# CHAPTER 25

# OTHER INDUSTRIES

## FARMING

In 1961, Canadian commercial farms, defined as farms with sales of agricultural products of $1,200 or more, numbered some 353,000. In the same year over 200,000 individual farmers filed tax returns, of whom some 74,000 paid about $27 million tax on a total income of approximately $323 million. Table 25-1 gives this information by provinces.

TABLE 25-1

| Province | Total Commercial Farms (1) | Number of Farms with Sales over $5,000 (2) | Number of Farms with Sales over $10,000 (3) | Number of Farmers Reporting Taxable Income (4) | Income Reported by Taxable Farmers (thousands of dollars) (5) | Taxes Paid (thousands of dollars) (6) |
|---|---|---|---|---|---|---|
| Nfld. | 456 | 169 | 93 | n/a | n/a | n/a |
| P.E.I. | 4,530 | 1,210 | 315 | 168 | 579 | 34 |
| N.S. | 4,939 | 1,569 | 633 | 333 | 1,318 | 97 |
| N.B. | 5,116 | 1,582 | 597 | 434 | 1,865 | 144 |
| Que. | 62,497 | 15,722 | 3,871 | 1,031 | 4,761 | 429 |
| Ont. | 90,345 | 43,091 | 19,190 | 19,339 | 90,262 | 8,086 |
| Man. | 33,522 | 12,191 | 3,225 | 5,945 | 22,219 | 1,371 |
| Sask. | 82,285 | 33,251 | 8,961 | 24,361 | 103,753 | 8,130 |
| Alta. | 58,698 | 26,186 | 10,210 | 19,000 | 83,427 | 7,229 |
| B.C. | 10,902 | 5,289 | 2,746 | 3,491 | 14,754 | 1,287 |
| | 353,290 | 140,260 | 49,841 | 74,102 | 322,938 | 26,807 |

Sources: Columns (1)-(3). Dominion Bureau of Statistics 1961 Census of Canada: Agriculture, Bulletin 5.1-1, Ottawa: Queen's Printer, 1963, p. xii.

Columns (4)-(6). Department of National Revenue, Taxation Statistics, 1963, Ottawa: Queen's Printer, 1963, Section II, Table 8.

The taxation of farming income must take into consideration the special characteristics of this natural resource industry, the vagaries of nature and markets, the prevalence of small individual operators, and the close relationship of personal and business activities. On the other hand, if equity is to be achieved, the importance of these special characteristics must be considered in comparison with those encountered by taxpayers in other lines of endeavour. In making this comparison it is necessary to keep in mind the changes which have been taking place in agriculture and, in particular, the increase in the size of the farm unit, the increased technical assistance from government authorities, improved marketing arrangements, and the increased use of scientific knowledge and business methods.

In the Canadian tax system there are numerous provisions and practices designed for the special circumstances of farming. Statutory provisions in the Income Tax Act permit the cash basis of reporting income 1/ and the averaging of farm income, 2/ and restrict the deduction of "hobby" farm losses 3/. The Regulations permit straight-line depreciation 4/. Departmental practice provides, under the "basic herd" directive, 5/ for the treatment of productive livestock as a capital asset.

In general, we have found that many of the special tax provisions and practices are no longer appropriate. Because of the changing nature of the industry, farmers, or at least those with larger incomes, should now be able to report income on a basis similar to that followed by other small businessmen. Special tax treatment intended to meet the special circumstances of agriculture has in turn led to significant inequities, anomalies and loopholes, and to administrative difficulties. These are discussed below.

Cash Basis of Computing Income

Income from farming or a profession may be computed on a cash basis under the present tax legislation, whereas income from other businesses is basically the "profit" therefrom, such profit being generally determined on

the accrual basis. Because the cash basis seldom gives an accurate measure of income, and usually results in an understatement of income because of the non-recognition of assets, we recommend that its use should be prohibited unless the farmer is an individual whose principal source of income was farming and his gross revenue from farming was less than a specified sum, say, $10,000. This recommendation has many implications for agriculture.

The failure of the cash basis to reflect accounts receivable and payable would not materially affect the income of most farms, but its failure to take inventories into account is serious because of the substantial inventories of livestock or grain which are maintained on many farms. In such cases, the cash basis permits the cost of building up the inventories to be deducted immediately, thereby giving the farmer the advantage of a tax deferment equal to the tax which would have been exigible on an amount equal to the cost of the inventory. It is true that the advantage under the present tax system is only a deferment of tax in that the cost would ultimately be allowed as a deduction; however, the deferment is equivalent, in relative terms, to an interest-free, unsecured loan, which could be of material amount, and is not granted to business generally.

The cash basis of computing income has also created an extra incentive for wealthy individuals to establish a farm as a secondary endeavour, because losses reported for the early years of operation would be artificially high due to the write-off of the costs of building up inventories and other assets.

The cash basis of computing farm income also produces results which would be unfavourable to the farmer, and has necessitated special relieving treatment. For example, upon a dispersal sale of a herd due to the death or retirement of a farmer for any other reason, the entire proceeds would be subject to tax in one year under the cash method. When a farmer is engaged in producing livestock or livestock products for sale, this problem has been relieved by the practice of treating the original purchase and ultimate sale of a basic number of animals as a capital non-taxable transaction. This is based on the

principle of the "basic herd". This procedure has been satisfactory to the farming community, but it is unauthorized in the legislation and, as will be explained below, it has produced anomalies and loopholes. It is also questionable in principle, even under the present tax system, let alone under the comprehensive tax base which we propose.

There are therefore compelling reasons for requiring farm income to be computed on an accural basis; there remains the question of whether there would be undue difficulty for the farmer in computing income on this basis. It is likely that the cash basis for farm income became established, by practice and legislation, mainly because of the rudimentary records and business practices used in the industry in the past. However, an evolution has been taking place in farming in recent years, with an increase in the size of an economic farm and an attendant increase in capital employed in buildings and machinery; successful farming operations are now more similar to those of business generally. In view of these developments and the fact that only about one farmer in ten is taxable, we believe that most of the taxable farmers are probably already maintaining sufficient information to adjust cash records to an accrual basis. This is not to say that an exact determination of farm income could be expected, because the typical farm represents a complex manufacturing operation. We therefore suggest that the tax authorities, in consultation with representatives of the industry, develop guidelines for methods of valuing inventories at the lower of cost or market. The objective, it should be emphasized, is not to take up revenue before it is realized, but to defer the deduction of the cost of inventories until their disposal.

Special Problems in Valuing Livestock. The principle of a basic herd, that is, a number of cattle treated as a capital asset, was established under a directive of the tax authorities to relieve the problem faced by a farmer upon a dispersal sale when he had been computing income on a cash basis. Under this procedure a farmer may elect to set up a certain number of cattle as a

basic herd, in which case he does not deduct their cost from income and, upon reduction in the number of such animals by sale, the proceeds are not taxable. As we have said, this procedure has proved satisfactory to the farming community, and we received some representations that it should be supported by legislation.

Upon detailed examination, however, we have found that the basic herd procedure is an undue administrative burden and results in significant inequities and anomalies. For example, because the practice of treating productive livestock as a capital asset is not supported in the legislation, and probably would not be supported by the courts, it has remained possible for a farmer to claim a loss on disposal of a basic herd.

We understand that it has proved very difficult to determine for an established herd the number of animals whose acquisition costs did not reduce taxable income. For example, if a farmer has been on a cash basis, and a herd had been established in years for which records are no longer available and when losses as well as profits were incurred, it is not possible to establish whether the purchase price of the animals had reduced taxable income. We understand that most of the farmers applying to use the basic herd principle recently have been those who have had herds since 1947, and that this problem of establishing whether the animals' costs had been charged against taxable income still persists. For a farmer who has consistently been on the accrual basis, it is evidence that the acquisition costs had not been charged to taxable income to the extent that an inventory value was set up. However, in view of the method of inventory valuation which will be referred to below, the capitalization of the basic herd can be achieved at arbitrarily low values.

We have therefore concluded that the basic herd procedure should be discontinued except in those cases in which the farmer is permitted to continue his accounting on the cash basis. The continuance of this restricted use of the basic herd procedure should be established by legislation. The

difficulty arising upon the dispersal sale of a herd when using the cash basis of reporting income will not arise to the same extent under the accrual basis of accounting. Where there are abnormal profits resulting upon the final realization of a herd, the farmer will have recourse to the averaging provisions which we recommend. Because of the difficulties of ascertaining the actual cost of productive livestock, its inventory value might best be determined by using a conservative proportion of market value.

We should also mention section 1802 of the Regulations which, in general terms, permits a cattle breeder to value each animal of a species for inventory purposes at the same value as in the closing inventory of the previous year, or, if it is a new species, at a value comparable to that used by other taxpayers in the taxation district. In view of our general recommendations in Chapter 22 that inventories should be valued at a reasonable approximation of cost and that business inventories generally should be related to current costs even under the last-in-first-out method, this particular regulation for cattle breeders represents an unjustified exception and should be removed.

Transitional Features. The adoption of the accrual basis by taxpayers now on the cash basis would involve the immediate imposition of tax on the value of inventories and accounts receivable less accounts payable. Although this would only result in the immediate collection of tax that would have eventually been paid, in many cases it could result in severe hardships. We therefore recommend that the cost basis of the farm land as at the transition date, which would be its fair market value at that date and which would have to be determined for the taxation of property gains in any event, should be reduced by the amount of the net adjustment required to put the farm business on an accrual basis (in the case of the farms which go on that basis). The effect of this adjustment would be to defer bringing into income, until the farm was disposed of, the amount of the accrual adjustment.

Further discussion of the accrual adjustment is contained in Chapter 22 as it would apply to all businesses now on the cash basis. In Chapter 22 we

recommend that the requirement to compute income on the accrual basis should not apply in cases where gross revenue was less than, say, $10,000 a year pending the rendering of assistance to these small businesses in putting their records in order. Where a cash basis was continued, so also should the use of a basic herd be continued if applicable.

The tax value of the basic herd should also be increased to current market values, but in this case the amount of this adjustment should be regarded as a tax-free gain as would be the case on a sale of the basic herd under the present practice. This would involve a valuation of the basic herd as at the effective date of the legislation.

Personal Aspects of Farming

The segregation of personal and business factors is particularly difficult in farming operations in two main respects. First, the farmer usually lives on the farm, and consequently there has to be an apportionment of specific expenditures on the house into business and personal elements, and an identification of the produce consumed personally. Second, while almost every farming enterprise involves certain expenditures of a personal nature, there are some situations where a farm operation as a whole is carried on for personal rather than commercial reasons.

Specific Expenditures. The deductibility of specific farm home expenses is governed by the general provisions of the legislation applicable to income from a business or property, which allow a deduction for expenses incurred for the purpose of earning income, 6/ if they do not represent personal or living expenses 7/. In applying these provisions to farming, the following guidance is given in The Farmers' and Fishermen's Guide, published by the tax authorities:

> "If the home on your farm is used to earn farm income you may claim an amount not exceeding one quarter of all repairs to the home and a reasonable portion of the cost of light, power, taxes, telephone and fire insurance.
>
> "For a farm home, the capital cost allowance is based on not more than one fourth of the cost."

In practice, it is understood that the total cost of light, power, taxes, telephone and fire insurance is usually allowed. If the house is more luxurious than normal, the deduction permitted may be lower.

It appears to us that this practice is not in accordance with the provisions of the legislation referred to above, and we recommend that it be brought into line with that accorded other taxpayers such as doctors and storekeepers who use certain facilities both for business and personal purposes. If the determination of a reasonable portion in each case is too difficult to administer, a small percentage of all farm home expenses might be universally allowed, additional amounts being permitted only where supporting evidence was given to justify it.

With respect to farm produce consumed personally, the practice is to add to the income of the farm the out-of-pocket cost of such produce, and this appears satisfactory because it does not seem practical to impute an element of profit to it even though the economic benefit is greater than the cost.

"Hobby" Farming. There remains for consideration the treatment of those farm operations carried on as a hobby or sideline 8/. The motives may be varied: a natural interest in agriculture, a country place for recreation, future land development, creation of an asset out of what otherwise would have been highly taxed income (especially if the farm operation is reported on a cash basis), and so on. Aside from the proper separation of the income from the business element, how is the personal element to be segregated? When does it become predominant?

The general approach under the present legislation is to limit the deduction of a farm loss in a year to a maximum of $5,000 where the taxpayer's chief source of income for the year is neither farming nor a combination of farming and some other source 9/. Any balance of a loss unabsorbed may be applied against farming income in other years under the ordinary loss carry-over rules. This provision has, however, had a two-sided effect: a limitation on one hand but, on the other, an apparent invitation to claim a limited

deduction for any farming operation. We do not have any exact figures of the farming losses claimed by individuals in occupations other than farming 10/. Unpublished figures supplied to us by the Department of National Revenue for taxpayers in Canada reporting income of over $100,000 in 1960 show that, out of 549 such taxpayers, 59 reported farm operations and 52 reported losses. Of these losses, 31 were in maximum amount of $5,000. In view of the prevalence of losses in these part-time farm operations, it is perhaps reasonable to conclude that many of them were maintained for predominantly personal rather than business purposes.

Modifications can be made to improve the present legislation. We recommend that accrual accounting be required for larger farm operations, that a more concerted effort be made to disallow for tax purposes expenditures of a personal nature, that there be a reduction in the top personal rates of tax, and that gains on land transactions (above the recommended exemption for specified cases) should be included in the tax base. These measures should lessen the incentive for taxpayers to use farming of a personal or hobby nature for their tax advantage.

Another possible change could be the removal of ministerial discretion in connection with the "chief source of income" test, and basing that test on farming activity over a number of years rather than on one year. Alternatively, a maximum lifetime limit, say, $15,000, could be placed on the net amount of farm losses which could be claimed against other income, the balance of any losses to be allowed only against farm income in the future. This would give the bona fide farmer some time to get established, but after that he would have to make profits in some years in order to claim losses of other years.

We concluded, however, that the existence of "hobby" businesses was not limited to farming, and that, as part of an effective prohibition against the deduction of personal expenditures, it would be necessary to adopt a broader legislative provision. In addition, we concluded that further attempts to define "hobby" farming were unlikely to be any more successful

than past efforts, and that a more arbitrary and certain guideline was needed to indicate when losses should be disallowed as being of a personal consumption nature. Therefore, as we indicate in Chapters 9 and 22, we recommend that, once a business has had losses in three years out of five, it should thereafter (until it had made sufficient income from the same business to recoup such losses) be deemed to be a "hobby" business, and subsequent losses should not be allowed as a deduction from other income but should be carried back two years and forward indefinitely only for deduction from income (if any) of the same business. 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 should be noted that this proposal is considerably more liberal than the present hobby farm provision as it would permit an unlimited write-off against other income of the losses in the first three loss years. It should also be pointed out that we recommend in Chapter 22 that a business should not be required to reduce its income (or produce a loss) by claiming capital cost allowances.

In view of the more general provision proposed above, section 13(1), which now restricts the deduction of farming losses from other income, should be withdrawn.

Income Averaging

Under the present legislation, a taxpayer whose chief source of income is farming (or fishing) is entitled to average his income for a five-year period and pay tax as if his income for each year had been the average amount 11/. It is a "block" type of averaging under which the periods of averaging cannot overlap.

Subject to technical limitations concerning the "chief source of income" test, it appears that these averaging provisions have operated satisfactorily to even out the fluctuations of farm income which result from the unpredictable

effects of nature and markets. The need for such averaging still exists but, in view of our recommendation in Chapter 13 to permit all taxpayers to use a method of averaging, the present limited provisions applicable to farmers should be repealed.

Capital Cost Allowance

When the general change from the straight-line to the diminishing balance method of depreciation was made in 1949, farmers (and fishermen) were permitted to continue on the straight-line method if they wished 12/. It is difficult to see why this exception was made, because there appear to be no special circumstances which make the straight-line depreciation method more suitable to farming than the diminishing balance method. In fact, the reverse would seem to be true, for the diminishing balance method is simple to operate, and usually provides a better measure of the loss in value of depreciable assets on the farm. In addition, the exemption from tax of recaptured depreciation on the disposal of depreciable assets under the straight-line system is an inequity and has led to abuse. Accordingly, we recommend that this exception to the application of the diminishing balance method should be removed.

In Chapter 22, we discuss the general problem of "nothings", or expenditures that are not deductible under the present legislation. Our recommendations in that chapter would apply equally to farming, and would ensure that all expenditures reasonably related to the earning of farm income would be deductible, either in the year incurred or through capital cost allowance.

One specific category of asset should be mentioned. At the present time no deduction is permitted for the capital cost of orchards. This treatment is unrealistic, and we recommend that orchards should be treated like other depreciable assets.

Sale of Depreciable Property to a Child

Section 85H of the Income Tax Act provides that, where a parent sells depreciable farm property to his child, the price paid, provided it does

not exceed fair market value, will be recognized as the capital cost to the child, even though the price may have exceeded the original cost to the parent and thereby have created a non-taxable gain to the parent. Aside from the fact that this provision also applies to certain fishing assets, this is the only exception to the general rule in the present legislation 13/ that on a sale of depreciable property between related persons the depreciable amount cannot be higher than the capital cost to the vendor. At the present time, therefore, the farmer has considerable freedom in setting the price at which he sells depreciable property to his child, for if it is at a nominal price it does not offend the fair market value rule (which is generally not applicable to depreciable property transferred between related persons) 14/; and if it is at fair market value, the price constitutes the capital cost to the purchaser even though it may create a non-taxable gain to the vendor.

Because all proceeds on disposal of depreciable assets would be taken into account for tax purposes under our proposed system, we make the general recommendation in Chapter 22 that the fair market value test should be extended to depreciable assets transferred between related persons, and we recommend that this general rule should also apply to depreciable farm property. It may be contended that this would impose hardship because it would force a farmer to sell his property to his child at nothing less than fair market value. However, not only is this treatment the same as that proposed for property generally and for other kinds of business but, in addition, the farmer would be eligible for the lifetime exclusion of $25,000 for realized gains on residential and farm property that we recommend in Chapter 15. Thus, the owner of even a moderately sized farm would normally be exempt from tax on the disposition of his farm, and the purchaser, for example, his son, would be able to claim depreciation on the fair market value of the property acquired. The only change in most cases in which a farmer transferred a farm to his son would be the requirement to recapture depreciation.

If a farm operator wished to confer a benefit on his child by transferring the farm at less than fair market value, it should be recognized

for what it was, a gift, and should be subject to the usual rules set out in Chapter 17. It should be noted that, if the proposed lifetime exemptions for gifts received had not been used up by the son's family unit, a transfer at a price below market value would be exempt from tax to the extent of $5,000 for each of the son and his wife.

Sale of Farm Land

In accordance with our comprehensive tax base, any gain realized on a disposal of farm property would be taxable. We recommend in Chapter 15 that such a gain should be eligible for the lifetime exemption of $25,000 which applies to gains on the sale of residential properties and farms.

Revenue Effects

The most important of our suggested changes in terms of revenue would be the adoption of accrual accounting, which would not permit the deduction of the cost of increasing inventories 15/. In addition, net changes in accounts receivable and payable would be taken into account in computing income. The exemption from tax of profits on the disposal of basic herds would disappear.

The stricter segregation of personal expenditures on the farm, and the stricter treatment of farm operations carried on for personal rather than commercial reasons, would produce some additional revenue. Adoption of the diminishing balance method of depreciation would tend to reduce tax revenue. Against this, however, tax revenues would be increased by taxation of depreciation recaptured upon disposal of depreciable assets.

In terms of overall income tax revenue, these changes should not be material. On balance, there should be some increase 16/.

## FISHING

This natural resource industry has characteristics similar to those of farming. It is affected by the vagaries of the weather, the fluctuation in the supply of fish due to disease and changes in the life cycle, and the prevalence of many small operators.

The specific provisions in the legislation for the farming industry concerning income averaging, the use of straight-line depreciation and the sale of depreciable property to a child also apply to the fishing industry, as do our recommendations regarding them.

## FORESTRY

As a natural resource operation, forestry may be viewed as a unique kind of long-term crop. Like other crops it is renewable, but a very long time is involved in the process. Furthermore, it may not be possible to obtain a new crop similar to the previous one, so that a timber stand is a constantly changing asset. These basic characteristics, together with the great variety in forms of ownership, have created problems in measuring income for tax purposes, especially by reason of the application of the distinction between capital and income which has been followed in Canada.

### Measurement of Income

A measurement of the change in real value of a privately owned forestry operation would have to take into account the imperceptible increase naturally occurring in the value of the timber. Aside from the difficulty of making such an estimate, the amount estimated, even if accurate at the time, might be subject to considerable subsequent variation. In the long period of time before realization of income, changing markets, technology, and the natural hazards of fire and disease could make the previous estimate quite inaccurate. An annual period of measurement is clearly inappropriate for forestry and, accordingly, the measure of the income of a forestry operator for tax purposes in terms of annual change in economic power is bound to be imprecise.

Deduction of Cost

Public and Private Ownership. Most of the productive timber resources in Canada are provincially owned, and a stumpage charge is imposed on the forestry operator at the time of cutting. For the privately owned forest there would have been an initial cost of acquiring the property, and the main recurring cost paid to government is property taxes. Both types of forest are subject to other recurring costs such as fire protection and surveying. To determine whether there is any serious discrimination between public and private ownership, a comprehensive review of all types of costs and the various provincial and municipal taxes would be required. This is clearly beyond the scope of this Commission, but at least we must consider the effect on income taxation of the time at which costs are allowed.

We have considered whether the private owner who has to carry an investment in timber resources would be on a more nearly equal footing with a lessee of timber resources if he were allowed an immediate deduction for his investment. It appears to us that there is some merit in this suggestion, but on the other hand there are advantages to private ownership which offset the burden of carrying an investment. These include the ready availability of a source of raw material and, in some cases, the right to harvest crops indefinitely in the future. From the evidence presented to us it appears that private ownership of timber resources is valuable, and accordingly, we do not see any need for an immediate deduction by private owners of the cost of timber limits.

