PART C

DETERMINATION OF BUSINESS INCOME

CHAPTER 22

GENERAL BUSINESS INCOME

We are concerned in this chapter with the measurement of business income. Individuals either own businesses directly as proprietors and partners, or own them indirectly by holding residual claims against intermediaries, such as corporations, co-operatives and trusts, that carry on business. We have already discussed the tax implications of carrying on business through these particular forms of intermediaries in Chapters 19, 20, and 21. The important conclusion was that the business income accruing to the benefit of an individual taxpayer should be measured by common standards regardless of the particular kind of business or the form of intermediary through which it passes. Therefore, in this chapter we are concerned with the determination of the income of a business without regard to the legal form under which it is conducted.

Succeeding chapters deal with the problems of measuring and taxing the business income of taxpayers in some industries that have unique characteristics. These are mining, petroleum, financial institutions (including life insurance), farming, forestry, fishing, general insurance, and construction. In seeking to resolve these problems our objective is to achieve neutrality in the treatment of business income arising from different kinds of businesses.

Although this chapter is concerned with the determination of business income, it is important to keep in mind that much of the significance attached to the source of income under the present legislation would disappear under our proposals. Of particular importance is the elimination of most of the tax consequences of the present distinction between income from business and income from property, a differentiation that is often difficult to make and has caused much of the uncertainty and inequity in the present tax system. Therefore, although it is useful for descriptive purposes to discuss our proposals as they apply to the various sources of income, we will suggest very few measures that are applicable to only one of the sources.

THE PRESENT SYSTEM IN GENERAL

Income from a business is brought into charge under sections 2 and 3 of the Income Tax Act, and section 4 provides that income from a business for a taxation year is the profit therefrom for the year. Section 139(1)(e) provides that business "includes a profession, calling, trade, manufacture or undertaking of any kind whatsoever and includes an adventure or concern in the nature of trade but does not include an office or employment".

The provision in section 4 that income from a business is the "profit" therefrom requires a determination of profit. That term is not defined in the Act but in practice the starting point for such determination is usually profit as established under recognized accounting practices 1/. Such practices must yield, however, both to express provisions of the Act and to decisions of the courts holding that in certain respects such practices are not applicable in the computation of income for tax purposes.

In calculating profit it is, of course, necessary to consider what is to be brought into income, when the income is to be brought into account, what expenditures are deductible and when such deductions can be made.

In determining what is to be brought into income, accretions to capital or property gains and other capital items are now excluded, in accordance with the established doctrine discussed in Chapter 9. There are also certain statutory exemptions which will be referred to later in this chapter.

Business income is ordinarily brought into account on the accrual basis, although farmers and members of professions may compute income on the cash method 2/.

The use of the word "profit" in the general definition of income from a business necessarily means that only net income is to be taxed, that is, gross revenue less the costs incurred in producing it. Such costs are, broadly speaking, of two kinds: those incurred in the day-to-day operation of the business, and an appropriate proportion of those costs incurred for the production (or preservation) of future revenue.

In determining whether particular expenses are deductible, account must be taken of recognized accounting practices, the express provisions of the Act and established legal doctrines. There are a number of provisions that limit the deductibility of certain expenditures. In Chapter 9 we discuss: section 12(1)(a) which prohibits the deduction of any outlay or expense except to the extent that it is made for the purpose of gaining or producing income; section 12(1)(b) which prohibits the deduction of capital expenditures or allowances for depreciation, obsolescence or depletion except to the extent that they are specifically permitted by the Act; section 12(1)(c) which prohibits the deduction of an outlay or expense if made to produce exempt income; section 12(1)(h) which prohibits the deduction of personal or living expenses of a taxpayer except for designated travelling expenses; and section 12(2) which prohibits a deduction in respect of an otherwise deductible expenditure except to the extent that it is reasonable in the circumstances.

The exclusion of capital receipts from income is based on legal decisions rather than any express provision of the legislation. The law contains a general prohibition against the deduction of capital expenditures 3/. Allowances for some capital expenditures, such as the cost of fixed assets, specified interest payments and certain costs of obtaining financing are expressly permitted 4/. Other capital expenditures, because the Act does not specifically permit their deduction, may not be deducted either currently or, because they do not fall within the capital cost allowance provisions, over a period of time, and are known for tax purposes as "nothings".

As to the timing of deductions, the ordinary rules of accrual or cash accounting, depending on the method followed by the taxpayer, will usually apply.

Income for the year is income from all sources, 5/ and a taxpayer is permitted to deduct a business loss from his other income in the year in which the loss was sustained. He may also carry business losses back one year and forward five years, but only against business income 6/. This is

subject to restrictions in the case of a corporate taxpayer if control of the corporation changes and the business in which the loss was incurred is discontinued 7/. The rule as to deduction of business losses from other income is subject to a limitation in the case of so-called "hobby farmers", as explained in Chapter 25 which deals in part with agriculture.

We also consider in this chapter the position of new and small businesses, which have a very important place in the Canadian economy.

Appraisal

We have reviewed briefly the present general rules for the taxation of business income relating to the revenues and gains which are brought into account, the expenditures and outlays which are deductible, and the time when the revenues and expenditures are taken into account. When viewed in the light of our comprehensive tax base it appears to us that the present rules are deficient in all three respects. Under our approach, all revenues and all expenditures must be taken into account in the computation of income and the principal problems remaining are those of timing.

The provisions of the present legislation with regard to the carry-over of business losses and their application against other income are in our opinion too restrictive, and we shall make suggestions as to ways in which they should be liberalized.

We have also considered the existing rules relating to the tax treatment of business transactions between persons who do not deal at arm's length, as in the case of parent and subsidiary companies. We think that these rules are inadequate and that more comprehensive regulation of such transactions is required.

MAIN PROBLEM AREAS

Application of Accounting Practices

We mentioned earlier in this chapter that under the present tax system the usual starting point for the determination of profit from a business is

the application of recognized accounting practices. We also pointed out that such practices are in some cases overridden by statutory provisions and legal decisions. The courts look to accounting practices in determining the meaning of profit, but have found that such practices are not always permissible for tax purposes.

The present statute does not expressly state that business income is to be computed according to recognized accounting practices. We have considered whether some such provision could now usefully be inserted in the tax legislation. Such a change might permit the elimination of a number of statutory rules and the simplification of the legislation generally. In Chapter 9 we pointed out that this same question was the subject of serious consideration at the time of the revision of the Canadian income tax legislation in 1948, and that it was then decided that the wide divergences in accounting practices were such that a provision of this kind was not practicable. The result was that the statute simply provided that income from a business was the "profit" therefrom.

In view of the many developments in the principles and practices of accountancy, we felt we should put to the accounting profession itself the question whether a specific reference in the legislation to accounting principles or practices would be desirable. The question was referred to a Special Tax Committee of the Canadian Institute of Chartered Accountants and referred by that Committee to the Institute's Accounting and Auditing Research Committee. In view of the importance of the matter, the full text of the reply of the latter Committee is given in Appendix A to this Volume. It states that the majority of the Committee reached the conclusion that a specific reference to accounting principles or practices in the income tax legislation would not be desirable.

We have concluded that the opinion expressed by the Canadian Institute of Chartered Accountants should prevail, and that the income tax legislation should not contain a provision prescribing the application of accounting principles and practices in the computation of profit. This conclusion does

not imply that accounting principles or practices are deficient, for indeed, we believe that recognized accounting practices should be taken into account, subject to the express provisions of the legislation and applicable court decisions as is now the case. Rather, it reflects our belief that the concept of income for tax purposes has unique characteristics which are frequently at variance with accounting concepts. In the detailed discussion below, we propose that some of the present statutory provisions affecting the computation of income from a business should be repealed, and we expect that if this were done the courts would look more to accounting and business practices in the future than they have in the past. However, in areas where these practices were not sufficiently precise for tax purposes some statutory rules would have to be used, and because such rules would doubtless have to cover many situations they might have to be arbitrary in order to avoid undue legislative complexity.

When we approached the Canadian Institute of Chartered Accountants, we were unable to tell them of the material changes in the computation of business income for tax purposes which the adoption of our comprehensive tax base would bring about. We believe it is unlikely, however, that the opinion they formed would be altered by our proposals.

Inclusions in the Tax Base

In determining the income of a business for tax purposes it is necessary at present to distinguish between gains of an income nature and those of a capital nature. Earlier in this Report we discussed the development of this concept in Canada and also summarized the treatment in the United States and United Kingdom. As far as a business is concerned, gains of an income nature are those arising in the ordinary course of the commercial activities which the business was formed to carry on, an obvious example being the revenue from the sale of inventory to customers. Gains of a capital nature may arise from the disposition of the business itself as a going concern or of all or part of what may be called the permanent structure of the business, an example being the gain on a disposition of the land,

buildings or equipment of the business. As such assets are regarded as capital assets, gains arising on their disposition are ordinarily regarded as accretions to capital and are not normally brought into income for tax purposes. In some of the legal decisions the distinction is drawn between receipts from the disposal of circulating capital, which are income, and those from the disposal of fixed capital, which normally are not.

There are some statutory exceptions to the rule that the proceeds of disposition of capital assets are not taxable. Under section 6(1)(j), amounts received which are dependent upon the use of, or production from, property are brought into income even if they are instalments of the sale price of property (other than agricultural land). This provision materially limits the forms in which a transaction may be cast without giving rise to tax liability by the vendors of properties such as patents, franchises and mineral rights. Under section 20, capital cost allowances taken on depreciable assets may be recaptured if the assets are sold for more than their undepreciated capital cost. On the sale of a business or part of a business, the consideration received for inventory must, under section 85E, be taken into account in determining income.

Other illustrations may readily be given of the distinction which has been drawn by the courts between gains of an income nature and gains of a capital nature. Thus,profits on foreign exchange will be taxable if they relate to inventory transactions, but not if they relate to the acquisition of capital assets. The proceeds of fire insurance will be treated as taxable if the property damaged or destroyed is circulating capital, but not if it is fixed capital (unless by way of recapture of depreciation). Compensation received for the failure of the other party to carry out a normal commercial contract will ordinarily be treated as income, but if the contract is one of major importance and forms part of the permanent structure of the business such compensation may be treated as capital. Government subsidies will be regarded as income if they are granted to supplement income, but as capital if their purpose is to assist in the acquisition of capital assets.

We have already referred to the difficulties under the existing system of determining whether a business is being carried on and whether particular income is from business or from property. Where it is plain that a business is being carried on, it may still frequently be difficult in practice to distinguish between gains of an income and those of a capital nature.

Because capital is invested in a business or property to gain an economic reward, we think it follows that any resulting gain of any kind should be taken into account in the determination of income for tax purposes. Accounting practices recognize that in the long run all revenue, as well as all expenditure, must be taken into account in measuring the income of a business. Because income is measured in annual periods, the main concern is to produce a record of annual earnings that indicates fairly the progress of the business. It is recognized that to a considerable extent the allocation of revenue and expenditure between annual periods is necessarily inexact, and that the inclusion in one year of miscellaneous amounts having to do with a different year is inevitable. The main concern of the accountant is to show such amounts separately if they would otherwise materially distort the income for the year concerned. But even though they are shown separately, they would usually be included in the calculation of total income for the year, and would certainly be included in arriving at income accumulated to date. On the sale of an asset, any costs applicable to it that have not been written off previously as an expense would be charged against the proceeds of the sale and, to the extent that such proceeds exceeded the unabsorbed cost, the excess would usually be regarded as income available for distribution.

Thus, the position under the present law is that a distinction of little significance to businessmen or accountants is of major importance for tax purposes. In the business world the question is not whether, but how or when, particular receipts or expenditures should be reflected in earnings. For tax purposes the segregation of capital and income items is now fundamental. This distinction is inequitable in our view, because any gain or loss changes the economic power of the taxpayer. In addition, the current tax treatment has

produced uncertainty and has given an exaggerated importance to the tax implications of many business transactions.

The present exemption of property gains from tax frequently leads to attempts to cast transactions in a form which minimizes tax. For example, on the sale of a business there may be considerable advantage to the purchaser, with no disadvantage to the vendor, if the consideration for goodwill is included in the price of a depreciable asset. As we shall see later in dealing with expenditures, there is also a significant anomaly within the tax system because the cost of developing a capital asset such as goodwill may be deductible, for example, the cost of advertising, whereas the proceeds of these assets when sold are non-taxable. The desire to realize non-taxable asset gains may also cause taxpayers to sell their businesses or business assets, rather than operate them to earn income that would be taxable.

At the present time, gifts received by a business are not ordinarily included in income for tax purposes. Cancellation of debt generally gives rise to income only when it is considered to be some kind of price rebate. Under the comprehensive tax base all such gains would be included in income. The implications of this change are discussed in Chapters 17, 18 and 20.

The comprehensive tax base that we recommend requires that all revenue be included in the tax base regardless of the way in which it arises or the source from which it comes. The adoption of this base would not only establish a common ground on which to measure the business income of all taxpayers but would also produce the following results:

1. Reduce uncertainty in the present tax system by removing the distinction between property gains and income.
2. Simplify the present legislation by permitting the elimination of provisions necessitated by such distinction.
3. Bring the tax treatment into closer touch with the realities of the business world and thereby reduce the effect of tax considerations on business transactions.

Timing of Revenue

The ideal method of determining the business income of all taxpayers would be to measure changes in economic power, including unrealized revenue. This approach would recognize that the creation of revenue is a gradual and continuous process, starting, for example, with the construction of production facilities and continuing through the development of a market, the taking of orders, the production of a commodity, and finally to the sale and delivery. Because all these steps are necessary in creating revenue, why should recognition of the revenue be delayed until the final moment of sale? We discuss in Chapter 8 the problems that would arise if income was recorded only when realized.

Completely objective measures of the potential revenue created at various stages in the process have not yet been developed, so that compromises are necessary. The determination of income is today a matter of recognizing revenue when the readily identifiable events of sale or disposition take place and of matching costs as accurately as is practicable against that revenue. In considering whether revenue should be recognized as arising at other times, it is important to bear in mind that objectivity, which is one of the prime considerations in accounting, is equally essential for tax purposes and therefore we cannot contemplate, at least for the present, a tax system based on rules less objective than those used in accounting.

Under accounting practice, revenue is not usually taken into account until goods or services have been provided to the customer and cash or a legal obligation convertible into cash has been received for them. Not infrequently, of course, amounts are received in advance of the provision of goods or services. Uncertainty as to the proper treatment of such amounts led to the enactment of section 85B of the Act, which deals in a comprehensive fashion with the timing of revenue. This section provides that "...every amount received in the year in the course of a business...that is on account of services not rendered or goods not delivered before the end of the year or that, for any other reason, may be regarded as not having been

earned in the year or a previous year" shall be included in income, but it also permits reserves to be established in respect of the portion of such amounts unearned during the year. The section also provides that (unless the taxpayer is on the cash basis) in computing income "...every amount receivable in respect of property sold or services rendered in the course of the business in the year shall be included notwithstanding that the amount is not receivable until a subsequent year...", and it permits certain reserves to be established in respect of amounts so receivable for property sold.

Because this section does not differ greatly from business practice and provides a legal framework within which to determine a taxpayer's liability, it may be thought to provide a satisfactory rule for tax purposes. We cannot, however, view the section with complete satisfaction. It is open to the objection that it requires amounts to be included in revenue that may not give rise to any net income at all, and the taxpayer is not assured that offsetting relief is afforded by the section. The provision, as it stands, is so complex that many of its implications are still not fully understood, even though it has been in the legislation since 1953. It is broad enough to deal with many of the situations which may arise in practice but there are still areas of uncertainty 8/. It appears to us that one of the key provisions that makes the section workable is that the reserves to be deducted must be reasonable, and yet this same test would be applied in any computation of profit according to recognized accounting practices. In their appearance at the public hearings of this Commission, representatives of the Canadian Institute of Chartered Accountants recommended the repeal of section 85B, subject to the retention of specific rules regarding instalment sales and the introduction of an allowance (which the section now denies) for guarantees, indemnities and warranties 9/. We agree with this proposal, because we have concluded that accounting and business practices have developed to a satisfactory degree.

Another problem with respect to the timing of revenue arises from the fact that, although revenue may be treated as realized when a sale is made

on credit, the receivable may turn out to be uncollectible. This possibility is recognized in the present legislation by paragraphs (e) and (f) of section 11(1) which permit, respectively, the deduction of a reasonable reserve for doubtful accounts and for accounts which turn out to be bad. In general, these provisions have proven satisfactory, although certain taxpayers have complained that the tax authorities place too much emphasis on an examination of specific accounts in determining what reserve is reasonable.

Under section 12(1)(e), no deduction of reserves is permissible in computing income unless such reserves are expressly provided for in the legislation. Apart from allowances for depreciation and depletion, this means that reserves for business generally are restricted to those permitted under sections 11(1)(e) and 85B. These provisions may have been necessary in the days when the businessman determined arbitrarily the amount set aside from profits for various purposes. However, we believe that the general prohibition of reserves has led to an over-emphasis by the tax authorities on the time at which revenues are recognized, and that in the present state of accounting and business practice such a provision is undesirable.

It also should be noted that the Canadian Institute of Chartered Accountants has recommended that the term "reserve" be applied only to a restricted number of items 10/. We suggest that in any future legislation the terminology suggested by the Institute should be taken into account.

In view of the foregoing considerations, we recommend the following:

1. The general disallowance of reserves should be deleted from the legislation.
2. The present specific provisions for reserves, namely, sections 85B and 11(1)(e), should also be repealed; with the result that the general statutory test of reasonableness would then apply to allowances for unearned income, to allowances for estimated losses in the value of accounts receivable, and to allowances in respect of the losses that could result from guarantees, indemnities and warranties.

3. In those cases where a test of reasonableness is difficult to apply and where it would be feasible to employ an arbitrary standard, the legislation should contain specific provisions with arbitrary rules to eliminate uncertainty. However, such rules should be framed so as to permit the most accurate estimate to be made of the average losses anticipated and should not make any allowance for contingencies. Thus, in Chapter 24, which deals with financial institutions, we recommend that specific arbitrary percentages should be established for the use of banks in valuing their loan accounts, and for all taxpayers in valuing real property mortgages receivable.

The implementation of these recommendations would be facilitated by consultations between the business and professional communities and the tax authorities, and we envisage that such consultations could take place through the informal advisory committees we recommend in Chapter 32.

This discussion concerning the timing of revenue for tax purposes has been in terms of the "accrual" basis of accounting, which we consider gives the best measurement of business income. The use for tax purposes of another common method of accounting referred to as the "cash" method is discussed later in this chapter.

Deductibility of Costs

Our affirmation of the general principle that all realized revenues of a business should be brought into income carries with it the further principle, to which we subscribe, that all reasonable business expenditures should be deductible at some time. However, we have also expressed support for the cardinal principle that in computing his taxable income no taxpayer should be permitted to deduct costs of a personal consumption nature. Thus, while we suggest that all costs related to the earning of income should be deductible at some time, we point out in Chapters 7 and 8 that expenditures which relate to personal enjoyment, use, or consumption cannot be allowed to reduce the comprehensive tax base. The problem in determining what costs

should be deductible is to ascertain whether an expenditure reasonably relates to the earning of income or is of a personal consumption nature. Most of the following discussion is concerned with establishing procedures for making this distinction in a feasible manner. We also consider the problem of determining the time at which a deductible expenditure should be allowed as a charge against income.

In Chapter 9 we discussed the deduction provisions contained in the present legislation, and the implications for these provisions of the adoption of the comprehensive tax base. We then suggested which sections of the Act could be eliminated and what general changes should be made in the remaining sections concerning the deductibility of expenditures. More important, we recommended that the sections remaining should be applicable to all income and should not be restricted in application to certain kinds of income. It is useful at this point to review the conclusions detailed in Chapter 9 and to point out their implications for the determination of income from a business. It is important to keep in mind that business income would continue to be determined for tax purposes in accordance with recognized accounting practices, but would be subject to the express provisions of the legislation and to any applicable legal decisions.

Section 12(1)(a) denies a deduction for an outlay or expense that was not made for the purpose of producing income. We believe that this limitation is unduly restrictive for there are expenditures, such as those which save costs, which may not be productive of income in a narrow sense but which should be allowed. Therefore, we suggest that the legislation should provide for the deduction of expenditures that are reasonably related to the gaining or producing of income. Such a provision should be expressed in wide, general terms.

Section 12(1)(b) provides that no deduction may be made in respect of capital expenditures or in respect of depreciation or depletion except as expressly permitted in the legislation. The general denial of a deduction of capital expenditures in computing income is simply another reflection of

the distinction between income and capital items for tax purposes which has existed in Canada since income tax legislation was first introduced. Accretions to capital have not been included in the computation of income, and expenditures for capital purposes have not been deductible. It is clear that the distinction between current and capital expenditures is frequently difficult to draw and has caused, and is continuing to cause, confusion and uncertainty among taxpayers and the tax authorities.

Some types of capital expenditure may qualify for capital cost allowance so that in some cases the question of whether an expenditure is a current or capital item simply affects the timing of the deduction. There are, however, a number of types of proper business expenditures, the so-called "nothings", which have been considered to be of a capital nature but for which no capital cost allowance is permitted. Examples of expenditures falling into this category include the cost of obtaining or terminating contracts of particular types, the cost of acquiring lists of customers, certain losses on advances to suppliers or customers, certain costs related to the issuance of securities, payments for goodwill, and certain expenditures for projects which are proposed but not consummated, for example, payments under options and architects' fees.

During our public hearings we received representations concerning the treatment of expenditures of this nature from a number of participants including the Canadian Bar Association and the Canadian Institute of Chartered Accountants. The 1965 amendments to the Income Tax Act provided relief in respect of a few such items. Under the comprehensive tax base all business expenditures would be allowable at some time, so that the problem would then become one of timing. Accordingly, we recommend that all expenditures that would be deductible under our test should be taken into account when incurred, unless they result in the acquisition of an asset which either falls within the definition of a specific capital cost allowance class, or is an asset, such as land or securities, which is not ordinarily expected to depreciate in value and the cost of which would be taken into account in computing the gain or loss when the asset was

disposed of. This would involve an extension of the present capital cost allowance system, and would mean that a particular business expenditure would be deductible when incurred unless it was the cost of an asset of the type referred to above or was an item that the legislation specifically required to be amortized over a period of time. Much of the present uncertainty would disappear, and the term "nothings" would become obsolete. This recommendation is discussed further in the next section on "Timing of Costs".

The deduction of expenditures for the purpose of producing exempt income is denied by section 12(1)(c). Under the comprehensive tax base, we anticipate that exempt income would be virtually eliminated, and that such a provision would cease to be necessary. We also propose that the present specific restrictions on the deduction of interest expense should be repealed.

Section 12(1)(h) denies a deduction for personal or living expenses except for certain travelling expenses. We have already emphasized that a very difficult and important distinction must be made between business and personal expenditures, for there can hardly be fair treatment of all taxpayers if some can charge personal expenses against taxable income and others cannot. The problem is broader than that already discussed in connection with employment income because it can also involve personal benefits provided to customers or suppliers of the business or to the owner of the business. In the last case, there is no natural constraint on the amount of the benefit because the payer and recipient are the same. We have already proposed a general rule that expenses be related in a general way to the earning of income. In addition, we recommend the retention of the present section 12(2) that limits deductions to an amount that is reasonable in the circumstances. We also agree that a provision is required to prohibit the deduction of expenditures that are of a personal nature. We have already discussed the current interpretation of section 12(1)(h) by the courts, and we have expressed the belief that, at least initially, it should continue to be left to the courts to establish the rules for border-line cases in this area. Some specific and arbitrary rules should, however, be included in the

Regulations to indicate the amounts to be deducted for specific kinds of expenditures where the uncertainty is great or where as a matter of policy a particular rule is to be adopted.

In Chapter 14, we suggested specific rules for travel and entertainment expenses, commuting expenses, club dues, etc. The guidelines we laid down there for identifying and valuing personal benefits should also apply to business income. The general approach for dealing with expenses that benefit employees should be applied to expenses that benefit customers, suppliers, or shareholders, that is, the expenditure involved should generally be deductible in determining the income of the business, and should be reported in the income of the individual who received the benefit. Failing such identification with the recipient, tax on a grossed-up basis at the top personal rate should be payable by the business whether or not the business was itself tax-exempt. The tax so paid by the business should be treated as an expense for tax purposes. Where the expenditure represented a gift conferred by an owner of the business, the amount thereof should be treated as income of the actual recipient, because it would represent a gift to him, and should also be taxed, on a grossed-up basis, to the owner of the business.

Section 12(2) denies the deduction of expenses to the extent that they are not reasonable in the circumstances. This provision, which has not been the subject of a great deal of litigation, permits the Department of National Revenue to disallow expenditures which could hardly be justified from a taxation point of view. Thus, it is a necessary part of the legislative measures that are required in order to differentiate between expenditures for the purpose of earning income and those that are of a personal nature. It is true that the test has given rise to some complaints because businessmen feel that they should be the best judge of what expenditures are reasonable for the purposes of their business, and we appreciate this point of view. However, it seems to us that this constraint on the principle that all business expenditures should be allowed is a fair one and should be retained. The question of reasonableness in particular circumstances would, of course,

continue to be left to the courts for ultimate determination in the event that the taxpayer and the tax authorities were unable to resolve a dispute.

Timing of Costs

If business income could be measured in terms of increments in economic power, whether realized or not, there would be no need to deal separately with expenditures. The result of operations would be shown by comparing the net change in economic power for any given period, thereby automatically allowing for both the incomings and the outgoings. Because it is not always possible to measure a change in economic power when it is not realized, and one is ordinarily forced to recognize revenue only when a transaction takes place, we have to deal separately with expenditures. Expenditures usually precede the realization of related revenue, so that the rules for measurement of business income must provide for the treatment of expenditures made in advance of the receipt of revenue.

One approach is often referred to as a process of matching costs against revenue. As we shall see in reviewing different types of costs, it is often difficult to identify specific costs with specific revenue, and, moreover, there is no certainty that any revenue will result from many types of expenditures.

Another approach is to treat expenditures as costs when incurred except when it is known they will bring future benefit. Under this approach, assets on a balance sheet, such as inventory and depreciable assets, can be viewed as residues of unabsorbed costs that are being carried forward against future periods.

Both these approaches raise the common problem that they require estimates to be made of the extent to which expenditures already made will produce a benefit in future periods. In other words, even though revenue is usually brought into account when realized, costs must frequently be carried forward beyond the period in which they were incurred. For this reason the treatment of costs is one of the most difficult problems in

accounting practice, and arbitrary rules may be necessary for tax purposes to provide certainty in the treatment of taxpayers in different businesses and to minimize differences in the treatment of their costs.

Inventory. The word "inventory" generally is used to describe goods which are purchased or manufactured for sale in the ordinary course of business. The purpose of inventory accounting is to bring certain costs into appropriate accounting periods. The determination of business income is then simply a matter of delaying the deduction of the costs of obtaining or creating the inventory until its sale. For a simple retailing operation in which goods are sold very soon after being purchased this is a fair statement, but for many business activities the matter is not simple. There are difficult problems in deciding which costs should not be written off as incurred but included in the inventory, and in determining by objective standards the extent to which the costs will benefit future periods 11/.

These difficulties are largely glossed over in the present provisions with respect to inventory valuation for tax purposes. Section 14(2) of the Act permits inventory to be valued at cost or market, whichever is lower, and section 1801 of the Regulations permits inventory to be valued all at cost or all at market. The terms "cost" and "market" are not defined. In practice, the various ways of determining "cost" and "market" under accounting methods are usually accepted, although there are some areas of dispute. For example, there may be difficulties regarding the amount of overhead to be included in cost, or regarding the valuation of second-hand items. In cases where the cost of inventory is written down to estimated market value, the tax authorities may contend that such an adjustment constitutes a "reserve" that is not allowed by the legislation.

It is evident that the rules regarding inventory valuation in the present legislation reflect the variety of methods used in practice, but they do little to help with the real problems, and should be removed. At the same time complex legislation would be necessary to provide satisfactory rules to ensure that taxpayers with businesses in different circumstances

would be treated fairly. Because the tax authorities are concerned with the degree of variation in inventory valuation found in businesses in similar circumstances, we considered the desirability of simple specific rules to ensure a minimum common standard in measuring business income. For example, one such rule would be to require that all businesses include in inventory the costs of the estimated variable and fixed overhead applicable to their inventory. We concluded, however, that specific rules should be introduced only if, after consultation between the tax authorities and the business and professional communities, there was little consensus on acceptable methods of valuation, and if the courts' interpretation of the word "profit" did not produce a satisfactory result.

Once the amount of cost embodied in an inventory has been determined, there remains the problem of matching that cost against the proceeds of sale. Such identification is often physically impossible, and a common assumption is that the items first purchased or manufactured are those which are first sold (first-in-first-out method), or alternatively that the cost of an item sold is represented by the average cost of items on hand at the time of the sale. In a period of rising prices the matching of costs in order of purchase or manufacture against the current selling price will result in higher recorded profits than with the average cost method. Conversely, in a period of falling prices, the recorded profits would be lower under the first-in-first-out method. Use of the average cost method accelerates the rate at which the recorded costs change after prices have risen or fallen. Another assumption used in certain businesses is that the last items of inventory purchased are sold first (last-in-first-out method). The emphasis in the last-in-first-out method is entirely on matching changing costs with revenues.

The present legislation offers no guidance on the appropriate method of matching costs of inventory against revenue. In the well-known Anaconda case 12/, however, it was held that this is one area where a practice that was acceptable for accounting and commercial use was not always acceptable for

tax purposes. The Supreme Court of Canada found that the last-in-first-out method of inventory valuation was an acceptable accounting method of determining profit for tax purposes in the circumstances of the particular business 13/. However, the Privy Council reversed this decision on the grounds that while the method might be acceptable for accounting or commercial purposes, it was not acceptable for tax purposes because, on the assumptions made, it disregarded ascertainable physical facts relating to the value of the remaining inventory, and permitted an increase in inventory values to be free of tax in a period of rising prices, and so was not appropriate to a tax system which measured income on a year-to-year basis 12/.

In this context, we believe that the tax purpose is at variance with the accounting purpose. Under the accounting purpose we can see that in certain circumstances there is some validity in using the last-in-first-out method of inventory valuation in measuring the annual income of a business as a going concern. Although accountants are somewhat concerned about the balance sheet inventory value that may result from this procedure, many accountants regard balance sheet considerations as secondary to those of the income statement. For tax purposes, we are of the opinion that the cost figure attributed to inventory on hand should be close to its most recent cost, and that the first-in-first-out method is generally preferable.

Although we have this important reservation about the use of the last-in-first-out method of inventory valuation for tax purposes, we recognize that in those circumstances where it is particularly appropriate, taxation based on other methods may cause a strain on cash resources for temporary periods. We have therefore given careful consideration to whether a means could be found to permit limited use of the last-in-first-out method for tax purposes, which would prevent it from being used as a protection against inflation and yet at the same time meet the requirements of these taxpayers. Such an approach would mean that the inventory value could not depart materially from current market value. If market values rose above cost as calculated under the last-in-first-out method, the inventory value should

be adjusted upwards so that it was no less than, say, 80 per cent of the average market value of the past three years, including the current year. If, on the other hand, market values fell below cost and the inventory value was therefore written down to market, it should be adjusted upward by any subsequent market recovery until its original cost value was reached. After that point, inventory values would be adjusted above cost only when cost was less than 80 per cent of average market value as already stated. In addition, we believe that any such provision should be limited to those industries where this method of inventory valuation is suitable to the circumstances of the industry and is actually used by businesses in their financial statements. As noted in the Exchequer Court decision in the Anaconda case, 14/ the last-in-first-out method is appropriate in circumstances where the sale price of the finished product closely reflects the current replacement cost of the materials content of the finished product, the inventory is large with a slow rate of turn-over, and the company does not speculate or trade in its materials. With these restrictions, it seems to us that only those taxpayers to whom the last-in-first-out method was particularly suited would make use of the provision, and that at the same time it would be useful to them. We have also given consideration to the economic implications of this method of inventory valuation. As we have already indicated in the discussion on economic stability in Chapter 3, investment in inventories is a source of short-run instability. Because the last-in-first-out method of inventory valuation tends to reduce profits in periods of rising prices, and to increase profits in periods of falling prices, its use might tend to stabilize business decisions. On the other hand, it would reduce the funds diverted to taxation in periods of upswing and would increase the diversion of funds in times of downswing with a destabilizing effect on the supply of funds to business.

In view of these considerations, we recommend that those businesses for whom the last-in-first-out method of inventory valuation is suited (as above set out) should be permitted to use that method, provided that they use it for their financial reporting and that, for tax purposes, the value

attributed to the inventory should not be permitted to fall below 80 per cent of the average market value. With the exception of these rules concerning the last-in-first-out method, we think that the valuation of inventories should not be subject to legislative rules.

Depreciable Assets. We now consider the timing of the deduction for expenditures on certain assets, such as buildings and equipment, which are useful over long periods and are commonly referred to as depreciable assets.

For tax purposes the most equitable method of deducting costs of depreciable assets would be one which matched the cost of such assets against the income arising from their use. Obviously to do this before their useful life had in fact expired would not be a simple task, because useful life might vary from one year to many years, and productivity would change from year to year. Yet, if the business income of all taxpayers is to be measured on the same basis, allowance must be made for these costs in a way which produces a reasonably accurate statement of income from year to year.

Under the Income War Tax Act depreciation on a straight-line basis was permitted on tangible assets, but only at the discretion of the Minister. Depreciation was considered to be essentially an allowance for wear and tear, so that it could apply only to tangible assets actually in use, and did not take into account the diminishing value due to obsolescence. There was dissatisfaction with the system because no official rates were ever published, and a taxpayer could never know whether he was receiving the same allowance as his competitors in the same business. Profits or losses on disposal of depreciable assets were considered capital in nature and were not taxable or deductible.

When the Income War Tax Act was replaced in 1948, and ministerial discretion was almost completely abandoned, "depreciation" gave way to the "capital cost allowance" concept for the amortization of the cost of assets. At the same time the allowance was extended to include certain intangible assets such as leasehold improvements, patents and certain franchises or concessions

for limited periods. Provision was also made on sale of assets for "recapture" of any excess capital cost allowance recovered through the sale. The use of the diminishing balance method, with its greater allowances in earlier years, in effect gave recognition, though in an indirect way, to obsolescence.

Under the present system the taxpayer has a statutory right to capital cost allowances. For simplicity, the so-called depreciable assets are grouped in the Regulations into a relatively small number of classes, for each of which a rate is prescribed. The maximum annual allowance is determined by applying the class rate to the unclaimed capital cost, that is, cost less capital cost allowance previously claimed, of assets in the class. Typical rates are 20 per cent for machinery and equipment, 5 per cent for buildings of concrete or steel construction, and 30 per cent for automobiles. When an asset is disposed of, the proceeds are deducted from the unclaimed costs of the class, thereby reducing allowances to be claimed in the future, or to the extent they exceed the unclaimed balance in the class, taken directly into income. Should the proceeds on disposal exceed the original cost of the particular asset concerned, such excess is not taxable. Taxpayers may claim capital cost allowance as soon as they own a particular asset, regardless of when it is put into use or whether construction is complete, and they have the privilege of claiming whatever amount of capital cost allowance they wish up to the maximum amount computed by using the specified rate.

Submissions to the Commission indicate that the present system has served its purposes well and has operated to the satisfaction of taxpayers. However, we think it pertinent to ask how closely it has enabled costs to be matched against resulting revenue, and whether it has placed the measurement of business income on as fair a basis as possible.

For guidance in this matter, we looked to the practice followed by business management in reporting income from operations. In a confidential survey of a number of corporations conducted by our research staff, it was found that most large business firms did not use the diminishing balance method of depreciation in their accounts. For the years 1955 to 1962, during which

time the 113 corporations surveyed accounted for 25 per cent to 30 per cent of the total capital expenditures of all corporations in Canada, capital cost allowances claimed exceeded depreciation recorded in the accounts of the corporations by approximately $1,200 million. The total deferment of tax resulting from these additional allowances is estimated to be almost $600 million and, when added to the deferred taxes of about $100 million recorded prior to 1955, a total cumulative deferment of tax of approximately $700 million to the end of 1962 results. These figures support the conclusion that the charges permitted under the present capital cost allowance system are, at least in the early years, in excess of what, in the view of management, is reasonably required to measure "actual depreciation".

Because the allowances under the present system appear to be generous in relation to a basis of determining business income that was free of tax considerations, we considered whether more reliance should be placed on accounting and business measurement of depreciation in order to reflect more accurately the individual circumstances of each business and thereby to achieve greater equity. However, we found that the accounting profession itself readily acknowledged that any particular method of depreciation was at best an estimate, and that it laid primary emphasis on some reasonable method of amortizing cost which would be adopted and applied consistently. Thus, an amortization of equal annual amounts over an estimated lifetime, the "straight-line" method, may be just as acceptable as a method under which the annual amounts continually diminish, as under the "diminishing balance" method. It therefore appears to us that reliance on accounting methods in this area would produce uncertainty, and would also have an unfortunate effect on business practices because the depreciation methods adopted would probably be adjusted to achieve the maximum tax advantage 15/.

We have therefore concluded that because of the uncertainty that could result from an attempt to match, on an annual basis, the costs of depreciable assets against resulting revenue, the use of simple and arbitrary tax rules is preferable. While such rules are unlikely to reflect accurately the annual loss in value of the assets, they at least ensure a minimum common standard

available to all taxpayers, and the ultimate allowance of all cost provides for a final reckoning. Liberal allowances are probably inherent in any simple system, and the present rates therefore appear generally to be satisfactory 16/. As we suggest in Chapter 4, a degree of liberality here can be accepted because it would probably assist in economic growth.

We therefore recommend that the basic system of capital cost allowances for depreciable assets and the general level of rates remain unchanged 17/.

Although the basic system of capital cost allowances is satisfactory, some technical modifications should be made in its structure. We comment on the more important of these below. Comments on other specific features of the system are contained in a separate study 18/.

As we have already noted, the present system permits a deduction to be claimed for assets even before they are put into use. This conflicts with the principle of matching costs against revenue, which we believe should govern. Therefore, we recommend that this feature should be deleted from the basic capital cost allowance system.

The permissive nature of the capital cost allowance system is such that the taxpayer is not required to claim any allowance if he does not wish to do so. This again is a departure from a measurement of business income that is free of tax considerations and has had undesirable side effects, the nature of which will become evident in the later discussions concerning business losses and incentives such as the three-year exemption for new mines. It would thus appear that some capital cost allowance should be required to be charged in arriving at a satisfactory measurement of business income. Because the rates under the present system tend to be on the liberal side, any mandatory deduction of capital cost allowances could hardly exceed 50 per cent of the permitted rates in any taxation year. The undesirable effects of the permissive nature of the capital cost allowances are, however, considerably reduced because of our recommendations for the more liberal treatment of losses and for the elimination of tax incentives in the form of

exemptions of certain income from taxation. Accordingly, we do not think the legislative complexity and record keeping which would be involved in requiring a deduction of capital cost allowance is warranted.

Under the present capital cost allowance system, proceeds in excess of the original cost of an asset are not taxable. In accordance with our proposals for a comprehensive tax base, the excess should be included in income. Generally, the excess should be taken directly into income, and should not be credited to the class in which the asset was included. To avoid compliance problems on small dispositions, taxpayers might be permitted to credit to the asset class any proceeds of less than, say, $5,000 from bona fide separate disposals, regardless of the original cost of such disposals.

