans.

The above rules would apply to distributions to resident shareholders. In the case of non-residen shareholders different considerations would apply and the rules with respect to distributions to them should remain very much as they are at present.

These suggestions are obviously not complete, but they indicate the general approach which we believe should be taken.

Allocation of Income

Our proposed procedure for the allocation of taxed income without capitalization is new, and care would have to be taken in its implementation. An allocation would be effected by action of the board of directors of a company and would have significance only for tax purposes. The purpose of this procedure would be to permit the shareholders to obtain the benefit of a distribution for tax purposes without a distribution actually being made. We consider this procedure to be necessary in order to achieve the objectives of integration and avoid the double taxation which would result if taxable gains arising on the sale of shares reflected a substantial amount of income which had been subject to corporation tax that had not been credited to the shareholders. In the case of many corporations it may not be feasible to capitalize all of their retained earnings. Such a capitalization would presumably involve the payment of withholding tax by non-resident shareholders who obtained no benefit from integration. It might also result in tax complications for non-resident shareholders under the tax laws of their own countries. Even companies without non-resident shareholders might be reluctant to capitalize all of their after-tax undistributed earnings annually since this would restrict their freedom to declare dividends in the future. Accordingly, in order that our proposals be fair and workable and neutral with respect to the distribution or retention of corporate earnings, we believe it is important to permit the allocation of taxed income without distribution.

It would, of course, be necessary to provide that when income had been allocated, a subsequent distribution of the same income would not again be included in the income of the shareholders. Such a subsequent distribution should be treated as a return of capital. When an allocation was made, the net amount allocated to a shareholder should be added to the cost basis for his shares. When a distribution was made out of income previously allocated, it should be applied to reduce the cost basis of the shares.

Where shares were held in the names of brokers or banks or other nominees, administrative problems may arise with respect to allocations, as they would with respect to other distributions. These problems would be simplified to some extent by the requirement which we recommend for each taxpayer to report in his return the securities which he owned and the transactions which he had during the year. Since it would be in the interest of resident shareholders to obtain the benefit of any allocations on shares which they owned, the responsibility should be placed on the shareholder to establish that he was entitled to the benefit of such an allocation in respect of any shares which were not registered in his name. This should encourage more resident investors to have their shares registered in their own names.

One question that arises in connection with this procedure concerns the fact that the persons to whom an allocation was made may not be the persons who would eventually receive the distribution. Shares change hands from time to time, and additional shares of a particular class may be issued. However, this situation should not produce any inequity. The full amount of realized capital gains and losses would be included in the computation of income. An allocation would result in an increase in the cost basis of shares and would be taken into account in computing the gain or loss on the disposition of shares, while a distribution of income previously allocated would result in a corresponding decrease in the cost basis and would likewise be taken into account in computing the final gain or loss on disposition. Therefore, we do not believe that any distortion would result from the fact that an allocation may be made to one person while the corresponding distribution was subsequently made to another holder of shares of the same class.

However, if it was possible for an allocation to be made to the holders of shares of one class and the corresponding distribution to be made to the holders of shares of another class, then there might be opportunities for the deferment or avoidance of tax. Accordingly, the rules relating to allocations should prevent this possibility in most circumstances. For example, they should provide that an allocation could only be made to the persons who would have received a dividend if one had been declared at the time the allocation was made. They should also provide that an allocation could not be made to the holders of shares of a class which carried a non-cumulative dividend only, unless that dividend was actually paid before the right to it expired. Later in this chapter and in Appendix H to this Volume we discuss some further provisions which may be necessary to prevent tax avoidance or deferment through the use of the allocation procedure.

Corporate Incentives

The implications for shareholders of any tax concessions received by corporations would depend on the total impact the government wished to achieve through its measures. We particularly have in mind temporary measures that the government might wish to enact from time to time as part of stabilization policy, such as accelerated or deferred depreciation, or a subsidy or tax reduction equal to a proportion of investment expenditures.

Under our proposal, a number of possibilities would remain open to the government that could be used for any particular programme. The amount of the benefit, once identified in the accounts of the corporation that are suggested in Appendix H to this Volume, could be passed on to the shareholders as a dividend having no implications for the cost basis of shares, as a distribution of capital requiring a reduction in the cost basis of shares, and so on. The government would select that alternative which best met the particular objective it may be attempting to achieve in any given situation. However, it should be emphasized that, although we agree that there are circumstances when tax incentives are appropriate, we are strongly opposed to any incentive that involves a general exemption of income at the corporate level or that would have the effect of creating new, permanently exempt forms of income for the shareholder.

Foreign Income

In Chapter 26 we deal at some length with the various considerations bearing on the Canadian tax treatment of income received by a Canadian corporation from outside Canada and in turn distributed to its Canadian shareholders. Therefore, we discuss the matter only briefly in this chapter where our particular concern is with the implications for the integration proposal of the foreign origin of some part of Canadian corporate income.

Our main conclusion in Chapter 26 is that, in order to maintain a reasonable balance between the tax results of domestic and foreign investment by Canadians, we must recommend some integration of foreign taxes paid on income which was subsequently distributed to resident shareholders by a Canadian corporation. However, this integration must be limited to ensure that at least some Canadian taxes were collected on foreign source income. In arriving at our recommendations we have noted that the present dividend tax credit, which is a form of partial integration, is granted without distinction as to the origin of the income being distributed and therefore is applicable to foreign source income.

Our foreign tax credit proposals for business income received from a foreign direct investment operation have three major features. Details and definitions are contained in Chapter 26.

1. Foreign source direct investment income should be subject to income tax of at least 30 per cent on an accrual basis, that is, in the year it is earned. If foreign taxes paid do not reach this level, then a special tax equal to the difference should be paid in Canada by the Canadian direct investor, either corporate or individual.

2. The net business income earned or dividends received (after any withholding tax) from foreign direct investment should be grossed-up at a 30 per cent rate, with the aggregate amount included in the income of the Canadian direct investor, either corporate or individual, and the 30 per cent recorded as the amount available as a tax credit.

5. Where foreign direct investment income is earned or received by a corporation, an additional tax equal to 20 per cent of the grossed-up foreign source income should be withheld from amounts distributed or allocated to shareholders out of foreign source direct investment income. This additional tax would facilitate the record keeping for corporate distributions by bringing the total tax credit available to resident shareholders up to 50 per cent. This tax should not be payable on distributions to non-residents.

If such income were to be subject to a gross-up and credit at a 30 per cent rate, few Canadian shareholders in receipt of income from a Canadian corporation with income from direct investment abroad would be worse off than at present, and low and middle income shareholders would be absolutely better off. Therefore, we recommend this rate of gross-up and credit for foreign direct investment. It should be noted that, in order to avoid application of different rates of gross-up and credit to different portions of a dividend, we propose that, at the time of making a distribution or an allocation to resident shareholders from foreign source direct investment income, a Canadian corporation should pay a withholding tax sufficient to bring the total tax attributable to the foreign source portion of the dividend up to the 50 per cent that would have been levied on the portion earned in Canada. This mechanical device would enable the shareholder to gross-up all dividends received at the 50 per cent rate and also to claim a tax credit at that rate. As we have already indicated, it would be necessary to establish rules as to the order in which income from different sources was distributed, so as to determine the time at which this additional tax would be payable. In Appendix H to this Volume it is suggested that distributions should be regarded as having been made on a pro rata basis from the grossed-up income which had been subject to full corporation tax and from the grossed-up foreign source income.

Carry-Over of Losses

Because losses cannot be allocated to shareholders in the same manner as income, their identification with the shareholders is less direct. In the case of losses which were deemed to be of a personal nature, their deductibility would be limited so that the shareholder would be required to bring a deemed benefit into income in the same way as any other expenditure at the corporate level that was deemed to result in a personal benefit to a shareholder. In the case of ordinary business losses, the loss could be carried back by the corporation up to the amount of the income of the previous two years that had not been paid or allocated to the shareholders. Any unabsorbed balance of the loss could be carried forward indefinitely against future income, subject to the limitation referred to in Chapters 9 and 22 that is designed to prevent the deduction of losses deemed to be personal in nature. To the extent that the losses reduced share values, the shares could be revalued downward. The resultant loss could be claimed as a deduction from other income by the individual shareholder, who would also have the usual averaging privileges we recommend in Chapter 13.

Intercorporate Dividends

When the shareholder was a resident corporation, the procedure would be the same as for an individual, that is, a grossed-up dividend from another taxable resident corporation would be brought into taxable income and the related tax credit would be deducted from the resulting tax. If, however, the receiving corporation incurred a loss on its other operations, the loss could be applied against the dividend and a refund could be claimed. These procedures would result in the top personal rate of tax being imposed only once, regardless of the number of corporations involved, with an eventual credit for the applicable corporation tax to the individual shareholder upon distribution or allocation to him of the taxed income.

Special Corporations

There would appear to be no further need for the present provisions concerning personal corporations. The shareholders of such corporations could avoid any overpayment of tax on the corporate income by having the corporation make a high level of distribution or allocation to its shareholders. On the other hand, underpayment of tax would be prevented by virtue of the high level of corporation tax already imposed on the income flow. The present provisions regarding investment corporations would also seem to be unnecessary. Life insurance corporations would follow the same procedure as ordinary corporations in respect of corporate distributions received. Because of the unique nature of their business the tax treatment of insurance companies is dealt with more fully in Chapter 24.

Other Canadian Recipients

The tax treatment of dividends paid to pension funds and other forms of retirement income plans is discussed in Chapter 16. The income of Registered Retirement Income Plans would be exempt from tax, and they would be entitled to a full rebate of tax already paid in respect of dividends received from taxable resident corporations. The income of non-registered plans would be allocated to beneficiaries, to whom these plans would be entitled to pass on the tax credit.

The treatment of dividends paid to charities, private clubs, and other types of special corporations is dealt with in Chapter 20.

Preferred Shareholders

We recommend that dividends on preferred shares should be eligible for the normal gross-up and credit. The reasons for this treatment are the same as those that resulted in the eligibility for the present dividend tax credit being extended to preferred dividends. It is impossible to distinguish classes of shares in such a way as to allow a deduction for dividends paid on "pure" preference shares. Accordingly, such dividends are paid from after-tax income and the credit should be provided. We recognize that because the dividend on preferred shares is fixed, the extention of the gross-up and credit for corporation tax paid to such shares would greatly increase the after-tax yield on presently outstanding preferred shares and that as a result they would increase in value. However, we are satisfied that this increase in value would not be excessive, because our studies show that almost 90 per cent of the outstanding Canadian preferred share issues carry a fixed redemption price and, in the event of a material rise in values, such issues would probably be redeemed.

In our view, interest on income bonds, which is not deductible by the paying corporation under the present law, should be eligible for the same treatment as dividends on preferred shares.

Non-Resident Shareholders

If the general practice among countries was to "look through" the corporation for tax purposes, so that the residents of foreign countries would be treated in a manner similar to what we propose for residents of Canada, a reconciliation of the Canadian and other national schemes of taxation might be possible. In fact, however, the usual approach in other countries is to tax corporations as separate entities and, accordingly, it would be impossible to extend to non-residents on a reciprocal basis a treatment comparable to that which we propose for residents. However, we are satisfied that, generally speaking, non-residents should not have grounds for complaint regarding our proposals, because the proposals generally would not increase the weight of tax on non-residents compared with the present system.

One exception to this statement should be mentioned. Many non-resident shareholders could be adversely affected if the corporations in which they held shares increased their level of distribution by issuing stock dividends. This might be the case in the United States, where such stock dividends are generally excluded from income (until they are disposed of or redeemed and a capital gain or income results).

While their position is not entirely clear, a non-resident portfolio investor might lose the tax credit for the Canadian withholding tax on a stock dividend or capitalization. A non-resident corporation which is a direct investor is often permitted to claim a foreign tax credit in respect of dividend income for the underlying corporation taxes paid by a Canadian subsidiary as well as the withholding tax. If the payment of a stock dividend caused either of these tax credits to be lost, then the direct investor would also be adversely affected. We would recommend, therefore, that the Canadian authorities undertake to negotiate future treaty arrangements to provide specifically, at least for direct investors, that either stock dividends be treated, at the election of the non-resident, as ordinary dividends, so that they would carry the full tax credit, or that the non-resident have the right to obtain credit for the withholding tax (and where applicable for the underlying corporation income taxes) against his tax payable on a subsequent sale or redemption of the shares.

In any event, we have provided for this situation until such time as a suitable solution can be found. Under our proposal a Canadian corporation having substantial foreign ownership could avoid declaring stock dividends and could achieve the same result for its Canadian shareholders, without any unfavourable consequences for non-residents, by employing the procedure for an allocation of surplus. No withholding tax would be payable on such an allocation.

Dividend Taxation Related
to Share Gain Taxation

The relationship of corporate earnings and retentions to share gains and losses is discussed elsewhere in this <u>Report</u> but may be touched upon again here. It is our belief that the very substantial incentive which the implementation of our proposal would create for the distribution or allocation of corporate income, either in cash or non-cash form, would virtually eliminate the influence of retained earnings on taxable share gains and losses.

Under our proposal, corporations controlled by Canadian shareholders would have every reason to allocate corporate earnings to shareholders approximately as earned, for most resident shareholders would benefit by receiving a tax credit or rebate and none would be hurt by such allocations. Virtually all earnings retained in the corporation would, therefore, have been distributed or allocated to shareholders by means of stock dividends, or by one of the other procedures we have described. Because non-cash distributions or allocations to shareholders would be added to the cost basis of the shares, increases in share prices that resulted from retained corporate income would not be taxed on the disposition of shares. This can be readily illustrated by a simple example. Suppose that an individual with a marginal rate of 30 per cent buys a share for $100. Suppose that corporate earnings before tax are $20 a share and that the corporation retains the $10 of after-tax income, but allocates this amount to the shareholder. The shareholder would bring the grossed-up value of the $10 retention, that is $20, into his income, would calculate his tax as $6 and would obtain a refund of $4. In addition, he would increase the cost basis of his share from $100 to $110. If the share price rose by the amount of the cash retention and the share was subsequently sold for $110, there would be no taxable gain because there would be no difference between the adjusted cost basis of $110 and the selling price of $110. Therefore, while the retention of earnings would continue to generate increases in share prices as they do at present, the adjustment of the cost basis would mean that this part of the gain would not be brought into income.

A shareholder wishing to sell his shares prior to a distribution date would endeavour to recover in his selling price the expected distribution in order to net the same amount as if he had held the shares. The income distribution would then be "capitalized" in the price of the shares, and the purchaser who received the distribution should incur an offsetting reduction in the value of the shares upon subsequent resale. There are, of course, other factors affecting share values, and it would be hard to isolate the above effect in the ordinary market transaction. However, with a higher level of distribution and higher tax credits, this factor would be more important than it is at present.

If share values did drop simultaneously with a distribution, the purchaser of the shares would have a "wash" transaction (no gain or loss), for the distribution included in income would be offset by an equivalent loss on the shares, and the personal tax on the income would be collected through taxing the vendor's gain on the sale of the shares. This is appropriate, because the income would have accrued while the vendor held the shares, and would be reflected in the gain he realized on disposition of his shares. We discuss these and other economic implications of integration at greater length in Chapter 37.

Corporate Acquisitions and Reorganizations

The system we propose would achieve a reasonable balance of the tax consequences of a sale of shares for both vendor and purchaser. We are also satisfied that the system we propose would achieve substantial neutrality as between a purchase of shares and a purchase of assets as a result of the combined effect of the taxation of gains on the disposition of property, the taxation of gains on the disposition of equities, and the great reduction in the importance of undistributed income. In addition, the purchaser of all the shares in a corporation should be allowed to revalue the underlying assets, other than goodwill, to their market value, in order to establish a current basis for capital cost allowance. Another contributing factor would be the proposed deduction of interest on money borrowed to acquire shares, the present disallowance of which gives an additional bias toward the purchase of assets. Under our proposal interest costs would be allowed in either case. The fact that companies would be less likely to accumulate large amounts of undistributed income, and that undistributed income could be eliminated for tax purposes through allocations of income in non-cash form, should facilitate corporate recapitalizations and reorganizations.

Closely Held Corporations

Mention should also be made of the effect of integration on the shareholders of closely held corporations. Under the present tax system such companies have encountered severe problems because of the inherent tax liability on accumulated surplus and because of the difficulty encountered in distributing a substantial amount of cash to an estate, often for the purpose of paying estate tax, without giving rise to substantial income tax. Under our proposals, methods would be readily available to all such companies to make adequate provision for most of their tax problems. The realization of share gains on death would create a tax liability for the difference between the cost basis of the shares and their market value, including the goodwill element. However, if closely held companies and their shareholders took advantage of our various proposals by making regular allocations of earnings and thereby obtained credit for corporation tax and an upward revision in the cost basis of the shares, the impact of the disposition on death should be reduced. In any event, there would no longer be a potential tax liability on the distribution of accumulated surplus and it would be possible for a company to make a large cash distribution to an estate without giving rise to any tax liability. In addition, the full deductibility of interest costs would permit the company to borrow in order to make the necessary cash distribution on redemption of senior securities.

Shareholder Information

The shareholder should be provided each year with a T5 statement listing the following details to the extent applicable:

1. The amount to be included in income.

2. The tax credit in respect of the amount to be included in income.

3. The amount of cash distributions.

4. The amount of non-cash distributions (to be added to the cost basis).

5. The amount that was a return of capital, including proceeds of redemptions of shares, dividends paid out of previously allocated surplus and dividends paid out of surplus on hand at the transition date (to be deducted from the cost basis).

Determination of the Rate of
Corporation Income Tax Credit

Under a system of grossing-up the dividend and of allowing a credit for the corporation income tax, the selection of the corporation income tax rate eligible for the credit is obviously of importance. Should it be the rate of tax for the current year or the rate of tax over a period of years? We recommend that it should be the rate of tax applicable to corporate income in the year of the distribution or allocation. The normal situation would be that dividends would be declared principally from current income, and our proposal would therefore conform with the general case. It would also greatly facilitate both public understanding and ease of calculation if the grossing-up and crediting were to take place at the current rate. Under our proposal for a 50 per cent corporation income tax rate, the dividend paid in the year would be grossed-up by doubling the net dividend, the resulting amount would be included in taxable income, and a credit of 50 per cent of the amount of the grossed-up dividend would be deducted from the personal income tax of the shareholder.

When the rate of corporation income tax is changed, which for reasons outlined later should not be often, we recommend that the gross-up and credit on future distributions should take place at the new rate until a further change is made. Details of the adjustments to be made by corporations in their accounts in this connection are set out in Appendix H to this Volume.

Option to be Taxed as a Partnership

With the introduction of integration and a single rate of tax for corporations, corporations with shareholders in the lower tax brackets would pay tax at the rate of 50 per cent, while the shareholders would be entitled to obtain refunds at a later date. In the case of a large, well-financed corporation this should not impose any hardship, but in the case of many small, closely held corporations it might cause financing problems. It seems to us that there should be a simpler method of allocating income to the shareholders in such cases, so that they would not be required to go through the procedure of paying tax at the 50 per cent rate and then claiming refunds. It is also our view that where feasible, corporate losses should be allocated to these shareholders, rather than to require that they be applied only against other corporate income.

Accordingly, we propose that certain corporations should be permitted to elect to be taxed as partnerships. If such an election was made, the corporation would pay no tax, but the shareholder would include his *pro rata* proportion of the profits of the corporation in his income and pay tax thereon in the normal manner (but, of course, without the use of the gross-up and credit formula). He would also increase the cost basis of his shares by the amount included in his income. When dividends or other distributions were paid out of the income attributed to the shareholders, such distributions would be free of income tax but the amount received by each shareholder would be applied to reduce the cost basis of his shares. If the corporation sustained a loss, the shareholder would be entitled to deduct his pro rata proportion of the loss from his other income, and this amount would be applied to reduce the cost basis of his shares. In this case, the corporation would not be permitted to carry the loss back or forward.

It would be necessary to establish certain restrictions and requirements in order that the provisions could be readily administered and would be as free as possible from anomalies. The following are examples of requirements which might be imposed, although additional conditions would undoubtedly be required:

1. The election for any taxation year would have to be made by the corporation at any time within that taxation year or within 90 days thereafter. An election once made would be effective until revoked or until the corporation ceased to fulfil all the necessary conditions.

2. The election would be made by filing a form to be prescribed by the tax authorities and based on the prior approval of the holders of at least 90 per cent of the outstanding shares of the corporation. The election could be revoked by action of the board of directors or by the action of the holders of a majority of the shares of any class.

3. The income of the corporation for the taxation year in question, as determined in the usual way, could not exceed, say, $200,000.

4. The election would not be permitted if the corporation had more than fifteen shareholders at any time during the taxation year, or if any of the shares of any class were owned by non-residents at any time during the year.

5. An election could not be made unless all income of the corporation for prior years in which the option was not elected had been distributed or allocated. This would mean that all dividends paid in the

year by the corporation would be paid out of income which was or had been included in the incomes of the shareholders and accordingly would be treated as a return of capital.

6. If the corporation had more than one class of shares outstanding and the holders of any class were entitled to a non-cumulative dividend, none of the income would be allocated to the shares of that class unless the dividend was paid.

Particular consideration would have to be given to problems arising from the transfer of shares during the course of the year. It might be possible to apportion the income attributable to shares transferred during the year on a per diem basis. Alternatively, it might be necessary to withhold the right to be taxed as a partnership where a transfer of shares was made at any time other than at the year end.

SOME PROBLEMS IN THE PROPOSAL

We have arrived at the proposal advanced in this chapter after an exhaustive consideration of the defects of the present Canadian system and of various alternative systems. It meets more closely than any other alternative the objective of a comprehensive base taxed at graduated rates, and provides a means of curing the most troublesome of the problems that have plagued the taxation of corporations for half a century. We believe that it is the best solution that could be put forward.

Despite our confidence in our proposal, we are fully conscious of the fact that we are dealing with one of the most complex and controversial areas of taxation, and we are under no illusions that we have produced the perfect answer. It is incumbent on us, therefore, to point out and evaluate some of the objections that might be advanced against our recommendation.

Rigidity

It might be said that our proposal would introduce an element of rigidity into the tax system by requiring that the corporation income tax rate and the highest marginal rate of personal income tax should be either identical or should be separated only by a small margin. To accomplish the results we hope for, there must not be a substantial gap between the two rates. In support of this feature of our proposal we would suggest that, the absence of a tax on share gains, the lack of integration of the corporation and personal income taxes and the divergence between the two rates have been the main sources of tax avoidance efforts in the past. Introduction of a tax on share gains would remove much of the problem, but a complete solution to the problem of tax deferment as it concerns resident shareholders would involve either adopting our proposal or giving up the personal tax on corporate distributions, an alternative we find unacceptable. More important, under a system of full credit for corporation income tax, the rate of corporation income tax would determine the amount of credit or rebate which Canadian shareholders would obtain from the government. Thus, the rate would become considerably less significant than at the present time, and the element of rigidity would be of relatively little consequence.

Federal-Provincial Relations

Our recommendations have important implications for federal-provincial relations. It is obvious that any solution must take this matter into account, and in Chapter 38 we put forward proposals for overcoming the main difficulties.

Tax Avoidance

In view of the importance of the tax credit or tax rebate under our proposal, one method of fraudulently exploiting the system would be to use fictitious dividend notice slips. The prevention of this would require strict control over the issuance of T5 slips by corporations, with severe penalties for non-compliance with the official regulations introduced for this purpose. An additional check would also be provided from the record of assets to be filed by individuals that we recommend in Chapter 15.

If shares were transferred at artificial prices between residents who were in different tax brackets, the allocation provisions might permit deferment of tax liabilities unless there were special provisions to prevent this. If such a transaction was between a resident and a non-resident, then the appropriate tax liability might be avoided in the absence of a preventive provision. Accordingly, there should be a provision to the effect that if shares were acquired otherwise than in a bona fide transaction between parties dealing with each other at arm's length, the transfer would be deemed to have taken place at the fair market value and the transferor would have made a gift to the transferee equal to the difference between the actual price and the fair market value. If the shares were transferred by a resident shareholder to either a resident or non-resident purchaser in an arm's length transaction at less than the fair market value under an agreement or option or pursuant to some other right, additional provisions would probably be necessary to prevent tax avoidance or deferment. These suggested provisions are discussed in Appendix H to this Volume.

Transactions between Residents and Non-Residents

Another possibility for abuse of the system of integration would arise as a result of transactions between residents and non-residents. Dividends received by a non-resident from a Canadian corporation would be subject to a Canadian withholding tax and in some cases an additional tax payable by the non-resident to his own country. However, any resident individual to whom the non-resident sold the shares could receive the distribution, could probably avoid having any income by reselling the shares (because the income distributed would be offset by the loss on the resale of the shares) and could therefore obtain a refund of all or part of the corporation tax already paid. Even if the non-resident were taxed in his own country on the gain realized upon selling his shares to the resident, there could still be a sufficient tax reduction to make the arrangement worth while. The protection provided within Canada against such procedures would lie in the full taxation of share gains, but this would not reach non-residents. The net result of this avoidance procedure would be that Canadian tax on the corporate income accruing to the non-residents who participated would be reduced.

The source of this potential problem is the accumulation of unallocated tax credits that, although they were attributable to the shares held by the non-resident, would be of no benefit to him otherwise than through a "stripping" operation. Because the non-resident could not receive any benefit from these credits in the ordinary course of business, measures taken to eliminate the accumulation would not have an inequitable effect on the non-resident. Therefore, the legislation might include a provision that restricted the accumulation of tax credits on taxed income that was attributable to non-residents. Alternatively the Act might require a corporation that was controlled by non-residents to allocate any income that was not distributed within one or two years of the year in which it was earned. This measure would not result in any liability for withholding tax, but would prevent the accumulation of unused tax credits. Such an approach might well be extended to all companies in which non-residents held a major interest, and would ensure that Canadian minority shareholders would obtain the benefits of integration. It may also be necessary to have a provision to the effect that if shares were transferred by a non-resident to a resident in such circumstances that the resident had not obtained a bona fide interest in the business or property of the corporation, but only a temporary interest, no refund would be paid to the resident on a distribution or allocation. This should inhibit artificial transactions under which non-residents would sell the shares temporarily to residents in order to obtain a reduction of the effective tax rate.