At the other end of the scale, we considered whether the cost of timber properties which carried a right to all future crops should be subject to any amortization for tax purposes, especially with the development of sustained yield operations. The degree of success in indefinitely sustaining the yield of a forest must be extremely varied, and a considerable time elapses before realization of future crops occurs. Accordingly, the amortization of cost seems best made in respect of the crop obtainable in the immediate future.

Timber Limits or Rights. Timber limits or rights can take a multitude of forms, varying from a right to cut specific trees out of a given area, to complete ownership of the land and its timber.

The general approach under the present tax legislation is to permit the forestry operator to claim a deduction for the cost of his timber rights as the timber is cut, calculated on a production basis 17/. Although this is commonly referred to as a depletion allowance, it is an amortization of cost and is therefore unlike the depletion allowance granted to oil and mining operations, which is based on a percentage of profits. An amortization of costs, rather than a deduction of a percentage of profits, produces a better measurement of business income. Furthermore, relating the amortization to the production is a more accurate way of matching the cost against resulting revenue. Any attempt at amortization on the basis of the time period of the limit or right would be futile because of their extreme variability in form, though not necessarily in substance.

Under section 1101(3) of the Regulations, each timber limit or right is to be treated as a separate class. In practice, however, companies often group different limits together and base their amortization on the group of limits, and this practice is accepted by the tax authorities. Schedule C of the Regulations requires that the cost subject to amortization should not include the residual value of the property, that is, the value after the merchantable timber has been removed. In practice, however, such a value is seldom assigned, and the complete cost of the limit or right may be written off even though a residual value exists. Thus, there is considerable divergence between practice and the law. If the allowance is to be calculated on a production basis as set out in the legislation, the provisions either would have to be much more complicated so that they would be precise, or would have to be set out briefly in broad terms. Because the amortization of the cost of timber limits or rights is usually a relatively minor part of the costs of large, integrated forestry operators, the latter approach is probably the better.

Another approach would be to bring the allowance for the cost of timber limits more into line with the capital cost allowance system generally by placing all costs in a class subject to a diminishing balance rate of amortization. Advantages of this system would include the allowance of a cost regardless of the actual production from specific limits, and the recognition of a continuing value where the rights to future crops exist. For the large forestry operators it might be possible to find a rate which would correspond to their usual experience. For a small forestry operator it would be difficult to find a rate which would be generous enough and, accordingly, some option to claim on a production basis would have to be given.

In view of these considerations we recommend that, for the measurement of business income from a forestry operation for tax purposes, the cost of a timber limit or right should continue to be amortized on a basis related to production, but in broader terms than at present. Provisions regarding residual value of the timber limit should be retained and enforced, although, for reasons explained below, this distinction would be of less importance if our recommendations relating to the disposal of timber properties were adopted. Survey and other costs incurred in acquiring a timber limit or right should be added to the cost of the timber limit or right and not, as at the present time, be written off on the basis of one tenth a year. In addition, during the operation of a timber limit, the taxpayer may have to do additional surveys, or he may have to incur costs in making unsuccessful applications for other timber rights, neither of which may be allowed under the present legislation. Our proposals to deal with "nothings" would take care of the latter items.

<u>Woods Assets</u>. A taxpayer may construct in the woods such assets as roads, bridges or camp buildings, which will be of no further use to him once the merchantable timber has been removed. Under the present legislation, the taxpayer has an option to write off the cost of such assets on the diminishing

balance basis at an annual rate of 30 per cent or on a production basis 18/. In general, the diminishing balance basis appears to be preferred. Mechanical equipment used in the woods is eligible to be written off at the rate of 30 per cent on the diminishing balance basis. These allowances appear to be operating satisfactorily, and we have no specific recommendations to make concerning them.

Carrying Charges. Generally speaking, carrying charges are those recurring costs of owning property which bear little direct relation to the use of the property or to changes in its value. They are important to the owners of privately owned timber limits, for, while it can be said that they do not specifically add value to the property, these costs are, because of the long maturing period of timber, essential costs to the owner if the increase in the value of the timber is to accrue to him. Furthermore, such costs can be more important than the original cost of the timber limit if a long period of time is involved.

Under the present tax legislation the carrying charges on timber limits or rights are usually allowed as operating expenses, although occasionally disallowance has occurred on the basis that carrying charges on inoperative properties are either not for the purpose of earning income or are outlays of a capital nature. As we shall see in the section below concerning disposal of timber properties, the exemption of capital gains makes the treatment of these carrying charges very important under the present legislation.

The proper matching of carrying charges against realized income is an almost impossible task, and any attempt to defer them as costs of earning income in future years could be frustrated by fire, disease and changing conditions. Although the results of a forestry operation over a long period of time are more predictable than, say, the results of exploring for minerals or oil, or of the building up of goodwill by an ordinary business corporation, the same general treatment appears appropriate. We therefore recommend that the tax legislation clearly allow carrying charges on timber limits and rights

as a current expense, although the taxpayer should be permitted to capitalize them if he so elected. Therefore, these expenses would not be lost as a deduction merely because of the long period of time involved before the resulting revenue is realized.

Reforestation. In Canada, the renewing of timber resources occurs mainly through the natural processes of nature. In some areas, however, and with certain types of trees, these natural processes are not adequate, and artificial reforestation is carried out at considerable cost.

The general tax treatment is to permit reforestation costs as a current expense if they are intended to replace the previous stock of timber, but to disallow any portion which would tend to increase the previous potential.

With increasing development of forest management policies, the treatment of reforestation costs as a maintenance item has a semblance of reasonableness. However, we have already concluded that the best approach to the matching of costs and revenue in the forest industry would be to look to the immediate crop of timber only. In this light, reforestation is theoretically a cost of developing an asset beyond the immediate future and should be deferred to the future. However, if reforestation is a required condition in removal of the present crop, and does not carry with it any rights for future cutting, its cost is reasonably related to the present. The immediate allowance of such costs may also be justified on other grounds. These would include the time gap between the costs and the resulting revenue, the achievement of equity between those timber owners whose reforestation occurs by natural processes and those who must adopt artificial means, and the general economic desirability of encouraging conservation. In view of these considerations, we recommend that it be made clear that the cost of reforestation would be allowed as a current expense. An exception might be made in the case of trees grown for sale as Christmas trees, where the period of time involved is much shorter.

Proceeds from Disposal of
Timber Limits or Rights

Under the present tax treatment, the first question to be settled is whether a disposal represents realization of a capital asset or a transaction in the ordinary course of trade. If it is the latter, the profit is fully taxable, whereas the former is taxable only to the extent that the proceeds may be considered to represent recaptured capital cost allowances 19/.

Where a taxpayer has taken all the timber of commercial value to him from a timber limit and claimed the entire cost, it is still possible that proceeds from a sale of the property may be considered to represent a recovery of capital cost allowance even though the specific property for which the allowance was claimed no longer exists.

The satisfactory application of the recapture rules depends on an allocation being made between the merchantable timber, the remaining timber, and the remaining value of the land and mineral rights, etc. This is an extremely difficult thing to do, as evidenced by the fact that residual value of timber properties is seldom recorded in practice.

It is anomalous that, although the gain on disposal of a timber limit may be treated as a non-taxable capital receipt, the carrying charges incurred in developing the limit could well have been allowed against other income in earlier years. Furthermore, the exemption of a gain on a block disposal of a timber limit encourages taxpayers to sell out for a tax-exempt gain rather than to operate for taxable gains. While there is little evidence that this has affected the actions of large forestry operators, it has probably influenced the actions of small ones.

The adoption of the comprehensive tax base we propose would require that all proceeds on disposal of a timber limit would be taken into account for tax purposes. The difficulties referred to above in dealing with the proceeds would disappear. Of course, an allocation among the elements of a

timber limit would still be needed in establishing the timing of deductions for the purchaser. There would be no problem in deciding whether certain expenses would be allowed or not.

Provincial Logging Taxes

Until recently, provincial taxes on logging income were deductible in the computation of income in a manner similar to the deduction given for provincial taxes on mining income 20/. For 1962 and subsequently, however, the allowance was changed to a tax credit. The lesser of two thirds of the provincial logging tax or 6-2/3 per cent of the taxpayer's logging income in the province is permitted as a deduction against federal income tax, 21/ and one third of the provincial logging tax is permitted as a deduction against provincial tax in Ontario and Quebec, and 18 per cent of the provincial logging tax against provincial tax in British Columbia.

For the same reasons given in Chapter 23 concerning provincial mining taxes, we recommend that provincial logging taxes should be treated as an expense and that no federal tax credit should be allowed.

Concessions to the Industry

The risk to which the industry is exposed arises mainly from the time factor in producing mature timber. For tax purposes, compensation for this feature may be found in early allowance of costs and the generous treatment we recommend in respect of carrying charges and reforestation costs, proposals that will have the incidental effect of benefiting the taxpayers in this industry and encouraging preservation of this natural resource. A further form of encouragement of privately owned timber limits and rights could be achieved by adopting a diminishing balance basis of capital cost allowance which could be claimed regardless of production. However, we do not believe that such a concession is warranted.

### Revenue Effects

The recommendations concerning the write-off of costs would tend to defer revenue slightly. On the other hand, the taxation of all gains from disposal of timber properties would increase revenue slightly, although the effects would be sporadic. On balance, the effect on revenue would be relatively minor.

## CONSTRUCTION

The construction industry has some characteristics that raise special problems of taxation. The most troublesome characteristic is the length of time that it may take to complete a single unit of production, for example, a bridge, a dam, or a large building. Many projects last more than a year and they do not fit easily into the pattern of taxing annual profits. Thus, it is relevant to consider how much reliance should be placed on accounting practices in computing income.

### Measurement of Income

Contracts in the construction industry can be divided into four classes:

1. Fixed-total-price contracts, under which the contractor agrees to perform specified work for a fixed sum.

2. Fixed-unit-price contracts where the price is fixed by reference to units of work done, for example, so much per yard of asphalt laid.

3. Cost-plus contracts where the contractor is entitled to cost plus a fee related to costs.

4. Fixed-fee contracts where he is entitled to cost plus a fee of a fixed amount.

In fixed-total-price and fixed-fee contracts the progress billings are based on the contractor's estimate, usually approved by the architect or supervising

engineer, of the proportion of the total work done. These progress billings are seldom paid in full because, under provincial laws and often under the contract itself, between 10 per cent and 20 per cent of the amount billed is held back by the owner until the project is completed. Completion is signified by the architect's or engineer's acceptance of the project, and the hold-backs are then paid over to the contractor.

There are two generally accepted methods of accounting for income from construction contracts. The first is the "completed contract" method, under which no profits are recorded from a contract until it is completed or substantially completed. The other is the "percentage of completion" method, under which a proportion of the estimated total profit from a contract is taken up periodically according to the contract's stage of completion. The ratio of costs incurred by the end of a period to total estimated costs is generally considered to be the best measure of the degree of completion. The ratio of progress billings to the total contract price is not usually considered to be a suitable measure, because progress billings may be based on optimistic estimates of the degree of completion and may have been rendered in the hope of accelerating the cash flow from the contract.

The completed contract method is most appropriate for fixed-total-price contracts when major uncertainties or hazards make it impossible to estimate the financial outcome with any reasonable certainty until a large part of the work has been done. On the other hand, the percentage of completion method is appropriate when a minimum profit is assured, as in a fixed-fee or cost-plus contract. Under a fixed-unit-price contract, there may be some uncertainty as to the proportion of total profit while the project is in progress, because the average cost per unit over the whole contract may vary with the total number of units, which is still unknown, or the direct costs of each unit may vary by the nature of the work, even though the price per unit is fixed. However, the percentage of completion method would usually be followed. The major factor which makes the completed contract method the

more suitable is a high degree of uncertainty as to the final profit in a contract, and this is most evident in the fixed-total-price contract.

Present Tax Treatment

For several years prior to 1960 the Department of National Revenue used an arbitrary time basis for permitting certain fixed-total-price contracts to be reported on the completed contract basis. The procedure adopted by the Department was to require the percentage of completion method for cost-plus, fixed-fee and fixed-unit-price contracts and those fixed-total-price contracts lasting at least two years; and to accept, at the taxpayer's option, either the completed contract or the percentage of completion method for fixed-total-price contracts lasting less than two years. Thus, the only circumstances in which the completed contract method was accepted for tax purposes was for fixed-total-price contracts lasting less than two years. The tests for the suitability of the completed contract method were therefore the type of contract and the length of the contract, rather than the degree of uncertainty in its outcome.

While the fixed-total-price contract is the most suitable for the completed contract method, the length of a contract is not necessarily a measure of its risk, and therefore the distinction used for tax purposes did not fully accord with accounting and business concepts. Nevertheless, it appeared to work well and many contractors adopted the assessing procedure to record profits in their accounts. The main complaint was that assessors were unduly reluctant to accept anything other than the profit originally budgeted on a contract as the basis for the percentage of completion method, and taxpayers urged that the completed contract method should also be permitted for fixed-unit-price contracts lasting two years or more. From the Department's point of view, an objection to the unlimited use of the completed contract method was that the completion of short-term contracts was sometimes artificially delayed.

From about 1960 on, business and taxation calculations of contract profits began to diverge widely as a result of two cases—M.N.R. v. John Colford Contracting Co. Ltd. 22/ and Wilson and Wilson Ltd. v. M.N.R. 23/. In the Colford case the Supreme Court affirmed the finding of the Exchequer Court that hold-backs were not income until the contractor became entitled to receive them, which was usually not until the supervising engineer or architect approved the completed project. In the Wilson and Wilson case the Exchequer Court concluded that the completed contract method was not acceptable for income tax purposes, and that the proper measurement of income was to be based on the amount of progress billings made to the end of the year less the contract costs incurred to the end of the year, including the cost of materials delivered to the job site. While it was also suggested that section 85B required the gross amount of progress billings to be included in income, this part of the judgment was effectively reversed by the decision of the Supreme Court in the Colford case. The combined result of the two judgments, which is often referred to as "the legal basis" of contract accounting, is that, when a contract is in progress at the end of a fiscal period, the income to that date is the difference between progress billings then rendered, net of hold-backs, and all job costs then incurred. A taxpayer may now choose to compute his taxable income on the legal basis or according to the two-year rule, because the Department still accepts the latter method. From the contractor's point of view, the legal basis is usually more advantageous than the two-year rule because, at a mid-point in a contract, costs incurred, including materials delivered to the job site, often exceed progress billings net of hold-backs. The legal basis, because it does not require hold-backs to be included until the project has been accepted, is almost always better for the contractor than the percentage of completion method. The legal basis usually defers the tax liability longer than any usually accepted accounting method, and thereby improves the taxpayer's cash flow.

Using progress billings rendered to determine the contract profit at a mid-point is not a method that the industry has ever considered suitable for business purposes, because it can result in a substantial overstatement of the interim profit.

Appraisal

Because we would like to see a close correlation between business and taxation concepts of income, we consider the present situation in the construction industry to be unsatisfactory. We have stated that wherever possible income should be measured and taxed as it accrues. Accounting methods have been developed in the construction industry to record income as earned, and we believe that, as a means of determining contractors' taxable income, normal accounting methods would be preferable to the legal basis which has been developed. Unfortunately, for purposes of a tax system, the degree of risk in a contract, which is the logical factor for deciding whether to use the completed contract or the percentage of completion method, is not one which can be used because it is so difficult to determine. Discussions between the Department and taxpayers as to the risk on particular contracts could only be frustrating to both sides. If the method followed in a taxpayer's accounts were to be applied for tax purposes, the completed contract method would likely come more widely into use, to the detriment of both the tax revenue and accounting practices.

Some more workable, even though arbitrary, method must be found. The two-year rule which was administered fairly successfully in the past is one such solution. We can suggest another and, we think, a better one. At the taxpayer's option, consistently exercised, no profit would be taken up on any fixed-total-price contract until the costs directly applicable to the contract (excluding any allocations of administrative overhead) exceeded 35 per cent of the contract price, excluding extras. We suggest direct costs and contract price as the elements of the formula because they are less open to argument than other bases of measurement, such as total costs incurred

and total estimated costs. Almost one half of the work would have been done by this point, and thenceforward sufficient information would usually be available to make a reasonable estimate of the contract profit or loss. Once direct contract costs exceeded 35 per cent of the contract price, the percentage-of-completion method would be used. The percentage-of-completion method should be required for the other three types of contract regardless of the stage of completion. The nature of the percentage-of-completion method to be used should be prescribed by regulation, and should be based on the proportion of costs incurred rather than on billings rendered. Estimates of profits would, of course, include the amount of any hold-backs. The Regulations should also provide for a reasonable increase in estimated costs due to problems which were known to exist at the year end, and for the full deduction of an estimated loss on a contract as soon as costs exceeded the 35 per cent mark.

It seems to us that an arbitrary rule such as this would work more equitably among various contractors than the two-year rule which tends to favour the contractor dealing principally in short-term contracts. It would also remove any tax advantage from delaying the completion of a contract, and would eliminate the disputes that now arise as to whether a contract is completed. With the recognition of estimated costs of completion and full deduction of losses at an early stage in the contract, the two-year carry-back of losses we recommend elsewhere should be quite adequate for the construction industry. By setting out the rules in the Regulations, the present legal basis and the accounting principles in this area would be overridden to give a more satisfactory result for tax purposes.

## GENERAL INSURANCE

For the purposes of this discussion, the term general insurance includes all classes of insurance other than life insurance. In broad terms, all general insurance written falls within the classifications of automobile, casualty, and fire. The general insurance business in Canada is carried on

by Canadian-controlled joint stock and mutual companies, foreign-controlled companies, and branches of foreign companies. These foreign companies are also joint stock and mutual.

The main tax considerations relate to provisions for policy claims (commonly referred to as "reserves"), mutual insurance, and the treatment of foreign companies operating in Canada.

Provision for Policy Claims

General insurance is intended to cover losses that might occur as a result of injury or damage to persons or property, and the "reserves" are the amounts set aside to meet these losses. The obligation of the insurer to pay claims is based on unpredictable events and therefore determining the appropriate provision for policy claims is not easy. The risk insured against is generally uniform throughout the term of the policy, usually from one to three years. It is therefore unlike the risk under certain types of life insurance policies where the contingency insured against will inevitably occur, and the chances of occurrence increase with the length of the policy term.

The provisions allowed for tax purposes in section 85B(5) of the Act and section 1400 of the Regulations are the unexpired portions of the premiums calculated on a time basis, plus certain other policy reserves required to be included in the annual statement filed with the Superintendent of Insurance, or, if the corporation is not required to submit financial statements to the Superintendent, the provincial authority under whose jurisdiction the corporation was incorporated. These other policy reserves are linked to specific groups of policies and do not include any general contingency reserves. Their purpose is to cover peculiar risks under guarantee and nuclear insurance, and to provide some reserve for group accident and sickness policies which, because they are generally written on a monthly basis, require little or no reserve under ordinary calculations.

Representations were made to us suggesting that an additional deduction should be allowed for tax purposes equal to the 15 per cent excess of allowable assets over liabilities as required under section 103 of the Canadian and British Insurance Companies Act 24/. It was also suggested that a deduction equal to 25 per cent of the yearly reserve for claims be permitted to cover catastrophic and abnormal events.

The general provision for estimated losses involves relating revenue to the year in which it is earned. This provision should be reduced by an estimate of agents' commissions paid in respect of the unearned premiums that have been written off as expense. Reasonable provisions should be allowed against losses which have occurred in the taxation year but for which final settlement is delayed. However, no provision should be permitted for occurrences which have not taken place, because to do so would be to anticipate possible future events. Accordingly, neither the additional specific policy reserves required in statements filed with the Superintendent of Insurance, nor the additional contingent reserves on which we received representations, should be accepted for tax purposes. Although these are intended to help ensure the solvency of the companies, it is not the function of the tax system to regulate the industry. It may also be noted that, if taxes should be overpaid because of an over-estimate of income in the early years of certain policies, they would be recoverable under the two-year carry-back of losses. However, one type of special reserve is related to events that have taken place in the year but have not given rise to claims as at the year end. Thus, specific provisions for guarantee insurance should be allowed, to the extent that they are based on an estimate of losses that occurred during the year.

Mutual General Insurance

Basically, mutual general insurance companies are owned by the policyholders and have various methods of raising working capital, setting premium rates, and paying policy dividends. One type of mutual organization, whose

operations are similar to those of a stock company, is called a cash mutual. Some cash mutuals charge single cash premiums for their policies, sometimes called non-assessable policies. The policyholders of large cash mutuals can become increasingly separated from the management in the same way as shareholders of large and widely held joint stock companies.

Another type of mutual is known as a premium note mutual. These organizations issue what is known as an assessable policy by taking a note for the premium based on the estimated cost of the insurance. Assessments are levied against the notes for cash to carry the overhead and other expenses and losses. Many mutual insurance companies started business as premium note mutuals, but recently they have tended to charge premiums in the same way as joint stock companies by the issue of non-assessable policies.

The remaining incorporated mutuals charge premiums which can range from a close estimate of the cost of the insurance to an amount considerably exceeding the estimated cost. Some of the organizations return almost all the excess to policyholders in the form of policy dividends, while others retain substantial amounts of the excess premiums as reserves. In the latter group the excess premium charge is often called a deposit premium. Factory mutuals that usually underwrite certain heavy risks in the manufacturing industry operate on the deposit premium basis.

Prior to 1947, mutual insurers were exempt from income tax under section 4(g) of the Income War Tax Act, while joint stock insurers were taxable under the general law. Pursuant to the recommendations of the 1945 Royal Commission on Co-operatives, the specific exemption for mutual insurance companies was repealed in 1947. In 1953, however, it was held by the Supreme Court of Canada that a mutual fire insurance company was not carrying on business for profit and therefore was not liable to tax on its income 25/. Section 68A was enacted in 1954 and imposed a tax on non-life mutual insurers.

Mutual insurance corporations receiving premiums wholly from the insurance of churches, schools, or other charitable organizations are exempted

from tax by section 62(1)(j) of the Income Tax Act. The 1945 Royal Commission also recommended that exemption from tax be granted to insurers which derived 50 per cent of their gross premiums from the insurance of farm and fishing property, and in 1954 section 62(1)(s) was introduced to this effect.

Our aim in the taxation of all mutual organizations is to tax the economic gain arising from the mutual operation. However, as is already obvious from the description of mutual general insurance, it is difficult to measure the gain in this field.