At present, a terminal profit on disposal of all assets in a class can, on election, be taxed under section 43 as though it had been received over the five years ending in the year of disposal. No similar provision exists for terminal losses. In view of the expansion of the loss carry-over provisions and the averaging provisions which we recommend elsewhere, this special provision in respect of terminal profits on disposal of depreciable assets would no longer appear to be necessary. However, the present practice of deducting the amount of the proceeds of disposition of an asset, up to the amount of its capital cost, from the balance in its capital cost allowance class should be continued. This would appear to be a simpler procedure and, where gains arise, more favourable to the taxpayer than the alternative of computing the undepreciated capital cost of the assets sold, deducting this amount from the balance in the class, and using this figure as the cost basis in computing the taxable property gain.

The unclaimed cost of assets in a particular class cannot at present be deducted until all assets in the class have been disposed of. In certain cases, 19/ the rates of capital cost allowance may tend to be inadequate and there can be times when the unclaimed cost in any class may considerably exceed the original cost of the assets still on hand. We therefore recommend adoption of the suggestion made by the Canadian Institute of Chartered

Accountants that there should be a provision for an interim claiming of a terminal loss to the extent that the unclaimed cost in any class exceeded the original cost of the remaining assets.

The subject of capital cost allowance cannot be closed without considering leasing arrangements under which the lessee has some right to acquire the property. By renting a long-term asset instead of owning it, a taxpayer may enjoy most benefits of ownership and yet obtain a faster deduction of its cost for tax purposes in the form of rent than he would have obtained in the form of capital cost allowance had he owned the asset. If the lessor is subject to all the normal requirements of the capital cost allowance system in respect of the asset, this arrangement need not be of particular concern to the tax authorities. If, however, the lessor is able to accelerate the deduction of the cost of the asset, either by way of terminal loss upon disposal of the fixed asset, or as an inventory loss upon transfer of title to the lessee, the net effect is to achieve a faster write-off of the long-term asset and thereby to defeat the purpose of the capital cost allowance system.

Prior to 1963, there were provisions in a previous section 18 of the Act which were intended to prevent lessees under lease-option agreements from obtaining faster write-offs on capital assets covered by such agreements than would have been available if they had been purchased outright. In effect, the provision treated such agreements as agreements for sale of such assets, and treated payments thereunder as payments on account of the purchase price rather than as rental payments for the use of the property. The lessee's deductions from income in respect of such payments were limited to the equivalent of the capital cost allowances on the portion of the purchase price attributable to depreciable property. However, many shortcomings remained in the section despite various amendments and it was finally repealed in 1963. 20/

While the leasing business is based primarily on financial, rather than taxation, considerations, once a leasing arrangement is contemplated there is

an opportunity to obtain tax advantages. With the widespread use of leasing today, the treatment of such arrangements for tax purposes is a matter therefore of great concern if the capital cost allowance system is not to be undermined. In reviewing the problem, we realized that, with the great variety of terms on which leasing arrangements can be drawn, it would be impossible, as was found under the repealed provision, to provide detailed legislative rules to deal with the situation. This would be particularly true if the rules were based on possible events to take place in the future. At the same time, we believe that some specific provisions are required to control the tax postponement possibilities under this type of arrangement.

We recommend that a specific provision should be introduced into the legislation to allow deduction for rentals of long-term assets that the lessee has a right to acquire only to the extent that they are reasonable and that any excess be treated when paid as being on account of the purchase price of the asset. If the asset was a depreciable asset, this excess would be eligible for capital cost allowance when the asset was acquired, or would be deductible if the option lapsed. We also recommend that it should be specifically provided that where a lessee acquired, at less than its fair market value at the time of acquisition, an asset which he had been renting, such deficiency in the purchase price should be regarded as a reduction of rents previously claimed, except to the extent of the rents disallowed under the first part of our proposal, and the amount thereof should be brought into income immediately with an offsetting amount to be amortized in the future under the capital cost allowance regulations 21/.

"Nothings". There are certain expenditures that may be made for the long-run benefit of a business that are not now deductible for tax purposes as current expenses, and are not provided for in the capital cost allowance regulations. These are often referred to as "nothings".

The equitable treatment of business income requires that these expenditures should be allowed at some time. The problem of estimating the period over which benefits will result from the expenditures is, however, even more

difficult than in the case of depreciable assets. Evidence of this difficulty is seen in accounting practice under which costs incurred by a business in developing future markets are usually treated as current expenditures, and yet in special circumstances may be deferred 22/. Current write-off is usually recognized in practice by the tax authorities even though this treatment may be questionable. If, however, an item such as goodwill is purchased from another business its cost is disallowed as being of a capital nature, and no allowance is available either in the form of amortization of the cost over a period of years or as a final write-off when the goodwill no longer exists.

The most difficult of the "nothings" to deal with is goodwill. It is usually measured as the difference between the total value of a business as a going concern, equal to the expected annual level of earnings capitalized at the desired rate of return, and the value of its assets. The factors that might contribute to the creation of goodwill of a business are a particularly capable staff, established relationships with customers, "know-how" (including secret processes and technical data), a well-known company or product name with a good reputation, a franchise of indefinite life, or a special location. Some of these factors can be built up through good recruitment and training programmes, advertising campaigns, scientific research, or market research. The relative importance of the various factors is difficult to determine and will vary from one situation to another.

If income could be measured by changes in economic power, whether realized or not, then the goodwill arising because of certain expenditures incurred or actions taken would automatically be brought into account and there would be consistent treatment for all taxpayers. However, we have concluded that the measurement of income on the basis of the annual change in economic power would be generally impracticable, and we must deal with goodwill in the same manner as other factors contributing to business income, that is, recognizing revenue from it when realized and, in principle, deducting expenditures as incurred except to the extent that they benefit future periods.

In a continuing business it is almost impossible to identify the extent to which expenditures such as staff training, advertising, market research, and product development will benefit future periods. In practice, such expenditures are usually written off as incurred, both for purposes of the financial statements and under present tax treatment. It seems to us that this rather liberal treatment should continue, both as a practical matter and on the ground that it may have some economic advantages to the extent that it operates as an incentive to research and product development.

Where the ownership of a business changes, and part of the purchase price is for goodwill, the situation is different because a value has been placed on the goodwill factor as a result of bargaining between independent parties. Under the comprehensive tax base the proceeds of a disposition of goodwill would be subject to tax. There are arguments for permitting the purchaser some amortization of this value for tax purposes. The earning potential represented by the goodwill and created by the former owner will gradually disappear unless maintained by the new owner. It may therefore be reasonable to amortize this cost, while also permitting immediate deduction of the costs of maintenance under the new owner. An incidental effect of such a treatment would be to simplify some of the tax considerations in business take-overs, because it would mean that there would be few tax implications involved in the allocation of the purchase price between goodwill and other intangible assets of an indefinite life, which are not depreciable, on the one hand, and the tangible assets and intangible assets of limited life, the cost of which can be amortized, on the other.

To allow the amortization of purchased goodwill would be liberal because the value of goodwill generally does not depreciate. While immediate deduction of the costs of developing goodwill may be a necessary departure from an ideal tax system, the amortization of purchased goodwill would not be a necessary part of such a procedure, particularly as an independent value would have been placed on the goodwill. Furthermore, the costs to the new owner of maintaining or increasing the goodwill would still be deductible

when incurred. More important, if the purchased goodwill did in fact later decline in value or was sold, a deduction at that time should be permitted.

The treatment of goodwill must also take into account the relationship between the measurement of business income and the tax treatment of corporate source income under the comprehensive tax base. Share gains would be fully taxable and share losses fully deductible, and the tax paid by the corporation would be fully creditable on distribution or allocation to resident shareholders. The market value of shares would generally reflect the goodwill element in the business and, accordingly, once the proposed tax system was in effect, taxation of share gains would mean that gains or losses in goodwill, when realized in market transactions, would be taxed or allowed currently even though such gains or losses would not be reflected in the underlying financial statements of the business. To the extent that the value of the goodwill was thus reflected in the value of the shares, the sale of a corporation's business would not result in any additional tax to the shareholders, for any tax paid on that gain by the corporation would be creditable to the shareholders.

In addition, to permit goodwill to be amortized by the purchaser when there was no demonstrated decline in value would tend to create a tax incentive to business take-overs, because this portion of the purchase price could be recovered through tax write-offs. Furthermore, if all purchased goodwill could be amortized, and all our other proposals were accepted, the possibility of an additional tax advantage would be created because the value of the goodwill at the effective date of implementation would be included in the cost basis of the shares and would be free of tax upon realization by a vendor, but would be amortizable by a purchaser. It might be possible to eliminate this latter advantage by prohibiting the amortization of goodwill that existed at the effective date. However, it would become increasingly difficult to maintain the identity over time of this opening goodwill.

Therefore, we conclude that it would not be reasonable to permit the

amortization of goodwill and other intangible assets of indefinite duration purchased from another taxpayer, and that a deduction should only be permitted upon disposition or when it could be established that a significant loss in value had occurred.

In accordance with our recommendation that all expenditures that meet the three general tests enumerated (that they be related to the earning of income, not be of a personal nature, and be reasonable) should be deductible at some time, expenditures that fall into the classification of "nothings" should be deductible. The only question remaining is the time when such deductions should be permitted. In the same way that it is difficult to identify the extent to which expenditures contributing to goodwill in fact benefit future income, so it is often not possible to distinguish these other outlays as being costs of a current or of a longer term nature. Not only is the accuracy of any allocation doubtful, but uncertainty as to what allocation would be acceptable to the tax authorities complicates the determination of taxable income. For accounting purposes, it is usual to write off against income most of these expenditures when incurred.

We have thererore concluded that the preferable approach would be to permit the immediate deduction for tax purposes of all business expenditures unless the legislation specifically categorized the outlay as one that must be capitalized. This approach is liberal and would minimize uncertainty. These are advantages that should override the arbitrary nature of the designation of certain expenditures as being for the longer run benefit of the business, and therefore subject to amortization over a period of time. To implement this approach, we suggest that a new capital cost allowance class should be established. Initially, the regulations could define this class to include commissions 23/ and other costs of financing; costs of incorporation and other expenses of acquiring or establishing a business; legal and other expenses to defend successfully a franchise or copyright, to obtain long-term contracts, or long-term commercial advantages, for example, lower import duties; and such other similar costs as can be defined. It should not include the costs of investigations or plans that were not in fact proceeded with, because these expenditures do not directly lead to future income, and should be deductible immediately.

In summary, we recommend that the times at which reasonable business expenditures should be allowed are as follows:

1. All business expenditures should be allowed currently except certain designated expenditures that demonstrably benefit the business beyond the taxation year. We have pointed out that many expenditures that produce current revenue also benefit future periods, but are virtually impossible to allocate over appropriate periods. Other expenditures are clearly incurred to produce income for more than one period. We recommend that, on practical grounds, most expenditures should be written off as incurred regardless of the extent to which they provide some future benefit, unless they are specified by the Regulations as falling in one of the classes referred to below.
2. Expenditures that benefit the business beyond the taxation year and are not specifically permitted as a deduction in the year incurred should be segregated into:
   a) Those contributing to inventory value which would later become a cost of sale.
   b) Those attributable to long-term assets, such as equipment and buildings, and intangible assets of limited life, which would be subject to amortization on a prescribed basis.
   c) Others, such as purchased goodwill or other purchased intangible assets of indefinite life, securities, and land, where any loss would be eligible for deduction only on disposition or upon a proven significant loss in value.

   Where a deduction for loss in value of category (c) assets was made without a disposition, and the value of the asset subsequently increased, such recovery would have to be brought back into income to the extent of the amount deducted.
3. Long-term expenditures subject to amortization would include the cost of tangible assets and of certain intangible assets with limited life as currently set out in the Regulations. Any intangible property

not included in another class that had a period of existence reasonably measurable by law, agreement or nature, should be included in class 14.

4. A new class should be added, which would include defined expenditures, whether or not they resulted in the acquisition of property, and should be eligible for an allowance of 20 per cent of the original cost a year.

In view of the above recommendations and others made in this Report, the use of the term "capital" in differentiating expenditures of a current and long-term nature would no longer appear to serve any useful purpose, and we suggest that consideration should be given to discontinuing its use. This would emphasize that the distinction involved is one of timing and not of any inherent quality.

It will be noted that under our recommendations virtually all expenditures would be allowed at some time. The allowance of all business expenditures, even some that might have a long-term benefit, and the introduction of the new class for capital cost allowance would permit immediate deduction or amortization of many outlays that are not deductible under the present tax system. In effect, any business expenditure that did not fall within a capital cost allowance class, was not part of inventory, or was not part of the cost of acquiring an item of property of indefinite life, would be deductible when incurred. Purchased goodwill would not be amortizable, and, accordingly, in the purchase of a business as a whole, the allocation of price between goodwill and other assets would still be important and might cause difficulties. A deduction for purchased goodwill could be made on its eventual disposition or deemed disposition, or upon a proven loss in value, and in this way the existing difficulties should be reduced.

The "Cash" Method of Computing Income. The means we have discussed for placing the measurement of business income of all taxpayers on a common basis would involve recognizing income when it was realized. that is, when property was disposed of or services rendered, and allowing the deduction of costs either as incurred or as the benefits therefrom were used up. This approach

is substantially what is referred to in accounting terminology as the "accrual" method of computing income. Although the accrual method is generally required for computing business income on the grounds that it is the only method that gives a reasonably accurate measure of "profit", section 85F of the Act specifically permits a taxpayer engaged in farming or a profession to elect to use the "cash" method of computing business income.

Under the cash method, income is computed simply by deducting cash disbursements from cash receipts. Thus, sales are not taken into income until paid for in cash, and expenditures are not deducted until a cash payment has been made. Such a system ignores the fact that a sale may have resulted in a legal obligation readily convertible into cash, and that cash laid out may have been replaced by an asset of equal value. It also ignores expenses that have been incurred but not yet paid. Therefore, it is not a measurement of business income but tends to reflect cash flow. In some small businesses cash flow and income will be approximately the same, but this would not apply generally.

The cash method of computing income represents a significant departure from our concept of the best measurement of business income, and results in at least a temporary understatement of income for certain taxpayers. We therefore recommend that the right to use the cash method of computing business income should be restricted. In our view, it would create some hardship to require all farmers and professional individuals to adopt the accrual method because of the accounting and liquidity problems which this might involve for those with relatively small incomes. Accordingly, we recommend that any individual whose principal source of income is farming or a profession should be entitled to continue to use the cash method as long as his annual gross revenue from farming or the profession was less than a specified sum, say, $10,000. We also recommend that all other business income should be required to be computed on the accrual method. If an individual whose principal source of income was farming or a profession adopted the accrual method, either through choice or because his gross revenue exceeded the sum specified, he should not thereafter be entitled to revert to the cash method.

We are aware that the immediate implementation of this recommendation without some transitional provisions could cause hardship for those farming and professional businesses where the cash flow was inadequate to meet the unanticipated tax liability. In addition, there would be a problem where the accounting records were inadequate to compute income on the accrual basis. Therefore, our recommendations should be implemented in stages, starting first with those larger businesses where the cash flow was more substantial and where the records were adequate. The Department of National Revenue could provide standard forms to assist those businesses which required them to put their records in order. We do not feel that the burden of maintaining adequate records or of paying taxes on an accrual basis is unreasonable.

A problem lies in the appropriate treatment of the opening assets (accounts receivable and inventories less accounts payable) of businesses that are on a cash basis, which would be affected by transfer to an accrual basis. To bring such opening assets into income at the effective date would require payment of tax which the taxpayers concerned had expected to postpone until death, or sale, or discontinuance of the business. One possibility would be to exempt these opening assets from taxation, and to regard this as a necessary price of placing all taxpayers on an equal footing in the future. On the other hand, to exempt this income completely from tax would not give equal treatment with other taxpayers including those who, though eligible to use the cash basis, did not elect to take advantage of it and were therefore already "paid up".

Because many taxpayers would consider such a tax to be a special levy, and in many cases would be unable to make payment, equity could be served on transition by establishing for each taxpayer who converted to the accrual basis a contingent liability equal to the tax, which would become payable upon the reduction or ultimate liquidation of the opening assets. This might require a record to be maintained until the disposition of the business or until the taxpayer died or left the country which could be a substantial period of time. Another alternative would be to relate this problem to the determination of the cost basis of the business at the

effective date, for purposes of determining the eventual property gain or loss on final disposition. Thus, the estimated market value of the business at the effective date of the new legislation could be reduced by the excess of the assets over liabilities set up to convert the accounts from a cash to an accrual basis. Then, on ultimate disposition, this adjustment would be taken into income. This procedure would be substantially the same as at present, because a taxpayer is now required to bring into income the proceeds on disposition of certain assets, that is, accounts receivable and inventory. We recommend the adoption of the latter alternative because it would impose tax on the balances outstanding at the valuation date on the same basis as currently applies, because the taxpayer would not face an unexpected tax liability, because it would put the current records on an accrual basis, and because it would tax future profits in each year in which they accrued. When a farm or professional practice was acquired in the future the purchaser should be required to set up the appropriate portion of the purchase price as inventory and receivables, irrespective of the level of his gross revenue, a procedure that should not give rise to liquidity problems.

Business Losses

The proper treatment of business losses for tax purposes raises a number of issues.

The first question we shall consider is the extent to which the government should share in the losses as well as in the profits of business. Under the present system some sharing of losses takes place. If an individual with non-business income incurs a business loss, he may offset the one against the other in the year of loss, and to the extent that the tax otherwise payable on his other income is reduced, the government has shared in his business loss. Similarly, an individual or corporation engaged in several different lines of business at the same time may set off a loss in one business against income of the other.

There is no doubt that a full sharing of losses by the government, involving the payment of subsidies to a business to the extent of its business

loss multiplied by the going tax rate, would have some desirable results. The tax system would no longer make a distinction between businesses which can offset their losses against income and those which cannot, so that a disturbing effect on business activity would be eliminated and equity achieved between taxpayers. In particular, it would eliminate the tax disadvantage suffered by the small, risky business, which is already at a considerable disadvantage compared with the diversified, well-established business. In terms of stability, a sharing of business losses would provide funds in times of low economic activity and thereby act as an automatic stabilizer. Losses would no longer have any relevance for tax purposes beyond the year in which they were incurred or for any taxpayer other than the one incurring them, and the legislation would therefore be simplified.

Despite these attractions, we are convinced that a full sharing of losses by the government would be repugnant to most Canadians. We do not accept the argument that because the government shares in all income it should also share in all losses. Subject to this limitation, however, rules should be devised to place all taxpayers on as nearly equal a footing as possible.

The questions to be answered are when, and to what extent, business losses can reasonably be taken into account in determining income. We have no doubt that a business loss of any particular year should be applied to income from other sources in the same year as is now done. If a business loss is not completely offset by other income in the current year, however, to what extent should it be carried back against income of other years or carried forward against income of future years? Under the present tax legislation, an unabsorbed business loss in one year may, within certain limits, be carried back one year and forward five. In this respect Canada is not unlike many other countries, although the practice varies 24/.

The seven-year span covered by the present loss carry-over provisions might be considered satisfactory from the standpoint of measuring business income if the only cause of business losses was the ordinary fluctuations in business activity. However, the five-year carry-forward period is not

sufficient for a new business that requires a long development period, and the one-year carry-back is often not sufficient for a business that is winding up. As we noted earlier in this chapter, the period over which benefits are received from any given expenditure may be long, and a liberal carry-forward of losses is essential to overcome this limitation of the annual period of measurement. There is, however, an anomaly in the present tax system in that, because of the permissive nature of capital cost allowances, a taxpayer may fail to make any claim for capital cost allowances and thereby in effect carry losses forward indefinitely to the extent that they would have resulted if normal depreciation had been claimed.

The tax treatment of losses can also have either a stabilizing or destabilizing effect on the economy. For example, if losses occur to a greater extent during a downswing or a low level of business activity, tax refunds in respect of loss carry-backs could be helpful in encouraging business expenditure. On the other hand, a reduction in tax as a result of the application of losses against subsequent income could occur during an upswing, and thus encourage an increase in business expenditure when restraint would be more appropriate. Except in very major swings of the economy, however, the importance of the treatment of business losses for stabilization purposes may not be great because the bulk of business income is earned in large businesses which do not incur losses frequently, and because the timing of losses does not necessarily bear a direct relationship to the business cycle.

Apart from the proper determination of business income and the economic considerations which have been discussed above, there is an overriding consideration from the standpoint of equity. With the adoption of the comprehensive tax base a taxpayer should not be regarded as having any taxable capacity until such time as all his losses from any source have been recovered.

We have reached the conclusion that the present seven-year period over which losses may be spread is not adequate to place the measurement of the

business income of all taxpayers on the same basis. Therefore, we recommend that the period be extended to permit losses to be carried back two years and carried forward indefinitely 25/. We do not suggest a longer carry-back because it could lead to administrative difficulties. Furthermore, we do not feel it would improve equity, for shareholders could claim the loss on their shares even if the corporation was not able to carry back the full loss, and because our averaging proposals would provide the individual with a longer period of carry-back.

In general, under the present legislation, a business loss can be offset against any other income of the same year. The only limitation, which we discuss below, is in respect of farming carried on as a side-line activity 26/. To the extent that a business loss is unabsorbed in the current year, however, it can be applied only against business income in the previous year or in the succeeding five years. We think that this limitation is inequitable and that it should be permissible to apply most business losses against all other income during the carry-over period.

Losses of a Personal Expenditure Nature. In Chapter 9 it was pointed out that some "business" losses could in fact be items of personal expenditure, as when the taxpayer is not pursuing a business activity with a reasonable expectation of profit, but may be primarily engaged in a hobby or a form of recreational activity. The reasons for not allowing the deduction of personal expenditures have already been discussed. The problem is in distinguishing between the business that is pursued for profit and the one that is more of an avocation or recreational activity. The present legislation partially recognizes this problem in the case of farming carried on as a side-line activity. However, the question of "hobby businesses" is not limited to farming, and is of particular concern having regard to our proposals for the liberal treatment of business and property losses. Although our proposals would specifically preclude the deduction of personal expenditures, experience has indicated that it is difficult to apply such a provision to many of the expenditures of a "hobby" business, that is, expenditures that

are in fact related to a "business", but one which does not appear to be directed to a business purpose. We were unable to develop a definition of either a genuine business or a hobby business that could clarify this problem and that appeared to be capable of application in a manner that would produce certainty. We therefore recommend that an arbitrary restriction should be employed to ensure that taxpayers could readily determine which business losses were to be considered personal expenditures and therefore not deductible. The limitation should apply when a particular business sustained losses over a lengthy period.

It is our recommendation that losses of a business should be deductible from income from all sources in the year of loss, in the two preceding years, and in future years, unless and until losses have been sustained in three years which fall within a five-year period. However, once losses have been incurred in three such years, any further loss incurred following the third such loss year should not be deductible from any income of the taxpayer (either in the year of loss or any other year) from sources other than the loss business. Such subsequent losses could be carried back two years and forward indefinitely and applied against income of the same business. If, after sustaining such losses, the business then became profitable, and the profits realized in the years subsequent to the loss years exceeded all losses from the same business deducted in previous years (including the losses deducted from other income), such business would again become eligible to claim an unlimited write-off of losses against other income unless and until the three-year rule again became operative. The five-year period is suggested for ease of administration, but if the use of such a period permits some taxpayers to deduct recurring losses of a personal expenditure nature then it should be extended.

It might also be provided that any losses sustained subsequent to the three years would be deductible from all other income if the profits of the business during a period of, say, seven years beginning with the year of loss exceeded the losses during the same period. A provision of this nature would permit, for some businesses, the deduction of a loss from other income in the year of loss, rather than requiring it to be carried forward for deduction from income of the same business.

It is not our intent that our proposals should inequitably worsen the position of the bona fide farmer who needs to take off-farm employment to assist in maintaining and expanding his farm. If it is felt that our proposals would deter such farmers from taking off-farm employment, consideration should be given to a modification of the loss limitation. For example, it might be provided that where stipulated conditions exist income from part-time employment would be treated as farm income.

Because a new business would be permitted an unlimited loss deduction for the first three years, and would only become subject to the above procedure in the fourth year, the limitation should pose no difficulty for new businesses. In this way, the losses of a new business would be eligible for full deduction, without dollar limitation, from other income regardless of whether it was a "hobby" business. This procedure is quite liberal, because 100 per cent capital cost allowances could also be claimed by a qualified new business.

In addition, there are three points relating to the computation of a gain or loss from a business that should ensure that only "hobby" losses were disallowed. First, in Chapter 15 we recommend that certain expenditures relating to non-personal property, such as interest, property taxes, costs of establishing and defending a property right, and damage claims resulting from the holding of property, instead of being written off when incurred, should be permitted to be added to the cost basis of the property if the taxpayer so chose. Second, earlier in this chapter we pointed out that capital cost allowances should not have to be taken unless the taxpayer chose to do so. Both of these options would enable a taxpayer to reduce his losses for tax purposes and should mean that in most cases there would be sufficient taxable income that the three-year loss rule would not apply. The third factor would be a limitation on the taxpayer, for we recommend that in applying the three-year loss rule, gains from the holding or disposition of property of the business (other

than inventory) should be excluded from the computation as being income from property rather than from business.

The recommended provisions should not restrict the claiming of losses by bona fide businesses, but taxpayers engaging in an activity for personal enjoyment would find that the right to deduct any losses from such activity from income from other sources after an initial three-year loss period would be denied under the tests we have suggested. The present hobby farm provision should therefore be removed.

The disallowance of a loss to a corporation would be an idle gesture if the shareholders could then in effect claim the loss when they disposed of their shares at a price less than otherwise could have been realized. However, because the loss would be deemed a personal benefit, the amount would either have to be attributed to the shareholders or deducted from the cost basis of their shares. If this was not feasible, an amount equal to the loss would have to be subjected to the top rate of personal tax on a grossed-up basis. This is the procedure we recommend for other personal benefits which cannot be attributed to specific individuals.

Separate Businesses. Our recommendation for the treatment of losses of a personal nature has implications for the definition of a business. Although the current definition in section 139(1)(e) should be satisfactory for the purpose of determining whether a business exists, it is of little assistance in distinguishing between separate businesses, which would be necessary under our proposals because losses on some businesses would be subject to special limitations. This question has already been raised in Chapter 20, which deals with the taxation of clubs, charities, and certain tax-exempt entities. It would also be important in connection with our recommendations for new and small businesses later in this chapter.

The task of finding a suitable test for a "separate business" is not easy, considering how diverse the business operations of firms and individuals

are, and the degree to which essentially different operations may be integrated with one another.

Under the present Income Tax Act there are provisions which now require the identification and separation of the various businesses that a proprietor, partnership, or corporation might be operating. The most important examples concern the claiming of loss carry-forwards where there has been a change in control under sections 27(1)(e) and 27(5), and the requirement that separate businesses set up separate capital cost allowance schedules under Regulation 1101(1).

Although we do not propose a specific definition of what constitutes a separate business, we suggest that the legislation might contain some provisions on this matter for the guidance of the courts. Generally speaking, where business operations carried on by one taxpayer were interdependent they should be regarded as one business. The operations may be integrated vertically, like flour milling and the bakery business; mining iron ore and steel making; or producing, refining, and marketing petroleum products. Operations might also be integrated horizontally, as in the case of a chain of stores, hotels, or restaurants with central management and service functions. In these cases the operations should all be regarded as one business, even though it would have been possible to operate them separately. On the other hand, if two operations were of different kinds and neither contributed to the other by providing materials or services, promoting sales or sharing services, so that the only substantial connection between them was common ownership, they should be regarded as separate businesses. There would no doubt be many cases when one operation contributed in some way to the other operation. We do not think a token relationship should satisfy the test, but that there should be a genuine and substantial commercial integration.

The present jurisprudence suggests that businesses of an identical

nature may be separate if conducted in different locations. We do not agree that this treatment is fair, and we recommend that operations of a similar nature carried out by the same owner in one or more locations should not be considered as separate businesses.

Somewhat more difficult is the question of whether a business which has been discontinued is the same business once it recommences operations. We recommend that where a business had completely terminated and was recommenced, it should then be considered a separate business. However, this should not be the case if the cessation of operations was temporary and the facilities and basic organization were maintained during the period of cessation.

Consolidated Returns. It is convenient at this point to deal with the situation where a group of corporations is operated under common control. Because the present legislation does not permit the filing of consolidated returns, it is advantageous to conduct operations in one corporation rather than in a number of corporations, so that profits and losses can be immediately offset. The deficiency of the present legislation is evidenced by the fact that many groups of companies have been forced to adopt artificial means of offsetting losses against profits within the group 27/.

Consolidation is permitted in the United States without payment of any extra rate of tax. An 80 per cent degree of ownership is required, and there are a number of special rules, particularly in respect of corporations entering and leaving the consolidated group. In the United Kingdom, consolidation as such is not permitted, but companies with 75 per cent common ownership can in effect offset profits against losses within the group because a profitable company can deduct a payment (referred to as a "subvention payment") made to an associated company which would otherwise sustain a loss.

The failure of the present Canadian tax system to permit offsetting of profits and losses within a group of companies operated under common control does not arrive at a proper measure of the shareholders' ability to pay, and is not in accordance with our recommendations for a comprehensive tax base. It has led to artificial transactions in many cases. We therefore recommend

that the legislation should be amended to permit companies having common ownership to aggregate their incomes and losses for tax purposes. Of course, to the extent that a loss was set off against the income of another related company in the same year, it would not be available for carry-back or -forward. However, if there was an overall consolidated loss in any year, it should be available for carry-back or -forward against the consolidated income for other years of the same group of companies, or of a group which was eligible in the year of deduction to file consolidated returns and included the companies which sustained the loss. For practical reasons the privilege of filing consolidated returns should be limited to situations where there were no minority interests.

Transferability of Losses. We must now consider the treatment of business losses where the ownership of a loss business changes. Under the present tax system, the new owner of an unincorporated business does not obtain any deduction in respect of unabsorbed losses of the previous owner. The same position arises where assets of an incorporated company with unabsorbed losses are purchased. In each of these cases the purchaser is a different taxpayer from the vendor and is not permitted to utilize the losses of the vendor for tax purposes.

Where, however, shares rather than assets of a corporation with unabsorbed losses are purchased and the taxpayer that has sustained the losses, that is, the corporation, continues in existence, the question then arises whether the carry-forward of such losses should be restricted. The present rules 28/ are that losses sustained in an earlier year cannot be carried forward if (a) since the end of that year (or since the winding-up or discontinuance of the loss business in that year) control of the corporation has changed, and (b) during the current taxation year the corporation was not carrying on the business in which the loss was sustained. There is thus a somewhat limited restriction on the carry-forward of losses where control changes. As long as the original business is continued, which is not always easy to determine, the losses may be carried forward notwithstanding that the new owners may inject into the corporation new businesses which are productive of income against which the earlier losses may be offset.

We have stated our belief that a corporation should be regarded as an intermediary for the shareholders. The proposed liberal allowance of losses is not intended to be used in such a way that one taxpayer can deduct losses sustained by another and thereby defer or avoid tax liability. Accordingly, we recommend that losses should not be transferable from one taxpayer to another, and that the right to carry losses forward should be denied to a corporation where there is a change in control, either through a sale of its shares, through granting a right to acquire a controlling interest (unless the right is exercisable only on death or default of an obligation or under a first refusal arrangement) or through a statutory amalgamation. A vendor of the shares who was resident in Canada would, of course, be able to deduct from other income any loss on the disposition of his shares. However, if the change in ownership of the business or control of the corporation took place in a reorganization which was not regarded as resulting in a realization of a gain or loss by the shareholders or by any corporation, 29/ the carry-forward of the business loss should be permitted.

Reference should also be made to an anomaly in the present system, related to the transferability of losses, which arises from the permissive nature of capital cost allowances. A loss for tax purposes may be decreased or eliminated by reducing the claim for capital cost allowances, and some taxpayers are therefore able to transfer business losses freely in the form of unclaimed capital cost allowance on depreciable assets. This would be corrected to a great extent by requiring that all taxpayers claim at least 50 per cent of the statutory capital cost allowances. As already stated, we do not recommend this. Our recommendations would provide more liberal treatment of losses and would thereby reduce the need for a taxpayer to transfer unclaimed costs to another taxpayer.

Under our proposed tax system a shareholder of a corporation which incurred losses would have a much greater possibility of claiming them against his income from other sources. A loss on shares would be fully

deductible when they were sold or revalued, as set out in Chapter 15. In addition, share losses not absorbed against income from other sources in the current year, could be applied against such income in the two previous years or any succeeding year.

The revaluation of securities and the write-off of losses against any income would be particularly valuable in the first few years of a business, and should act as a stimulant to the risk taker. This result is consistent with one of our primary purposes, to assist new businesses.

Transactions Not at Arm's Length

If the business income of all taxpayers is to be measured by common standards, the basis on which transactions take place must be subject to common market forces. Where the two parties to a business transaction do not have opposing economic interests, the actual results of the transaction may not be a reliable basis for taxation because the parties are in a position to arrange the terms of the contract to produce the least amount of tax. Although separate legal entities, they have, by virtue of their particular relationship, a common economic interest, and persons in such circumstances are said not to deal with each other "at arm's length". Legislation has been enacted in many countries to prevent such a relationship between persons from distorting or reducing the tax effects of a transaction between them.

Under the detailed provisions of section 139(5) "related persons" are conclusively deemed not to deal at arm's length, and certain types of transactions between them are subject to provisions designed to adjust the transactions for tax purposes so as to reflect what would have occurred between independent persons. Related persons include individuals related to each other by blood, marriage or adoption, and corporations one of which controls the other or which are subject to common control 30/. It is provided in section 139(5) that it is a question of fact whether two parties not related to each other are dealing at arm's length. So far, however, case law has held that a mutual interest in keeping taxes to a minimum does not, by itself, constitute evidence that the parties are not dealing at arm's length.

In the determination of business income for tax purposes there are at least three factors which can be affected significantly by a relationship not at arm's length:

1. The level at which the price of a transaction is set.
2. The allocation of price between different assets.
3. The time within which the price is payable.

Level of Price. Generally speaking, transactions between parties not dealing at arm's length are subject for tax purposes to a fair market value test, which is applied in different ways to different circumstances. First, specific provision is made in certain cases for the adjustment of the taxpayers' accounts so as to give effect to the fair market value of such a transaction rather than the value attributed to it by the parties. Such provisions are contained in section 17. Second, the Act explicitly provides in section 137(2) for the taxation of "benefits" which are conferred by one party upon another in a transaction not at arm's length, regardless of the form or legal effect of the transaction. Certain other general provisions of the Act can also be invoked to frustrate the artificial effect of transactions not at arm's length as, for example, section 8(1) which is concerned with the conferment of a benefit by a corporation on a shareholder, and section 12(2) which prohibits the deduction of unreasonable outlays or expenses.

Special rules are contained in section 20(4) for determining the capital cost of depreciable property which is acquired by a taxpayer from a person with whom he does not deal at arm's length. The essential purpose and effect of these provisions is to prevent the inflation of the cost basis of depreciable assets upon which capital cost allowance may be claimed by means of artificial transactions between persons who do not act independently.

There is evidence that where corporations were subject to common control, artificial transactions have been used to offset the profits of one company against the losses of another. Common devices included transactions in services and fixed assets which are not subject to the fair market value adjustments provided for in section 17.

In our opinion, the general approach followed in determining the level of prices in transactions not at arm's length has been satisfactory, except for some points we will refer to specifically. Certain of the difficulties which arise under the present law would be removed if our principal recommendations were implemented. For example, the adoption of the comprehensive tax base would eliminate some of the problems relating to the disposition of depreciable assets at artificial prices, because the vendor would bring his entire gain into income and there would be no incentive to inflate the price. Similarly, our recommendation for the consolidation of profits and losses within a group of corporations would remove much of the incentive for artificial transactions within the group. Nevertheless, the need for provisions designed to prevent transactions not at arm's length from being effective for tax purposes would remain, particularly in respect of transactions with non-residents, and we recommend the following changes in the existing provisions:

1. Where a transaction between persons not dealing at arm's length is adjusted for tax purposes to reflect fair market values, such adjustments should be applied to the tax accounts of both parties and for all purposes of the legislation.

2. The fair market value test should be applied to all transactions not at arm's length, including transactions in depreciable assets, payments for services and the use of property, interest, and rent, except in cases where special rules were applicable that permitted transactions to be carried out at prices other than fair market value. These rules are discussed in Chapter 15.

3. As a result of recommendation 2 above, the special rules for depreciable assets which are now in the Act should be repealed.

<u>Allocation of Price</u>. Where different kinds of assets are sold in one business transaction it is possible that, after a total price has been tentatively agreed upon by the usual bargaining between the two parties, the allocation of the agreed value between the various assets may be artificially arranged

to achieve a reduction of tax that can be shared by the two parties. For example, under the present Act, if business assets are being sold and the vendor is faced with a full recapture of depreciation on his depreciable assets in any event, he would not object if some of the value reasonably attributable to goodwill and to land was included in the price allocated to the depreciable assets. Such a re-allocation would create a depreciable outlay to the purchaser and a non-taxable receipt to the vendor; the tax benefit could be shared with the vendor by an increase in the price for the business.

Section 20(6)(g) of the Act provides that where depreciable property and other property are sold together, the vendor's allocation of the proceeds between depreciable property and other assets must be reasonable, regardless of the form of the agreement, and the same allocation must apply to the purchaser. Under section 85E(2), and somewhat in conflict with the preceding provision, the two parties may agree upon the portion of the price that is to be allocated to inventory, and that portion is deemed to be the price for both vendor and purchaser. In the absence of an agreement, the Minister may fix the price 31/. These sections are not specifically concerned with transactions not at arm's length, but do compel both the vendor and purchaser to employ identical valuation procedures, regardless of what may appear to be reasonable for their own purposes.

Under the system of taxation which we propose, the allocation of the proceeds between various assets would no longer be so important, because all the proceeds would be taxable at some time. The time of taxation, however, would still be significant, and legislation along the present lines should probably be retained with modifications. We think it is inequitable and impracticable to require that the allocation of price between depreciable and other property should be the same to both parties. Therefore we recommend that the allocation for each party should be reasonable from his own standpoint, and that the present requirement placing them both on the same basis should be removed.

Time of Payment. At the present time, business income is ordinarily computed on an accrual basis, and other income, such as employment income, on a cash basis. Therefore, it is possible for salary expense to be accrued against a business without the corresponding income being reported by the employee until payment at a later date. Where an employee is in control of the corporation operating the business, he is in a position to use the different accounting methods as a device for delaying the payment of tax. To meet this situation, and possibly to counteract the introduction of fictitious charges by related non-resident persons, section 12(3) was introduced into the legislation many years ago, disallowing until the time of actual payment the deduction of items payable to persons not dealing with the taxpayer at arm's length, and not paid within a stipulated time 32/. In 1964 this provision was repealed and replaced by section 18(1), which is similar in effect to the former section 12(3), but also makes the disallowance permanent at the end of three years unless the parties file an agreement to the effect that the amount in question is deemed to have been received by the creditor and loaned back to the debtor.

Section 18(1) can result in certain anomalies and we suggest that these should be eliminated. For example, it should not apply if the creditor is on the accrual basis and has taken the amount into account in computing its income. Also, if no agreement is filed and the amount is paid subsequent to the three-year period, we think that the deduction should be allowed at the time of payment. Subject to these points, the section seems reasonable and we recommend that it be continued.

NEW AND SMALL BUSINESSES

Dual Corporate Rate

Until 1949 all corporate income was subject to the same rate of income tax. In that year the Minister of Finance introduced a dual rate of corporation

tax with the comment:

> "The House will at once recognize this as tax relief for small businesses and will, I trust, be heartily in accord with the policy. Our country as a whole owes a great deal to the small family type of business. They have to struggle along, grow and develop in competition with large and well financed corporations whose activities may be nation-wide. My own belief is that small businesses should be encouraged and it seems to me that a useful way to do this is to lower the tax and take less out of the funds they need for growth and expansion." 33/

The lower concessionary rate was thus introduced to encourage the growth of small businesses by leaving them with more funds for expansion. Subsequent changes in the concession, by increasing the amount of income taxable at the low rate, have been accompanied by similar statements pointing out the need to assist small businesses. Since 1961, the corporation income tax rates have been 21 per cent on the first $35,000 of income, and 50 per cent on the excess 34/.