Interest Paid to Non-Resident Shareholders

Another avoidance possibility would be that non-residents who controlled a Canadian company might effectively avoid the corporate rate of tax by the use of interest-bearing obligations instead of equity investments. Because virtually all interest payments would be deductible under our proposals, contrary to the present treatment that prohibits the deduction of interest on funds borrowed to acquire shares on which the dividend income is exempt, avenues for abuse would be opened. For example, a new subsidiary might be set up with a loan capital of $1,000,000 and invested capital of $100. When net earnings (after interest) reached a point where material Canadian taxes were payable, the shares of the Canadian subsidiary could be sold to another newly formed Canadian subsidiary at a price which would represent the capitalized value of anticipated earnings, and the new company would again have a very high ratio of debt. The simplest solution to this problem of interest payments by a Canadian corporation to non-resident investors with whom it did not deal at arm's length would be to deem such payments to be dividends, an approach that would be similar to that followed in the United Kingdom. Thus, they would not be deductible and would be subject to withholding tax at the rate applicable to dividends 19/. We recommend that this course should be followed, at least in a number of well defined cases.

Transitional Problems

The implementation of our proposals for the integration of the personal and corporation income taxes poses some major transitional problems. These involve the timing of the introduction of the proposed changes, the treatment of surplus on hand at the effective date of the legislation and the problem arising from the probable temporary reduction in revenue during the period immediately following the introduction of the proposals.

Timing of Proposed Changes

One important question relates to the time at which the various proposals for integration of the personal and corporation income taxes and the full taxation of capital gains would be introduced. We believe that the greater the initial step and the fewer the subsequent steps, the less would be the total market disturbance. The impact of the immediate introduction of the full taxation of all asset gains would be eased by the fact that tax would apply only to the portion of the gain accrued after the transition date. Because share values are primarily related to future earnings, a lowering of the future tax, with an increase in the net after-tax return, would bolster share values and help to offset the depressing effect of a tax on share gains. Immediate introduction of these changes would have to be accompanied by a reduction in the top rate of personal income tax and also the provision of special measures for small businesses previously entitled to the lower rate of corporation tax.

Our conclusion favouring the immediate implementation of the bulk of our proposals runs counter to the assumption, valid in most circumstances, that substantial changes should be introduced gradually. In a gradual approach, we foresee a repetition of disturbances equally upsetting at each step and a series of technical adjustments of extreme complexity. For example, the introduction of the tax on share gains by a gradual extension of the portion of the gain to be included in income would be a disturbing factor in the market for several years as it sought to adjust to each new change. A single step making the full change would probably be no more disturbing if accompanied by all the other reforms we have proposed. This question of a gradual introduction of some of the proposals is discussed below in connection with one of the possible procedures put forward as a transitional provision.

For non-resident shareholders the transitional considerations are quite different because the proposed changes in the Canadian tax treatment of share gains and corporate income do not affect them directly. Accordingly, whether future distributions to non-resident shareholders came out of existing surplus or future surplus would be of no importance; the same withholding tax should apply to any distribution.

Treatment of Surplus on Hand at the
Date of the Legislation

Under the present system, the general intention has been to collect tax on the undistributed income at the time it is distributed, and to permit capitalization after payment of a special tax (section 105). But we have seen that this intention has been frustrated by the various ways of making distributions free of tax or at low rates of tax through surplus-stripping procedures. An attempt could be made in the future to collect tax upon distributions of surplus existing at the transition date. But it would be necessary to employ a method that did not perpetuate the inequity of the present system which grants an advantage to shareholders of those corporations that retain surplus indefinitely. Furthermore, it must be kept in mind that no onus has hitherto been placed on a corporation to make distributions of income as earned. On the contrary, both the tax system and the needs of the economy have favoured the retention of earnings for reinvestment. The assumption has been made in the past that tax deferment through the retention of earnings was not a concern of the authorities and that no opprobrium was attached to it.

It is our view that shareholders should not be allowed the benefits of integration on corporate earnings retained in the past. The portion of these accumulated earnings that was applicable to residents should be regarded as capitalized so that future distributions to residents from such surplus would be free of personal income tax. The procedure would be to treat a distribution from this surplus as a partial realization of the shares, and therefore to reduce the cost basis of the shares by the amount of such a distribution. Because the share value would probably decline by a similar amount, this approach would prevent such a distribution from creating a deductible loss on the shares.

Problems Arising from Temporary Reduction in Tax Revenues from Corporate Source Income

The initial impact of the proposed integration procedure would probably cause a number of shareholders who held shares at the time of the change to benefit from windfall increases in the price of their shares, despite the depressing influence on share prices of the proposal for the full taxation of share gains. More important, integration itself would result in an initial loss of tax revenues that would only be offset after a number of years by the other measures that we propose for taxing corporate source income and share gains. This latter temporary impact is significant. If overall government revenues were to be maintained in the transitional period (an objective set by our terms of reference) and if a change in the taxation of corporate source income would result in a temporary revenue reduction (our other proposals for corporate source income would more than offset the deficiency once the transitional period had elapsed), it would be necessary to develop some additional, but temporary, source of revenue.

The problem of the immediate windfall gains would be partially resolved if the full taxation of share gains was implemented before the market anticipated the favourable effects of integration. Shareholders who experienced large share gains from the adoption of our integration proposal would at least be taxed on such gains at full personal rates. However, since it would probably not be possible to arrange the timing of the taxation of share gains in this fashion, there would likely be some untaxed windfall gains. A transition tax on shareholders, which temporarily depressed share prices, might serve to reduce these windfall gains. A transition tax on shareholders would also moderate the impact of our proposals on the stock market if such a transitional measure did not bear as heavily on those industries most severely affected by the removal of special concessions.

The full taxation of share gains would reduce the buoyant effect of integration, but we do not expect that the offset would be complete. On balance, share prices should rise, although there would be substantial differences between the changes in the share prices of different corporations. Generally speaking, shareholders of corporations with the following characteristics would have the greatest share gains:

1. Corporations in a monopoly or quasi-monopoly situation that would not shift the tax reduction through lower selling prices or higher purchase prices; and

2. Corporations that had been expected to make relatively large taxable distributions to their shareholders in the future.

Unfortunately, there is no simple, consistent and objective measure of either characteristic that would make it possible to impose heavier taxes on the shareholders of such corporations in order to limit the windfall gains from integration or to reduce the after-tax benefit from such gains. There are so many determinants of share prices that are constantly changing that it would be impossible to determine with confidence the extent to which particular share gains resulted from integration. We are recommending many other changes in the tax system that would add to or subtract from the effects on particular corporations of our proposals for integration and the full taxation of gains.

As we have already indicated, integration would produce a revenue loss that presumably would have to be recouped elsewhere in the tax system. Over the long run the full taxation of share gains would provide much of the necessary increase in revenue. The removal of most of the special industry and business tax concessions would more than make up the balance. In the long run, as discussed in Chapter 35, the total tax revenues from corporate source income would be moderately greater under our proposals than under the present system. The simultaneous adoption of integration and the full taxation of share gains would, nevertheless, result in a temporary revenue loss because integration would reduce revenue immediately while the full taxation of share gains would increase revenue only gradually. The realization of share gains would be postponed by shareholders, but share losses, through revaluation, if not realization, would probably be taken into account in the year they arose. In addition, we have proposed that the removal of special industry tax concessions should be done gradually over a period of years so that again the potential increase in tax revenue would not be realized immediately.

The question, then, is whether this temporary deficiency in tax revenue should be ignored or be offset by a temporary increase in tax on all income or whether it should be offset by a temporary tax on corporate source income. The general economic conditions at the time would be critical in assessing the first alternative. The last alternative would have the advantage that it would bear on those who would obtain the direct benefit from integration, that is, the shareholders, but the economic impact would be uncertain and there would be administrative difficulties in imposing such a tax. The second alternative, on the other hand, does not appear to be unreasonable. A transition tax on all income would not be an inequitable burden on the non-shareholder, for he would benefit not only from the general effects of integration already discussed but also from an eventual increase in the tax revenue from corporate source income.

Whatever method is adopted for making up the temporary loss in revenue resulting from integration should, in our view have the following characteristics:

1. It should provide overall equity among resident shareholders;

2. It should not have a retroactive impact or place an undue burden on corporations;

3. It should not affect non-resident shareholders since they would not benefit from integration; and

4. It should not be unduly cumbersome or complex.

The only alternative to a special transition tax which we considered and which would have these characteristics was a procedure that amounted to a gradual introduction of our integration proposal. Under this alternative, our other recommendations (e.g., the changes in the tax base, including the full taxation of property gains) would be implemented at once to achieve immediately the consequent improvements in equity and ease of administration. Corporate distributions would be grossed-up to the full amount of the tax at the corporate level, but the shareholders would not be allowed to immediately claim the full corporation tax credit. Instead the credit would be increased gradually over, say, three years from 35 per cent to 40 per cent to 45 per cent and then to 50 per cent in the fourth year. This time period could not be too long. An extended transitional period would create unfavourable distortions with share gains taxed in full and distributions still subject to some double tax. It would also encourage manipulations in profits and distributions to defer the latter until the full gross-up was available.

Although this alternative does not involve a loss of any of the major administrative advantages of our overall proposals, it does pose some administrative difficulties. Not only would the changes in the gross-up rate be confusing to some shareholders, but under this "solution" to the transitional problem it would either be necessary to stipulate and enforce a minimum level of distributions, in order to prevent corporations from merely delaying distributions until the full credit was available, or special adjustments would be required in the corporate records to account for the changes in the gross-up rate. In any case it would be necessary to ensure that corporate profits were computed exactly each year because of the extra value placed on a one- or two-year deferment of "income". Thus, the determination of receivables, liabilities, and other items would be particularly significant, and there would be administrative difficulties in applying the provisions to inter-company dividends. Special alleviating provisions would be needed for small businesses because they would have lost the low rate of corporation tax without the offsetting compensation of full integration. Finally, this alternative would have a similar impact on all companies, whether old and established or new and growing.

It would delay the impact of full integration on new and rapidly expanding companies, a delay that we seek to avoid with the alternative proposed. The solution of a special transition tax, although not without its own difficulties is, we believe, preferable.

One type of special tax that could be used to raise the necessary revenues while also carrying out to some extent the existing intention to levy a second tax on all corporate profits, would be a once-and-for-all flat-rate tax on all existing surplus. The payment would be amortized annually over a long period of time to ease the impact. Because the retained earnings of Canadian corporations at the end of 1964 amounted to over $20 billion, a tax thereon of, say, 5 per cent spread over 5 years would produce at least $200 million in revenue a year.

While in some respects this might appear to be the logical way to carry out the basic purpose of the present system, we find it unacceptable. Although the levying of an additional tax of over $1 billion on Canadian corporations as a group over the next five years would have a relatively minor impact on many corporations, it would no doubt have serious effects in some instances. In addition, many corporations have had no intention of ever distributing this surplus, so that such a tax would be a completely unexpected burden. This tax would also bear on non-residents and, although the 15 per cent withholding tax could be waived on distributions from this tax-paid surplus, it would nevertheless have an unfavourable impact on many non-resident shareholders, an impact which we do not consider would be fair.

Having considered various alternative procedures, we have concluded that if there was to be a special transitional provision to make up the temporary deficiency in tax revenues caused by our recommendations for corporate source income, it should be a general measure applicable to all income of resident individuals. In Chapter 35 we discuss several alternatives for raising revenues in the transitional period. If it was thought that the required revenues should be raised by a measure specifically applicable to corporate source income, the transition tax described in Appendix J to this Volume would be recommended.

CONCLUSIONS AND RECOMMENDATIONS

1. Taxes can be collected from organizations such as corporations but the burden is ultimately on people—customers, employees, suppliers or shareholders—whose power to consume is reduced by the tax on the organization. Corporations have the rights and obligations of persons under the law; management often makes corporate decisions without consulting the shareholders. These are valid but irrelevant propositions in considering who bears the corporation tax.

2. Equity and neutrality could best be achieved under a tax system where there were no taxes on organizations, and all individuals and families selling and holding interests in organizations were taxed on the realized and accrued net gains derived from these sales and holdings. The net gains from selling and holding interests in organizations would be treated in the same way as other kinds of net gains, and the net gains from selling and holding interests in all kinds of organizations would be taxed identically.

3. Unfortunately this ideal system cannot be recommended for two reasons:

   a) At the present time, valuation problems preclude the annual taxation of accrued net gains. In the absence of accrual taxation, and if there was no tax on the income of corporations, some individuals could postpone their personal income taxes on the income they wished to save.

   b) If the Canadian corporate source income of non-residents was taxed at lower rates than are now in effect, it would reduce the net benefit Canada derives from foreign direct investment in Canada. Because of existing tax treaties and the retaliation that would follow if these treaties were ignored, it would not be feasible to tax this income at the present level except by a corporation income tax like the tax now imposed at a rate of approximately 50 per cent.

4. Retaining the corporation income tax at a rate of approximately 50 per cent, but providing full integration of this tax with the personal income tax of residents, would solve the deferment problem, would maintain the net benefit from foreign direct investment in Canada and would achieve the greatest possible equity and neutrality.

THE PROPOSED INTEGRATION SYSTEM

5. The basic features of the full integration system we recommend are as follows:

a) The income of corporations should be subject to tax at a flat rate of 50 per cent.

b) The income of individuals and families should be subject to progressive rates of tax with a top marginal rate of 50 per cent.

c) The corporation should be allowed to allocate after-tax corporate income to shareholders without having to pay cash dividends.

d) The tax base of the resident shareholder should include the corporate income paid or allocated to him, grossed-up for the corporation tax paid.

e) The resident shareholder should receive credit against his personal tax liability for the full amount of the corporation tax on after-tax corporate income paid or allocated to him, with a refund of the corporation tax if the credit exceeded the liability.

f) Realized gains and losses on corporate shares should be included in income and taxed at full progressive rates.

g) The cost basis of shares should be increased when the corporation allocated retained corporate earnings to shareholders and thereby created "allocated surplus", so that share gains resulting from the retention of earnings that had been taxed to the shareholder would not be taxed again to the shareholder when realized.

h) When dividends were paid out of allocated surplus they should not be included in the shareholder's income but should be deducted from his cost basis for the shares, because such dividends would represent a realization of funds already included in income and previously added to the cost basis of the shares.

i) A corporation with a small number of shareholders which met specified conditions should be entitled to elect to be taxed as a partnership in order to avoid the payment by the corporation of tax at 50 per cent and the claiming by the shareholders of refunds equal to the difference between that tax and tax calculated at their personal rates.

ADVANTAGES OF INTEGRATION

6. The integration system has the following advantages relative to the present system:

a) The system would neither encourage nor discourage the retention of earnings by corporations.

b) Corporate cash retentions could be increased without worsening the cash position of most shareholders.

c) To the extent that the tax reduction was not passed on in the form of lower selling prices or higher purchasing prices, after-tax corporate income from Canadian equities would be increased for most resident shareholders with the result that share prices would rise, the cost of equity capital would fall, and the rate of capital formation by corporations would be increased until a new equilibrium was reached, that is, until rates of return declined toward their original levels.

d) Non-residents holding shares in Canadian corporations would be encouraged to sell them to Canadians, and Canadian corporations wholly owned by non-residents would be encouraged to raise capital by issuing equities in Canada.

e) Tax avoidance through surplus-stripping should no longer be a problem.

f) Tax avoidance through the creation of associated corporations to take advantage of the dual rate would be removed. This should not result in a worsening of the position of new and small businesses because we recommend a more effective incentive in Chapter 22.

g) The tax treatment of corporations, trusts, and mutual organizations including co-operatives would be put on a similar basis.

h) The allocation of resources would be improved with a resulting increase in the output of the goods and services that Canadians want.

i) All corporate source income would be taxed at progressive rates of tax.

DOUBLE TAXATION

7. The present tax system imposes double taxation on most corporate source income in the literal sense that income is taxed to the corporation and is often taxed again in the shareholder's hands when distributed, although the dividend credit of 20 per cent approximately offsets the corporation tax on small income corporations.

8. This does not mean that the present corporation income tax is wholly borne by current shareholders; indeed, the presumption is that it is not. Changes in the corporation income tax are, to some indeterminate extent, shifted almost immediately to suppliers and consumers through changes in the buying and selling prices of the goods and services bought and sold by corporations. To the extent that these price changes are made, the after-tax income of corporations remains unchanged. Where these price changes are not made, changes in the corporation income tax cause changes in expected after-tax rates of return that are capitalized in share prices.

When a tax increase is shifted, consumers and suppliers bear the burden of the tax through higher prices or lower costs; when the tax increase is not shifted, those who hold shares at the time of the tax change suffer capital losses. The converse holds when corporation income taxes are reduced. Increases in the corporation income tax have the effect of being partly a crude sales tax and partly a crude tax on one kind of wealth at one point in time. The greater the shifting, the greater the extent to which the corporation income tax is a crude sales tax, and vice versa. These effects are not confined to the corporation tax, since an increase or reduction in taxes on other organizations and individuals may also be shifted to an undetermined extent.

9. Changes in the corporation income tax cause changes in the allocation of resources. When the tax is shifted, relative prices are changed and this results in changes in the kind of goods and services bought by consumers and hence produced by labour, capital, and natural resources. When changes in the corporation tax are not shifted, expected after-tax rates of return are changed, and this results in changes in the relative rates of fixed capital formation among industries and among corporations within industries. Although there may be exceptions, the presumption is that, on balance, the imposition of a general

corporation income tax has an adverse effect on the allocation of resources. Fewer goods and services of the kinds that Canadians want are produced. This is the real burden of the tax today. The increase in future output is a major benefit that would result from its removal.

10. The results of the removal of the double tax on corporate source income through integration can be summarized as follows:

a) To some extent, the tax change would be shifted in the form of lower selling prices or higher purchase prices.

b) To the extent that the tax reduction was not shifted, shareholders at the time would make capital gains, since the anticipated after-tax earnings would be increased. The amount of these gains would be reduced by the proposed taxation of capital gains.

c) The size of the capital gains would depend on expectations about the speed with which the higher after-tax rate of return would be brought down through increased investment by competitors.

d) Where productive facilities were readily reproducible and where the degree of competition was great, the adjustment in the rate of investment would be more rapid, the after-tax rate of return would be reduced more quickly, and the initial capital gain from the removal of the double tax would be smaller.

11. While the primary purpose of eliminating the double tax on corporate source income is to secure a re-allocation of resources and an increase in output in the economy, it is important that this be done under a system which would secure neutrality and consistency of treatment for income derived through all kinds of organizations and from all forms of transaction. Apart from the other benefits this would produce, it should eliminate the problem of surplus-stripping and should substantially reduce opportunities for other forms of tax avoidance.

INTEGRATION AND CAPITAL GAINS

12. Introduction of full taxation of property gains would partially offset the favourable effects of integration so that the share gains from the adoption of integration would be substantially reduced relative to what they would be if integration alone was adopted. Some of our other proposed reforms, such as the removal of the special incentives for the resource industries, would also have a negative influence on share gains. To reduce the unwarranted windfall gain to current shareholders that would result from the adoption of our integration proposal, it would be imperative also to adopt full taxation of share gains.

COMMITTEE-OF-FOUR PROPOSAL

13. Under this proposal, all distributions would be subject to tax at a flat rate of 15 per cent; no further tax would be imposed on shareholders, but refunds would be allowed to low income shareholders. This proposal was carefully considered and rejected. Our fundamental objection is that it fails to apply the same progressive rates of tax to corporate source income as to other kinds of income. It would presumably be adopted in conjunction with concessionary rates of tax on share gains and with the maintenance of the dual rate of corporation tax. A system embodying this proposal would lack neutrality and would be about as inequitable as the present system. Most of the present problems would be perpetuated. If the proposal was combined with the taxation of share gains at concessionary rates, it would add some new complexities and avenues for avoidance.

OTHER ALTERNATIVES

14. A number of other alternative systems of taxing corporate source income were considered and rejected on the grounds discussed in the text, in Appendix F to this Volume and in supporting studies. We also considered

the methods of taxation of such income that are used in some other countries, and these are also discussed in the text and in Appendix G to this Volume.

TECHNICAL ASPECTS OF THE PROPOSAL

15. The corporation should be required to pay any additional taxes necessary to bring the total taxes paid or deemed to be paid on all distributions to 50 per cent, so that shareholders would always claim credit at that rate, and the complexities of the system would all be at the corporate level where they could be dealt with more readily.

16. A shareholder should acquire the right to a gross-up and credit for corporation income tax if a distribution or allocation was made by a corporation in any of the following ways:

a) cash dividend;

b) stock dividend;

c) capitalization of surplus without stock dividend; or

d) allocation of earned surplus without capitalization.

Corporate income allocated by any one of the last three methods would be added to the cost basis of the shares. An allocation under the fourth method would be made by the company for tax purposes only.

17. Foreign source direct investment income when earned (business income), or received (dividends), should be subject to an arbitrary rate of gross-up of 30 per cent for the foreign tax credit to be allowed. If this income was not subject to foreign income tax of at least 30 per cent at the time it was earned in the foreign jurisdiction, then a special Canadian tax equal to the deficiency should be paid at that time. Canadian corporations with foreign source direct investment

income should withhold an additional tax of 20 per cent on amounts distributed or allocated to Canadian resident shareholders in order to bring the total taxes paid on such distributions up to 50 per cent.

18. Losses realized by the corporation should not be allocated to shareholders, but should be carried back and forward in the manner described in Chapter 22. However, losses could be carried back and applied in the two preceding years only to the extent of the taxed income not previously distributed or allocated to shareholders. Losses at the corporate level that were reflected in reduced share prices could be deducted by the shareholders from other income, whether or not realized, through revaluation of their shares as proposed in Chapter 15.

19. Intercorporate dividends or allocations should be treated in the same way as dividends or allocations received by an individual with the full gross-up and credit. Corporations which incurred losses on their operations and which received dividends should be entitled to refunds as a result of the credit on the dividends received.

20. The personal corporation and investment corporation provisions of the present Act would be unnecessary. The provisions in the Act to counter avoidance of tax on corporate surplus could also be removed.

21. Life insurance companies and the trustees of Registered Retirement Income Plans should be entitled to the gross-up and credit with respect to dividends received, and would be entitled to a refund of the corporation tax paid where applicable.

22. Dividends on preferred shares should be treated on the same basis as common stock dividends.

23. Distributions or allocations under any of the above procedures should be treated as having been paid first out of income on which the corporation had paid tax or was deemed to have paid tax. Any distribution

in excess of the income which had been subject to corporation tax would be treated as a return of capital and would be applied to reduce the cost basis of the shares.

24. In future treaty negotiations, an attempt should be made to secure for stock dividends the same treatment as is now accorded ordinary dividends. In the meantime, the "allocation of surplus without capitalization of surplus" procedure would make it possible for foreign-controlled Canadian corporations to bestow the advantages of integration upon their Canadian shareholders without adverse tax consequences to themselves. In addition, some types of capitalization might be treated as not being subject to withholding tax.

25. The gross-up and credit to the shareholder should be made at the rate of tax applicable to corporate income in the year of distribution or allocation.

PARTNERSHIP OPTION

26. A corporation with a relatively small income and with a small number of shareholders should be entitled to be taxed as a partnership if it complied with certain conditions. This would avoid the necessity for payment of the corporation tax and the claiming of refunds. Each shareholder would include in his tax base his portion of the corporation's income. If the corporation had a loss, each shareholder could claim his portion of the loss as a deduction from other income, but the corporation could not then carry the loss back or forward.

SOME PROBLEMS IN THE PROPOSAL

27. To reduce tax avoidance, it would be imperative that top marginal personal income tax rates should not substantially exceed the corporate rate for protracted periods of time. This would create some rigidity in the system, but it would not be serious. Because of the tax credit

and refund procedure, the level of the corporate rate would not have as much significance under our proposal as it now has, and it would be possible to achieve the same or greater control over corporate investment without changes in the corporation tax rates.

28. The implications of our integration proposal for federal-provincial fiscal relations are discussed in Chapter 38.

29. Strict control should be imposed over the issuance of T5 slips by corporations.

30. Provisions should be introduced to preclude the postponement of allocations of profits which should be attributed to non-resident shareholders. This would be necessary to prevent the sale of shares by non-residents to residents who would obtain distributions or allocations of the tax-paid earnings, obtain the credit on such distributions or allocations and sell the shares at a loss that would offset the income.

31. To prevent the avoidance by non-residents of the full rate of corporation income tax, interest payments by a Canadian corporation to non-resident investors with whom it was not dealing at arm's length should be deemed to be dividends. They would therefore be non-deductible and should be subject to witholding tax at the rate applicable to dividends.

TRANSITIONAL PROVISIONS

32. It would be preferable to introduce all of the proposed changes, including full integration and the full taxation of capital gains, at one time rather than in stages over a period of years.

33. The surplus existing at the date on which the provisions became effective should be regarded as capitalized. Any distribution out of this surplus to a resident shareholder should be treated as a partial realization of the shares and should be applied in reducing the cost basis of the

shares. Distributions out of this surplus to non-residents should be subject to withholding tax in the same way as distributions to them out of any other surplus.

54. The revenue from the full taxation of share gains and from the elimination of most of the special corporation tax concessions would grow very slowly, while the revenue loss from integration would be immediate. If the economic conditions at the time the legislation was to be amended made it necessary to maintain the level of government revenues, two acceptable alternatives would be available to accomplish such an objective. The general level of tax on all income of resident individuals could be increased temporarily, or a special tax applicable only to corporate source income could be imposed for a transitional period. We favour the first approach, but in the event that the second alternative was chosen, we have outlined in Appendix J to this Volume the form that such a tax could take.

REFERENCES

1/ See, for example, Richard Goode, "Alternative Approaches to the Integration of Corporate and Individual Income Taxes", Proceedings of the National Tax Association, 1947, pp. 134-145.

2/ $$\text{Grossed-up corporate income} = \text{Distributed or allocated corporate income} \times \frac{100}{100 \text{ minus the corporation income tax rate}}$$

3/ The lower federal rate of corporation income tax of 18 per cent plus 3 per cent old age security tax is discussed in detail in Chapter 22. We only note here that the determination of eligibility for, and the prevention of abuse of, the provision has been the source of endless difficulty in the fifteen years since the dual rate was introduced.

4/ In this chapter we use the terms "retention", "retained earnings", "surplus", "accumulated surplus", and "undistributed income" interchangeably.

5/ At the request of the Department of Finance, our staff prepared a study on surplus-stripping in the fall of 1963. The purpose of the study was to analyze this problem and to suggest solutions within the context of the existing tax system, that is, in the absence of a tax on capital gains. Although the study represented preliminary views of the staff that were subsequently modified substantially, and although it has only limited relevance in terms of the system we recommend, it is being published as a separate study without revision because we believe it provides a useful analysis of some basic weaknesses in the present tax system. In addition, Appendix D to this Volume contains a further discussion of this problem and the various legislative measures that have been implemented in an effort to eliminate surplus-stripping.

6/ Section 28(2).

7/ Section 105B.

8/ Section 105C.

9/ Section 68.

10/ An earlier Royal Commission considered this question. In suggesting a possible method of integrating the personal and corporation taxes the Rowell-Sirois Report of 1940 observed:

> "Investment income in the form of dividends is taxed twice while all other income (including investment income in the form of bond interest) is taxed once only."