In principle, the economic gain to a member is the amount he saves on insurance premiums by insuring through a mutual instead of through a joint stock company. However, as in the case of life insurance premiums, it is difficult to determine just what the market rate is because there is such a variety of policies and risks. In our discussion of mutual life insurance companies in Chapter 20 we discuss the matter of pricing out, and the question of the extent to which policy dividends represent refunds of excess premiums. Our conclusion is that there should be no attempt to apportion policy dividends into the respective elements, and that such dividends should be deductible to the insurer and should be included in full in the income of the recipient. This treatment is similar to that recommended for other mutual organizations, for example, co-operatives. We accept that some pricing out will take place, but there is no feasible way of alleviating the problem, other than adopting a procedure for imputing income. (See Chapter 20.) However, in the general insurance field, a substantial proportion of the insurance written by mutual companies is issued to businesses which are entitled to deduct the premiums. In these cases pricing out is immaterial, because it would have no net effect on the income of the insured.

As far as the business income of the insurer is concerned, it should be determined in the same way as for other general insurance companies and should be taxed in full. In this regard, the exemptions granted to certain mutual

general insurance organizations are an unwarranted departure from equitable taxation, and we recommend that they should be repealed.

Foreign Companies

Under the present legislation, the business income of foreign insurance companies is calculated on the same basis as that applicable to Canadian companies, but in practice there are the following important exceptions: investment income is not included in taxable income, and no deduction is allowed for head office expenses incurred outside Canada.

At one time a deduction was allowed for head office expense, but apparently it proved difficult to arrive at some reasonable method of preventing excessive claims, and efforts were made to devise a system of taxation which would avoid the necessity of attempting to verify head office expenses, or to devise a formula for a maximum allowance. The idea of effecting a partial offset to the disallowance of head office expenses by eliminating investment income seemed to offer certain advantages. It met the problem at hand and removed what might in some circumstances be regarded as a disincentive to a foreign company to maintain assets in Canada.

This method of taxing foreign companies transacting general insurance business in Canada departs from our concept of equitable taxation. The exemption of investment income may provide some incentive for retention of assets in Canada but, in many cases, tax in respect of this income is payable in the foreign jurisdiction, so that the incentive may not be effective. We admit that there can be problems in determining reasonable allowances for foreign head office expense. However, as in the case of other businesses, no claim should be allowed except to the extent it can be shown to be reasonable. The foreign head office might be required to supply information regarding its world-wide operations to support the reasonableness of the portion of expenses charged to Canadian operations.

Therefore, we recommend that the business income from the Canadian operations of foreign general insurance companies should be determined in the same way as for Canadian companies, so that the investment income from assets required to be on deposit for the business would be included in the computation of profit, and a reasonable portion of head office expenses would be deducted.

Investment income from assets held in excess of those reasonably required for the Canadian business should be treated in the same manner as Canadian investment income of non-residents in general.

Part VIII of the Regulations provides for a reduction in the normal withholding taxes in the case of foreign companies registered with the Department of Insurance. In broad terms, the normal taxes are reduced by the proportion which Canadian liabilities are of Canadian assets. Canadian liabilities are defined to include double the amount of policy reserves as a "cushion" 26/. In view of the exemption of investment income of the business, which was granted in practice, this formula was probably designed as a method of confining the withholding tax to investment income which is not part of the income of the business. Because of our recommendation that investment income arising in the operations should be included in business income, the definition of Canadian liabilities for the purposes of the reduction in withholding tax should include only 100 per cent, and not 200 per cent, of policy reserves. This would increase the amount of investment income which would be subject to withholding tax and would reduce the amount of investment income which would be taxed as business income at the 50 per cent rate applicable to corporate income generally.

Foreign general insurance companies are exempt from the additional 15 per cent tax on the after-tax income of a branch operation imposed by section 110B of the Income Tax Act. We see no reason why Canadian branches in this line of business should receive special treatment and we therefore recommend that the exemption be repealed.

We should mention two other special features in the taxation of foreign companies. First, policies reinsured with companies not registered or licensed to transact insurance business in Canada are ignored. This usually means higher tax to the companies carrying on business in Canada, because they are required to pay tax as if they had retained the profits that normally would accrue to the company that accepts the reinsurance. However, it avoids the problem of verifying the profits or losses on reinsurance of Canadian risks ceded by a foreign head office to other foreign companies, and is probably the only practical approach under the circumstances of the business 27/.

Second, marine insurance transacted in Canada is not taken into account in computing the taxable income of a foreign company. The reason for this may be that taxation of profits of marine insurance in Canada would cause the insurance to be written at the other end of the voyage. This does not appear to be a sufficient reason for excluding the profits from such business from income, and we recommend that they should be taxable.

## CONCLUSIONS AND RECOMMENDATIONS

### FARMING AND FISHING

1. Income from farming should be reported on the "accrual" rather than the "cash" basis except in the case of an individual whose principal source of income is farming and whose gross revenue from farming is less than a specified sum, say, $10,000.

2. The use of the "basic herd" principle in the farming industry should be discontinued except where the farmer is permitted to continue on the cash basis, and the special regulation concerning the valuation of the livestock should be repealed.

3. The present administrative treatment of farm home expenses is unduly favourable to the taxpayer and should be altered.

4. The present specific restriction on the deduction of losses from hobby farming should be replaced by a general provision designed to prohibit the deduction from other income of losses incurred (after the first three loss years) by any business which consistently operated at a loss.

5. In view of the general averaging provisions recommended in this Report, the specific averaging provisions now applicable to farmers and fishermen would cease to be necessary.

6. The cost of depreciable assets used in farming and fishing should be amortized in accordance with the diminishing balance method of capital cost allowance which applies to all other types of business.

7. Profits made on the disposal of farm property should be taxable, subject to the lifetime exemption of $25,000.

8. Sale of farming or fishing property to the taxpayer's child should be deemed to be at the fair market value. If the sale price was less than fair market value, the difference would be treated as a gift.

FORESTRY

9. The cost of timber properties should continue to be amortized on a production basis, but technical changes in the current Regulations appear desirable.

10. Carrying charges and reforestation costs should be deductible as incurred. The taxpayer should have the option of capitalizing carrying charges.

11. Any gain realized on disposal of timber properties should be included in income in the same manner as gains on disposal of other types of property.

12. Provincial logging taxes should be deductible in computing income as an expense, and should not be claimed as a tax credit from federal tax otherwise payable.

CONSTRUCTION

13. There should be an arbitrary rule in the Regulations prescribing the basis for reporting profits from contracts in progress at a year end. The suggested rule is that all contracts should be reported on a percentage-of-completion basis except that, in the case of fixed-total-price contracts, percentage-of-completion reporting should not be required until direct costs have exceeded 35 per cent of the contract price, excluding extras. The percentage-of-completion formula would be based on the proportion of total costs to date to total estimated costs and would provide for reasonable adjustments in estimated costs based on known factors, and for full deduction of any estimated losses on fixed-total-price contracts as soon as direct costs exceeded 35 per cent of the contract price, excluding extras.

GENERAL INSURANCE

14. The deduction of premiums applicable to the unexpired portion of policies should be continued, but the current allowance of certain policy reserves should be discontinued and reserves for contingencies should not be permitted.

15. General insurance companies should continue to be permitted to deduct policy dividends in computing income. The exemption of certain mutual general insurance companies from tax should be discontinued.

16. The business income of Canadian branches of foreign general insurance companies should be determined in the same manner as that of Canadian general insurance companies (with certain minor exceptions).

17. Canadian branches of foreign general insurance companies should be subject to the special 15 per cent tax on branch profits under section 110B of the Income Tax Act.

## REFERENCES

1/ Section 85F.

2/ Section 42.

3/ Section 13.

4/ Part XVII.

5/ Canada Gazette, Information Bulletin No. 3, Part I, January 20, 1951.

6/ Section 12(1)(a).

7/ Section 12(1)(h).

8/ The general problem of distinguishing between activities conducted for personal and for business reasons is discussed in Chapter 22.

9/ Section 13.

10/ Department of National Revenue, Taxation Statistics, 1963, Ottawa: Queen's Printer, 1963, Section II, Table 3, shows that in 1961 individual taxpayers in occupation categories other than farming or fishing (where the individual farming and fishing losses exceeded the farming and fishing gains) filing tax returns claimed farming or fishing losses in an amount of at least $7,771,000. In addition, those filing non-taxable returns showed farming or fishing losses in an amount of at least $7,662,000. Because the figures quoted are the result of netting the losses and gains of all taxpayers in each category, the total farming and fishing losses actually claimed would have exceeded these amounts.

11/ Section 42.

12/ Regulations, Part XVII.

13/ Section 20(4).

14/ Section 17(7).

15/ At the end of 1963, the market value of farm inventories was $3 billion, of which about $1 billion was in grain and $2 billion in livestock. (This information was supplied to us directly by the Dominion Bureau of Statistics from unpublished sources.) The cost value is not known and could not be estimated with reasonable accuracy, but presumably would have been in the order of $1 billion to $2 billion, of which only a minor portion would be reported as inventory for tax purposes. In addition, most of the livestock inventory reported for tax purposes would be in basic herds, the proceeds from which would be tax-exempt.

16/ In 1961, the income tax revenue from individuals engaged in farming full time was almost $27 million, and for corporations in the farming business was $1.6 million. Individuals, other than those in the farming category, reporting taxable income claimed farm losses in the amount of at least $7.7 million. See _supra_, reference 10 for an explanation of this amount.

17/ _Regulations_, section 1100(1)(e) and Schedule C.

18/ _Regulations_, section 1100(1)(f); Schedule B, Class 10(1), and Schedule D, Class 15.

19/ Even if a disposal represents realization of a capital asset, the entire proceeds may be taxable under section 6(1)(j) of the _Income Tax Act_, if they are dependent upon subsequent production or use from the property.

20/ Section 11(1)(p).

21/ Section 41A.

22/ [1960] Ex. C.R. 433. An appeal to the Supreme Court of Canada from this decision was dismissed from the bench without written reasons, [1962] S.C.R. viii.

23/ [1960] Ex. C.R. 205.

24/ R.S.C. 1952, Chapter 31. This section requires that, at all times, a company maintain allowable assets to a value of at least 15 per cent in excess of the total unearned premiums, matured claims, and other liabilities of every kind.

25/ Stanley Mutual Insurance Company v. M.N.R., [1953] 1 S.C.R. 442.

26/ In lieu of the amount of such liabilities, an amount may be claimed on the basis of deposit requirements, if it is larger.

27/ The non-Canadian operations of these companies are not required to be reported to the Superintendent of Insurance, and the chief Canadian agent of the company may have no knowledge of the reinsurance of Canadian risks by his principal.

# PART D

## INTERNATIONAL

# CHAPTER 26

## INTERNATIONAL ASPECTS OF INCOME TAXATION

A major objective that we have sought in our proposals for the domestic tax system has been tax neutrality. A neutral tax system would contribute most to the efficient allocation of resources, and hence to the greatest output of the goods and services Canadians want, and is also a prerequisite of an equitable tax system.

It will be evident by now that the economic and administrative realities of the practical world have forced us to accept compromises with true neutrality and equity in our domestic tax proposals. In our proposals for the taxation of international income we have had to make even greater concessions since here the administrative and economic problems appear in a more acute form. Not only are the problems of valuation and enforcement more difficult in the international area, but market imperfections are likely to be more important. Hence, purposeful deviation from tax neutrality under certain circumstances may become a necessity. In addition to the extreme complexity of the subject, the controversy that surrounds many of its fundamental principles and the lack of guiding evidence by which to settle those controversies militate against the adoption of simple, generally accepted solutions. In this area more is left to opinion and judgment, both because little is known with certainty of the consequences of adopting alternative policies, and because there are substantial differences of opinion as to the relative importance to be attached to the competing objectives. In the international sphere perfect tax neutrality is neither administratively feasible nor necessarily economically desirable.

The subject is therefore a challenging one and one which Canada of all countries can least afford to ignore. Canada's heavy stake in foreign trade and investment gives this country a particular interest in well-ordered international tax arrangements. Fortunately a good deal of progress has been made toward some standards of conduct for international tax behaviour

by negotiation and agreement. Over the last half-century the leading trading nations, under the auspices of world organizations, have developed a few basic ground rules that eliminate the grosser inequities and economic dislocations that would otherwise arise. While these rules fall far short of the ideals of neutrality and equity, their embodiment in national taxing statutes and in international treaties gives some order and certainty where chaos could otherwise rule. The value of these arrangements has also increased with the more extensive use of income taxes by both developed and developing countries as the major source of their revenue. The direct use of income tax provisions by many countries for the achievement of domestic economic objectives, and the heightened sophistication of taxpayers in arranging their affairs to minimize their tax liabilities, will add further to the need for international tax arrangements in the future.

## MAJOR ISSUES

While the subject bristles with complexities and controversies, the larger issues in international taxation are surprisingly few. Substantially they are:

1. The treatment to be accorded income of non-residents at the time it is earned in Canada.

2. The treatment to be accorded certain forms of income of non-residents at the time it is withdrawn from Canada.

3. The treatment to be accorded foreign income of residents of Canada at the time it is earned outside Canada.

4. The treatment to be accorded foreign income of residents of Canada at the time it is received in Canada.

The practical questions to be settled are even fewer, since custom and the international tax treaties have already disposed of many of the issues that might have arisen under these headings.

1. For the foreign income of residents, two questions arise:

   a) To what extent should such income be taxed as earned abroad?

   b) What form of recognition should be given to the fact that the country of source of such income will have levied a tax on it?

2. For the Canadian income of non-residents, the main question is the level of withholding tax that should apply on the withdrawal of certain forms of payments from Canada.

In seeking to apply our standards of equity and neutrality to these problems we have proceeded on the basis of certain assumptions which should be stated here:

1. The treatment of foreign income of Canadian residents should include some recognition of foreign taxes levied on that income.

2. Foreign income of Canadian residents should also be taxed under the comprehensive tax base in accordance with procedures which minimize tax deferment and the use of tax havens, which are countries through which income can be channelled at little or no tax cost.

3. The benefits of integration of personal and corporation taxes should be restricted to domestic shareholders. We have adopted this position primarily because a similar alleviation of the tax on dividend distributions to non-residents would result in a cost to the Canadian treasury which would largely accrue to the benefit of foreign treasuries. This is admittedly a form of discrimination. However, we have assumed that this discrimination in favour of residents would not have adverse effects on foreign confidence, nor should it bring about retaliation as the tax position of the vast majority of non-residents would not be worsened relative to their present position except to the extent that non-residents would become worse off because of the removal of specific industry and corporation incentives, an impact that would apply equally to some residents.

4. We should strive for tax arrangements which maintain and, if possible, increase the net economic benefit that Canada derives from capital movements across its borders, consistent with our treaty obligations and the normal standards of international taxation. This implies that tax provisions that would permanently impede capital movements in either direction should be avoided. We do not review in this chapter the full discussion of the international economic issues covered in Chapter 5. In particular, the net benefits that might be secured by increasing foreign portfolio investment in Canada and reducing foreign direct investment correspondingly, are not dealt with further; nor is the question of Canada's dependence on a net capital inflow reopened. However, we take for granted that those who would eliminate the net capital inflow into Canada are not seeking to eliminate gross capital movements between Canada and the rest of the world. Capital movements may be impeded during the adjustment period following the introduction of our integration proposals, but it is not put forward as a measure intended to produce a permanent effect of this kind.

5. The net economic benefit that would result from higher taxes on dividend income going to non-residents would be too small and uncertain to warrant the risk in raising such taxes. An increase would probably provoke retaliation from foreign governments, particularly since the present level of Canadian corporation and withholding tax on dividends is close to, or in some cases even exceeds, the level of tax credit granted by the country of residence of the foreign investor. Where the tax on other forms of income going to non-residents is not subject to this constraint we have proposed an increase.

The domestic tax system which we propose as a means of more completely realizing Canada's economic and social objectives is radically different from the existing Canadian system and is unlike the systems in effect in other countries. Our most important task in this chapter is to develop tax provisions that would allow the adoption of a new domestic system without adversely affecting our economic ties with the rest of the world. This involves working out the technical problems resulting from the taxation of the income flows across the Canadian border. It also requires the development of tax provisions that maintain, and preferably increase, the net economic benefit that Canada derives from foreign investment in Canada and from the investment by Canadians outside of Canada, consistent with our treaty obligations and with the normal standards of international taxation.

The second task is to develop tax provisions that treat Canadians with foreign source income equitably relative to other Canadians. Thus, not only must all foreign source income be brought into the comprehensive tax base and be subjected to progressive rates of income tax, but it must be brought in under procedures that minimize tax deferment. In addition, it is necessary to eliminate the serious loopholes existing in the present system that allow some Canadian residents to avoid paying full tax on their income by the utilization of companies in tax-haven countries.

At the present time the rates of tax imposed on the Canadian source income of non-residents vary with the nature of the payment. Some payments (e.g., dividends) are subject to substantial Canadian tax, others to low rates of tax, and still others are not taxed at all. These disparities place an undue significance on the form of the payment, thus encouraging the adoption of procedures that lessen Canadian tax collections. Reducing these disparities is the third general task with which this chapter is concerned.

## PRINCIPAL PROPOSALS

Our principal proposals deal with the form of tax credit to be granted to Canadians in respect of their foreign income, the manner in which such income should be taxed in Canada and the rate of withholding tax to be applied to the income of non-residents originating in Canada. These proposals are discussed in detail later in this chapter but are summarized here for convenience:

1. The present exemption from tax of certain foreign dividends received by a resident corporation which is provided by section 28(1)(d) should be withdrawn. Dividends received from foreign direct investment should be grossed-up at an arbitrary rate of 30 per cent and a foreign tax credit of the same amount allowed. If the dividend was received by a resident individual, then the applicable Canadian tax on the grossed-up amount would be payable at the time of receipt. However, if the dividend was received by a resident corporation, no tax would be payable until the income was in turn distributed or allocated, at which time a withholding tax of 20 per cent of the grossed-up amount should be collected so that the resident shareholders would be entitled to a tax credit of 50 per cent of the grossed-up distribution (the original 30 per cent foreign tax credit plus the additional 20 per cent withheld).

2. A foreign direct investment should be defined as an investment by a Canadian resident or associated group of Canadian residents:

    a) in a non-resident corporation in which he or the group holds a 10 per cent or greater interest in the voting power, in the profits or in the assets distributed on liquidation of the non-resident corporation, or

    b) in a foreign property or business in which he or the group holds a 10 per cent or greater interest.

3. Canadian taxpayers having foreign direct investments should report annually the foreign income earned and the foreign income taxes paid in each foreign jurisdiction. If the foreign income taxes paid on this current income (including those paid by a non-resident corporation) were less than 30 per cent of the foreign income earned, the difference should be paid to Canada as a special tax. This procedure would ensure that all foreign source direct investment income was immediately subject to income taxes of at least 30 per cent on an accrual basis. If the foreign income was subsequently subjected to a withholding tax in the foreign country on distribution to the Canadian investor, the special tax paid on such income would be refunded to the extent of the withholding tax. If a Canadian taxpayer with less than a controlling interest in a foreign direct investment could establish that he was unable to obtain sufficient information to compute the foreign income, he should be entitled to elect that it be taxed as portfolio investment income (i.e., income from an investment other than a direct investment) with credit only for withholding taxes paid.

4. For the purpose of these computations, foreign income should be defined as income reported to the foreign jurisdiction (or in an audited financial statement) with certain adjustments to make this figure generally comparable to income as defined for Canadian tax purposes. These adjustments would not be numerous or detailed, and we will suggest an additional modification that should mean that computations would rarely be necessary for most income derived from the United States and the United Kingdom.

5. Canadian portfolio investors (investors who were not direct investors) should be given an option:

   a) to be taxed on the same basis as direct investors as described above; or

   b) to be taxed as at present with a credit only for withholding taxes paid.

6. The basic withholding tax on most payments to non-residents other than dividends should be increased from 15 per cent to 30 per cent. This withholding tax should be applied to gifts and bequests, income from employment in Canada and the income portion of payments from pension plans, in addition to interest, royalties, etc. This 30 per cent rate might be lowered for some specific types of payments (e.g., the present exemption for certain interest payments to tax-exempt entities) and reduced by treaty for certain payments to specified countries.

7. A withholding tax of up to 10 per cent should be imposed on payments for services that were deducted in the computation of business or property income and were not already subject to a withholding tax. These services might well be rendered outside Canada but the benefit from them would be obtained in Canada. This withholding tax should not apply to amounts paid in reimbursement of expenses.

8. In certain specific cases non-residents should be entitled to elect to be taxed as residents of Canada, reporting their world income from all sources and deducting foreign tax credits on the present basis for foreign taxes paid on income from foreign sources. This election should be available in the following cases:

   a) where a Canadian resident became non-resident and elected to be taxed as a Canadian resident for each year after the change of residence; or

   b) where a non-resident received certain kinds of income from Canada, including gifts, inheritances, the income portion of pension and annuity payments and employment income.

The implementation of these recommendations would, we believe, confer the following important advantages:

1. Substitution of a 30 per cent gross-up and credit for the section 28(1)(d) exemption:

   a) Removal of the exemption under section 28(1)(d) for foreign dividends received by a Canadian corporation from a company in which it held at least a 25 per cent interest would eliminate a major loophole in the present tax system through which some Canadians have in effect avoided the payment of their full Canadian tax on Canadian source income which has been diverted through companies in tax havens.

   b) The use of an arbitrary flat-rate tax credit would reduce, to a great extent, the significance of the tax mix of the source country. Thus, the balance between income taxes and withholding taxes would be unimportant and the extent to which other taxes (e.g., sales taxes) were utilized in the foreign jurisdiction would be less important.

   c) Once it was decided that a broad exclusion like section 28(1)(d) was not appropriate, the use of an arbitrary rate would simplify the computations and remove much of the uncertainty. Both of these advantages would be particularly important to ensure that Canadian corporations were not discouraged from establishing foreign operations. Although the procedure would require the measurement of the underlying foreign source income from most countries, this would not generally apply to income derived from the United States or the United Kingdom (from which over three quarters of the foreign source dividends of Canadians are derived). This special treatment could perhaps later be extended to other countries after experience has been gained in administering the provisions. In any case, the adjustments required for the other countries, although arbitrary, would be relatively simple. Because property gains would be taxed in full to Canadians on realization, full Canadian tax would be

collected in the long run. Arbitrary procedures to compute the annual tax liability therefore would not be as inequitable as they might otherwise be.

d) A flat-rate gross-up and credit would result in the progressive rate schedule being applied to foreign source direct investment income.

e) Adoption of a rate of 30 per cent for the gross-up and credit would have two advantages: Canada would derive some (albeit small) net revenue from foreign source dividends, and most shareholders in Canadian companies with foreign direct investments would pay no more Canadian tax on foreign source dividends than they do at present.

f) The gross-up rate could be adjusted from time to time to meet particular circumstances. A reduction in the rate might be necessary if over time the expected before-tax rates of return on corporate assets in Canada declined following the adoption of the integration proposal.