Also in 1949 the dividend tax credit was introduced to remove "completely double taxation of small businesses" 35/. This credit now stands at 20 per cent, and, when used together with elections under section 105, has the effect of almost eliminating the "double" taxation for shareholders in low income corporations who have marginal personal income tax rates of 22 per cent or less, and of more than eliminating it for shareholders paying personal income tax at rates of 26 per cent or greater. This rather perverse impact is illustrated in Table 22-1, which shows that in the case of a shareholder in the 50 per cent tax bracket the total tax paid on distributed income would be 38.78 per cent. This latter effect is particularly significant as these tax concessions were only extended to businesses conducted by corporations and were not made applicable to proprietorships or partnerships.

TABLE 22-1

MAXIMUM TOTAL CORPORATION AND PERSONAL TAXES ON CORPORATE INCOME OF $100 TAXED AT 21 PER CENT a/

Marginal Rate of Share-holder %	Corporate Income $	Corporation Tax at 21 per cent $	After-Tax Corporate Income $	Net Personal Tax Rate b/ %	Personal Tax on $79 Dividend $	Total Corporation and Personal Tax %
(1)	(2)	(3)	(4)	(5)	(6)	(7)
10	100	21	79	-10	-7.90 c/	13.10
20	100	21	79	0	0.00	21.00
30	100	21	79	10	7.90	28.90
40	100	21	79	17.5	13.83	34.83
50	100	21	79	22.5	17.78	38.78
60	100	21	79	27.5	21.73	42.73
70	100	21	79	32.5	25.68	46.68
80	100	21	79	37.5	29.62	50.62

a/ Assuming no retention of after-tax corporate income and that the section 105 election is utilized.

b/ Marginal rate of shareholder less 20 per cent dividend tax credit on all of the dividend until the marginal personal rate exceeds 35 per cent, then only on one half the dividend with the flat 15 per cent tax under section 105 on the other half.

c/ Assuming the taxpayer has other income from which this can be deducted.

These figures must be qualified, however, to the extent that earnings are not paid out in the form of dividends. Many shareholders in corporations taxed at 21 per cent have not paid the personal taxes shown in column (6) of Table 22-1. Personal taxes on corporate source income have frequently been reduced or eliminated altogether. The sale of shares of corporations with retained earnings taxed at 21 per cent has made it possible for shareholders to realize all or part of the retained earnings as tax-free share gains. In the case of closely held corporations some relatively small costs have been involved in "surplus-stripping". We estimate that the top combined rate of corporation and personal income tax on low income corporations has been about 35 per cent when the optimum statutory provisions for special rates of tax on distributions have been followed.

This means that high income individuals whose income should be taxed at high marginal rates, have been able to reduce substantially their effective marginal rates of tax by holding the shares of corporations taxed at the low corporate rate. Far from suffering "double" taxation, these individuals have paid less tax on corporate source income than employees, proprietors, and partners have paid on incomes of the same size.

After carefully examining this low corporate rate concession we have come to the conclusion that, in addition to the above inequity, it has the following major defects:

1. The low corporate rate does not apply to unincorporated businesses, which may have just as much or more difficulty in raising funds.

2. An income of $35,000 or less does not mean that the corporation is owned by low income shareholders, that it has few assets or small gross sales, or that it is new. Using the low income criterion as a means of selecting the corporations eligible for the low rate results in a situation where the incentive has little if any relationship to the underlying problem which is the inadequacy of funds for expansion because of the imperfections in the capital market.

3. The low rate is inefficient as an incentive because it applies to the first $35,000 of corporate income regardless of the magnitude of the total income of the corporation. It thus reduces the average rate of tax for larger corporations which have no difficulty in raising capital in the market.

4. The concession is also inefficient because it applies whether the rate of return is high or low, or whether the assets or sales of the corporation are expanding or contracting. The concession has no time limit, so there is no inducement for the corporation to expand. Indeed, as its income expands its taxes increase more than proportionately.

5. By reducing the tax on low income corporations in perpetuity it tends to cushion the market pressures on inefficient and declining firms.

6. The concession also creates many potential avenues for abuse. To stop the worst loopholes it has been necessary to enact elaborate provisions designed to prevent the break-up of "large-income" companies into a number of "small-income" companies that would each enjoy the reduced rate of tax.

For all these reasons we recommend in Chapter 19 that the 21 per cent rate of tax on the first $35,000 of corporate income should be withdrawn, and that a uniform rate applicable to all corporate income should be substituted. We further recommend that this rate should be 50 per cent, including federal income taxes (before deducting the provincial tax abatement) and the old age security tax now levied against corporations. This 50 per cent rate is equal to the top marginal personal rate specified in our proposed rate structure. Because the provincial rates of corporation tax now differ slightly, a uniform 50 per cent rate could be achieved only by federal-provincial agreement. This matter is discussed in Chapter 38.

This does not mean that we believe the Income Tax Act should contain no special provisions for new businesses. On the contrary, we believe that the easy entry of new businesses can play an important role in the Canadian economy, and that preferential tax treatment is one of the ways in which they can be encouraged.

The easy entry of new firms can increase competition and hence bring about a more efficient allocation of resources. Moreover, new firms are frequently the vehicle by which new techniques and new products are introduced into the economy. In fact, an economy that actively encourages new enterprises will probably be one in which established large firms are active innovators as they seek to forestall the growth of competitors.

We are aware that easy entry is not an unmixed blessing in a world where many small investors have very imperfect knowledge. Some industries that are highly competitive with respect to price are characterized by a multitude of small proprietors, many of whom exist only long enough to use up their personal wealth. While this situation may be attractive to consumers, who can thus obtain goods and services below full cost, there is certainly no reason to introduce tax incentives that would encourage this uneconomic behaviour. Nevertheless, we believe that the advantages of fostering easy entry outweigh this disadvantage.

While many new businesses are small businesses at the outset, it is necessary to consider whether encouragement should be given to small businesses generally. It is important to distinguish between help for new businesses that are small because they are new, and help for small businesses _per se_. In some branches of retailing, for example, many proprietors receive low rates of return on their capital and below market wages for their time. There is chronic excess capacity.

Although directly or indirectly subsidizing small businesses is sometimes justified on political or social grounds, maintaining an environment characterized by countless numbers of small inefficient business units exacts a substantial cost in the long run in terms of a lower standard of living for Canadians.

We do not suggest that the tax system should be used to force a rationalization of industry, nor do we believe we can justify tax measures that have the effect of perpetuating businesses that cannot earn a competitive rate of return, whether they are large or small. Our objective is to

design a tax system that is neutral with respect to the size of the business and to restrict any concessions to new businesses that, because the owners may be relatively unknown or have relatively few assets, are forced to begin in a small way. This is where the capital market imperfections are probably greatest, as we have discussed in Chapter 4.

Investors discount expected rates of return on assets that are risky and for which there is no ready market. Therefore, the expected rate of return required to induce a flow of capital into a new business with untried management must be substantially higher than the expected rate of return required to induce the same flow into large established firms with a record of successful operations. Furthermore, the cost of underwriting small issues of securities adds considerably to the cost of financing new, small enterprises. Private sources of funds are often an expensive form of financing.

Canadian financial institutions have rarely invested in risky ventures. This may be entirely due to the high interest rates available on senior securities, but it could be also partly explained by legislation that restricts their portfolio selection, partly by the fact that they are not eligible for, or are unable to take advantage of, the dividend tax credit, partly by the rules of thumb used to select their portfolios, and partly by the fact that share losses have not been deductible for tax purposes.

There have been a number of important developments in recent years that have helped to reduce the financing problems of new and small businesses. Governments have played an increasingly important and valuable role in assisting them to finance their capital expenditures. The recent development of new financial institutions specializing in intermediate and long-term financing for new and small businesses is also encouraging. Implementation of the recommendations of the Royal Commission on Banking and Finance would go a considerable distance toward removing the remaining barriers faced by new and small businesses in raising funds for development and expansion. We therefore think that the problem of financing the entry of new firms is less pressing today than it was a decade or two ago.

Furthermore, a number of the recommendations we make elsewhere in this Report would help to reduce the barriers to investment in new and small businesses.

1. The liberal treatment of business and property losses would reduce the risk of investing in new ventures. We recommend that taxpayers should be permitted to carry business losses back two years and forward indefinitely, that such losses should be permitted as an offset against other income in any year, and that capital losses should be treated in the same way as business losses. The removal of most limitations on the timing and extent of the deductibility of losses would remove a major disincentive to investment in new and small businesses. The revaluation procedures discussed in Chapter 15 would also assist in this regard.

2. We recommend in Chapter 19 the complete integration of corporation and personal taxes, with a gross-up and credit for resident individual shareholders with respect to the Canadian corporation income tax. A comparison of the present system with the proposed full integration system is given in Table 22-2.

3. We recommend a new personal rate structure with a top marginal rate of 50 per cent.

4. We recommend that the shareholders of an incorporated business should, under certain circumstances, be permitted to file their tax returns as if the business were a partnership. Not only would such an election facilitate the claiming of losses by a shareholder against other income, but it would also enable him to avoid paying the flat rate 50 per cent corporation income tax and instead would allow him to pay his taxes at his own personal rate on a quarterly basis. This would ensure that his cash position was not temporarily worsened by the removal of the low rate of corporation income tax.

These reforms would substantially reduce the hardship that otherwise would be created by the removal of the lower corporate rate, and should to some extent provide an incentive to investment in new and small businesses.

TABLE 22-2

COMPARISON OF CORPORATION AND PERSONAL TAXES ON
$100 OF CORPORATE INCOME UNDER THE
PRESENT AND PROPOSED SYSTEMS

Present Marginal Rate of Share-holders (per cent)	Present System: Corporation Taxed at 21 per cent With Full Cash Distribution a/	Present System: Corporation Taxed at 50 per cent With Full Cash Distribution a/	Proposed System of Integration of Personal and Corporation Taxes With Top Personal Rate of 50 per cent b/ and With Full Allocation	Difference Between Present System and Proposed System (-) Reduction in Tax (+) Increase in Tax: Corporation Tax of 21 per cent	Difference Between Present System and Proposed System (-) Reduction in Tax (+) Increase in Tax: Corporation Tax of 50 per cent
	(dollars)				
	A	B	C	D(A-C)	E(B-C)
10	13.10	45.00	10.00	-3.10	-35.00
20	21.00	50.00	20.00	-1.00	-30.00
30	28.90	55.00	30.00	+1.10	-25.00
40	34.83	58.75	40.00	+5.17	-18.75
50	38.78	61.25	50.00	+11.22	-11.25
60	42.73	63.75	50.00	+7.27	-13.75
70	46.68	66.25	50.00	+3.32	-16.25
80	50.62	68.75	50.00	- .62	-18.75

a/ For illustrative purposes only. We do not wish to imply that full cash distributions would be usual. The table is for resident shareholders and follows the same assumption as in Table 22-1, where half the distribution was assumed to be under section 105 at a flat 15 per cent.

b/ It is assumed that the present marginal personal rates apply below 50 per cent, and that a 50 per cent rate applies to all taxpayers who previously had marginal rates over 50 per cent.

This is shown by the calculations given in Table 22-2. These calculations assume corporate income of $100 per share and include personal and corporation income taxes with full distribution (or allocation) of all after-tax corporate profits. It will be seen that removal of the low corporate rate, without integration and without the new personal rate structure, would substantially raise the taxes borne by that portion of the corporate stream of income now being taxed at 21 per cent, particularly for the low income shareholder. Under the proposed integration system, however, the increase in tax burden would be moderate and would be confined to the middle and upper income groups. Most shareholders with marginal rates of less than 30 per cent would have a reduction in tax.

However, here, too, this comparison requires careful qualifications. As we have pointed out, there have been a variety of techniques by which middle and upper income shareholders have been able to avoid some or all personal taxes on corporate source income. We have estimated that the top combined rate of tax on low rate corporate source income probably has not exceeded 35 per cent. Therefore, even with integration, the effective marginal rate of tax on high income shareholders in what have been low rate corporations would probably be raised by about 15 per cent.

With abolition of the low corporate rate, full integration of corporation and personal income taxes, and full taxation of share gains, shareholders in corporations that previously enjoyed the low rate would pay exactly the same taxes as individuals earning comparable incomes from employment and from operating unincorporated businesses. This would provide tax relief for the low income shareholder but would generally involve an increase in taxes for other shareholders, because under the present system these individuals are not subject to full progressive rates of tax on all their income (as we define income).

Rapid Write-off of Capital Cost

Despite our great reluctance to recommend the complex tax provisions that are inevitable when the tax structure is used to achieve specific

economic purposes, we believe it would be unwise to recommend withdrawal of the low corporate rate without making some adjustment within the tax system designed specifically to assist new and small businesses. We are concerned that if we did not propose a technique of assistance within the tax system, either our major reforms would be rejected because aid to new and small businesses outside the tax system might be thought to be impractical, or they would be implemented without the adoption of compensating policies outside the tax system, to the detriment of new and small businesses. We have decided that a concession to such businesses within the tax system that would assist in the financing of capital expenditures would reduce the major difficulty that confronts many of these businesses.

The concession we envisage should be designed to accomplish the following objectives:

1. To reduce the cost of capital to new businesses or rapidly expanding small businesses where those who control the business are not in a position either to put up much capital themselves or to raise capital cheaply because of their lack of an established financial position or an established reputation as successful managers.

2. To help fill the gap in the present capital market with respect to longer term financing of capital investment. We think that, in general, the regular sources of financing should provide the required funds for financing accounts receivable and inventory.

3. To avoid creating pressure on taxpayers to change the way they conduct their affairs in order to secure a tax advantage.

4. To promote the expansion of businesses rather than to perpetuate stagnating or declining businesses.

To accomplish these ends, we recommend a system of accelerated capital cost allowances with the following provisions:

1. The concession should be available to all qualified businesses, including farming, without regard to the legal form under which the

business was carried out, that is, corporation, trust, co-operative, proprietorship or partnership.

2. In order to qualify, the business should have to meet three tests for each year in which the accelerated capital cost allowances were claimed:

   a) The assets, after capital cost allowances, of the business and of other businesses controlled by the same shareholders should be less than $1 million and gross revenues should be less than $10 million.

   b) At least 70 per cent of the beneficial interest, defined as either the right to control or to receive income, in the business should be held by Canadian residents.

   c) At least 70 per cent of the beneficial interest, either direct or indirect, in the business should be held by one or more resident individuals, no one of whom:

      i) had a beneficial interest of more than 30 per cent in another business that was qualified or had been qualified for the accelerated write-off of capital costs, or

      ii) had, within the previous ten years, owned a beneficial interest of greater than 30 per cent in another business that was qualified for the accelerated capital cost allowance at the time the interest was held.

   In determining whether a 30 per cent beneficial interest was held or had previously been held by an individual in another business, the interests of members of his family unit should be included.

3. The business should be required to apply to the tax authorities for status as a qualified business. The applicant would have to satisfy the authorities that the business met all the statutory conditions in order to qualify. This would be done by an application setting forth the relevant facts of the business. Refusal of the authorities to

qualify a business would be subject to appeal to the courts. If an application or appeal was successful, the qualifications would be effective as of the date on which the original application was made. The procedure would be optional to the taxpayer, and he would not have to qualify an eligible business unless it was advantageous for him to do so.

4. Qualified businesses should be permitted to claim capital cost allowances up to the full actual capital costs in computing taxable income in any one year, or over a period of years, to a total value of $250,000, without regard to the maximum capital cost allowance rates specified in the Regulations.

5. Capital costs incurred before qualification would not be deductible after qualification, except at normal capital cost allowance rates.

6. Having once been deducted, capital costs should not be claimed again under any circumstances. If the assets were sold for more than their undepreciated capital cost the excess would be brought into income in the usual fashion.

7. Businesses in existence at the effective date of the legislation should be permitted to apply for qualification for capital costs incurred subsequent to the effective date of qualification.

8. The definition of a separate business has been discussed earlier in this chapter.

9. If a business had qualified for the rapid write-off in one year, and was subsequently disqualified because of the growth of its assets or sales, the unused part of the $250,000 should be deductible in later years if, through a decline in assets or sales, it subsequently qualified. Ten years after qualifying, the business should be automatically disqualified even if part of the $250,000 accelerated capital cost allowance had not been deducted.

10. A business that exhausted its $250,000 of accelerated capital cost allowances, or became disqualified by the passage of the ten-year period, would not again become qualified.

We are under no illusions that this rapid write-off of capital costs for new and small businesses would be simple to administer. Despite these administrative difficulties, we believe that our proposals would not create the complexities that now exist in the present "associated corporations" provisions of the Act.

When the split corporate rate was introduced in 1949, it was made applicable to all corporations, with the exception that those subject to common control were required to share the low rate of tax. Presumably, it was considered that, even though the existence of separate corporate entities had a sound business reason, they should be regarded as a unit for purposes of the tax relief to small businesses. At the same time, the associated corporations rule was an anti-avoidance measure intended to restrain the the proliferation of corporations purely for the purpose of obtaining additional low rates of tax.

The concept of control in determining association was immediately viewed by taxpayers as too stringent, 36/ and, in 1950, retroactive to 1949, the test of control was replaced by that of a 70 per cent degree of ownership. This basic test was supported by other rules, one of the main objectives of which was to treat individuals not dealing at arm's length as a common group. These rules became more complex and difficult to interpret, and, at the same time, the ingenuity of taxpayers was such that the intent of the legislation was being thwarted. In 1960, the legislation was substantially amended to abandon the 70 per cent ownership test and revert to the test of control. This still proved insufficient to prevent undue advantage being taken of the low rate, and in 1963 the government added the present overriding section 138A(2) under which the Minister may deem corporations to be associated if their separate existence is not solely for the purpose of carrying out their business in the most effective manner,

and if one of the main reasons for such separate existence is to reduce the amounts of taxes otherwise payable. Such ministerial action can be appealed, but will be set aside only if it is determined that none of the main reasons for the separate existence is to reduce the taxes otherwise payable. This last change has probably checked the undue proliferation of corporate entities for tax minimization, but it is based on determining the intention of the taxpayer, which is always difficult, and the appeal provisions seem to be slanted in favour of the Minister.

Our proposal should, if implemented, lead to fewer avoidance problems than the split corporate rate for three reasons:

1. The relief would be available only to qualified businesses and, in order to qualify, the business would have to make an application to the tax authorities. In this way the authorities could obtain all the information necessary to trigger quick action to close loopholes.

2. The rapid write-off of capital costs would be, in effect, an interest-free loan to those small businesses that were acquiring fixed assets within a relatively short period. Because the relief would take the form of a deferment of tax, rather than a permanent remission of tax, this should reduce the lengths to which taxpayers would go to obtain qualification.

3. By restricting the provisions to businesses controlled by Canadian residents, the proposed concession should be more easily policed than the present low rate provision.

It is quite true that we have not defined a new business but only a small business, and so it might be argued that our proposal is no great improvement over the present system. However, it should be noted that after a transitional period of about ten years, during which time all the qualified small businesses would have used up their accelerated depreciation or their qualifications would have expired, the concession would apply only to new businesses. We assume that all small businesses that could qualify would do so as quickly as possible after the provision was introduced.

We emphasize the liberality of the transitional provisions we recommend. Because most existing small businesses would be able to qualify if our proposal was introduced, those that undertook substantial capital expenditures after qualification could probably avoid payment of corporation taxes for several years. If the total income of the business before depreciation did not exceed $250,000 over a ten-year period, and if it acquired depreciable assets to a value at least equal to its income before depreciation, no income tax would be payable for the ten years. Moreover, at the expiration of the qualification period, or on the exhaustion of the $250,000 allowance, the tax burden would not be unduly harsh. Because the tax on business income would then be levied at personal rates, low income individuals who owned or controlled small businesses would ordinarily pay lower taxes than at present, even with the split rate. Upper income individuals in receipt of income from small businesses would pay higher taxes on this income than at present, but this would only bring them into line with other individuals with the same level of income from other sources. The reduction in the top marginal personal rate would ensure that no individual was faced with a marginal rate of over 50 per cent on his business income.

CONCLUSIONS AND RECOMMENDATIONS

COMPUTATION OF BUSINESS INCOME

1. Business income for tax purposes should continue to be based on "profit" as a starting point.

2. Some of the present statutory provisions for computing income should be repealed, as indicated below, to permit the tax authorities and the courts to look more to accounting and business practice in determining profit.

3. The legislation should be amended to ensure that all types of revenues were included in business income, including property gains, gifts, windfalls, and the forgiveness or cancellation of debt.

4. The present provisions for a general disallowance of "reserves", and for the specific allowance of "reserves" in respect of unearned income and doubtful accounts should be repealed. The general statutory test of reasonableness should apply to allowances for unearned income, to estimated losses in value of accounts receivable, and to allowances in respect of losses that could result from guarantees, warranties, and indemnities.

DEDUCTIBILITY OF EXPENSES

5. All expenditures reasonably related to the gaining or producing of income should be deductible at some time. They should be deductible when incurred unless they were applicable to inventory, to an item defined in a capital cost allowance schedule, or to property of an indefinite life such as purchased goodwill, land, and securities. Costs allocated to the first group should be deductible from the proceeds of sales, those of the second group should be amortized as permitted by the schedules, and for the last group, losses should be deductible on disposition or when there was a proven significant loss in value.

6. Any element of personal benefit in business expenditures may generally be allowed in arriving at business income, but should be reported as income of the recipient. If such allocation to the recipient is not possible, the business should be subject to a special tax on such personal benefits on their grossed-up amount at the top personal rate, and this special tax should be allowed as a deduction.

7. The general test of reasonableness should continue to apply to all business expenditures. Where individuals carry on business directly, personal or living expenses of the indiviuals should not be deductible. However, the disallowance of expenditures for the purpose of producing exempt income should be deleted.

8. The present rules regarding inventory valuation should be deleted, and more reliance should be placed on accounting and business practice, with satisfactory guidelines developed by the business and professional community and the tax authorities. The use of the last-in-first-out method of inventory valuation should be allowed on a restricted basis.

9. The amortization of costs provided under the present capital cost allowance system should be continued with the present general level of rates unchanged, but the system should be broadened to cover certain defined outlays now known as "nothings" that are at present non-deductible. The following modifications should be made to the system:

   a) There should be no allowance until an asset has been put into use.

   b) In accordance with our recommendation for a comprehensive tax base, the proceeds from disposal of a depreciable asset in excess of its original cost should be taxable.

   c) A deduction should be permitted to the extent that the unclaimed cost in any class exceeded the original cost of the remaining assets.

   d) Rentals for long-term assets with a purchase option should be allowed only to the extent that they were reasonable and any excess should be treated as being on account of the purchase price of the asset. In addition, there should be a specific provision requiring an amount to be brought into income and capitalized where a lessee acquires, at less than fair market value, an asset which he has been renting.

10. The cost of purchased goodwill, or other intangible assets of indefinite life, would be deductible upon disposition or upon an established, significant loss in value in the same manner as recommended for land and securities in Chapter 15.

ACCRUAL BASIS

11. All businesses should compute income on the accrual basis, including farming and professions, except that an individual whose principal source of income was farming or a profession, and whose annual gross revenue from that source was less than a specified sum, say, $10,000, would be entitled to continue on the cash basis. A transitional provision would defer payment of any tax liability on the initial accounts receivable and inventory until final disposition of the business.

BUSINESS LOSSES

12. Business losses should be subject to the following treatment:

    a) The present provisions for applying losses against other income should be broadened by allowing most losses to be carried back against any income of the two previous years, and carried forward indefinitely against any income of future years.

    b) Some form of consolidation for tax purposes should be permitted for groups of corporations under the same ownership.

    c) Transfer of losses between taxpayers should be prohibited, except on certain tax-free reorganizations.

    d) Certain losses, determined by an arbitrary formula, should be deemed to be of a personal nature and should only be deductible from gains from the same business in the two previous years or in any succeeding year.

TRANSACTIONS NOT AT ARM'S LENGTH

13. The rules applied to transactions between parties who do not deal at arm's length should be amended as follows:

    a) The test of fair market value should be applied to all transactions between parties not dealing with each other at arm's

length, except where special rules are applicable.

b) Where the purchase price of property has to be allocated among more than one type of property, such as inventory, depreciable assets, and goodwill, each party should be permitted to make a reasonable allocation from his own point of view.

NEW AND SMALL BUSINESSES

14. The dual rate of corporation tax should be replaced by a single rate of 50 per cent which would include the old age security tax.

15. New and small businesses should be allowed to write off expenditures for assets eligible for capital cost allowances at any time, if they so elect, subject to the following restrictions:

a) The privilege would be available only to those businesses, whether incorporated or not, that had gross revenues of under $10 million in the tax year and total assets, net of capital cost allowances, of less than $1 million book value.

b) The privilege would be available only to those businesses that made application to the tax authorities, and would apply only to the cost of assets acquired after the application.

c) The privilege would be available only to those businesses in which at least 70 per cent of the beneficial interest in voting power or profits was owned directly or indirectly by Canadian resident individuals who, together with members of their family units:

i) did not hold a beneficial interest of more than 30 per cent in another business that was qualified, and

ii) had not held, within the previous ten years, a beneficial interest of more than 30 per cent in a business that was qualified at the time the interest was held.

d) The value of depreciable assets the cost of which would be eligible for the accelerated write-off would be limited to $250,000.

e) A business that had ceased to qualify, either because it had used up its $250,000 allowance or because it had failed to use up the allowance within a ten-year period, could not again become qualified.

f) As soon as the business ceased to meet either of the restrictions on gross revenue or asset value, any additional capital assets would be subject to the regular capital cost allowance regulations.

g) All assets of such a qualifying business should be subject to the regular provisions applying on disposition of depreciable assets.

REFERENCES

1/ As used in this Report, the expression "accounting practices" may be taken to include not only the practices of accounting but also the underlying principles on which the practices are based.

2/ Section 85F.

3/ Section 12(1)(b).

4/ Section 11.

5/ Section 3.

6/ Section 27(1)(e).

7/ Sections 27(5) and 27(5a).

8/ As shown, for example, in the case of Atlantic Engine Rebuilders Ltd. v. M.N.R., 64 DTC 5178, where the Exchequer Court expressed doubt as to whether section 85B applied to certain deposits.

9/ See the brief submitted to this Commission by the Canadian Institute of Chartered Accountants, pp. 12-13.

10/ Canadian Institute of Chartered Accountants, Committee on Accounting and Auditing Research, Bulletin No. 9, January 1953.

11/ While it is fairly obvious that material and labour directly used in the production of a product should be included in its value, the inclusion of variable overhead, such as a foreman's salary, is less obvious, and the inclusion of fixed overhead, such as depreciation and property taxes on a factory building, is still more questionable. The general practice varies from including an estimated amount for all the overhead to that of including no overhead, depending on the particular circumstances involved and the theory adopted. (The first approach is commonly referred to as "absorption costing" and the second as "direct costing".) The reason for a variation in practice

is that a business is viewed as a going concern, and consistency in the treatment of inventory is considered more important than accurate reflection of the historical position of the business at a given date. The English courts have held that a taxpayer who has consistently employed direct costing cannot be required to depart from it (Duple Motor Bodies Ltd. v. Ostime (1961), 39 T.C. 537).

In estimating the extent to which the cost of the inventory will benefit future periods, market value is often available as an objective measure. The market value, depending on the type of inventory, may be determined in terms of replacement cost or net realizable value upon sale. If the market value is higher than the cost of the inventory, the full amount of the cost can be deferred, whereas if the market value is lower the usual practice would be to carry costs forward only to the extent of that market value. However, there is some lack of agreement on whether market value should be based on replacement cost or net realizable value, and in determining net realizable value there is dispute as to whether cost should be written down to permit realization of a reasonable profit in the subsequent period.

12/ M.N.R. v. Anaconda American Brass Limited, [1956] A.C. 85.

13/ M.N.R. v. Anaconda American Brass Limited, [1954] S.C.R. 737.

14/ [1952] Ex. C.R. 297.

15/ Striking evidence of this was the change in business practice after the present system of capital cost allowances was introduced in 1949. It was initially provided, until the 1954 taxation year, that a taxpayer could not claim the capital cost allowances unless he entered an equivalent amount of depreciation in his accounts. To obtain the benefit of the more generous tax allowances, many taxpayers changed the amount of depreciation charged in the accounts.

16/ We did receive representations that some of the rates were not adequate, for example, in respect of heavy construction equipment, building equipment, certain hotel equipment, and electronic equipment. We note, however, that the Regulations were recently amended to provide a higher rate for heavy construction equipment. Occasional adjustments of rates are appropriate, although it must be kept in mind that the simplicity of the system arises from the grouping of a multitude of types of assets into a relatively few classes, and the rate for a specific type of asset may well not be accurate.

17/ Recommendations are made elsewhere in this chapter to expand the capital cost allowance system to cover certain "nothings".

18/ R. W. Davis et al., Capital Cost Allowances, a study published by the Commission.

19/ One of which was presented to the Commission by International Business Machines Ltd.

20/ The terms of the legislation appeared to be such that in the case of long-term leases very substantial annual capital cost allowances could be claimed by regarding the purchase price for the property as the aggregate of the annual rentals payable plus the option price. In two recent Exchequer Court decisions, however, the purchase price has been treated as being the final option price: Louis J. Harris v. M.N.R., 64 DTC 5332; Consolidated Building Corporation Limited v. M.N.R., 65 DTC 5211. The taxpayer's appeal in the former case was dismissed by the Supreme Court of Canada (66 DTC 5189) on the ground that the arrangement violated the rule against perpetuities, and that in any event, (a) the final option price was the purchase price on which capital cost allowances should be calculated, and (b) the allowance claimed would artificially reduce the taxpayer's income and should be disallowed under section 137(1).

21/ This discussion of leasing has been in terms of depreciable assets. If land is involved the potential tax reduction is even greater, and similar rules should apply. The offsetting amount would be added to the cost basis of the land.

22/ If a business goes through a lengthy period of development, the costs of development may be amortized over an arbitrary period of operations. Or again, where a business incurs extensive advertising or promotional expenses toward the end of a year, some or all of the costs may be deferred and applied against income of the following year. The problem, of course, is in forecasting the future benefits of such expenditure.

23/ Some controlling provisions might be required because of the possibility of inflating share values and overstating these expenditures.

24/ In the United States a loss may be carried back three years and forward five. The United Kingdom permits an indefinite carry-forward and, on cessation of business only, a three-year carry-back. The Netherlands permits a one-year carry-back, but there is no provision for carrying back losses in France, Germany or Sweden. A carry-forward period of five years is common, although Norway permits a carry-forward of ten years; and, in The Netherlands, where the standard period of carry-forward is six years, a new business may carry forward indefinitely losses incurred in the first six years.

25/ We have proposed that this same carry-over should also apply to most other losses, including losses from the disposition of property (including shares). These loss carry-over rules would be in addition to the methods of income averaging which we recommend in Chapter 13. In the case of corporations, however, the carry-back would be limited to the amount of the income for the years in question which had not been distributed or allocated to the shareholders.

26/ Further discussion of the deduction for farm losses is contained in Chapter 25.

27/ This point was emphasized by the Canadian Bar Association in its appearance before this Commission. Under the present legislation transactions at other than market value are possible in respect of such items as fixed assets, service, and interest, as explained in the discussion later in this chapter of transactions not at arm's length. In addition, the tax authorities do not always insist on the application of the fair market value rule in transactions between Canadian companies.

28/ Sections 27(5) and 27(5a).

29/ For example, by a transfer of assets or shares from one wholly owned subsidiary to another wholly owned subsidiary of the same parent corporation. Tax-free reorganizations and transfers are discussed in Chapter 15.

30/ A modification to this rule is suggested in Appendix A to Volume 3, which deals with tax avoidance.

31/ Where this price is not the fair market value, the question arises whether section 17 overrides section 85E when the parties are not at arm's length. It has generally been departmental policy not to apply section 17 where section 85E applies.

32/ We understand that there was also concern that a Canadian corporation might claim deductions for merchandise purchased from a non-resident parent, and then subsequently receive a non-taxable forgiveness of the liability for the purchases. This possibility would no longer exist under our comprehensive tax base because forgiveness of debt would be income to the debtor.

33/ Budget Speech, Ottawa: Queen's Printer, 1949, p. 14.

34/ This rate includes the 3 per cent old age security tax and is calculated before deduction of the provincial tax abatement. The rate is higher in those provinces where the provincial tax levied exceeds the abatement. See Appendix I to this Volume for a discussion of the dual rate of corporation income tax.

35/ Budget Speech, op. cit., p. 15.

36/ The major complaint is said to have been that the test of control discouraged the formation of new corporations that depended upon capital furnished by existing corporations, or by individuals who already controlled one or more corporations; Report of Proceedings of the Fourteenth Annual Tax Conference, Toronto: Canadian Tax Foundation, 1960, pp. 43-44.

CHAPTER 23

MINING AND PETROLEUM

The Income Tax Act has a number of special provisions relating to the mining and petroleum industries. A detailed examination of their effects can be found in studies published by the Commission 1/. Several participants in our public hearings also submitted extensive studies of the tax provisions together with illustrations of their application under different circumstances. The most significant of the tax provisions from the point of view of revenue loss are outlined briefly below:

1. In general, qualifying corporations 2/ can claim immediately the costs of exploration and development as deductions from income from any source 3/. Any portion of these costs not absorbed against current income may be carried forward indefinitely. Depreciation on plant and equipment is not allowed as an exploration or development cost as such assets are subject to regular capital cost allowance.

2. The income of new mines is exempt from tax for a period of three years 4/. Because a taxpayer may defer deduction of any capital cost allowance or development costs until after this period of exemption, income tax is unlikely to be paid for some additional years after this initial three years.

3. Taxpayers who operate oil or gas wells or mines 5/ (with the exception of gold 6/ and coal 7/ mines, which are given special allowances) are permitted to claim a depletion allowance equal to one third of their taxable income from petroleum production or mining operations. (The term "petroleum" when used in this chapter should be taken to include natural gas.) In general, this provision can be said to reduce the effective rate of corporation tax by one third. Non-operators are entitled to a depletion allowance of 25 per cent 8/ of their gross income from the mining or petroleum operation. In addition, shareholders are permitted to deduct 10 per cent, 15 per cent or 20 per cent

of the amount of dividends paid by certain corporations resident in Canada if the income of the corporation which was derived directly or indirectly from the operation of a mine, oil or gas well meets the prescribed tests 9/.

These provisions of the Income Tax Act and the Regulations have been subject to controversy over the years between those who have argued that they reflect only the necessary distinction that should be made to take account of the peculiar characteristics of these extractive industries, and those who argue that the provisions result in an unwarranted tax concession to a particular type of economic activity.

The present tax treatment of business income has several major defects as discussed in Chapters 9 and 22. In particular, because of the exclusion of capital items from income, some costs are not deductible at any time. The limitations on the carry-forward, carry-back, deductibility against other income and transferability of losses mean that the present system is seriously biased against risk taking by new and small businesses. The low rate of corporation tax on the first $35,000 of corporate income appears to be a relatively inefficient and ineffective method of compensating for the apparent bias of the capital market against risk taking by small firms.

With the adoption of the recommendations made elsewhere in this Report these defects would be virtually eliminated for all businesses. To the extent that the mining and petroleum industries have been particularly penalized by these deficiencies in the present system, these industries would obtain a greater benefit than other industries from the general reforms which we propose.

The defects in the present system are of omission as well as commission. If all costs are made fully deductible, all gains should be made fully taxable. The recommendations made elsewhere would bring into tax all property and other gains at full rates and would subject all corporate income to a

flat rate of tax of 50 per cent. The question is therefore whether the present special tax concessions to the mining and petroleum industries would have any place in a reformed tax system that eliminated some of the defects in the existing system that perhaps justified granting the concessions in the first instance. The great emphasis that has been placed throughout this Report on the paramount importance of horizontal equity and neutrality of tax treatment among different activities means that deviation from the full taxation of all income is only acceptable if there is an overwhelming reason for doing so.

After carefully analyzing the many arguments advanced in support of special concessions to the mining and petroleum industries, we have concluded that, in general, adoption of the reforms recommended for the taxation of businesses and corporations would make the special tax concessions to these industries unnecessary and unacceptable. Percentage depletion and the three-year exemption for new mines are extremely costly in terms of revenue, and the available evidence suggests that these concessions are inefficient (i.e., that they have a relatively small effect on mineral and petroleum exploration and production per dollar of tax revenue forgone).

It is estimated that in 1964 the three-year exemption for new mines and the depletion allowances reduced tax revenues by over $150 million. It is true that in the absence of these concessions the income generated by mining and petroleum almost certainly would have been less, but the increased investment in other industries of funds which were invested in mining and petroleum would have increased taxable revenues from these other industries. Hence, if the concessions are as inefficient as we believe them to be, any overstatement of the revenue loss is relatively small. When it is recognized that $150 million is almost equal to the revenue raised by four percentage points of the corporation income tax, it is apparent that a significant reduction in the taxes levied on other businesses would be possible if the concessions were removed.

There is no doubt that these concessions encourage the mining and petroleum industries. As a result of the concessions, Canada has more investment in these activities, more people are employed in them, and the volume of our exports of minerals and petroleum is no doubt greater and the volume of our imports of minerals and petroleum is no doubt smaller than otherwise would be the case. In addition Canada's known mineral and petroleum reserves are probably somewhat greater than they otherwise would be.

The issue is not the direction of the effects of the concessions but rather:

1. Have the effects been significant?

2. To the extent they have been significant, did the diversion of labour and capital from other uses to the mining and petroleum industries increase or decrease the total output of the goods and services that Canadians want (or that could be traded for such things)?

3. To the extent that the diversion increased the economic welfare of Canadians, could it have been achieved at lower cost?

In our opinion, the concessions probably brought about an increase in the allocation of capital and labour to mineral and petroleum extraction; but there is no presumption that this had a beneficial effect on the overall economic well-being of Canadians. Even if the re-allocation did improve general economic well-being, the concessions were an unnecessarily costly method of achieving this result.

THE DETERMINATION OF INCOME FROM MINERAL AND PETROLEUM EXTRACTION

Discovery Value

The "discovery value" of a mineral or petroleum deposit—the value of a deposit in excess of its cost of discovery—is the net gain in the value of a right to or interest in property resulting from the discovery of a

mineral or petroleum deposit. To maintain equity in the tax system it is necessary that those who realize such net gains, either through the disposition of the interests or rights in the property or through the sale of the minerals or petroleum extracted from the deposits, should be taxed in full on the net gains. It is impractical to tax most property gains on an accrual basis because of valuation problems. This is certainly the case with respect to discovery value. To tax discovery value at the time of the discovery (i.e., on an accrual basis) would be virtually impossible because of the difficulty of estimating the quantity of reserves, the costs of extraction and the trend of future market prices for the product.

Discovery value is, in essence, a capital gain. Because the present tax system does not bring capital gains into tax, it is sometimes argued that to define income from the extraction and sale of minerals or petroleum as the difference between gross revenues and the actual costs of generating those revenues would overstate "true" income because the capital gain element would not be deducted from gross revenues. This overlooks the fact that those who are in the business of making capital gains are subject to tax on those gains, and those who hold rights to or interests in mineral or petroleum properties usually are in the business of making discoveries. In any event, whatever the merits of this argument in the context of the present system, under the system which we have proposed, discovery value would be taxed on the same basis as other kinds of gains and a reduction in income from mineral or petroleum extraction to reflect discovery value would be inconsistent with the treatment accorded other kinds of net gains.