Report of the Royal Commission on Dominion-Provincial Relations, Book II, Chapter VIII, p. 152.

11/ The change in the allocation of resources caused by the corporation tax may, as we have said, compensate for distortions resulting from external effects and market imperfections that would have existed in the absence of the tax. In these circumstances, the corporation income tax improves the allocation of resources. There is no presumption, however, that these nice compensations occur frequently; indeed, the presumption is that they much more frequently do not. In any event, the compensating adjustments should be made explicitly in most situations where they are required and should not be applied to all corporations. Corporations have nothing in common except the form of organization. General provisions in the tax system are a very inefficient way of solving specific resource allocation problems.

12/ This recovery in the prices of shares is analogous to the increase in the price of a discounted bond as the maturity date of the bond approaches. The original decline in price reflects the expectation of a less than market rate of return for a certain number of years, with the annual gain (or recovery) in price being in effect part of the yield—so that the gain in price plus the income from the asset equals the market rate of return. However, in the case of shares, both the length of the adjustment period and the magnitude of the adjustment are uncertain so that this process of recovery would not be as smooth or predictable as is often the case for bonds.

13/ Even if it is assumed that aggregate rates of saving and risk preferences remain unchanged, other things are unlikely to be completely equal, because the riskiness of different industries may be changed as a result of the liquidity effects of a change in the unshifted portion of a corporation income tax. Moreover, all this is quite apart from other things which may change but which have nothing to do with the corporation income tax.

14/ Report to the Minister of Finance by the Special Committee on Corporate Taxation, March 21, 1961, published as "Special Report No. 8", Canadian Tax Reporter, Toronto: CCH Canadian Limited, 1963.

15/ For example, it is discussed briefly in the study on "Stripping of Corporate Surplus" published by the Commission. See also Appendix N to this Volume.

16/ The Committee stated that it adhered to the basic principle that the shareholder's tax should be fixed at a flat rate of 15 per cent. It stated, however, that if it was considered desirable as a matter of policy to modify the flat rate to introduce a limited degree of progressiveness, then shareholders with incomes above $10,000 could be taxed on their dividend income under a special schedule of maximum rates. These rates ranged from 15 per cent to 40 per cent. The Committee also said that "Even the above rates will invite, in some degree, resort to devices to avoid these taxes". "Special Report No. 8" op. cit. pp. 18-19. Because of the Committee's reluctance to apply progressive rates to the dividend income of shareholders with incomes of $10,000 or more, and because it was acknowledged that this approach would be subject to the abuses they sought to correct, we assume that the application of progressive rates was not part of their major recommendation and do not discuss it further. A comparison of the taxes that would be paid on corporate source income under the Committee-of-Four proposal and under the system we recommend is presented in Appendix N to this Volume. This comparison is on the same basis as the comparison of our proposal with the present system given in Appendix M to this Volume discussed earlier.

17/ L. Fisher and J.H. Lorie, "Rates of Return on Investments in Common Stocks", Journal of Business, Vol. XXXVII, 1964. This subject is discussed further in Chapter 37.

18/ A "goodwill" capital gain is an increase in the value of the shares that is not a reflection of an increase in the tangible assets of the corporation, but rather reflects an intangible asset, that is, the premium the prospective shareholder is willing to pay for the anticipated earnings of the corporation.

19/ The United Kingdom Finance Act, 1965, which provides for a new corporation tax, nullifies any possibility of tax reduction by non-resident parent corporations through the use of intercorporate loans rather than equity capital to finance the operations of their British subsidiaries. It does so in two ways: first, by imposing a withholding tax on interest payments and, second, by prohibiting the deduction of interest by the subsidiaries in the computation of profit.

The interest payment, if it is a "distribution", is not deductible by the British company in computing its profit for corporation tax purposes (Finance Act, 1965, ss. 52(2) and 53(5)), and it is also subject to withholding tax at the standard rate of 41.25 per cent, unless modified by international tax agreement. In effect, therefore, such interest payments could bear an aggregate British tax of 64.75 per cent (corporation tax of 40 per cent and withholding tax of 41.25 per cent on distribution). This is the same as the rate applicable to dividends, unless altered by tax treaty.

The term "distribution" has been given an extremely wide meaning under Schedule 11 (section 47(5)) and includes any interest in relation to securities issued by a company to a company not resident in the United Kingdom, where the former is a subsidiary of the latter or both are subsidiaries of a third company (Schedule 11, 1(1)(d)(iv)). In this context, a "subsidiary" of another company means a body corporate of which not less than three quarters of its ordinary share capital is owned directly or indirectly by that other company (Finance Act, 1965, Schedule 11, 1(1)(d)(iv); Finance Act, 1938, Chapter 46, section 42(1)).

CHAPTER 20

MUTUAL ORGANIZATIONS AND TAX-EXEMPT ENTITIES

THE NATURE OF THE PROBLEM

We define the term "mutual organizations" broadly. While the term commonly is associated with co-operatives, credit unions, caisses populaires, and mutual insurance companies, we believe it is also applicable to such organizations as boards of trade, labour organizations, fraternal orders and private clubs, and to some aspects of charitable organizations. We also include incorporated and unincorporated bodies in this term, and our recommendations throughout this chapter are applicable to both types of bodies.

In the typical business operation four groups are involved: suppliers of goods and services that are used in the production of other goods and services sold by the business, suppliers of funds on a contractual basis, suppliers of funds on a residual-claimant basis and the buyers of the goods and services produced by the business. Each party pursues its own self-interest: the residual claimant, or the management that represents the residual claimant, strives to reduce costs and increase revenues; the suppliers of goods and services and contractual funds strive to increase the prices they charge the business; the customers try to obtain goods and services at the lowest possible prices. While it is by no means simple to determine the income of each party for tax purposes, as the discussion of business income in Chapter 22 demonstrates, usually one can at least begin with records of transactions based on prices that have been determined at arm's length. However, the primary characteristic of mutual organizations for tax purposes is that each member is usually a residual claimant against the organization and is also a supplier to the organization or a customer of the organization, or perhaps all three simultaneously. Accordingly, measurable economic gain does not emerge naturally and may not appear at all.

Although in practice the functions may be combined, it is useful for analytical purposes to distinguish three types of mutual organizations:

1. Those that market the stock-in-trade of their members.

2. Those that supply the members with goods and services that are used in the business operations of the members.

3. Those that supply their members (and sometimes non-members) with consumption goods and services.

Mutual organizations that perform functions 1 and 2 we shall designate as producer co-operatives; mutual organizations that perform function 3 we shall call consumer co-operatives. Many mutual organizations that are not usually considered to be consumer co-operatives, such as private clubs, have many of the same characteristics as consumer co-operatives. Thus, what we say about consumer co-operatives often applies to them too, as we shall show later.

Producer Co-operatives Performing a Marketing Function

Most producers of goods and services enter into a contractual relationship with those who buy their output. They receive cash or a contractual right in exchange for their goods and services. Members of marketing co-operatives, however, transfer goods and services to the co-operative in exchange for cash <u>and</u> a residual claim against the income of the organization. The form of the consideration, whether cash, contractual claim, or residual claim, is of no significance from the point of view of the comprehensive tax base, which should include all such elements.

If a co-operative's profits were distributed annually to satisfy the residual claims of its members, or if the change in each member's interest in the enterprise was valued each year, there would be little occasion to impose tax on the organization. But such is not the case, so it becomes necessary to tax the undistributed profits in the hands of the co-operative, which otherwise could be accumulated in such a way as to defer the receipt of income by individuals.

Producer Co-operatives Performing a Supply Function

Two situations can be distinguished for co-operatives of this type:

1. Those in which members pay regular market prices for the production goods they buy and receive a residual claim against the income of the organization.

2. Those in which members buy production goods from the organization at less than market prices.

Because the costs incurred in buying production goods are deductible in computing the net gain of a member, no tax problem is created when the member buys his producer goods below regular market prices. His net gain will be larger and it will be taxed in his hands. When the member buys producer goods at market prices and acquires a residual claim against the income of the organization, his net gain from production would be understated if the value of the residual claim were ignored. As in the case of co-operatives that perform a marketing function, patronage dividends should therefore be added to the income of the members, and the income of the co-operative not distributed to members should be taxed at full rates to the organization.

Consumer Co-operatives

Consumer co-operatives have different tax implications from producer co-operatives because their products are mostly consumer goods, expenditures on which are not deductible from income for tax purposes for reason discussed in Chapter 8. If the members of consumer co-operatives can get more consumption goods for the same cash outlay, or the same consumption goods for a smaller cash outlay, relative to persons who are not members of the co-operatives, members would have greater economic power than non-members. In principle, this gain should be brought into the tax base of the members. However, the present tax system does not bring into income either patronage dividends "in respect of consumer goods or services", or any benefits received through the acquisition of goods or services at less than their regular market price.

Other Forms of Mutual Organization

Most of the other forms of organization mentioned, such as caisses populaires and credit unions, private clubs, and labour and business non-profit organizations, are in effect mutual organizations that fall into classifications similar to those discussed for co-operatives. While private clubs and credit unions are similar to consumer co-operatives, labour or business organizations promote the interests of their members in much the same way as producer co-operatives. Thus, while private clubs and credit unions, to the extent that they reduce the cost of a service, provide a form of tax-exempt benefit to their members, labour and business organizations are primarily concerned with increasing the employment or business income of members, a form of income that is at present taxable.

Assessment of the Present Tax Treatment

In arriving at their taxable incomes, co-operatives are able to deduct all or most of their patronage dividends, which are taxable to the recipient (except in the case of consumer co-operatives). Only their unallocated income is subject to corporation income tax. This is in accordance with the principles we have enunciated. Nevertheless, co-operatives have had a distinct advantage over corporations, because the equivalent treatment of a corporation would be the allowance of the deduction of interest <u>and</u> dividends in the determination of income.

Adoption of our integration proposal would go a long way toward removing this disparity by bringing the treatment of corporations closer to the treatment that has heretofore been accorded co-operatives. By allowing a full credit for corporation income tax paid, the tax burden on shareholders would be the same as that accorded to members of co-operatives. This is eminently desirable. However, the payment of tax on corporate income before the deduction of dividends reduces the cash available for retention by the corporation, and accordingly it would be necessary to establish rules requiring that a minimum proportion of the distributions of co-operatives be in cash, if co-operatives were not to have a cash flow advantage over corporations.

The non-profit organization performing functions similar to the co-operative has been in a better position to the extent that accumulated net income is not taxed at all. For many non-profit organizations the excess of income over expenditures would not be material.

Conceivably, a mutual organization could "price out", that is, eliminate any net earnings, by selling consumer goods and services at out-of-pocket cost on precisely the same terms to members and non-members alike. This would be most unlikely, however, if the operation of the organization required a significant investment by the members. If the organization were able to offer below-market prices to all and sundry, the business would presumably grow rapidly, and the organization would need more capital. The members would be unlikely to contribute more capital if the benefits of membership were also available to non-members. Accordingly, it would usually be necessary to retain earnings so that they could be ploughed back into the business. Indeed, if it were possible to ensure that mutual organizations always offered to members and non-members precisely the same goods and services at precisely the same terms, and informed members and non-members alike as to what was available, there would be little tax problem; for these organizations would be modest in size and the prices established would probably be close to market prices.

What is of concern is the situation where members invest in a mutual organization and secure a return on their investment by way of below-market prices for the consumer goods or services that they consume, or through a rebate on their consumption expenditures by means of a patronage dividend or similar distribution. Such gains may be attributable only to the main activity of the organization, that is, the activity for which the organization was formed, if all the capital is employed in that activity; or they may flow from an unrelated business or investment. An example of the latter is the use of dividend or interest income received by the organization to reduce the selling prices of regular consumption goods and services (either directly or through patronage dividends). If all these gains are not included in income, an unfair tax advantage is conferred on the members of mutual organizations relative to other individuals who are taxed on the returns on their investments.

In summary then, the producer mutual organizations pose few problems in the reporting of the proper amount of income, but do involve some difficulties as to when income is reported. However, the need to prevent deferment of income taxes is not unique to this area. On the other hand, the consumer mutual organizations at present produce tax-free income for their members. Thus, the overall proposal for a comprehensive tax base, and our recommendations for the stricter taxation of employee and shareholder benefits, logically extend to encompass a more realistic approach to mutual organizations.

Section 75 of the present Income Tax Act partially limits these benefits available to members of a co-operative organization by restricting the deduction of patronage dividends so that:

1. The co-operative will have at least a 3 per cent return on the capital employed.

2. The dividends will not exceed that part of the income attributable to sales to members.

However, not only is the required minimum return much too low to eliminate the tax advantage, but these organizations are able to reduce the significance of the limitation on the deductibility of patronage dividends by conferring benefits on members, not by paying patronage dividends, but rather by making goods available to them at cost. In addition, it is possible to "price out", or eliminate, other forms of income received, such as interest, dividends and rent, by using such income to reduce prices to members. Another deficiency of the present system is that patronage dividends "in respect of consumer goods and services" are not included in the income of members. Furthermore, there is a wide variety of other mutual organizations which, in effect, perform the same function as consumer co-operatives but are not brought under the statutory limitations we have just mentioned. We have in mind private clubs and non-profit organizations with substantial incomes from non-members that can use this income to subsidize the personal consumption of their members.

One "solution" to this problem would be to have the tax authorities revalue all transactions of mutual organizations and assess tax on the basis of what the gains would have been at fair market value. This would be hopelessly difficult. Another approach would be to require all mutual organizations to bring into their income at least an imputed return on all their assets. This income imputed to the organization would then be subject to the 50 per cent rate in its hands, unless allocated to the members, who would have to bring it into their taxable incomes. This has the great advantage of simplicity and enforceability. It might appear to be somewhat incongruous to impute income to a man with respect to his club but not with respect to the use of his own home or for some other personal arrangement. However, while an individual would ordinarily be confined to specific and isolated arrangements, a mutual organization provides a focal point through which many individuals can engage in a merging of income earning and personal expenditure activities, without having to make a number of separate arrangements. Moreover, when an organization is involved it may be possible to arrange that measurable income does not arise from transactions that would give rise to income if entered into directly by individuals. This would be the case, for example, if investment income of the organization was used to reduce prices of goods to members.

Proposed Solution

We suggest that, as a general rule and subject to our specific recommendations, the following features should be part of the taxation of income from mutual organizations (as defined):

1. All patronage dividends and similar distributions should be taxable to the individual; they should be subject to a 15 per cent withholding tax as discussed below.

2. Patronage dividends and similar distributions should be deductible by the organization to the extent that at least one half of the distribution was paid in cash. That is, in order that a patronage dividend of $100 would be deductible, $50 would have to be paid in cash.

3. Dealings with non-members should be deemed to be a separate business from dealings with members.

4. Losses originating from the provision of consumer goods and services to members of the organization should not be deductible from other income of the organization but should be eligible for carry-over against income from the same activity.

5. The unallocated income of mutual organizations should be taxed at the rate applicable to corporations.

The legislation should define the types of organizations that would be eligible for the above treatment. Because preferential tax treatment would be involved (at least in the case of consumers' organizations), the procedures for determining eligibility should be restrictive, and such eligibility should be subject to periodic review. The requirement for such review would involve better annual reporting and close scrutiny by the tax authorities. Just as we would allow a closely held company to elect to be taxed as a partnership, so we believe that a mutual organization should be given the option of being taxed either as a mutual organization or a corporation. This option would ensure that no mutual organization would be at a tax disadvantage relative to a corporation with which it competes. Such an election would mean application of the usual rules relating to benefits conferred on shareholders and members. These rules would not otherwise apply to benefits conferred by a mutual organization in the course of carrying on its principal activity.

The above approach continues to involve a concession to the members of consumers' mutual organizations, in that their tax bases would not include an amount for an imputed return on their assets used in conducting the principal activities of the organization (a concession that is similarly available to any individual in respect of assets employed for personal consumption). However, it would prevent the deduction from other income of any losses realized on the disposition to members of consumer goods and services (a limitation that is similarly applicable to individuals with other losses and expenditures of a personal consumption nature). We have recommended this approach on the assumption that it would reduce the major tax advantages that would otherwise be available through use of a mutual organization. In addition, we have assumed that our recommendations would prevent mutual organizations from using substantial income from other businesses or from non-members to subsidize benefits to members. Unfortunately, as we show later, the rules necessary to prevent this latter abuse are complex. Should the complexities be overwhelming, or should avoidance or evasion prove to be substantial, it would be necessary to introduce a procedure for imputing a rate of investment return on the assets employed in the primary functions of the organization. Such an alternative appears to be the only practical way of taxing at least some of the indirect benefit flowing from a mutual organization. Certainly it would be more effective than attempting to limit the business done with non-members, and might be more practical than attempting to assess tax on business with non-members.

This procedure would involve taxing imputed income derived through these organizations, and so would be a departure from our general recommendation that, for administrative reasons, imputed income should be excluded from the tax base. However, in this case the inclusion need not be unduly complex. Once an appropriate rate for the deemed investment yield has been arrived at, the problem would be to determine the assets to which it should be applied. We assume that these assets would be valued at cost less an appropriate rate of amortization, or by some other procedure similar to those employed in determining the rate bases of regulated utilities. If the assets to be included were those defined in Chapter 22 as contributing, for tax purposes, to the future income of the business, the problem would be one of determining which business activity should be subject to the deemed investment yield.

Most securities and income-producing real property would be excluded, because the income therefrom would be taxed separately, but the assets employed in the primary functions of the mutual organization, such as buildings, furniture and fixtures, and inventory, would be included.

CO-OPERATIVES

In recent years the business operations of co-operative organizations have enjoyed rapid growth, and it is vigorously claimed by their competitors that the tax treatment of co-operatives has been a significant factor in their success. In this chapter we consider the nature of the co-operative organization in relation to income tax, and the appropriateness of present tax measures. No aspect of taxation was more fully dealt with in the public hearings before the Commission, and we are grateful to the participants for their full expression of all points of view.

The Co-operative Form of Organization

Originally, co-operatives arose to meet a pressing social and economic need in areas where the ordinary working of the market was not producing acceptable results. From somewhat limited origins, however, co-operatives have grown to fill a relatively small but vital part in the economic life of Canada, and many have taken on the characteristics of complex business enterprises. Although limited largely to certain areas of Canada and to certain industries, there is nevertheless no doubt that co-operatives have become firmly established in the economy.

There are many types of co-operatives, and in a short space all that can be done is to indicate their principal characteristics. Co-operatives have the stated objective of providing goods and services to their members at cost. This is generally achieved by pricing the goods and services initially at something near market, and later distributing any resulting surplus among the members as a patronage dividend in proportion to their business with the co-operative, frequently as a credit to members' accounts rather than in cash. Co-operative organizations are usually incorporated by provincial statute and, therefore, like all corporations, are separate legal entities. Unlike the ordinary corporation, however, the customers or the suppliers of the co-operative are usually its owners. The authorized capital is usually small, and the main sources of funds are the patronage dividends left in the co-operative and loans from the members 1/.

Applicability of an Income Tax

In the representations made to the Commission, strong opinions were expressed on three basic questions. Does a co-operative activity create income? If so, how is it measured? Is it income of the co-operative, of the members, or of both? These questions are discussed below.

With respect to the creation of income, it was contended by many that, because the co-operative was intended only to provide goods and services to the members at cost, rather than to produce a profit, any surplus resulting from its operations was merely an adjustment in arriving at this fundamental objective and was not income as such. In other words, the co-operative was organized to carry out specific activities on behalf of its members, and any margin resulting from its operations was merely a saving for its members for whom it was acting as an agent. On the other hand, it was argued that co-operatives carry on business in the same fashion as business organizations and that their motive is economic gain.

In our view, the important point is that, if the economic position of the members is improved as a result of the activity, the economic gain is a proper subject for taxation.

There are problems in the measurement of that economic gain, however. As we have said, the co-operative is unlike an ordinary business enterprise. The owners in this case are usually the customers (or suppliers) and accordingly are indifferent as to whether income, or economic reward, arising from the operations is distributed in the form of price reductions or rebates or patronage dividends. Thus, while theoretically there is a return on capital and managerial ability, it cannot be said with exactness how great it is.

On the other hand, the stated general policy of most co-operatives is to follow market prices where they are determinable, and to avoid price wars and the danger of forecasting their margins incorrectly. Any major attempt to adjust prices to produce a break-even result at the end of the year, generally referred to as "pricing out", could affect their financial stability. When a co-operative prices its goods and services according to the market, the surplus it reports before distributing patronage dividends should represent a reasonable measurement of the income produced in the operation.

The stated policy of most co-operatives of following market prices does not ensure that pricing out will never occur. Moreover, some goods and services will have no generally established market price. Because pricing out can effectively be employed to distribute income by reducing the cost of goods and services, so that income does not emerge in the normal course, special provisions are necessary if such income is to be taxed.

There remains the question of whether the income is income of the co-operative, of the members, or of both. Many representatives of the co-operatives contended that it was basically income of the members, since the co-operative was acting as their agent for specific purposes, and the members could share in the income of the co-operative only if they did business with it. They further contended that this was supported by the allocation of patronage dividends to members according to volume of business, and by the fact that most provincial legislation requires substantial distribution of surplus earnings. On the other hand, it was contended by others that co-operatives, when incorporated, have a separate legal entity and separate management, so that in many cases they are virtually indistinguishable from ordinary business corporations, and that as co-operatives have become larger they have lost contact with the members despite the rule of "one member one vote".

Because of the present tax treatment of ordinary corporations, the question of whether income of a co-operative activity is to be regarded as income of the co-operative organization itself or of the members is extremely important. However, under our proposed tax system, all income flows would be taxed in the same manner regardless of whether they came through partnerships, ordinary corporations, or other organizations; and the question of how much income was income of the organization would be of minor importance. In our view, the income of the co-operative should ultimately be taxed at the individual rates of the members in the same manner as the income of ordinary corporations should ultimately be taxed at the individual rates of the corporate shareholders. Admittedly, this objective is easier to achieve in the case of co-operatives than in ordinary corporations, because a high proportion of a co-operative's income is already allocated to members. Furthermore, the equity of a member in a co-operative is not marketable, so that no adjustment has to be made for a different value which he might achieve on the market. Despite this greater simplicity in the case of co-operatives, we can see no good reason for a material difference in the tax treatment of the two forms of organization.

History of Tax Treatment

Under the Income War Tax Act of 1917, there was a general provision that mutual corporations without share capital were not taxable, but the position of co-operatives was not clearly stated and they were generally disregarded by the taxing authorities. Where they were assessed, patronage dividends were deductible in arriving at taxable income. In 1930, a section was inserted in the Act to exempt co-operatives provided they met certain requirements. However, during the 1930's and the early war years, co-operative operations were extended to include manufacturing, processing, wholesaling, etc., and groups of related co-operatives were formed. In 1944, the government appointed a Royal Commission to review the tax treatment of co-operatives. The main findings of this Royal Commission were that the co-operative association and its members did make a profit as a result of their trading ventures, and that to the extent the profit was made readily available to members or customers it should be considered income of the members or customers and not of the association.

Under the legislative changes made in 1946, which remain in effect to the present time, the tax exemption for co-operatives was removed, and they became subject to tax upon their income generally in the same manner as other corporations. At the same time, however, a section was introduced permitting a deduction of patronage dividends in computing income 2/. Although this provision was not restricted to co-operatives, it was useful only to a co-operative operation where there was a common interest between the customer (or supplier) and owner of the business. Limitations were imposed on the deduction of patronage dividends to the effect that they could not be used to reduce the taxable income of the co-operative below 3 per cent of employed capital, 3/ nor to deduct on distribution to members the profits on business with non-members 4/. In addition, a provision was added to give new co-operatives a three-year exemption from income tax 5/. From the standpoint of the individual member, patronage dividends were to be reported as income, or as a reduction in cost of goods or services, if they related to his income from a business or property. Patronage dividends relating to goods or services for personal consumption were not required to be included in income.

Analysis of Tax Treatment

The imposition of tax on the income of co-operatives in 1946 was a recognition of the main conclusions of the Royal Commission on Co-operatives, and represented a considerable step forward in the tax treatment of this form of organization. Given the general system of taxing corporations, the 3 per cent minimum limit beyond which patronage dividends could not reduce taxable income was an attempt to prevent co-operatives from entirely avoiding the tax treatment applied to ordinary corporations. The three-year exemption of new co-operatives was originally given to help them get started. The reason for the exemption of consumer patronage dividends is not clear, but presumably it was based on the theory that such dividends merely represent a reduction in a consumer expenditure.

Since 1946, co-operatives have continued to grow, and their corporate competitors have contended that this growth was attributable to the ability of co-operatives to retain tax-free funds for expansion, mainly because the corporation income tax is not applied to income that is allocated to members but not paid out in cash.

The importance of the difference in tax treatment may have been overemphasized. Any adequate explanation of the growth of co-operatives must take into account broad social, political and economic factors. Furthermore, with respect to the tax factor itself, it may be noted that in the case of smaller corporate operations the combination of the lower rate of corporation income tax and the dividend tax credit has meant that the level of taxation on income flowing through an ordinary small income corporation has been close to that on income flowing through a co-operative; any remaining tax differential then mainly rests, as it should, in differences between the tax brackets of the members and the shareholders. The acceptance by members of co-operatives of non-cash distributions is probably due to the fact that this is a condition of membership in the co-operative, and therefore arises more from the nature of the organization than from the tax system. On the other hand, there is no doubt that, where there are large scale operations, the ordinary corporation is at a significant disadvantage because of the immediate withdrawal by the government of one half of the income before any distributions to shareholders, and the higher level of overall taxation imposed in respect of the distributed portion.

If the present basic method of taxing corporate income were to continue, it would be difficult to reduce substantially the difference between the taxation of corporations and co-operatives. Moreover, even if co-operatives could be effectively taxed in the same way as ordinary corporations, this would extend to co-operatives the serious inequities of corporate taxation which we have already discussed in Chapter 19. It does not seem to us that a requirement that patronage dividends be deducted only when paid in cash, as suggested by some participants, would equalize the situation or be entirely effective, because members of a co-operative could hardly be prevented from lending cash distributions back to the co-operative.

Under our proposed method of taxing corporate income, the taxation of ordinary corporations would be much closer to the present method of taxing co-operatives, for the end result in each case would be taxation of distributed income at the personal income tax rates of the owners. However, there would still remain a difference in the cash flow of the entities themselves, arising from the difference in the method of integration. For the ordinary corporation, a corporate rate of tax would be applied to all the income of the corporation, with credit for that tax being given to the shareholders in respect of distributions. In the case of the co-operative, the corporate rate of tax would apply only to the income not allocated among members. A withholding tax levied at the co-operative source on all patronage dividends allocated or paid to members, with credit therefor being claimable by members, would serve both to reduce this difference (or eliminate it, if the withholding rate were 50 per cent) and, as with distributions by ordinary corporations, would facilitate administration.