2. Requiring payment of income tax on foreign direct investment income at a rate of at least 30 per cent:

a) A requirement that taxes of at least 30 per cent be paid each year to either the foreign jurisdiction or to Canada as the foreign income was accrued would reduce the tax deferment and the minimization advantages provided directly or indirectly by tax havens.

b) The recommended procedure would reduce the importance, from a taxation viewpoint, of the form of organization adopted for carrying on foreign operations. It would also largely eliminate any effect Canadian taxes might have on the decision to retain or remit funds from the foreign operation.

3. Increasing the level and scope of withholding taxes:

   a) The increase in the standard withholding tax (on most payments other than dividends) to 30 per cent would narrow the gap between the rates of tax imposed on different types of return on capital. It would reduce the attractiveness of some of the present methods employed to reduce the Canadian tax liabilities on income derived from this country and would thereby increase Canadian tax revenues.

   b) The application of a withholding tax to another form of remittance from Canada, namely, service fees, would ensure that at least some tax revenue was collected on income from services enjoyed in Canada and performed by non-residents who were not physically present in Canada when the services were rendered.

The balance of the chapter is devoted to further consideration of the concept of neutrality and its implications for our specific tax proposals, to an outline of the actual tax systems in effect in Canada, the United States and the United Kingdom, and to separate consideration of the tax issues and of our proposals for Canada as a country receiving income from abroad and as a country which is the source of income going abroad. We then examine some of the administrative aspects of international taxation and finally we review the nature and effect of the tax treaties.

## NEUTRALITY AS AN INTERNATIONAL CONCEPT

Because of its key position in our consideration of the various proposals for international taxation, we will explore at some length in the following paragraphs the meaning of "neutrality" as a guiding concept for these proposals.

To achieve complete international tax neutrality, the tax systems of all nations would have to be so harmonized that each individual would be indifferent, from a tax point of view, about his citizenship, his country of

residence, the location of his property, the location of his business and the location of his job. This would require that all nations:

1. Provide the same public goods, services and transfer payments to those residing or carrying on business in the country 1/.

2. Finance the provision of these public goods, services and transfer payments with the same kinds of taxes levied at the same rates.

3. Avoid, shift and adjust to the same taxes to the same degree and at the same time.

4. Tax each individual on his world income, defined in a uniform manner, at the same rates as those at which he would be taxed if he derived all of his income from his country of residence; these rates would have to be the same whatever his country of residence 2/.

In deciding where to work, where to invest and where to carry on business, tax considerations could be ignored because the ratio of the expected after-tax rate of return to the expected before-tax rate of return would be a constant for each individual. If these conditions were realized, expected before-tax rates of return in different countries would not be distorted, relative to one another, as a result of differences in national tax systems.

The conditions cited above would be extremely difficult to realize even with the best of intentions on the part of all nations. If all nations were to provide the same kinds and levels of public goods to their residents with the same bases and tax rates, per capita national incomes would have to be approximately the same. This condition is unlikely to be met in the foreseeable future—if ever. Differences in national preferences between public and private goods and between different kinds of public goods will continue to prevail. National resource endowments, national market sizes and national mixes of industries are so diverse it is difficult to imagine that

avoidance, shifting and adjustments to taxes will ever be the same in all nations.

In Chapter 19 we discuss how before-tax rates of return on productive assets change in response to changes in taxation. It is useful to briefly review that discussion here.

Unless all taxes are avoided or shifted to exactly the same extent and at the same speed, the imposition of what purports to be a completely neutral tax will nevertheless change the allocation of resources among alternative projects. To illustrate what is involved, assume that in a world with no taxes there are two kinds of projects, types A and B. Each kind of project is expected to yield a before-tax rate of return of 10 per cent. Suppose that a tax of 50 per cent is imposed on the net gains from both kinds of projects and that there is no avoidance. If the tax on the income from type A projects is fully shifted, the before-tax income is doubled and the after-tax income is unchanged; if the tax on type B projects is not shifted the before-tax income is unchanged but the after-tax income is cut in half. Investment in type A projects would be much more attractive than that in type B projects. However, over time the higher rate of return would lead to increased investment in type A projects which would increase the output of the goods produced by these projects. The increased supply of these goods would gradually force their prices down. As a result the before- and after-tax rates of return on investments in type A projects would decline. Conversely, the reduced investment in type B projects over time would result in an increase in the before- and after-tax rates of return from type B projects. Under simplifying assumptions, the before-tax rates of return on both kinds of projects would, in time, converge and once again be equal.

These adjustments of before-tax rates of return to changes in taxes must be taken into account in analyzing international income taxes. Resources would not necessarily be allocated efficiently throughout the world if expected before-tax rates of return were the same in all countries.

The expected before-tax rates of return may differ between two countries not because capital was more productive in one than the other but because the same taxes imposed at the same time in both countries were not shifted to the same extent and the investment adjustment process had not yet reduced the return in the tax-shifting country or raised it in the non-shifting country.

Because of market imperfections, differences in expected before-tax rates of return among alternative projects are an imperfect indication of the net benefit that would be derived from different investments within a nation. The interpretation of international differences in expected before-tax rates of return is even more difficult because, in addition to the "normal" market imperfections, nations not only have different tax systems but have purposely adopted substantial barriers to the flow of goods, capital and labour. Because of the distorting effects of these differences in tax structure and of countervailing national economic barriers we cannot presume that the allocation of resources on a world basis in accordance with these expected before-tax rates of return would lead to greater world output.

Realization of the fourth condition would be particularly difficult in a world consisting of debtor and creditor nations. If the types and amounts of each nation's foreign source income were equal to the types and amounts of its domestic source income flowing to (or attributable to) non-residents, the problem would be straightforward. All nations could agree to tax income on a destination basis. Whatever their views about the "proper" allocation of revenues between origin and destination countries, if they all adopted the same policy there would be neither revenue gain nor revenue loss, for the additional revenues obtained from fully taxing the foreign source income of residents would just be offset by the revenues forgone by not taxing the domestic source income of non-residents. But because some nations are net debtors and some net creditors such an easy solution is not possible. To tax solely on a destination basis would mean that debtor

nations would be worse off; to tax solely on a source basis would mean that creditor nations would be worse off.

Thus, even if all nations had identical tax systems, there would be an inescapable conflict between net debtor and net creditor nations as to the "proper" division of revenues between source and destination countries. Debtors would continue to argue that the major share of the revenue should go to the country in which the income originated; creditors would continue to argue that the major share of the revenue should go to the country of residence of the recipient of the income.

From this discussion of the conditions necessary for the realization of international tax neutrality, it is obvious that such an objective is unattainable within the foreseeable future. But what is even more important, international tax neutrality may not even be desirable while other international economic barriers exist (such as tariffs, immigration laws, foreign investment guidelines, and foreign exchange controls). All of these artificial barriers to the free movement of goods, capital and labour among nations distort the international allocation of resources just as much or more than unneutral tax systems. It would only make sense to strive to develop an internationally neutral tax system if by doing so a more efficient international allocation of resources throughout the world would be achieved. As long as these non-tax barriers between nations prevailed, an improvement in the international allocation of resources would probably require national tax systems that deviated from neutrality to compensate for the other barriers.

Once this point is reached we are forced to admit that it is impossible to make any general statements about how international income flows should be taxed by any particular country if the purpose is to achieve an efficient allocation of world resources. It depends entirely upon the particular circumstances. While compensating deviations from a neutral tax system are theoretically possible, it would be extremely difficult in the present state

of knowledge to determine the form and magnitude they should take.

This is a depressing conclusion because we know that, in the absence of all barriers to the movement of labour, capital and goods between nations (or with offsetting adjustments if they could not be removed), world output would be greater. The nations that would gain from the removal of barriers to international mobility could more than compensate the nations that would lose, and still be better off. Although it would be naive to expect that this idyllic state of the world will soon be attained, men of good will must not lose sight of this long-run objective. If they cannot further its realization, they can at least refrain from creating obstacles to its ultimate attainment.

We do not advocate the unilateral removal of all international barriers by Canada. It is impossible to say, except in terms of the particular facts, whether or not a unilateral reduction in a particular barrier would be in our long-run interest. Some Canadian barriers are probably necessary to compensate for the barriers erected in other countries. If other nations raise international economic barriers Canada may have no alternative but to raise countervailing barriers. We need this retaliatory capability. However, we should try to avoid situations that would require retaliation by Canada or would lead to retaliation by other countries against Canada.

We do not doubt that Canada should pursue its self-interest. But we believe that a world with lower national barriers to the movement of labour, goods and capital would be in Canada's long-run self-interest. We can hardly expect reductions in international barriers to be made by others if we are busy erecting our own.

## PRESENT TREATMENT OF INTERNATIONAL INCOME IN THE UNITED STATES, THE UNITED KINGDOM AND CANADA

As a background to our specific proposals it is useful to set forth a brief composite picture of the present Canadian, United States and United

Kingdom systems for taxing international income. The present Canadian system is described in greater detail after discussion of the composite picture. To facilitate the following description, we will discuss international income under three general headings:

1. Business Income
2. Property Income
3. Employment Income

Business Income

Business income arises from the carrying on of a direct business activity in one country by a resident of another country. One of the principal instances is operations carried on by a corporation through a branch; another is activities of a business character carried on directly by an individual or sole proprietor.

Business income under our comprehensive tax base would, of course, include gains on property disposed of by a non-resident in the course of carrying on a business in Canada.

Property Income

Property income is composed mainly of the normal forms of return from the investment of capital, the lending of money or the rental or licensing of property in another country, where the activity is not of such a character as to constitute the carrying on of a business. These forms of income (dividends, interest, rents and royalties) are usually subject, on distribution to a resident of another country, to "withholding" taxes levied by the source country. In some instances, withholding tax is also applied to other types of income.

The concept of "property income" as applied to international taxation would not include gains realized on the disposition of property. Such gains would usually be taxed only if realized by residents of the source country.

We have already pointed out, however, that under the comprehensive tax base property gains would be included in income where they formed part of business income, whether earned by a resident or a non-resident.

In the case of dividends received, a distinction is usually made in the country of destination, for purposes of levying its own taxes, between dividends from a company in the source country in which the holding is sufficiently large to constitute "direct investment" and those from a company in which the holding falls below the test for direct investment and is treated as "portfolio investment". Normally the distinction has no relevance in the country of source in the application of its taxes on payments leaving the country.

The test for direct investment, although not referred to as such, is established by statute; in the United States ownership of 10 per cent or more of the voting shares is required and in Canada more than 25 per cent. It is of interest to note that even ownership of all the shares of a company in another country constitutes investment in that other country and not the carrying on of a business. For purposes of taxation in the foreign country, the wholly owned subsidiary would normally be regarded as a resident of that country and subject to the usual taxes in that country. The fact of foreign ownership would be of relevance only for the application of additional taxes on dividends leaving the country.

Employment Income

This classification is almost self-explanatory. It consists of income received under a contract of employment where the employment is performed by a resident of another country.

Set out below is a skeletal description of the way in which these various types of income are taxed (subject, of course, to a number of exceptions) under the Canadian, United States and United Kingdom systems. Because the United States tax treatment of foreign source income is of particular

interest in view of our recommendations, a more detailed description of its procedures is contained in Appendix L to this Volume.

Taxation in the Country of Source

1. Business Income. Income tax is imposed at full domestic rates on "business income" earned in a country of source by a non-resident.

2. Property Income. Tax is levied at a flat rate on investment income (interest, dividends, rents and royalties) paid to a non-resident.

3. Employment Income. Domestic graduated rates of tax, or a flat-rate tax in lieu thereof, is normally applied to the income of a non-resident, such as salaries and wages, for personal services performed by the non-resident in the country of source.

Taxation in the Country of Destination

1. Business Income. Business income earned by direct business activity in a source country is included in income in the destination country, whether remitted or not. It is grossed-up to include direct taxes paid in the country of source and a credit is allowed for those taxes against the taxes in the country of destination, but not exceeding the tax on the same income in the country of destination.

2. Property Income. Property income from a source country (other than dividend income from direct investment) is included when received, and is grossed-up to include withholding or similar taxes paid to the country of source. A credit is allowed for those taxes against the taxes in the country of destination, but not exceeding the tax on the same income in the country of destination.

3. Employment Income. Is accorded the same treatment as property income.

For dividends the above statement for property income applies to "portfolio investment", but a different treatment is provided for "direct investment".

Where either the United States or the United Kingdom is the country of destination of a dividend from direct investment, that dividend is grossed-up to include direct taxes levied in the country of source on the corporate income from which that dividend was declared as well as the withholding tax on the dividend, and a credit is allowed up to the amount of the domestic income tax on the same income for the underlying corporation income tax of the source country and for any withholding tax levied by the source country on the dividend when paid. In the United States, interest income received from the direct investment is aggregated with the dividend income in computing the foreign tax credit. Where Canada is the country of destination of such a dividend, a different treatment applies. The dividend, when received by a Canadian corporation, is free of any further Canadian corporation income tax.

Some notable modifications of this general description, usually based on the pursuit of an economic objective, may be found in all three countries. In the United States they include the Western Hemisphere Trade Corporation, the 1962 tax-haven legislation against the "controlled foreign corporation", the exceptions therefrom granted to the Export Trade Corporation and to companies operating in under-developed countries, and the Interest Equalization Tax. In the United Kingdom a comparable instance was the Overseas Trade Corporation which, under the 1965 Finance Act, was abolished as of April 6, 1966. A Canadian example is the treatment of foreign business corporations.

## PRESENT TREATMENT OF INTERNATIONAL INCOME IN CANADA

The following very brief outline of the Canadian method of taxation brings the subject closer to our direct lines of inquiry.

Residents

The basic Canadian test of liability for income tax is residence, as contrasted with citizenship or domicile or combinations of these three factors which are used in some other countries. A Canadian resident, whether an individual, corporation, or any other form of entity, is taxable in Canada at Canadian rates on total world income. The general concept of residence is not a clear one. For most purposes, an individual who lives more or less continuously in Canada as part of the routine of his life is a resident. For a corporation, the general rule is that it is resident at the place where it is managed and controlled. This rule has been modified and extended in recent years by statute, so that in most cases a corporation is now resident in Canada if it is incorporated in Canada, regardless of where its management and control is located.

Business Income. Where a Canadian resident carries on business directly in a foreign country, as through a branch, the whole income is taxed in Canada as earned, and a credit is allowed for income taxes paid to the foreign country up to the amount of the Canadian income tax on the same income.

A special type of resident corporation—one whose assets and business operations are substantially outside Canada—is exempt from Canadian tax liability as a "foreign business corporation".

Property Income. Where a Canadian resident receives property income from abroad (dividends, interest, rents, royalties, etc.), that income is grossed-up to include any withholding taxes levied by the country of source and a credit for those taxes is allowed up to the amount of the Canadian income tax on the same income.

This treatment is modified where more than 25 per cent of the voting shares of a foreign company are owned by a Canadian corporation. In these circumstances, dividends from the foreign company are received by the Canadian corporation free of corporation income tax under section 28(1)(d) of the Income Tax Act.

Employment Income. A resident individual receiving employment income from a foreign source will include that income for Canadian tax purposes on a grossed-up basis and deduct from his income tax otherwise payable a credit for the foreign income taxes paid up to the amount of the Canadian income tax on the same income.

Non-Residents

Business Income. A non-resident carrying on business in Canada is taxed in the same way as a resident in respect of the earnings from that business activity, the main difference being that the income included in the computation of the rate of tax applicable is limited to the income earned in Canada. However, in the case of a business carried on in Canada through a branch of a foreign corporation, an additional tax of 15 per cent is imposed on a part of the profits of the branch remaining after payment of corporation income tax on those profits. A special deduction in respect of investment in fixed capital is allowed in calculating the income subject to this tax.

Property Income. Payments of property income by residents to non-residents of Canada are subject to withholding taxes as follows:

1. Dividends of a company owned to the extent of 25 per cent or more by Canadians (with a variation in this rule if the shares are listed on a stock exchange)—10 per cent; all other dividends—15 per cent.

2. Interest—15 per cent with certain exceptions, the most important being the exemption for interest payments on bonds issued after April 15, 1966, by the federal, provincial, and municipal governments, and for interest payments to organizations exempt from tax in their country (conditional on certificates of exemption being provided).

3. Rentals—15 per cent, but in the case of realty rentals a non-resident may elect to pay tax at the applicable Canadian tax rates after filing an income tax return of net Canadian rental income.

4. Royalties—copyright royalties are not subject to withholding tax; film and tape royalties—10 per cent; all other royalties—15 per cent. A recipient of timber royalties may elect to be taxed on his net Canadian income by filing a return as in the case of a recipient of real estate rentals.

5. Estate and trust income and patronage dividends—15 per cent.

A 15 per cent tax in lieu of any other tax (including the withholding tax on dividends and interest paid) is imposed on the income of a non-resident-owned investment corporation—a corporation substantially owned abroad whose income is substantially from investments.

Employment Income. A non-resident of Canada who has been employed in Canada must report his Canadian income and pay tax on that income at the usual graduated rates. An appropriate proportion of the Canadian concessions and allowances is granted as a deduction in determining taxable income.

The foregoing describes the main elements of the Canadian tax system for non-residents under the Income Tax Act. Modifications made by treaty have not been discussed.

## TAXATION IN CANADA AS THE COUNTRY OF DESTINATION

### Equity Considerations

Equity requires that all foreign source income, whether it results from working, investing or carrying on business abroad, be taxed to residents on the same basis as domestic source income. Under our proposal for the full taxation of property gains, this would mean that residents holding rights to or interests in property located outside of Canada would be taxed on the disposition of such rights or interests (including a disposition on death) or on the net gains deemed to have been realized on giving up Canadian residence.

Because income not brought into Canada must necessarily result in an increase in the value of the resident's interest in foreign property (ignoring foreign source income that the resident spends on personal consumption outside of Canada), all foreign source income would ultimately become subject to Canadian taxation. This would close what is now a substantial loophole in the tax system. Residents can now establish a foreign corporation to hold their income-earning assets in a country with low corporation taxes. The income can be retained in the foreign corporation and the resident can realize this income without Canadian tax by the sale of the shares in the foreign corporation.

Unfortunately the full taxation of property gains poses significant problems. If the property gains on rights to or interests in property located outside of Canada were brought into income only when realized, there would be a deferment problem. We have already demonstrated that the postponement of taxes can be about as advantageous as the avoidance or reduction of taxes. On the other hand, if such gains were taxed on an accrual basis, it would be difficult to determine the market value of property located in another jurisdiction.

Our proposal for the domestic tax system initially brings only realized property gains into income. We have also proposed that, unless the current earnings of Canadian intermediaries are brought into the income of shareholders and beneficiaries annually, such income should be subject to tax in the organization—usually at the top personal rate. This prevents the deferment of tax that would otherwise be possible if distributions were subject to additional personal tax. To place residents with interests in foreign corporations and trusts on the same basis as persons with domestic investments, the interest of Canadian residents in the income of these foreign organizations should also be taxed currently at the top personal rate. However, if these organizations did not make cash distributions, some Canadian shareholders or beneficiaries might

not have the cash available to pay the Canadian tax imposed in respect of the accrued income. In addition, there would be a number of administrative problems involved in the determination of the amounts to be taken into account each year.

These administrative questions would basically be concerned with determining what was the foreign source income for Canadian tax purposes, when the foreign income should be brought into account and what was the amount of the foreign tax credit that was to be deductible in determining the Canadian tax liability. Obviously business income for tax purposes in the source country need not be the same as business income for tax purposes in Canada—and in fact the differences in legislation are apt to result in substantial variations. A recomputation of the foreign source business income on the basis of Canadian rules could be an extremely complex procedure for the taxpayer, and yet, without such a recomputation, the amount included in the Canadian tax base would not properly reflect the Canadian rules for the determination of income. The question of timing also has administrative implications because it affects the determination of the amount of foreign source income and taxes that should be taken into consideration in each year.

Economic Considerations

There are economic as well as administrative questions that have to be considered in any attempt to attain neutrality in the taxation of the foreign source income of residents. The principal question is the extent to which Canada should give residents credit for the taxes paid to other governments on their foreign source income. At the one extreme, it can be argued that in so far as the Canadian government is concerned, the taxes paid to a foreign government by a Canadian-controlled foreign corporation are simply an expense of doing business abroad, and no credit should be given for foreign taxes (corporation or withholding taxes) against the resident's Canadian tax liabilities. This would mean that in deciding whether to invest in Canada or in another country that imposed income taxes,

the expected before-tax rate of return on a foreign project would have to be higher than the expected before-tax rate of return on a Canadian project.

At the other extreme, it can be argued that Canada should give full credit for foreign taxes paid against Canadian tax liabilities—even to the point of refunding foreign taxes if they exceeded the Canadian tax liability. If this were done, the Canadian investor would be completely indifferent to the taxes imposed by other countries. Other things being equal, projects with the same expected before-tax rates of return would be equally attractive wherever their location because they would all have the same expected after-tax rate of return to the Canadian resident.

For the reasons outlined in our discussion of international tax neutrality, we are convinced that it is impossible to say categorically what this foreign tax credit should be if Canada wished to achieve an efficient allocation of capital throughout the world. We simply do not know the extent to which the expected before-tax rates of return in different countries reflect the "true" return from capital. We are forced to fall back on pragmatic considerations.