Percentage depletion allowances are also advocated as a method of compensating for the exhaustion of the deposit. In manufacturing, for example, the cost of the machine used up in producing the goods that are sold is deducted from revenues in determining income. It is argued that similarly mineral and petroleum deposits, being wasting assets, are used up by extraction and a similar deduction for the cost of acquiring the asset

is appropriate. This point of view is valid and leads to the conclusion that all of the costs incurred in acquiring mineral and petroleum rights and in discovering and developing the deposits should be deductible from revenue at some time 10/. However, it does not justify the writing-off of discovery values. The discovery value of a deposit is, by definition, the gain in value of a right to or interest in property after deducting all costs of discovery. Discovery value should not be deducted from the revenues from the sale of minerals or petroleum any more than revenues from the sale of manufactured goods out of inventory should be reduced if these revenues exceed the cost of producing the goods sold.

As in the case of other businesses, the income from mineral and petroleum extraction should be determined by including in income all revenues and by deducting from income all of the costs actually incurred in earning that income. There is little if any problem in determining what should be included and deducted in computing income. There is a problem in determining the time at which costs should be deducted in order to measure income from mineral and petroleum extraction in a manner that is comparable with measures of income from other kinds of business.

Exploration Costs Generally

The more uncertain the value of the asset created by a particular expenditure, the more rapidly the cost should be written off. Because the probability of success for a particular exploration venture is usually low, it is reasonable to deduct exploration costs immediately in determining income. The immediate write-off of these costs would be an effective form of tax incentive to new mineral and petroleum discovery and would also be consistent with the recommended treatment of research and product development costs for businesses generally.

Development Costs Generally

Development costs in mineral and petroleum extraction are comparable to inventory costs in, say, a manufacturing business, although the value of the asset created by the latter expenditures is more certain than is the case with exploration costs. Development costs are much more directly related to the earning of future income. In principle, therefore, if the method of measuring income from mineral and petroleum extraction is to correspond with the method of measuring income from other industries, development expenses should be deferred and written off against the revenue received from disposing of the minerals or petroleum in the developed deposit or well.

In order to match development expenses against the revenues from the extraction of minerals and petroleum it would be necessary to segregate exploration and development costs. The dividing line is uncertain in the mining industry and even less clear in the oil industry. But it should not prove impossible to draw up arbitrary but reasonable rules that would separate the two kinds of costs. Ultimately an attempt should be made to do so. The Canadian Petroleum Association has already agreed on some division for statistical purposes. We believe that regulations could be written after discussion between the tax authorities and industry representatives that would provide adequate guidelines for the allocation.

The accounting practices followed in financial statements would not provide a suitable basis for segregating exploration and development costs. Not only is there considerable variation in the practices now followed by companies, but also accounting practices would be adversely influenced if they became significant in the determination of the tax liability.

There are three general ways of determining the write-off of development costs once these costs have been segregated. The first would be to relate amortization to the rate of extraction of the mineral or petroleum. This would match costs against revenue, but it is usually impossible to obtain a reliable

estimate of the total expected production. A second method would be to write off development costs on the basis of the life of the mine or well, subject to an arbitrary maximum period to avoid severe administrative difficulties. The difficulty of obtaining a reliable estimate of the amortization period would remain. The third alternative would be to have arbitrary rates of write-off regardless of the life of the mine or well.

The third alternative would be the most workable and would not unduly depart from the principle of matching revenues and expenses. Accordingly, it would be preferable to establish some general arbitrary rate at which development costs could be written off—as is done for capital assets generally. Depending on the dividing line eventually established between exploration and development costs, the rate of amortization on a diminishing balance basis that would treat the mining and petroleum industries in a manner similar to other industries would be approximately 20 per cent.

Costs other than those related to exploration and development would be deductible from income in the way already recommended for business costs in general.

Exploration and Development Costs in Mining

Development expenses in mining are approximately four times as great as exploration expenses. The Dominion Bureau of Statistics reported that prospecting and exploration costs were about $45 million in 1960. The costs incurred after the decisions are made to develop the mines average about $200 million a year. Our survey of the mining industry 11/ showed that the development period is usually from one to four years in length but may run over seven years. The same survey suggested that of the total expenditures on depreciable assets and development, depreciable assets constituted between 25 per cent and 90 per cent and averaged about 75 per cent. Most of the responding companies in their accounts wrote off their exploration expenses in the year incurred but wrote off development costs against subsequent income from production.

Depreciable Assets Used in Mining

As already indicated, in the mining industry a substantial investment in depreciable assets is required in the development period. Most of these assets are used for purposes of production. While the physical characteristics of the depreciable assets themselves are similar to those used in business generally, the unique feature of mining assets is that they are of little commercial use if the mine is abandoned. It would therefore be appropriate, for the matching of costs against revenue, that the method of writing off the depreciable assets should reflect the life of the mine. Accordingly, to the extent that depreciable assets were used in the development period, depreciation thereof should be treated as part of the development costs and written off in the same manner as other development costs. However, certain depreciable assets, such as a smelter or a refinery, may not be dependent upon one mine for usefulness. In addition, certain associated facilities such as townsites, railways and airports may be constructed primarily for purposes of the mine, but may have other possible uses to the taxpayer in the future. In neither of these cases would a write-off of cost over the life of one mine (or at the arbitrary rates used for administrative reasons in the case of development costs) necessarily be the most appropriate procedure.

The Mining Survey indicated that in the mining industry a great variety of depreciation methods are used for corporation accounting purposes. The straight-line method is frequently adopted, with rates varying from 4 per cent to 15 per cent; but both the unit-of-production method and the diminishing balance method are also employed.

Exploration and Development Costs in Petroleum

Although the breakdown between exploration and development costs in the petroleum industry cannot be determined exactly, the statistics provided

by the Canadian Petroleum Association suggest that expenditures in each of these activities are about $100 million to $200 million annually.

While only a small proportion of exploratory drilling has resulted in productive wells, 80 per cent to 90 per cent of development drilling has been successful.

The appropriate treatment of exploration and development costs for petroleum has raised considerable controversy in accounting circles in Canada and the United States in recent years. Some argue that anyone embarking on an oil exploration programme accepts the fact that a certain amount of drilling will be unsuccessful, and that therefore the cost of the unsuccessful drilling should be treated as part of the cost of the oil reserves resulting from successful drilling. This "full costing" approach would have the deduction of all exploration and development costs deferred in some manner and amortized against subsequent production of oil; it has been gaining some support recently and has been adopted by some Canadian companies. Many, however, object to this method on the grounds that the hope of eventual success may never be realized and that it is not realistic to bring together costs of operation and revenues in unrelated geographic areas 12/.

PRESENT TAX TREATMENT

All prospecting, exploration and development costs, including the costs of oil rights and properties purchased from others, but excluding mining rights, 13/ are generally deductible immediately to the extent of the taxpayer's income from all sources (excluding exempt dividends and before deducting the depletion allowance). Any costs not deducted in the year may be carried forward indefinitely against income of future years.

Once a mine has commenced production, the cost of any further development work (referred to as "forward development") is usually regarded as a current operating expense except to the extent that it relates to underground work designed for continuing use, such as a mine shaft, a main haulage way

or an extension thereof. The treatment of the latter type of expense is set out below.

As already indicated, there are also special provisions permitting depletion allowances to be deducted in arriving at income for tax purposes.

Equipment and structures acquired for use in the production of petroleum are generally entitled, under the present legislation, to be written off on the diminishing balance basis at the rate of 30 per cent 14/.

Mining machinery and equipment and buildings acquired for the purpose of gaining or producing income from a mine (except office buildings that are not situated on the mine property and refineries) are subject to capital cost allowance at 30 per cent on the diminishing balance basis 14/. Mine shafts, main haulage ways and other similar underground work designed for continuing use and constructed after the mine came into production are permitted an annual write-off of up to 100 per cent 15/. This permits the taxpayer to treat them as expenses when he chooses. Associated facilities such as roads, railways, airports and wharfs are subject to the ordinary capital cost allowance rates for such assets, which range from 4 per cent to 10 per cent on the diminishing balance basis 16/. Under the present capital cost allowance system the allowance is dependent upon ownership, and accordingly commences upon acquisition rather than use 17/. No recognition is given for tax purposes to the cost of facilities, such as developed sites and buildings, which are donated by the taxpayer to the local authorities 18/.

In addition to the above provisions concerning the treatment of costs, there are other special provisions, one of the most important of which is the exemption from tax for three years of the income of a new mine. This exemption is rendered more significant by the fact that a taxpayer may defer claiming any capital cost allowance on depreciable assets and any pre-production costs until after the three-year period.

ARGUMENTS FOR SPECIAL TAX PROVISIONS

Based on a review of published material, the briefs presented to us, the views expressed at the hearings and interviews conducted by members of our staff, we found that most of the arguments advanced in support of special tax provisions for the resource industries fell into one or another of five general categories. These categories are briefly described below:

1. The "accounting neutrality" argument: in determining taxable income, all costs of generating income should be deductible at some time; and because of the uncertainty of the return from outlays incurred in the extraction of minerals and petroleum these costs should be deducted quickly. Thus, early write-offs are advocated as a means of achieving inter-industry neutrality.

2. The tax system bias against risk-taking argument: mineral and petroleum extraction is particularly risky; tax systems that lack complete loss-offsets discriminate against risk taking; the present tax system does not provide complete loss-offsets; the present tax system therefore discriminates against mineral and petroleum extraction. Special tax concessions to the extractive industries are therefore required to compensate for this feature of the tax system in order to achieve inter-industry tax neutrality.

3. The capital market bias against risk-taking argument: mineral and petroleum extraction is particularly risky; the capital market discriminates against risky ventures; the capital market therefore discriminates against mineral and petroleum extraction. Special tax concessions to the extractive industries are required to compensate for this market bias.

4. The corporation tax discrimination against mineral and petroleum extraction argument: the corporation tax falls on one factor of production—equity capital; the extractive industries are equity

capital intensive and rely relatively little on debt financing; following imposition of a corporation tax the resource industries either have to raise their prices more in the short run or reduce investment more in the long run than other industries in order to restore inter-industry equilibrium in after-tax rates of return. If the adjustment is through reduced investment, the corporation tax reduces investment in the mining and petroleum industries more than in other industries. Tax concessions to mineral and petroleum extraction are required to compensate for this non-neutral feature of the corporation tax.

5. Expanded investment in the extractive industries confers social and economic benefits argument: expanded resource industries provide benefits to the economy that individual investors do not take into account. Consequently, without tax incentives (or subsidies) there would be too little investment in the resource industries from the point of view of society as a whole. In particular, without tax concessions foreign direct investment in Canada would be reduced and Canadian capital destined for the extractive industries would be invested abroad to the detriment of Canadians. This argument can be broken down into a number of more specific contentions which are listed and discussed later in this chapter.

Some of these arguments are complex, and many of them (particularly the last one) involve issues that go beyond the immediate subject matter of this Report. In the balance of this section we attempt to appraise the principal issues and set forth our views on them. More detailed discussion is contained in the study previously cited 19/.

Accounting Neutrality

Because of the low probability of generating any revenue as a result of an outlay for mineral or petroleum exploration, and because of the long and variable time lags between search and discovery and between

discovery and production, it is argued that all costs should be written off and that they should be written off rapidly in order to achieve a measurement of income from mineral or petroleum extraction that is comparable with the measurement of income from other industries. The rapid write-off of costs that may not be matched by revenues is therefore advocated, in this case not as a concession to mineral or petroleum extraction but as a necessity for inter-industry neutrality in the determination of income. While it is difficult to determine just how rapid the write-off should be to achieve neutrality, we believe that the treatment recommended later in this chapter is liberal. This treatment is basically that the cost of exploration and development should initially be allowed in full as claimed by the taxpayer. After a transitional period the rate of write-off of development costs should be reduced.

The Tax System Bias Against Risk Taking

There are, unfortunately, no accurate and reliable measures of the relative degrees of risk attached to investments in different industries 20/. No one can doubt that the probability of loss on a single exploratory venture in the extractive industries is very high indeed 21/. Whether the probability of loss from such an isolated venture is greater than the probability of loss from a single research experiment by a manufacturing firm, say, in the chemical or electronics industry, is a moot point.

The diversification of risks is an important consideration. Many firms engaged in mineral and petroleum extraction are large enough to be able to undertake many exploratory ventures themselves. Both in mining and petroleum, joint ventures or syndicates are often formed, and through them smaller firms can hold small partial interests in many exploratory ventures. The greater the diversification, the more stable and predictable the percentage of successful ventures. The large manufacturing corporation also can undertake many pieces of research and thus reduce its risk. However, the smaller manufacturing concern usually does not have the opportunity to

participate in syndicate arrangements by which it could have a small share in a multitude of research projects as does a small mining or petroleum company in the case of exploration projects.

Because the joint venture arrangements for the pooling of risks in the extractive industries are more fully developed than in most other industries, to focus attention on the undeniably high risk attached to a particular exploratory venture grossly overstates the degree of risk of investments in the mining and petroleum industries relative to other industries. This is not to deny that the new small mining company or the new small petroleum company is subject to great risk if it cannot enter into joint ventures with other companies or that it is subject to substantial risk even if it can enter into such arrangements. We are not convinced, however, that even these firms are subject to greater risks than small firms in some other industries characterized by rapid technological and product change.

Nevertheless, it is clear that, to the extent that a tax system fails to fully recognize losses through tax refunds, it is biased against risk taking—whether by a small or large manufacturing firm, or a small or large mining or oil company. However, as part of our general reform proposals we recommend a much more liberal treatment of business losses than at present. We also recommend a liberal treatment of property losses to match the full taxation of property gains. Together, these provisions would come close to the perfect neutrality which can only be reached by payment of subsidies on losses. If the tax system accorded similar treatment to gains and losses, so that risk taking was not penalized by the tax system, there would be little need for any special concessions to the mining and petroleum industries even if it was felt that they were characterized by greater risk than other industries.

The Capital Market Bias Against Risk Taking

On the assumption that investment in the extractive industries is

subject to greater risk than investment in other industries, it is also argued that, because the market discriminates against risky ventures, concessionary tax provisions are necessary to compensate for the market bias. A market bias would raise the cost of capital to the mining and petroleum industries. It is argued that, in the absence of concessionary tax provisions, the higher cost of capital would result in too little investment in the extractive industries relative to other industries. Tax concessions that overcame this bias would be efficient in the sense that the additional resources devoted to mining and petroleum as a result of the concessions would yield a more valuable output than if the resources were put to alternative uses.

We are sceptical that investment in the extractive industries is more risky than investment in other industries, given prevailing institutional arrangements. But to the extent that the diversification of risk is not achieved, it is conceded that if investors demand a risk premium to compensate for the uncertainty of the expected returns from exploration there may be some under-investment in the extractive industries—and in other industries with the same characteristics 22/. To compensate for any possible market bias against the mining and petroleum industries we will recommend a special provision that would permit the immediate write down of shares when funds were raised for exploration and development, rather than restrict the write-down to whatever losses were accrued or realized.

Corporation Tax Discrimination Against
Mineral and Petroleum Extraction

It can be argued that the corporation tax discriminates against mineral and petroleum extraction. If the production of the mining and petroleum industries was sold in world markets at prices that were unaffected by the Canadian output, the Canadian corporation tax could not be shifted in the short run through higher prices. Imposition of the corporation tax would necessarily be followed by reduced investment in the

future. Moreover, where Canadian output does affect world prices, to the extent that the extractive industries are more capital intensive than other industries (that is, if they have high physical capital/output ratios) and have lower than average debt/equity ratios, a greater investment adjustment would be necessary for the extractive industries than for other industries to restore equilibrium among after-tax rates of return.

There are five points to be made in responding to this argument:

1. While some Canadian-produced minerals are sold at prices unaffected by Canadian output (notably gold) there are many that are not (notably nickel).

2. Even when the world price is unaffected by Canadian production many other countries that produce minerals and petroleum also impose corporation taxes and these taxes may affect quantities produced and world prices.

3. It would be inconceivable to grant tax concessions to all corporations that are unable to shift the corporation tax through short-run price increases.

4. There are other industries in Canada that are more capital intensive than the extractive industries and some that rely as heavily on equity financing.

5. The proposed integration of personal and corporation income taxes removes any tax discrimination against equity investment that might exist.

We therefore reject this argument for tax concessions for the extractive industries.

Social and Economic Benefits

Finally, tax incentives to the resource industries are advocated on the grounds that they achieve one or more of the following results:

1. Provide employment.
2. Maintain Canada's resource base.
3. Maintain Canada's position as a world producer of minerals and petroleum.
4. Increase Canada's exports.
5. Make Canada more self-sufficient.
6. Encourage direct investment in mining and petroleum in Canada by non-residents and discourage direct investment in mining and petroleum in other countries by residents.
7. Encourage industrial development generally by providing important energy sources (e.g., oil and uranium).
8. Foster regional development, particularly in the far North.
9. Encourage domestic ownership in the mining and petroleum industries.

Needless to say, those who advocate the tax concessions believe all of these alleged results to be desirable. They also assume that:

1. Either the benefits can be achieved without cost; or
2. The benefits outweigh the costs; and
3. To the extent that there are costs, the same benefits could not be achieved at a lower cost.

Since all of these alleged benefits from tax concessions to the extractive industries are dealt with at some length in the studies prepared for us and cited above, we shall discuss none of them extensively, although we shall consider most of them briefly.

Providing Employment. To provide employment when there is unemployment is clearly an advantage. It is not necessarily an advantage, however, if increased employment in the extractive industries means less employment elsewhere. There are more effective methods of preventing unemployment than the provision of industry incentives, as discussed in Chapter 3.

Maintaining the Resource Base. No one would dispute the proposition that, if natural resources could be discovered without cost, then the more natural resources that were discovered the better. But the discovering of additional natural resources is far from costless, and the relevant question is whether the additional discoveries warrant the additional cost in terms of the output forgone when labour and capital are devoted to this use rather than alternative uses. Only if the long-run cost of the new reserves was less than the cost of substitute materials (including foreign supplies) would special tax incentives be warranted. Even then, if the objective was to increase reserves, to be efficient the incentive should apply to exploration and not to development and production. This question is considered again later in the chapter.

Encouraging the Production of Exports and Import-Competing Goods. Minerals and petroleum constitute important exports for Canada and Canadian-produced minerals and petroleum displace commodities that otherwise would be imported. It does not follow, however, that these facts justify special tax concessions to encourage the mining and petroleum industries. To take the view that exports and import-competing industries should be given tax incentives implicitly assumes that, if capital and labour were not producing exports or import-replacing goods, they would not be producing anything else. Over the long run (and that is the relevant period) this assumption is invalid.

Canadians should specialize in producing the goods and services in which they have a comparative advantage and not necessarily the goods that have been exported or that have displaced imports in the past. This can be illustrated in a simple way by supposing that, unknown to anyone, there were no undiscovered mineral deposits or petroleum reserves in Canada, and that the government adopted a policy of subsidizing the production of minerals and petroleum for export. As a result of the subsidy more resources would be devoted to exploration and marginal mines and wells would be brought into

production. By increasing the subsidy, more resources would be devoted to searching for reserves and producing minerals from fewer and fewer productive mines and wells. Less and less of other things would be produced. Canadians would become less and less well off. We do not for a moment wish to suggest that the return from exploration is, in fact, zero. We do wish to suggest that the policy of encouraging a particular kind of export is probably not consistent with the overall economic well-being of all Canadians.

Furthermore, the effect on the balance of payments of increasing the volume of minerals and petroleum exported and the domestic production of import-competing minerals and petroleum is most uncertain. It depends on, among other things, the foreign demand for these products and the changes in the volume and composition of Canadian imports which result from the diversion of resources to the production of more minerals and petroleum. If the foreign demand for minerals and petroleum is inelastic (i.e., small increases in the volume of exports bring about large reductions in price) and resources are taken from other export or import-competing industries to produce more minerals and petroleum, it is conceivable that Canada would weaken rather than strengthen her balance-of-payments position.

Encouraging Foreign Investment in Canada. Many nations, in particular the United States, offer substantial tax concessions to the extractive industries. It is urged that Canada must offer equivalent tax concessions to the extractive industries if the rate of foreign investment in these industries is to be maintained.

The question of foreign investment in Canada is, as the discussion in Chapter 5 points out, extremely complex. Little can be done in a brief review except to call attention to some relevant points:

1. A substantial proportion of foreign direct investment in Canada is probably related to considerations other than the after-tax rate of return to parent corporations. The securing of sources of supply,

investment in a politically stable country near the United States market and the maintenance of a share of the market are clearly significant factors in the decision to invest in Canada. It is impossible to determine with any certainty the sensitivity of foreign direct investment to changes in after-tax rates of return. From what our staff has been able to ascertain about many, if not most corporations, the expected after-tax rates of return are either not computed with sufficient precision to reflect many of the tax concessions now offered to the mining and petroleum industries, or these concessions are not a significant factor in the decision whether or not to invest. Hence, changing the tax system might be of greater significance in the assessment of factors other than the rate of return, such as those mentioned.

2. If it is true, as some persons contend, that international "mineral" capital is exclusively devoted to mineral and petroleum extraction and is seldom available for other forms of investment, there is a strong presumption that it is invested where the probability of finding ore or oil is greatest—and is insensitive to after-tax rates of return.

3. A principal benefit—but not the only benefit—that Canada obtains from foreign investment in Canada is the revenue from taxing the income generated by such investment. To determine the rate of tax on the income from foreign investment in Canada which would maximize the net benefit to Canada would require a knowledge of the sensitivity of foreign investors to changes in after-tax rates of return and a knowledge of the indirect benefits from foreign investment. Neither of these crucial facts is known. If, as we suspect, much foreign investment in the Canadian mining and petroleum industries is insensitive to changes in after-tax rates of return, the net benefit to Canada could be increased by raising Canadian taxes on the income.

4. Undoubtedly, the optimum taxes that Canada should impose on the resource industries are not entirely independent of the foreign tax

treatment of these industries. If foreign governments grant larger concessions to the resource industries than Canada does, the weight of tax that Canada can impose without having some adverse influence on foreign direct investment in these industries is less than it would otherwise be. On the other hand, if foreign governments grant foreign tax credits that exceed current Canadian taxes, the latter can be raised without reducing such investment.

5. How high the Canadian tax on the income of Canadian mining and petroleum corporations could be raised without reducing the net benefit from foreign direct investment in these industries is impossible to say with certainty. It can be argued that higher Canadian taxes on such income would reduce investment in these industries. In some circumstances this would undoubtedly be the case. It is also necessary for Canadians to bear in mind that some investments made in Canada by non-residents could not be made by Canadians because they are only profitable when a market for the output is assured. In some circumstances, only a foreign parent company can provide such a guaranteed market, as was the case in the development of most of the Canadian iron ore mines.

6. The only way to maximize the net benefit for Canada would be to treat each foreign-financed Canadian venture separately, taking into account the sensitivity to differences in tax treatment and the net benefit to Canada that would be provided. This venture-by-venture discrimination is both impractical and unacceptable. Consequently, any uniform treatment applied will result in some instances in less than the optimum net benefit for Canada—because some foreign direct investment that would have provided a net benefit will be kept out by Canadian taxes, and because some foreign direct investment in Canada will obtain a greater after-tax return than the minimum it would have been willing to accept.

7. Adoption of our mining and petroleum recommendations would undoubtedly make foreign direct investment in these industries less attractive than

it is now. Some foreign investment that would have provided a net benefit would be lost, while Canada would obtain a greater net benefit from some foreign investment than it does now.

8. We are also satisfied that it would be a grave error to adopt the approach that, whenever a foreign country adopted a tax concession for a particular industry, an equivalent tax concession should be provided in Canada for that industry so that foreign investment in the Canadian industry would remain equally attractive. Often the best Canadian policy to pursue when foreign governments give large concessions to particular industries would be to import the subsidized goods from the foreign country and devote Canadian resources to producing other goods, or to establish foreign subsidiaries of Canadian corporations in the foreign industry with the concessions to take advantage of the higher after-tax returns.

When there is full employment in Canada we may need net foreign investment to maintain the rate of capital formation without reducing domestic consumption. But usually what is required is access to foreign goods and services in general, not access to foreign dollars destined for a particular use in Canada. If Canada can call upon foreign savings for investment in other industries, Canadian labour and capital can be employed in the resource industries (or any other industry) and foreign goods and services can be substituted for domestically produced goods that are forgone because of the increased investment in the resource industries. Aside from the instances where assured foreign markets or specialized foreign technology are involved, Canada can and should adopt general policies to control the inflow of foreign capital and should eschew industry concessions that could substantially reduce the net benefits from such foreign investments.

<u>Discouraging Foreign Direct Investment by Canadians</u>. If Canada does not match the concessions to the extractive industries given by other countries, Canadian capital destined for these industries may be invested abroad. This

point of view is often expressed by those interested in the Canadian mining industry 23/. It is an argument for maintaining the concessions now given the Canadian mining industry—concessions that are admittedly liberal relative to those offered by most other countries 24/.

With full employment in Canada, increased investment abroad by Canadians, unless offset by increased foreign investment in Canada, would require either a reduction in current domestic consumption or a reduction in domestic investment. If there was no offsetting increase in foreign investment in Canada and the increased investment abroad by Canadians was accompanied by a reduction in current domestic consumption, then Canadian savings would have increased and the national income of Canada would grow more rapidly in the future by the additional income earned abroad by Canadians.

If there was no offsetting increase in foreign investment in Canada and the increased investment abroad by Canadians was at the expense of domestic investment, the national income would grow more or less rapidly depending upon the after-foreign-tax return earned on the additional foreign investment by Canadians, the before-tax return that would have been earned on the forgone domestic investment, and the indirect effects of the two kinds of investments.

Ignoring these indirect costs and benefits, 25/ under the conditions assumed in the preceding paragraph, if Canada gave credit for the foreign taxes paid on the income from such investments, it is possible that a foreign investment that was profitable to the Canadian investor would result in a net economic loss to Canada. The investor presumably is indifferent as to whether he pays taxes to one government or another. However, the net benefit to Canada from the investment would be reduced to the extent that, by investing abroad, revenues were transferred to a foreign treasury. If, as seems probable, the net indirect benefits from investment abroad were less than from domestic investment, the higher the foreign taxes imposed on such

investments and the more generous the foreign tax credits provided by Canada, the more likely that it would be that increased investment abroad would result in a net economic loss to Canada.

The situation would be different, however, if increased investment abroad by Canadians was offset by increased investment in Canada by non-residents. Even if the before-tax rate of return on direct investment abroad was no higher than it was in Canada, Canada could obtain a net benefit from increased Canadian direct investment abroad under some conditions. The conditions would be:

1. Foreign direct investment in Canada was as productive as the Canadian investment it replaced; and

2. Canada taxed the income from foreign direct investment in Canada at a rate higher than other countries taxed the income from Canadian direct investment abroad.

To be more explicit: (a) if the removal of the tax concessions to mining in Canada resulted in increased investment abroad to take advantage of the tax concessions other countries gave to mining; and (b) if non-residents increased their investment in Canada (presumably not in mining) by a corresponding amount; and (c) if Canada was able to tax the income from increased foreign investment in Canada at a higher rate than other countries taxed the increased foreign investment of Canadians, Canada would obtain a net economic benefit from the change.

Enough has been said about the complex issues involved to establish that it is impossible to make any unequivocal statements about the net economic gains and losses from increased direct investment abroad in mining by Canadians.

This leads to the second aspect of the problem. Would a removal of the Canadian tax concessions in fact lead to increased investment by

Canadians in mining in other countries? There can be little doubt that, if the Canadian tax concessions to mineral extraction were removed, foreign direct investment in mining would be relatively more attractive to Canadians than it is now. But the proposals for mining are not made in isolation. The integration proposal, as will be illustrated later in this chapter, would partly compensate resident shareholders for the removal of the concessions, although the after-tax rate of return from Canadian mining corporations would be reduced for many shareholders. However, because we propose in Chapter 26 that the credit for foreign taxes should be restricted to 30 per cent and that the income of foreign subsidiaries of Canadian corporations should be taxed on an accrual basis at a rate of 30 per cent, foreign direct investment by Canadians would also, in some circumstances, be less attractive than it is now.

With offsetting pulls toward other kinds of domestic investment and offsetting pushes away from foreign investment, we are satisfied that a large increase in Canadian investment in foreign mining ventures would be unlikely to occur as a result of removing the special concessions to mining in Canada. To the extent that an increase did occur, it could not be presumed to be against the national interest.

<u>Energy as a Leading Factor for Growth</u>. It may be contended that the growth of the economy is particularly dependent on sources of abundant energy. The implication is that the oil and gas industries merit favoured treatment. The comments made above apply also in relation to this argument. Specifically, if supplies of oil and gas could only be produced domestically at a higher real cost than the cost of importing them, Canada would obtain a net economic benefit if they were imported.

<u>Regional Development</u>. The pioneering role of mineral extraction in the remote areas of Canada is often stressed, particularly in reference to populating the far North. But, as direct employers, mining and petroleum companies do not rank high, and their indirect employment effects in the immediate region of their

mining and producing operations are relatively low. It should also be observed that a forced pace of settlement has certain social costs (i.e., the provision of transportation, housing and associated services) that could exceed the costs to the industry. There is no economic reason why the pace of development of raw materials with higher real costs should be forced before supplies available in more accessible regions have been fully exploited. Nonetheless, many of Canada's remote regions are ill-suited to economic pursuits other than mining and there are non-economic reasons for encouraging the population of some areas.

If settlement subsidies for particular regions are required in the light of national policy, they should not be confined to one type of industry but rather to specified areas. Provision of transportation facilities and social capital are much more effective in partially redressing the problems of high costs and below-standard living conditions than are tax concessions to one type of industry. Nevertheless, if specific encouragement to the extractive industries to develop particular areas is deemed to be desirable, the recently introduced loan fund for exploration in the North is clearly a much more efficient device than general tax concessions to these industries.

A variant of the regional development argument supports aid to sectors of the industry in the interests of slowing or halting the decline of communities. Such is the rationale for the direct subsidies paid to coal mines and gold mines and for the more favourable depletion allowance accorded to these industries. Mining, being regionally specialized, is particularly prone to this "ghost town" problem; but it is not unique. Such subsidization is justified as a short-run measure on the grounds of social cost in terms of human dislocation. In the interest of administrative efficiency, the direct subsidy should be made adequate to the task, and the hidden subsidy, in the form of a more generous depletion allowance, should be abandoned.

But long-run solutions demand a shift of resources from declining industries. In this task government aid should play a role, most obviously in

subsidizing the movement of and retraining of displaced workers, but also, where such movement is not possible or desirable, in the form of incentives to new industry to enter the area. Such a policy of encouraging new industry in declining mining regions need not exclude other branches of mining, which might be given assistance on a regional basis in finding and developing new minerals, without being permanently subsidized.

Encouraging Domestic Ownership in the Extractive Industries. It is argued by Canadian petroleum companies that the present Canadian treatment of the extractive industries is not generous enough because the combined impact of United States and Canadian tax laws favours the operations of United States residents (individual and corporate) over those of Canadian residents. This viewpoint was adopted by the Royal Commission on Canada's Economic Prospects. As a counter measure, that Commission advocated a form of depletion for Canada based on gross earnings.

Given the situation of an independent Canadian petroleum producer, the argument is not without merit. It has, however, also been taken up by the major integrated oil companies, who are currently in the most advantageous position of all, as is shown later in this chapter in Table 23-3.

Such advantages as exist for non-residents apply to Canadian branches of United States companies before their production income in Canada exceeds the cost of their current exploration and development programmes. Prior to reaching this point, these branches can carry forward their pre-production expenses for write-off against future taxable income in Canada. At the same time they can obtain an immediate recovery for intangible drilling costs and the cost of unproductive acreage against income otherwise subject to United States tax, without affecting the size of their concurrent depletion allowances in the United States. A Canadian company, on the other hand, gets no depletion so long as its write-offs exceed its production income. However, once the United States company attains a tax-paying position in Canada it loses this advantage. It has, in addition, to contend

with the 15 per cent non-resident withholding tax. The effective rate of tax on its Canadian operations then becomes the higher of the Canadian and United States rates that apply to that part of its total operations.

The major international integrated oil companies with Canadian affiliates incorporated in Canada, and which account for the major proportion of the impressive statistics on United States ownership of Canadian petroleum resources, do not have any advantage in Canada that stems from United States tax law. Integrated oil companies, whether they be Canadian or non-resident-owned, do have some advantages under Canadian law. The chief advantage is that, if their write-offs of exploration and development costs exceed their production income, the excess may be written off against refining and marketing income.

A liberalization of the Canadian depletion allowance would, of course, apply to the previously mentioned United States subsidiaries as well as to Canadian-owned corporations, thus reducing the claims for Canadian tax paid that the former would make on their United States returns. The net effect, then, could well be a transfer of revenues from the Canadian treasury to the United States treasury.

It is probable that the dominance of United States-controlled companies in the Canadian oil industry is an episode in the world-wide integration of the industry and does not stem from the application of tax laws. Furthermore, the very success of Canadian crude in penetrating the United States market may in part be a result of that dominance.

We are satisfied that a further tax concession to the resource industries in the form of gross depletion would not, if it had any effect, produce more than a minor increase in Canadian ownership. The adoption of our integration proposal should be more effective for this purpose and would not involve a transfer of revenues from the Canadian to foreign treasuries.

As we will show later in this chapter (see Tables 23-4, 23-5 and 23-6), although our proposals would increase the after-tax rate of return to Canadian shareholders, the taxation of share gains would mean that the total after-tax return to a substantial proportion of the Canadian shareholders in Canadian mining and petroleum corporations probably would decline. To the extent that this reduction was not shifted through higher mineral and petroleum prices, it would be capitalized in lower share prices. The total after-tax return on most shares of corporations not in the extractive industries would probably rise as the net benefits of integration not lost through short-run shifting were capitalized. Most resident shareholders, then, would generally realize windfall losses on shares in Canadian mining and oil companies and windfall gains on the shares of other Canadian corporations.

The after-tax return on Canadian mining and petroleum shares would be reduced more for non-residents than for residents because the former would not obtain the benefits of integration. Non-resident portfolio investors would therefore generally find it to their advantage to sell their shares to residents.

The after-tax rate of return to non-resident direct investors in Canadian mining and petroleum would also be reduced. However, because the price that could be obtained for the shares of most large Canadian mining and petroleum companies would likely be less than at present, there would be no incentive to non-resident parent corporations either to sell the outstanding shares of these subsidiaries to Canadians or to offer them new equity issues.

Foreign-controlled companies raising funds for exploration and development might find that new issues commanded higher prices because of the special write-off that we will propose for such issues. This write-off would reduce the cost of Canadian equity capital to these companies, and more new issues for this purpose by foreign-controlled corporations might occur.

A SUMMARY OF OUR VIEWS

After reviewing all of these arguments we have reached the conclusion that:

1. if all costs were deducted at some time in the determination of business income from the extraction of minerals and petroleum,
2. if these costs were written off rapidly to reflect the uncertainty of the return that would be generated by these outlays, and
3. if the tax treatment of losses was such that risk taking was not discriminated against by the tax system,

the only ground for special tax concessions to the extractive industries would be to compensate for the possible discrimination against risk taking in the Canadian capital market. In other words, to the extent that there was a bias in the capital market against risk taking, and to the extent that mineral and petroleum extraction was unusually risky, a deviation from a neutral tax system would be justified to compensate for this bias, assuming that more efficient methods of compensation were not available.

It has already been pointed out that the large corporations in the extractive industries can spread the risks of exploration by undertaking either several ventures at once or a series of ventures and by participating in syndicates which take a partial interest in several ventures in order to pool risks. The large and established companies can also offset the costs of unsuccessful exploration ventures against production income. These companies, in effect, obtain refunds of taxes on their exploration losses.

There is no question of capital market bias against these large companies in the extractive industries. They are able to raise capital in the market at costs that are no higher than those incurred by corporations of comparable size in other industries, as their price/earnings ratios attest. To the extent that it exists, the capital market problem is confined to the financing of mineral and petroleum exploration by small, recently established

corporations that do not have the financial resources needed to spread the risks by carrying out many ventures simultaneously, cannot join syndicates (or enough syndicates) to pool risks, and do not have income from mineral or petroleum extraction or refining against which the costs of unsuccessful exploration ventures can be offset. Under these conditions the cost of capital for mineral and petroleum exploration is probably high. However, it is difficult to say whether the cost of capital is higher for such exploration than for research by small manufacturing companies.

While the capital market may be biased against exploration under some conditions, there is little if any evidence that known mineral and petroleum reserves are inadequate. Present reserves are adequate for current requirements, and for most minerals the reserves are growing rather than declining relative to current output. The question of oil reserves requires specific attention. Although the market bias against risk taking may adversely affect independent oil companies, the seriousness of the problem should be judged in terms of Canada's oil reserves.

We have been told that there are no insurmountable technical obstacles to the commercial production of oil from the Athabasca tar sands. The principal problem is that, if oil from the tar sands is to be competitive with conventional crude oil, large scale productive facilities are required and these must operate near rated capacity. With the output of conventional crude oil substantially below 50 per cent of capacity, the Province of Alberta has been reluctant to grant permission to the industry to proceed with the exploitation of the tar sands on an adequate scale because this would entail a cut-back in the production of conventional crude. But if costs of conventional oil exploration continue to rise it is apparent that, if the tar sands are not now competitive with conventional crude, they will be competitive in the near future, and Canada's oil reserves, for all practical purposes, will be limitless. Devoting resources to the search for conventional oil is, or will become, unnecessary. Hence, to grant

increasingly generous tax concessions to encourage the discovery, at higher and higher costs, of more conventional oil when tar sands crude was available in limitless quantities but could not be exploited because of the limited market, would be perverse.

We have generally adopted the view that wherever possible, when incentives are needed, subsidies rather than tax concessions should be granted. The cost of subsidies is apparent and they can be equally efficient as, or more efficient than, tax concessions. If public policy dictates that mineral exploration should receive greater encouragement than would be provided by the tax treatment that we recommend, any or all of the following measures would be effective:

1. The recently announced government loan programme for exploration in the North could be expanded.

2. Increased subsidies for transportation, communication and geological surveys could be made.

3. A subsidy equal to a fraction of additional exploration expenses could be provided.

We have therefore come to the conclusion that the need for special encouragement to mineral and petroleum exploration to compensate for a capital market bias against risky ventures is small, if it exists at all. We are also convinced that there are fiscal methods available that would be as efficient as, or more efficient than, tax concessions in encouraging exploration if this was deemed to be in the public interest. It is against this background that the efficiency of the present concessions will be analyzed.

EFFICIENCY OF THE PRESENT MAJOR TAX CONCESSIONS

The purpose of tax concessions to the extractive (or any other) industries is to make additional activity more attractive. This can be done by increasing the after-tax net return on investment in an attempt to expand

investment, and thus lead to increased exploration, discovery, development and output. But concessions related to current profit, such as percentage depletion and the three-year exemption, are inefficient devices for increasing the long-run supply of minerals and petroleum because they apply to the output that would have occurred without the incentive as well as to additional output. From this starting point the effect of the present concessions may be reviewed briefly assuming that the tax reduction resulting from the incentive is not shifted in the short run through lower prices or higher costs.

By increasing immediate profits, the tax concessions increase the capitalized market value of existing assets in the industry, including the equity shares of existing corporations and the value of proven or potential reserves. However, if the establishment of new mines or new petroleum wells is barred, either through monopoly control or through the prohibitive cost of new discoveries, such tax concessions are pointless.

If the opportunity to open up new deposits is relatively unrestricted and if long-run costs do not rise sharply, higher current profits resulting from the introduction of tax concessions will induce a shift of resources into the industry. If this happens, and if the country's increased output of the given mineral can be sold with no appreciable reduction in price, windfall gains to owners of existing assets will be at a minimum. The tax concessions will be as efficient as possible. An allocation of resources that is different from what it would have been under free market conditions will have been achieved.