Proposed Treatment

We have already listed our recommendations with respect to all mutual organizations, including co-operatives, but we think it would be helpful at this point to indicate in tabular form a comparison between a corporation and a co-operative, showing the similarity of result of our proposals. It is important that the co-operative form of business organization should be in exactly the same cash position as the corporation. As indicated in Table 20-1, if patronage dividends were deductible only to the extent that they were at least 50 per cent paid out in cash, this requirement would appear to be met.

We appreciate that there would have to be detailed regulations concerning the kinds of transactions that would be deemed to be cash distributions in order to qualify for the deduction (in particular, requiring that the

TABLE 20-1

AN EXAMPLE OF THE RECOMMENDED TAX TREATMENT OF INCOME FLOWING THROUGH A CORPORATION AND A CO-OPERATIVE

	Corporation $	Co-operative $
Profit before tax	100	100
Assuming that the organization is to retain no cash		
Distribution:		
In cash	50	100
By attribution (or grossing-up)	50	-
	100	100
At the organization level:		
Taxable income	100	-
Tax payable	50	15 a/
Cash retained	-	-
At the shareholder or member level:		
Taxable income	100	100
Tax payable or (refundable) net of withholding tax, assuming the individual is subject to a 30 per cent rate	(20)	15
Cash distribution received	50	85
Total cash after tax	70	70
Assuming that the organization is to retain $50 of cash		
Distribution:		
In cash	-	50
By attribution	100	50
	100	100
At the organization level:		
Taxable income	100	-
Tax payable	50	15 a/
Cash retained	50	50
At the shareholder or member level:		
Taxable income	100	100
Tax payable or (refundable) net of withholding tax, assuming the individual is subject to a 30 per cent rate	(20)	15
Cash distribution received	-	35
Total cash after tax	20	20

a/ Withholding tax at 15 per cent. This would be calculated on the full amount of patronage dividends and deducted from the cash portion, as discussed in the text.

payment must be unconditional), but nevertheless we feel that such an approach could be administered. The other limitations at present applicable to the deductibility of patronage dividends should be removed, because they would be inconsistent with our proposal that the income flowing through the organization should be fully integrated at the time of distribution with that of the owners.

Any economic gain resulting from a co-operative activity is a proper subject for taxation. The amount of such economic gain is difficult to measure, but when the co-operative follows market prices the income before patronage dividends should represent a reasonable approximation of economic gain. When such a pricing policy is not followed, it is difficult to arrive at such an approximation. When the operations relate to business activities of the members, the income will be reported in any case as a reduction of business expense, or as an increase in revenue. Where the co-operative activity relates to personal goods or services, the patronage dividend should be taken as a measure of economic gain, and should be reported as income by the member.

Patronage dividends should continue to be deductible, but only to the extent that half of the dividends in any fiscal period had been paid unconditionally in cash. This means that a co-operative could declare all of its income by way of patronage dividends and pay out one half of this amount in cash. The other half would be retained by the co-operative but it would pay no tax, because the patronage dividends, which would be taxable to the members, would fully offset its income. This requirement would mean that the cash flow of the ordinary corporation would be the same as that of a co-operative. Thus, while the corporation would pay half of its profit in the form of tax, the co-operative would pay half of its profits either in taxes or in a cash distribution to members.

The recommended procedure still provides the member of the co-operative with some slight advantage as to the time of payment, since he would pay out only the tax for which he was liable, while the shareholder in effect has 50 per cent paid on his behalf and must then wait for a refund of any credit due. For administrative reasons a withholding tax of, say, 15 per cent should be imposed on all patronage dividends. This would be calculated on the total patronage dividend, including both the cash and the non-cash portions, and would be deducted from the portion payable in cash. This should improve taxpayer compliance and would reduce the difference in the impact of taxation on funds immediately available to members and shareholders of co-operatives and corporations respectively.

We also recommend that the three-year exemption for new co-operatives should be discontinued. Of course, the special provision proposed for new and small businesses generally that is discussed in Chapter 22, would be applicable to new co-operatives.

In addition, it is necessary to prevent property income and business income from activities that are unrelated to the primary function from being, in effect, passed out tax free to members. Elsewhere in the Report we have emphasized the necessity of taxing, whenever practical, personal benefits provided to the owners of a business. In the case of co-operatives these benefits can take the form of price reductions on consumer goods and services. While we do not recommend a procedure of pricing all transactions at market prices, as is done in the case of the transactions not at arm's length of ordinary corporations, we feel that profits from unrelated activities should not be used to reduce the cost of goods and services consumed by members. For this purpose, business conducted with non-members of the co-operative is an activity unrelated to the major function of the co-operative, as is the earning of interest, dividends, and rental income. To prevent the application of such income to reduce the personal expenditure of members, it should be provided that any losses arising from the business activity of providing consumer goods and services to members of a co-operative should not be deductible from any other income of the co-operative and should only be eligible to be carried back two years and forward indefinitely as a deduction from income derived from the same activity. This treatment is consistent with that proposed for other business "losses" that are considered to be in fact personal expenditures.

As has already been discussed, it might become necessary to also include in taxable income a deemed rate of return on the assets employed in the primary functions of co-operatives which provide consumer goods and services. Although such a procedure might be required to reduce the use of mutual organizations as tax-saving devices, we do not recommend the immediate introduction of such an imputed income measure.

If the value of a member's interest in a co-operative declined below his cost basis, except to the extent that the decline had resulted from losses in providing consumer goods and services to members, the member should be permitted to revalue his shares downward, and to claim a deduction for any resulting loss.

There should be no special problems in regard to any balance of undistributed income on hand as at the transition date. This income would generally have already borne tax at the corporation income tax rate, and therefore if distributed should be treated in the same manner as is recommended for corporations in Chapter 19.

CREDIT UNIONS AND CAISSES POPULAIRES

Credit unions and caisses populaires form another type of co-operative organization that has enjoyed rapid growth in recent years. Their income is exempt from tax 6/. These organizations now have an important role in the Canadian financial system. Some corporate competitors question the tax exemption afforded the credit unions and caisses populaires on the grounds that the function of many has become indistinguishable from that of other financial enterprises.

Form of Organization and Operation

Basically, a credit union or caisse populaire is formed as a separate legal entity under provincial law by a group of individuals having some common bond, such as employment, nationality, religion, or location of residence.

The primary business activity consists of receiving money from and lending money to its members and, if the growth of the organization permits, its activities may be extended to other types of banking services, such as chequing accounts and safety deposit box rentals 7/. An individual who comes within the common bond can usually become a member by acquiring one share at a cost of $5. Members are entitled to one vote regardless of the number of shares held or the amount deposited. Usually a limited rate of interest (or dividends) ranging from 3 per cent to 5 per cent is paid to members on funds obtained from their shares and deposits 8/. The interest charged on loans to members usually ranges from 6 per cent to 12 per cent with interest rebates made in some cases on a patronage basis. There is no stated policy of following the interest rates currently charged by other money-lending institutions.

The gross revenue of these organizations consists substantially of interest charged on loans to their members. The rate of interest paid on funds borrowed from members is usually at a predetermined rate based on the past experience of the organization. After the deduction of this interest, operating expenses and certain statutory reserves, some income may be allocated at the discretion of management to reserves for educational purposes, or for specific purposes such as a building. At this point, patronage dividends or rebates to borrowers are considered if it is the policy of the organization to make such adjustments; many do not, and merely reduce future interest charges where surplus earnings permit. Rarely, if ever, are retroactive adjustments made in the interest payable to depositors.

Representatives of the credit unions and caisses populaires defend the present tax exemption by emphasizing the desirable social effects of these organizations which promote thrift and self-help, combat high interest rates by co-operative action, and provide readily obtainable credit. They contend that no true profit exists because the organizations merely provide members with a service at cost; moreover, any technical profit that might be considered taxable could easily be eliminated by pricing out.

Applicability of an Income Tax

Largely because of the social effects stated above, the Royal Commission on Co-operatives recommended in 1945 that credit unions and caisses populaires be exempt from income tax. For tax purposes, however, we believe that the main consideration is whether a measurable economic gain results from the activity. If it does, there is an appropriate basis for taxation. Furthermore, the position of the credit unions and caisses populaires has substantially changed in the last twenty years; they have grown considerably in size and have become much more professional and competitive in their activities.

We do not doubt that members of credit unions and caisses populaires benefit economically from participation in these organizations 9/. The borrowing member may pay less interest in dealing with a credit union or caisse populaire than with some other financial organization, but as long as individuals generally are not required to include in their tax base an amount of imputed income for interest forgone because of investment in personal property, we see no justification for imputing income to the borrowing member of a credit union or caisse populaire 10/. Although the members are borrowing from a co-operative form of organization, the mutuality of interest between borrowing members and lending members is not readily apparent. While as members they all share in ownership of the organization, the conflict of economic interest between lenders and borrowers should give reasonable assurance against artificially low interest rates. The economic gain to the lender would appear to be the interest paid or credited on his shares or deposits; because the borrower is a mutual organization, the interest is in excess of what he could earn elsewhere does not matter, because it all represents taxable income in any event.

The portion of the economic gain retained by a credit union or caisse populaire as surplus earnings could be measured by the ordinary rules for determining business income as set out in Chapter 22. This procedure would probably result in the disallowance of some of the reserves at present recorded in the accounts of these organizations and, it might be contended, would threaten their financial stability and encourage pricing out. However, it is their ability to accumulate tax-free income that is the most significant tax factor in giving them a competitive advantage. If the credit unions or caisses populaires wished to do so, they could pass out more of their surplus earnings to members in non-cash form, and thereby reduce the impact of the corporation income tax and yet retain financial stability. However, for the reasons already outlined in our discussion of co-operatives, it would be necessary to require that dividends paid or credited to members by a credit union or caisse populaire be deductible only to the extent that half of them were paid out in cash.

Proposed Treatment

Credit unions, caisses populaires and their members should be treated for tax purposes in a manner similar to that proposed for co-operatives and their members, which in turn is generally similar to that proposed for other forms of business organization.

All credit unions and caisses populaires should file returns of income. Their income should be measured under the ordinary rules for measuring business income and, to the extent that it was retained in the organization, should be subjected to the general rate of corporation income tax. Interest and dividends paid or credited to members, and interest rebates made on a patronage basis, should be deductible, but only to the extent that half of such amounts had been paid unconditionally in cash. As in the case of co-operatives, there should be regulations defining what types of payments would and would not be deemed to be cash disbursements. Thus, the cash flow of the credit union or caisse populaire would be affected by the tax system in the same way as that of the ordinary corporation.

Interest paid or credited on shares and deposits, and interest rebates made on a patronage basis, should be treated as taxable income in the hands of recipients, and should be subject to the same withholding tax of 15 per cent that we recommend for the patronage dividends of co-operatives.

In addition, a similar provision to that recommended for co-operatives should apply to the property income and the business income from activities that are unrelated to the primary functions of these organizations. In this case, the interest received on loans to members, less an appropriate part of interest paid and overhead costs, should be considered to be the income of a business separate from the other activities of the organization. Because this business provides a consumption service to members, any losses should be regarded as personal expenditures, and therefore should not be deductible from other income and should only be eligible to be carried back two years and forward indefinitely as a deduction from income derived from the business of making loans to members. This treatment is consistent with that proposed for other business losses, including those of co-operatives. Again it might be necessary at some future time to include in this computation a form of imputed income on certain assets employed in the business.

Because the undistributed income accumulated to the transition date in the credit union or caisse populaire would not have borne any income tax, and because distributions from these accumulations would, as at present, be subject to tax, it might be necessary to specify some order of distribution for interest and dividends paid. Consistent with our recommendations with respect to corporations, it would seem appropriate that future distributions to members should be regarded as having been paid first from current income, then from surplus accumulated subsequent to the transition date, and then from the opening surplus.

MUTUAL INSURANCE COMPANIES

Our recommendations concerning the mutual aspects of life insurance are included in other chapters of this Report: the measurement of the business income of a life insurance company in Chapter 24 and the treatment of the policyholder, for premiums and policy proceeds, in Chapter 16. Consistent with our approach to co-operatives, we recommend that allocations to policyholders in the form of policy dividends should be deducted in arriving at the income of the life insurance company, whether stock company or mutual, and should be subject to a 15 per cent withholding tax. However, we do not think that a minimum cash payment would be necessary in the case of life insurance policy dividends, because the competitive situation is not similar to that existing for co-operatives, and because the cash retained from this source by the companies is not an important factor in the provision of capital funds for the operation. We also recommend that policy dividends should be taxed in full in the hands of the policyholders.

As we indicate in detail in Chapter 25, mutual general insurance companies follow such varying practices in setting premiums and paying policy dividends that it is difficult to establish a true measurement of the economic gain arising from the operation. Nevertheless, consistent with the tax treatment proposed for co-operatives, policy dividends should be deductible by the company, and includible in the income of the policyholder. Where the insurance coverage is of a business nature, the tax consequences of allowing the full premium as an expense and taxing the policy dividend as income would be equivalent to allowance of the net amount as an expense. Where the insurance coverage is of a personal nature, for example, on a residence or personal automobile, the tax treatment would differ from that at present in effect, but premium rates on participating policies would doubtless be revised to reflect more closely the actual costs, and as a consequence policy dividends would reflect more closely the actual gain from participation. Any unallocated earnings retained in the mutual insurance company should continue to be subject to the corporation income tax.

MISCELLANEOUS TAX-EXEMPT ORGANIZATIONS

The list of organizations or trusts, the income of which is specifically exempted from tax, has increased over the years and is now fairly extensive 11/. Several of these are discussed elsewhere 12/. The remainder will be dealt with below.

The income of some of these organizations is unconditionally exempt from tax. Several are exempt only if no part of the income was payable to, or was otherwise available for the personal benefit of, any proprietor, member or shareholder. Others are exempt only if they comply with certain statutory conditions. In no case is there exemption for only part of the income; if the organization meets the conditions for exemption, all its income is immune from taxation. Conversely, it would appear that if an organization does not meet the conditions for exemption, all of its income, however measured, is subject to tax.

Our general approach to such organizations (with the exception of governmental organizations) is that they should be exempt from tax only in so far as their primary functions are concerned.

Filing of Income Returns

An organization that is tax-exempt is ordinarily neither required to file a tax return nor is it subjected to tax audit. Therefore, at present there is little information available as to the flow of income through such organizations.

We recommend that all organizations, whether or not they claim exemption and whether or not they have taxable income, should be required to file returns of income. This would enable the tax authorities to audit the returns, to check on donations claimed where applicable, to ascertain whether receipts and benefits from tax-exempt organizations are being reported for tax purposes, and to judge the nature and scope of the operations that they carry on.

Governmental Organizations
(Including Public Utilities)

The Income Tax Act exempts from tax: municipalities and municipal or public bodies performing functions of government 13/; and corporations, commissions and associations not less than 90 per cent of the shares or capital of which is owned by Her Majesty in right of Canada or by a province or by a municipality, and wholly owned subsidiaries thereof 14/. A limited number of Crown corporations are, however, denied an exemption by the Act and other federal legislation 15/.

Where strictly governmental functions are performed, we do not see a case for taxation of income, nor do we see a valid distinction between functions performed by government itself and those performed by separate entities formed by government for the purpose.

However, where government undertakes activities which compete with those of private business, the exemption of government instrumentalities from tax to which their privately owned competitors are subject, provides the former with an advantage to which the latter may quite reasonably object. There are many examples of government-owned corporations which compete with privately owned companies. For example, Canadian National Railways and Canadian National Telegraphs compete with Canadian Pacific Railways and Canadian Pacific Telegraphs respectively. Canadian National hotels compete with other hotels. Hydro authorities owned by provincial governments compete with privately owned suppliers of gas and oil for use in the home and in industry. The list could be extended.

As is indicated above, some corporations which are owned by the Canadian government are subject to income tax. These probably include most Crown corporations which compete with private industry. This treatment should be continued and the list should be reviewed from time to time to ensure that those federally owned companies which compete with privately owned corporations are subject to income tax.

It is well established that the federal government has no power to impose taxation upon a provincial government and that no province has power to impose taxation on the Canadian government or on the government of another province 16/. The restriction on taxation of another government extends to any corporation which is an agency or emanation of that government. Whether any particular corporation owned by a government is an agency or emanation of that government is a question of fact and of interpretation in each case. There is, of course, nothing to prevent the Canadian government from taxing its own Crown corporations, and there would be nothing to prevent the Canadian government from taxing any corporation owned by a province, if the province waived its exemption and agreed to such taxation. From a practical standpoint, there would be difficulties in imposing taxation on a provincially owned corporation if agreement of the province was not obtained. Because of the constitutional problem and considerations of federal-provincial relations, we do not recommend that such corporations should be taxed unless the provinces agree to such taxation.

The Canadian government has made no attempt to impose income tax on any corporation which is owned by a provincial government or a municipality. On the other hand, Ontario legislation provides for the imposition of corporation income tax on certain corporations owned by the Canadian government 17/.

We suggest that, where governments or non-taxable government bodies are shareholders (with less than a 90 per cent interest) of companies which are subject to tax, they should be denied the right to the normal tax credit on distributions on such shares. There would be no practical way in which such credits could be integrated in the final analysis with the taxation of the individuals benefiting from the corporate source income. There probably would have to be provisions in the legislation to ensure that such credit is not obtained indirectly.

Privately Owned Public Utilities

Government-owned public utilities are exempt from tax under section 62(1)(c), while privately owned utilities are taxable. We have already emphasized the competitive inequality created by this type of provision. We point out, however, that the reduction of tax on corporate source income under our proposals, by reason of the integration of the personal and corporation income tax would substantially narrow the tax disparity between the two types of organization.

Representatives of privately owned utilities who appeared before this Commission contended that the exemption from income tax of government-owned utilities resulted in serious discrimination. They pointed to the heavy element of income tax in the sales dollar of a utility as compared to industry generally (15 per cent to 20 per cent as compared with 3 per cent to 5 per cent), and suggested an end-use tax on all electricity or gas instead of the present income tax.

The significance of the tax factor in this realm has been emphasized in recent years by provincial take-overs of privately owned hydro utilities, and suggestions that further take-overs might take place. Such take-overs have supposedly been encouraged by the fact that the portion of corporation tax revenue at present going to the federal government could be retained by the province for its own purposes, or used to reduce rates to hydro consumers.

The rate of federal corporation income tax on privately owned utilities which supply electricity, gas and steam in Canada is slightly less than that for industry generally. This rate is 45 per cent, or two percentage points less than the general rate of 47 per cent on income in excess of $35,000 18/ (excluding in both cases the 3 per cent old age security tax); and one half of the federal tax revenue so produced is at present returned to the provinces. Despite these modifications there is still pressure to return all the revenue from these public utilities to the provinces.

Some time ago, the federal government announced its willingness to pay to the provinces 95 per cent of the corporation income tax levied on these utilities (excluding the old age security tax). Federal authorities expressed the hope that the provincial authorities would transfer or credit the amount of this payment to the utilities so that it could be passed on by them to consumers, placing publicly owned and shareholder-owned utilities on a more equal footing. Since that conference, Parliament has passed the Public Utilities Income Tax Transfer Act, which authorized the Minister of Finance to pay to a province up to 95 per cent of the income tax paid by a designated corporation which is attributable to gross revenue from the sale of electrical energy, steam or gas, after January 1, 1966. That Act also provides that, if a province pays or credits to a utility corporation any amount received from the federal government, the amount will be exempt from income tax.

Later we recommend that the federal government should consider arranging a transfer of revenue sources by which the federal government alone would levy all corporation income taxes, and the federal government would provide the full credits for corporation income tax. The corporation tax would become a method of collecting tax from shareholders rather than a tax on the corporation *per se*. Consistent with these other recommendations, we also recommend that the rate of tax on privately owned utilities should be the same as on other corporations. We appreciate that this might place such utilities at a disadvantage in competing with publicly owned utilities, but this seems unavoidable. If the federal government turns over to the provinces 95 per cent of the corporation income tax imposed on such utilities, under our proposals this would represent moneys which had also been credited by the federal government to resident shareholders. However, we make no recommendation with respect to this payment since it is outside our terms of reference.

Charities and Other Non-Profit Organizations

Under this heading we deal with a number of organizations at present exempted from tax by section 62 of the Act, and not already discussed in this chapter. Thus, we intend to discuss the tax treatment of charitable organizations, agricultural organizations, boards of trade, chambers of commerce, certain housing corporations, the Canadian Universities Foundation, non-profit corporations for scientific research, labour organizations, and non-profit organizations exempted under section 62(1)(i).

The characteristics of these organizations vary greatly, and there is no consistent single rationale that would support the complete tax exemption accorded to all of them. In fact, organizations have been extended exempt status over the years without the establishment of any clear principles as to why such exemption should be granted and who should receive it. For the purpose of determining the most appropriate tax treatment that should apply, it is necessary first to establish the justification for extending special treatment, and then to assess whether the present tax treatment appears to meet the objectives satisfactorily. The organizations being discussed can logically be divided into three general groups.

The first group consists of charitable organizations as now defined in the Act, although with some modifications as discussed later, and so includes non-profit organizations that have been formed to pursue some general public purpose. Such organizations are not intended to provide any benefit to the contributor members, other than the better organization of the disbursement of their contributions to charity. The mutuality of interest exists more as a matter of convenience in organizing charitable endeavours than as a means of obtaining more direct benefits. If the organization does in fact meet the requirement of having a charitable purpose, there is some justification on social grounds for special tax consideration. However, if the purpose of the organization is to manage charitable endeavours, it would be reasonable to expect that the organization would not be actively engaged in a business.

The second group includes those organizations that are similar to the mutual organizations discussed earlier in the chapter. They exist primarily for the benefit of their members and are essentially of a private character. Their objectives are probably close to those of the consumer co-operative, in that the organization has usually been formed in order to provide personal goods and services to the members. Therefore, the element of personal benefit exists, for the goods or services are usually items of personal expenditure, and in many cases may be provided at a lower cost than would otherwise be paid. Examples of the type of organization that would be included in this group are those private clubs and societies that are formed essentially to provide social or recreational services or facilities for their members.

Certain other non-profit organizations fall in this group because they provide benefits for their members and do not qualify under the specifications of the other two groups. One example is fraternal benefit societies. Organizations in this second group do not appear to warrant any special tax consideration, because they exist to benefit individual members. To the extent that charitable goals are pursued, it should be possible to divide the activities of the organization into their separate functions so that the appropriate tax treatment could be applied to each.

The third group consists of organizations that do not fall in either of the first two groups. Examples of this type of organization are the trade, professional and union associations that, in general, attempt to better the position of their members in a fashion that would increase their taxable incomes. For tax purposes, the outstanding characteristic of this group is that, to the extent that the activities of the organization provide some benefit to the members, the benefit is generally reflected in increased income for the members. Thus, any benefit would generally be taxable. However, these organizations sometimes provide services to their members that, in effect, are items of personal expenditure. In pursuing their primary functions, it is sometimes necessary for them to engage in business activities or have operations that might be considered to be in competition with outside business operations.

In assessing the present tax treatment of these three types of organizations, it is necessary to relate their activities to the role they play on behalf of their members or the individuals contributing to their support. To the extent that such organizations perform functions similar to a consumer co-operative, the comments we have already made on organizations of that nature apply equally to them. That is, all benefits conferred on members should be brought into the income of such members to the extent it is practicable to do so, and any income retained by the organization should be taxed at the full corporate rate. Similarly, any loss arising from an activity of the organization that is carried on for the personal benefit of members and not with a view to profit should be regarded as a personal expenditure and not deductible from other income in the current or any other year (but could be carried back two years and forward indefinitely for deduction from income from the same activity). This approach differs somewhat from the complete tax exemption at present extended to most of these organizations.

To the extent that the organization is thought to have a broader social purpose, the same reasons that support the concessionary allowance for charitable donations might be applied to at least some of the income of the organization. There would be little purpose in granting a concessionary allowance to individuals and then taxing the charitable organization on the receipt of such contributions. On the other hand, we have emphasized that there should not be any tax concessions that give one business a competitive advantage over another, and the present exemption of business income earned by charities could well be regarded as such an advantage. In addition, it is easier to control concessions if they are related to individuals and not extended to organizations which do not pass them on to the individual. Therefore, if any income exemption is to be extended to charitable organizations, it should be limited and, in particular, no business activity of a charitable organization should be given a competitive advantage.

Present and Proposed
Tax Treatment

Charitable Organizations. The present general exemption from income tax for charitable organizations is contained in paragraphs (e), (f) and (g) of section 62(1) of the Act. Paragraph (e) exempts charitable organizations, whether or not incorporated, all the resources of which are devoted to charitable activities carried on by the organization itself; paragraphs (f) and (g) respectively, exempt charitable corporations and charitable trusts, each of which must meet certain stipulated requirements, and which may act as conduits for distributing funds to charitable organizations. In addition, paragraphs (ga), (gb) and (gc) of section 62(1) specifically exempt certain housing corporations, the Canadian Universities Foundation, and non-profit corporations for scientific research, while some other housing corporations are exempt by virtue of section 62(1)(i). We recommend that these bodies should be treated in the same way as charitable organizations.

The word "charitable" is not defined in the Act, but the accepted definition of "charity" is that given by Lord Macnaghten in Pemsel v. Special Commissioners for Income Tax:

> "'Charity' in its legal sense comprises four principal divisions: trusts for the relief of poverty, trusts for the advancement of education, trusts for the advancement of religion, and trusts for other purposes beneficial to the community not falling under any of the preceding heads. The trusts last referred to are not the less charitable in the eye of the law because incidentally they benefit the rich as well as the poor, as indeed every charity that deserves the name must do, either directly or indirectly." 19/

The definition in the Pemsel case appears to us to be generally satisfactory for tax purposes. However, it has been held in England that a trust for the relief of poverty among the relatives of the settlor is charitable 20/. We suggest that the legislation specifically exclude the recognition of such a trust as a charitable body for income tax purposes.

Prior to the 1966 Budget there was no requirement for an organization to obtain recognition from the Department of National Revenue that it qualified as a charity under the relevant provisions of the Act. However, a directive was issued under the Income War Tax Act in 1948 which specified the types of organizations that would be recognized, primarily in connection with the claiming of a deduction for charitable donations made to such bodies. This directive has been followed under the Income Tax Act, and no further rulings have been issued 21/. It may be noted in passing that the four charitable purposes laid down in the directive do not all accord with those in the Pemsel case; though the first three purposes follow those of that case, the directive purports to confine purposes beneficial to the community to those "analogous to the three other purposes".