Ignoring the implications of the adoption of our integration proposal, which will be discussed later, we reject the proposition that Canada should provide a full credit for foreign taxes (including the making of refunds if the foreign taxes paid exceeded the Canadian tax liability). We likewise reject the proposition that Canada should give no credit for foreign taxes. The granting of full credit with refunds is rejected because this would require Canada to rebate taxes it had never collected and would leave the Canadian treasury at the mercy of foreign treasuries. Full credit for foreign taxes up to the Canadian tax is rejected because we believe that every resident of Canada enjoys some public benefits and should bear some of the Canadian tax burden of providing these benefits and because the resident should be made aware that foreign investment imposes a revenue

loss on Canada. For, from a restricted point of view, if the before-tax return on a Canadian investment is greater than the after-foreign-tax return on a competing foreign investment, Canada "loses" the amount of the differential if the foreign investment is undertaken.

The net economic benefit that Canada derives from foreign investment by Canadians is uncertain. Some Canadian direct investment extends markets for Canadian goods, secures supplies, and improves Canadian technology. It is undoubtedly profitable to individual Canadians and economically advantageous to the nation. At the other extreme, some foreign portfolio investment is only profitable to individuals because Canada gives credit for the withholding taxes imposed by other governments, and presumably confers little if any net economic benefit on Canada. Unfortunately, there are no adequate measures of the net benefit from either.

Changes in the Canadian tax treatment of residents that would deter investment abroad are less likely to shake international investor confidence in Canada or lead to foreign retaliation than adverse changes in the tax treatment of non-residents who invest in Canada. However, we cannot be indifferent to the reactions of non-residents and foreign governments to changes in Canada's treatment of Canadians who invest abroad. If Canada deters its residents from investing abroad we are obviously in no position to complain when other nations seek to deter their residents from investing in Canada. Although the immediate net benefit to Canada of foreign investment by Canadians may be small (conceivably negative), if Canada adopts tax provisions that discourage foreign investment by Canadians and this results in foreign retaliation, Canada could lose more elsewhere than it would gain through the reduction of foreign investment by Canadians. How this net loss could come about can be readily explained.

Canada obtains a net economic benefit from most investment in Canada by non-residents. The revenues obtained from taxing the income earned by such investments are an important part of that benefit. The revenues that can

be raised by taxing foreign investment in Canada without deterring such foreign investment are dependent upon the credit that foreign governments give to their residents with respect to the taxes paid to Canada. If foreign governments gave lower or no credits for taxes paid to Canada, Canada would be forced to lower its taxes on the income of foreign investments in Canada to prevent a sharp drop in such investment 3/. This would reduce the net benefit we obtain from foreign investment in Canada.

We do not know whether foreign governments would remove or reduce their foreign tax credits if Canada refused to give Canadian residents credit for foreign taxes. But the gains from reducing foreign investment by Canadians would be small and uncertain even if there were no foreign retaliation, while the losses would be large and predictable if there were retaliation. Therefore, we reject the idea that Canada should seek to inhibit investment abroad by Canadians by withdrawing credits for foreign taxes paid on the income resulting from foreign investments by Canadians.

## Specific Types of Income

It will be recalled that we are concerned with the tax treatment in Canada of three main types of income: business income, property income and employment income.

*Property Income and Employment Income*. A discussion of the treatment of property and employment income can be readily concluded since we propose no substantial changes in the present procedures, except for dividends which will be discussed in detail below.

Property income from abroad is now included in Canadian income grossed-up for any withholding tax imposed by a source country and with a credit allowed against the Canadian tax for such a foreign tax to an

amount not exceeding the Canadian tax on the foreign source income. We see no reason for departing from this procedure.

For employment income earned by Canadians abroad we propose continuation of existing procedures without change.

Direct Investment Income (Including Business Income). We bring income derived from direct investment in a foreign corporation and foreign business income together for the present discussion because their underlying similarity raises the same general issues. The conduct of business in a foreign country through a wholly or substantially owned subsidiary differs little, from an economic point of view, from direct operation through a branch, and the same general issues of taxation are involved. The singular difference for tax purposes under the present law is that interposition of the foreign corporation means that the Canadian company operating abroad through direct investment in a corporation includes as income only dividends actually received from that corporation, whereas the Canadian company operating directly through a branch is regarded as having earned and received the full profits of the branch each year and obtains credit for the foreign tax thereon. As we have seen, in the United States and the United Kingdom the same general procedure—the full gross-up and credit procedure—is used for both direct business activity and direct investment income. Canada, although ostensibly reaching much the same general objective by the two routes, has adopted different forms of treatment for branch income and dividends from direct investment. Branch income, as we have said, must be included in Canadian income grossed-up for the foreign income tax and recalculated to conform to Canadian rules for computing taxable business income. The Canadian tax is calculated on the foreign income so adjusted and a credit is allowed for the foreign tax paid, but not in an amount that exceeds the Canadian

tax. On the other hand, dividends derived from direct investment in a foreign corporation—at present where more than 25 per cent of the voting shares are owned—are exempt from Canadian corporation income tax on receipt in Canada. The only condition for this exemption is the required degree of ownership.

It is apparent that within the Canadian treatment of foreign source business income may be found the two classical extremes of allowance for foreign taxation. One provides for the full, accurate and precise measurement of the foreign income and tax liability, with a precisely computed credit against Canadian tax. The other grants an exemption from tax under conditions very easily met. The United States and the United Kingdom have followed the first method both for branch income and direct investment income, and no provision comparable to section 28(1)(d) of the Income Tax Act may be found in the tax system of either country. There are some examples of exemption of foreign dividends to be found in other countries, but Canada is virtually unique in its adoption of a provision as sweeping as section 28(1)(d). Its origins and effects are therefore of considerable interest.

The exemption contained in section 28(1)(d) appears to have had as its original purpose the achievement of an equitable and administratively simple alternative to the complexities of the gross-up and credit procedure. At the time of its introduction in 1949, the bulk of Canadian foreign source income originated in countries having corporation taxes as high as the Canadian, mainly the United States and the United Kingdom. The effect of this section was undoubtedly to provide directly for the virtual exemption of foreign source income from Canadian tax which was the end result of the complicated gross-up and tax credit procedure previously in force. Its origins in section 4(r) and subsections (2A) and (2B) of section 8 of the

Income War Tax Act are clearly discernible, and the fact that both of these sections were repealed in 1949 on the enactment of section 27(1)(d) (now section 28(1)(d)) supports the conclusion that, initially, the provision was looked on mainly as a device for administrative simplification. At first the ownership requirement was 50 per cent or more but in 1951, following the recommendation of the Advisory Committee on Overseas Investment, the ownership test was reduced to its present 25 per cent as a means of encouraging foreign investment by Canadians. It has since remained at that level.

One result of these provisions is that the Canadian taxpayer has enjoyed a much greater simplicity and ease of calculation for foreign income than his United States or United Kingdom counterparts. The tax minimization possibilities of the exemption privilege, in combination with the use of foreign tax havens, have not gone unnoticed. The provision can be used to reduce Canadian tax on income generated in Canada for the benefit of Canadians. By establishing companies in jurisdictions which impose little or no tax, Canadians can reduce their Canadian tax by engaging in a series of paper transactions which exploit the provisions of tax treaties in combination with section 28(1)(d).

There is also evidence that the provision has offered the possibility to use Canada itself as a tax haven for international business. Data compiled for us by the Taxation Division show that over a period of years a very substantial part of the dividends reported under this section has originated in jurisdictions imposing little or no tax, and that a very high proportion of these dividends has been received in Canada by holding companies not having a substantial Canadian economic interest but representing for the most part foreign ownership. Of a total of $1,500 million received by all Canadian corporations (including those that were owned by non-residents) in the five years from 1957 to 1961, only 10 per cent came from the United States and 4 per cent from the United Kingdom.

The defects of the present section 28(1)(d) are obvious, and we therefore recommend its repeal.

Full Gross-up and Credit

The most obvious alternative to the present Canadian treatment of income from direct investment (it is already in effect in Canada for direct business activity in a foreign country) is that employed by both the United States and the United Kingdom—the so-called "full gross-up and credit" method. We have recommended the full gross-up and credit method as the appropriate basis for the taxation of Canadian corporation income for residents. The logical counterpart would be to extend the same principle to the foreign direct investment earnings of Canadian corporations and individuals. The effect would undoubtedly be to produce a more exact calculation of the foreign tax credit and a more accurate allowance of that credit against the Canadian tax.

One serious disadvantage of the full gross-up and credit system in the international field is that it is far more complicated than the present Canadian method and would introduce a whole new range of administrative complexities for both taxpayers and tax authorities. In principle, it would require that the foreign corporate income being grossed-up be completely recalculated on the same basis as the Canadian, so that the taxable income, the tax to be credited and the tax credit limitations would be comparisons of like with like. Such adjustments are required now only in a relatively limited number of cases for direct business activity, mainly involving branches. But the extension of the full gross-up treatment to all foreign companies in which there was a Canadian direct investment would greatly multiply the number of companies affected. Also, consideration would have to be given to allowing a similar grossing-up procedure for the subsidiaries of the main foreign subsidiary (i.e., sub-subsidiaries) in order to carry the taxes of the sub-subsidiaries through the main subsidiary to the Canadian parent. (The United States law now provides for inclusion of only the

second level of foreign subsidiaries.) Furthermore, questions of the method for calculating the average rate of tax, the identification of years in which income was earned by the subsidiary and received by the parent and a host of other problems not now of significance would take on great importance for all Canadian companies having a direct investment in a foreign company.

The effect of the full gross-up and credit system is to bring up to the level of Canadian taxation the corporation income tax on business income earned anywhere in the world. While we do not in general favour the use of taxation for international competitive purposes, we are forced to recognize that in many new countries one of the few means available for granting economic incentives is taxation. To require that the tax on business income earned in those countries must ultimately be at least 50 per cent would completely frustrate, or "neutralize", any incentives extended by the new countries. Also, in these same countries indirect taxes are frequently a large element in the tax mix. These represent a burden on any business operating in a country of source which, in the present state of international taxation, is not taken into account in determining the tax credit in the country of destination. In bringing the ultimate corporation income tax burden up to a rate of 50 per cent, we would be disregarding the existence of these indirect taxes.

The recent experience in the United States with attempts to cope with similar problems is indicative of the complexities that can be encountered where the full gross-up and credit system is extended to overcome tax avoidance through foreign tax havens. As a measure to assist the balance-of-payments problem, President Kennedy recommended to the Congress in 1961 that foreign-earned corporate income be deemed to have been received and to be taxable in the United States as it accrued abroad. It was reasoned that if tax deferment were removed, United States companies would immediately bring home their foreign earnings. The proposal met with a storm of protest from United States industry and, after protracted hearings and Congressional

studies, a measure emerged directed not at tax deferment in general but at deferment of tax on certain forms of income accruing in tax-haven jurisdictions. Income of a "controlled foreign corporation" of a specified character (generally of a "passive" type, that is, not related to the conduct of an economic activity in the actual location of the foreign subsidiary) is deemed to be received by the United States shareholders owning 10 per cent or more of the voting shares of the corporation and is then taxable. Exceptions are made where certain minimum distributions are made by the controlled foreign corporation, where the controlled foreign corporation is operating in a less developed country or where it is a corporation devoted exclusively to export trade 4/.

We have considered this United States legislation as a possible model for Canadian action but have concluded that it is far too complex in its detailed application for our more limited goal. The role of the United States in the world economy is so crucial that a measure of this sort must meet a wide and conflicting variety of objectives, and in the process assume such complexity that its full ramifications are not even yet fully apparent. Much of this complexity stems from the fact that the objective of the legislation was to bring into taxation, at full United States rates, accumulating foreign source income, the natural result of applying the full gross-up and credit mechanism. The conditions under which this onerous treatment should apply and the nature of exemptions from it, therefore, had to be defined with great care. We have concluded that our much less ambitious objectives could be achieved by adopting somewhat more arbitrary but simpler methods. We have designed our proposal with this in mind.

The remaining objective we have sought, a degree of integration of foreign corporation taxes with Canadian personal income tax, could as well be achieved under the gross-up and credit method as under any other by adopting some arbitrary and simplified procedures. However, we have already concluded that full integration of foreign corporation taxes with the

Canadian personal income tax is not acceptable, as it would mean that the Canadian government would be required to make massive refunds to Canadian shareholders of taxes collected by other governments. This, then, is the primary reason for rejecting the use of the full gross-up and credit. We have therefore sought in our solution a degree of integration that is something less than would be achieved by the system of full gross-up and credit for foreign direct investment income.

Our Proposal

We have concluded that Canadian objectives can be met adequately by a solution somewhere between the full gross-up and credit at the one extreme and the exemption provided under the present section 28(1)(d) at the other. We are primarily concerned at this point with the position of companies having foreign subsidiaries which now qualify under section 28(1)(d). The future status of business activities carried on directly abroad through branches will be referred to later.

Foreign Direct Investment Income

Scope of application. We propose that the treatment outlined below should apply to a foreign direct investment. A foreign direct investment would be an investment by a Canadian resident or associated group of Canadian residents (a) in a non-resident corporation in which he or the group held a 10 per cent or greater interest in the voting power, in the profits or in the assets distributed on liquidation of the non-resident corporation, or (b) in a foreign property or business in which he or the group held a 10 per cent or greater interest. This percentage is smaller than the 25 per cent now specified in section 28(1)(d), but would appear to be a reasonable dividing line between an investment which is not made for purposes of having a direct influence in the affairs of a company, and one which can carry with it some measure of control. However, because of other provisions discussed below, this artificial dividing line should not result in any inequity for a taxpayer who had less than a 10 per cent interest and, accordingly, was not

able to qualify for the 30 per cent gross-up and credit. In the case of an investment in a foreign company, the 10 per cent would only apply to direct shareholdings. Subsidiaries of a foreign company in which a direct investment was held should be included if an interest of 50 per cent or more was held by the foreign parent and by other shareholders who were not dealing at arm's length with that company.

Procedure. Where a direct investment was held, the following procedure would apply:

1. The income and tax liability would be computed (as described below) generally in accordance with the broad principles of the Canadian tax law.

2. In the case of a Canadian individual with a direct investment in a foreign property or business, his proportionate interest in the income earned in the foreign jurisdiction would be included in his income for Canadian tax purposes in the year it was earned, the net income after foreign tax being grossed-up to include the foreign taxes paid or deemed to be paid, not exceeding 30 per cent. Therefore, the applicable Canadian tax would become payable immediately and credit would be allowed for the foreign taxes paid or deemed to be paid up to the 30 per cent maximum.

3. In the case of a Canadian individual with a direct investment in a foreign company or with an investment in a Canadian company that itself had a direct investment in a foreign company, property or business, the procedure would be more complex:

   a) Where foreign taxes were paid or were deemed to have been paid at the rate of 30 per cent or more on the foreign source income so recalculated, generally no Canadian income tax should be payable until the foreign income was distributed to Canadian individuals. Thus, no Canadian tax should be payable by a Canadian

individual with a foreign direct investment company until he received a dividend. Similarly, in this case, no Canadian tax should be payable by a Canadian corporation with a foreign direct investment, either when dividends were received or when property or business income was earned. However, when such a Canadian corporation in turn distributed or allocated the foreign source income to its individual or corporate shareholders, or when the foreign dividends were received directly by a Canadian individual having a direct investment in the foreign company, the full rates of Canadian tax should apply to the grossed-up dividend, with a deduction of a deemed foreign tax credit at the 30 per cent rate. We recommend that where a Canadian company received the foreign income and subsequently made a distribution or allocation it should be required to withhold 20 per cent of the grossed-up amount distributed or allocated to residents in order to bring the total tax credit available to its Canadian shareholders up to the full 50 per cent 5/.

b) Where foreign income taxes were paid, or were deemed to have been paid, at a rate of less than 30 per cent, a Canadian investor (corporate or individual) having a direct investment in the foreign company should be required to pay a tax on his pro rata share of the grossed-up foreign income so recalculated sufficient to bring the total income taxes paid on such income up to 30 per cent. This would be the case whether or not the income was distributed or allocated to the Canadian investor. Thus, the Canadian tax would be the difference between 30 per cent of his pro rata share of the grossed-up income for Canadian tax purposes and his pro rata share of the actual foreign income taxes paid on this income. It might be provided that this computation would be based upon the average foreign taxes paid over a period of time, so that major differences in the tax liability between years would not distort

the overall tax position of the Canadian shareholder. If withholding taxes were imposed on a subsequent distribution by a foreign company in which the direct investment was held, a claim could be made for a refund of the special Canadian tax paid up to the amount of the tax withheld. Otherwise, a distribution would be treated in the same manner as is outlined under (a) above and 4 below.

4. When a Canadian direct investor, corporate or individual, received a dividend from the foreign corporation, the net amount received or earned (after any withholding tax deducted at source) should be grossed-up by an arbitrary 30 per cent for the deemed foreign income taxes paid. When property or business income is earned on a foreign direct investment it should be grossed-up at the lesser of the actual foreign income taxes paid or 30 per cent. In either case the grossed-up amount would be included in income and a credit would be allowed for the 30 per cent as foreign income taxes paid. Examples of this procedure are given in Table 26-1 below.

To recapitulate, the substance of our proposal is to require that income taxes (foreign and Canadian) of at least 30 per cent be paid on income from a foreign direct investment from year to year as it accrues. Other than the requirements of making whatever computation was necessary to determine whether income taxes of at least 30 per cent had been paid and of paying any Canadian tax liability that may be due as a result of such computation, there would be no further Canadian tax implications until the income from the direct investment operation was actually distributed by the resident corporate direct investor. Where a resident corporation received such income, there would be no tax consequences at the time of receipt, but only when it made a distribution or allocation to resident individuals. Thus, income would be taken into account in Canada only when received by individuals and the computation of the gross income and foreign tax credit would be relatively simple.

TABLE 26-1

AN EXAMPLE OF A TAX ARISING FROM A DIVIDEND RECEIVED BY A RESIDENT SHAREHOLDER OF A RESIDENT CORPORATION WITH INCOME DERIVED SOLELY FROM FOREIGN "DIRECT INVESTMENT", ASSUMING FULL DISTRIBUTION BY THE CORPORATIONS OF ALL EARNINGS AFTER TAXES

## Under the Proposals in This Report

| Net Foreign Dividends Received by Resident Parent Corporation | | |
|---|---|---|
| Annual before-tax income of the foreign direct investment | | $100.00 |
| Foreign corporation tax at, say, 50 per cent | | -50.00 |
| | | $ 50.00 |
| Foreign withholding tax at, say, 15 per cent | | -7.50 |
| Dividend received by resident parent corporation | | $ 42.50 |

| After-tax Resident Corporate Income Distributed or Allocated to Resident Shareholders | | |
|---|---|---|
| Resident parent corporation brings into income a/ | | $ 60.71 |
| Foreign tax deemed to have been paid b/ | $ 18.21 | |
| Withholding tax payable on distribution to resident shareholders c/ | 12.14 | $ 30.35 |
| After-tax corporate income distributed or allocated to resident shareholders | | $ 30.36 |

| Resident Personal Tax and Rebate | 25 per cent marginal rate | 50 per cent marginal rate |
|---|---|---|
| Resident shareholder brings into income d/ | $ 60.71 | $ 60.71 |
| Personal tax thereon | -$ 15.17 | -$ 30.35 |
| Corporation tax credit | +30.35 | +30.35 |
| Canadian tax rebate | $ 15.18 | $ 0.00 |

| Cash Position of Resident Shareholder | 25 per cent marginal rate | 50 per cent marginal rate |
|---|---|---|
| Cash dividend | $ 30.35 | $ 30.35 |
| Net resident tax rebate | 15.18 | 0.00 |
| Net cash | $ 45.53 | $ 30.35 |

## Under the Present Tax System

| Net Foreign Dividends Received by Resident Parent Corporation | $ 42.50 |
|---|---|
| After-tax Resident Corporate Income Distributed to Resident Shareholders | $ 42.50 |

| Resident Personal Tax | 25 per cent marginal rate | 50 per cent marginal rate |
|---|---|---|
| Resident shareholder brings into income | $ 42.50 | $ 42.50 |
| Personal tax thereon | -$ 10.62 | -$ 21.25 |
| Dividend tax credit | 8.50 | 8.50 |
| Net tax paid | $ 2.12 | $ 12.75 |

| Cash Position of Resident Shareholder | 25 per cent marginal rate | 50 per cent marginal rate |
|---|---|---|
| Cash dividend | $ 42.50 | $ 42.50 |
| Net resident tax paid | 2.12 | 12.75 |
| Net cash | $ 40.38 | $ 29.75 |

Notes:

a/ $\$60.71 = \frac{\$42.50}{100 - 30 \text{ per cent}}$ (i.e., $42.50 dividend received grossed-up at a rate of 30 per cent)

b/ $18.21 = 30 per cent of $60.71 (or $60.71 less $42.50)

c/ $12.14 = 20 per cent of $60.71

d/ $\$60.71 = \frac{\$30.36}{100 - 50 \text{ per cent}}$ (i.e., $30.36 dividend received grossed-up at a rate of 50 per cent)

Table 26-1 illustrates the basic gross-up and credit computations required under our proposal for a Canadian shareholder and a Canadian parent corporation of a foreign subsidiary and contrast them with the present system. It is assumed that the foreign subsidiary had before-tax income of $100 and that the balance remaining after tax was distributed in full right through to the individual Canadian shareholder.

Most Canadian individual shareholders who held an interest, either personally or through a Canadian corporation, in a foreign direct investment that was subject to foreign income taxes of at least 30 per cent would have their position improved by the use of an arbitrary 30 per cent gross-up procedure.

We pointed out earlier in this Report the importance of eliminating possibilities for tax deferment, and in our recommendations concerning taxation of domestic source income we suggested procedures to accomplish this objective. An extension of this approach to the foreign direct investment income of Canadians would be to impose an additional 20 per cent tax on a Canadian corporation having such income at the time it was earned in order to bring the total of the creditable foreign taxes and Canadian taxes on its portion of the foreign income up to 50 per cent. A Canadian individual having a foreign direct investment would include his portion of the income in his tax base at the time such income was earned. However, we do not recommend such a major step at the present time for a number of reasons. In the first place we have not recommended that capital gains be subject to tax on a full accrual basis and accordingly the taxation of foreign source income on this basis would be more severe than our recommendations for some types of domestic income. Secondly, if distributions were made by a foreign corporation to provide funds to pay the Canadian tax, this might result in liability for withholding tax in the foreign country which would further increase the taxes immediately payable. Accordingly, the imposition of the additional 20 per cent tax might adversely affect the competitive position in the foreign country of an enterprise having Canadian direct investors.