However, if the price is maintained by effective control of total output and if there is freedom to open up new deposits, new investment will indeed be attracted by the tax concessions but it will result in idle capacity. There will be no increase in the output of the industry in question and less of other commodities will be produced. In this sense the re-allocation of society's resources will have been wasteful.

On the other hand, if output is permitted to rise but prices are highly sensitive to the country's output, the additional output resulting from a net increment in investment will quickly reduce profit expectations from further increments. The sensitivity of price to output will depend, in particular, on the size of Canada's output in relation to world demand for a given product. If small increases in output lead to large price reductions, there will be little impact on the country's final output as a result of the concessions.

Depletion Allowance to Operators. Percentage depletion is an extremely expensive incentive for encouraging mineral and petroleum exploration for the following reasons:

1. The incentive is related to current profit and not to costs. The impact of the incentive is therefore indirect—the after-tax rate of return on production is increased and this increases the value of mineral and petroleum resources, and hence encourages exploration. More exploration could be encouraged at the same revenue cost, or the same exploration at a lower revenue cost, by relating the incentive to additional exploration, so that exploration that would have taken place without the incentive would not be unduly rewarded.

2. Because exploration expenses must be deducted before depletion can be claimed, the more a corporation spends on exploration the less it benefits from depletion. This objection could be removed by the adoption of gross depletion; but as already stated, the additional revenue cost would be substantial and the incentive would still be less efficient than a direct subsidy to exploration.

3. The depletion allowance provides a benefit only to established corporations with operating income. Both in mining and oil a few corporations (eight in all) claimed substantially over three quarters of the more than $150 million claimed in depletion by mining and petroleum

companies in 1964. The smaller corporations obtain little if any direct benefit from this concession, which favours most those corporations which need it least, because the cost of capital to the largest mining and petroleum corporations is comparable with that of corporations of similar size in other industries.

Deduction of Exploration and Development Costs

The rapid write-off of exploration and development expenses yields an imputed interest saving. As a device intended to cause the re-allocation of resources, this concession is the most efficient of those under consideration. It has the great virtue that there is a direct relationship between the stimulus and the desired response.

The present deduction provisions can, however, be subjected to two major criticisms. First, they are more advantageous to those corporations which have operating income and so can immediately utilize the rapid write-off, than to those that do not. Second, the privilege applies to all stages of pre-production activity—from primary reconnaissance through to final development. Given that the risks of failure have been greatly reduced by the development stage, the direct effect of the rapid write-off provisions for development costs is likely to be a more rapid development of known mineral deposits and petroleum reserves rather than a search for new deposits and reserves.

The Three-Year Exemption for New Mines

Where the three-year exemption is an alternative to the write-off provisions, as it is in the case of a short-lived mine operated by a corporation without operating income, this exemption adds little to the profitability of a mine. However, where it is applied in addition to the write-off it may add substantially to the profitability of a mine, especially where the write-off is obtained immediately against other income. Thus, it is relatively advantageous in the case of a short-term project that is associated with an existing mining organization.

As an incentive device the three-year exemption is more efficient than the depletion allowance. Its impact is related only to the early productive period of a mine and not to its lifetime income, so that the primary influence of the three-year exemption is not on asset values in the entire industry but only on those mines that are in the development phase. Since it is more selective, it may be less costly for each unit of additional activity induced than the depletion allowance; but even so it involves large elements of waste. The exemption is applied to all new mines whether or not their development would have taken place in its absence. In terms of benefits, the additional production with which it can be credited is only from those properties which would otherwise have been expected to return less than the minimum acceptable profit.

Here too the incentive provides the greatest benefit to those who need it least. During the period 1955 to 1964, five large mining companies reported about 70 per cent of the income exempted under the new mine provisions. These corporations had operating income against which exploration and development expenses could have been immediately offset, and they operate on such a large scale that they are quite capable of spreading their risks. There is no evidence of a capital market bias against their shares. Three of these companies claimed $117 million in tax-free income in 1964 alone—at a tax revenue loss of nearly $60 million. It is open to question whether this tax saving had a major impact on the investment expenditures made by these companies. Even if it did, it is most unlikely that the benefits obtained exceeded the lost tax revenue.

THE PROPOSED TAX TREATMENT

If we were recommending a tax system that accorded only such concessions to the mining or petroleum industry as are recommended for industry in general, the depletion allowances would obviously be eliminated as would the three-year exemption for new mines. All costs, including property costs, would be deductible at some time and at the following rates:

1. Exploration costs would be written off immediately. Depreciable property which was useful only in connection with one exploration project would be included in this classification. If there was insufficient income to absorb such costs currently, they would be carried over for deduction from income in a subsequent year.

2. Development costs (excluding the cost of acquiring properties or property rights) would be amortized on the diminishing balance basis at a rate of, say, 20 per cent.

3. Equipment, buildings and other facilities used in the development and production phases would be amortized on the diminishing balance basis at the same rate of 20 per cent, as their usefulness would be closely related to the life of a particular mine or well. A smelter or refinery should be permitted only the regular rates of capital cost allowance applicable to buildings and machinery generally.

4. The 100 per cent capital cost allowance for small and new businesses would also apply to mining and petroleum.

5. The cost of purchasing a mining or petroleum property would be amortized on a time or a production basis where the property had an ascertainable useful life or where the amount of reserves was determinable. On the other hand, if both the useful life and the quantity of reserves of the property were indefinite in duration and amount, the cost would be written off only to the extent that a loss in value could be shown to have occurred.

6. The write-off of development costs and depreciable assets used in development and production would not be permitted until production commenced, consistent with the proposed general rule that, in the absence of a concession, capital cost allowance should not be claimed until the assets are put to use.

7. Capital outlays which did not result in the acquisition of property would be deductible either directly or by way of capital cost allowance in the manner recommended in Chapter 22 for "nothings" generally.

The Proposal

It is our view that this method of determining business income should not be immediately applied to income from mining and petroleum operations. While it represents the same tax treatment as would be applicable to other industries, its immediate adoption might well have major adverse effects. However, the present depletion allowance for both mining and petroleum and the three-year exemption for new mines appear to us to be not only more generous than is necessary to compensate for any risk factor but are, in addition, inappropriate and inefficient incentives. In our view, to the extent that there is to be a divergence from a neutral tax treatment, it would be better to permit an accelerated write-off of all costs, including the cost of properties, development costs and the cost of depreciable assets which are useful only for a particular exploration or development project or for production from a particular mine or oil or gas well (but not the cost of smelters and refineries). When combined with the deductibility of share losses and the more liberal treatment of business losses, such treatment should be quite adequate to offset any bias in the capital markets that might exist against the mining and petroleum industries. The operator of a mine or oil well would therefore pay little tax until he had recovered all of his costs. After that point, there is no reason why his income should not be taxed in full.

However, it must be emphasized that a tax treatment incorporating these special write-offs would be considerably more liberal than the treatment recommended for industry generally and need not be extended indefinitely to all mining and petroleum companies. We will therefore propose the gradual restriction of some of these write-offs to rates of capital cost allowance that would be closer to those provided for industry.

We have agreed that there may be some capital market bias against small and medium-sized mining and petroleum companies, although smaller companies in these industries probably do not face financing problems significantly more difficult than those encountered by manufacturing concerns of the same size. On the other hand, we were unable to find any evidence that the larger companies in these industries were subject to any capital market bias. Therefore, to achieve inter-industry neutrality, any special write-offs for the extractive industries should, in the long run, be limited in amount. They should also be restricted to the smaller companies. We considered whether the provision already outlined in Chapter 22 for new and small businesses would be satisfactory in this regard. The allowance of 100 per cent capital cost allowance is quite sufficient as a concession, but there remains the question of what size of operation should qualify for this treatment. The limits suggested in Chapter 22 refer to assets (net of capital cost allowance) of under $1 million and to annual gross revenues of less than $10 million. Of these two limits, the one applying to assets would be more significant for the mining and petroleum industries. Thus, although the new and small business provision would be of assistance to a new mining or petroleum company, it would not assist a medium-sized company that had accumulated assets in excess of the stipulated limit. We therefore examined alternatives that would have some effect on medium-sized companies, as well as on smaller companies which had used up the $250,000 of accelerated capital cost allowance permitted under the new and small business provision. We rejected an expansion of the limits on the size of assets or revenues that would be applicable only to mining and petroleum companies, as this would increase the administrative difficulties to which the new and small business provision would give rise. At some future date such a special provision might be a useful means of extending accelerated capital cost allowances to more mining and petroleum companies.

We believe that another proposal we make later in this chapter for a special write-off for shareholders who acquire newly issued shares of mining

or petroleum companies would be of greater direct benefit to these companies. This latter provision would not be restricted to companies of any particular size, but we would expect that it would primarily be utilized by small and medium-sized companies undertaking an exploration or development programme.

Our specific proposals, which we discuss in more detail in the following pages, are these:

1. The present depletion allowance for the mining and petroleum industries and the three-year exemption for new mines should be withdrawn.

2. Exploration costs (including the cost of depreciable assets that can be used only in connection with a specific exploration project) should be included in a separate capital cost allowance class with a rate of write-off of 100 per cent.

3. Development costs (including the cost of depreciable assets which can be used only for production from a particular mine or oil or gas well) should be included in the same capital cost allowance class with exploration expenses during a transitional period of five to ten years. Thereafter they should be segregated in a separate capital cost allowance class and subject to write-off at a rate of 20 per cent to 30 per cent on a diminishing balance basis.

4. The cost of mining and petroleum properties should be capitalized in a separate capital cost allowance class for each property. The costs should then be amortized by the write-off of amounts related to the operating revenues derived from the same property. The capital cost allowance rate should be substantial (say, up to 50 per cent) in the transitional period, but thereafter should be set at 10 per cent to 20 per cent of the operating revenue from the property. In addition, if the property is disposed of, abandoned or becomes valueless, the unamortized balance should be written off.

5. Losses in the mining and petroleum industries (whether they result from the write-offs referred to above or otherwise) should be available in the same way as other business losses for carry-back two years and forward indefinitely. They should also be subject to the rules we have proposed to restrict the transferability of losses, but Canadian resident shareholders would be entitled to deduct losses on shares.

6. All profits made on the disposition of mining and petroleum properties should be included in income, in accordance with the comprehensive tax base. The full gain should be included in income, even if some portion of that gain accrued prior to the effective date of the legislation implementing our proposals. However, where shares are disposed of by persons who are not in the business of dealing in securities, only the profit accruing after the date of the legislation would be included in income.

Three-Year Exemption and the Depletion Allowance

Our reasons for recommending the withdrawal of these concessions will be apparent from the discussion earlier in this chapter. We have concluded that they are more liberal than is justified by any disadvantage of the petroleum and mining industries in obtaining capital and, furthermore, are inappropriate and inefficient incentives. Our recommendation for withdrawal extends to all the depletion allowances—for operators, non-operators and shareholders.

As we have said, we recognize that the withdrawal of these depletion allowances and the three-year exemption and the simultaneous imposition of a restriction on write-offs to regular capital cost allowance and amortization procedures could result in a serious impact on the larger integrated companies in the mining and petroleum industries. While most of the benefit of these concessions (particularly of depletion) accrues to the larger and better financed companies, nevertheless the smaller companies plan their affairs

in anticipation of being in a position to benefit from the concessions, and certainly the three-year exemption has benefited some smaller mining companies. Therefore, while we recommend the immediate withdrawal of percentage depletion, we suggest that provision be made for transitional periods for both the withdrawal of some of the more liberal write-off provisions and the withdrawal of the three-year exemption for new mines. We recommend that the exemption continue to apply to new mines brought into production during a five-year period, but that for this period the amount of exempt income for any one mine should be limited to $1 million.

We will also propose a further measure that will reduce the impact of the withdrawal of percentage depletion by permitting the deduction, over a transitional period, of a portion of those property costs that were not deductible in previous years. This deduction is discussed in greater detail later in relation to the treatment of property costs.

Withdrawal of percentage depletion and the three-year exemption would be major changes in the tax structure and would greatly increase the future tax liabilities of the few large integrated mining and petroleum corporations. It would undoubtedly make capital formation by these corporations less attractive than it has been in the past. However, it would be a mistake to over-emphasize the magnitude of the negative effects. The rate of capital formation by some of the largest companies probably would not be greatly affected because they enjoy a substantial degree of market power and only increase capacity to meet increasing demand or to maintain a share of the market.

The after-tax rate of return to many Canadian shareholders on investments made by many of the smaller companies that have relatively little operating income would be materially improved. (See Tables 23-3 and 23-6.) However, the benefit to Canadian shareholders of our proposal for the integration of corporation and personal income taxes would in many cases be offset by the full taxation of share gains.

If percentage depletion is regarded as compensation for the present limitation on the deduction of costs, the justification for such depletion would disappear under the proposed tax system. If percentage depletion and the three-year exemption for new mines are looked upon as compensation for the bias against risk taking in the present system because of the restricted treatment of losses, adoption of the proposed reforms would eliminate the need for such compensation. If the bias in the capital market against risk taking or the indirect economic and social benefits of mineral and petroleum extraction are thought to warrant an incentive for mining and petroleum, then our recommendations embody such an incentive. Because the recommended treatment satisfies all of these requirements, we have no hesitation in recommending the abolition of percentage depletion and the three-year mining exemption.

Exploration Costs

We propose that the costs of exploration, including the cost of depreciable property which can be used only in connection with a specific exploration project, should be included in a new capital cost allowance class which could be written off at the rate of 100 per cent. If the amount claimed in any year exceeded the income of the taxpayer, the deduction would result in a loss which, under our general proposals, would be available for carry-back two years or forward indefinitely against income. If the taxpayer was a member of a group of companies which filed consolidated returns, the loss could be offset against the income of other companies in the group in accordance with our recommendation.

The immediate write-off of exploration costs is a concession that is similar to the proposed write-off of all costs of research and product development for industry generally, and is an incentive that can be supported on general economic grounds.

Development Costs

We recommend that initially development costs, including the cost of depreciable assets which can be used only for production from a particular

mine or a particular oil or gas well, should be treated in the same way as exploration costs and should be included in the same capital cost allowance class—although we have indicated that such development costs should in principle be deductible only over a period of years. We recommend that after a reasonable transitional period of, say, five to ten years, these development costs should be segregated in a separate capital cost allowance class and should be subject to write-off at a rate of, say, 20 per cent to 30 per cent on a diminishing balance basis. When this separation between exploration and development costs becomes effective, the regulations should specify what items are to be included in the development cost class and which in the exploration cost class. Any other expenditures not included in these classes should be deducted currently.

In the transitional period a 100 per cent rate of capital cost allowance would be applicable for both exploration and development costs so that there would be no need to distinguish immediately between such costs, which could be grouped into a single new capital cost allowance class that would be subject to a rate of 100 per cent. Unclaimed costs of exploration and development as at the effective date of the new legislation should also be included in this new capital cost allowance class. In the event of a reorganization under which all the underlying properties of a corporation were transferred, the undepreciated balance would likewise be transferred and the present limitations on the sale of unamortized costs should no longer apply. On the other hand, the taxation of property gains would mean that any gain on disposition would be taxable.

The above treatment should not apply to depreciable assets used in smelting and refining. These should continue to be subject to capital cost allowance at the regular rates for buildings and equipment.

Property Costs

Mining and petroleum properties are wasting assets which often have an indeterminate life. To be consistent with our recommendations for industry

generally, the costs of finding and maintaining mineral and petroleum reserves should be allowed as a deduction when incurred, while the cost of purchasing a property should be amortized over the life of the property if this is determinable or, if it is not determinable, the cost should only be deducted when a loss in value can be shown to have taken place. In the case of mining and petroleum properties it should usually be easy to demonstrate such a loss, for when a property proves unproductive or is closed down a loss in value would be established.

Because of the difficulties in estimating the amount of mineral and petroleum reserves with any degree of accuracy, it would not be feasible for tax purposes to attempt to match all of the costs of the property against the revenue produced. Rather, the exploration costs should be immediately deductible and the development costs should be amortized at an arbitrary rate, a procedure which would generally result in a faster write-off of costs than would otherwise be the case. In addition, the proposed rapid write-off provisions should also apply to the costs of acquiring property rights, even if subsequent exploration and development work was successful.

Accelerated write-offs assist the taxpayer to conserve internal sources of funds by deferring his tax liabilities, and therefore reduce the need for outside capital. However, in the case of the purchase cost of mining and petroleum properties an unlimited write-off, even for a transitional period, could have undesirable consequences. Not only would such a write-off be unduly liberal for the larger concerns, but it could well become a tax incentive to the larger companies to take over the smaller operations. If companies that were in a taxable position could immediately write off the full costs of acquiring a developed property, they would have a substantial advantage in the market for properties as compared to companies that were not yet taxable. Such an incentive would be particularly attractive to non-resident-owned companies, as integration would not apply to reduce the relative value of the immediate write-off.

In Chapter 22 we discuss a problem of a similar nature that is applicable to business in general. Although purchased goodwill and trade marks are intangible assets, while mining and petroleum properties are tangible assets, the problem of matching the revenue and related expenses is similar where the useful life and the quantity of reserves are indefinite in duration and amount. In principle, all the costs of developing or acquiring these items should be capitalized and then amortized so as to be matched with the revenue produced from the exploitation of the property. It is often difficult, if not impossible, to ascertain the useful life of each asset, for this depends upon the revenues that can be derived from it. The level of such revenues will be affected by many factors, usually beyond the control of the taxpayer. In Chapter 22 we recommend that all the costs of developing and maintaining such assets as goodwill and trade marks should be deductible in the year incurred, despite the fact that such costs should in principle be capitalized and amortized, but that the cost of purchased goodwill or trade marks should only be deducted when it could be demonstrated that a loss had occurred.

We will recommend a procedure for the mining and petroleum industries that will allow them to continue to receive more liberal treatment than other industries. Our proposals are as follows:

1. For companies qualifying under the new and small business provision the cost of mining and petroleum properties should be treated in the same way as is recommended for exploration and development costs, that is, allowed as a deduction when incurred up to a maximum of $250,000.

2. For other taxpayers the purchase cost of mining and petroleum properties should be capitalized in a separate capital cost allowance class for each property. The cost should then be amortized by the write-off of amounts related to the operating revenues derived from the same property. While in the transitional period the proportion

might be up to 50 per cent, after a period of five to ten years it should be set at, say, 10 per cent to 20 per cent of the operating revenue from the property. A provision of this nature should not be difficult to administer as it should be possible to develop administratively feasible regulations defining what property costs were to be capitalized and how operating revenues were to be determined.

Any unamortized balance of the property cost should, of course, be allowed on the disposal or abandonment of the property or when it could be demonstrated that the property was valueless.

As a transitional measure, it perhaps should also be provided that the restriction on the write-off of property costs should not immediately apply to purchases of property rights from a government. The petroleum industry has had the right to an immediate write-off of the cost of such property rights since 1962 and to defer the deduction of these costs, while simultaneously withdrawing depletion, might be too great an adjustment for the larger integrated companies to make at one time. However, after, say, five years the limitations outlined above should be extended to all purchased properties.

Deduction of the costs of mining and petroleum property rights should differ in one respect from the usual procedures applicable to other costs included in capital cost allowance classes. A taxpayer acquiring a mining or petroleum property directly would capitalize the full costs, which would be amortized or written off as described above. A taxpayer acquiring a company that held such properties should not be permitted to adjust upward to market value the depreciable capital cost of the properties, as we have suggested he could do with other depreciable assets of the purchased company. Rather, the company should continue to claim capital cost allowance on the same basis as before the change in control and the excess of the purchase price of the shares over the undepreciated capital cost of the mining or petroleum property, if any, should in effect be regarded as goodwill. This procedure would create a bias between the purchase of shares and

the purchase of assets, but nevertheless would be necessary because of the difficulty of differentiating between the value of the properties and other intangibles such as goodwill.

Property Gains

We have recommended that property gains should be taxed in full (a procedure that is already applicable to petroleum properties), and that gains accrued prior to the date of implementation of our proposals should be excluded from income. However, in the case of mining and petroleum firms, we do not recommend that this exclusion should apply.

Our rejection of an exemption for gains unrealized at the transition date is dictated partly by tax avoidance considerations and partly by practical considerations. Experience at the time of the change in treatment of petroleum rights in 1962 indicated that, if petroleum properties could be sold tax free while the cost to the purchaser could be written off, many sales would probably take place for tax reasons and there would be an unacceptable loss in tax revenues. As a practical matter, it would be extremely difficult, if not impossible, to value many mineral properties. The allocation procedure suggested in Chapter 15 would be inappropriate because of the extreme fluctuations in the value of these properties over time, and because of the inhibiting effect that such a procedure would have on mobility. We discuss these difficulties later in this chapter.

In any event, the hardship which would result from the denial of the exemption is limited. For one thing, the general exclusion of gains accrued prior to the transition date should not apply to those taxpayers whose business included the realization of such gains. Also, all gains realized on the disposition of petroleum properties are already subject to tax. More important, the shareholders of a company holding property rights would not be subject to tax on the accrued property gains to the extent that such gains were reflected in the value of their shares at the transition date. Thus,

what would appear to be harsh treatment at the corporate level would be fully compensated for at the shareholder level as far as resident shareholders were concerned. Furthermore, in the case of prospectors, we recommend that some recognition should be given to the fact that their property gains are now tax free. In view of the difficulties in valuing mineral properties, the transitional provision for prospectors should provide for the taxation of such gains in stages.

We have recommended that all property gains should be taxed in full when realized. Thus, the disposal of any mining or petroleum property would be a taxable transaction; and the amount that would be amortizable to the purchaser would be an amount equal to the proceeds of disposition included in the income of the vendor. The taxation of the vendor's gains should produce much of the revenue to offset the write-off claimed by the purchaser. However, if the vendor was a non-resident while the purchaser was a resident, the liability to Canadian tax is not assured. We have expressed our belief that all gains realized on the disposition of Canadian property are a reasonable subject of Canadian tax. We have also stated that at the present time it is administratively impracticable or, in some cases, impossible to collect a tax on many such property gains—the prime example being the gains of non-residents on dealings in Canadian securities. On the other hand, we have recommended that gains and losses on the disposition of real property by non-residents should be included in income. Not only do we believe it is possible to administer such a provision, but also it is necessary to levy tax in these circumstances to avoid putting the Canadian holder of real property at a competitive disadvantage. These same considerations apply to mineral and petroleum rights and we therefore recommend that they be treated in the same manner as other interests in real property. Thus, the ownership in Canada of real property, or of an interest in real property, should be deemed to be a permanent establishment in Canada, with the result that any gain or loss on the disposition of such property or property interest would be taken into account in computing Canadian source business income.

Deduction for Shareholders

In order to ensure that the benefits of the proposed rapid write-offs accrue to the small and medium-sized companies as well as to the integrated operations, we recommend that an option be available to mining and petroleum companies to pass on to the purchasers of new shares the right to the immediate deduction of exploration and development costs. This transfer would be accomplished by permitting the purchasers of the newly issued shares to write down the cost basis of such new shares to the extent that the proceeds of the issue were to be spent on exploration and development. This reduction in the cost basis, which would produce a "loss" that could be deducted from other income, would be allowed at the time of the investment even though the costs would not then have been incurred by the mining or petroleum company. When the company did incur the costs they would not, of course, be available as a deduction to the company and as a result corporation income tax would become payable at an earlier date. The tax authorities should establish certain controls to ensure that the company did in fact expend the funds on exploration and development. For example, a trust account might be required and a special tax might be imposed on any part of the designated funds that had not been spent on exploration and development within the period specified. It is not intended that costs of financing or administration would be included in this special write-off, but only the direct costs of exploration and development. This provision should be applicable to new share issues only, and not to outstanding shares. It should greatly facilitate the raising of risk capital by independent exploration companies and put them on essentially the same basis as the larger integrated corporations. Also, it should help to equalize the positions of the large and small companies as regards their ability to utilize the liberal write-off provisions that we have proposed.

Taken together, these proposals would virtually preclude the possibility of incomplete loss-offsets for expenditures in mining and petroleum exploration

and development. The large successful companies would deduct their costs of unsuccessful ventures from other business income. The newly issued shares of corporations that did not have operating income would, if the corporation made the election outlined above, immediately be eligible for a write-down to the extent of exploration and development expenses. The shareholders could immediately offset these expenditures against other income. The shares of corporations with inadequate operating income that for some reason did not follow the immediate write-down procedure would decline in price if the market judged the venture to be unsuccessful. The shareholder could then write down the value of his shares to market value. With all of these methods available for deducting losses from other income, we are satisfied that the tax system would not be biased against risk taking in the mining and petroleum industries.

Undeducted Property Costs

Although we have proposed some measures to reduce the impact of withdrawing percentage depletion, we believe that an additional transitional provision is required. As depletion was at least in part intended to compensate for non-deductible costs, and as substantial costs have been incurred in the expectation that any income would be eligible for a depletion allowance, some recognition should be given to costs that have not yet been absorbed. Therefore, we recommend that mining and petroleum operations that are now eligible to claim depletion should be able to deduct (over, say, a three- or five-year period) all costs of exploration and development which were not deductible in the past, including the cost of mining and petroleum properties, leases and licences, to the extent that such costs exceeded the amount of depletion claimed. This provision should only apply to costs incurred in Canada and depletion claimed over a certain number of years. As the deductibility of exploration and development costs was considerably expanded in 1948, this might be an appropriate year from which to begin the determination. The computation should be applied to associated companies on a consolidated basis.

The unclaimed costs of properties for petroleum companies are probably between $500 million and $750 million 26/. These companies claimed depletion between 1947 and 1964 of over $350 million, so that a provision of this nature would probably result in an amount of about $300 million becoming deductible by petroleum companies. The amounts of unclaimed costs would not be as large for mining companies, which have claimed depletion over this period in excess of $1,000 million. Thus, most of the benefit of such a write-off would accrue to those mining companies that had claimed little or no depletion.

Prospector and Grubstaker Exemption

There remains no justification for exempting the profits of prospectors and grubstakers from full rates of personal income tax. With the full deductibility of costs, with the averaging provisions recommended elsewhere in the *Report*, and with the provisions suggested later in this chapter to ameliorate any liquidity problems that would arise when property rights were exchanged for a non-cash consideration, the exemption can be withdrawn without hardship. However, the withdrawal should perhaps be implemented in stages over a transitional period, because we recommend that any properties held at the transition date by an individual prospector should be valued at his cost so as to obviate the problem of determining a market value.

Shareholder Depletion

With the full deduction of all costs, it would not be necessary to provide shareholders with an allowance for the depletion of their "capital". Accordingly, the provision for shareholder depletion should be repealed.

Special Aspects of the
Proposed Tax Treatment

We now turn to certain special aspects of mineral and petroleum operations: the treatment of costs of exploration outside Canada, payments to the provinces for petroleum rights and mining taxes, the purchase and sale of

mining and petroleum rights and properties, and the application of the proposed incentives to particular types of taxpayers.

Exploration Outside Canada. Under the present legislation, the costs of exploring for minerals and petroleum outside Canada are generally not deductible. This disallowance was probably adopted in the past to encourage the development of Canadian resources and to obviate any tax avoidance opportunities which their deduction might have created. Such an opportunity might have arisen, for example, in circumstances where a taxpayer resident in Canada deducted the costs of foreign exploration and then, in order to escape Canadian tax on any resulting profits, transferred the income-producing property to a company in a low tax jurisdiction.

The allowance of these costs is a desirable step if the measurement of income from mineral and petroleum extraction is to be improved, and we therefore recommend that these expenses be made deductible. It may be necessary to enact provisions which would require a resident company which transfers a property to a non-resident to include in its income at least the fair market value of the property transferred. Having regard to the provisions we recommend for deemed dispositions and the taxation of income from direct investment abroad, we are of the opinion that the problem of avoidance should not be a serious barrier to the allowance of these costs.

Payments to the Provinces. A continuing problem over the years has been the determination of what is a reasonable allowance under federal taxation for the various levies on natural resources imposed by the provinces. Where a province has retained proprietary rights in natural resources under the British North America Act, it may levy a charge in compensation for relinquishing those rights. In effect, it may sell its natural resources at a reasonable price. Any province may also exercise its constitutional powers to impose a direct tax on the exploitation of any natural resource, whether or not the province retains a proprietary interest in the resource. Such a direct tax may be imposed in addition to the natural resource charge, because

the legislative powers of the provinces in respect of property and taxation are not mutually exclusive.

Normally, the proprietary cost is recognized through a charge based on the quantity and quality of the resource depleted; typical examples are the stumpage charges in the forestry industry and the royalty charges for petroleum. These are normally recognized without question by the federal authorities as being allowable expenses of the taxpayer.

The provinces, particularly Alberta, have obtained substantial revenues from their oil resources by charging operators, by way of initial payments and annual charges and royalties, for rights to take oil 27/.

Royalties have always been allowable as a deduction in computing income for tax purposes, but payments for rights to take the oil were deductible only to a limited extent prior to 1962. When the cost of these rights became fully deductible in 1962, oil producers could afford to pay higher prices for the rights; consequently, a major effect of the change was to increase the prices of such rights and thereby transfer from the federal to the provincial treasury some of the government revenues from oil resources.

The provinces have had little difficulty in exercising their right to revenue from petroleum, probably because of such inherent characteristics as its homogeneous nature and the fact that the market value is relatively easy to establish. Because petroleum has an established value at the well-head, it would be somewhat easier than in the mining industry to determine the income from the actual extraction of petroleum and to levy a tax thereon. The provinces, however, have not thought it desirable to apply to the petroleum industry an income tax comparable to the mining tax, but rely on a royalty based on barrels of production.

Originally, the provinces derived revenue from mining by levying a flat charge per ton of ore removed. Most provinces now obtain their main revenues from mining through a tax on mining income—although the

provincial revenues from mining are much less than one half of those derived from petroleum. While simple in theory, the determination of the meaning of mining income for tax purposes has given rise to certain complications. Elaborate definitions have been devised to formulate a method of determining such income, the general purpose being to establish a concept of income earned in extracting the ore and raising it to the surface. In some cases this is done by direct computation; in others by a calculation to eliminate from the total profits of the operation the profit made on milling and processing. The federal government has its own definition governing the sort of tax it will recognize as being deductible and, while most of the provinces adhere fairly closely to this definition in levying their charges, there are some troublesome differences in the treatment of certain factors in the computation. The most serious differences arise in the case of the Quebec tax which is levied on a broader base than is contemplated in the federal definition.

Whether the provincial governments derive revenues from natural resources through lease payments, royalties, or a tax on income, the charges are nevertheless a cost of acquiring a supply of the mineral or petroleum concerned. Therefore, such charges, regardless of their form, should be deductible in full in the computation of income in the same way as any other cost of doing business. However, as they are a cost of earning income, they should not be eligible for any form of tax credit.

Purchase and Sale of Mineral and Petroleum Rights and Properties. A mining or petroleum property may pass through many hands before being developed. In the case of mining property, a typical chain of events for a discovery not made by a major mining company is that a prospector first stakes a property and, having done some work on it, enters into an agreement with an exploration company under which the company, in consideration for an interest in the property, undertakes to investigate the property. If the investigation warrants it, the exploration company does some development work on the property and interests a major mining company in financing it to a producing

state. At this stage a new company is formed in which the prospector, the exploration company and the mining company each have an interest. Usually, throughout this chain of events, little or no cash changes hands between the parties and frequently no price is stipulated when the property passes from one owner to another. Each party takes or retains an interest in the property either in the form of rights to participate in net income from production or shares in a company controlling the property.

Transactions also occur in mining properties that have been fully developed or are in production, but these are not nearly as common as transactions in proven or producing oil properties.

In general, the proceeds from the sale of mining properties by prospectors or grubstakers would probably be considered taxable, but specific exemption is at present provided in section 83(2) of the Income Tax Act. Mining properties that have been developed or are in production are normally considered capital assets, and any proceeds from their sale are non-taxable except to the extent of recaptured depreciation unless the vendor is found to be dealing in mining properties. There is no recapture of exploration and development costs that have been claimed and are subsequently recovered upon sale of the mining property. Circumstances in which pre-production expenditures can be transferred between taxpayers are referred to below.

Thus, while the present system ignores purchases and sales of mining properties, the actual costs of exploration for and development of mining properties are generally recognized, either as deductions against other income of the taxpayer incurring the costs or, under certain conditions which will be discussed in more detail below, by transfer to other taxpayers. The important exceptions to this general statement are prospectors and grubstakers and the exploration companies and mining companies that themselves have insufficient income to absorb such costs and are unable to enter into transactions that would enable the costs to be transferred to other taxpayers.

The present system is inequitable and contrasts sharply with our recommended basis for determining business income. Certain anomalies and loopholes have incidentally been created. In this connection, we have already proposed that all the costs of acquisition and development of mining rights should be allowable, and it would follow that any proceeds attributable to these activities should be included in income.

The main difficulty in introducing a system under which the purchase and sale of mining properties would be taxable transactions lies in placing a value on the consideration, most of which would usually be in the form of shares. There are several alternative methods of valuation:

1. Fair market value might be adopted as the measure of the consideration. In some cases information would be available as to the value of the shares, but often there would be no adequate indication of value for several years. It does not seem practicable to wait a number of years to establish the value.

2. Only the cash consideration might be recognized for tax purposes. This would make for greater certainty, but would be inequitable when so little of the consideration would usually be paid in the form of cash. It would also invite artificial avoidance procedures.

3. Only the costs related to the property that were not yet claimed by the vendor might be regarded as consideration for tax purposes. This treatment would give recognition to the fact that many transactions in mining properties are steps in a continuous chain of events resulting in the emergence of operating income. It would not serve equity, however, where the fair market value was considerably in excess of the cost.

Despite the practical difficulties involved, we recommend, with the exception noted below, that the purchase and sale of mining properties be treated as taxable transactions. It follows that the present exemption of amounts realized by prospectors and grubstakers from the sale of mining

properties should be discontinued and that any costs which they have incurred should be allowed. The general basis of valuing transactions in mining properties should be fair market value, although in certain circumstances the use of the unclaimed costs of the vendor would be acceptable. Where a mining property was exchanged for shares in a new company that were not publicly traded or for shares that were publicly traded but represented an interest in a company of more than 25 per cent, we recommend that the vendor of the property should be permitted to adopt as the cost basis of the shares an amount equal to his unclaimed costs. This would mean that no profit would be recognized for tax purposes at the time of transfer. Under our proposed treatment of losses, any decline in the value of the property or shares could be taken into account whenever such loss could be established. In Chapter 15 it is also recommended that a disposition of the shares received in exchange for property should be deemed to take place when the shares satisfy two conditions: they represent an interest in the company of 25 per cent or less, and are publicly traded.

We have already noted that in 1962 fundamental changes were enacted in the tax laws applicable to the petroleum industry. The cost of oil rights and properties became a deductible expenditure, and the proceeds from disposal of all petroleum properties, regardless of their date of acquisition, became taxable. However, the costs of properties acquired prior to the effective date were not deductible. Representations have been made to us concerning this anomalous result, and accordingly further comment is appropriate.

Originally, it was proposed that the proceeds from the sale of any property acquired prior to April 11, 1962, would not be taxable, a procedure that would have followed the more or less traditional approach of avoiding retroactive taxation of amounts that were previously exempt. However, since the cost of any property acquired after that date was to be immediately deductible, there arose the possibility that taxpayers would exchange

properties at high prices to their mutual tax advantage, creating capital gains for the vendors and deductible costs for the purchasers. Because of the way in which oil fields are shared by companies, it soon became evident that this potential avoidance technique was an actual one. Accordingly, when the changes were finally enacted it was provided that the proceeds of the disposal of all oil properties not acquired by inheritance would be included in income unless they were acquired before April 11, 1962, and disposed of before November 9, 1962. 28/

Actually, the taxation of proceeds from the disposition of properties acquired prior to April 11, 1962, has probably had a limited retroactive effect as the purchaser, now that the cost of acquisition is deductible at some time, can afford to pay a much higher price and thereby leave the vendor in almost the same net position as before. It has also been contended that the impact of tax on the profit from dispositions of oil properties has been such as to discourage transactions from actually taking place. However, the size of the tax impact is a reflection of the fact that a property may be carried at a much lower tax value than its real value. When a taxpayer actually realizes this difference, the government must collect the full tax at that time. It is the consequence of taxing income on a realized basis and allowing accelerated write-off of costs.

The denial of a deduction for the cost of properties acquired prior to April 11, 1962, is of more concern. However, as part of our recommended transitional provisions we have suggested that the excess of these unclaimed costs over depletion claimed should become deductible, and therefore in effect all costs would be deducted in one manner or another.

Application of Mining and Petroleum Provisions to Particular Types of Taxpayers. Under the present legislation considerable complexity is caused by the fact that provisions for the taxation of mining and petroleum income apply to different taxpayers in different ways, primarily according to the principal business conducted by the taxpayer, but also according to whether the taxpayer is an

individual or a corporation. Many of the provisions presumably were intended as incentives available only to persons in mining and petroleum. This policy does not generally appear to be valid. It is therefore recommended that the limitations on the availability of the special provisions be removed. An incidental and important effect of this change should be to encourage wider participation by Canadians in the mining and petroleum industries.

Proposed Tax Treatment of the Mining and Petroleum Industries Compared with the Proposed Tax Treatment of Other Industries

The effects of our proposals on the mining and petroleum industries, relative to the present treatment of these industries and relative to the proposed treatment of other industries, can be shown in tabular form. Table 23-1 deals with the treatment of costs; Table 23-2 deals with the treatment of losses.

The outstanding features of the recommended changes in the treatment of costs can be briefly stated:

1. All costs would be deductible at some time for all industries.

2. The mining and petroleum industries would be allowed an immediate write-off of all exploration costs and initially of all development costs, with the exception of depreciable assets used in smelting and refining (although the new and small business provision applicable to all industries would also apply to mining and petroleum).

3. The purchase cost of mining and petroleum properties and property rights could be amortized, initially at a rapid rate and later at a more moderate rate. The cost of abandoned or valueless properties could, of course, be written off when the loss in value was shown to have occurred.

TABLE 23-1

COMPARISON OF PRESENT AND PROPOSED TREATMENT OF COSTS FOR MINING AND PETROLEUM WITH COMPARABLE COSTS OF OTHER INDUSTRIES

Type of Cost		Present Treatment		Proposed Treatment	
Industry Generally	Mining and Petroleum	Industry Generally	Mining and Petroleum	Industry Generally	Mining and Petroleum
Research and product development	Prospecting and exploration	Current and capital costs for scientific research—immediate write-off a/ Other current costs—immediate write-off Other capital costs—no write-off unless under capital cost allowance provisions	Immediate write-off	Immediate write-off	Immediate write-off including special write-off for holders of newly issued shares
Inventory	Development costs (including forward development)	Charged against income when goods sold or on a loss in value	Generally immediate write-off	Charged against income when goods sold or on a loss in value	Immediate write-off during initial period—capital cost allowance at 20 per cent to 30 per cent thereafter, also special write-off for holders of newly issued shares
Patents copyrights and goodwill	Property rights	Fixed life—amortized over life Other—not deductible	Petroleum—immediate write-off Mining—not deductible b/	Fixed life amortized over life Other—deductible when lost or reduced in value	Amortized as a percentage of revenues from the property or written-off on a proven loss in value
Depreciable assets	Depreciable assets: a) used in prospecting, exploration, extraction and reduction b) used in smelting and refining c) unclaimed capital costs on effective date	Immediate write-off for assets used in scientific research—otherwise capital cost allowance rates	Capital cost allowance rates	Immediate write-off for assets used in scientific research. On other assets capital cost allowance rates unchanged except for small and new businesses	a) Immediate write-off b) Unchanged except for small and new businesses c) Unchanged

Notes:

a/ Until the end of the 1966 year an additional 50 per cent is also deductible.

b/ Depletion is sometimes regarded as a roughly equivalent deduction.