The Department appears to have attempted to administer the provisions of the Act dealing with charitable organizations somewhat restrictively. Apparently, as a general rule, section 62(1)(e) is treated as being limited to organizations which actually operate charities, such as hospitals, as opposed to organizations which distribute their funds to other operating charities. Where possible, the Department attempts to bring charities under 62(1)(f) rather than 62(1)(e) 22/ because of the restrictions contained in (f), and also attempts to insist in many cases that charitable activity must be confined to Canada 23/.

We have elsewhere recommended the continued allowance of charitable contributions in arriving at the taxable income of donors. We have also recommended the use of a comprehensive tax base which includes in income all gifts received by the donee. Thus, in general, the beneficiary of a charitable contribution would be taxable on the benefits received, but only to the extent that they exceed his deductions and tax credits. If it was thought to be socially desirable to encourage taxpayers to make charitable donations, it would seem to be a negation of the objective to tax the income of the charitable organization. The primary purpose of a charity is to collect donations and then to apply these funds in the manner prescribed by the organization; it is not a basic function of a charity to be in business in competition with other business operations. Therefore, although it would appear reasonable to exempt from tax the donations received by a charity, the proper tax treatment of business income (as described below) is not so clear.

It is not uncommon for a charitable organization to have funds available in excess of its current requirements, and the investment of these funds to earn income is a reasonable function of the organization. Although it may not be reasonable to accumulate and hold these funds over a long period of time, or at least this may not be a function that warrants a special tax concession, we could devise no fair means of differentiating between charities in order to extend a selective concession based on reasonable accumulations. However, a second and more important question arises if such an organization engages in a business activity. Should a tax concession be extended to revenue from this source? While an assessment of the reasonableness of the retention by charitable organizations of large amounts of their annual revenue is not a responsibility of this Commission, a conclusion on the tax treatment of competing businesses is required, and we recommend that the tax exemption should not be extended to business income.

By "business income" in this context we mean all income from a non-portfolio investment, whether it be an investment in an incorporated or an unincorporated business. Our concept of a non-portfolio investment essentially includes any interest of 10 per cent or more in a business, whether incorporated or not. For this purpose the ownership of real property is defined to be a business. The problems of defining a separate business and what should be considered to be business income are discussed in Chapter 22, and the conclusions reached in that chapter should also apply to charitable organizations. However, the approval procedure discussed below should minimize the difficulties of determining which income is to be taxable. One exception, for administrative convenience, would involve the exclusion of a certain minimum amount of income from occasional sales, for example, bazaars and rummage sales, and from small sales operations, such as gift shops.

Therefore, while most of the income or losses (contributions and portfolio income less expenditures related to the charitable purpose) of the charitable organization should continue to be excluded from the tax base, the income from non-portfolio investment should be subject to the full rate of corporation tax. Because portfolio income would be exempt from tax, the charitable organization should be refunded any corporation and withholding taxes collected on its behalf.

We consider that the present exemptions contained in paragraphs (e), (f) and (g) of section 62(1) should be combined into one exemption for charitable organizations, which would be modelled substantially on the present paragraph (e) but which would specifically include trusts for charitable purposes. It should be made clear that charitable organizations can carry on their work inside or outside Canada. While the 1966 amendment provides partial relief in this regard, we would prefer that the definition be expanded further.

We also recommend that a supervisory body be established, composed of members of different departments of government, which might include the Department of National Health and Welfare and the Department of National Revenue, to grant tax-exempt status to charitable organizations. Once such approval was given, it would be subject to periodic review by the supervisory body. An appeal would lie from a decision of this body to the courts. Every charitable organization, to qualify for exemption, would be required to apply for approval to the supervisory body, which would then maintain (and perhaps publish) a list of approved charities. This might work some hardship in those cases where victims of a disaster within a community were given relief by a charitable organization newly established for the purpose. Often the response to such a campaign is great during the first fortnight or so when the disaster is news, but might be small by the time the charity could be expected to have received approval. Perhaps the answer to this problem would lie in requiring not prior approval, but approval at some time, in order to have the receipts recognized as deductions for tax purposes. This would not necessarily preclude the use of receipt forms issued by the tax authorities, which could be used on a tentative basis. It would seem that a system could be devised whereby the District Tax Office would have available official receipt forms, duly numbered, so that they could be identified.

It was suggested to us during the hearings that, in order for a charitable body to retain its qualification, it should have its statements certified each year by an independent auditor. After consideration, we concluded that, although obtaining a regular auditor's certificate might place an undue burden on many small charities, it would not be unreasonable to require the annual submission of a special certificate signed by the responsible officers of the charity and the auditor. Such a certificate could attest to the existence of proper books and records maintained in a satisfactory condition, and could refer to a certain minimum checking of the accuracy of the statement of operations. Once a charitable organization had established a proper system, including its own verification procedures, such an annual reporting should not be onerous. As with any other organization, the books of account should be readily available for examination by the tax authorities; and because preferred tax treatment is involved, it might be advisable to require publication of the annual financial statements.

As part of the original (or any revised) application for approval as a charitable organization, applicants should be required to define the scope of their proposed activities and the types of revenue that they expect to receive. Because we recommend that the proceeds of the charitable activity should be excluded from the tax base of the organization, whether it resulted in a profit or a loss, it would be necessary to be relatively explicit as to what revenues and expenses were part of such activity. Contributions received, portfolio income, receipts from small bazaars, etc., should be excluded, as well as the ordinary expenditures connected with the charitable operation. However, any other business income should be specifically included in the tax base. Thus, the question of what income was to be taxable and what was to be exempt would be settled as part of the application procedure, and should produce only minor difficulties in subsequent years. The periodic review already referred to would include examination to ensure that the stated revenue allocations (taxable and non-taxable) were being adhered to.

Private Clubs and Similar Organizations. This second group consists of organizations at present exempt from tax if they qualify under section 62(1)(i) of the Act. This provision exempts "a club, society or association organized and operated exclusively for social welfare, civic improvement, pleasure or recreation or for any other purpose except profit...." These organizations may engage in activities with outsiders as well as with members, and the activities can give rise to profit on sales of goods and services and to various other kinds of income. To qualify for tax exemption, no part of the income may be payable to, or otherwise made available for the personal benefit of, any proprietor, member or shareholder. Members therefore will not receive income directly as a result of the activities carried on. However, to the extent that such activities are profitable, the members will receive an indirect personal benefit through a reduction in dues or other charges below what would otherwise be necessary or, alternatively, the assets of the club itself will increase.

In practice, many clubs engage in activities with outsiders, presumably to the benefit of members, without losing tax-exempt status. The legislative requirement that "no part of the income...was payable to, or was...for the personal benefit of, any proprietor, member or shareholder" is difficult to interpret and apply and would appear to be of limited value.

Income might also be presumed to arise from activities of clubs involving members only. For example, if an individual makes an investment from which he derives income in the form of interest or rent, and spends the income on recreation, he will be taxable on the income but will not be allowed the cost of the recreation for tax purposes. When an individual invests in a recreation club, however, the investment and recreation activities are merged in the club and he does not receive any readily measurable income from his investment; the income that otherwise would have arisen has been used to reduce the cost of his recreation below what would have been necessary if he were acquiring it separately. In principle, income should be imputed to those individuals who merge these income-earning and personal benefit activities; there is no difference in the taxable capacity of those who merge the activities and those who do not. However, we have already concluded that, at least for the time being, income should not be imputed from assets employed for personal use and consumption.

Organizations of this nature are primarily intended to provide recreational facilities or other benefits on a collective basis for their membership, instead of having each member attempt to obtain the same benefits on an individual basis. Therefore,the cost to the members (fees) is a personal expenditure, and there would be little purpose in taxing the organization on the receipt of such fees, as they in turn are expended on providing the recreational facilities. Just as for the charitable organization, any profit or loss on the conduct of the primary activity of the organization should be excluded from the tax base. However, in this case there is no reason to permit portfolio income to be received as part of this tax-exempt activity, for no broad social purpose is involved and, in effect, such income is used only to reduce the personal expenditures of the members. Similarly, any income from a business other than the primary activity of the organization should be taxable.

Because tax-exempt status is a privilege that should be closely regulated, we recommend that the same general procedure of initial application and annual returns suggested for charitable organizations should be followed here. The tax authorities, rather than a separate board, should pass directly on these applications, subject to appeal to the courts, and should publish a list of the organizations approved. The annual returns should include financial statements that show separately income from the operations of the approved activity and any other income. One section of the legislation, similar to the present section 62(1)(i), should set out the types of organizations eligible to apply. The requirements for maintaining eligibility would be established by regulation.

Because an organization would define its exempt activity in its initial (or any revised) application, it should not be unduly difficult to segregate taxable and non-taxable activities. It should be provided that membership fees and the revenue from dining and bar facilities attributable to their use by members and a limited number of guests are part of the exempt activity. Business with non-members should be defined to be a separate activity. Any other activities, for example, retail outlets, that were operated for the convenience of members, and any revenue from non-members received from the primary activity, should be permitted to be included in the exempt category as long as the total annual gross revenue of all such activities did not exceed a stipulated percentage, say, 5 per cent, of the gross revenue of the primary operation.

Organizations of this general type represent basically a non-dividend-paying form of consumer co-operative, and should be taxed in the same general fashion. Thus, a private club would be taxed on an amount equal to its undistributed property income and business income from activities unrelated to the primary activity of the organization. Distributions of such income would be taxable in the hands of the members, and should only be deductible to the extent that half of such payments had been paid unconditionally in cash, and they should be subject to the standard withholding tax of 15 per cent.

Thus, profits realized from exempt activities would not be subject to tax, and losses from these activities would not be eligible for offset against other income. This treatment differs in form, although it is unlikely to differ in substance, from that recommended for co-operatives, for any income, as well as any loss, arising from the primary activity of the club would be excluded from the tax base. We consider this necessary in order to eliminate the complexities of determining the amount of income of a private club under the standard rules when membership fees and large capital expenditures are involved. We do not feel that this procedure would produce inequities between private clubs and competing organizations.

A club, therefore, would not be permitted to accumulate property income or unrelated business income free of tax to subsidize the provision of personal goods and services to members. Also, because these organizations should be taxed in a manner similar to co-operatives, if eventually a procedure was established for imputing income on certain assets, the requirement should also apply to this group of organizations. In any event, the use of an imputed income provision would be preferable to any form of gross revenue tax, an alternative that has been suggested as a means of reducing the competitive advantage that tax-exempt organizations have over ordinary business operations.

Other Non-Profit Organizations. The general composition of this third group of organizations has already been discussed. It includes agricultural organizations, professional organizations, boards of trade, chambers of commerce, and labour organizations. The present tax treatment of these organizations is similar to that outlined for private clubs.

As the organizations contained in this group possess some special characteristics that set them apart from private clubs, we are proposing that they be taxed in a manner nearer to that recommended for charitable organizations. To reduce the advantages of the deferment of tax involved, we also propose that a postponement fee (discussed below) should be applied to income from portfolio investment that is not to be taxed at the corporate rate. Therefore, designation as an organization of this kind could be a valuable concession and should be limited in application. We recommend that the legislation should set out the general requirements for approval, that the tax authorities should pass directly on the applications and annual returns (subject to appeal to the courts), and that a list of those organizations that become qualified should be published. Because preferred tax treatment is involved, it might also be advisable to require publication of their annual financial statements as a condition of qualification.

Contributions and donations to these organizations, for example, membership fees and union dues, would not be deductible as charitable contributions, but would usually qualify as ordinary business or employment expenses. Although these organizations would make few disbursements to members, when they do occur, as in the case of strike pay, they would be included in the income of the recipient. We recommend that distributions to members should be deductible to the organization and taxable to the members.

We propose that the income of these organizations should be treated in the same general way as we recommend for the income of charitable organizations. Thus, the net income from non-portfolio investment should be taxed at the corporate rate, and portfolio income should be exempt from the corporation tax. Again, the primary activity of the organization, as defined in its application for special tax treatment, should be an exempt activity for tax purposes, whether it resulted in a profit or a loss on operations. Membership fees and contributions, portfolio income, and a limited amount of revenue from ancillary activities would be specifically included in the exempt activity, and any corporation and withholding taxes applicable to such income should be refunded. Business conducted with non-members, other than the minimum allowed for administrative reasons, would similarly be defined to be a separate business. We also recommend that, because the portfolio and sundry business income would receive special tax treatment, the tax authorities should ensure that if such income was being used for the direct benefit of members it be reflected in their income. This last requirement should be a problem only if employee or shareholder benefits were derived through the organization.

These proposals provide opportunities for the substantial deferment of income through these organizations. This deferment could arise because contributions would generally be deductible, because portfolio income would not be subject to tax at the organizational level, and because members would only be taxed on their interest in the organization when benefits were received. Elsewhere in the Report we recommend that the tax advantages of such deferment should be reduced or eliminated, either by the imposition of a substantial withholding tax on any income that was not allocated (and taxed) to the beneficiary, or by the imposition of a postponement fee to compensate for the delay in the distribution of the income. In this case the latter alternative would appear to be preferable. Thus, any undistributed portfolio income should be subject to a postponement fee of up to 15 per cent. This fee would not be refundable, and the member would still be taxed in full on any benefits received.

Obviously an organization can have more than one purpose. However, it should be possible to classify each non-profit organization as a member of one of the three groups we have described. Where the organization had several purposes, and no one purpose clearly dominated, it would be reasonable to require that procedures be established to account separately for the activities related to each purpose.

CONCLUSIONS AND RECOMMENDATIONS

CO-OPERATIVES

1. Co-operatives should be taxed at the corporate rate on their taxable incomes.

2. Patronage dividends should be deductible in computing the taxable income of co-operatives to the extent that half of them had been paid unconditionally in cash, that is, the deductible amount of such dividends could not exceed twice the amount thereof paid in cash. There should be no other limitation on the deduction of patronage dividends.

3. Losses arising from the business activity of providing consumer goods and services to members of the co-operative should not be deductible from any other income of the co-operative, and should only be eligible to be carried back two years and forward indefinitely against income from the same activity. Business conducted with non-members should be considered as a source of income separate from the business with members.

4. The three-year exemption from tax of new co-operatives should be discontinued. However, the other provisions recommended for new and small businesses in Chapter 22 should also be available to co-operatives.

5. Patronage dividends, whether paid in cash or attributed, and including those relating to consumer goods or services, should be subject to a withholding tax of 15 per cent and should be included in the income of the member. The withholding tax would be calculated on the full amount of patronage dividends and deducted from the portion paid in cash.

CAISSES POPULAIRES AND CREDIT UNIONS

6. Credit unions and caisses populaires should be taxed at the corporation income tax rate on their taxable incomes.

7. Interest and dividends paid and credited to members, and interest rebates made on a patronage basis, should be deductible in computing the taxable income of credit unions and caisses populaires to the extent that half the amounts were paid unconditionally in cash.

8. Losses arising from the business activity of providing loans to members should not be deductible from any other income of the credit union or caisse populaire, and should only be eligible to be carried back two years and forward indefinitely against income from the same activity.

9. Interest and dividends paid or credited on deposits and shares , and interest rebates made on a patronage basis , should be subject to a withholding tax of 15 per cent (to be deducted from the portion thereof paid in cash), and should continue to be taxed to the recipients.

MUTUAL INSURANCE COMPANIES

10. Mutual general insurance companies should continue to be taxable at the corporation income tax rate. Life insurance companies are dealt with elsewhere.

11. Policy dividends paid and credited by life and general insurance companies should be deductible in computing the income of the paying companies and should be treated as income of the policyholders. Such dividends should be subject to a withholding tax of 15 per cent and should be included in the incomes of the recipients.

GOVERNMENTAL ORGANIZATIONS

12. No change is recommended in the taxation of bodies controlled by the federal or provincial governments or by municipalities.

PUBLIC UTILITIES

13. Privately owned public utility companies should be taxed at the same rate as other corporations.

MISCELLANEOUS TAX-EXEMPT ORGANIZATIONS

14. All organizations that are to have tax-exempt status for some of their activities should be required to apply for such exemption, and to file annual information returns and returns of income. Profits and losses on the operation of their primary activities (as defined) should be excluded from taxable income.

15. Charities should pay tax at the corporation income tax rate on business income, including income from non-portfolio investment, defined as any interest of 10 per cent or more in a business, but their other income should be exempt from taxation.

16. An interdepartmental supervisory body should be established to grant tax-exempt status to charitable organizations and to review this status periodically.

17. Private clubs and similar non-profit organizations which exist primarily for the personal benefit of their members should be taxed at the corporation income tax rate on their undistributed income, except that derived from their primary activities and other sources incidental thereto. They should be taxable on income from all other sources, including both portfolio and non-portfolio income. Distributions should be deductible to the extent that half of such payments were paid unconditionally in cash, and should be subject to the standard withholding tax of 15 per cent.

18. Other non-profit organizations, including agricultural organizations, professional organizations, boards of trade, chambers of commerce and labour organizations, should be taxed at the corporation income tax rate on the undistributed income from non-portfolio investment. On distribution, this income should be subject to gross-up and credit. Their undistributed portfolio income should be exempt from the corporation income tax, but should be subject to a postponement fee of, say, 15 per cent.

REFERENCES

1/ Aside from grain co-operatives, where outside financing is unusually significant, the ratio of financing by members' investment to outside financing has in recent years been running about 1.75 to 1.

2/ Now section 75(1).

3/ This restriction is now contained in section 75(3) which, in effect, allows certain interest payments to be calculated as part of income for the purpose.

4/ Now section 75(2).

5/ Now section 73(1).

6/ Section 62(1)(k).

7/ In the case of credit unions, the capital invested by the members is usually represented by shares, whereas in the case of caisses populaires it is largely in the form of deposits. The caisses populaires lend a considerably higher portion of their funds in the form of mortgages on real estate. Credit Unions in Canada, Ottawa: Department of Agriculture, 1964, gives the following information in this respect for 1963 (the institutions in Quebec being mostly caisses populaires and those in other provinces being mostly credit unions):

	Percentage of Total Liabilities	
	Quebec	Rest of Canada
Shares	11	72
Deposits	82	14

	Percentage of Total Assets	
	Quebec	Rest of Canada
Mortgages	40	14

8/ The relative importance of shares and deposits as a means of obtaining funds varies from one province to another. Dividends are roughly synonymous with interest. For the purpose of simplicity, from this point on the phrase "interest on shares and deposits" should be interpreted to include all dividends paid on shares.

9/ In determining this economic gain, a member's interest in the retained unallocated earnings is probably of no value. Unlike an interest in an ordinary corporation, it is not realizable by sale, and on a winding-up of the organization, because of provincial laws, there is often no possibility (or at best a remote possibility), that the member will receive any part share of the retained earnings.

10/ Where the money borrowed is used to earn income from a business or property, any differential is automatically taxed because it reduces interest expense.

11/ These exemptions are provided for in section 62 of the Act. For convenience we shall treat the term "organization" as including a trust.

12/ For example, the exemption of credit unions and caisses populaires, new co-operatives (for three years) and government-owned public utilities are referred to elsewhere in this chapter; trusts under various types of employee benefit plans are dealt with in Chapter 16; personal corporations are discussed in Chapter 19; and foreign business corporations in Chapter 26.

13/ Section 62(1)(b).

14/ Section 62(1)(c).

15/ Section 84 of the Income Tax Act, and the Financial Administration Act, R.S.C. 1952, Chapter 116, Schedule D.

16/ The British North America Act provides in section 125 that "No lands or property belonging to Canada or any province shall be liable to taxation". It appears from decided cases that even if this section did not exist, it would be inconsistent with the scheme of the Act to permit the federal government to tax a province or vice versa.

17/ The Corporations Tax Act, R.S.O. 1960, Chapter 73, section 58, and The Corporation Tax Regulations (Ontario), section 801

18/ Section 85.

19/ (1891) 3 T. C. 53, p. 96.

20/ Goff v. Webb (1602) Toth 30; White v. White (1802) 7 Ves. 423.

21/ Department of National Revenue, Information Bulletin No. 17, outlines in general the qualifications required for charitable donations.

22/ The enactment of the provision dealing with charitable trusts (the present section 62(1)(g)) was made necessary by court decisions which held, in effect, that a trust for charitable purposes was not a "charitable institution" and presumably would not qualify as a "charitable organization" under section 62(1)(e). M.N.R. v. Trusts and Guarantee Company Limited, [1940] A.C. 138; Executors of the Honourable Patrick Burns v. M.N.R., [1950] A.C. 213.

23/ However, the Budget of March 29, 1966, proposed that under certain circumstances recognition be given to contributions to non-resident charities.

CHAPTER 21

TRUSTS

Broadly speaking, a trust arises when property is transferred to a person, the trustee, who by accepting the trust undertakes to hold such property for the benefit of the beneficiaries of the trust. The trustee holds title to the trust property and usually has certain powers of management over it, but the income from, and the capital or "corpus" of, the trust property will ultimately be distributable to the beneficiaries in accordance with the terms of the trust 1/. Trusts may be created during one's lifetime or by will, and may endure for varying periods of time. The income from trust property may be distributed as received or after a period of accumulation; the capital of the trust may be partially distributable during the term of the trust, but any part not so distributed is distributable on its termination. The beneficiaries of a trust may be identified at the outset or only over a period of time. The beneficiaries entitled to income and those entitled to capital of the trust may or may not be the same. The rights of the beneficiaries to income and capital may be specified in the trust, or the trustee may be given a discretion to distribute or to accumulate income, to hold or distribute the corpus, or to select from members of particular classes of possible beneficiaries those to whom distributions of income or capital will be made.

The trust is a very flexible legal instrument that can be adapted to a variety of purposes. It is this very flexibility which makes it difficult to tax trusts properly and fairly, not only in comparison with other forms of intermediary such as partnerships and corporations but also in comparison with property transferred directly to a beneficiary rather than through a trust.

While there are problems associated with the taxation of other property that flows through a trust, it is the taxation of gifts to a trust that causes the most difficulties. Under the present tax system such gifts are, in general, subject to either a gift tax or an estate tax. These taxes apply to a transfer of property to be held in trust in exactly the same manner as a transfer made directly to a donee. The liability for payment of these taxes rests primarily on the donor or his estate. We have proposed that the gift tax and the estate tax should be eliminated, and that gifts should be included in the income of the recipient as part of the comprehensive tax base. We have also recommended that the donee should be primarily liable for the tax, although in some circumstances the donor might have an obligation to withhold tax. Under this proposal a trust would include in its tax base not only the income from a business or from property but also any gifts or bequests which it received.

A trust is an intermediary, much like a corporation or a co-operative, and, as such, is a conduit through which income passes on the way to the beneficiaries. As a conduit, the trust does not in itself have a taxable capacity, but rather represents the individuals who are its ultimate beneficiaries. Thus, any taxes levied on the trust should be regarded as having been collected on behalf of the individuals who are the ultimate beneficiaries of the income being taxed.

Throughout this Report we have stressed the importance of equity and neutrality in the tax system, which means that individuals should be taxed on substantially the same basis regardless of whether income is received directly or is accumulated by an intermediary. We have pointed out that to attain greater equity it is necessary not only that the tax system should be as neutral as possible in its impact but also that all taxpayers should pay their tax liabilities as soon as their ability to pay has increased, whether the increase was direct or indirect.

To attain these objectives it is necessary that different types of intermediaries should be treated in the same way for tax purposes, as far as this is possible. We have proposed that a corporation should pay tax at the top personal rate of 50 per cent; that amounts distributed or allocated to the shareholders should be included in their incomes, grossed-up to include the tax; and that the shareholders should be entitled to a credit for the tax paid by the corporation. We propose the same basic approach to the treatment of trusts. Accordingly, trusts should be taxed in much the same way as other types of intermediaries that accumulate income for the individual, and income of a trust (including gifts) should be brought into account at the same time as income of any other intermediary or individual. The trust should be regarded as an instrument to be employed for good personal or business reasons and should not be permitted to be used as a tax-avoidance device.

For these reasons the provisions applicable to trusts should be analogous, as far as possible, to those proposed for corporations. There are a number of difficulties, discussed later in this chapter, that arise when applying such a procedure to trusts. Accordingly, while our proposals for the taxation of trusts are consistent in principle with those for the taxation of corporations, they necessarily differ in detail.

Trusts frequently receive gifts or bequests which would be free of tax under our proposals if received by the ultimate beneficiary, who was a member of the family unit of the donor. It would obviously be unfair to tax the trust on such income and require the beneficiary to claim a refund, particularly if his right to the gift, and therefore the refund, could not be established for a considerable period.

To meet these difficulties, we propose a number of modifications to the general approach which we have adopted for dealing with intermediaries. The major modification we propose is to permit a trust to pay tax at the rates which would be applicable if a prospective beneficiary had received the payment directly, rather than at the top personal rate 2/. This would result in neutrality of treatment between a gift made directly to a beneficiary and a gift to be held in trust for him. It is important that a direct gift should not be taxed either more or less favourably than a bequest in trust for the same prospective beneficiary. If, however, the terms of the trust were such that the prospective beneficiary could not be determined with reasonable probability, the trust would pay tax at the top personal rate.

TERMINOLOGY

The divisibility of property into many successive interests, limited in time and enjoyment, made the development of the trust possible. But at the same time it created the necessity of the trustee, as fiduciary, being held strictly accountable for all the various interests in the property held by the trust. Because some beneficiaries may have an interest only in the income of the trust, while others have rights to distributions out of capital, the division between capital and income is one which is fundamental to trust law. A trustee must, under the applicable trust law and trust instrument, determine for whose benefit various kinds of payment are received, and against whose interest in the trust, expenditures should be charged.

The terms "income" and "capital" have meanings which are reasonably well defined under trust law, and it is common in wills or other trust instruments to provide for payments out of income or payments out of capital. However, income as determined for the purposes of trust law may not be the same as income determined for tax purposes. For example, if a trust receives a stock dividend from a corporation, the stock dividend will be capital for trust purposes, but may result in income to the trust for tax purposes. Depreciation would normally not be taken into account in determining income under a trust instrument, but capital cost allowances would be deductible and recapture of depreciation would be includible in computing income for tax purposes. While gifts, bequests, and certain property gains are regarded as capital under a trust instrument, under our proposals they would be treated as income. For these and other reasons, it is quite possible that the income of a trust for trust purposes may be either greater or less than the income for tax purposes. Accordingly, under our proposals the distinction between income and capital for trust purposes would not be relevant, and the significant factor for income tax purposes would be whether a distribution was made from income of the year as determined for tax purposes or was made from accumulations.

In this chapter we use the term "income" only in the sense in which it is used for tax purposes, unless the context clearly indicates otherwise. We use the expression "current income" to mean income earned or otherwise arising in a trust in a particular year. By the terms "accumulation" or "accumulated income" we mean amounts that were received by the trust as income or otherwise in a prior year, but were not distributable to beneficiaries in that year and have been retained in the trust.