Thirdly, there may be circumstances in which a Canadian investor has a minority interest in a foreign corporation and is not in a position to obtain information as to the amount of the foreign income or is unable to obtain distributions with which to pay the additional Canadian tax, and special relief would presumably be necessary for these cases. Fourthly, we later recommend that the additional 20 per cent tax should not apply to that portion of the foreign direct investment income of a Canadian corporation which is distributed to non-resident shareholders, so that if this tax was imposed on an accrual basis special provisions would be required to exempt the income accruing for non-resident shareholders. While for these reasons we do not recommend the taxation of foreign direct investment income on a full accrual basis at this time, consideration might later be given to this possibility to prevent undue deferment of the tax liability. If this were done we would suggest that it should not apply to foreign direct investment income earned in the United Kingdom and the United States and possibly in other countries designated by regulation, so as to ensure that the above difficulties do not apply to most foreign direct investment income.

As a means of combating tax avoidance we examined the possibility of defining tax havens in order to apply special rules to income derived from those sources. Although we believe that such a definition is possible (perhaps by defining a genuine business operation), any test that essentially must rely on a business purpose rule would be difficult to administer. Since the purpose of rules relating to tax-haven companies would be to speed up the imposition of a tax that would eventually become payable on distribution or realization, it would be necessary to require that the full Canadian tax be paid on an accrual basis. We do not recommend the use of such a business purpose test or any other definition of a tax-haven operation at the present time. However, if the use of tax havens continued to increase despite the immediate imposition of tax up to a 30 per cent level and the full taxation of property gains, consideration should be given to the limited application of the full accrual procedure to income of tax-haven operations.

It should be noted that the general procedures we have proposed in Chapter 19 for the recording of adjustments to the cost basis of property would be equally suitable for recording the taxation of foreign source income on a full accrual basis if, for example, at some future time this was considered desirable in the case of tax-haven companies or foreign direct investment income generally (other than from listed countries). The cost basis of a foreign direct investment could be increased each year by the amount of income after foreign taxes which was earned in the foreign jurisdiction. Any dividends paid, up to the total amount of these increments in the cost basis, would then be considered a return of capital and would result in a reduction in the cost basis or, if they exceeded the cost basis, the excess would be included in income. The Canadian investor would be entitled to a refundable credit in respect of any withholding tax which was imposed by the foreign country at the time the dividend was paid. A procedure along these lines would necessitate a detailed annual computation of the foreign source income for Canadian tax purposes. However, the use of arbitrary rules along the lines already discussed would simplify these computations and should prevent the procedure from becoming unduly cumbersome.

Rate of Foreign Tax Credit for Foreign Direct Investment Income. The choice of the rate of gross-up and credit for foreign corporation taxes and withholding taxes paid by foreign corporations in which Canadians hold direct investments deserves a special comment. Assume, for the moment, that an investment of $1,000 in corporate assets yields before-tax income of $100 both in Canada and in the foreign jurisdiction. Assume a corporate rate of tax of 50 per cent in each country. If a Canadian resident forms a Canadian corporation that operates entirely in Canada and distributes all of its after-tax income, shareholders with marginal rates of 50 per cent now receive an annual after-tax return of $35. 6/ If, on the other hand, the Canadian corporation forms a foreign subsidiary, the $1,000 in corporate assets invested abroad returns to the Canadian shareholder of the Canadian corporation $29.75 after taxes, assuming the rates of foreign tax used in the calculation

above. In other words, the before-tax income on the corporate assets of a direct investment in the foreign country would have to be about 16 per cent greater than the return in Canada to be equally attractive to a Canadian shareholder.

Under our integration proposal, if there was no shifting or adjustment in the rate of investment in Canada, a Canadian resident taxed at a marginal rate of 50 per cent who owned shares in a Canadian corporation with Canadian source income would earn $50 7/ per $1,000 of corporate assets rather than $35 as at present. If the tax treatment of income from a foreign direct investment remained unchanged, the Canadian direct investor in the example cited earlier would have to earn a before-tax income on corporate assets that was about 68 per cent higher in the foreign country than in Canada to make the same after-tax return 8/. This percentage would vary, depending on the rates of foreign corporation taxes and withholding taxes. Under the proposal that we recommend (a gross-up and credit for foreign taxes at 30 per cent) the total tax liability on foreign direct investment would be slightly reduced for the 50 per cent shareholder in most circumstances. It would be more substantially reduced for most low income and middle income resident shareholders (as shown in Table 26-1). The after-tax return from the foreign direct investment would equal that received from a Canadian investment with the same before-tax income only if the total rate of foreign taxes was 30 per cent or less.

The adoption of the 30 per cent gross-up and credit for foreign corporation taxes would have the following consequences:

1. In most cases a Canadian resident with direct investments abroad would not be worse off with respect to dividends received from such investments.

2. Income from foreign direct investments in most cases would be taxed much less heavily to low income Canadian shareholders than at present.

3. The refunds to low income shareholders for foreign corporation taxes would be more than offset by the Canadian taxes collected from upper income shareholders.

4. There would be a reduction in Canadian revenues from foreign direct investment by Canadians, but there would be no net refund by Canada of taxes levied by foreign governments.

With a credit of less than 30 per cent for foreign corporation taxes, upper income shareholders of Canadian corporations with direct investments abroad would be worse off. With a higher credit, Canada would refund more through the foreign tax credit than would be collected on the same income at the progressive rates of Canadian tax. As a result, corporations competing against Canadian foreign subsidiaries in other countries would justifiably protest that Canadian foreign subsidiaries were being subsidized by the net rebates by Canada of foreign taxes paid.

The estimate that the before-tax return on corporate assets would have to be higher in a foreign country which imposed corporation and withholding taxes at rates totalling more than 30 per cent than in Canada (about 68 per cent higher in the example cited) to yield the same after-tax return to a Canadian shareholder was, as we said, predicated on the assumption that there would be no change in the before-tax rate of return on corporate assets in Canada as a result of integration. As we indicated in Chapter 19, we do not expect this assumption to hold.

There would be some reverse shifting under integration—that is to say, some portion of the reduction in the corporation tax would be passed on to consumers or suppliers or both—and, in addition, the improved cash position of corporations and the higher prices of Canadian shares should bring about a re-allocation of investment in Canada. We frankly admit that we have no precise estimates of the speed with which these adjustments would take place but we are confident that they would take place and that

they would, in time, reduce the before-tax rate of return on corporate assets in Canada.

It is important to recognize, therefore, that the immediate result of adopting our integration proposal would be to make Canadian investment in Canada much more attractive to Canadians from the standpoint of taxation than most foreign investment. However, the adjustment subsequent to integration would tend to reduce the before-tax rate of return on corporate assets in Canada, and because the before-tax rate of return on foreign corporate assets would not likely be affected by integration in Canada, the relative unattractiveness for Canadians of investing abroad would gradually be reduced.

The uncertainty as to the speed of the adjustment of the return on corporate assets following integration makes it extremely difficult to select the optimum rate of credit for foreign corporation taxes that should be adopted. If the adjustment were slow, a high rate of credit would be required if foreign investment by Canadians was not to be substantially reduced for a prolonged period. If the adjustment were rapid, a lower rate of credit would be acceptable.

The extent of the adjustment is also relevant in determining the rate of the credit. When the adjustments following integration had been completed, would the expected before-tax rate of return on corporate assets in Canada be equal to, greater than or less than those that now prevail? What would be the differential between these Canadian expected rates of return and those in other countries? Answers to these questions obviously would depend upon a multitude of factors, including national savings and investment rates, changes in attitudes toward risk and technological changes. Fortunately these difficult questions do not have to be answered because the credit does not have to be fixed in any ultimate sense.

If expected before-tax rates of return on Canadian corporate assets declined to the point where foreign investment became more attractive than

domestic investment, the 30 per cent credit could, of course, be reduced 9/. In any event, the extent to which foreign investment by Canadians should be encouraged or discouraged in the future would have to be judged in the context of the future needs of the economy and our international commitments at that time. The credit device is sufficiently flexible that we think it could be used to discourage or encourage foreign investment by Canadians as the occasion demanded.

Computation of Foreign Source Income for Canadian Tax Purposes. It will be recalled that a cardinal feature of our proposal is to require that income taxes of at least 30 per cent be paid on income from a foreign direct investment from year to year as it accrues. If foreign income taxes were less than 30 per cent of the foreign income, the difference would be paid to Canada as a special tax. In order to satisfy this requirement it would, of course, be necessary to compute the foreign income.

It is extremely important, we believe, that any procedure adopted for the taxation of foreign source income should be certain in its impact and relatively simple to administer. Complex tax provisions under which the exact tax implications are not known for some years after a transaction is completed are inequitable and a serious deterrent to international business.

We therefore recommend that the computation of foreign source income for Canadian tax purposes should not be based upon the full and detailed application of the Canadian legislation; with some exceptions, it should be the income as reported to the foreign tax authorities. However, certain general principles should be applied to foreign source income in the same way as to income earned in Canada, even if these principles were not part of the law of the foreign jurisdiction. For example, if all kinds of gains of Canadians were to be taxed and no type of income was to be exempt from tax, foreign source capital gains should also be taxed in full. Similarly, percentage depletion on mining and petroleum operations should be disallowed whether the income was derived from Canada or from a foreign jurisdiction.

Thus, the starting figure for the foreign source income subject to tax should be the income as reported to the foreign tax authority. But adjustments of a general nature should be made so that foreign source income would be defined in roughly the same way as Canadian source income. Alterations should not be made to put the timing of the income on exactly the same basis or to ensure that the allowance or disallowance of minor expenditures was similar. The depreciation or capital cost allowance permitted by the foreign jurisdiction should generally be accepted.

The required adjustments should be explicitly detailed in regulations to prevent uncertainty. These regulations would also specify which foreign taxes were to be treated as income taxes for purposes of the tax credit computation.

In some cases there would be no requirement to report income to a foreign tax authority, as, for example, where certain tax havens were used. In other cases the concept of income as computed for tax purposes in the foreign country would not be at all comparable to the Canadian concept. In these circumstances, it probably would be necessary to base the computation on the income as shown in audited financial statements, with adjustments to bring it into line with the concept used for Canadian tax purposes. In the absence of a reliable audited financial statement, it would be necessary to compute the income in detail in accordance with Canadian tax law.

To further simplify procedures, income derived from the United States or the United Kingdom (with perhaps other countries to be similarly designated subsequently) should be subject to virtually no adjustments for, generally, income from Canadian direct investment in these countries would be deemed to have been subjected to income taxes of at least 30 per cent. The only circumstances in which adjustments would have to be made would occur when the amount of the foreign source income as defined for foreign income tax purposes was substantially different from what it would have been for Canadian tax purposes because certain specified items of particular

significance under Canadian tax law had not been taken into account (e.g., capital gains, depletion and a few others). These adjustments should be required only when they exceeded a specified proportion of the income reported to the foreign tax authority for a period of three or five years. In such an event the procedure applicable for other countries should be followed. Because over three quarters of foreign direct investment income attributable to Canadian individuals is derived from these two countries, and because the exception would not often apply, well over one half the foreign direct investment income of Canadians would not be subject to adjustment.

Problems Arising from Lack of Control by Foreign Direct Investors. Because a foreign direct investment would be defined to include an interest of 10 per cent or more in a foreign corporation, which may be less than a controlling interest in the foreign corporation, it may happen that a Canadian resident having such an investment would be unable to obtain information from which to compute his tax liability. Where this was the case and the taxpayer made a declaration that he was unable to obtain access to the necessary corporate information, either by himself or in conjunction with other shareholders with whom he was not dealing at arm's length, he should be entitled to make an election that the investment be treated as a portfolio investment. This election should be possible only if the taxpayer had taken all reasonable steps to obtain the information, and it would not be available in any case in which he controlled the foreign corporation either alone or together with other shareholders with whom he was not dealing at arm's length.

It is also possible that a shareholder with a direct investment in a foreign corporation subject to a low rate of foreign income tax would not be able to obtain any distribution from the corporation with which to pay the special Canadian tax on the income earned by the corporation. If the corporation was in a jurisdiction which imposed income taxes at the rate of 30 per cent or higher, no Canadian income tax would then be payable on the income earned (until it was distributed by the Canadian corporate direct investor),

and there would not be any such difficulty. If the corporation was in a jurisdiction which imposed income taxes at a lower rate, the shareholder would be liable for a special tax. However, there would only be a "double" tax if the investor disposed of his foreign direct investment without having received the income on which he had paid the special tax. Relief could be provided by permitting a tax credit in these circumstances for the amount of the applicable special tax paid.

<u>Taxes "In Lieu" of Income Tax</u>. Industries in some taxing jurisdictions are subject to taxes other than income taxes. While we fully realize the complications involved in such a recommendation, we believe that with an increased reliance on the gross-up and credit procedure it would be essential to recognize any tax levied by another country that could reasonably be regarded in the circumstances as an alternative to an income tax. Such taxes may take the form, for example, of pay-roll taxes or natural resources taxes. We recognize that comparable taxes levied by the Canadian federal government or a provincial government in Canada would be treated as a charge on net profit; nevertheless, it might well be reasonable to deem such foreign taxes to be income taxes for purposes of computing the foreign tax credit. We do not consider that this treatment should be extended to sales taxes or import duties.

Canada does not now allow credit for income taxes imposed by a political subdivision of a foreign country. From the standpoint of the investor there would generally not seem to be any difference in principle between taxes paid to a central government or to a provincial or state government. Accordingly, it may be desirable in some cases to specify that income or equivalent taxes paid to a political subdivision of another country would be deemed to have been paid to the government of that country, at least where the government of the other country granted a credit for income taxes imposed by Canadian political subdivisions, as well as for taxes imposed by Canada.

<u>Integration with Canadian Individual Income Tax</u>. We have proposed the partial integration of foreign corporation taxation with the Canadian individual income tax on the distribution of dividends to Canadian individual shareholders. A 30 per cent gross-up on such dividends and a credit against individual income tax at a rate of 30 per cent has been recommended. We estimate that this is approximately the average Canadian rate of personal income tax on foreign source corporate income 10/. A credit of this amount would, however, provide some Canadian tax revenues even though a number of shareholders would be eligible for refunds, because some tax would be collected on income derived from tax-haven operations. In addition, adoption of this rate would ensure that most Canadian shareholders would not receive less credit than they do under the present procedure. Many shareholders would have their tax credits considerably increased.

A uniform gross-up at a rate of 50 per cent for all dividends received from Canadian corporations, no matter what the source of the income from which they were derived, would greatly simplify the system for the shareholder. To achieve this result, we have proposed that at the time of making a distribution or allocation a Canadian company having foreign direct investment income should withhold an additional tax of 20 per cent of the grossed-up portion of the dividend paid or allocated to resident shareholders that was deemed to come from foreign direct investment income. For this purpose it was recommended in Chapter 19 that distributions should be deemed to come <u>pro rata</u> from the grossed-up amounts of domestic and foreign source income. It will be seen that a corporation having foreign direct investment income which made an allocation of taxed income would be required to make a cash payment sufficient to pay this withholding tax. A detailed method of computing and allowing credit for this tax is discussed in Appendix H to this Volume.

Levying this additional tax to facilitate the recording of distributions to Canadians, however, would have unfavourable implications if applied to distributions made to non-resident shareholders. At the present time non-resident

shareholders pay only a Canadian withholding tax on distributions paid from foreign direct investment income flowing to a Canadian company in which they hold shares. Because such dividends would continue to be subject to the regular non-resident withholding tax, it is not intended that the total taxes imposed on these shareholders should be increased. Accordingly, the special 20 per cent withholding tax should not be deducted or paid in respect of distributions to non-resident shareholders. In the case of shares beneficially owned by non-residents but registered in the names of Canadian nominees, the special 20 per cent withholding tax on distributions out of foreign direct investment income would, of course, be withheld and remitted to the government by the corporation making the distribution or allocation. In this case the non-resident beneficial owner of the shares should be entitled to apply to the government for a refund.

Where a Canadian corporation had a substantial interest of, say, at least 10 per cent in another corporation which made a distribution or allocation out of foreign direct investment income, the receiving corporation should be entitled to apply to the government for a refund of the 20 per cent tax withheld by the corporation making the distribution or allocation. It could be provided as an alternative that such a receiving corporation could file a form with the distributing corporation which would exempt distributions or allocations to the receiving corporation from the special withholding tax. In either case the distribution or allocation made out of foreign direct investment income would be treated as foreign direct investment income of the receiving corporation, so that the 20 per cent would be withheld when the receiving corporation itself made a distribution.

Effect of Our Proposal for Direct Investment Income. Some effects of the proposal just outlined may be briefly summarized:

1. For income received from direct investment in foreign countries levying direct taxes on corporate income of 30 per cent or more, the simplicity at present achieved under section 28(1)(d) would be retained. Some countries obviously fall into this category. We

suggest that they should be named by the administration as qualified sources. We have in mind particularly the United States and the United Kingdom.

2. The effect of requiring that at least a 30 per cent tax be paid on an accrual basis on the income of a foreign direct investment would at least partially restore equity among individual Canadian shareholders by ensuring that a substantial rate of income tax was paid on all investment income no matter where earned. We believe that this device would reduce tax avoidance by Canadians through the use of tax havens.

3. Foreign source income would be subject to progressive rates of tax. The use of an arbitrary gross-up and credit would extend to foreign source income the same procedure as that applied to Canadian corporate income. This would ensure that the progressive rate schedule would be equitably applied.

4. The credit permitted for foreign income taxes paid would be the maximum credit which is consistent with the collection of some Canadian tax revenue from foreign source direct investment income.

5. An unfortunate side effect of the proposal, although it is not as serious as it would be under a system of full gross-up and credit, would be that the tax concessions granted by under-developed countries would be "neutralized". We chose this alternative rather than the complicated provisions necessary to separate a legitimate investment in an under-developed country from a tax-haven operation. To reduce this undesirable effect, we propose that "tax sparing"—the allowance of a credit for a foreign tax whether payable or not—be authorized on a country-by-country basis. This could be done by treaty.

6. The partial integration of foreign corporation income tax with Canadian personal income tax would restore the relief that would be lost on

withdrawal of the dividend tax credit. This credit is now allowed on dividends declared by a Canadian corporation from foreign source income.

Compared with other countries (for example the United States) the foreign tax credit we recommend might appear small. The Canadian credit would be limited to 30 per cent in respect of foreign corporation and withholding taxes. In some countries the credit is 50 per cent or more. It must be borne in mind, however, that while a credit is given against the United States corporation income tax for the full amount of the foreign taxes (up to the effective United States corporation tax rate), the credit does not go beyond the United States corporation. Its value to the individual shareholder is the benefit he may derive indirectly from a reduced corporation tax. Under our proposal the benefit to the shareholder would be reflected in a direct reduction in his personal income tax and possibly in a refund of tax. The amount of the refund could be material for a low income shareholder. Throughout this Report we have emphasized that it is the tax burden on the individual that is the crucial consideration.

Business Income. The proposal detailed above also encompasses the disposition of business income earned in a foreign country through an unincorporated branch. It is now dealt with simply as income of the Canadian resident. It is taxable in full on a grossed-up basis in the year earned, whether distributed or not, with a credit for direct taxes paid to the foreign jurisdiction. We have had to bear in mind particularly that foreign branch profits of a Canadian company can be the source of dividends distributed to Canadian shareholders. We concluded that foreign business income of a branch should, as far as possible, be dealt with in the same way as income from direct investment in foreign corporations. This would, in general, provide neutrality between the different possible procedures for carrying on business or holding property in a foreign country. The credit for foreign income taxes paid would therefore be limited to 30 per cent,

and the income included in the return of the Canadian taxpayer would be the result of grossing-up the net after-tax foreign business income for taxes deemed to be paid at the rate of 30 per cent, regardless of the actual foreign income taxes paid. Also, the Canadian corporation would not be subject to any Canadian tax, over and above the amount of any special tax due if the foreign income taxes were less than 30 per cent, until such time as the foreign source direct investment income was allocated or distributed to resident shareholders. One discrepancy between forms of business organization would remain, however, as Canadian individuals operating unincorporated businesses abroad would in effect be taxed on the full accrual basis, while incorporating the business would permit them to defer their Canadian tax liability until the profits were both remitted to Canada and distributed or allocated to resident shareholders.

Portfolio Investment Income

Portfolio investment income would be that income received from foreign investments where less than a 10 per cent interest was held in a corporation, a business or a property. We recommend that, generally speaking and subject to the option referred to below, portfolio investment income should continue to be taxed as at present and that the dividend or other payment should be grossed-up for the amount of foreign withholding tax (if any) and included in income. Credit should be allowed only for the foreign withholding tax paid on the dividend or other income and not for any underlying corporation tax. However, for the reasons outlined below, we also recommend that a portfolio shareholder should be permitted to elect to be taxed as a direct investor on certain dividends received. In practice, we would expect that this election would only be used for dividends from United States and United Kingdom companies or companies in other countries designated in the regulations as being countries for which the full 30 per cent credit was allowed. However, it might be extended to other cases if the shareholder was able to provide the necessary detailed and verified information concerning the income of the foreign company and the taxes paid by it.

One reason that we are able to propose the full taxation of share gains is that, under our integration proposal, the so-called "double taxation" of corporate source income would be eliminated. On distributed earnings, only the personal rate of tax would apply. In addition, under our proposals, retained earnings could be allocated to resident shareholders by Canadian corporations in such a way as to preclude the "double" taxation of that part of share gains resulting from corporate retentions. These corporate allocations would have no tax consequences for non-resident shareholders but would be advantageous to resident shareholders. Canadian corporations thus would have everything to gain and nothing to lose from the allocation of retained earnings.