TABLE 23-2

COMPARISON OF PRESENT AND PROPOSED TREATMENT OF LOSSES
FOR MINING AND PETROLEUM WITH OTHER INDUSTRIES

Type of Loss	Principal Features of Treatment	Present Treatment: Industry Generally	Present Treatment: Mining and Petroleum	Proposed Treatment: Industry Generally	Proposed Treatment: Mining and Petroleum
Business losses	Carry-back	1 year	Same as industry generally	2 years	Same as industry generally
	Carry-forward	5 years		No limit	
	Deductible from other kinds of income	All income in year of loss—business income in other years		No limit a/	
	Transferability	Restricted		Restricted but this is largely irrelevant because losses on shares deductible as described below	
Losses on shares	Carry-back Carry-forward Deductible from other kinds of income	Not deductible	Not deductible	Same as treatment of business losses	Same as industry generally
	Write-down to market without realization	Not deductible	Not deductible	Deductible	Deductible

Note:

a/ Except for limitations to preclude deduction of personal expenditures.

4. The mining and petroleum industries would therefore be allowed to write off the following kinds of costs more rapidly than industry generally would be allowed to write off costs of a comparable type:

   a) pre-production and development costs;
   b) the cost of depreciable assets used in exploration and development; and
   c) the purchase cost of mining and petroleum properties and property rights.

5. The mining and petroleum industries would be better off under our proposals than they are at present so far as the treatment of costs is concerned; the major advantage would be enjoyed during the initial period when development costs could be written off when incurred.

6. New mining and petroleum companies that met the asset and sales qualifications for new and small businesses would be entitled to an immediate write-off of all depreciable assets within liberal limits. In addition, the newly issued shares of mining and petroleum companies would be eligible for a special write-off to the extent that the proceeds of the share issue were to be expended on exploration and development.

The outstanding features of the recommended changes in the treatment of business and property losses are set forth in Table 23-2.

1. The treatment of business losses would be liberalized for all industries in the following respects:

   a) the carry-back of losses would be extended from one to two years;
   b) the five-year limit on the carry-forward of losses would be removed;
   c) business losses could be used to offset other income of the individual in any year of loss or any other year in which the loss could be carried back or forward;

d) limitations on the transferability of losses would remain, but because property losses would be deductible to shareholders the significance of the restriction would be much reduced.

2. Share losses for all industries would be treated in the same way as other property losses; under the present system share losses are not deductible because the gains are not taxed.

Effect of the Proposed Tax Treatment

It is difficult to make precise estimates of the overall effects of our proposals on the after-tax rate of return from mining and petroleum companies. The impact of the recommended changes would depend upon many circumstances that would differ substantially from company to company. It is useful, however, to cite the following estimates from a study prepared for us 29/. These estimates, as given in Table 23-3, are based on simplified assumptions that are set forth in the study and do not purport to represent any particular company. Rather, they show the position of a "typical" company under hypothetical but reasonable conditions. Estimates have been prepared for both hypothetical mining companies and hypothetical petroleum companies. Because of the different assumptions made for the two industries, estimates of the rates of return are not comparable between the two, but are comparable within each industry.

Although we freely acknowledge that these indices are subject to severe limitations and must be interpreted with caution, they reflect the general orders of magnitude involved. The data in Table 23-3 suggest that:

1. Because of the incentive element built into the capital cost allowance rates generally, corporations in all industries have a higher after-tax cash flow rate of return than they would have with a "pure" accounting concept of income (Index 2 compared to Index 1).

2. The proposed treatment of mining and petroleum companies would provide a substantially higher after-tax cash flow rate of return than that proposed for other industries (Index 3 compared to Index 2).

TABLE 23-3

INDICES OF THE AFTER-TAX CASH FLOW RATE OF RETURN TO A CORPORATION ON INVESTMENTS IN PETROLEUM AND MINING UNDER HYPOTHETICAL CONDITIONS AND ALTERNATIVE TAX TREATMENTS

Tax Treatment	Petroleum	Mining
1. Complete matching of costs and revenues over a period of time, with no percentage depletion or three-year exemption. This is a "pure" accounting concept of income.	100.0	100.0
2. Exploration and development expenses in a 30 per cent capital cost allowance class.	119.0	121.4
3. Proposed initial treatment for mining and petroleum a/.	151.6	147.5
4. Present treatment b/		
a) integrated company—i.e., one with operating income to offset all exploration and development costs.	196.7	165.9
b) non-integrated company—i.e., one without operating income other than from the particular mine or oil well.	141.0	150.5

Notes:

a/ The index for petroleum is higher than that for mining because of the relatively greater importance in petroleum of the cost of property rights. Thus, an accelerated write-off of such costs is of more value to petroleum companies. The indices for both petroleum and mining reflect our proposals for the transitional period, and therefore are slightly higher than what might be expected when the costs of development and of property rights are not written off immediately or at a 50 per cent rate but are amortized over a period of years.

b/ In Bucovetsky's study a period of 25 years was employed for the petroleum and 15 years for the mining examples. Because the depletion allowance becomes more valuable once all the costs of exploration and development have been written off, a longer time period increases the relative value of the present concessions. Thus, the index of 165.9 for mining would be an understatement of the position of a mine with a longer life.

Source: Bucovetsky, The Taxation of Mineral Extraction, Appendices E and F.

1. Petroleum Case 12; Mining Case 14.
2. Petroleum Case 15; Mining Case 17.
3. Petroleum Case 14; Mining Case 13.
4. Petroleum Case 3; Mining Case 2.
5. Petroleum Case 1; Mining Case 1.

3. The after-tax cash flow rate of return to petroleum companies with operating income would be reduced by our proposals by about 23 per cent; 30/ the cash flow rate of return to petroleum companies that now cannot offset exploration and development expenses would be raised by 5 per cent to 10 per cent (Index 3 compared to Indices 4 and 5).

4. The after-tax cash flow rate of return to mining companies with operating income would be reduced by about 11 per cent; the after-tax cash flow rate of return to mining companies without adequate operating income to provide a full offset would decline about 2 per cent (Index 3 compared to Indices 4 and 5).

The integrated company would be subject to the most unfavourable change at the corporate level, as shown by the indices of after-tax cash flow of rates of return in Table 23-3. Despite the substantial reduction in after-tax corporate income for integrated petroleum companies that would follow from the implementation of the recommended tax treatment for the petroleum industry, the compensating effects of integration at the shareholder level would largely offset, for Canadian shareholders receiving dividends, the increased burden at the corporate level. This is demonstrated in the example given in Table 23-4 which compares the respective positions of Canadian shareholders who receive dividend income from an integrated company and who are subject to tax at marginal rates of 50 per cent and 30 per cent under the present and proposed systems. Clearly, shareholders at the higher income levels are not absolutely worse off and at the lower income levels are absolutely better off.

However, the hypothetical example given in Table 23-5 illustrates that the favourable effects of integration do not offset, for resident shareholders in integrated companies, the negative effects of both the corporation tax changes with respect to petroleum companies and the full taxation of share gains. On the other hand, Table 23-6 illustrates that low and middle income resident shareholders in non-integrated companies would have their

TABLE 23-4

AFTER-TAX DIVIDEND INCOME OF A CANADIAN SHAREHOLDER IN AN INTEGRATED PETROLEUM CORPORATION—COMBINED EFFECT OF PROPOSED CHANGES IN TAX TREATMENT AT THE CORPORATE LEVEL AND INTEGRATION OF CORPORATION AND PERSONAL TAX

	Present Treatment	Proposed Treatment
Corporation		
Assumed after-tax corporate income based upon the indices in Table 23-3 a/	$100.00	$ 77.00
Shareholder with a 50 per cent marginal rate		
Dividend (assuming 100 per cent distribution)	$100.00	$ 77.00
Personal Tax at 50 per cent	-40.00 b/	-77.00 c/
Tax Credit d/	+16.00	+77.00
After-tax dividend income to shareholder	$ 76.00	$ 77.00
Shareholder with a 30 per cent marginal rate		
Dividend (assuming 100 per cent distribution)	$100.00	$ 77.00
Personal tax at 30 per cent	-24.00 b/	-46.20 c/
Tax credit d/	+16.00	+77.00
After-tax dividend income to shareholder	$ 92.00	$ 107.80

Notes:

a/ If an index of 196.7 equals $100.00, then the index of 151.6 equals $77.00. The difference in the income figures reflects the removal of the depletion allowance but does not take into consideration any write-off of old exploration and development costs that would be deductible under the proposed transitional provisions.

b/ Personal tax computed as follows:

Dividend	$100.00
Less shareholder's depletion at 20 per cent	-20.00
Net dividend taxable	$ 80.00
Personal tax at 50 per cent	$ 40.00
Personal tax at 30 per cent	$ 24.00

c/ Personal tax is levied on the grossed-up amount

$$\text{(i.e. } \$77.00 \times \frac{100}{100 \text{ minus corporation tax rate}}\text{)}$$

d/ The tax credit at present is the dividend tax credit of 20 per cent of the net dividend after depletion, while under the proposal it would be the credit for the corporation tax paid.

TABLE 23-5

EFFECT OF THE PROPOSED TAX CHANGES—BOTH CORPORATE AND PERSONAL AND INCLUDING TAXATION OF SHARE GAINS—ON THE AFTER-TAX RATE OF RETURN FROM A HYPOTHETICAL INTEGRATED PETROLEUM CORPORATION TO A CANADIAN SHAREHOLDER WITH A MARGINAL PERSONAL TAX RATE OF 30 PER CENT

		Present		Proposed
Corporate after-tax income per share		$100.00		$ 77.00 a/
Cash retained by corporation b/		50.00		38.50
Dividend to shareholder		$ 50.00		$ 38.50
Personal tax at 30 per cent		-12.00 c/		-46.20 d/
Dividend tax credit (present) or tax rebate (proposed)		8.00 c/		77.00 e/
After-tax cash income to shareholder		$ 46.00		$ 69.30
Assumed share gain: f/				
from retention	$50.00		$38.50	
from goodwill	50.00	100.00	38.50	77.00
Personal tax on share gains		-		-11.55 g/
Total after-tax return to shareholder h/		$146.00		$134.75

Notes:

a/ It is assumed that changes in the tax treatment at the corporate level reduce after-tax corporate income by 23 per cent. (See Table 23-4.)

b/ It is assumed that retained earnings are one half of after-tax corporate earnings.

c/ Personal tax is computed as follows:

Dividend	$ 50.00
Less shareholder depletion at 20 per cent	10.00
Net dividend taxable	$ 40.00
Personal tax at 30 per cent	-$ 12.00
The dividend tax credit is 20 per cent of $40.	-$ 8.00

d/ It is assumed that all corporate income is allocated to the shareholder so that the shareholder would bring into income $154.00 (the grossed-up figure for $77.00 of after-tax income) and would be subject to a 30 per cent tax on this amount.

e/ Full credit for the corporation tax paid.

f/ It is assumed that share gains are double retained earnings per share (and therefore that "goodwill" capital gains are equal to retained earnings). A higher ratio of goodwill gains to retained earnings would further improve the relative after-tax return of the present system as compared to our proposals.

g/ Because of the upward adjustment of the cost basis by the amount of the retention, the share gain resulting from the retention would not be subject to tax to the shareholder. It is assumed that the goodwill property gain is realized.

h/ For a shareholder subject to a personal rate of tax of 50 per cent the comparable figures would be $138.00 at present and $96.25 under the proposal.

TABLE 23-6

EFFECT OF THE PROPOSED TAX CHANGES—BOTH CORPORATE AND PERSONAL AND INCLUDING TAXATION OF SHARE GAINS—ON THE AFTER-TAX RATE OF RETURN FROM A HYPOTHETICAL NON-INTEGRATED PETROLEUM CORPORATION TO A CANADIAN SHAREHOLDER WITH A MARGINAL PERSONAL TAX RATE OF 30 PER CENT

		Present		Proposed
Corporate after-tax income per share		$100.00		$100.00 a/
Cash retained by corporation b/		50.00		50.00
Dividend to shareholder		$ 50.00		$ 50.00
Personal tax at 30 per cent		-12.00 c/		-60.00 d/
Dividend tax credit (present) or tax rebate (proposed)		8.00 c/		100.00 e/
After-tax cash income to shareholder		$ 46.00		$ 90.00
Assumed share gain: f/				
from retention	$50.00		$50.00	
from goodwill	50.00	100.00	50.00	100.00
Personal tax on share gains		-		-15.00 g/
Total after-tax return to shareholder h/		$146.00		$175.00

Notes:

a/ It is assumed that changes in the tax treatment at the corporate level do not have any net effect on after-tax corporate income. Table 23-3 indicates that the proposed treatment would not vary greatly from the present situation. As depletion is of little value to the non-integrated company, the improvement in write-offs is sufficient to offset its removal. On the other hand, for those companies that permitted their shareholders to take advantage of the special write-off on newly issued shares, the proposed tax treatment would improve their position over what presently exists. For these companies the assumption of an unchanged corporate after-tax income would be conservative.

b/ It is assumed that retained earnings are one half of after-tax corporate earnings.

c/ Personal tax is computed as follows:

Dividend	$ 50.00
Less shareholder depletion at 20 per cent	10.00
Net dividend taxable	$ 40.00
Personal tax at 30 per cent	-$ 12.00
The dividend tax credit is 20 per cent of $40.	-$ 8.00

d/ It is assumed that all corporate income is allocated to the shareholder so that the shareholder would bring into income $200.00 (the grossed-up figure for $100.00 of after-tax income) and would be subject to a 30 per cent tax on this amount.

e/ Full credit for the corporation tax paid.

f/ It is assumed that share gains are double retained earnings per share (and therefore that "goodwill" capital gains are equal to retained earnings). A higher ratio of goodwill gains to retained earnings would improve the relative after-tax return of the present system as compared to our proposals.

g/ Because of the upward adjustment of the cost basis by the amount of the retention, the share gain resulting from the retention would not be subject to tax to the shareholder. It is assumed that the goodwill property gain is realized.

h/ For a shareholder subject to a personal rate of tax of 50 per cent the comparable figures would be $138.00 at present and $125.00 under the proposal.

positions improved by our proposals, unless the capital gain element was a substantial proportion of their total investment return.

While the negative effects of the proposed tax treatment of companies with operating or refining income would be greater than for other companies in the extractive industries, we acknowledge that the position of a substantial proportion of resident shareholders of Canadian mining and petroleum corporations would be less favourable than it is now. Non-resident shareholders would not benefit from the integration proposal, and therefore to the extent that the additional Canadian tax was not eligible for foreign tax credit their position would be worsened even more substantially. This is an unfortunate but inescapable result of removing an inefficient concession. Unless we are willing to accept the existing tax system as immutable, we must also accept undesired windfall gains and losses. They are the inescapable concomitants of change.

Our recommendations would have a greater revenue impact on the mining industry than on the petroleum industry. The amount of depletion claimed by the mining industry is more than double that claimed by the petroleum companies, although three petroleum companies are included in the eight companies that, in 1964, together accounted for about 85 per cent of the total depletion claimed by all mining and petroleum companies. In addition, the removal of the three-year exemption for new mines would be applicable only to the mining industry and would produce about the same increase in tax revenues as the elimination of depletion. Again, the largest companies would be subject to the greatest impact, as is demonstrated by the fact that, in 1964, four mining companies accounted for over three quarters of the exempt income under this provision.

The question that then arises is whether the removal of the major concessions would have a serious impact on the activities of the larger companies. In seeking the answer, we reviewed the operating figures of a number of companies to compare their position with what it would have been

if our proposals had been in effect. A review of four large iron ore mining companies, which together have claimed approximately $250 million in exempt income under the three-year provision, indicated that under our recommended procedures they would on average still not pay any income taxes until they had been producing for over ten years. This is somewhat more than a year earlier than would have been the case under the present system. The major difference is that under our proposals it would have been necessary to claim substantially all of the capital cost allowance available in order to eliminate their taxable income. In any case, the accelerated write-offs would mean that tax liabilities could be deferred for a considerable period of time, and certainly could be deferred until the total financing obtained to put the mines into production had been repaid. We do not believe that a procedure for computing taxable income that would have deferred the payment of income taxes for over ten years would have prevented the development of an economically feasible project.

Another interesting example of the impact of the present concessions is provided by some of the uranium mining companies. The major uranium producers up to 1964 had produced and sold over one billion dollars worth of ore from mines that represented a capital investment of under a quarter of a billion dollars. After retiring all debts and writing off the whole investment, they realized about a quarter of a billion dollars of which somewhat less than one half was paid out in dividends. After deducting exempt income and depletion, the total income tax liability (including taxes paid by shareholders) was under $30 million, or about 10 per cent of the profits. Under our proposals the tax liability would have been about the same, but all of their capital cost allowances would have been claimed. Thus, their future taxes would be substantially higher, but this fact would not have precluded the development of any of these mines.

Finally, we reviewed the operating figures for the past three to ten years for a number of large integrated mining and oil companies. The average

total taxes paid on income before tax and before depletion, including an estimate of the income taxes paid by shareholders on dividends received, was just over 40 per cent. The mining companies were taxed at less than this rate because of the three-year exemption (one large mining company in particular paid taxes at a substantially lower rate). We estimate that under our proposals the average tax rate applicable to all corporate source income attributable to Canadian residents would be substantially less than 40 per cent. Therefore, the Canadian shareholders in mining and petroleum companies would experience a reduction in the total income tax liability on their portion of the corporate profits of these companies. Non-resident shareholders in these companies would experience an increase in the Canadian tax on their portion of the profits. Canadian shareholders would, however, also be subject to a tax on share gains at full personal rates and so would pay tax on gains at a level that would be higher than that faced by non-residents. Consequently, the total taxes paid by a substantial proportion of the Canadian investors in mining and petroleum companies would be increased.

We have emphasized that the small and medium-sized mining and petroleum companies obtain very little direct benefit from these two major tax concessions. We have pointed out that a major purpose of such special tax concessions is to offset a capital market bias that is presumed to exist. However, we do not believe that the larger companies experience any unusual difficulties in financing their operations and therefore, from this point of view, the concessions are misdirected. For the small and medium-sized companies, we feel that the proposed rapid write-offs of exploration and development costs, and the special write-off for new shares issued to finance exploration and development, would be at least as beneficial as the present concessions. Further assistance to such companies, if it is required, would be best directed to them in the form of exploration subsidies and assistance in meeting transportation and other special costs.

CONCLUSIONS AND RECOMMENDATIONS

1. The present Income Tax Act contains special provisions for the mining and petroleum industries. The most important of these provisions are:

   a) the immediate deduction of exploration and development costs by qualified corporations against income from any source with an indefinite carry-forward of such costs not written off;
   b) the three-year exemption of income from new mines;
   c) the deduction of a proportion of the income from oil, gas and mining operations as an allowance for depletion, which is permitted to oil, gas and mining companies and their shareholders.

2. These special provisions have probably brought about an increase in the allocation of labour and capital to mineral and petroleum extraction in Canada. Whether there is a net gain in economic well-being from this diversion of labour and capital from other uses to mineral and petroleum extraction, and whether the same result could be achieved at lower revenue cost, are the crucial questions.

3. The treatment of business income generally in the present Act is seriously deficient in three respects that are relevant for the taxation of the mining and petroleum industries:

   a) some costs laid out to earn income are not deductible at any time;
   b) restrictions on the deduction and transferability of business losses create a bias against risk taking; and
   c) some net gains are excluded from business income.

   To the extent that the mining and petroleum industries are more adversely affected by (a) and (b) than industry in general, and to the extent that (c) is less advantageous for the extractive industries than for industry generally, the special provisions for mining and petroleum have some justification in the context of the present tax system.

4. The adoption of the recommended changes in the treatment of business income generally would virtually eliminate all of the features of the present system that justify special concessions to the extractive industries either through percentage depletion or the three-year exemption for new mines. Specifically:

   a) all costs of earning income would be deductible;

   b) the limitations on the carry-forward, carry-back, deductibility and transferability of losses would be either substantially reduced or made much less important; and

   c) virtually all net gains would be taxed on the same basis.

ARGUMENTS FOR SPECIAL
TAX CONCESSIONS

5. We accept the argument that, because of the uncertainty of the return on outlays for mineral and petroleum discovery and extraction, a more rapid write-off of costs is required to achieve tax neutrality between the mining and petroleum industries and other industries. The recommended changes in the provisions for the mining and petroleum industries reflect this acceptance.

6. We accept the view that, unless losses are accorded treatment that is similar to that given to gains, the tax system is biased against risk taking. (Equality of treatment could be achieved only with unlimited tax refunds on business losses.) The proposed treatment of business and property losses would virtually eliminate this bias for all businesses.

7. We doubt that the capital market bias against risk taking adversely affects the mining and petroleum industries more than other industries. Large mining and petroleum companies can diversify their risks by undertaking many exploration ventures; both large and small companies can form syndicates and pool their risks. Small manufacturing companies usually are unable to spread the risks involved in research and

product development. To the extent that there is a problem, it is a problem mainly for the small mining and petroleum companies which have operating income less than their exploration and development expenses and which do not participate in sufficient joint ventures with other companies to spread the risk sufficiently. However, to remove any possible doubt, some concessionary provisions for exploration and development costs are embodied in our recommendations for the extractive industries.

8. The extractive industries are highly capital intensive and rely on equity financing to a greater extent than many other industries. The argument has been advanced that the adjustment to the imposition of the corporation tax—a tax on the return on equity capital—must therefore be more onerous to the mining and petroleum industries than to other industries; and that more shifting through price changes or larger reductions in investment must be required to restore after-tax rates of return on investment in mineral and petroleum extraction following imposition of the corporation tax. There are, in fact, other industries that rely as heavily or more heavily on equity financing and there are other industries as capital intensive as the mining and petroleum industries. The problem is therefore not unique to these industries. It would not be feasible to reduce the corporation tax for those corporations that shift the tax least—for there are no unequivocal measures of the extent to which the tax is shifted. In any event, the adoption of our integration proposal would remove any tax discrimination against equity financing. This argument is therefore rejected.

9. Tax concessions to the resource industries increase the allocation of labour and capital to these industries and hence to the known reserves and the production of minerals and petroleum. It is alleged that many economic and social benefits result, including increased employment,

domestic investment, exports, industrial development in general and regional development in particular. It is by no means obvious that some of the alleged benefits are, in fact, net benefits. Frequently, it is assumed that the additional employment, investment and output of the mining and petroleum industries are achieved without cost in the form of reduced employment, investment and output elsewhere in the economy.

10. A careful review of the many arguments advanced in support of the present concessions to the mining and petroleum industries does not suggest that the economy would be adversely affected by their removal. Indeed, because of the probable insensitivity of foreign direct investment in the Canadian mining and petroleum industries to changes in after-tax rates of return, the net economic benefit to Canada from such investments could be increased by the withdrawal of the concessions. With the adoption of the proposed treatment of foreign source income of Canadians, substantial increases in foreign direct investment in mining by Canadians are unlikely to occur and such increases, if they did occur, would not necessarily be against the national interest.

11. Canadian mineral and petroleum reserves apparently are not declining relative to rates of utilization. In particular, methods of extracting oil in commercial quantities from the almost inexhaustible Athabasca tar sands have been developed; the costs of discovering conventional crude oil are apparently rising; and the exploitation of the tar sands is being held back because of the limited market for oil. All of these factors suggest that there is no obvious need for special incentives to encourage oil exploration.

12. If, as a matter of public policy, mining and oil exploration is to be encouraged there are several methods of doing so that would be equally effective and much less costly in terms of tax revenue than the present percentage depletion and the three-year new mine allowances.

13. Similarly, if development of the far North is to be encouraged as a matter of public policy, specific incentives for that purpose should be adopted rather than inefficient incentives to particular industries.

EFFICIENCY OF THE PRESENT
MAJOR TAX CONCESSIONS

14. The present incentives to the mining and petroleum industries are relatively inefficient as an encouragement to additional exploration because they increase current after-tax operating income and thus provide only an indirect stimulus to exploration.

15. Percentage depletion is a particularly inefficient incentive because:

   a) the more that a company spends on exploration the less its relative benefit from percentage depletion; and
   b) percentage depletion appears to have been of little benefit except to the larger companies, which have no need for the incentive to offset any market bias against risk taking.

16. The three-year exemption for new mines is a more efficient incentive than percentage depletion but benefits most the companies that need it least.

17. The rapid write-off of exploration and development costs is the most efficient of the three incentives now available in the mining and petroleum industries.

18. Under the proposed treatment of business income generally, research and product development costs would be written off immediately, inventory costs would be written off against sales or on a loss in value, depreciable assets would be written off at capital cost allowance rates and purchased goodwill either would be amortized over the life of the asset (where the life was fixed) or would be deductible when lost or reduced in value. The application of the same approach

to the costs of mineral and petroleum extraction would therefore call for the following treatment:

a) exploration costs - immediately written off;

b) development costs - deferred and written off against revenue, or written off if the property was abandoned;

c) cost of depreciable assets - amortized through capital cost allowance classes;

d) cost of property rights - amortized on a time or production basis where the useful life or amount of reserves was determinable, or otherwise deducted when a loss in value occurred.

19. It is recommended that exploration costs, including the cost of depreciable assets that could be used only in connection with a specific exploration project, should be included in a separate capital cost allowance class which would be subject to write-off at the rate of 100 per cent.

20. It is recommended that development costs, including the cost of depreciable assets which could only be used for production from a particular mine or oil or gas well, should be included in the same capital cost allowance class with exploration expenses during a transitional period of five to ten years. Thereafter they should be segregated in a separate capital cost allowance class and subject to write-off at a rate of, say, 20 per cent to 30 per cent on a diminishing balance basis.

21. It is recommended that the cost of mining and petroleum properties should be capitalized in a separate capital cost allowance class for each property. The costs should then be amortized by the write-off of amounts related to the operating revenues derived from the same property. The capital cost allowance rate should be substantial, say, up to 50 per cent, in the transitional period, but thereafter

should be set at 10 per cent to 20 per cent of the operating revenue from the property. If the property was disposed of, abandoned or became valueless, the unamortized balance should be written off. During a transitional period of, say, five years an immediate write-off should be allowed for the cost of property rights acquired from a government.

22. Exploration and development expenses which are presently available for deduction but had not been claimed at the effective date of the legislation should be included in the same capital cost allowance class with exploration costs.

23. Losses in the mining and petroleum industries should be available in the same way as other business losses for carry-back two years and forward indefinitely.

24. Consistent with the comprehensive tax base, all profits made on the disposition of mining and petroleum properties should be included in income. Non-residents should be subject to tax on the disposal of Canadian mineral and petroleum properties. The full gain should be included in income, even if some portion of that gain had accrued prior to the effective date. Shareholders would in effect be exempt from tax on the gain accrued to the transition date because of the transitional provision applying to the valuation of shares.

25. It is further recommended that mining and petroleum companies intending to sell shares to finance exploration and development should be entitled to apply for special tax treatment. Under this concession, the purchasers of newly issued shares would be entitled to write down the value of the new shares for tax purposes to the extent that the proceeds of the issue were to be used for exploration and development. This would ensure that the shareholders of such companies would be able to deduct immediately from other income any potential losses from exploration

and development and would reduce the cost of equity capital to mining and petroleum companies undertaking exploration and development projects.

26. Depletion allowances for the mining and petroleum industries should be withdrawn immediately. This includes the percentage depletion for operators, non-operators and shareholders.

27. The three-year tax-exempt period for new mines should be withdrawn. Complete withdrawal should be delayed for five years, but in the interim the amount of tax exemption that could be claimed for any one mine should be limited to $1 million.

28. As an additional transitional measure, taxpayers in the mining and petroleum industries should be permitted to deduct, over three or five years, the excess of formerly non-deductible costs of mining and petroleum properties over depletion claimed.

29. The cost of exploring for minerals outside Canada should be deductible.

30. Payments to the provinces for natural resources should be deductible. Similarly, the mining taxes paid to the provinces should be allowed as a cost of earning income and not as a tax credit.

31. Prospectors and grubstakers should be taxable on their profits. However, any such person who transferred mining properties to a newly formed company in consideration for shares should record the sale at a price equal to his unclaimed costs. He should bring any increment in value into income when the shares became publicly traded if they represented a 25 per cent interest in the company or less.

32. The provisions recommended should apply to all taxpayers, whether individuals or corporations, and should not be limited by reference to the taxpayer's principal business.

33. Adoption of these recommendations would accord more favourable tax treatment to the mining and petroleum industries than to industry generally, particularly with respect to the treatment of costs.

34. These tax concessions to the mining and petroleum industries would more than compensate for any possible capital market bias against risk taking that might, in the absence of the concessions, reduce investment in these industries below the levels required for an efficient allocation of resources.

35. Withdrawal of depletion and the three-year exemption for new mines, coupled with the recommended changes in the treatment of costs described above, would reduce the after-tax cash flow rate of return to integrated petroleum companies and, to a lesser extent, to those mining companies that had operating income after deduction of exploration and development costs. The after-tax cash flow rate of return to non-integrated mining and petroleum companies that had insufficient operating income to offset exploration and development expenses should, however, be improved. The present concessions are greatest for the largest companies, which are the most unlikely to be subject to higher costs of equity capital as a result of a capital market bias. The recommended changes would ensure that the full value of the concessions was available where it was most likely to be needed.

36. Removal of percentage depletion and the three-year exemption for new mines and the full taxation of share gains would be offset to a large extent by the recommended treatment of costs and, for resident shareholders, by the integration of personal and corporation taxes. Nevertheless, a substantial proportion of resident shareholders of mining and petroleum corporations would be worse off than at present. Because most non-resident shareholders of such corporations would not benefit from integration, they would suffer a greater reduction in after-tax income.

REFERENCES

1/ M. Bucovetsky, The Taxation of Mineral Extraction; D.Y. Timbrell, Taxation of the Mining Industry in Canada; C.G. Burton, Tax Treatment of the Oil Industry, studies published by the Commission.

2/ In general, corporations which qualify to use the special tax provisions are those whose principal business activity is in petroleum or mining, although there have been some extensions to corporations in related activities. It is assumed in most of the discussions in this chapter that the corporation concerned does qualify. The implications of limiting the qualification are discussed under the heading "Application of Mining and Petroleum Provisions to Particular Types of Taxpayers".

3/ Section 83A.

4/ Section 83(5).

5/ Regulation 1201(2).

6/ Regulation 1201(3).

7/ Regulation 1203.

8/ Regulation 1202.

9/ Regulations 1300-1303.

10/ For a discussion of the historical justifications for percentage depletion see Appendix K to this Volume.

11/ This survey of large Canadian mining companies was conducted by us in conjunction with the Canadian Metal Mining Association. We shall refer to it hereafter as the Mining Survey. The results are published as an appendix to the study by D.Y. Timbrell cited earlier.

12/ In a recent research study prepared for the Canadian Institute of Chartered Accountants, entitled Accounting Problems in the Oil and Gas Industry, by W.B. Coutts, F.C.A., it was advocated that costs should be accumulated by "area of interest". Such a procedure requires that costs be accumulated for exploration in any particular area while exploration is in process, and that such costs be deferred against production revenue from the area if the project is successful, or be written off immediately if it is unsuccessful. This approach would be supported on a theoretical basis by many practising accountants, but it is beset with practical difficulties. For example, an evaluation of the results of exploring in a particular area could be very much a matter of personal opinion, and management might be inclined to defer a distasteful decision if it meant writing off in one year costs that had accumulated over several years. Furthermore, because an individual project may not be successful, it may be wise to write off arbitrarily a certain percentage of costs while the project is still under way. Thus, while something like the "area of interest" concept would most adequately portray the actual results of operation over a period of time, it is followed in practice by only a relatively few companies. The general procedure is rather to defer costs only in respect of known assets; thus the drilling cost and sometimes the land cost of productive wells may be deferred over their productive lives.

13/ Section 83A.

14/ Regulations, Schedule B, Class 10.

15/ Ibid., Class 12.

16/ Ibid., Classes 1, 3, 4 and 6.

17/ Section 11(1)(a).

18/ Except under section 27(1)(a) which permits, inter alia, a deduction of up to 10 per cent of income for gifts to municipalities.

19/ M. Bucovetsky, The Taxation of Mineral Extraction.

20/ Because of differences in accounting treatment and because they provide no information about unsuccessful companies, price/earnings ratios are an inadequate measure of relative risk among industries.

21/ A study prepared for the Royal Commission on Banking and Finance by E.K. Cork, Finance in the Mining Industry, states at p. 37 that from 1907 to 1953 there were over 400,000 claims recorded in Ontario and 6,679 metal-mining companies formed, of which 348 went into production and only 54 paid dividends. In a supplementary submission to us, the Canadian Petroleum Association cited an average success ratio of 7.4 per cent in exploratory drilling for the period 1947 to 1962, after eliminating from the calculation wells which were initially successful but which later proved unsuccessful.

22/ When investors demand a risk premium, this may reduce the investment in the industry relative to the social optimum because the risk to the individual investor on a particular venture is greater than the risk on all similar ventures taken as a group. Risks can be reduced through pooling.

23/ Because most Canadian corporations in the petroleum industry are subsidiaries of international companies this discussion is less relevant to that industry. There are, however, some Canadian petroleum companies that would be affected.

24/ See the study by Bucovetsky, previously cited, for a comparison of the Canadian and United States provisions.

25/ The indirect costs and benefits are extremely difficult to determine because they depend upon the particular circumstances. See Chapters 5 and 26.

26/ For the period from 1949 to 1962 the amounts paid to provinces for oil rights and rentals amounted to something in excess of $1 billion and, after allowing for deduction of rentals not exceeding $1 per acre and lease costs of abandoned properties (both of which are already deductible under section 83A), possibly $500 million to $750 million would not have been allowed for tax purposes. Various estimates of the amount of such costs were supplied to us by industry representatives, and an amount within this range would appear to be a reasonable estimate.

27/ The amounts of these provincial revenues are indicated by the following figures for Alberta for the sixteen-year period 1947-62 as quoted in Oil and Gas Bulletin of the Royal Bank, No. 17, August 31, 1963:

	(Millions of dollars)
Sale of Crown reserves	653.8
Rental from leases	333.2
Royalties from oil and gas	329.3
	1,316.3

28/ Section 83A(5b).

29/ M. Bucovetsky, The Taxation of Mineral Extraction.

30/ The transitional provision proposed (the allowance of all development costs not already recovered through depletion) would result in a smaller reduction for many companies for a certain number of years.

CHAPTER 24

FINANCIAL INSTITUTIONS

For purposes of this Report any institution that forms a link between those who are savers of money and those who are borrowers of money will be termed a financial institution. The rapid growth that has taken place in the use of credit, and the impracticability of its being provided substantially by direct dealings between borrowers and savers, has led to a considerable increase in the business conducted by financial institutions. Table 24-1 lists the principal financial institutions and, as a rough measure of their size and importance, shows their total assets at the end of 1962.

TABLE 24-1

ASSETS OF PRINCIPAL FINANCIAL INSTITUTIONS, 1962

Institution	Assets (millions of dollars)
Bank of Canada	3,231
Chartered Banks	14,848
Quebec Savings Banks	357
Trust Companies	1,877
Mortgage Loan Companies	1,286
Caisses Populaires and Credit Unions	1,666
Finance and Consumer Loan Companies	2,689
Industrial Development Bank	181
Life Insurance Assets in Canada	9,950
Fire and Casualty Insurance Assets in Canada	1,585
Mutual Funds	710
Pension Funds	4,572
TOTAL	42,952

Source: Royal Commission on Banking and Finance, Report, Ottawa: Queen's Printer, 1964, p. 106.

The Bank of Canada and the Industrial Development Bank, agencies of the Government of Canada, are not discussed in this Report. Credit unions and caisses populaires are discussed in Chapter 20, fire and casualty insurance companies in Chapter 25, and mutual and pension funds in Chapter 16. In this chapter we deal with banks, trust companies, mortgage loan companies, finance and consumer loan companies, and life insurance companies.

BANKS, TRUST COMPANIES, MORTGAGE LOAN COMPANIES, AND FINANCE AND CONSUMER LOAN COMPANIES

All these financial institutions, directly or indirectly, collect the savings of individuals and corporations and lend them. They differ in the forms they utilize to accumulate savings and again in the arrangements by which they lend the funds at their disposal. Some of them concentrate their lending activities primarily in short-term loans, others in long-term mortgages. The types of borrowing which they traditionally use range from demand deposits to long-term debt. The variety is not haphazard or simply a matter of choice, but is closely related to the uses to which each institution expects to put the money in attempting to relate maturities of assets and liabilities. Some of them perform other important services in fiduciary and agency capacities. However, all have the common characteristic of being dealers in financial claims. There has been a noticeable trend toward diversification of activity, with an overlapping of functions, so that many institutions now find themselves competing with others that are essentially known for their activities in other parts of the financial field. Therefore, many of the differences are blurred as the various types of institutions compete with each other on both sides of the borrowing-lending process.

Another general characteristic of these financial institutions is the magnitude of assets under their control in comparison with the equity capital of the companies concerned. This is because they rely so heavily on borrowed funds as an integral part of their method of doing business, a hardly surprising result for institutions that specialize in money. On average, they

derive about 90 per cent of their funds from borrowing, while equity accounts for less than 7 per cent. This may be compared with industrial companies that on average obtain over one half of their total funds from equity sources.

Most types of financial institutions are subject to extensive government supervision and control. Again, this is not surprising in view of the extent to which they are heavily indebted to the public. Questions concerning government regulation are beyond the terms of reference of this Commission. However, we take the position that it is the responsibility of the supervisory authorities and regulatory legislation to see that financial institutions conduct their activities in a way that ensures their solvency; these businesses should not be granted tax concessions to induce them to do so, or to compensate them for doing so.

Main Tax Considerations

Generally speaking, the determination of the income of financial institutions for tax purposes is relatively straightforward. While it is not suggested that the determination of their income presents no problems, the tax problems are, for the most part, common to other industries as well. Furthermore, a number of these problems would disappear with, or be mitigated by, the implementation of certain of our recommendations. For example, under existing tax law, security gains earned as a result of trading activities are taxable, but if derived from investment activities they are not subject to tax. Some financial institutions find themselves in the peculiar position of being taxed on some of those gains but not on others. However, the treatment we recommend for security gains in Chapter 15 would eliminate these discrepancies by subjecting all such gains to tax. As a further example, while interest and general expenses incurred to earn non-taxable dividend income are currently disallowed, the integration of personal and corporation income tax described in Chapter 19 and our recommendations in respect of business income in Chapter 22 would generally result in the allowance of these expenses.

Financial institutions generally account for their revenues and expenses on an accrual basis. Estate, trust and agency fees are exceptions. Estate fees require court approval and are not legally collectible until so approved. It is common practice for trust companies to account for them on a cash basis, and in some cases all estate, trust and agency fee income is accounted for on a cash basis for the sake of internal consistency in dealing with these activities. In addition, some consumer loan companies account for their interest income on a cash basis as permitted by section 6(1)(b) of the Income Tax Act. In line with our general recommendations for the expanded use of the accrual basis, we suggest that it should be required that these forms of income also be recorded on an accrual basis. We believe that acceptable techniques can be readily developed to accomplish this result.

The only problem in the determination of income of financial institutions that is both significant and of particular applicability to them alone arises in the estimation of losses on loans. Loans and other investments provide the major source of income of these institutions and, because of their magnitude relative to equity capital, a small percentage difference in the losses that are incurred on them will have a significant impact on income. For example, a loss of 1 per cent on these investments can be the equivalent of as much as a year's income.

The problem stems from the impossibility of determining accurately in advance what losses will occur on existing accounts. Differences of opinion between the taxpayer and the tax administration as to what is a reasonable provision for losses are not easily reconciled. Apart from the recognized measures of doubtful collectibility such as overdue accounts, management decisions as to provision for losses will be based on other less well-defined, but valid, criteria such as general business conditions, a knowledge of the particular industry, familiarity with the affairs of debtors, and past loss experience.