When we refer in this chapter to an amount being "distributable" in a particular year, we mean that it is either distributed in that year or the beneficiary has a right to enforce payment of it in the year. The amount would be included in the beneficiary's income (unless it was an amount which was tax free to him) at the time it became distributable to him under this definition.

The above-mentioned terms are significant, because the treatment of amounts distributable to a beneficiary out of current income would differ from the treatment of amounts distributable out of accumulations. If the "income" as determined for trust purposes was greater than the income as calculated for tax purposes, the amount distributable to an "income beneficiary" may be regarded for tax purposes as partly a distribution out of current income and partly a distribution out of accumulations. On the other hand, if the "income" as determined for trust purposes was less than the income as determined for tax purposes, the amount distributable to "income beneficiaries" would be entirely out of current income, and the balance of the income as determined for tax purposes would be distributed to "capital beneficiaries" or accumulated.

PRESENT TAXATION OF TRUSTS

Property received as a gift by a trust is now treated as corpus of the trust, and is not taxed as income of the trust any more than a gift received by an individual is taxed as his income. To avoid confusion we will use the term "trust fund" when speaking of the corpus of a trust. Income of a trust under the present law is either income from property, such as interest, dividends or rent, or income from a business carried on by the trust. Income which is accumulated rather than distributed usually becomes part of the trust fund, although its disposition will depend upon the terms of the trust instrument.

The income tax treatment of trusts is provided for in section 63 of the Income Tax Act. A trust is treated as a separate tax-paying entity, taxable on its income at the same rates as an individual, but is not entitled to any personal deductions. However, in some respects a trust is regarded as a conduit and may deduct any part of its income which is paid or payable to beneficiaries in the year. Such distributions are taxed to the beneficiaries as their income. Accordingly, in considering the taxation of the income of a trust for a particular period, one must differentiate between the income which is distributed to the beneficiaries and that which is accumulated in the trust.

The conduit principle is also applicable to a number of deductions. The trustee may allocate among the beneficiaries the capital cost and the depletion allowances which he could otherwise claim. Tax credits such as the dividend tax credit and the foreign tax credit, that would otherwise be available to the trust, may be claimed by the beneficiaries to the extent that such credits are allocable to the income paid or payable to them.

The Income Tax Act, in common with the United Kingdom and United States legislation, has provisions to prevent avoidance of tax where the taxpayer transfers property to a spouse or a minor child, or where the taxpayer retains a benefit in or specified rights over the trust property 3/.

There are also provisions to prevent the reduction of tax payable by trusts on accumulated income by the creation of "multiple" trusts 4/.

The basic method of taxing trusts with respect to currently distributed income is similar in Canada, the United Kingdom and the United States. This method seems reasonable and is consistent with our overall approach of treating the intermediary as a conduit, and taxing the income in the hands of the beneficiary. It is in dealing with accumulated income and distributions of capital that most of the problems appear, and the methods of the three countries differ. In addition, our recommendation to tax gifts in the hands of the donee would add a new factor to the taxation of trusts.

A summary of the main features of the taxation of trusts in the United Kingdom and the United States is given in Appendix B to this Volume.

PROPOSED TAXATION OF TRUSTS

Proposal in Outline

A trust is an entity which acquires property by way of gift, or bequest, or for a consideration, and earns income from the holding or disposal of property, from business, or otherwise. It incurs expenses in the process of earning income. It makes distributions to beneficiaries either out of current income or out of accumulated assets. Accordingly, a trust is an intermediary for the beneficiaries. The trustee is in a fiduciary position which is somewhat similar to that of the directors of a corporation or a co-operative. In these circumstances, it is our opinion that for reasons of equity, neutrality, and administrative convenience, a trust should be responsible for filing returns and paying an initial tax on the income of a trust, but that the ultimate burden of tax should be borne by the beneficiaries and should be measured by their ability to pay. The trustee should have no personal liability to pay tax, except out of the assets under his control.

We have recommended that income tax should be imposed on corporations at the top personal income tax rate of 50 per cent. The income of a corporation could then be distributed or allocated to the shareholders, who would be entitled to refunds if they were taxable at lower rates. Trusts differ from corporations in a number of important respects which may be summarized as follows:

1. Trusts often receive gifts and property passing on death, which, under our proposals, would not be included in income if received by a member of the family unit of the donor but would otherwise be included in income. The beneficiaries or possible beneficiaries of a trust may include members of the donor's family unit.

2. The profits of a corporation can be distributed or allocated to the shareholders year by year. While the ownership of the shares may change, the persons entitled to any distributions which may be made at any particular time can be readily determined. This is not always feasible in the case of a trust because the interests of the beneficiaries are often discretionary or contingent. The ultimate beneficiary of accumulated income, including gifts or bequests, may not be known for a number of years.

3. The interests of shareholders in a corporation can be bought or sold from time to time and, in the case of publicly held corporations, the shares are freely marketable. Interests of beneficiaries in trusts are often not readily salable, particularly because they are often contingent and depend, for example, upon whether the beneficiary or some other person will be alive at the time of the vesting of his interest. Accordingly, the beneficiary usually realizes on his interest in a trust only when it is distributed to him. One exception to this is a trust which issues transferable units, such as an investment trust, or unit holders' trust, which is discussed later in this chapter.

Our recommendations for the taxation of trusts differ from those relating to corporations in some ways in order to take account of these differences.

However, our recommendations are intended to accomplish the same general objectives, and to achieve as far as possible neutrality of treatment of gifts and other income, whether received by trusts, corporations or individuals. Our proposals are designed to impose tax on trusts at equitable rates and to prevent the use of trusts to avoid or defer payment of tax.

We recommend that gifts or other income received by trusts should be subject to an initial tax. In the absence of a special provision to the contrary, the rate of initial tax should be the top personal rate of 50 per cent. However, where a gift or other income was distributable currently, the beneficiary should be entitled to elect that the income would be taxable to himself, with the result that the trust would not pay tax. In the case of a gift or bequest or other income which was not distributable currently, but which was accumulated in a trust for the benefit of a prospective beneficiary who could be identified with reasonable probability, the prospective beneficiary should be entitled to elect that the initial rate would be the rate which would have been applicable if he had received the income directly. Where the trust received a gift or bequest and the beneficiary who was entitled to the income from the gift or bequest or the prospective beneficiary of the corpus was a member of the family unit of the donor, there should be no initial tax on the gift or bequest. However, where the prospective beneficiary or beneficiaries could not be identified with reasonable probability, or where no election was made, the initial tax would be payable at the 50 per cent rate.

When a trust distributed property to a beneficiary there would be a disposition, and the trust should be deemed to have received the fair market value, unless the distribution represented property given to the trust, and the beneficiary was a member of the donor's family unit. This is consistent with our proposals outlined in Chapter 15 that the making of a gift should be a disposition that would be deemed to have been made at the fair market value of the property given. It is also consistent with our recommendation that upon a distribution of property by a corporation to its shareholders there should be a disposition at fair market value. This proposal would affect the amount of income which had accrued in the trust and which would therefore be subject to initial tax in the trust. It may be significant under our rules relating to the order of distribution in determining what part of the amounts distributed would be included in the incomes of the beneficiaries.

An amount distributed or distributable by a trust to a beneficiary should be included in his income unless the amount represented a gift and the beneficiary was a member of the donor's family unit. The amount distributable would be grossed-up to include any initial tax which had been paid by the trust, and the beneficiary would be entitled to a credit for the tax paid.

If a trust had been established prior to the effective date of the legislation implementing our proposals, the amounts ultimately distributed should be free of tax to the extent of the value of the property held in the trust on the effective date. Such property may already have been subject to gift tax, estate tax, or income tax, or may represent capital gains which had accrued prior to the effective date.

Where a trust received a gift or other income which was distributable to a beneficiary in the same year in which it was included in income, the implementation of our proposals should be fairly simple. However, in relation to a gift or other income which was accumulated for distribution at a later time, particularly if the rights of the beneficiaries were contingent or depended upon the future exercise of a discretion, the provisions required to implement our proposals would necessarily be more complex.

In some cases, there is one general trust fund from which various payments and distributions are to be made to various beneficiaries. In other cases, a trust is divided into different funds which are to be held for different beneficiaries. In order to simplify the calculation of initial rates of tax and to deal with all beneficiaries as equitably as possible, we propose that if a fund was established under a trust and was required to be kept separate from other assets of the trust, the fund should be regarded as a separate trust for the purpose of calculating the initial rate of tax and for the purpose of determining the tax credit to which the beneficiary will ultimately be entitled. Similarly, if specific property was to be held in trust for distribution in a particular way, it should be treated as a separate trust for these purposes. References in this chapter to a trust should be taken to include reference to such a fund or such specific property where applicable.

Our basic proposals are set out in Tables 21-1 and 21-2. They may be summarized as follows:

1. The income of a trust, calculated in the same way as the income of any other taxpayer, and including gifts and bequests, should be subject to an initial tax for which the beneficiaries (other than non-residents) would receive credit. In the absence of a special provision to the contrary, the initial tax would be at the top personal rate of 50 per cent, but this would be subject to the special provisions referred to below.

2. A resident beneficiary to whom income was distributable in the year it became income of the trust would be entitled to elect that he, rather than the trust, would be subject to tax on the income. Where such an election was made, the trust would not be entitled to a refund of tax in respect of dividend income, interest income, or foreign income, which was distributable to the beneficiary who made the election, but that beneficiary would be entitled to credit for his proportion of the tax which would be refundable to an individual receiving such income.

3. If income was not distributable in the year in which it was earned, but was accumulated, its treatment would depend upon whether there was a "prospective beneficiary" for whom it was being accumulated. An individual would be a prospective beneficiary of an amount if it was indefeasibly vested in him, or if he would be entitled under the trust

instrument to receive the amount, if he was living, not later than the death of an income beneficiary who was older than he by at least ten years or on his attaining a specified age not exceeding forty years, or on the later of these events if both conditions were applicable.

4. If trust income consisted of a gift or bequest and:

   a) it was distributable in the year to a member of the donor's family unit,

   b) it was held for a prospective beneficiary who was a member of the donor's family unit, or

   c) all the income from the given property as determined either for tax purposes or trust purposes was distributable to one or more members of the donor's family unit,

   no initial tax would be payable on the gift or bequest.

5. If a gift was accumulated in a trust for a prospective beneficiary other than a member of the donor's family unit, or if income other than a gift was accumulated for any prospective beneficiary, the prospective beneficiary would be entitled to elect that the initial tax would not be calculated at the rate of 50 per cent, but would be the amount of additional tax which would have been payable by him (i.e., the total tax he would have paid if he had received the income directly, less the tax actually payable by him on his income).

6. If a gift or bequest was accumulated in trust, and no election was made as described in paragraph 5, whether or not anyone was eligible to make such an election, a life tenant or other income beneficiary who was entitled to all the annual income derived from the gift or bequest would be entitled to elect to receive interest from the government each year at the rate of, say, 5 per cent or 6 per cent on

the amount by which the 50 per cent initial tax exceeded the tax which would have been payable if the gift which produced the income distributable to him had been taxed as part of his comprehensive tax base.

7. When property was distributed to a beneficiary, the trust would be deemed to have disposed of the property at its fair market value and any resulting gain or loss would be taken into account in computing the initial tax unless the property was a gift which was distributed to a member of the donor's family unit.

8. A beneficiary would include in his comprehensive tax base all amounts which became distributable to him from a trust in the year, whether out of income or corpus. This should be subject to the following exceptions:

   a) A gift received by the trust which was distributable to a member of the family unit of the donor would not be regarded as income.

   b) Amounts distributable out of trust assets on hand at the effective date of the legislation would be tax free. Property gains which had accrued in the trust up to the effective date would be free of tax to the same extent as similar gains of any other taxpayer.

9. The initial tax on any income would be deemed to have been paid by the trust on behalf of the beneficiary who ultimately became entitled to the income, in the same way as a withholding tax. Accordingly, the amount which he would be entitled to receive from the trust would be reduced by the amount of the initial tax deemed to have been paid thereon.

10. Amounts distributable to a beneficiary and included in his income would be grossed-up to include any initial tax paid. The beneficiary would receive credit for the initial tax, and if it exceeded his tax

otherwise payable, he would be entitled to a refund of the excess. Our proposed rules for determining the rate of initial tax which had been paid on any particular distribution are discussed later in this chapter.

11. Where trust income, other than gifts and bequests, was distributable in the year to a non-resident beneficiary, or was held for a non-resident prospective beneficiary, the 50 per cent initial tax would not be reduced and amounts distributed to the beneficiary would be subject to a withholding tax at the rate applicable to dividends. However, the non-resident beneficiary would be entitled to elect that instead of the 50 per cent initial tax and the withholding tax, the income payable to him would be subject to the same withholding taxes as if the income had been paid to him directly. Gifts and bequests which were distributable to a non-resident beneficiary would be subject to initial tax at the rate of 30 per cent, and no further withholding tax would be payable.

It will be seen that the tax treatment we propose would depend upon the type of income of a trust, or of a fund established under a trust, the time at which the income was distributable, and the type of beneficiary who was entitled or expected to receive the income. This tax treatment is set out in Tables 21-1 and 21-2.

Table 21-1 shows our proposed tax treatment of gifts received by a trust, including property passing on the death of an individual to the trust arising on his death.

Table 21-2 shows the proposed tax treatment of income of a trust other than gifts and bequests. This would include income from trust property, and property gains realized by a trust.

TABLE 21-1

PROPOSED TREATMENT OF GIFTS RECEIVED BY A TRUST

	Type of Beneficiary	When Distributable a/	Proposed Tax Treatment b/
1.	Member of donor's tax unit	Currently	Free of tax
2.	Member of the donor's tax unit was prospective beneficiary	At future time	Free of tax
3.	Beneficiary not a member of donor's tax unit, but a member of donor's tax unit was entitled to the annual income from the property given or bequeathed	At future time	Free of tax
4.	Resident who was not a member of donor's tax unit	Currently	Taxable, but beneficiary may elect to include gift or bequest directly in his income in which case no initial tax would be payable
5.	Resident who was not a member of donor's tax unit was prospective beneficiary (unless 3 above applicable)	At future time	Taxable, but prospective beneficiary may elect that initial tax payable by trust would be the amount of additional tax that would be payable if he had received the gift or bequest directly c/
6.	Prospective beneficiary not determinable	At future time	No elections provided c/
7.	A non-resident was beneficiary or prospective beneficiary	Currently or in the future	Initial tax will be at rate of 30 per cent; no withholding tax on distribution

a/ "Currently" means that the gift is distributable to a beneficiary in the year in which it is income of the trust. "At future time" means that it is not distributable to a beneficiary within that year, so that the gift is "accumulated" in the trust.

b/ Except where otherwise indicated the trust would pay initial tax at the rate of 50 per cent.

c/ If item 5 was applicable and no election was made thereunder, or if item 6 was applicable, and if all the income from the property given or bequeathed was distributable annually to a resident beneficiary, the trust would pay initial tax at the 50 per cent rate, but the income beneficiary would be allowed to claim interest from the government at 5 per cent or 6 per cent per annum on the difference between this initial tax and what his tax would have been if he had received the gift directly.

TABLE 21-2

PROPOSED TREATMENT OF OTHER INCOME RECEIVED BY A TRUST

	Type of Beneficiary	When Distributable a/	Proposed Tax Treatment b/
1.	Resident, whether or not a member of testator's or settlor's family unit	Currently	Taxable, but beneficiary may elect to include amounts directly in his income in which case no initial tax would be payable
2.	Resident, whether or not a member of testator's or settlor's family unit	At future time	Taxable, but prospective beneficiary may elect that initial tax payable by trust would be the amount of additional tax that would be payable if he had received the income directly
3.	Prospective beneficiary not determinable	At future time	No elections provided
4.	Non-resident beneficiary or prospective beneficiary	Currently or in the future	Initial tax at the 50 per cent rate and further withholding tax on all distributions at the rate applicable to dividends. But the beneficiary or prospective beneficiary would be entitled to elect that instead of this initial tax and withholding tax the income would be subject to the same withholding taxes as if he had received it directly

a/ "Currently" means that the gift is distributable to a beneficiary in the year in which it is income of the trust. "At future time" means that it is not distributable to a beneficiary within that year, so that the gift is "accumulated" in the trust.

b/ Except where otherwise indicated the trust would pay initial tax at the rate of 50 per cent.

We will now discuss some aspects of our proposals in greater detail.

Transitional Provisions

We do not intend that the proposed system of taxation of trusts and their beneficiaries should be retroactive. The gifts and bequests held by trusts at the effective date of the legislation may already have been subject to gift tax or estate tax. Trust assets on hand at that date may also include capital appreciation which under our proposals should continue to be tax free. Accordingly, the assets held by trusts, other than inventory, which were on hand at the effective date would have to be valued in the same manner as property held by any other taxpayer at that date and gains which had accrued to the effective date would be free of tax to the same extent as similar gains of any other taxpayer. This latter subject is discussed in Chapter 15.

Subject to the exceptions relating to inventories of a business and to the recapture of depreciation which are already subject to tax on realization of the property, the gains which had been realized or had accrued up to the effective date would not be subject to initial tax in the hands of the trust, and would not be taxable to the beneficiaries when distributed. However, gifts or bequests received and property gains accruing after the effective date would be subject to initial tax in the hands of the trust, and would be included in the income of the beneficiaries when distributed to the extent and in the manner outlined in this chapter.

Order of Distribution of Trust Assets

Because some accumulations in a trust may be tax free because they were gifts accumulated for a member of the donor's family unit or amounts accumulated to the effective date of the legislation, and others may be taxable on distribution on one basis or another, it would be necessary for each trust to keep records of current income and the initial tax paid thereon, and of accumulations of income and the initial tax paid thereon. If the trust existed before the effective date of the legislation, any remaining trust property would represent assets on hand at the effective date.

In our opinion, it would be essential to adopt rules settling the order in which amounts were distributable by a trust. This would be necessary in order to determine which distributions to beneficiaries would be taxable under our proposals, and which would be free of tax as distributions of gifts to members of a family unit or as property on hand at the effective date of the legislation. In the case of a taxable distribution, it would also be necessary to determine the rate of initial tax which had been paid on the amount distributed to determine the tax credit available to the beneficiary. We propose that the order of distribution should be as follows:

1. Amounts distributable in a year would first be regarded as having been paid out of the income of the trust for that year, to the extent of that income. If the trust had paid initial tax on that income, the beneficiary would gross-up the distribution to include the initial tax at the rate paid by the trust, and would obtain credit for this tax.

   Amounts distributable in one year to two or more beneficiaries in the same class under the trust instrument, would be pro-rated among the beneficiaries. If the beneficiaries were not in the same class, amounts distributable out of income would be attributed first to the beneficiary or beneficiaries who were income beneficiaries under trust law, and then to those who were capital beneficiaries under trust law.

2. Distributions would next be considered to have been paid out of accumulations on which the trust had been subject to initial tax. The beneficiary would gross-up any such distribution to include the initial tax attributable thereto, and would obtain credit for the initial tax.

3. If the trust had received gifts free of initial tax on the ground that they were received for the benefit of a member of the donor's family unit, further distributions would be regarded as distributions of those gifts which would not be taxable to the recipient if he was a member of the donor's family unit, but otherwise they would be taxable.

4. Any further distributions would be considered to have been paid out of property on hand at the effective date of the legislation and would be free of tax in the hands of the beneficiary.

This order of distribution would be applicable to each trust. However, as we have indicated earlier, if specific property was held in trust for disposal in a particular way, or if a separate fund was established within a trust, it should be treated as a separate trust fund. It would not be pooled with other assets of the trust in determining the order of distribution, and the initial tax on the property and the credit available to the beneficiary would be calculated separately.

Income Currently Distributable

Income of a trust may consist of gifts or bequests, business income or property income. All such income should be subject to initial tax at the top personal rate of 50 per cent, unless the rate was reduced by reason of an election (as referred to below). However, a gift which was for the benefit of a member of the donor's family unit would not be regarded as income, and would not be subject to initial tax.

In Chapter 17 we recommend that where a gift arose on death it should be included in the donee's income at the time of actual or constructive receipt, but, in any case, not later than twenty-four months after the date of death. We also propose that if the identity of the donee was not known twenty-four months after the date of death, the gift should then be included in the income of the trust arising on death. If the gift was to be held in trust under the terms of a will, it should be included in the income of the trust at the time letters probate or letters of administration were obtained; but, in any event, not later than twenty-four months after the date of death.

If a trust received a gift which was distributable immediately to a member of the donor's family unit, or if a bequest was made to a member of the family unit of the deceased, the trust (or estate) and the beneficiary should file appropriate returns to establish this fact. In that case the trust would not be subject to initial tax and, upon receiving the gift from the trust, the beneficiary would not be subject to tax.

If a trust received a gift which was distributable immediately, or if a bequest was distributable immediately to a beneficiary who was not a member of the donor's family unit, it would be subject to tax. If a trust had income other than a gift, which was distributable within the same year, it would be subject to tax whether or not the beneficiary was a member of the donor's family unit. In both of these cases the trust would be liable to pay initial tax on the income at the rate of 50 per cent, unless an election was made as referred to below. The initial tax would be deemed to have been paid on behalf of the beneficiary as a withholding tax and accordingly the amount payable by the trust to the beneficiary would be reduced by the amount of the initial tax applicable thereto. On distribution, the beneficiary would include in his income the amount he received, grossed-up to include the initial tax, and would be entitled to a credit for the initial tax. In this way the treatment of trust income which was currently distributable would be similar to that provided for in the case of corporate income.

However, the imposition of an initial tax at the rate of 50 per cent might cause hardship if the beneficiary was taxable at a substantially lower rate, or if the income which was distributable was a gift consisting of property other than cash or marketable securities. Accordingly, a resident beneficiary should be entitled to file an election that the trust would not be subject to an initial tax at the 50 per cent rate on income which was distributable during the year to the beneficiary, and that he would be subject to tax on such income which was distributable to him. The income would be taxable in his hands on the same basis as if he had earned or received it directly rather than through the trust. The trust would, of course, be required to file a return reporting this income and the amounts distributable to beneficiaries in the year. The right to make an election of this kind would simplify the procedure for the trustee, for the beneficiary, and for the tax authorities. It would be analogous to an election by a corporation to be taxed as a partnership.

If a trust received dividend income, or if income was attributed to it by a Canadian corporation, the trust would normally be entitled to a credit for the 50 per cent corporation income tax. However, if an income beneficiary elected to be taxed directly on all of the income, the trust should not be entitled to this credit, but rather it should go directly to the beneficiary. Similarly, the trust would not be entitled to a refund in respect of withholding tax on interest income or to a credit for foreign tax on income from foreign sources. These amounts, as far as they were allocable to an income beneficiary who elected to be taxed on the income directly, would be credited to him. The amounts distributable to the beneficiary would be grossed-up to include the total amount of tax credits allocable to him, and he would be entitled to deduct these credits from the tax otherwise payable by him.

If property was settled in trust for the benefit of a minor, with power to the trustee to use the income of the trust fund or any part thereof for the benefit of the minor until he attained the age of 21 years, the income used for the benefit of the minor would be treated as his income. In most cases this would probably be taxed as part of the income of the family unit of which the minor was a member.

Income Accumulated

If a gift or bequest received by a trust was not distributable to any beneficiary in the year in which it was included in income, it would be subject to an initial tax in the hands of the trust unless it was to be held in trust for a member of the donor's family unit. Income other than a gift or bequest which was not distributable currently but was to be accumulated in the trust would also be subject to an initial tax in the hands of the trust. The initial tax would normally be at the top personal rate of 50 per cent. However, this may cause hardship if the property was to be held in trust over a long period, and if the ultimate beneficiary would be taxable at a substantially lower rate. The hardship would be such that it could not be adequately relieved by the eventual payment of interest to the beneficiary on the overpayment of tax. Accordingly, where there was a prospective beneficiary to whom the accumulated income would probably be distributed, the prospective beneficiary should be entitled to file an election that the initial rate payable by the trust would be the amount of additional tax which he would have paid if he had received the income directly.

For the purpose of applying these provisions, a person should be regarded as a prospective beneficiary under a trust only if the terms of the will or other trust instrument were such that he was likely to receive the trust property. On the other hand, it would seem unduly rigorous to require that the property be fully vested in him. We suggest that an individual should be considered a "prospective beneficiary" of an amount if it was indefeasibly vested in him or if the terms of the trust were such that he would receive the amount in question if he was living, not later than either of the following events (or than the later of the following events if both must occur):

1. On the death of an income beneficiary who was older than he by at least ten years.

2. On his attaining an age specified in the trust instrument not exceeding forty years.

This definition of a "prospective beneficiary" would provide a reasonable test of whether a remainderman would be likely to receive the corpus of the trust or a portion of it in the normal course of events. Sometimes the possession and vesting of an amount would be deferred until the death of an income beneficiary who would usually be a generation older than the remainderman. In other cases, possession and vesting would be deferred until the beneficiary reached a mature age, which ordinarily would not exceed forty years. While this definition may require some refinement in the legislation, generally speaking it would seem that a beneficiary who did not qualify under one or other of the tests suggested would have such a remote chance of obtaining the corpus that his tax rates should not be used in determining the amount of initial tax payable by the trust.

Where a prospective beneficiary was eligible to file an election it would be necessary for the trustee to report to him the amount of income accumulated for him. If the prospective beneficiary then filed the election, he would report to the trustee the amount of the additional tax which he, or his family unit, would pay if the trust income for the year which was not distributable in the year, but was accumulated, had been received by him. He would also file with the tax authorities a return showing his calculation of the additional tax. Most of this information would be derived from his regular income tax return or that of his family unit. The income of the trust for the year which was accumulated for him would be added to his regular income and the tax calculated. He should have the right to calculate the tax on a block averaging basis if he chose to do so, but not to assume that he had made any contribution to a Registered Retirement Income Plan or any deposit in an Income Adjustment Account unless he had actually made the contribution or deposit. The amount by which the tax so calculated exceeded his regular tax for the year would be the additional tax applicable to the trust income.

Where there were two or more prospective beneficiaries of a trust fund, the problem of arriving at an appropriate amount of initial tax would be more difficult. If their prospective interests were determinable, the income could be allocated among them in accordance with their interests for the purpose of permitting them to make elections and thereby to determine the amount of initial tax. If the interests of the prospective beneficiaries were not determinable, and there was a discretion as to which beneficiary would receive the fund, an election could be made only if all the beneficiaries made the election, and each calculated the additional tax which would have been payable if he had received the entire amount of the trust income. The trust would then pay initial tax equal to the amount of tax that would have been paid by the prospective beneficiary who reported the highest additional tax. Where a fund was being accumulated partly for a prospective beneficiary and partly for a person who did not qualify as a prospective beneficiary, the initial rate would be reduced below 50 per cent only in respect of the part of the income which under the trust instrument could be identified as being accumulated for the prospective beneficiary.