The situation of Canadian minority shareholders in foreign corporations would be completely different. If a tax credit was allowed for withholding taxes only, the underlying foreign corporation tax would be a "double" tax. Whether the Canadian shareholder derived his income in the form of dividends or share gains, he would still be subject to full personal taxes on the gross amount of the income (before any withholding tax) and would receive no credit for the underlying corporation taxes paid. Therefore, even if the present credit for withholding taxes was continued, our proposal to tax share gains in full could increase substantially the total income taxes on Canadian portfolio investors in foreign corporations—unless some additional credit was given for foreign corporation taxes.

In order that portfolio investors in foreign securities should not be unduly worsened relative to their present position, it should be provided that portfolio investors be given the option of claiming the same arbitrary gross-up and credit of 30 per cent which we recommend for direct investors if foreign corporation and withholding taxes in excess of this amount were actually paid. Because United States and United Kingdom corporations would ordinarily be deemed to have paid foreign taxes at least to the extent of 30 per cent, Canadians holding portfolio

investments in United States and United Kingdom corporations (or in corporations of any other countries which might be designated in the regulations) could in general obtain the 30 per cent credit without having to compute in detail the income of, and taxes paid by, the foreign corporation. The dividend return from these shares would become more attractive than it is now, and this would mitigate the effect of the full taxation of share gains. In many cases Canadian portfolio shareholders of corporations in other countries would not be able to determine the current income of the corporation for accrual purposes and therefore would not be able to take advantage of this option. Limitations on the application of the option may be required to ensure that the provision was not used for tax avoidance.

Non-Resident Trusts. It is quite possible that some taxpayers would endeavour to avoid Canadian tax liabilities through the creation of non-resident trusts which would receive income and accumulate it for Canadian beneficiaries. This may present a particular challenge to the Canadian tax authorities in view of the possibilities for tax deferment under such an arrangement. If the interests of the Canadian beneficiaries were contingent or were subject to the exercise of discretion by trustees, it may be difficult to devise a method for taxing such income in Canada on an accrual basis. However, to the extent that income of a non-resident trust was payable to a Canadian beneficiary or was vested in a Canadian beneficiary, we would recommend that it should be treated as direct investment income and subjected to tax under the rules we have recommended for other foreign direct investment income.

Transitional Provisions. A computation of the earnings accumulated as at the transition date by foreign subsidiaries would be important in determining the tax status of future distributions. For we have recommended that any distributions out of earnings accumulated prior to the transition date, whether they were accumulated domestically or in the foreign subsidiary, should be regarded as distributions of capital. Accordingly,

the amounts distributed would not be included in income but rather would be taken as a reduction of the cost basis of the shares held. The order of pay-out should also be similar to that recommended for domestic companies, with any distribution deemed to come first from income earned subsequent to the transition date and, to the extent that it exceeded such income, would be deemed to be paid out of surplus existing at the transition date.

## TAXATION IN CANADA AS THE COUNTRY OF SOURCE

### Equity and Neutrality Considerations

It is quite clear at the outset that it would be impossible to achieve equity in the sense that the income of non-residents would be taxed on the same basis as that of residents. The cardinal rule we have adopted for the taxation of residents is that all net gains should be brought into the tax base of the individual or family and the aggregation subjected annually to progressive rates of tax. This rule cannot be applied to non-residents because Canada cannot determine the net gains of non-residents that arise outside of Canada and, in fact, cannot determine all the net gains of non-residents arising in Canada (e.g., it is difficult to identify many property gains realized by non-residents). Even if this administrative hurdle could be overcome, and we are convinced that it cannot except in certain specified circumstances, the problem would not be resolved, for the total tax burden of non-residents obviously depends on the taxes imposed by other countries as well as the taxes imposed by Canada. To attempt to tax a non-resident on his Canadian source income in the same way as he would be taxed if he were a resident would mean that Canadian taxes would have to be adjusted to compensate for the other taxes paid by the non-resident. Canada would have to tax the Canadian source income of non-residents lightly if the non-resident's own government did not give credit for Canadian taxes or had heavier taxes than Canada. This would be administratively impractical; it would also mean that other nations would be encouraged to refuse to give

their residents credits for Canadian taxes, with the result that the net benefit from foreign investment in Canada would be reduced.

Having concluded that non-residents cannot generally be taxed in the same way as residents, we believe that there are basically two alternative methods of taxing the Canadian source income of non-residents:

1. A uniform rate of tax imposed on all kinds of Canadian source income.
2. Different rates of tax imposed on different kinds of Canadian source income.

The former alternative has the advantage that it would reduce the avenues for avoidance. With different rates of tax, it may be possible to achieve a substantial tax saving by changing the form of an investment in Canada or the form of a payment to the non-resident investor. The uniform rate of tax has several important deficiencies.

Because of the foreign tax credit provisions of other governments, non-residents can offset some Canadian taxes on some kinds of income against their domestic tax liabilities. In essence the Canadian tax is at the expense of the foreign treasury rather than of the foreign investor. Because the credits given by other governments are not uniform as between different kinds of income, full advantage could not be taken by Canada of these foreign tax provisions if a uniform rate were adopted by Canada.

If Canada lowered taxes that the foreign investor did not bear because of the credits provided by other governments, Canada would lose the revenue and the non-resident investor would not benefit. On the other hand, if Canada raised taxes that the foreign investor would pay because no credit or an incomplete credit was provided by other governments, foreign investment may be deterred. In the latter case, what would be gained from a higher rate probably would be more than offset by a lower base.

We have concluded, therefore, that as long as foreign governments continue to vary the credits which they provide their residents against foreign taxes paid on different kinds of foreign source income, Canada should not attempt to impose tax on such payments at a uniform rate. However, to minimize the opportunities for avoidance, in future treaty negotiations Canada should seek to reduce tax rate differentials on different kinds of income. Canadian subsidiaries of foreign parent companies can readily arrange to make payments to their parents in a form which will minimize tax. Neither parent nor subsidiary is generally interested in what the payment is called as long as it is made.

Having concluded that differential tax rates should be continued, we now consider some of the factors involved in determining the rates to be imposed by Canada.

As we pointed out in Chapter 5, there is little doubt that Canada obtains a net benefit from foreign investment. A substantial part of that benefit, but not the whole of it, arises through taxing the income flowing to non-residents from their investments in Canada. The net benefit would be increased if more Canadian revenues could be raised from this source without directly reducing the inflow of foreign capital or without bringing about retaliatory measures by other governments that would indirectly reduce the inflow.

Canada could raise the general level of taxes levied on some of the Canadian source income of foreign investors with few adverse effects. On the other hand, the present level of tax on corporate source income attributable to non-residents is substantial and, in the case of both the United States and the United Kingdom, is close to, or exceeds, the maximum amount that the non-resident investor can claim as a foreign tax credit. We have no way of knowing how sensitive foreign investment is to changes in after-tax rates of return; we do not know the effects on foreign confidence of a given tax change; we do not know how likely foreign retaliation would be

or the form it would take. Faced with this lack of knowledge, we believe that the general level of tax rates applicable to the Canadian source dividend income of foreign investors should not be increased if this could be avoided without sacrificing Canada's ability to reform its own tax system.

We are convinced that while Canada must avoid tax changes that would shake the confidence of non-residents or bring about retaliation by other governments, this concern for the interests of non-residents should not be carried to the point of guaranteeing to non-residents that, having invested in Canada in the past under a set of tax rules, tax provisions would never be changed if this would affect non-residents adversely. There are few if any domestic tax provisions that do not have some significance for non-residents. A guarantee that the tax position of non-residents would never be worsened would, in effect, freeze the domestic tax system forever. It would be extending a guarantee to non-residents that would not be available to Canadian residents and would not be made to non-residents by their own governments. We think that Canada has an obligation to provide liberal and smooth transitional provisions when the tax system is changed. Tax changes should generally apply to residents and non-residents alike. But neither residents nor non-residents should be exempt from general tax reforms merely because investments were made at a time when tax provisions were favourable.

The withholding tax rate on such income as interest and royalties, is not, however, subject to this constraint and we are recommending that it be increased from 15 per cent to 30 per cent. Initially this change would adversely affect very few non-resident investors because most are residents of countries with which Canada has tax treaties that provide for a 15 per cent rate. However, the level of tax that should eventually apply under the treaties would be a matter for future negotiations. For some payments it would appear that Canada should endeavour to collect the higher rate, while for other payments a rate of 15 per cent or less might well be appropriate. This increase would

also serve a useful domestic purpose. Although our proposal for the taxation of foreign source direct investment income should mean that income tax of at least 30 per cent would be paid on income accumulated in tax-haven countries, the higher rate of withholding tax would provide additional assurance that tax of at least 30 per cent had been paid on payments to companies in tax-haven countries. Because the 30 per cent withholding rate is the "standard" rate in the United States and approximates the standard rate in some other countries, from which reductions are made by treaty, there would be little or no risk of retaliation or of weakening foreign confidence in adopting the same rate for Canada.

The Concept of Residence

We recommend that residence continue to be the principal basis for determining liability to tax, largely because residence seems to imply a closer association than citizenship between the taxpayer and the use of services provided by a taxing jurisdiction 11/. It is the test which has been followed from the beginning of Canadian income tax and on which most of our existing practice is based.

Unfortunately the concept is not without its share of obscurity. The Income Tax Act neither fully defines the term "resident" nor indeed gives very much guidance as to its meaning. It is a product of jurisprudence, and both the literature and the cases show that it has been the subject of a great deal of dispute. The need for greater certainty would be all the more pressing under some of the proposals in this Report (e.g., the deemed realization of property gains on a change of residence), and we therefore are most conscious of the desire for further clarification. Any greater certainty by means of statutory rules can be achieved only at the expense of being arbitrary. Nevertheless some progress may be possible.

For an individual some statutory guidance is given by an arbitrary rule which deems a person to be resident on the basis of the duration of

physical presence in Canada (183 days or more in the year) 12/. However, the rules derived from case law are of equal or greater importance. They establish that the determination of residence is a question of degree and that each case turns on the facts which bear on the relationship of a person with Canada, such as, for example, the maintenance of a dwelling in Canada, the general routine of visits to Canada, the reasons for and the amount of time spent in Canada during such visits both in the taxation year and in previous years, family and other associations (clubs, ownership of property, etc.) in Canada, and similar criteria.

For a corporation, the traditional rule under the case law is that it is resident where its central management and control are situated. This is ordinarily where its directors reside and hold their meetings, with the result that a change in the location of such meetings can result in a change of the residence of the corporation. If it can be shown, however, that the central management and control are in fact exercised not by the directors but by the controlling shareholder, the corporation may be treated as resident in the jurisdiction in which the control is exercised 13/.

The importance of the traditional tests in Canada has greatly decreased in recent years as statutory rules have been introduced to frustrate tax avoidance by residence changes. Legislation enacted in 1961, 14/ provided that a company was deemed to have been resident in Canada throughout a taxation year if it was a company incorporated in Canada which carried on business in Canada at any time during the year. Under this provision, a corporation meeting both conditions was a resident even if its central management and control were outside Canada. This provision was amended in 1965 to establish that Canadian incorporation is conclusive evidence of residence for companies which were incorporated after April 26, 1965, or which were resident or have carried on business in Canada in any taxation year ending after April 26, 1965. The general effect of these provisions is that a company will be resident in Canada if its central management and

control is in Canada or if it was incorporated in Canada, unless it has been a non-resident and has not carried on business in Canada since prior to April 26, 1965.

Even with the above-mentioned statutory provision the traditional test will still apply in areas of major importance. Foreign incorporation is still a key element in many tax avoidance schemes, and it is essential that the judicial concept be applied on a practical basis if purely artificial corporate entities which are in fact managed and controlled from Canada are not to escape Canadian tax liability. We have seen that such corporations may be held to be resident in Canada notwithstanding foreign incorporation and foreign directorates, and it is possible that in some cases the Canadian tax authorities may be able to establish liability to tax on this basis.

Later we suggest changes for strengthening administrative procedures. At this point we would mention only that the annual filing of a return of assets for purposes of the proposed tax on asset gains should assist the administration in identifying the holdings of Canadians in foreign companies which may in fact be controlled and, hence, may possibly be resident, in Canada.

Carrying on Business
in Canada

Unfortunately the concepts of business, and the carrying on of a business, are no more clearly defined than is residence. The Income Tax Act provides little guidance. Business is defined as including "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" 15/. A good deal of case law has been devoted to settling the meaning of some of the basic ingredients of this definition, such as calling, trade, manufacture, undertaking and adventure or concern

in the nature of trade, so that without reference to judicial decisions the definition as a whole is not conclusive. The courts have frequently been concerned with such terms in determining the taxable status of gains for purposes of domestic taxation, and the criteria that have emerged—such as the "badges of trade"—are of relevance to the same question when encountered in its international context.

The Income Tax Act has gone somewhat further for international purposes by providing an extended meaning of "carrying on business" in the case of non-residents. It is as follows: 16/

> "Where, in a taxation year, a non-resident person
>
> (a) produced, grew, mined, created, manufactured, fabricated, improved, packed, preserved or constructed, in whole or in part, anything in Canada whether or not he exported that thing without selling it prior to exportation, or
>
> (b) solicited orders or offered anything for sale in Canada through an agent or servant whether the contract or transaction was to be completed inside or outside Canada or partly in and partly outside Canada,
>
> he shall be deemed, for the purposes of this Act, to have been carrying on business in Canada in the year."

The other source of guidance on the international taxation of business is the tax treaties. Over time some concepts have become common in dozens of treaties entered into between nations. Where such a treaty applies and conflicts with the general law, the treaty will prevail. In most treaties a primary requirement for taxing business earnings in the nature of "industrial and commercial profits" is that there be a "permanent establishment" of the foreign business in the country attempting to levy tax. The nature of a permanent establishment is usually defined at some length.

Adoption of our comprehensive tax base would reduce the importance of the distinction between business and non-business activities for domestic purposes. But in the international area we must continue to rely on a number of tests and safeguards to prevent avoidance of Canadian taxation through artificial devices and to frustrate those who would use Canada as

a tax haven. We have no proposals for revisions in the underlying concepts, which seem incapable of more complete or satisfactory definition in the statute; only the courts can bring these concepts into sharper focus. We suggest, however, that the "permanent establishment" concept should be incorporated into the legislation so that the existence of such an establishment would be conclusive evidence that business was carried on in Canada. Later, in our proposals on administration, we urge a more energetic use of the means that are now at hand to ensure that Canada obtains a full measure of tax on the business income earned in this country either through foreign direct business activity or foreign direct investment.

Business Income

We have only a few comments, in addition to the foregoing observations, regarding liability for tax on business income in Canada. First, the earlier recommendations made for the determination of business income would apply alike to residents and non-residents carrying on business in Canada. The main effect of this would be that gains or losses on the disposition of property would be included in the income of the business activity carried on in Canada by a non-resident. We also suggest that a non-resident should be deemed to have a permanent establishment in Canada if he holds real property or rights to real property (including mining or oil rights) in Canada. Thus, the ownership of an interest in real property in Canada by a non-resident would constitute "carrying on business". Any gain or loss on the disposition of such property or property interest would therefore be taken into account for Canadian tax purposes. The proposed transitional provisions would exclude from income any gain unrealized as at the effective date of the legislation.

In the next section, the taxation of property income derived from Canada by a non-resident is discussed. Although the definition of property income would exclude income from a business, a non-resident should be treated in substantially the same way whether he derived income directly from

carrying on business in Canada or by way of dividends from a corporation which carried on business in Canada. For this reason, we recommend that the special tax now imposed under section 110B of the Income Tax Act on a portion of the business income of a Canadian branch of a non-resident corporation be continued. This special tax should be retained at the same level as the dividend withholding tax.

Property Income

Property income—which we define as income from property in Canada other than business income—is subject to a withholding tax, generally at a rate of 15 per cent. The withholding tax technique, and its application to this particular form of income, raises questions as to the theoretical basis for a tax of this type, the proper scope of its application and the appropriate rate.

The withholding tax is a rough-and-ready alternative to the generally unenforceable requirement that non-residents file a tax return on their world income. It represents a major but inescapable departure from the taxation of income at graduated rates.

Statutory withholding rates reflect nothing more than a judgment as to the best level from which to start the bargaining process with other countries for mutual reductions. By this process rates of 30 per cent or higher which are imposed by the law of some countries have in most treaties become a bargained rate of 15 per cent.

We have considered whether in this light the statutory level of the Canadian withholding rate should be higher—perhaps double its present level of 15 per cent.

In the case of dividend payments, we have concluded that such an increase would conflict with our general objectives set out earlier in this chapter. A higher level than the present 15 per cent might discourage

some foreign investment unless the investor was able to obtain a foreign tax credit for the full amount of the tax withheld, and this is unlikely. Therefore, we do not recommend any increase in the rate of withholding on dividends. We recommend that the rate should be the same regardless of whether the corporation had a degree of Canadian ownership. In the case of many companies the rate is now 10 per cent, and in fact some companies have issued shares to the Canadian public in reliance on the present law. While in many cases the 15 per cent rate would not result in hardship since it could be claimed as a credit against foreign tax, this would not be true in all cases. Accordingly, we suggest that the rate might be fixed at 15 per cent and then a reduction to 10 per cent offered in treaty negotiations with other countries. In the event that shares of a company were issued or sold in order for it to qualify for the lower rate of withholding tax and it was not covered by a treaty providing for a 10 per cent rate, special provision should be made to continue the withholding rate at 10 per cent.

We are inclined to a different view with respect to payments which leave Canada without having suffered any burden of Canadian direct taxation because they are deductible in computing taxable income (e.g., royalties, rentals, interest and similar payments). On payments of this nature the withholding tax is the only tax collected by Canada. A higher level of withholding tax would increase Canadian revenues with relatively small danger of an unfavourable effect. In addition, it would be useful in treaty negotiations if the general level of Canadian withholding tax exceeded that which Canada was willing to levy against payments flowing to the country with which the treaty was being negotiated. We therefore recommend that the general level of withholding tax should be increased to 30 per cent, but that Canada continue to reduce this rate when specific circumstances warrant a lower rate for certain countries and certain kinds of payments. In fact the rate would be restricted to 15 per cent under many treaties which are now in effect. However, for many kinds of payments, and in the absence of reduction of the rate by treaty, it would be to Canada's advantage to

impose a rate of withholding tax that was higher than 15 per cent.

There is an additional problem in that the credits for foreign taxes provided by some countries make it advantageous to change the form of the investment in a foreign subsidiary.

With a Canadian corporation tax of about 50 per cent, and a maximum Canadian withholding tax of 15 per cent, most foreign parent corporations can offset most of their Canadian taxes against their domestic taxes. Substantial reductions in their Canadian taxes would not reduce, therefore, the total taxes paid by the parents. Under the United States tax system, domestic parent companies with subsidiaries in a number of different foreign countries can determine the limitation on their United States foreign tax credit either separately for each country or on an overall basis aggregating the income of and taxes paid by all foreign subsidiaries. The low foreign taxes paid in some countries can then be used to offset the high foreign taxes paid in other countries. Furthermore, foreign withholding taxes on dividends, interest (with certain exceptions), royalties and other returns on capital are treated on the same basis as foreign corporation income taxes in computing the United States foreign tax credit. If a United States parent cannot completely offset Canadian corporation taxes and Canadian withholding taxes against its United States tax liabilities, it has an incentive to change the form of its investment in its Canadian subsidiary to reduce the Canadian corporation tax. If the United States parent has foreign source income from countries other than Canada, and to the extent that the taxes in these other foreign countries are greater than the United States tax liability, the parent will have an incentive to reduce its Canadian taxes. This can be done by taking the return from the Canadian subsidiary in a form other than dividends.

To put this rather complex matter in a slightly different way, a United States parent has nothing to gain from a reduction of the Canadian income tax on its subsidiary if the Canadian tax can be fully offset by

United States tax credits. However, to the extent that Canadian taxes are greater than United States taxes, or that the taxes of a subsidiary in a country other than Canada or the United States are greater than United States taxes, there is something to be gained by reducing Canadian taxes. Because it may be relatively easy to change the form of a United States parent's investment in a Canadian subsidiary without affecting the substance of its investment, the present tax system, which imposes a tax of 50 per cent on earnings plus 15 per cent on dividends, or a total of 57.5 per cent, but only 15 per cent on interest, royalties and other returns on capital, provides ample scope for this kind of manipulation.

On the basis of investigations we have made, we do not believe that this transformation of dividend payments into other forms of payment has been an important problem in the past. Nevertheless, with declining United States corporation taxes, rising foreign corporation taxes and pressure from the United States Government on United States parents to remit the earnings of foreign subsidiaries to the United States, we can foresee a time when this could become a serious problem for Canada—particularly in the case of subsidiaries of United States companies established in Canada in the future. We believe that Canada is now obtaining adequate tax revenues from most foreign investment in Canada. However, if part of the Canadian source income from direct investment by non-residents should, in effect, gradually become subject to tax at 15 per cent rather than 57.5 per cent, the net benefit to Canada from foreign investment would be substantially reduced.

Adoption of the recommendation in Chapter 19, that certain payments of interest by a subsidiary to a non-resident parent company should be deemed to be dividends and therefore not be deductible, would reduce the number of instances where manipulation between these types of payments could occur. Nevertheless, a narrowing of the differential between the total taxes levied on returns from different forms of capital investment

would also appear to be an appropriate objective. Such a narrowing is difficult because of the conflicting objectives of attempting to obtain the maximum tax revenue from foreign investment while not raising taxes to a level that would discourage such investment. A substantial reduction in the taxes currently levied on dividends could be costly in terms of revenue, while a substantial increase in the rate of tax on interest might reduce this desirable form of foreign investment. At this time, therefore, we recommend only that the basic rate of withholding tax on interest payments (and other forms of return on capital other than dividends) be increased and that possibly a small reduction in the rate of withholding tax on dividends be offered by the government in future treaty negotiations. The latter change, to a rate of, say, 10 per cent, should preferably be accomplished by tax treaty and should be accompanied by equivalent concessions on the part of the other country signing the treaty. Such a reduction in the dividend withholding rate would have the added advantage that, to the extent that it benefited the non-resident investor and did not merely increase his domestic taxes payable, it would at least partially match the added incentive given to most Canadian investors by our proposed integration of the Canadian corporation and personal income taxes.