While the problem of evaluating receivables is faced by all businesses, where the amount invested in them is small relative to total assets their valuation is not likely to bear significantly on the determination of income. In the case of financial institutions, however, materiality and volume combine to make the problem both more significant and more difficult. Financial institutions ordinarily have large numbers of loans and other receivables outstanding 1/. Neither the taxpayer nor the tax assessor can review individually a significant proportion of the accounts within the bounds of reasonable time. Moreover, even if the time were available, it would not be possible in the case of certain secured transactions, for example, those involving mortgages and conditional sale agreements, to complete a useful review of individual accounts, because there will seldom be any data available on the underlying security other than that collected at the time the loan was made.

Present Tax Treatment
of Reserves

The income tax treatment of banks differs in one respect only from that accorded to corporations generally and that is in the treatment of valuation reserves. Banks are permitted to deduct reserves "not in excess of the reasonable requirements of the bank" without having to substantiate them on the basis of losses expected at the end of the fiscal year 2/. In other words, in addition to providing for "specific" or anticipated losses, banks are permitted, within certain limits, to provide reserves for contingencies that cannot be foreseen at the time.

It is the Minister of Finance, not the Minister of National Revenue, who determines the reasonable requirements of banks with respect to contingency reserves. At least once each year the Inspector General of Banks must inquire into the affairs of each bank and report to the Minister of Finance. This examination is made "for the purpose of satisfying himself that the provisions of this Act having reference to the safety of the

creditors and shareholders of the bank are being duly observed and that the bank is in a sound financial condition" 3/. This responsibility includes ensuring that the banks maintain adequate reserves.

At the present time the maximum reserves that a chartered bank can claim for income tax purposes are prescribed in rules issued by the Minister of Finance, which set out the procedure for determining tax-free inner reserves. This maximum is based on a percentage of certain of the assets of banks and in 1963 was 3.504 per cent of eligible assets 4/. This ratio is adjusted annually by a formula that takes into account the change in the average loss experience over successive 25-year periods, and has been declining because of the relatively favourable loss experience of recent years. The Quebec savings banks are permitted reserves up to a fixed percentage of 5 per cent of eligible assets.

The United Kingdom permits banks to make specific provision for bad and doubtful debts, but has never permitted banks to deduct contingency reserves in the determination of taxable income. In the United States, a bank has the option of creating a contingency reserve for loans or of charging annual losses directly against income. Until recently the allowance permitted to each bank for contingencies was based on the bank's own loss experience, the maximum being three times its ratio of annual loss experience to eligible loans for any twenty consecutive years starting not earlier than 1927. However, beginning with the 1965 taxation year, the procedure has been changed to allow a flat 2.4 per cent of outstanding loans. The definition of eligible loans excludes those guaranteed by the federal or state governments or their agencies, but is generally broader than the Canadian definition. It should be noted that this reserve applies to loans only.

The Income Tax Act also permits taxpayers, whose business includes lending money on the security of mortgages, to deduct, in computing taxable income, amounts sufficient to provide up to 3 per cent of their mortgage loans outstanding as a reserve in lieu of the general provisions for doubtful debts otherwise permitted 5/.

The above-mentioned tax provisions are the major ones having specific applicability to financial institutions. It will be appreciated that they go only part of the way in dealing with allowances for losses on the multifarious investments in which financial institutions engage. For loans that are not made by banks or are not in the form of mortgage loans, the taxpayer can invoke the provision that is available to taxpayers generally for valuing receivables 6/. This provision permits a taxpayer to deduct a reasonable reserve for doubtful debts. The most satisfactory method of ascertaining the amount of such a reserve is on the basis of a valuation of specific accounts. Alternative methods are to base the reserve on bad debt experience in recent years and the relative delinquency position (accounts outstanding more than 60 days, 90 days, etc.) of current portfolios of accounts. The valuation of other investments of financial institutions is subject to the same general rules that are applicable to other taxpayers; rules that would become more certain with the inclusion of all gains and losses in the computation of income.

The statutory provision in the United Kingdom is somewhat more stringent than in Canada, and the tax authorities do not accept allowances calculated as a percentage of total receivables. However, as in Canada, they will accept allowances calculated with reference to total amounts delinquent for various periods of time. The statutory position in the United States is more flexible and we understand that allowances are permitted there that are somewhat more favourable than those allowed in Canada but, nevertheless, protracted negotiation is often required.

Evaluation of Present Tax
Treatment of Reserves

Before commenting on the present tax treatment of financial institutions, it will be useful to make a brief reference to certain general conclusions that we reached earlier in the <u>Report</u>.

First, the importance of tax neutrality has been emphasized. Although

different financial institutions bear different designations and are governed under different statutes, their functions overlap and they are competing with one another increasingly. In these circumstances, it would be inequitable to apply different tax rules to different institutions, except where necessary for administrative reasons, and even then material differences in tax impact should be avoided.

Secondly, general or contingency reserves should not be recognized for tax purposes. Only those losses in asset values and those liabilities that can reasonably be expected to occur should be allowed. All business is subject to some risk and uncertainty in the ascertainment of income on an annual basis. We believe that the general recommendations we make for the treatment of annual losses would provide sufficient recognition of these factors for taxation purposes.

Thirdly, where it is extremely difficult to determine reasonable annual allowances, we have acknowledged that it may be necessary to adopt rather arbitrary procedures. For example, we conclude in Chapter 22 that the use of simple, and arbitrary rules would be appropriate in the case of depreciation provisions, because of the high degree of uncertainty in matching this kind of cost against revenues 7/.

Finally, we have said that where certain actions are deemed to be necessary or desirable as a matter of public policy, taxation should not be the vehicle for regulating the actions where other more direct measures are available.

Allowances for Doubtful Accounts. The valuation of receivables under the existing general tax provision presents difficult assessment problems. Even though the tax authorities are willing to accept arbitrary procedures for determining the allowance for doubtful accounts which might result in an amount liberal to the taxpayer, there continue to be many disputes as to the reasonableness of the loss allowances that are claimed 8/.

We recommend in Chapter 22 the withdrawal of the existing general provision in respect of doubtful debts, on the grounds that it appears to rely primarily upon what is "reasonable", that the test of reasonableness should be found in the application of accepted accounting and business practice, and that the provision is therefore unnecessary. Where amounts claimed appear to be reasonable and are not significant determinants of income, there would seem to be little call for disturbing them on assessment.

It must be conceded, however, that repeal of the provision would not solve the basic problem. Where an allowance for losses is a significant determinant of income, and where objective evaluation of specific accounts is not possible, allowances that are claimed by taxpayers cannot be accepted for assessment purposes without careful review. Inasmuch as we recommend that all business costs be allowed, including accounts that ultimately proved to be uncollectible, the application of arbitrary rates of provision against such accounts to determine the amount of an allowance may be appropriate where the problem was significant and undue difficulties of compliance and administration could be mitigated. In the interests of administrative simplicity and consistency, these arbitrary rates might be applied in all cases if practical means could be found for doing so. The alternative to arbitrary rates would be the application of criteria which would be more contentious and more difficult to administer, but which would still not reflect accurately in advance what losses were likely to arise, and therefore might well be inferior to well-chosen arbitrary rates.

It is apparent that to be administratively most effective, optional arbitrary allowances would have to be based on rates that were sufficiently generous to ensure that most taxpayers would elect to use them rather than make detailed estimates. If the taxpayer was not allowed the option of either using the arbitrary rates or making detailed estimates, the arbitrary rates would still have to be sufficiently generous to ensure that few, if any, taxpayers suffered because of the requirement. Nevertheless, rates should not consciously provide a margin for contingencies.

Trade accounts receivable will ordinarily result from a sale that has been reflected in income. The most accurate matching of revenues and expenses in terms of timing would call for accounts that proved to be uncollectible to be matched against the revenue recorded at the time of sale, rather than at the time the account was determined to be uncollectible. Because this would usually involve reopening the accounts of a past year whenever an uncollectible account was written off, practical considerations call for making allowances in the year of sale on an estimated basis to the exclusion of making any retroactive adjustment on the basis of subsequent events. Indeed, it is the necessity of having a practical basis for matching revenues and expenses that constitutes the justification for doubtful account provisions in general and, in the case of financial institutions in particular, for permitting allowances for losses in advance of the determination that a debt is uncollectible. There is, however, one important respect in which the opening of a loan account receivable differs from an ordinary trade account. The loan is not always a reflection of income that has already been taken into account, but is usually evidence of an investment, the income from which will accrue subsequently. We do not suggest that this distinction is of much assistance in determining the loss provisions that should be allowed to financial institutions 9/. However, it should be appreciated that to make full allowance against losses as loans were granted would not necessarily represent a more accurate matching of revenues and expenses than would the claiming of the expenses only as accounts proved to be uncollectible.

The problem of estimating the ultimate collectibility of a long-term real estate mortgage will ordinarily be greater than in the case of a short-term loan or of a trade account receivable. It does not follow, however, that the allowance for loss should be higher. The type of security held is of basic relevance, and a real estate mortgage ordinarily has greater protection against loss than an unsecured trade account receivable.

It also should be emphasized that no allowance should be made for an untoward economic trend that cannot be foreseen. Such a provision would be carrying the principle of providing for losses beyond what appears to be reasonable, that is, beyond losses and into the area of possible losses. Moreover, commercial businesses are subject to this risk, many of them to a much greater degree than financial institutions, and it is difficult to contemplate how such a provision could be applied generally in a reasonable fashion. This general economic risk is just one of the risks of being in business that should not, and cannot, be the basis of a tax allowance.

The matter of reserves for financial institutions was reviewed by the Royal Commission on Banking and Finance and that Commission recommended the continuation of an allowance at a level somewhat higher than the allowance now granted to the chartered banks. The emphasis of our consideration has been primarily on the tax implications of the present treatment, and we have made it amply clear that we are averse to the use of the tax system for objectives other than those we have referred to frequently in this Report. We have expressed our understanding of the need for reserves against possible losses on loans and investments within the dictates of ordinary commercial and accounting practice, and for administrative reasons we see considerable advantage in the use of an established rate. However, we find ourselves unable to accept the view that an allowance larger than is justified on these grounds should be granted in order to assist in preserving the liquidity and soundness of a financial institution. We are much more inclined to agree with the Banking Commission in its general approach that the public benefit will best be served by institutions whose strength rests to some extent on public inspection and supervision, but primarily is based on the ability of the institutions to meet competition in a financial market which has been freed of some of the artificial impediments which now exist in Canada.

We stated earlier that taxpayers should not be permitted to claim general or contingency reserves for tax purposes, but rather that they should be

restricted to making a reasonable provision for expected losses. If certain institutions need to be regulated to ensure their continued solvency and liquidity, we do not believe that such regulation calls for any departure from the general rules for determining their actual income for tax purposes. Indeed, we do not believe that tax legislation should be designed to assist in ensuring solvency and liquidity. Such policy goals can be provided for adequately only by specific legislation, and there is legislation in force that specifically provides for the regulation of such institutions. However, we have pointed out that it can be extremely difficult to value a large number of receivables in a manner that is acceptable both to the taxation authorities and to the taxpayer. For the same reason that arbitrary depreciation allowances have proved to be a relatively efficient and mutually satisfactory way of allocating costs for tax purposes, so have the arbitrary reserves for banks and mortgage lenders proved to be attractive from the administrative point of view. It should be noted, however, that an arbitrary allowance provided for a type of institution, rather than for a type of loan, has the weakness of allowing the same loss provision against relatively secure loans (other than those that may be specifically excluded from any loss provisions) as against relatively high risk loans, and is unfair as between competing types of institutions.

In the case of banks and on the basis of long-term loss experience, the permitted ratio of valuation reserves to eligible assets appears to exceed greatly the rate that would be employed to reflect an allowance for bad debt losses only. While an allowance based on previous loss experience could be unrealistic, we believe that past experience is the best single criterion on which to establish an arbitrary rate of provision against bad debts. Although during one five-year period in the 1930's losses averaged 1.25 per cent of loans, over the twenty-five-year period from 1940 to 1964 the annual average loss experience was about one seventh of 1 per cent 10/. While the annual loss experience is only one factor in determining a reasonable loss allowance, a reserve exceeding twenty times the average loss experience over the last twenty-five years would appear to be excessive.

Unfortunately there is no meaningful breakdown of the present inner reserve figures into their two components, specific and contingency reserves, the former reflecting expected losses, and the latter possible losses. The Royal Commission on Banking and Finance pointed out that specific reserves were about three quarters of 1 per cent of eligible assets, 11/ but since at present little significance is attached to the division between specific and contingency reserves, this percentage is unlikely to represent what the specific reserves would be if computed carefully.

One other percentage that is of interest because it reflects the position of a competing institution that specializes in higher risk loans, is the allowance for doubtful accounts established by those companies in the small loan business. At the end of 1963, their allowance for doubtful loans was 2 per cent of outstanding accounts 12/.

Another consideration is whether one arbitrary rate should apply to all loans, or whether there should be a number of rates to reflect the varying loss experience on different kinds of loans. Certainly a single average rate would tend to be relatively less favourable for the bank that accepted a greater degree of risk. Although it would obviously be difficult to define the kinds of loans in a manner that would segregate them into risk classes, the present arbitrary allowance is already selective to some extent, because it applies only to certain assets. However, some of the assets included would virtually never be realized at a loss, while other assets involve a certain amount of risk. In addition, it would be expected that on average the losses would be relatively higher for the smaller loans than for the larger ones.

A final consideration relates to the administrative problem of determining the loss provisions for a large number of accounts. Because the taxpayer should always be given the option of claiming specific reserves if he found the arbitrary allowance to be deficient, it is desirable that there should be a liberal arbitrary allowance applicable to those accounts where the determination of specific allowances would be unreasonably time consuming.

Because over 99 per cent in number and 50 per cent in amount of the bank loans outstanding are under $100,000, 13/ the need for arbitrary provisions is greatest for these accounts.

As in the case of allowances for loan losses of banks, some arbitrary rule for determining allowances for losses on real property mortgage loans could produce administrative simplicity and taxpayer equity, while providing a degree of certainty. The present provision for real property mortgages appears to do these things, while having the additional desirable feature of relating the allowance to a type of asset, rather than restricting it to a kind of business. However, in line with our other recommendations that reduce the importance of the distinction between operating a business and holding an investment, it would appear more reasonable to extend this allowance to all taxpayers rather than only to those who are in the business of lending on this type of security. In addition, a review of the actual mortgage loss experience over the past thirty years leads to the conclusion that the present arbitrary rate of 3 per cent on these relatively secure investments is excessive 14/.

We question also whether a single arbitrary rate should apply to all mortgages. Obviously the degree of risk is not uniform as between, say, first and third mortgages. There already exists a generally acknowledged test for distinguishing between secure and hazardous loans in the laws which prohibit federally or provincially incorporated trust and loan companies from acquiring mortgages with a face value exceeding 75 per cent of the fair market value of the real property. Although there are no accepted standards of valuation that would ensure that this rule is applied uniformly across the country, it is important that the group of companies under federal and provincial trust, loan and insurance legislation, which hold the major proportion of the outstanding real property mortgages, are limited to loans of up to 75 per cent of the fair market value of the security. Therefore, to distinguish between mortgages on the basis of whether they were more or less

than 75 per cent of the value of the property is an arbitrary distinction that could be readily applied, because most of the companies concerned would only qualify for a single arbitrary reserve rate. It thus would be practical to have two rates for determining allowances, one for mortgages (whether first, second or third) that in total did not exceed 75 per cent of the value of the property and a second, and higher rate for other mortgages. There obviously would be administrative difficulties for those companies with a mixed portfolio of mortgages that qualified for both rates, but we do not think these problems would be insoluble, and we feel that the advantages of arbitrary rates would outweigh the problems involved, particularly because most of the problems would be of a transitional nature in establishing the procedures to be followed. The legislation should probably specify that all companies regulated by specific federal or provincial legislation (relating to trust and loan companies and insurance companies) would be eligible only for the low rate, while all other taxpayers could split their portfolios into the two classes of mortgages.

The present tax legislation does not contain any arbitrary allowances for doubtful accounts other than those already mentioned. However, the problems of compliance and assessment that we have discussed in connection with banks and mortgage lenders are also encountered by other financial institutions. This is true of those institutions that have a large number of accounts making up a substantial proportion of their assets and who experience some difficulty in determining an appropriate reserve on an account-by-account basis, or even in negotiating some arbitrary rates that are acceptable to the Department of National Revenue. We have stressed the importance of neutrality of treatment of competing organizations, but have also stated that arbitrary rates should be applied only in cases where it was not administratively practical to do otherwise. The two arbitrary provisions discussed above are readily applied because there is little difficulty in determining what qualifies as a bank, or what qualifies as a real property mortgage. While some of the other financial institutions are

as easily defined because they also are incorporated under special legislation, the allowance of arbitrary provisions to trust companies, credit unions, and small loan companies, for example, would to some extent increase the competitive inequities unless such provisions were also extended to finance and other companies of a similar nature. Unfortunately, the latter companies cannot be so easily defined. If it should be decided that an extension of the arbitrary provisions was warranted, the preferable method would appear to be an expansion of the allowance for mortgages. For example, if the mortgage provision were expanded to include mortgages and conditional sales agreements on chattels, most of the loans of financial institutions would become eligible for arbitrary provisions. There would be some difficulty in administering such an extension, because it would encourage some taxpayers to rearrange their loans so as to qualify, but at least such an approach would not extend a preference to only some kinds of businesses.

Deduction of Bad Debts. Ranking equally in importance with the control of provisions for doubtful accounts, is the exercise of control over the circumstances under which bad debts may be written off against income for tax purposes or against accumulated provisions for doubtful accounts. Rules respecting provisions for doubtful accounts are of little consequence, particularly in the case of arbitrary provisions, if debts may be written off by the taxpayer at will 15/. We believe that this control is best established for taxpayers who claim the arbitrary reserves by limiting the write-off of bad debts to accounts in respect of which it can be proved that a "loss" has occurred. The term "loss" would continue to have the meaning ascribed to it in current jurisprudence 16/.

Appraisal

Our basic conclusion is that there is little reason not to tax financial institutions in the same way as other taxpayers. Therefore, not only should all our general recommendations apply equally to these institutions but, in particular, the treatment of their reserves should be altered to conform to

general practice. The allowances for expected losses should be computed on the basis of accounting and business principles. No contingency element should be included. The term "reserve" should no longer be used in this context; the word "provision" or "allowance" or some similar term is a more appropriate designation.

Because the application of accounting and business principles in this area cannot always be easily and equitably administered, we conclude that financial institutions are a reasonable subject for the greater use of arbitrary allowances. Nevertheless, the use of such arbitrary allowances should not become a means of claiming contingency reserves. Although it would be desirable to make arbitrary rates and their attendant advantages available to other taxpayers concerned with the valuation of receivables, the difficulty of determining percentages that would be a reasonable reflection of expected losses for the full range of business receivables seems insurmountable.

Banks. In the case of banks, it would appear that the best way to give effect to our conclusions would be to vary the arbitrary rates by the size of the loans outstanding, and to further restrict the assets that would be eligible for such allowances. Specifically, we recommend that banks should continue to be allowed to employ an arbitrary provision for certain kinds of loans; that the list of eligible loans should be further limited so as to remove loans to municipalities and school boards, call loans, guarantees and acceptances, letters of credit, foreign exchange provisions, and any publicly traded securities not already excluded; that the allowable provision should vary in relation to the size of the loan balance outstanding; that there should be two arbitrary procedures which are optionally available; and that the overall level of the permitted reserves for tax purposes should be substantially reduced. Each bank would then be able to elect one of three general methods of determining its loss allowance for loans, depending upon which of the following procedures appeared most appropriate in the circumstances:

1. A specific reserve arrived at by valuing each loan.

2. An arbitrary allowance based on the outstanding balances of eligible loans. Rates of something less than 2 per cent for balances of up to $100,000, and of one half of 1 per cent for balances of between $100,000 and $500,000 would appear to be reasonable. The suggestion of something less than 2 per cent is based largely upon the experience of small loan companies which would probably have higher losses than banks and have found that a provision of 2 per cent is adequate. This allowance would also be based on the expectation that on average the larger loans would show an even lower loss experience. The percentages chosen should represent an average of what would be reasonable for the smaller loans and the larger balances.

3. An arbitrary allowance for eligible loans that were under the defined limit of $500,000 of up to seven times the average loss experience for the previous five years. The loss experience for each of those years would be defined as the net write-offs for the year expressed as a percentage of the eligible loans outstanding at the end of the year. Because different banks specialize in different kinds of loans, some probably experience more losses than others. A single arbitrary rate for all loans of the same general size might tend to discourage entry into less secure loans, and therefore we suggest this alternative to take such loss experience into consideration.

Loans in excess of $500,000, although numerous, should nevertheless not greatly exceed 2,000 in number for any one bank. These larger loans can reasonably be reviewed individually in the regular manner applicable to other taxpayers (which might well include the development of arbitrary procedures based upon past experience) to establish a reasonable provision for expected losses in the near term.

Federal and provincial securities with maturities in excess of one year from the date of issue which are held by financial institutions should

be valued on an amortized basis rather than at the lower of cost or market. This method of valuation is preferable for these companies because the securities are usually held for longer periods as an investment. Accordingly it provides a better matching of revenue and expenses than a valuation at the lower of cost or market. However, in order to provide for the substantial losses that may occur on disposal of the securities, it would appear reasonable to allow these institutions an arbitrary allowance of one half of 1 per cent of the amortized value.

We can see no justification for allowing a provision for tax purposes that was greatly in excess of that required to provide for reasonably expected losses. Therefore, the arbitrary rates to be employed should reflect the expected losses, and should bear a reasonable relationship to the provisions claimed by competing institutions. The actual rates to be employed should be designated only after more detailed analytical work had been completed on the actual loss experience of the various financial institutions.

We do not believe that the deductible allowances should be in any way related to what the banks record in their fiscal accounts.

Because these proposals involve a substantial adjustment in the existing tax allowances, special transitional provisions in the Act would be required. Therefore, a period of not more than ten years should be allowed for the gradual adjustment of the present tax allowances to the proposed amounts. It should be emphasized that the banks would not have to maintain their accounts on the same basis as the proposed tax allowance, and would be permitted to claim specific allowances if they did not elect to use the arbitrary percentages.

The savings banks should be subject to the same arbitrary provisions as other banks.

Mortgages. Section 85G which contains the loss provisions for real property mortgages should be amended to apply to all taxpayers (except banks) whether or not they are in the mortgage business, to exclude all insured mortgages (not only National Housing Act mortgages), and to differentiate in general between mortgages that are for less than 75 per cent of the fair market value of the real property and those that are for amounts exceeding this limit. The present allowance of 3 per cent should be substantially reduced to something close to 1 per cent for those better secured mortgages under the 75 per cent limit, and to something less than 2 per cent for the other mortgages on real property. A size limitation of $500,000 should also apply, because a very large mortgage should be capable of periodic review and assessment.

This arbitrary provision should not apply to any insured mortgage loans, including National Housing Act loans, because the risk of loss has been transferred, in whole or in part, to the insuring organization. The insuring organization should be permitted to base its allowance for tax purposes on these same arbitrary rates. In addition, the banks should be excluded from the application of this provision, not only because of certain arbitrary allowances already proposed for the banks, but because of the difficulty of differentiating between ordinary loans and loans secured by mortgages. However, the proposed arbitrary rates should generally be such that mortgage companies and banks would be claiming similar allowances.

The present limitation on the annual increase in the allowance for mortgage losses contained in Section 85G does not appear to be consistent with the concept of providing for expected losses, and therefore should be removed.

Taxpayers should be able to elect to set up their loss allowances on the basis of an appraisal of individual loans. There should be no requirement that the tax allowance and the books of account be in agreement. Again, it would be necessary to provide for the gradual adjustment of the present tax allowances to the proposed amounts. However, the adjustments would be

relatively smaller in this case, 17/ and a period of five years would appear to be reasonable.

While, in general we have concluded that loans and mortgages on which arbitrary allowances have been claimed should be written off (for tax purposes) only when an actual loss has taken place, we appreciate that such a procedure can also be administratively difficult. Therefore, we recommend that the write-offs for banks should be accepted without dispute so long as the recoveries did not exceed 10 per cent of write-offs. Any recoveries exceeding the designated percentage should be carried back to the earliest years of write-off for the accounts recovered, tax should be assessed on such increment in income, and interest charged for the number of years involved. Alternatively, it could be provided that in the case of small balances of under $10,000, a bad account would be eligible for write-off if no payment on account had been received for two years.

Other Financial Institutions and Other Accounts. We considered the extension of arbitrary allowances to other financial institutions as well as banks and to other accounts receivable as well as mortgages. In some cases, the use of general accounting and business practices could be just as inequitable and administratively complex for other taxpayers as for banks and for other accounts as for mortgages. Therefore such an extension might seem warranted. If this were to be done, the preferable method would appear to be an expansion of the mortgage allowance to include chattel mortgages and conditional sales agreements. The percentage used should be the same as the highest rate applicable to real property mortgages, which in turn should be equal to the arbitrary rate allowed to banks for the smaller accounts. This would ensure that only a minimum of account analysis would be necessary, and that most of the competing businesses would be on the same basis regardless of the form in which the loans were made. However, for various reasons we are unable to recommend the immediate implementation of such a measure, which would be significant for credit unions and caisses populaires, small loan

companies, and finance companies. For one thing, arbitrary rates should be sanctioned only when required as a matter of administrative convenience, as we explained earlier. Also, the use of flat rates, regardless of risk of loss, would give a greater benefit to some taxpayers than to others 18/. Finally, we cannot be sure that there would be a sufficient reduction in administrative complexity and improvement in taxpayer equity to warrant the revenue cost that could result.

Although the adjustments to the reserves of banks and mortgage lenders that we recommend are substantial, the liberal transitional provisions would spread out the tax impact over a number of years. In addition, since we recommend that the mortgage allowance be granted to all taxpayers, we would not expect the increase in tax revenues to be large.

LIFE INSURANCE COMPANIES

Characteristics of These Companies

The principal business of life insurance companies is entering into contracts to provide life insurance and life annuities. Some companies also write personal accident and sickness insurance.

The importance of the life insurance business is indicated by the fact that the total assets employed by Canadian life insurance companies in Canada and elsewhere at the end of 1964 amounted to over $11 billion, primarily in mortgage loans and bonds. The net investment earnings for that year from assets in Canada amounted to approximately $410 million for Canadian companies, and approximately $140 million for non-resident companies.

Life insurance exists because of the desire of individuals to provide for their financial responsibilities upon death. Because of the unpredictability of the time of this event for any one individual, and the problem of ensuring that he will have accumulated sufficient assets before that time to meet these requirements, the practical way to provide protection against

"mortality risk" is to share it with others so that its cost becomes predictable. There is a problem involved in this sharing, because the mortality risk, and therefore the cost of insurance, increases with age. This has been solved by the introduction of the level premium method under which premiums are greater in relation to the mortality risk in earlier years, and less in later years. The excess portion of the premiums in early years enables funds to be built up, the income from which reduces the cost of the insurance to the policyholder 19/.

Saving Aspects. The level premium method creates a form of saving. The individual could, instead of purchasing level premium life insurance, even out his total insurance costs by purchasing term insurance on a year-to-year basis. The funds which he would otherwise pay for a premium in excess of the mortality risk would be used to buy investments which, with the accumulated income thereon, would offset the higher cost of term insurance at a later date.

In addition, many insurance policies are available with various saving elements in addition to the provision for mortality risk. Most policies other than pure term insurance have a cash surrender value which ensures some return of amounts paid in premiums in the event of surrender before death occurs. Endowment policies provide for payment of a lump sum amount provided the policyholder survives to a specified age. Endowment policies may also have options under which the policyholder can convert the lump sum into an annuity and in this way provide for additional income upon retirement.

Role of the Insurer. Although the insurance business may be considered in a very broad way as pooling of mortality risk and saving, its wide-scale operation depends upon the introduction of an important intermediary, the insurer. This organization, which is a separate legal entity, contracts to provide a given amount of protection in the future for a given cost, 20/ subject to certain participating elements which will be referred to later.

The business of the life insurer is unique in certain respects when compared with other types of business. In most businesses the capital is primarily provided by the shareholders or investors who bear no relationship to the customers of the business. Commitments to customers are usually short term, and even when they are long term, as for example, in guaranteeing products sold to customers, they are not the dominant feature of the business. The general situation in life insurance is quite different. As an insurer grows in size, its principal customers—the policyholders—become the main source of funds, with the participating surplus and the actuarial reserves representing the policyholder's substantial interest in it. The important feature of the business is that the insurer commits himself contractually to meeting certain obligations to these customers over very long periods of time.

The main problems of income determination for the insurer are therefore in estimating the amount of the liability for future payments which will arise out of commitments already made, and in estimating its future investment income and expenses. In setting the premiums which it charges to the policyholders, assumptions must be made regarding future "experience" in respect of the three main elements, mortality, investment income, and expenses. The provision for the liability in respect of business which has been written is commonly referred to as a "policy reserve" or "actuarial reserve", but might more accurately be described as a "provision for future policy claims". In estimating this provision, the amount of policy benefits that are expected to be paid in future years based on established mortality tables, and the premiums yet to be received, are discounted to the present year by the application of a rate of expected investment yield. Thus, the current policy reserve, future premiums, and the investment income on such funds should accumulate to an amount sufficient to meet the expected claims. Expenses are usually covered by a "loading charge" included in the premiums.

Because of the uncertainty of long-term projections, the assumptions made regarding investment earnings and mortality and expense experience

tend to be conservative, and surpluses are often created as the actual results prove more favourable than those anticipated in setting the premiums.

Investment Policy. Commitments being of fixed amounts, insurance companies invest primarily in securities which involve little risk to capital, yield a fixed return and are of a long-term nature. In 1964 the market value of common shares in Canadian and foreign corporations represented about 8 per cent, and the book value about 4 per cent, of the assets held by all federally registered life insurance companies, although by legislation they were each permitted to hold up to 15 per cent in such shares. In 1965, this limit was extended to 25 per cent.

Participating and Non-Participating Insurance. In participating insurance, which represents about 70 per cent of the insurance in force today, the pooling aspect of insurance is emphasized, and the fixed commitments of the insurance company modified. The premiums for participating insurance are as much as 20 per cent to 30 per cent higher than for non-participating insurance, but the policyholder is given the opportunity of sharing in the favourable experience of the insurance company and presumably he hopes that such participation, in the form of policy dividends, will result in a net insurance cost lower than that for a non-participating policy. Competition between insurance companies provides some assurance to the policyholder that policy dividends will be forthcoming. However, the participating policyholder has no contractual right to share in favourable results, and there is no guarantee that policy dividends will be paid. Under non-participating insurance the commitment of the insurance company is fixed, and competition tends to produce premiums that do not vary widely from company to company.

Stock and Mutual Life Insurance Companies. The distinction between stock and mutual life insurance companies is not as clear as the distinction between ordinary corporations and co-operatives. The stock life insurance company may do a considerable amount of participating insurance business, and in respect of this business is in effect operating a co-operative enterprise.

In the accounts of a life insurance company the participating and non-participating operations are clearly segregated. As far as possible the segregation is applied to premiums, claims, actuarial provisions, salesmen's commissions, etc. For investment income, however, an arbitrary method of apportionment has to be adopted, because the assets are not split into separate funds. While the method of apportionment varies among companies, it is usually based on the average amount of assets in the two lines of business for the year. The method of allocation is closely supervised by the Department of Insurance to safeguard the interests of the participating policyholders.

In a stock company the shareholders are limited in the extent to which they can share in the surplus arising from the participating business. They are entitled to a maximum of 2.5 per cent to 10 per cent (depending on the size of the participating fund) of the amount of participating dividends that are distributed from the surplus earnings of the participating business. All the surplus arising from the non-participating business is for the account of the shareholders. However, no income tax is paid on either of these surpluses until such time as they are formally allocated to the credit of the shareholders. In practice, only sufficient surplus is allocated to cover dividend requirements and to provide a small margin. Thus, basically the stock companies pay income taxes only on dividends paid.

In a mutual life insurance company the ultimate owners of the company are the participating policyholders. Accordingly, they are entitled to surplus earnings created from all the business, non-participating as well as participating. However, because there are no shareholders, there is no income for tax purposes and no income tax is paid. Since 1958, five large Canadian life insurance companies have "mutualized", a procedure under which the policyholders in effect buy out the shareholders. The primary reason for this change was to keep control of the companies in Canada, and it was financially possible because of the magnitude of policyholders' capital in an insurance company. By special statutory provisions the amounts paid for the shares were entirely tax free to the recipients.

International Aspects. The international aspects of the life insurance business are important because about 30 per cent of the life insurance in force in Canada is placed with non-resident companies, and about 30 per cent of the insurance carried by Canadian companies is on non-residents, most of whom live in the United States.

Public Interest. The provision of funds to indemnify the estate of an individual, his dependants, or both, in the event of death has long been considered important from a social standpoint. Practices of the industry are supervised by the Department of Insurance, and no policyholder in a regulated Canadian life insurance company has ever lost a dollar through non-payment of the amount guaranteed under his policy. Under federal legislation governing the insurance industry, the investment yield assumptions in setting actuarial reserves cannot exceed 3.5 per cent for insurance, or 4 per cent for annuities. Recently, however, this has been modified to permit higher interest assumptions if special permission is given by the Department of Insurance.

Main Tax Considerations

Life Insurance as a Business. Life insurance has grown into a highly complex business employing large amounts of capital. In a society in which business income is taxed either to a corporate entity or to an individual, it is appropriate that the business income of a life insurance corporation should be taxed in a manner similar to the income of other businesses, after taking into account its special features. That surplus earnings do emerge beyond those needed for the protection of policyholders was clearly shown in the prices paid to shareholders upon mutualization of certain Canadian companies in recent years 21/.

Measurement of Income. Ignoring for the moment the problems presented by participating insurance, the major difficulty in measuring the income of a life insurance business results from the long-term nature of its commitments. Because of this it is contended by some that an annual measurement

is futile and that any surpluses indicated in an annual measurement are needed to provide for unforeseen contingencies which may produce unfavourable experience in the future. When viewed in relation to other businesses, however, this contention is not convincing. The problems of annual measurement are not unique to the life insurance industry. There are other kinds of businesses in which the income may not finally be established for many years. For example, in the oil and forestry industries it is not unusual for capital to be committed for periods of 50 years, from which the final income to be derived cannot be forecast with any degree of accuracy.

The fact that the long-term nature of the life insurance business lies in its commitment to customers in the future is unique, but this does not mean that for tax purposes future contingencies should be provided for as the management sees fit. In the same way that there must be a limit on the rates at which depreciable assets can be written off, provisions for future liabilities should be subject to reasonable limitations.

The degree of latitude in providing for future liabilities of the life insurance business should be governed by the degree of uncertainty involved. This uncertainty centres primarily upon the possible future changes in mortality, expenses, and investment yield. With respect to mortality, the use of any of the accepted tables appears to be conservative, and accordingly, the only major mortality hazard would appear to lie in events such as war or epidemics. Except in case of violent inflation, the expense variations do not seem to be serious. Fluctuations in investment income are certainly an important element, but through its investment policy an insurance company can level out short-run fluctuations to a considerable degree. Most investments are of a long-term nature with a fixed return, some of which are uncallable, and most of those callable are subject to a premium. The investment yield assumptions used in calculating the policy reserves are usually quite conservative. At the present time, we understand that the typical assumption would be 3 per cent to 3.5 per cent, 22/ and yet the average net

yields for the insurance industry have not fallen below 3.5 per cent since 1900, and were almost 5.5 per cent in 1964. Since 1931, when the average annual yield fell below 6 per cent, there was only the seven-year period of 1945 to 1951 when the average annual yield was under 4 per cent, and it has increased every year but one from the 1948 low of 3.57 per cent. (See Chart 24-1.)

Furthermore, any adequate system of taxing income from life insurance must recognize that income may arise from favourable mortality and expense experience, as well as from an investment yield in excess of that required to meet obligations.

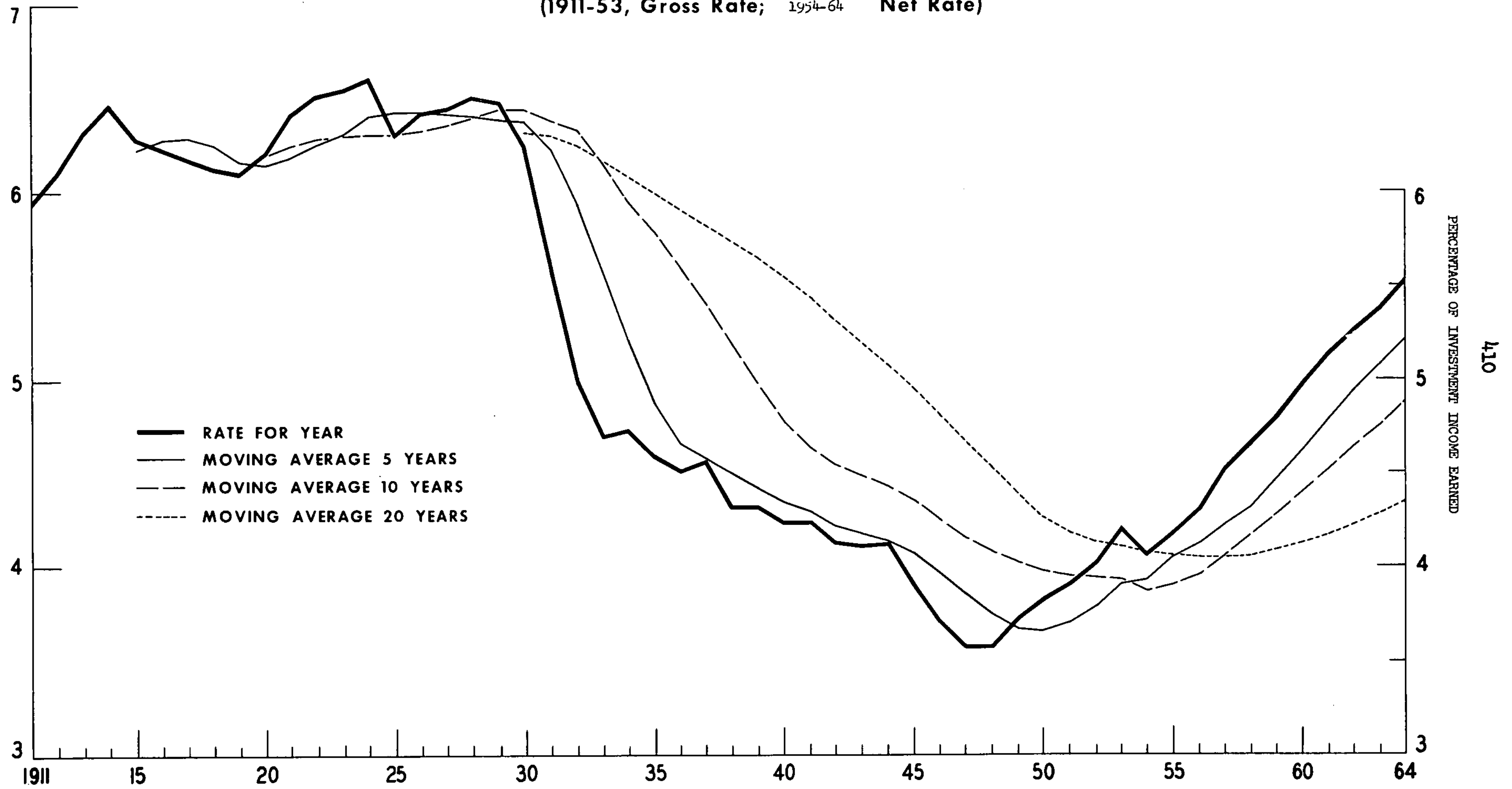
Mutual Aspect. Participating insurance, written by either joint stock or mutual life insurance companies, presents further problems in measuring the amount of the business income. The tax treatment is best explored by considering first the basis on which participating premiums are charged and the components of a policy dividend.