In some cases, a gift or other income would be accumulated in trust for members of a class which consisted of infants and might include persons who were unborn at the time the trust received the income. For example, it might be payable to all the children of a specified person who were living at a particular date. In such cases, no prospective beneficiary of any particular part of the income could be identified, but it might be quite possible to identify with reasonable certainty the family unit or units to which the members of the class belonged, or would belong if all of them were born. In such a case it would seem reasonable to allow that family unit to be treated as a prospective beneficiary and to elect that the initial tax would be the additional tax which would have been payable by the family unit if it had received the income.

We recommend in Chapter 17 that where a taxpayer received a gift consisting of property other than cash or marketable securities, the donee should have the option to pay the tax on the gift in instalments over five or ten years with interest. This provision should also apply with respect to the initial tax which would be payable by the trust in similar circumstances.

Alternative Election

We have considered an alternative solution to the problem which would arise because the 50 per cent rate of tax would be higher than that applicable to most taxpayers and would involve an overpayment of tax. Under this alternative, the trust would pay tax at the top personal rate of 50 per cent on gifts or bequests, and interest on an assumed overpayment of tax would be payable by the government to the beneficiary who was entitled to the annual income from the gift or bequest (referred to below as the "income beneficiary"). In many cases, the chief person to suffer from the payment of tax at an unduly high rate would be the income beneficiary, because the payment of the excess tax on the gift would reduce the fund which produced income. The remainderman would recover the overpayment when the trust fund was distributed to him. The income beneficiary would be compensated for the loss of income by requiring the government to pay interest to him each year at the rate of, say, 5 per cent or 6 per cent on the excess of the initial 50 per cent tax over the tax which would have been payable if the initial gift had been taxed as part of the income beneficiary's comprehensive tax base.

This solution would not give complete or adequate relief in all cases. A formula based on an assumed inclusion of the entire trust fund in the income beneficiary's income would often produce an unduly high tax rate, and would unduly reduce the amount on which interest was payable. The entire compensation for the imposition of an excessive rate would be payable to the income beneficiary, while the remainderman would be deprived of the opportunity for the appreciation in the value of the property which was applied in paying the excessive tax. The procedure would involve an enforced "loan" to the government. It could not be used where all or part of the current income of the trust was accumulated and was not distributable to any beneficiary.

These considerations make it clear that this procedure would not be adequate to provide relief in all cases. However, it would be useful in the case of some discretionary trusts where no prospective beneficiary of the gift or bequest could be identified and accordingly there would otherwise be no relief from the imposition of initial tax at the 50 per cent rate. It might also be equitable in the case of some trusts which had prospective beneficiaries, but where the protection of the income beneficiary was considered most important.

Accordingly, we suggest that this procedure should be available as an alternative which could be elected only if no election had been made by a prospective beneficiary to pay initial tax on the gift or bequest at a rate lower than 50 per cent. It could be elected by income beneficiaries who were entitled each year to receive, or have applied for their benefit, all of the annual income arising from the gift or bequest as computed either for tax purposes or for trust purposes. If such an election was made, each income beneficiary would be required to file an appropriate return to establish the amount upon which he was entitled to receive interest.

Gifts Held in Trust for a Member of the Donor's Family Unit

We recommend in Chapters 10 and 17 that where a gift or inheritance was received by a member of the family unit of the donor, it should not be subject to tax. By the same token, we recommend that no initial tax should be payable on a gift or inheritance to be held in trust for the donor's spouse or another member of his family unit. This would be the case as long as either all the income from the given property, as determined either for tax purposes or under trust law, was payable annually to members of the family unit, or a member of the family unit was the prospective beneficiary of the property.

Where all the income from the property given was payable to a member of the family unit, it is reasonable that no tax should be payable on the gift because the property would be used for the benefit of that member 5/. In view of the possible differences between the amount of income as determined for tax purposes, and the income as determined under trust law, it would be possible that an income beneficiary who was a member of the family unit would not be entitled to all of the income as determined for tax purposes. However, it would not be reasonable to impose tax on the property in these circumstances. Accordingly, we propose that no initial tax should be payable on the gift as long as one or more members of the donor's family unit received, or was entitled to receive, all of the income from the property as determined for tax purposes or all of the income as determined under trust law. The income beneficiaries would, of course, be subject to tax on the income from the property which was distributable to them.

If the prospective beneficiary of a gift was a member of the donor's family unit, the gift should likewise be free of initial tax, although income arising from the gift and property gains on the subject matter of the gift would not. If the donated property was ultimately distributed to that person while he was still a member of the family unit, the distribution would be tax free. Consistent with this treatment, the trust would not be treated as having made a disposition at fair market value at the date of the distribution.

If circumstances should change so that neither of the two conditions referred to above was present, the trust should be subject to initial tax on the donated property at that time. For example, if the prospective beneficiary was a dependent child, initial tax would become payable upon his ceasing to be a dependent child by attaining the age of twenty-one or otherwise.

Credit for Initial Tax at the Cumulative Average Rate

We have indicated that an amount distributed by a trust out of accumulated income should be included in the income of the recipient, unless it represented a gift to a member of the family unit of the original donor. Any initial tax paid by the trust on the amount distributed would be deemed to have been paid on behalf of the beneficiary as a withholding tax and accordingly the amount payable by the trust to the beneficiary would be reduced by the amount of the initial tax applicable thereto. The amount to be included in income would be the amount received, grossed-up to include the initial tax paid by the trust. The beneficiary would then obtain a credit for the initial tax and, if this credit exceeded his own tax liability, he would be entitled to a refund.

One problem arises from the fact that the trust may have paid initial tax on different parts of the accumulated income at different rates. In some years, tax may have been paid at the 50 per cent rate. In other years, elections may have been made by a prospective beneficiary to pay an amount equal to the additional tax he would have paid had he received the income. The rate at which this additional tax was calculated may have varied in the different years in which elections were made. A prospective beneficiary may have died after some income was accumulated and may have been replaced by another prospective beneficiary. The variety of possible circumstances, and of rates of initial tax, leads to the necessity of some reasonably simple but equitable formula for determining the rate of initial tax which would be available as a credit to a beneficiary who received a distribution of accumulated income.

We recommend that the gross-up and credit to such a beneficiary should be based on the cumulative average rate of initial tax paid by the trust on its accumulated income. The cumulative average rate would be determined by calculating the total income of the trust, other than currently distributable income, which had been subject to initial tax, and dividing this amount by the total initial tax paid thereon. When a distribution was made to a beneficiary out of accumulated income, the grossed-up amount included in his income and the initial tax for which he would receive credit would not be considered in any subsequent calculations of the cumulative average rate. It would be desirable for a trust to make this calculation year by year so that it would have a record of its accumulated income and of the initial tax it had paid on that income. No distinction would be made in this calculation between gifts and other income except that gifts accumulated for a prospective beneficiary who was a member of the donor's tax unit and which, therefore, would not have been subject to initial tax, would be kept in a separate account. If the initial tax paid had been unduly high or unduly low, this would be corrected when the distribution was made.

Tax Credits with Respect to
Dividends and Other Income

Dividends from Canadian corporations would be included on a grossed-up basis in the income of a trust, as they would be if received by any other taxpayer. In computing the initial tax, the trust would receive credit for the tax paid by the corporation. If the initial tax was lower than the credit for corporation income tax the trust should receive a refund in the same manner as any other shareholder. This treatment of dividends received by a trust is the same in principle as the one we propose for dividends received by a corporation. The chief difference in practice is that the trust's initial rate may be lower than 50 per cent, and that it therefore may be entitled to a refund.

A trust may receive income of various kinds which had already been subject to either Canadian or foreign tax and for which an individual recipient would be entitled to a tax credit. This would include dividend income as indicated above, interest income which had been subject to a withholding tax, and income from foreign sources which had been subject to foreign tax.

If the income was distributable in the year in which it arose, and the income beneficiary elected that it be taxed in his hands directly, the trust would not be entitled to a refund but would report the amount of the total tax credits to the income beneficiary. The income beneficiary would include these amounts in his income and would obtain credit for them against his tax.

If the income was accumulated, and the trust was subject to initial tax on the income, the trust would obtain the appropriate tax credits. If the credits exceeded the initial tax otherwise payable, the trust would be entitled to a refund of the excess. In computing the cumulative average rate of tax paid by the trust, the amount of the tax credits which had been applied in reducing the amount of initial tax payable would be deemed to have been paid by the trust as initial tax. In this way, the beneficiary would receive the appropriate credit when the accumulated income was ultimately distributed to him.

Losses

In our view, losses incurred by a trust should, as far as possible, be treated in the same manner as losses incurred by any other taxpayer. The treatment of property losses is discussed in Chapter 15 and the treatment of business losses is discussed in Chapter 22. However, in the case of a trust, certain special considerations have to be taken into account.

Where the income of a trust is payable to an income beneficiary and the trust fund will eventually be payable to a different beneficiary, any losses sustained by the trust will probably be borne by the remainderman rather than by the income beneficiary. However, under our proposals, the remainderman would not receive any immediate tax relief as a result of the losses. The losses would reduce the amount which he would ultimately receive from the trust and, in that way, would automatically be taken into account in computing the amount on which he was subject to tax. In the event that income was being accumulated in a trust, a loss incurred on the disposition of property or a business loss should be deductible from other income of the trust in the year of loss. It should also be available to be carried back for two years and forward indefinitely for the purpose of computing the amount which was subject to initial tax in the hands of the trust. In this way, such losses would be treated in much the same manner as losses incurred by a corporation or any other taxpayer.

If a trust received property by way of a gift or bequest which was subject to initial tax on the fair market value, this value would be the cost basis of the property to the trust. If the property was subsequently disposed of for more than this amount, the trust would have a taxable gain, but if it was disposed of for less than this amount the trust would have a loss. Where property, which was specifically identified as the property which had been subject to initial tax as a gift, was disposed of at a loss, it should be provided that the loss could be carried back for more than two years so as to reduce the initial tax on the gift.

Losses incurred by a trust from the holding of property should be treated in the same manner as similar losses incurred by any other taxpayer. At the option of the trust, these losses could be carried forward against operating income from the same property, or could be reduced by the amount of certain expenditures, related to the property, which would be added to the cost basis of the property in the hands of the trust. On the disposition of the property, the cost basis would be relevant in determining the amount of the gain or loss.

We considered whether there was any method whereby losses could be attributed to the beneficiaries and applied against their other income. However, except in the case of unit holders' trusts (referred to later in this chapter) which elected to file returns as partnerships, we do not think that this would be appropriate. The losses would affect the amounts which were distributed to the beneficiaries and, in this way, would be taken into account in computing their incomes when the trust property was distributed.

Benefits

Under the present Income Tax Act, tax is imposed in respect of:

> "The value of all benefits (other than a distribution or payment of capital) to a taxpayer during a taxation year from or under a trust, estate, contract, arrangement or power of appointment, irrespective of when made or created...." 6/

Under this section, a beneficiary is taxable on all benefits he derives from a trust. Examples of such benefits are not common, but money spent by the trustee to maintain residential property occupied by a beneficiary is one. We recommend that this type of provision be maintained in order to prevent avoidance. The amounts expended by the trust to provide such benefits should be deductible in computing that trust income which was subject to initial tax, because these amounts would in effect be distributions.

Reversions

A reversion is an interest which will come back to the donor when a limited interest in the trust property terminates and there is no remainder or other interest to follow. Also, if a trust instrument provides for a gift of a remainder interest in certain events, and those events do not happen, in the absence of a further gift there will be a reversion to the settlor.

If a settlor gives property in trust to provide income to designated beneficiaries, but retains a reversionary interest in the trust fund, the trust property will probably be subject to estate tax on his death under the present law 7/. Furthermore, the income from the trust property will be treated as his income under the Income Tax Act, 8/ even though it is payable to another beneficiary.

Many reversions are only intended to provide a sensible alternative provision if the principal gift fails. The difficulty in separating those reversions created for legitimate purposes and those created for tax avoidance has been set out as follows:

> "Contingencies of this nature may assume an infinite variety of shapes and forms to suit the need of the transferor. A stated contingency may represent a strong probability, and perhaps even a practical certainty, that the property will shortly return to the transferor. On the other hand, the possibility of regaining the property may be so remote as to be essentially non-existent. A general distinction might be made between contingencies which may reasonably be expected to occur and those which may not. Any such distinction, however, is too abstract to permit of efficient concrete application." 9/

Our proposals to pool the income of a family unit, to permit tax-free transfers within that unit, and to impose tax on a beneficiary outside the unit when he ultimately received a remainder interest would avoid many of the problems arising out of reversions under most tax systems. Most gifts involving reversionary interests are of a limited nature. The property would ordinarily be held in trust and the income would be paid to a beneficiary for his life or for a specified number of years. This beneficiary would properly be expected to pay tax on the income. If the property then reverted to the donor, the donee would only have paid tax on what he received 10/ .

We recommend that section 22(2) of the Income Tax Act which attributes the income of a trust to the settlor where there is a possibility of a reversion should be repealed. Under our proposals, the beneficiaries would pay tax on their interests in the trust fund and on the income from the fund. We consider this to be taxation according to ability to pay and therefore we do not recommend any special anti-avoidance provisions. Nevertheless, this is an area which should be kept under scrutiny to ascertain whether an unusual number of trusts, particularly *inter vivos* trusts with reversionary interests, were set up as a result of freer treatment of reversions and whether this resulted in any unfair avoidance of tax.

There is the further question of whether the donor who received a reversion of the property which he originally transferred to a trust should be taxed at all on the retransfer. We believe he should not, because no gift would have been made to another individual. The reason for not recognizing the retransfer in this case is both legal and equitable. Legally, there is no transfer on a true reversion; it is the intermediate interest which is considered as having been carved out of the entire interest. One may assume that reversions usually occur because of failures in the gifts intended and are thus not generally desired. Because there is no postponement of tax beyond the donor's power to postpone had he retained the property in his own hands, there is a good reason in equity not to levy tax on receipt of the reversion.

One exception to this treatment would arise if a reversion resulted from a renunciation or release by an intended donee after the expiration of the period of 90 days referred to later in this chapter. In this case, there would be a completed gift to the donee, and then a gift back to the original settlor.

If a donor made a gift to a trust so that, under the rules we have outlined, he would be an income beneficiary or a prospective beneficiary, the gift should be treated in the same way as if a member of the family unit of the donor was the prospective beneficiary. In this case, there would be no initial tax on the gift. However, if the terms of the trust were such that the donor was neither the income beneficiary nor a prospective beneficiary, the trust would be subject to initial tax on the normal basis.

If the property received by the donor on a reversion was the identical property which he transferred to the trust, he should receive the property at his original cost basis, and should not be regarded as having made any gain or loss. If the trust had paid initial tax on the gift, the donor would receive credit for this tax and would be entitled to a refund.

If the property received by the donor on a reversion was not the property he originally donated to the trust, the trust may have incurred a gain or a loss on the disposal of the original property or on the disposal of subsequently acquired property. If there had been a gain, it would have been treated as accumulated income of the trust and would have been subject to initial tax. Upon receiving the property, the donor would include in his income the accumulated income grossed-up to include the initial tax, and would be entitled to credit for the initial tax in the same manner as if the property had been received by another member of his family unit. However, as in the case of a gift which was distributed to a member of the donor's family unit, the trust would not be considered to have disposed of the property at its fair market value at the time of the reversion.

Taxation of Specific Kinds of Gifts

In addition to preventing deferment of taxation on gifts generally, and particularly on gifts in trust, it is our object to achieve and preserve neutrality in the tax treatment of various kinds of gift. There is a great difference in people's ability to give in different forms and at different times. In general, as income and wealth increase, there is a greater flexibility in the mode and timing of gifts. There appears to be definite correlation between the size of estates and the use of trusts. The major assets of many people in the lower wealth groups are equities in their homes and consumer durables which cannot readily be given during the owner's lifetime. Lower income groups have little or no margin of surplus income which would permit them to adopt a programme of planned _inter vivos_ giving. Under current law this is not so important because small estates are below the taxable level. Under our proposals, gifts from some small estates would be taxable in the hands of the donees, and it is important that no significant tax advantage should be gained by the mode and timing of gifts. At the same time, we should like to stress that the various forms of gift serve well-recognized purposes, and we have no wish that the tax system should either encourage or discourage any particular form of gift.

In order to illustrate the way in which our proposals seek to achieve neutrality, we first describe the manner in which a direct gift would be taxed, and then deal with gifts in trust where distribution of the trust fund is deferred, including the very important case of a life tenancy with a remainder interest. Our proposed tax treatment of direct gifts payable in instalments, such as annuities, pension, and life insurance payments, is described in Chapter 17.

Gifts To Take Effect Immediately. A gift *inter vivos* is usually given directly to the donee unless the property is to be held by a trustee. It would be included in the donee's income immediately, unless he was a member of the donor's family unit. However, all testamentary gifts are held in trust by executors or administrators until distributed. Inheritances are ordinarily held by an executor, administrator or trustee until the assets are realized and debts and inheritance taxes are determined and paid. If there are trusts to be administered, then the trustee of the estate holds the property under the terms of those trusts.

Where property was to be distributable as soon as the administration was complete, the beneficiaries would be ascertained. The beneficiaries would include the amounts received in their incomes, and would be entitled to a credit for the initial tax unless an election was made that no initial tax was payable. Thus, a beneficiary receiving a direct gift or legacy would pay tax at his personal rate after taking advantage of the averaging provisions. His net position should be the same as a donee receiving a direct gift *inter vivos*, as discussed in Chapter 17.

Annuities. Our recommended tax treatment of gifts of annuities where the capital has been provided by the donor prior to death, either by outright purchase, or under pension or other plans, is described in Chapter 17. However, an annuity may be provided under a will or a trust. It may be payable out of current income or out of accumulations. An annuity paid out of a trust would be treated under our proposals in the same way as any other amount paid to an income beneficiary or a remainderman, as the case may be. The annuity would be included in the income of the annuitant when received. However, if the annuitant was a member of the donor's family unit, only the portion derived from income arising after the gift had been made to the trust would be subject to tax. Where the trust had paid an initial tax, the amount received by the annuitant, or the income portion in the case of a family unit member, would be grossed-up to include the initial tax and the annuitant would receive credit for the tax.

Powers of Appointment and Encroachment. An individual may be given a power under a trust instrument to encroach on property for his own benefit or to appoint the property to himself or others. There are many variations in the terms of such powers and the ways in which they can be exercised. We propose a rule in Chapter 17 for dealing with these powers: where an individual was given a power of appointment or a power of encroachment which would give him the right to apply property for his own use in his lifetime, he would be regarded as having received the property when the power became exercisable, unless he irrevocably renounced or released the power within 90 days after he became aware of it or after it became exercisable, whichever was later. The property would not be included in his income unless the power was exercisable by him alone without the concurrence of any other person. If his right to apply the property for his own use was not exercisable immediately, the property would not be included in his income until the power became exercisable.

The individual could avoid the receipt of income by renouncing the power at any time before it became exercisable, or within 90 days thereafter. If a person had a power of appointment but was not entitled to apply the property for his own use during his lifetime, the property would not be included in his income, but would be included in the income of the person in whose favour the power was exercised.

Under this rule, property would be considered as distributable to the person holding the power when he became entitled to apply it for his own use and benefit. If he was a member of the donor's family unit, he would not be subject to tax on any portion of the property which consisted of a gift from the donor, although he would be subject to tax upon any portion of the property which represented income arising after the date of the gift.

If trust property was treated as distributable to a person having a power of encroachment or a power of appointment, it should not be regarded as part of the trust property for tax purposes, but rather as property belonging to the person having the power. If, before the power was exercised, the property produced income, such income should be regarded as the income of the person having the power. If the income was paid to another beneficiary outside his family unit, it would be included in the other beneficiary's income as a gift. If the power was subsequently exercised in favour of some other person this would be treated as a gift by the person exercising the power to the person in whose favour it was exercised. If the power was not exercised there would, nevertheless, be a gift from the person having the power to the person taking the property under the trust instrument.

Renunciation or Release. Renunciation and release are very similar and reflect the fact that a person is not required to accept a gift. A person may renounce or release a gift. In the first case, there is no completed gift; in the second case, there is a completed gift, and the property will be transferred according to the terms of the original gift but will either revert to the donor or will pass to some other person if provision has been made for this contingency in the original gift instrument.

The question which arises is whether such an act of release constitutes a transfer in itself or whether the transfer really springs from the original gift. In other words, should taxation be levied as if the person effecting the release had owned the property outright and had disposed of it by gift. The present Estate Tax Act makes a release a "disposition" in certain circumstances and therefore taxable as "property passing on death" 11/.

In our view, this question should be determined in accordance with the rule we have proposed for dealing with powers of appointment and of encroachment. If the terms of the instrument were such that the intended donee would be entitled to possession of the property for his own use, it should be regarded as distributable to him unless he renounced or released his rights within 90 days after he became aware of them or after his right to obtain possession arose, whichever was later. There should be no distinction in this regard between a renunciation and a release. If the intended donee renounced or released his right after the expiration of this period of 90 days, he should be regarded as having received the property and then given it to the person to whom the property reverted or passed, and tax would again be imposed on that person.

Remainder Interests. Because our proposals would require the trustee to pay an initial tax on amounts transferred to the trust, and would tax beneficiaries at personal rates on trust interests as they fell into possession, with credit for the initial tax, there would be no need to deal with contingent remainders differently from vested remainders. Both would be included in the beneficiary's income when distributed, unless excluded from income under the rules we have already discussed. This would achieve simplification of the rather complex provisions now required for payment of estate taxes and succession duties on remainders or expectant interests. This rule would also apply to deferred gifts where there was no life or other income interest. We recommend that remainder interests, whether vested or contingent, and deferred interests of all kinds should be included in the tax base in the year in which the property was received. The beneficiary would gross-up the amount received at the initial rate of tax paid and would receive a credit at the same rate which would be deductible from his tax. If the credit exceeded his tax, he would be entitled to a refund.

In many cases, the widow or widower of the donor would be entitled to the income of the trust and no initial tax would be payable on the gift to the trust. On the death of the income beneficiary, the estate would probably be distributable, and would be taxed in the hands of adult children or other beneficiaries. However, it may not be immediately distributable and, accordingly, it should become subject to initial tax upon the death of the income beneficiary. However, if all or any part of the trust fund was distributable to a resident beneficiary in the year in which initial tax became payable, the trustee and the beneficiary should be entitled to file an election that the trust would not be subject to initial tax, and that the beneficiary would be subject to tax on the amount distributable to him.

Income-Splitting and
Attribution of Income

In the past, trusts have sometimes been used as vehicles for income-splitting and sections 21 and 22 of the Income Tax Act attribute to the settlor the income from property transferred by means of a trust to a spouse, to minors under 19, or to anyone if the settlor of the trust reserves benefits to himself.

Under our proposals, where property was transferred to a trustee, and the income beneficiaries were a spouse or minor children of the donor, there would be no need for income attribution provisions because the income would be aggregated with that of the family. However, if the beneficiary of the income arising from the gift was a child who had opted out of the family unit or a spouse who had elected to file a separate return, the income might be taxable at a low rate. At the same time, if the donor or a member of his family unit was the prospective beneficiary of the gift itself, the gift would not be subject to tax. To prevent this possible abuse, we recommend that where property may revert to the settlor or a member of his family unit and the income from the property was payable to a dependent child who was eligible to be a member of his family unit but had filed a separate return, the income should not be taxed to the latter but rather to the settlor.

We have concluded that, except in this one case, we should not recommend special provisions to attribute income of short-term trusts to the settlor. Section 22(2) of the Income Tax Act now applies to all transfers in trust where the donor retains a right to have the property revert to him. Section 22(2) also attributes income to the settlor of property where he retains certain powers or benefits. It is our view that this provision should be repealed. If the settlor had an immediately exercisable power to reclaim the property it would be regarded as belonging to him under the provisions relating to powers of appointment and powers of encroachment. In this event, the income should be regarded as his income, and if it was distributed to someone else it would also be included in the income of that person as a gift. If the settlor did not have such a power, we do not think any provision would be necessary. However, this area should be kept under observation, and this conclusion should be reconsidered if a large number of trusts were created to reduce the applicable rates of tax on property income.

Multiple Trusts

Under the present law, an overall reduction in tax may be sought by creating a number of trusts and transferring the sum to be given equally to all the trusts—all of which have the same or similar beneficiaries. Each trustee pays tax as if each individual trust were a separate person and thus at a lower rate than if all the incomes were aggregated. Section 63(2) of the Income Tax Act seeks to prevent this by giving the Minister power to aggregate the income of one or more trusts where substantially all the property is received from one person and the trusts are for the same beneficiary or group of beneficiaries. However, this provision suffers from being both too broad and too narrow. It provides for the exercise of ministerial discretion, something which should be avoided where possible, and the conditions of application are too narrow to meet all the cases where avoidance may be in issue.

For three reasons, the opportunity to transfer income-producing property so that the income flowed to someone who was taxed at a lower rate than the transferor would be substantially lessened under our proposed system. First, under the family unit concept, the income of the members of a family would usually be aggregated rather than split. Second, a recipient of transferred property who was outside the donor's family unit would be taxed on the value of the property given to him. This would narrow the advantage of income-splitting. Third, the income of a trust would be taxable either at the top rate of 50 per cent or at the personal rate of the beneficiary or prospective beneficiary. If the beneficiary was entitled to income from a number of trusts, or if income was accumulating for him in a number of trusts, these would all be aggregated in determining the amount of additional tax which would be payable on the income as an alternative to tax at the 50 per cent rate.

For these reasons, under our proposals it should not be possible for rates of tax to be reduced by the use of multiple trusts. We believe that the method of taxation of accumulated trust income that we propose would be of broader scope than section 63(2), and would avoid the use of ministerial discretion. Accordingly, no provision such as section 63(2) would be necessary.

Exempt Trusts

Under the present law, a trust is exempt from income tax in some circumstances. The trusts which are now exempt are charitable trusts and trusts established under registered retirement savings plans, pension plans, and certain other types of employee benefit plans. Generally speaking, we think that this treatment should be continued.

In Chapter 20 we discuss the proposed treatment of charitable trusts, and recommend their continued exemption from tax, subject to certain qualifications.

In Chapter 16 we discuss our proposed treatment of Registered Retirement Income Plans. If a trust was established to fund a Registered Retirement Income Plan, and the plan retained its registration, it should be free of tax. The beneficiary or beneficiaries would likewise be free of tax until they actually received benefits from the trust.