The premium for participating insurance is higher than that for non-participating insurance to allow for experience in investment yield, mortality and expenses that is less favourable than can reasonably be expected (and less favourable than that assumed for non-participating insurance). Thus, the policy dividend may be viewed as arising from experience more favourable than that assumed in setting the premium for the participating policy. It has been argued by some that the policy dividend therefore merely reduces the insurance coverage to cost. To the extent that the policy dividend represents results better than those assumed for non-participating insurance, that is, to the extent that policy dividends exceed the difference between participating premiums and non-participating premiums, this argument is unacceptable, because the ensuing income would normally accrue to the owner of the business. To the extent that the policy dividend arises from experience no better than that assumed for non-participating insurance, the policy dividend could be said to be merely a return of "excess premium" which

Chart 24-1

AVERAGE RATE OF INVESTMENT INCOME EARNED BY CANADIAN LIFE INSURANCE COMPANIES

(1911-53, Gross Rate; 1954-64 Net Rate)



would not be required from a policyholder such as a non-participating policyholder who had no participation in the income of the company. On the other hand, the participating policyholder has no contractual right entitling him to any dividend.

However, in our discussion of the taxation of payments received from life insurance in Chapter 16, and in our discussion of co-operatives and other forms of mutual enterprise in Chapter 20, we emphasize that the only consistent and reasonable way to tax distributions by the organization to the shareholder, member, or policyholder is to regard such a distribution as a distribution of income and therefore to tax it in full in the hands of the recipient. We reached this conclusion largely because of the administrative problems of determining what proportion of the distribution, if any, is a return of capital, that is, the "excess premium" paid. The policy dividend therefore should be deductible to the company and taxable to the policyholder in somewhat the same manner as business income earned in a co-operative and distributed to its members 23/. However, to the extent that dividends are paid out of surplus existing at the effective date of the legislation, they should not be taxable to the policyholders and therefore should not be deductible to the company. The rules for determining what dividends would be considered to have been paid out of this surplus should be consistent with the rules relating to corporate distributions and would be worked out in co-operation with the insurance industry. We recommend that a 15 per cent withholding tax should be deducted by the company from taxable dividends paid or credited to policyholders. As is the case with co-operative enterprise generally, it is possible to "price out" participating insurance by lowering the original premium, although this possibility would be limited by the need for financial stability.

Investment Conduit Aspect. The main tax considerations we have discussed so far have dealt with the surplus earnings created in a life insurance business. The surplus earnings arise when the experience in respect of investment yield, mortality, and expenses is found to be better than that

required to meet the liabilities of the business. It must not be overlooked, however, that at least 80 per cent of the investment income of the insurance business is required to meet its liabilities, and, accordingly, even if included in the measurement of business income, it would not be taxed because liabilities incurred in operations are deductible.

Some would argue that the investment income is merely incidental to the insurance business, and to the extent it is required to meet the liabilities it should not be taxed. Viewed broadly, however, all the investments of an insurance company which produce income necessary to meet liabilities represent an alternative form of saving for the individual, and in this context the life insurance company is an investment conduit.

The avenues for investment now available are such that individuals have a practical alternative to saving through life insurance by combining personal investment with renewable term insurance, and the tax system should not discriminate between the two approaches.

The appropriate tax treatment of this aspect of life insurance therefore depends primarily on the treatment of the individual in respect of other forms of saving through pension plans, mutual funds, etc., which are dealt with elsewhere in the Report.

Effect of Tax Treatment on Industry Practice. Because the solvency of life insurance companies is important to the public interest, any method of taxing them that incidentally encouraged practices that tended to impair the solvency of companies could lead to difficulties. However we emphasized earlier that protecting the solvency of financial institutions is a matter for the applicable regulatory legislation and should not be regarded as a function of taxation. The impact of taxation should fall as evenly as possible on participating and non-participating business, and on stock and mutual companies.

Present Tax Treatment

Income Tax: Canadian Companies. The ordinary provisions concerning business income do not apply to a life insurance company. Rather, the income of

a company, by a special provision, is deemed to equal the amount credited to shareholders' account 24/. The amount so taxed does not include amounts credited to the non-participating fund contingency reserves, such as investment reserves or surplus, both of which are available to shareholders. In practice, the amount credited to shareholders' account is usually little more than that required to pay dividends on the shares. For example, while in 1964 revenues of Canadian insurance companies exceeded expenditures, including policy dividends and a normal increase in actuarial reserves, by $90 million, income taxes were paid on an amount of less than $5 million.

A deduction from taxable income is allowed to the company for the portion of the amount credited to shareholders' account that is considered to represent (on a pro rata basis) dividends received from taxable Canadian corporations and charitable donations made by the company. A pro rata share of profits and losses on investments is included in arriving at the taxable amount. In the same manner, a Canadian life insurance company includes in its taxable income a portion of the income from foreign operations. However, a tax credit is granted in respect of foreign income taxes, 25/ and, because the latter are usually much higher than the corresponding Canadian income tax, there is little or no Canadian income tax on foreign operations.

As mutual life insurance companies and fraternal benefit societies do not have shareholders' accounts, they are in effect exempt from income tax. Where a stock company is given permission to mutualize, the payments to shareholders to buy them out are specifically exempted from income tax under the Canadian and British Insurance Companies Act in the case of a federal insurance company, and under section 68B of the Income Tax Act in the case of a provincial company.

Income Tax: Foreign Companies Operating in Canada. There are no special provisions concerning Canadian branches of foreign companies, and, because foreign companies are considered to have no shareholders' accounts in Canada, they are not subject to Canadian tax on the business income from their Canadian

operations. The foreign companies are subject to non-resident withholding tax of 15 per cent on the portion of Canadian investment income which relates to assets in excess of 110 per cent of the Canadian liabilities 26/.

Premium Tax. A provincial premium tax of 2 per cent is levied on all insurance premiums less policy dividends.

Summary of Present Tax Revenue. Table 24-2 presents information on the income tax revenues in respect of life insurance business in 1964.

TABLE 24-2

INCOME TAXES ON CANADIAN LIFE INSURANCE COMPANIES

Canadian Income Taxes		
Federal	$1,631,557	
Provincial	295,217	$ 1,926,774
Foreign Income Taxes		$13,819,168

Note: In addition, Canadian companies paid premium taxes of $9,905,387 to Canadian provinces and $5,018,419 in foreign countries. Foreign companies paid provincial premium taxes in Canada of $4,966,705 and Canadian and non-resident shareholders paid about $300,000 in Canadian taxes on share dividends received from Canadian insurance companies.

Source: Department of Insurance.

With only about 30 per cent of the life insurance carried by Canadian companies being placed abroad, the $13.8 million paid by them in foreign income tax offers strange comparison with the mere $1.9 million paid in Canadian income tax. The foreign income taxes paid by Canadian companies may also be noted relative to the fact that foreign companies paid no income tax to Canada on a comparable amount of insurance placed by them in Canada.

Evaluation of Present
Tax Treatment

In view of the main tax considerations discussed above, the present tax treatment of the life insurance business must be considered inappropriate and unsatisfactory for the following reasons:

1. The business income of a joint stock company is untaxed except for the portion which is credited to the shareholders' account in the financial statements.

2. There is no tax on the business income from mutual life insurance conducted by a joint stock company, except for a small percentage which may be withdrawn by the shareholders, nor on any of the business income of a mutual company.

3. The investment income generated in the life insurance business is considerable, and yet most of it is untaxed. This gives the holder of life insurance a tax preference over individuals who choose to save through some other investment form.

4. Because life insurance companies are virtually untaxed, the dividend tax credit is ineffective as an incentive to investment by them in Canadian equities. In fact, the existence of this credit tends to lower the rate of return before tax on equity shares and therefore to reduce their attractiveness for insurance companies as compared with other investments.

5. The business income of a Canadian branch of a non-resident insurance company is not subject to Canadian tax. Substantial tax may be levied on it in the country of residence.

6. While the mutualization of a life insurance company is permitted primarily to enable its control to remain in Canada, the procedure does enable surplus accumulated in a life insurance business to be distributed tax free.

7. Because the business income of life insurance companies is virtually untaxed, the other sections of the income tax legislation which impose restrictions on deductions are relatively ineffective. Primary examples are those relating to employer contributions to registered pension and other plans, charitable donations, and the rate of write-off of capital assets.

At the public hearings of this Commission it was suggested by the Canadian Life Insurance Officers Association that the present provincial premium tax serves as a substitute for income tax, but this does not appear valid either in principle or in terms of tax revenue. A tax on life insurance premiums is both a tax on saving and a tax on services. It is not a tax on income, and it is not a satisfactory substitute for an income tax.

It is not uncommon to tax both the income and sales of a business. Canada's present income and federal sales taxes do exactly this, and we recommend that services should be taxed in the same way as goods. The provinces have applied the premium tax to fire and casualty insurance premiums, even though these companies are also subject to income taxation. It may also be pointed out that in the United States the life insurance business is subject to premium taxes as well as to a comprehensive form of income tax. However, we have also advocated neutrality in tax treatment between competing organizations. Thus, it would not be equitable to continue a tax on life insurance premiums when savings invested through competing organizations are not subject to such a tax. Because the provinces would share in the tax revenues from life insurance profits, they might well decide to forgo the revenue from the tax on life insurance premiums. If not, then it would be hoped that the premium tax would be extended to apply to all forms of contributions to saving plans.

It has also been mentioned that income generated by insurance is taxed eventually because insurance proceeds are subjected to estate tax. The same could be said, however, of any form of income which is subjected to

tax and of which the unexpended amount is later subjected to estate tax. In any case, while insurance proceeds paid to Canadians in 1963 exceeded $600 million, only $50 million were included in assets on taxable estate tax returns.

Foreign Methods of Taxation

United States. Legislation which became effective on January 1, 1958 was the first attempt in the United States to tax the life insurance industry in a comprehensive fashion. Its provisions were designed to subject to tax the surplus which emerges each year in the same manner as corporate earnings generally. Under this legislation insurance companies are subject to tax on the following:

1. Taxable investment income, determined in the manner outlined below.
2. One half of the "underwriting gains", that is, of the excess of net income from all sources over taxable investment income.
3. Amounts distributed to shareholders or transferred to the shareholders' surplus account out of the policyholders' surplus account which arises from accumulations of the other half of the underwriting gains and of some other amounts which are deductible in computing underwriting gains.

In the event of an "underwriting loss", this is deductible in full from taxable investment income.

Taxable investment income is the insurance company's share of the investment income less investment expenses. This excludes the policyholders' share of investment income which is determined by applying to life insurance reserves an interest rate equal to the average earning rate of a company on all its assets for the five years ending in the taxation year.

In determining underwriting gains, an insurance company is entitled to deduct dividends to policyholders, except that if there is an underwriting

loss, policyholder dividends are deductible only to the extent of $250,000. In computing underwriting gains a company may also deduct 10 per cent of the increase in reserves for non-participating contracts or 3 per cent of the premiums for non-participating contracts, whichever is greater, and 2 per cent of the premiums for accident and health insurance contracts and group life insurance contracts.

Discussions with people familiar with the life insurance industry in the United States indicate that there are a number of technical difficulties in the legislation which have not yet been resolved. In view of the sudden increase in the tax burden on the industry, however, these technical difficulties are not surprising. What is more disturbing is that the industry is apparently having great difficulty in determining the tax implications of different management actions. Part of this difficulty arises from the fact that a sharp distinction is drawn between underwriting gains and taxable investment income. We understand that most of the present revenue is derived from taxable investment income.

In addition to the federal income tax, insurance companies are subject to premium taxes levied by the states, the most common rate being 2 per cent.

United Kingdom. In the United Kingdom the life insurance business is regarded primarily as an investment operation, and all the investment income, net of management expenses, but including the portion required for actuarial reserves, is taxed. The Revenue authorities have an option to tax an insurance business on its trading profit which is measured in a manner somewhat similar to that at present used in Canada, but apparently this is almost always lower than the investment income and is seldom used. Insurance premiums paid by individual taxpayers in specified circumstances are allowed to them as deductions from income for tax purposes.

Alternatives to Present
Tax Treatment

The main requirement of any alternative system of measuring the income from a life insurance business for tax purposes would be to impose some reasonable limit on the amount which could be set aside for future obligations, that is, the actuarial liabilities for future claims under outstanding policies. There is also a question of how the heavy initial expenses incurred in selling and writing an insurance policy should be treated.

Industry Practice. The simplest and most flexible approach would be to accept for tax purposes the provisions and write-offs established in the financial accounts of an insurance company. The amounts carried to surplus 27/ in the statements filed with the Department of Insurance could then form a basis for a regular tax on business income. This would amount to accepting for tax purposes procedures that have been developed for regulatory purposes. These purposes are usually in conflict because, while the first looks to the proper reporting of annual income, the second is concerned with protecting the policyholder. We have already stated our conclusion that regulatory goals can best be attained by direct legislation and that tax measures should not be used for this purpose, unless no other measure is available, because of the inequity that would result. Accepting the company statements would mean that the expenses of selling and writing insurance would be written off when incurred, a more liberal treatment than is now generally permitted to other taxpayers earning income under long-term contracts. Such a system would also create an inducement to defer tax by strengthening actuarial reserves by the use of lower interest rate assumptions. Such a deferment could have serious effects on tax revenue, because a conservative interest assumption in respect of amounts held for up to fifty years could prevent the emergence of surplus for a very long time. There would be some limit on the extent of such deferment because the Department of Insurance would discourage improper increases in reserves,

and competition in participating insurance requires the emergence of surplus for policy dividends. It is unlikely, however, that these influences would be sufficient to avoid undue deferment of taxation. There would be some discrimination as between different companies, because the large and well-established companies could more easily afford to strengthen their provisions for future liabilities without disrupting their financial positions than could their new and smaller competitors, but this discriminatory feature would not be unique to the life insurance industry. Because the liabilities recorded in each company's own records would determine its tax liabilities, there would be pressure on the companies to over-estimate their liabilities, an unfortunate result in view of the flexibility now enjoyed in this respect. In addition, such a procedure would allow the life insurance industry a degree of flexibility in computing tax liabilities that would not be available to other industries.

Arbitrary Assumptions for Tax Purposes. A second alternative for determining the amount of the actuarial provision that could be deducted in computing income for tax purposes would be to establish an arbitrary rate of investment yield. This rate might be struck as being reasonable for the long run and, for tax purposes only, all insurance companies would be required to adjust their actuarial provisions to reflect this factor. Alternatively, the arbitrary yield rate could be the maximum rate permitted under insurance legislation, this rate presumably being sufficiently conservative to protect solvency. Or again, the arbitrary yield percentage could be based on actual investment earnings of the individual company over an extended period of time. From the inquiries we have made, and from experience under the former methods of United States taxation, it appears that the use of a similar rate for all companies might not be entirely equitable because it would not reflect the individual circumstances of each company in relation to the nature of its investments and its policies.

On the other hand, there is evidence that any attempt to use different rates for different companies might lead to inequities and would certainly

cause administrative complexity. We regard this latter factor as extremely important, for if no system will produce complete equity because of the necessity for arbitrary guidelines, it is preferable to employ an approach that is readily understandable and can be administered with relative ease by both the taxpayer and the government. An arbitrary rate also makes clear beyond all doubt that, while fixed standards may be required for the practical necessities of taxation, for other purposes the evaluation of policy reserves by the management of individual companies should be undisturbed by tax considerations.

Excess Investment Yield as a Minimum. Because a substantial portion of the profit of an insurance operation usually arises from favourable investment experience, another alternative would be to ensure that the taxable business income was no less than the "excess" investment yield. This is an important feature in the United States method of taxing life insurance companies, and the formula is intended to identify the excess of the actual investment yield over that which would be needed if reserves (or accumulated assets) were limited to those needed under current yields. It appears, however, that this method might leave substantial profits untaxed, and involves an artificial segregation of investment and underwriting profits, which has proved to be one of the troublesome features of the United States system.

Annuities, and Accident
and Sickness Insurance

The principal type of annuity written by insurance companies is the life annuity, the payment of which begins either immediately upon purchase or at some date in the future if the policyholder survives it. Insurance policies do not specifically provide for annuities, although such policies may provide for a lump sum convertible into an annuity at maturity. About 90 per cent of the total annuities now in force are group annuities, which are usually carried by employers for the benefit of employees.

The income of a life insurance company which is generated from its

annuity business is taxed in the same manner as the rest of its income. Therefore, the treatment of income from the annuity business must also be considered and co-ordinated with the tax treatment of the life insurance business. Annuity premiums are not subject to the provincial premium tax. Within limits, an individual may deduct contributions for annuities registered for tax purposes, the proceeds from which are fully taxable. Contributions by an individual for annuities that are not registered for tax purposes are not deductible, and only the interest element in the proceeds is taxable. The appropriate tax treatment of annuities from the annuitant's standpoint is discussed more fully in Chapter 16.

In general, the income of life insurance companies from accident and sickness insurance is taxed in the same manner as their income from life insurance. Because of the freedom which this procedure provides in setting up liabilities allowable for tax purposes, the life insurance companies have a competitive advantage over general insurance companies in the same field.

Proposed Tax Treatment

Our primary conclusion is that the present system of taxing life insurance business in Canada is quite inadequate 28/. A more appropriate tax system would recognize the emergence of annual income which accrues to the shareholders of the stock companies, to the participating policyholders of the mutual companies and the stock companies, or to the members of the fraternal benefit societies. We recommend that each of these groups should be taxed in a similar fashion. Experience in the United States suggests that the system should be as simple as possible and designed in such a way that its effect on business transactions will be predictable. Also, it should not be discriminatory between different types of business or different forms of organization.

Business Income. The computation of the business income of life insurance companies for tax purposes should be based on procedures which permit the

deduction of reasonable provisions for future liabilities; that is, of reasonable actuarial reserves. Such reserves for tax purposes should be calculated using an assumed arbitrary rate of investment yield, rather than actual investment yields. The use of an arbitrary and uniform rate would reduce complexity to a minimum. The rate to be employed should ensure that virtually all companies would deduct reserves which were not less favourable to them than would result from the use of their expected long-term investment yield. The arbitrary rate is recommended for administrative simplicity in determining income and is not intended as a means of accumulating contingency reserves. The provisions for future policy claims that are required to ensure solvency under the worst of conditions are not necessarily those that provide a reasonable reflection of income for tax purposes.

We believe that the above requirements dictate an arbitrary yield rate at the present time for Canadian life insurance actuarial liabilities of more than 4 per cent. The actual rate to be employed should be determined after discussions between the government and representatives of the industry. Our reason for suggesting a rate of more than 4 per cent is that the 20-year moving average of the actual investment yields earned on Canadian investments by federally incorporated life insurance companies has not dropped below 4 per cent in the 1900's 29/. We appreciate that the conservative investment valuation procedures employed by these companies tend to increase the yield rates. However, this overstatement is probably more than compensated by the omission of property gains from the computations. Therefore, a rate of over 4 per cent would permit the companies to report their provisions for tax purposes on a very favourable basis. The arbitrary rates could be changed if a long-term trend in investment yields warranted an adjustment. However, we would not expect such adjustments to be frequent.

The rate suggested above refers specifically to Canadian business. Because the yield on foreign investments acquired to provide for foreign liabilities is unlikely to be the same as for Canadian business, it would

not be equitable to apply the Canadian rate to all business. If our recommendations in Chapter 26 are accepted, there would be little difficulty in this regard because foreign source direct investment income from designated countries would then be eligible for an arbitrary foreign tax credit when received, regardless of the actual level of underlying tax. Nevertheless, some foreign source income would not qualify for such treatment, and in this case a different arbitrary rate should be determined, based upon the relative investment yields in Canada and the foreign jurisdiction.

Actuarial liabilities for tax purposes should be established on the net level premium basis.

In Chapter 22 we suggest that expenses which contribute to earning income over a number of years should either be written off as incurred or should be capitalized and amortized through capital cost allowances. The expenses of obtaining new insurance business should receive the same treatment as would be accorded to similar expenses by other businesses, namely, an immediate write-off of most expenses.

As in all businesses, gains or losses on investments should be included in business income.

The above recommendations concern the computation of tax liability only. The provisions for tax purposes should not depend in any way on what the companies record in their fiscal accounts.

All the above provisions are liberal when compared with our recommendations for industry generally. Under these provisions, a new life insurance business would not pay any income tax for a number of years, although most existing life insurance companies would immediately begin to pay substantial income tax. However, the impact on the shareholders of insurance companies of taxing life insurers on the full amount of their earnings would not be as substantial under our proposals as it would have been if the companies were subject to the full rates of tax under the present system, because the

integration of corporation and personal income tax would permit the tax burden to be limited to the personal rates of the resident individual shareholders.

However, in the case of a mutual life insurance company there would be no shareholders to whom undistributed earnings could be attributed, while in the case of a stock company most of the undistributed earnings from the participating business would be allocated to the policyholders and not to the shareholders. We have indicated in this Report that a corporation or other organization should not in itself be regarded as having a tax-paying capacity but as being an intermediary for the "owners", or the persons who have residual claims against it.

We have proposed that when the 50 per cent tax was levied on a corporation it should be entitled to allocate to its shareholders the earnings which had been subject to tax in the hands of the intermediary but had not been distributed in cash. Canadian residents would then include the amounts allocated to them in income, grossed-up to include the tax paid by the intermediary, and would obtain a credit for this tax. This procedure, if adopted, would apply to the shareholders of stock life insurance companies. A treatment which would be consistent in principle would be to permit stock companies to allocate to participating policyholders the earnings which arose from participating insurance (other than the shareholders' proportion of those earnings) and to permit mutual insurers to allocate to their participating policyholders all of the income which arose from their life insurance business. Canadian resident policyholders would then include in income the amounts allocated to them, grossed-up to include the tax paid by the insurer, and would receive a credit for that tax. However, in the case of income allocated to participating policyholders the situation would not be exactly parallel to that existing for shareholders. There would be the question of when, if ever, the accumulated income might be distributed to the policyholders. Also, as we recommended in Chapter 16 that mortality gains should not initially be subject to tax and as the policyholder interest in a life insurance policy is not readily marketable, there would be a question

of how the policyholder should record for tax purposes the amounts allocated to him. It would therefore be necessary for detailed regulations to be developed after discussions between industry and Department officials.

Policy Dividends. Consistent with our recommendations for other forms of mutual and co-operative activity which are contained in Chapter 20, policy dividends should be deducted in arriving at the business income taxable to the insurance company. The policy dividend should be treated as a distribution of business income and should be subject to a withholding tax of 15 per cent.

Investment Income. Discussion of the tax treatment of the investment income credited to policy reserves is contained in Chapter 16. The investment income in excess of that portion credited to policy reserves would, under the procedures discussed above, be included in income and taxed in the same manner as income of other corporations. Thus, the life insurance company would include dividends received from Canadian companies in its income on a grossed-up basis, and would obtain credit for the corporation income tax. This should prove to be a substantial incentive toward investment in Canadian equities.

Branches of Non-Resident Companies. Branches of non-resident companies should be taxed in the manner set out above for Canadian companies. Because non-resident companies do not ordinarily file operating statements with the Department of Insurance, a special calculation would be required, based on a proration of the results of the entire operations of each non-resident company. This would involve an allocation of head office expenses to the Canadian business and of a portion of policyholders' surpluses to Canada. To the extent that assets were held in Canada in excess of the actuarial reserves, the investment income on that excess could be taxed at the ordinary non-resident withholding tax rates as at the present time. In addition, it would be necessary to extend to life insurance companies the special tax on branch profits that is applicable to other businesses.

Administration. Under a comprehensive method of taxing life insurance companies, it does not seem reasonable to expect the Department of Insurance, which has responsibility for supervising industry practices, to ensure that policy liabilities will be met and also to determine whether the tax liability has been correctly calculated. Therefore, we suggest that certain members of the tax administration should become sufficiently familiar with the industry to be able to assess its taxation and that they should work in conjunction with the Department of Insurance.

Accident and Sickness Insurance. Income of a life insurance company from accident and sickness insurance should be taxed in the same manner as that recommended for the general insurance business in Chapter 25.

Interest on Funds Left on Deposit. Insurance companies pay interest on policy dividends and other policy proceeds that are left with them by policyholders. We understand that this interest is not always reported as income by the policyholder. Because the assets held on deposit are substantial, over $900 million in Canadian companies at the end of 1964, the requirements for reporting this income to the government and to the policyholder should correspond to those for investment income generally. Thus, the companies should be required to report the income and withhold tax of 15 per cent.

Effect on Tax Revenue. The revenue which would be produced by taxing income of insurance companies in the manner outlined above, based on its full application to 1964, is indicated in Table 24-3.

TABLE 24-3

APPROXIMATE TAX ON THE BUSINESS INCOME
OF LIFE INSURANCE CORPORATIONS
(millions of dollars)

Canadian Federal Companies—amount carried to surplus (less net losses on investments) plus the estimated adjustment resulting from the use of a 4 per cent rate to provide actuarial liabilities	$143 a/		
Less—Foreign portion, say, 30 per cent b/	44		
		$99	
Foreign Companies, say, two sevenths of the income of Canadian companies		41	
Total taxable business income		$140	
Corporation tax thereon at 50 per cent			$70 c/
Additional 15 per cent non-resident tax on branch income and on dividends paid to non-residents			5
Provincial companies and fraternal benefit societies			5
			$80 d/

a/ Amount carried to surplus, less loss on investments, per Report of the Superintendent of Insurance. — $90 million
Adjustment of actuarial provision for year to reflect an interest rate assumption of 4 per cent instead of the existing rates which appear to average out to approximately 3 per cent — 53
$143 million

b/ It was assumed that after allowing for foreign taxes on the foreign income of Canadian companies there was no additional Canadian tax to be paid.

c/ The tax paid at the corporate level would be offset by credits to resident shareholders of approximately $15 million and might also be offset by credits of most of the balance to resident policyholders if allocations to them were provided for.

d/ Subject to the effect of integrating corporation and personal income tax, this figure can be compared with estimated revenue of $2 million under the present system of taxation as detailed earlier in this chapter.

Transitional Provisions

Taxation of Business Income. Because the measurement of business income is based on earnings in excess of those required to meet liabilities, implementation of our proposals should not cause financial difficulties. The effect of our proposals on stock companies would be to levy income tax on the income as it was earned, rather than to wait until it was eventually distributed. Although this would only bring the taxation of shareholders of companies in the insurance business into line with the treatment of other shareholders, it would change what has amounted to a permanent tax deferral into an immediate tax liability. It should also be noted that under our proposals the burden of tax on income allocated to shareholders or participating policyholders would be limited to the rate of individual income tax applicable to the shareholders or participating policyholders. Nevertheless, our proposals would reduce substantially the future retained earnings and the cash flow of stock life insurance companies. It is possible that some portion of the taxes paid might be passed on in the form of higher premiums on new policies, and in the form of reduced dividends on existing and future participating policies.

The position for mutual life insurance companies would be somewhat different from that outlined for stock companies. Because the income of a life insurance company is at present only taxed when transferred to a shareholder's account, and because a mutual company has no shareholders, the mutual life companies are at present effectively exempt from taxation. In the case of both stock companies and mutual companies, the burden of tax on income attributable to resident policyholders might be limited to the rate of individual tax of those policyholders. The comments made above concerning the impact of these proposals on policyholders apply equally to policyholders of a mutual life company 30/.

Therefore, we recommend that our proposals should be implemented in full

immediately, with no provisions for a transitional period. We also recommend that all business income should be taxed, including the income derived from policies issued prior to the date of the implementation of our proposals.

Surpluses Accumulated Tax Free in the Past. A tax on the annual earnings of life insurance companies should take into account the treatment of surpluses accumulated tax free in the past. For Canadian insurance companies, such surpluses, including special contingency reserves, amounted to over $900 million at the end of 1964. 31/

It would be virtually impossible to impose taxation on surpluses accumulated in the past by foreign companies.

Surpluses accumulated in the past by mutual companies on all their business, and by stock companies on their participating business (other than the 2.5 per cent to 10 per cent share of participating business profits that could eventually be credited to the shareholders), are exempt from tax under the present legislation, and accordingly tax should not be imposed on them. The surpluses remaining, mainly from the non-participating business of Canadian stock companies, are taxable under the present legislation upon transfer to shareholders, and, accordingly, provision might be made to tax them under new legislation. The amount of such surpluses relating to Canadian business, including the recommended adjustment of actuarial liabilities, would amount to almost $300 million. Alternatively, it could be argued that in the ordinary course of events the tax on surpluses accumulated in the past would have been postponed indefinitely under the existing legislation, and that to tax them now would discriminate against the stock companies. It should also be noted that most of the surplus retained by the insurance companies has not yet borne any corporation tax.

We recommend that the surplus on hand at the effective date should continue to be subject to the 50 per cent corporation income tax if and when

it is credited to shareholders' accounts, but when paid out in the form of dividends it should be treated in the same manner as for other corporations, that is, as a reduction in the cost basis of the shares.

Another transitional problem concerns the opening balance, for tax purposes, in the provision for actuarial liabilities. At present, all companies use an investment yield rate of 3.5 per cent, or less, for determining their life insurance liabilities, while we recommend that a rate higher than 4 per cent should be employed. We recommend that, for tax purposes, the surplus accounts at the effective date should be increased by the amount required to reduce the provision for actuarial liabilities to the amount determined under the new rate to be employed.

CONCLUSIONS AND RECOMMENDATIONS

BANKS, TRUST COMPANIES, MORTGAGE AND LOAN COMPANIES, AND FINANCE AND CONSUMER LOAN COMPANIES

1. Financial institutions should, in general, be taxed in the same way as other taxpayers. Federal and provincial legislation provides for the solvency and liquidity of most of these institutions, and we do not feel that income tax legislation should be made to help serve the same purpose.

2. The treatment of the reserves of financial institutions should be altered to conform to general practice as followed in determining taxable income of other taxpayers, and should not provide for contingencies. However, to reduce complexity and uncertainty these institutions should be allowed to provide for losses on designated kinds of loans on an arbitrary basis, as an alternative to the specific valuation of individual loans. The present use of arbitrary allowances for banks and mortgage lenders should therefore be continued, but, the level of rates should be considerably reduced. In the case of banks the rate should be reduced from approximately 3.5

per cent to variable rates, applicable to fewer assets, of something less than 2 per cent, and, in the case of mortgage lenders, from 3 per cent to about 1 per cent on most mortgages and to something less than 2 per cent on the riskier mortgages. In the case of banks only, an alternative arbitrary allowance against loans of up to seven times the average loss experience for the previous five years should also be available on an optional basis.

3. Federal and provincial securities with maturities exceeding one year which are held by financial institutions should be valued on an amortized basis, and should be eligible for an arbitrary allowance of one half of 1 per cent of the amortized value.

4. The special provisions with respect to mortgages contained in section 85G of the Income Tax Act should be extended to all taxpayers (except banks), whether or not they are in the mortgage business. The exclusion of insured mortgages should be extended to privately insured mortgages, and the percentage rates should be reduced as indicated above.

LIFE INSURANCE COMPANIES

5. The business income of resident insurance companies, whether organized as stock or mutual companies or as fraternal benefit societies, should, in general, be determined and taxed in the same way as the business income of companies in other industries.

6. An arbitrary investment yield assumption should be specified for use in estimating the actuarial liabilities for tax purposes. A rate exceeding 4 per cent would appear to be appropriate for determining life insurance liabilities.

7. Policy dividends (except those paid out of surplus existing at the effective date of the legislation) should be deductible in computing the income of the paying company and should be included in the incomes

of the recipients. They should be subject to a withholding tax of 15 per cent.

8. The business income of Canadian branches of non-resident insurance companies should be taxed in the same manner as the business income of resident companies. They should also be subject to the same tax on branch income as is applicable to other non-resident companies with branches in Canada.

9. Resident insurance corporations should be entitled to follow the gross-up and credit procedure in respect of dividends from resident companies that we recommend in Chapter 19.

10. Stock companies should be entitled to allocate to shareholders the income which is attributable to them in the same manner as any other corporation. It would also be desirable for both stock and mutual companies to allocate to participating policyholders the income which is attributable to them. The amounts allocated to resident shareholders and policyholders would be included in their incomes, grossed-up to include the corporation tax, and they would be entitled to credit for the corporation tax.

11. Interest on funds left on deposit with insurance companies should be reported to the tax authorities and should be subject to a 15 per cent withholding tax.

12. Surplus at the effective date of the legislation should be adjusted for tax purposes to reflect the revision of actuarial liabilities. Such surplus would continue to be taxable if credited to shareholders' account.

REFERENCES

1/ The chartered banks, for example, had over two and a half million individual loans outstanding at June 30, 1965, amounting to $10.5 billion. A few large retail organizations have this problem in common with the financial institutions, but their income is derived primarily from trade rather than from the business of lending money and provision for losses on receivables therefore is not as significant in income determination.

2/ This deduction is allowed under section 11(4) of the Income Tax Act. The deduction in computing income is permitted only of "such amount as is set aside or reserved", so that banks are limited to the lower of the maximum permitted reserves or the amount set up in their books as valuation reserves. Notwithstanding section 11(4) of the Income Tax Act, it would appear possible for a bank to claim a deduction alternatively under section 11(1)(e) and this conceivably could exceed the amount allowable under section 11(4). However, it is extremely unlikely that a bank would do so.

3/ Bank Act, S.C. 1953-54, Chapter 48, section 63(1).

4/ Royal Commission on Banking and Finance, Report. Ottawa: Queen's Printer, 1964, p. 386.

5/ Section 85G of the Act deals with loans "made...on the security of a mortgage, hypothec, or agreement of sale of real property". However, mortgages or hypothecs under the National Housing Act, 1954 or any of the Housing Acts as defined in paragraph (e) of section 2 of the Central Mortgage and Housing Corporation Act are excluded. The section was introduced in 1955 and was designed to permit, over a period of time, a maximum reserve of 3 per cent of the principal amount of mortgage loans outstanding plus interest due and unpaid on those loans. The rate of accumulation of the reserve was limited to

one quarter of 1 per cent a year, but was changed in 1965 to one half of 1 per cent a year. The Trust Companies Association of Canada in their submission to the Commission, pointed out that the former limitation was such that a company with annual increases in mortgage loans outstanding would not reach the 3 per cent maximum at any time in the future. However, the change in the limitation should ease this problem and the percentage reserved should move toward the maximum.

6/ Section 11(1)(e).

7/ Depreciation provisions constitute an important determinant of income for many businesses.

8/ Disputes may also arise over the right to make deductions. For example, the right of acceptance companies to claim losses in respect of wholesale or retail "paper" purchased has never been clearly established, but by departmental practice such claims have been allowed because the finance contracts have been regarded as "accounts receivable" or "inventory". In Ted Davey Finance Co. Ltd. v. M.N.R., [1965] Ex. C.R. 20, the Exchequer Court threw some doubt on this practice by finding that (1) a sale of such commercial paper was not a sale in the course of trade, (2) section 85D dealing with the sale of accounts receivable did not apply, and (3) the commercial paper was not "inventory".

9/ The fact that the anticipated income has not been earned, of course, does not affect the loss potential.

10/ Bank of Canada, Statistical Summary, February 1965, p. 90.

11/ Royal Commission on Banking and Finance, Report, op. cit., p. 386.

12/ Computed from Superintendent of Insurance, Report on Small Loan Companies and Money Lenders Licensed Under the Small Loans Act, Ottawa: Queen's Printer, 1963.

13/ The following percentage distribution of loan accounts outstanding by size at September 30, 1962, was prepared from figures in Royal Commission on Banking and Finance, Report, op. cit., pp. 132 and 134.

Category	Under authorization of:		No. of Accounts (per cent)	Outstanding Amounts (per cent)
1	Less than $10,000		96.3	30.9
2	$10,000 to $100,000		3.1 a/	19.4
3	$100,000 to $1,000,000			23.6
4	$1,000,000 or more		.6	26.1
			100.0	100.0
Number and Amount		2,068,105	$7,033,000,000	

a/ This figure pertains to categories 2 and 3.

14/ There are few published data on mortgage losses. Information concerning a major mortgage company and information supplied by the Department of Insurance relative to Canadian life insurance companies suggest that the average annual net losses over this period have been approximately one fifth of 1 per cent. When a mortgage is foreclosed, the eventual loss is usually only a small proportion of the amount defaulted.

The Dominion Mortgage Association has completed a survey of its members for the 1929 to 1948 period that shows an average annual loss allowance of just over two thirds of 1 per cent. However, representatives of the Trust Companies Association pointed out that losses since 1948 have been virtually non-existent. The annual average loss experience is only significant in indicating the magnitude of the losses that will be chargeable against the allowance. Therefore, perhaps a more useful comparison is the insurance fee of 2 per cent charged on the initial value of National Housing Act mortgages. In this case, it would appear that the allowance built up with these fees will be quite sufficient to take care of expected losses, even though the risk of loss on such mortgages is considerably greater than on most conventional first mortgages.

15/ The write-off for tax purposes itself does not affect the taxpayer's right of collection.

16/ See Chapter 22 for further discussion on the meaning of "loss".

17/ Figures supplied by the Department of National Revenue for nine companies in the mortgage business indicate a tax allowance at the end of 1963 of under 2 per cent in all cases. Three companies had an allowance of under 1 per cent, and all but one were under 1.5 per cent. However, the 1965 legislative amendment permitting a larger annual provision will have caused some increase in the percentages.

18/ Figures supplied by the Department of National Revenue for six finance companies indicate that the tax provision at the end of 1963 ranged from one quarter of 1 per cent to 2 per cent of outstanding accounts.

19/ The cost of protection and the benefits derived therefrom affect the taxable capacity of the individual. The appropriate tax treatment of the individual is considered in Chapter 16.

20/ Fraternal benefit societies may alter the terms of their contracts by by-law, but rarely if ever do so in practice.

21/ Summary for the five companies which mutualized (thousands of dollars).

Companies	Total Amount Paid for Shares	Capital Account	Surplus in Share-holders' Fund	Excess (Paid out of Policy-holders' Surpluses)	Policyholders' Surpluses as at December 31 of Year Prior to Start of Mutualization	
					Non-Participating	Participating
Canada Life Assurance Co.	$22,000	1,000	1,208	19,792	9,224	20,882
Confederation Life Assoc.	18,000	1,000	719	16,281	13,402	16,548
Equitable Life Insurance Co.	4,253	327	400	3,526	2,488	(1,077)
Manufacturers' Life Insurance Co.	41,250	1,500	2,234	37,516	14,736	23,812
Sun Life Assurance Co. of Canada	65,000	2,000	2,426	60,574	21,338	129,019

Source: Information supplied by the Department of Insurance.

22/ It should be noted that the investment yield assumption employed in setting premiums might be slightly higher than that used in calculating policy reserves.

23/ Although the participating policyholder, unlike the co-operative member, has no contractual right to share in surplus earnings, nevertheless the participating policyholders as a group have ultimate ownership of the surplus earnings of the participating business, and the suggested treatment would reflect the extent to which this participation takes place.

24/ Section 30.

25/ Income Tax Act, section 41(3) and Regulations, Part XXIV.

26/ Regulations, sections 802, 803.

27/ The amount carried to surplus does not include the regular actuarial provisions for future policy claims and policy dividends; it does include an adjustment for profits and losses on disposal of investments, special increases in provisions for future policy claims, changes in special reserves, and dividends to shareholders.

28/ We discuss the treatment of policyholders in Chapter 16.

29/ See Chart 24-1.

30/ Our recommendations concerning policyholders, including those who receive policy dividends, are given in Chapter 16.

31/ Adjustment of accumulated policy reserves to reflect the proposed arbitrary rate would increase this amount by over $800 million.