Exempt Beneficiaries

In some cases, the beneficiaries of a trust may include a charity or some other tax-exempt body. If current income was distributable to an exempt organization, that income would be free of tax, unless the income was from a business or an investment of a kind which would render it taxable under the rules discussed in Chapter 20. Similarly, if a gift was made in trust with a provision that all of the income as calculated for either tax purposes or trust purposes was payable to an exempt organization, there should be no initial tax upon the gift until the income ceased to be so payable. This is consistent with the treatment which would be applicable if the income beneficiary was a member of the donor's family unit. Similarly, if an exempt organization was a prospective beneficiary of a gift or other income which was accumulated, that income should not be subject to initial tax. However, an exempt organization should only be regarded as a prospective beneficiary if the property was indefeasibly vested in it.

If an exempt organization had only a contingent interest in a trust fund, initial tax should be payable by the trust in the usual way. If property which had been subject to initial tax was received by the exempt organization, the organization would receive credit for the initial tax in the same way as any other taxpayer and would be entitled to a refund.

Business and Investment Trusts, Including
Unit Holders' Trusts

In this chapter we have referred mainly to trusts arising on death or created by an inter vivos gift for the benefit of the donor's family and other beneficiaries. Such a trust may carry on business or may derive its income from property. The basic method of taxing such trusts and their beneficiaries should be generally the same regardless of the source of income, except that a gift or bequest for the benefit of a member of the donor's family unit would be treated differently from other income.

Business income, as well as other income, should be taxed consistently, without regard to the form of organization earning the income. Our proposals for the taxation of trusts are analogous to those for the taxation of corporations and co-operatives, subject to the necessity of some differences in treatment to take account of the nature of the interests of trust beneficiaries. Income of a trust which was currently distributable would be subject to tax at the rate of 50 per cent, but a beneficiary to whom such income was distributable could elect to pay tax at his personal rate, in which case the initial tax would not be payable. This election is analogous to an election that a corporation may be taxed as a partnership. Income accumulated by a trust would likewise be taxable at the 50 per cent rate, subject to the fact that in most circumstances a beneficiary would be entitled to make an election which would mitigate the burden of this tax.

While we have proposed that a corporation should be entitled to allocate its income to the shareholders who would then be entitled to refunds where applicable, we have not provided for a similar allocation to beneficiaries of trust income which was not distributable currently but was accumulated. The reason for this is that the interests of beneficiaries are often contingent or dependent upon future events so that it would often be impossible to make any appropriate allocation. Instead of providing for such an allocation, which would often lead to capricious results, we have provided for an election under which, in some circumstances, the trust would pay tax on accumulating income at a prospective beneficiary's rate rather than at 50 per cent.

Trusts are sometimes formed specifically for the purpose of carrying on a business, or for carrying out a project, or for the purpose of investment. Such a trust (which we refer to sometimes as "business trusts") is similar to a partnership, syndicate, or corporation. In Canada, business trusts have principally been used for investment, for example in mutual funds, and for joint investment in real estate by small groups. The legal nature of these trusts is discussed in Appendix C to this Volume.

There are distinctions between a business trust and a trust created by a donor for personal distribution of his property. The funds or property of a business trust are usually supplied by those who are the beneficiaries or unit holders and the powers of the trustee are tailored to their interests. In a personal trust, the donor and the beneficiaries are usually different and the trust reflects the wishes of the donor rather than of the beneficiaries.

Interests in business trusts are often issued as "units" of the trust and these units are often transferable. Sometimes they are redeemable by the trust, often at the request of the unit holder. Units of this kind are analogous to shares of a corporation. Our general proposals for the taxation of property gains would require that any gains or losses realized on the disposal or redemption of a trust unit or of any other interest of a beneficiary in a trust should be taken into account in computing the income of the unit holder or other beneficiary. Also, any costs incurred in acquiring an interest in a trust would be deductible by the beneficiary on disposal or realization of that interest.

Where a trust has issued transferable or redeemable units, each of which carries a specific undivided interest in the trust property and the trust income, the trust should be taxed in the same manner as a corporation. This means that the trust would be subject to initial tax at the rate of 50 per cent unless it elected to be taxed as a partnership. Income distributed to the beneficiaries would be treated in the same manner as dividends. The beneficiaries would gross-up the distribution to include the initial tax and would be entitled to credit for the initial tax. We refer to this type of trust as a unit holders' trust.

A unit holders' trust should be entitled to allocate income even if the income was not distributed in the year. Such an allocation would operate in the same way as one made by a corporation. The unit holders would include the grossed-up amounts allocated to them in their incomes, and would be entitled to credit for the initial tax and to a refund where applicable. In addition, the amounts allocated to each unit holder would be added to the cost basis of his unit and in this way would be taken into account in computing the gain or loss realized by him on the disposal or redemption of the unit.

Where the circumstances were such that a corporation would be entitled to elect to be taxed as a partnership, a unit holders' trust would be entitled to make a similar election. If such an election was made, the trust would not pay an initial tax, but the income would be treated as having been earned by the unit holders. Similarly, if the trust should incur a business loss or a loss on disposal of property, the unit holders would be entitled to deduct their portions of the losses in computing their incomes.

Residence of Trusts

Residence has been the principal jurisdictional test for income tax in Canada. In the case of a trust, this test is sometimes difficult to apply. The best view seems to be that a trust has the same residence as the trustee. Although the residence of the controlling trustee is a factor from which the residence of the trust can clearly be determined in most cases, in some circumstances it can cause great difficulty. Thus, if there are two trustees in equal control, residing in different countries, is the trust to be regarded as resident in each country? Even more difficult would be a case of three trustees in three jurisdictions subject to a direction that the majority of the trustees govern. Theoretically, there could be a trust with any number of trustees in any number of countries. It is quite possible for an individual or a corporation to be resident in two or more countries at the same time. A corporation may have dual or multiple residence where its central management and control is divided between two or more jurisdictions. This is presumably also true in the case of a trust.

We have considered a number of other bases for jurisdiction over trusts but have decided that the test for jurisdiction should continue to be primarily the residence of the trustees. The definition of residence should, of course, be stated as precisely as possible to enable the taxing jurisdiction to be readily determined. Therefore, without formulating a hard and fast rule, we suggest that a trust should be taxed as a Canadian resident in either of the following circumstances:

1. When the trustees, a majority of the trustees, or a controlling group of the trustees are resident or ordinarily resident in Canada.

2. When a trust carries on substantially all of its business in Canada or where substantially all of its property is situated in Canada.

All trust companies handling trust business in Canada must be incorporated either federally or provincially and therefore, under the present Act, they are regarded as resident in Canada if they are incorporated here 12/. Therefore, trusts with Canadian corporate trustees would be resident in Canada. It may be desirable, however, to exempt from Canadian jurisdiction trusts created by non-residents where it was principally the management abilities of Canadian trust companies which were sought. Accordingly, we recommend that a trust administered by a Canadian incorporated trustee should not be a resident of Canada for a taxation year, if the trust received substantially all of its property from a non-resident of Canada, all, or substantially all, of the assets were situated outside Canada, and all, or a majority, of the beneficiaries were non-residents.

We recognize that the residence test alone would not prevent avoidance, but we expect the fruits of avoidance to be denied by other measures which we propose to prevent leakage of tax revenue. These measures include withholding taxes on property income paid to non-residents, on gifts made to non-residents, and on property gains deemed to have been realized when a taxpayer ceased to be resident in Canada. Our specific recommendations for taxing payments from trusts to non-residents and payments to non-resident trusts are dealt with in Chapter 26 and later in this chapter.

We also recommend that where any of the beneficiaries of a non-resident trust were resident in Canada, the trust and the beneficiaries should be entitled to elect that the trust would be taxed as being resident in Canada. This is consistent with our view that a trust is an intermediary and that the persons bearing the tax are the beneficiaries. Such an election would permit the trust to pay initial tax on its income by reference to the rates of tax of the beneficiaries, where this was appropriate under our proposed rules. In making such an election, the trust would be required to file returns and to pay taxes as a Canadian resident, and to supply all information and records necessary for the assessment of its returns. It would also have to submit to the jurisdiction of the Canadian courts.

Change of Residence of Trust

It is possible that the residence of a trust may change, either because trustees change their residence or because of a change in trustees. The rules applicable where a resident trust became non-resident, or where a non-resident trust became resident, should be consistent with the rules applicable to changes in residence of other taxpayers. However, trusts present special problems, because their tax liability depends to some extent on the residence of the beneficiaries.

If a trust which was resident in Canada became non-resident, there should be a deemed realization at the fair market value of all trust property. This is the same rule that would apply to any taxpayer as explained in Chapter 15. If the beneficiaries were resident in Canada, the trust should also be required to pay sufficient additional tax on any accumulated income on which initial tax had been paid to bring the total initial tax up to 50 per cent of that income. These provisions which seem necessary to prevent tax avoidance, would not be unfair, because the trust could avoid the deemed realization and the additional tax by electing to continue to be taxed as a resident trust.

If a non-resident trust became resident in Canada, it would be entitled to have its property valued so as to establish a cost basis. This is the same right any other taxpayer would have on becoming a resident. If there were Canadian resident beneficiaries, the trust should be required to pay initial tax at the 50 per cent rate on accumulated income which would have been taxable if the trust had been resident, subject to the elections noted above in the case of property held for resident prospective beneficiaries. However, in computing this tax the trust should be entitled to credit for Canadian withholding tax paid on any income received from Canadian sources, and not previously distributed, and for foreign tax up to a maximum rate of 30 per cent on any undistributed income which it received from foreign sources. The trust, however, should not in any case be entitled to receive a refund as a result of these credits.

Income from Foreign Sources

Where a trust received income from foreign sources, it should be entitled to a credit for the foreign tax on that income. We recommend that this type of income should be taxed to a trust in the same manner as to a corporation or an individual, and that the credit should be so calculated 13/. Thus, the trust would be regarded as having paid the applicable foreign tax as part of the initial tax, so that the beneficiaries would obtain the appropriate credit on either the current income or the accumulated income distributed to them.

In the event that an election was filed under which income distributed currently was taxable in the hands of the beneficiaries, rather than subject to initial tax in the hands of the trust, the beneficiaries would be entitled to a tax credit in the same way as if they had received the income directly, except that all of the holdings of the trust in a foreign corporation would be taken into account in determining whether the income was from direct foreign investment. This is consistent with the treatment which would be accorded to a corporation which elected to be taxed as a partnership.

Payments to Non-Resident
Beneficiaries

There is evidence that there has been substantial tax avoidance through the provisions relating to the payment of trust income to non-resident beneficiaries. Such payments were normally deductible in computing the trust income and were subject to withholding tax at the rate of 15 per cent. In 1965, section 63(4b) of the Income Tax Act was enacted to prevent this type of avoidance. Prior to the enactment of this provision, a resident trustee could carry on a business and pay the income to a non-resident beneficiary subject only to a 15 per cent withholding tax. In computing the income of the trust, the trustee could deduct the amount paid and thus pay no other tax. If the non-resident beneficiary was a corporation resident in a tax-haven country and its shares were owned by a Canadian corporation, it could declare a dividend to its Canadian parent which would be free of immediate tax under section 28(1)(d). Section 63(4b) now denies the deduction to the trustee where income from a business carried on in Canada is payable to non-residents and certain others. However, this provision does not prevent a similar type of avoidance in the case of investment income. Under our proposals, this type of tax avoidance would not be possible. In Chapter 26 we recommend the repeal of section 28(1)(d). We also recommend changes, outlined below, in the taxation of trust income paid to non-resident beneficiaries.

We propose that income of a trust, other than gifts or inheritances, should be taxed in much the same way as corporate income. If distributable to a non-resident, or accumulated for the benefit of a non-resident, it should be subject to initial tax at the rate of 50 per cent, except that income from direct foreign investment would be taxable at 30 per cent less the allowable foreign tax credit, which would be deemed to have been paid as initial tax. The initial tax would also, of course, be reduced by any credits to which the trust was entitled in respect of dividend income from Canadian corporations. Upon payment being made to the non-resident, the recipient would not be entitled to any credit for the initial tax, and there would be a further withholding tax at the rate applicable to dividends. This would mean that most trust income, excluding gifts and income from direct foreign investment, would be taxable at a combined effective rate of 55 per cent or 57.5 per cent, that is, 50 per cent plus 10 per cent or 15 per cent of the remaining 50 per cent.

Where income of a trust was payable in the year to a non-resident, the combined effective rate of 55 per cent or 57.5 per cent might create hardship in some cases. If the non-resident had received interest or rental income directly rather than through a trust, the rate of tax would have been 30 per cent, or possibly less by reason of an international tax convention. If the non-resident received foreign income, no Canadian tax would be payable. However, if the non-resident received dividend income from a Canadian corporation, it would have been subject to a 50 per cent corporation income tax and the net amount payable would have been subject to a withholding tax of 10 per cent or 15 per cent, and accordingly the corporate income would have been subject to a combined effective rate of 55 per cent or 57.5 per cent. In order to avoid distorting the tax position of a non-resident by reason of the interposition of a trust, it should be provided that a non-resident who received income from a Canadian trust in the year it was earned, may elect that instead of the normal 50 per cent initial tax and the withholding tax, the income payable to him would be subject to the same withholding taxes which would have been payable if his allocable share of the income of the trust from each source had been paid to him directly. The initial tax would be applied against these withholding taxes and any excess would be refunded to the non-resident.

The same principle might be followed with respect to income accumulated for a prospective beneficiary who was a non-resident. If such a prospective beneficiary filed the appropriate election, the initial tax would be adjusted to the amount of tax which would have been payable if the income accumulated for him had been paid to him.

The treatment of gifts and bequests also creates a problem, because a combined effective rate of 55 per cent or 57.5 per cent would be unduly high as applied to gifts and bequests to non-residents. We have recommended that gifts made to non-residents directly, and not through a trust, should be subject to initial tax at the rate of 30 per cent, assuming the donee was not a member of the donor's family unit. Accordingly, we propose that in the case of gifts or bequests which were distributable to a non-resident, or were accumulated for the benefit of a prospective beneficiary who was a non-resident, the initial rate should be 30 per cent. If a gift or bequest had been subject to an initial tax at 50 per cent because the beneficiary was unascertained, and if the gift or bequest subsequently became distributable to a non-resident, the tax should be adjusted to 30 per cent and the trust should obtain a refund. If initial tax had been paid at a rate lower than 30 per cent, upon the gift becoming distributable to a non-resident, the trust would pay sufficient additional tax to bring the total up to 30 per cent. The distribution would not be subject to any further withholding tax.

To the extent that a distribution was made out of accumulations which had accrued prior to the effective date of the legislation, it should be free of withholding tax, because distributions to non-residents out of the capital of a trust are not now subject to withholding tax. Such amounts may include gifts or bequests which have been subject to gift tax or estate tax under the present law, accumulated income which has been subject to income tax, or capital gains which under the present law have accumulated on a tax-free basis.

To apply the appropriate rates, it would be necessary to provide an order of distribution. In the case of distributions to non-residents, the usual order of distribution discussed earlier in this chapter would have to be modified to distinguish between payments out of ordinary income of the trust and distributions of gifts received by the trust. We propose that where a fund consisted partly of gifts received after the effective date of the legislation and partly of other income earned after that date, distributions would be regarded as having been made first out of ordinary income and then out of gifts. If the trust had property on hand at the effective date, any remaining distributions would be considered to have been made out of that property.

Future Development of Trusts

Because trusts are often complex and are capable of infinite variety, the provisions we have suggested for dealing with them are necessarily complex. Under the present law, trusts have in many instances been complicated by the desire to minimize or avoid taxes. We think this would be less likely to occur under our proposals. The recognition of tax-free gifts to a member of the donor's family unit would eliminate the incentive to establish trusts in many cases. This should reduce the number of trusts which were established.

Most trust income now is distributed currently rather than accumulated. Our proposals should prevent the gaining of any income tax advantage from the accumulation of income, so that less income would likely be accumulated. New trusts would probably be designed in such a way as to facilitate allocations of income to income beneficiaries or prospective beneficiaries. Accordingly, there should be relatively few cases where hardship would result from the imposition of initial tax at a 50 per cent rate.

CONCLUSIONS AND RECOMMENDATIONS

1. A trust is an intermediary. It and its beneficiaries should therefore be taxed in a manner analogous to that applicable to corporations and co-operatives and their shareholders and members. Tax liability should be measured by the ability to pay of the beneficiaries rather than that of the trust, but provisions would be required to prevent deferment of the tax liability.

2. The income of a trust, calculated in the same way as the income of any other taxpayer and including gifts and bequests, should be subject to an initial tax for which the beneficiaries (other than non-residents) would receive credit. The initial tax would be at the top personal rate of 50 per cent, subject to the following special provisions:

   a) If the income consisted of a gift or bequest, as long as the prospective beneficiary was a member of the donor's family unit or all the income from the donated property as determined either for tax purposes or trust purposes was distributable to members of his family unit, no initial tax would be payable on the gift or bequest.

   b) A resident beneficiary, to whom income was distributable in the year in which it would be included in the income of the trust, would be entitled to elect that he, rather than the trust, would be subject to tax on that income. Where such an election was made the trust would not be entitled to a refund of tax in respect of dividend income, interest income, or foreign income which was distributable to the beneficiary who made the election, but that beneficiary would be entitled to a credit for his allocable portion of the amount.

c) If a gift was accumulated in a trust for a prospective beneficiary who was resident in Canada but was not a member of the donor's family unit, or if other income was accumulated in a trust for any prospective beneficiary who was resident in Canada, the prospective beneficiary could elect that the initial tax would not be at the rate of 50 per cent, but would be the amount of additional tax which would have been payable by the prospective beneficiary if he had received the income directly.

d) If a gift was accumulated in a trust for a prospective beneficiary who was not a member of the donor's family unit and no election was made under paragraph (c), or if a gift was accumulated in a trust in such circumstances that there was no prospective beneficiary, the initial tax would be at the rate of 50 per cent. But an income beneficiary who was entitled to all the annual income from the accumulation would be entitled to elect that he would receive interest from the government each year at the rate of, say, 5 per cent or 6 per cent on the amount by which the 50 per cent tax exceeded the additional tax which would have been payable if the initial gift which produced the income distributable to him had been taxed as part of his comprehensive tax base.

e) As is indicated in Chapter 26, the initial tax on income from direct foreign investment would be at the rate of 30 per cent rather than 50 per cent. This tax may be reduced by a foreign tax credit, but in that event initial tax would be deemed to have been paid at 30 per cent.

3. An individual would be a prospective beneficiary of an amount if it was indefeasibly vested in him or if he would be entitled under the

trust instrument to receive the amount, if he was living, not later than on the death of an income beneficiary who was older than he by at least ten years, or on his attaining a specified age not exceeding forty years, or on the later of these events if both conditions were applicable.

4. If specific property or a specific fund was required to be kept separate from other assets of a trust, the property or fund should be regarded as a separate trust for the purpose of calculating initial tax and for the purpose of determining the tax credit to which the beneficiary would be entitled.

5. Losses would be taken into account in computing the amount subject to initial tax on the same basis as in the case of any other taxpayer. If a trust received property by way of gift or bequest which was subject to initial tax at the fair market value, a loss incurred on the disposal of the specific property could be carried back for more than two years if necessary so as to reduce the initial tax.

6. When property was distributed to a beneficiary, the trust would be deemed to have disposed of the property at its fair market value and any resulting gain or loss would be taken into account in computing the initial tax, unless the property was a gift which was distributed to a member of the donor's family unit.

7. A beneficiary would include in his comprehensive tax base all amounts which became distributable to him from a trust in the year whether out of income or corpus. This would be subject to the following exceptions:

   a) A gift to the trust which was subsequently distributed to a member of the family unit of the donor would not be included in his income.

b) Amounts distributed out of trust assets on hand at the effective date of the legislation would be tax free. Property gains which had accrued in the trust up to the effective date would be free of tax to the same extent as similar gains of any other taxpayer.

8. Amounts distributable to beneficiaries in a year would be considered to have been paid out of trust assets in the following order:

   a) Out of income of the trust for the current year.
   b) Out of accumulations on which the trust had been subject to initial tax.

   c) Out of gifts which were free of initial tax because they were received for the benefit of a member of the donor's family unit.

   d) Out of property on hand at the effective date of the legislation.

9. The initial tax on any income would be deemed to have been paid by the trust on behalf of the beneficiary who ultimately became entitled to the income, in the same way as a withholding tax. Accordingly, the amount which he would be entitled to receive from the trust would be reduced by the amount of the initial tax deemed to have been paid thereon.

10. Where amounts were distributable to a resident beneficiary out of current income which had been subject to initial tax, the amounts included in the beneficiary's income would be grossed-up to include the initial tax thereon. He would receive credit for such initial tax and if it exceeded his tax otherwise payable he would be entitled to a refund of the excess.

11. Where amounts were distributable to a resident beneficiary out of

accumulated income of a trust which had been subject to initial tax, the amount included in the beneficiary's income would be grossed-up to include the initial tax thereon, and he would receive credit for such initial tax and a refund if applicable. The gross-up and credit would be based on the cumulative average rate of initial tax paid by the trust which would be determined by calculating the total accumulated income of the trust which had been subject to initial tax and by dividing this amount by the total initial tax paid thereon. This calculation would be made in each year in which distributions were made out of such accumulated income. The grossed-up amount of such distributions, and the initial tax for which beneficiaries received credit in the year, would be removed from consideration in making subsequent calculations of the cumulative average rate.

12. Benefits provided to a beneficiary otherwise than on a distribution would be included in the beneficiary's income.

13. If a donor was a beneficiary, he should be treated in the same way as a member of his family unit and the same consequences should follow. If property given by the donor reverted to him, he should not ordinarily be regarded as having made any gain or loss. If he received in return substituted property, he would be subject to tax on any gains made by the trust, but there would be no deemed disposal at fair market value by the trust when he received the property from the trust.

14. If an individual was given a power of appointment or a power of encroachment which would give him the right to apply property for his own use, he would be regarded as having received the property upon the power becoming exercisable, unless he irrevocably renounced or released the power within 90 days after he became aware of it, or after it became exercisable, whichever was the later. If he did not so renounce or release the power, and the property subsequently

passed to another person on the exercise of the power or under the trust instrument, he would be regarded as the donor of the property to the ultimate recipient. The income from the property would also be regarded as his income, and if it was paid to another person, it would be regarded as having been given by him to that person.

15. If an individual was a beneficiary under more than one trust, the income distributable to him or accumulating for his benefit under all the trusts should be taken into account in determining the additional tax payable under any election which he made. Because, under our proposals, it should not be possible to avoid or to defer tax or to split income through the use of multiple trusts, there would be no necessity for provisions such as sections 22(2) and 63(2) of the Income Tax Act. There would be an exception to this if the property may revert to the donor or a member of his family unit, and the income was distributable to a dependent child who was eligible to be a member of his family unit but had filed a separate return.

16. Where units were issued by a trust, any gains or losses realized on the disposal or redemption of a unit should be taken into account in computing the income of the unit holder. This would also be true in the event that an interest in a trust was disposed of by any beneficiary. If a beneficiary had incurred costs in acquiring an interest in a trust, they would be deductible in computing his gain or loss.

17. If a trust issued transferable or redeemable units, each of which carried a specific undivided interest in the trust property and the trust income, the trust and the unit holders should be taxed in the same manner as a corporation and its shareholders. Initial tax should be at the rate of 50 per cent, unless the trust elected to be taxed as a partnership. Unit holders would receive credit for the initial tax with respect to amounts distributed or allocated to them.

18. A trust should be taxed as a Canadian resident if a majority of the trustees or a controlling group of the trustees were resident in Canada, if the trust carried on business in Canada, or if substantially all of its property was situated in Canada. If any of the beneficiaries of a non-resident trust were resident in Canada, the trust and the beneficiaries would be entitled to elect that the trust would be taxed as being resident in Canada.

19. If a resident trust became non-resident, there should be a deemed realization at the fair market value of all trust property, and the trust should be required to pay sufficient additional tax on accumulated income to bring the total initial tax up to 50 per cent of that income.

20. If a non-resident trust became resident in Canada, the cost basis of its property would be the fair market value at that time. If the trust had Canadian resident beneficiaries, it should be required to pay initial tax at the 50 per cent rate on accumulated income, subject to credits for Canadian withholding tax and foreign tax previously paid.

21. Income distributable to non-resident beneficiaries, except income consisting of gifts or inheritances or income from direct foreign investment, would be subject to initial tax at the rate of 50 per cent, and the net amount distributed would be subject to a further withholding tax at the same rate as was applicable to dividends. However, the non-resident beneficiary or prospective beneficiary would be entitled to elect that instead of the 50 per cent initial tax and the withholding tax, the income payable to him would be subject to the same withholding tax as if it had been paid to him directly. Gifts and bequests which were distributable to non-resident beneficiaries would be subject to initial tax at the rate of 30 per cent, and would not be subject to any further withholding tax.

REFERENCES

1/ When the trustee has active duties to perform in managing the trust property, or has discretion over the manner in which income or the trust funds are to be distributed, the trust is known as an "active" trust. If the trustee is merely holding property for the beneficiary, he is known as a "bare" trustee, and any beneficiary of full legal capacity can require that the trust be terminated as far as he is concerned and the property (or his share of it) distributed to him.

2/ For example, a spouse or dependent child would not be taxable on gifts and bequests from the other spouse, and accordingly, gifts made to a trust in which members of the donor's family unit were the beneficiaries would not be subject to tax.

3/ Sections 21(1) and 22(1) dealing with gifts to a spouse and persons under 19, respectively, and section 22(2) dealing with trusts with retention of a benefit or rights.

4/ Section 63(2).

5/ This treatment would produce the desired neutrality with direct gifts, for the same tax result would be attained had the property been left directly to the member of the family unit and he in turn had later left it to the remainderman.

6/ Section 65(1).

7/ Estate Tax Act, sections 3(1)(d) and 3(1)(e).

8/ Section 22(2).

9/ Federal Estate and Gift Taxes: A Proposal for Integration and for Correlation with the Income Tax, Washington: United States Government Printing Office, 1947, p. 31.

10/ It is possible for an outright gift to be made subject to the possibility of a reversion under stated conditions. In this case, the original donee would be better off if he received the property in the form of an annuity or through a trust. Otherwise he would have to pay tax on the entire value of the gift without necessarily knowing how long he would retain it.

11/ Estate Tax Act, sections 3(1)(c) and 3(2)(b). The possible complexities of such determinations are well illustrated by the case of M.N.R. v. E.H. Smith and Montreal Trust Company, [1960] S.C.R. 477 where the Supreme Court divided 3-2 on the question whether, under the Dominion Succession Duty Act, R.S.C. 1952, Chapter 89, sections 3(1)(c) and 3(4), a disclaimer, made by a wife, of property received from her husband under Quebec law, was a fiduciary substitution, the exercise of a general power of appointment, or an *inter vivos* gift.

12/ Section 139(4a) of the Income Tax Act.

13/ This is discussed further in Chapter 26.