The exemption from Canadian withholding tax of interest paid to tax-exempt foreign investors should be continued. These are important sources of investment capital for Canada. Because the foreign investor is tax-exempt, he is unable to claim a tax credit for any Canadian tax paid. The imposition of a withholding tax on payments to such lenders would probably only increase the rate of interest charged to the Canadian borrower. In the 1966 amendments to the Income Tax Act this exemption was extended to all non-resident investors with respect to their holdings of federal and provincial government securities issued after April 15, 1966. 17/ While the extension of this exemption to taxable investors would appear to provide only limited direct benefits to investors, there are apparently some potential buyers of government securities who regard the withholding tax

as significant. However, any further extension of this exemption (e.g., to corporate securities) would appear to involve disadvantages that would outweigh the possible attractions. Not only would the effect of such a measure be limited, so that it would be an inefficient incentive, but it would be necessary to impose a number of restrictions to prevent the exemption from being used by regular investors as a means of withdrawing income from Canada free of tax.

Personal Service Income

We have considered whether there might be any feasible or desirable alternative to the present procedure under which a non-resident employed in Canada files a return of his employment income earned in Canada and pays tax thereon at graduated rates as if the Canadian income were his total income. There appear to be only two other methods worthy of consideration.

Under the first alternative, the taxpayer would be required to file a return showing his total world income, including his Canadian income, and would be taxed at a rate determined on this basis. As we have said previously, we are of the opinion that such a requirement would be difficult to enforce. The Canadian tax authorities would have no means of verifying the total income other than to obtain certified copies of the taxpayer's foreign tax return, and almost no recourse if the Canadian return were found to be false when the taxpayer was no longer receiving income from Canada.

The other alternative would be to impose a flat-rate tax on personal service income similar to the withholding tax on property income. This is the practice of the United States with respect to non-resident aliens who are not engaged in trade or business in the United States (as defined), and who are subject to a tax of 30 per cent in lieu of all other income tax.

We believe that the considerations for and against such a withholding tax are about equally divided. On the one hand, it can be argued that the withholding tax device has been accepted as appropriate for many other

forms of income and that it could as easily be applied to employment income. On the other hand, it can be said that the imposition of a flat-rate tax on many forms of payment is dictated by the differing income levels of the foreign recipients, the flat rate being a compromise of the varying marginal rates that would apply if the foreign recipients were to pay tax as Canadian residents, and that such an average rate means that some are overtaxed and some undertaxed.

Although the present system is not seriously deficient, the application of progressive rates to only that portion of the person's income which is earned in Canada is a departure from the principle of full progressive taxation and so is not satisfactory. Therefore, we recommend that consideration be given to levying a withholding tax at a flat rate of 30 per cent on personal service income earned in Canada by non-residents, and granting relief to recipients who would have been subject to lower rates by permitting the non-resident to elect to be taxed as a resident of Canada and, accordingly, to file a return reporting his world income. This option is discussed further below. Although control of the refunds would largely be dependent upon the honesty of the taxpayer, the procedure should nevertheless increase tax revenues. This same rate of withholding tax and the same right of election should apply with respect to the income portion of pension and annuity payments as discussed in Chapter 16.

We have also been impressed with the magnitude of the flow of payments from Canada for personal services not requiring the physical presence in Canada of the person rendering such services. These are mainly fees for consulting, professional, management and administration services, shown in the 1962 report under the Corporations and Labour Unions Returns Act (p. 41) to be in excess of $100 million. This compares with $169 million reported by corporations under the same Act as interest payments to non-residents. As the non-resident is not physically present in Canada, these payments are generally not taxable under the present legislation.

One reason for making a tax distinction between international income from capital, which is taxed where the capital is employed, and international income from services, which is taxed where the person physically performed the services rather than where they are exploited, is perhaps that the latter is more likely to involve substantial foreign-based expense than is the provision of capital. But this would support the imposition of a lower withholding tax on services than on property income, rather than complete exemption. Furthermore, the requirement of physical presence in the country seems to rest on assumptions that are being undermined by the development of modern communications media. The taxation of remuneration for many forms of services does not appear to present major problems of tax enforcement by the source country. Some definitional problems would exist, at least initially, but these could readily be met if a broadly based tax was applied to most payments for services. The present treatment results in frequent anomalies such as, for example, the imposition of tax on the portion of a payment that relates to a fee for the use in Canada of some property, say, a patent, and the exemption of the portion of the payment that is applicable to the management advice on how to use the patent.

In our view there is justification for the taxation of income from personal services by the countries in which they are exploited. The rate of withholding tax might be of the order of 10 per cent. Because this tax would generally not be eligible for a foreign tax credit in the country of destination, a relatively low rate should be imposed.

It is not intended that this withholding tax should be imposed on payments for services of a personal nature. It should be applied only where the benefit of the services was enjoyed in Canada and where the payment was deductible in computing business or property income for Canadian tax purposes. Since it would be a tax on payments for services, it should not apply to amounts paid in reimbursement of expenses. The exclusion for expenses would have to be carefully defined, having regard to the difficulties

that can arise in distinguishing between a payment for services and a reimbursement of an ordinary expense.

Gifts and Payments from
Trusts and Estates

Our recommendations in Chapter 21 for the taxation of trusts and estates involve the payment of initial tax on income received by the trust or estate. This tax would be imposed at different rates depending upon the type of income and the beneficiary to whom it was distributable or for whom it was accumulated in the trust.

We proposed that income of a trust (other than gifts and inheritances and income from direct foreign investment) which was distributable to non-resident beneficiaries or was accumulated for the benefit of non-residents should be subject to initial tax at the rate of 50 per cent. The initial tax would, of course, be reduced by any credits to which the trust was entitled in respect of dividend income from Canadian corporations. Upon payment being made to a non-resident beneficiary, the recipient would not be entitled to any credit for the initial tax and there would be a further withholding tax at the rate applicable to dividends.

We have also recommended that because of the hardship which might be caused by the imposition of both the 50 per cent initial tax and the withholding tax, a non-resident beneficiary should be entitled to elect that instead of these taxes the income payable to him should be subject to the same withholding tax which would have been payable if his allocable share of the income of the trust from each source had been paid to him directly. Accordingly, if the trust had income from interest or rent or similar sources, a non-resident who made this election would in effect pay a tax of 30 per cent on his portion of that income and would obtain a refund of any tax in excess of this amount which had been paid by the trust.

Income of a resident trust from foreign direct investment would be taxable in the same way as similar income received by a corporation. Gifts received by a trust, including property passing on death in the case of a trust arising on death, would be subject to initial tax at the rate of 30 per cent. Income of these types would not be subject to any further withholding tax on distribution to a non-resident beneficiary.

The creation of non-resident trusts and resident trusts with non-resident beneficiaries for tax avoidance purposes has been on the increase. In 1965 a special provision was enacted to deny generally a deduction to trustees of business income paid to non-resident beneficiaries and non-resident-owned investment corporations 18/. This is an example of a type of avoidance that seeks to extract from Canada income which ordinarily would be subject to higher rates of tax, by paying only the withholding tax. The proposed withholding taxes should reduce this type of avoidance, particularly with respect to business and dividend income and gifts.

Optional Filing of a
Canadian Tax Return

We have concluded that it would be impractical under most circumstances to require non-residents to file Canadian tax returns and to report their world income to Canada. However, we have also suggested that the level of withholding taxes on certain kinds of income should be higher and that withholding taxes should be imposed on some other kinds of remittances to non-residents that are not now taxed. In Chapters 15, 16 and 17 which are concerned with these particular types of payment (property income, deferred income and gifts including inheritances) we have pointed out why the withholding tax on these payments should be at a substantial level (i.e., at least 30 per cent). We have also acknowledged that while a withholding tax rate of less than 50 per cent creates possibilities for tax avoidance, a rate close to this maximum level could result in severe hardship for low and middle income taxpayers. It is for this latter reason that we recommend a rate of 30 per cent for

payments to non-residents of gifts, bequests, the income portion of pension and annuity payments and perhaps for certain employment income. However, even this rate could be inequitable for some recipients. We have therefore suggested that a non-resident receiving such a payment should be permitted to file a Canadian tax return on his world income as though he were a resident. In computing the Canadian tax payable, credits for foreign income taxes on foreign source income up to an amount equal to the Canadian tax on foreign source income would be deducted in the same manner as at present. For these taxpayers no credit would be given for any foreign tax on Canadian source income. Such a non-resident would obtain a refund of that portion of the Canadian withholding tax which exceeded the Canadian tax payable on the optional basis.

We have also suggested that any Canadian resident who became a non-resident should be permitted to elect to continue to be taxed as a Canadian resident, provided this election was made each year after the change of residence. This would preclude a deemed disposition of his property holdings, an event that we have recommended should take place when a taxpayer ceased to be taxed as a Canadian resident. This type of election would be necessary for the taxpayer who became non-resident and wished to continue his membership in an individual Registered Retirement Income Plan. (Non-residents would be eligible for membership in registered group plans.) This election would also be useful for a dependant who became non-resident but wished to remain a member of his family unit. By making the appropriate election he could receive gifts and bequests from other members of the family unit free of withholding tax, and transfers of property to such a dependant would not be dispositions by the family unit (which might result in taxable gains). A non-resident spouse would be exempt from the withholding tax on a gift from the resident spouse in any event, but would have to make this election to prevent a disposition from occurring for tax purposes on a transfer of property from another member of the family unit. It is likely that in practice this kind of election would be made only where the change of

residence was expected to be temporary. For taxpayers making this election credit should be given for all foreign income taxes on foreign or domestic source income on the same basis as under the present law, the credit being limited to the effective rate of Canadian tax on the same income.

Although the accuracy of the Canadian return would be difficult to verify, even if the taxpayer was required to submit a certified copy of his foreign tax return, the fact that the filing of the return would be optional, and that the government need not make a refund unless it was satisfied with the information supplied, would distinguish this procedure from one that required a non-resident to file a Canadian return. A substantial proportion of those making the election would probably be former Canadian residents for whom the Canadian tax authorities would have earlier returns.

We also accept that it would be reasonable to modify the withholding tax principle where the payment was one against which substantial business expenses should be offset. At the present time, an option is granted for the filing of a tax return with the Canadian authorities where the income received is from real estate rents and timber royalties. We would be prepared to see the right to file a net income return extended to other forms of payments to non-residents if the administrative difficulties were not too severe. In making this suggestion, we propose that any expenses that might otherwise be claimed as deductions in computing the net income, but which would be subject to withholding tax if paid by a Canadian resident, should not be deductible. In the case of employment income, we question the suitability of applying progressive rates only to that portion of the taxpayer's income that was earned in Canada. Accordingly, if the election was made, the return and claim for refund should be based upon the world income of the taxpayer.

Special Corporations

Two special classes of corporation are of particular significance in the area of international taxation in Canada: the foreign business corporation and the non-resident-owned investment corporation.

Foreign Business Corporations. A foreign business corporation is one which carries on substantially all its business outside Canada (section 71 of the Income Tax Act), although it may be incorporated and resident here. As such it enjoys complete exemption from Canadian tax. The category was first introduced in broad terms in 1918, and the legislation was amended in piecemeal fashion over a period of forty years as inconsistencies and abuses became apparent. It finally appeared that the provisions were not only giving too much scope for tax avoidance by Canadians but were also attracting foreigners who, according to the Minister of Finance of the day, "were interested in using Canada as an address but not as a home", thereby facilitating international tax avoidance on a grand scale. This occurred principally through purchases of goods in the United States and their sale in other countries under the protection of Canada's treaties. In 1959 the provisions were restricted in their application to corporations which qualified as foreign business corporations in that year and continued to so qualify annually thereafter. The number of foreign business corporations is therefore gradually declining, but some remain. Some of these are genuine in the sense of being corporations which the original legislation was intended to benefit. But many are products of ambitious tax avoidance plans. It seems to us anomalous that no restriction was placed on changes of control of corporations which qualified for the exemption in 1959 because the shares of these corporations are now seen to change hands from time to time, presumably as one group completes a tax avoidance scheme and another wishes to begin one.

We see the foreign business corporation provisions as being openly discriminatory and as favouring international tax avoidance. On these two grounds we recommend their entire repeal. Where a substantial business organization has been built up on the basis of existing rules, however, there is always an argument that a sudden change will create an unjustifiable hardship. Because some of the longest established Canadian corporations can

present this argument against repeal, we think that it may be reasonable to spread the repeal over several years and afford such taxpayers an opportunity to adjust their affairs. Canada would probably lose some revenue as a result of the entire repeal of the provision but, on balance, it appears unlikely that it would be significant. We recommend, therefore, that the foreign business corporation provisions cease to apply to any corporation after, say, five years, and that they cease to apply immediately to any corporation which is not a public company listed on a recognized Canadian stock exchange.

Non-Resident-Owned Investment Corporation. Under section 70 of the Income Tax Act, a corporation which is 95 per cent owned outside Canada may elect to pay a tax of 15 per cent on its income, provided such income is of a defined kind. In general, the income must arise from ownership of, or trading in, investments such as bonds, shares, debentures, mortgages, etc.; from the lending of money; from rents, hire of chattels and similar remuneration; or from estates and trusts. It is a condition that not more than 10 per cent of the income arises from rents and that the principal business of the corporation is not the lending of money or dealing in securities or mortgages, etc. No further tax is payable on withdrawal of the funds of the corporation by its non-resident owners.

The net effect of the provision is to anticipate the 15 per cent withholding tax on dividends paid to non-residents and to reduce to 15 per cent the rate of corporation tax that would otherwise apply to such income as interest, rent, royalties, etc., if received by an ordinary corporation.

The general rationale for this measure, developed since its introduction in the less sophisticated tax climate of 1936, is that it encourages the investment of foreign funds in Canada at little tax cost to the government.

We question whether the true interests of Canada are served by this provision, particularly in the light of the tax-haven opportunities which

it presents. Analysis of the provisions themselves suggests that they do not tend to encourage portfolio investment in Canadian equities, but rather encourage investment in interest-bearing securities and rental properties. Non-resident-owned investment corporations (NRO's) are subject to tax at the rate of 15 per cent on all their taxable income, including dividends from Canadian corporations. The inclusion of such dividends places NRO's at a disadvantage in comparison with ordinary Canadian corporations. The natural form of organization for non-residents wishing to invest in a portfolio of Canadian shares would be an ordinary Canadian corporation; in that event all Canadian tax would be deferred until the holding company paid dividends to its shareholders, and a faster rate of accumulation would be possible than with an NRO. For interest and rental income, the NRO is clearly preferable because a rate of 15 per cent is substituted for the ordinary rate of corporation tax.

We conclude that the effect of the NRO legislation in its present form, whatever purpose may have been intended or ascribed to it, is to enable non-residents to invest in interest-bearing securities and to invest directly or indirectly through subsidiaries in rental properties at rates of Canadian tax no greater than the rates of withholding tax. If this is an encouragement to investment in Canada, it is achieved by creating a mechanism which permits the foreign investor to avoid the tax of his home country without Canadian penalty. We find that the NRO provisions are contrary to our philosophy that we should not facilitate international tax avoidance. We therefore recommend that the NRO provisions be withdrawn, although this should be done gradually and with suitable transitional provisions, because of the large number of corporations now qualifying for the special treatment. It might be provided for example, that after the effective date the only corporations that could qualify as NRO's would be those that qualified as such in that year and in each subsequent year and that reduced the amount of their net assets by at least 10 per cent in each year subsequent to the effective date. The provisions could then be completely withdrawn after ten years.

## ADMINISTRATION

Elsewhere, we recommend steps which we feel will result in an improvement in the level of federal tax administration. We have some particular recommendations for international taxation.

### International Tax Avoidance

One of the most challenging problems in the administration of international taxation is the avoidance or reduction of tax liability through transactions with persons in another jurisdiction who are not at arm's length with the taxpayer. The difference between the domestic situation and the international situation is one of degree rather than of kind. The problem of checking and circumventing tax avoidance in non-arm's length transactions in the international field is greatly magnified by the fact that the Canadian authorities are limited both by jurisdictional and by practical considerations to reviewing only one side of the transaction. A few of the general areas in which this avoidance can take place—we do not consider details of the individual kinds of transaction—are indicated in the following discussion.

Inter-Company Transactions. By charges or payments for goods or services at prices other than market—at either abnormally high or abnormally low levels—associated companies may transfer profits from high tax to lower tax jurisdictions. The problem is not greatly different from that frequently encountered between taxpayers within the same country, and can be combatted only by a constant surveillance by the tax administration of inter-company pricing practices. A device that might be used would be to require special detailed annual reporting of all charges between international companies not dealing at arm's length. It might also be required that where an inter-company charge differed substantially from cost the taxpayer must satisfy the tax authorities that the profit was a fair one.

One of the greatest gaps in the international taxation of business

profits, and one from which many other difficulties stem, arises from the absence of any generally accepted rules for the allocation of earnings between countries when a business operates in several countries either through branches or subsidiaries. Such agreed rules would be comparable, for example, to those used in Canada for the allocation of profits between provinces for purposes of provincial taxation, since exactly the same issues are involved. The present general approach, as embodied both in national statutes and in international tax treaties, is to start with the profits as shown by the books of the company and make whatever adjustments can be justified. Failing this, there is seldom any other agreed approach. The United States is an exception, having provided by law a statutory allocation formula which operates when a reasonable allocation cannot be made either on the basis of independent factor cost or by adjusting the books of the taxpayer.

We recommend that the Canadian tax authorities study the implications of adopting a formula as an alternative to the adjustment of the books of account and of giving that formula official sanction by regulation. Where possible such a formula might be incorporated into some of the international tax treaties to which Canada is a party.

Situs of a Transaction. Generally, the rule is that a sale is concluded at the place where the contract for the sale of the goods is made. This provides legal opportunity for locating the situs of a transaction at a tax location suitable to the taxpayer—that is, a low tax jurisdiction—by a device no more elaborate than the incorporation of a company which maintains records. Because the rule itself is a fairly reasonable one, the resulting tax avoidance can most properly be overcome by general measures intended to ensure the immediate or ultimate taxation of the profit on such transactions; the recent United States measures and the proposals we have made earlier with respect to tax-haven companies should achieve this result.

Transformation of Payments. The pressure for the transformation of payments

from a taxable to a non-taxable form arises when, for example, dividend payments to a parent company are paid out of after-tax profits and are subject to a withholding tax. Attention centres on the transfer of profits to the parent by way of enhanced payments for management services, patents, copyrights, research, advertising, etc. Recent Canadian extensions of the scope of the withholding tax have apparently been directed against such practices.

If dividends must be paid out of after-tax income while interest is a business deduction, increased emphasis will be given to a debtor-creditor relationship between the companies so that inter-company payments will take the form of interest rather than dividends. We have already discussed this matter in dealing with the withholding tax.

Organization and Staffing

We recommend that special groups be developed both in the Department of Finance and in the Department of National Revenue (or its successor) to serve in removing causes and instances of overtaxation, in reducing causes and instances of international tax avoidance and in increasing co-operation with the tax authorities in other countries.

Among the responsibilities of the group in the Department of Finance might be the following:

1. To consider representations made by taxpayers with respect to Canada's international taxation policies and legislation.

2. To keep abreast of changes in the tax laws of other countries and the implications of these for the taxation of international transactions by Canada.

3. To work closely with their counterparts in other countries in developing solutions by statute or treaty to problems of overtaxation and undertaxation that come to its notice.

4. To advise on taxation policies generally and tax legislation in particular as they affect international operations.

5. To advise on and engage in treaty negotiations.

6. To keep abreast of techniques for international tax avoidance and to advise the tax administration on areas that should be subjected to particular scrutiny.

Among the functions of the group in the Department of National Revenue (or its successor) might be the following:

1. To deal with taxpayers having specific international tax problems and in particular to give advance rulings in the international area.

2. To determine taxpayer reporting requirements so that information would be obtained in a form that was most useful for assessing purposes.

3. To draft regulations and bulletins relating to international transactions.

4. To apply special matching and investigation procedures to certain tax returns and information.

5. To keep abreast of the tax laws of other countries and their administration.

6. To advise the Department of Finance of areas that were proving troublesome under existing legislation and treaties.

There would be need for close and continuous liaison between the two groups to prevent duplication of effort and to facilitate development of tax policy.

The tasks that we have referred to above would require larger staffs than are now engaged on international tax problems in the Departments of Finance and National Revenue. For example, the information returns we recommend below, far from allowing the assignment of less manpower to the

assessment of international transactions, would require more assessors if the potential was to be realized.

Moreover, given the complexities in this area of taxation, the staff assigned to it must include an unusually high proportion of people who were experienced in selection and investigation techniques and had knowledge of the ways in which non-arm's length situations may be exploited for tax purposes. Indeed, the staff should be the equal in imagination to those who were engaged in arranging transactions to minimize taxation.

The need for increased staff would be more marked in the tax administration area because of the division of responsibilities between the two departments. As the administrative group dealing with international tax problems broadened the scope of its activity, it would no doubt be found desirable to disperse the staff among the various regional offices.

Reporting and Returns. We have mentioned several areas in which provisions of the Income Tax Act have permitted tax manipulation in international transactions. While we believe that, even under the present provisions, additional tax could be assessed on many such transactions, this would involve reporting, selection and examination procedures for which the Department of National Revenue staff in the international area is not now equipped.

We believe that several of the recommendations made for the income tax structure generally, for example, the annual detailed information returns on holdings, acquisitions and dispositions of assets (integral to the taxation of gains on dispositions of capital assets), would tend to reduce tax avoidance substantially. In addition, we specifically recommend a detailed reporting of international transactions between taxpayers not dealing at arm's length. Adaptation of electronic equipment to the processing of this information would add greatly to its potential usefulness. However, receipt and processing of this information in mass would not automatically provide an effective solution to the problem of tax avoidance in connection with

international transactions; it would be necessary to select from the mass particular operations for further examination and, where indicated, close scrutiny.

We have recommended that persons emigrating from Canada should be required to obtain a tax clearance to ensure that the full Canadian tax, including that levied on any gains from the deemed disposition of property, has been paid. In order to ensure that all persons emigrating appreciate that this requirement exists it would be necessary to ask a brief question of people leaving the country. Those signifying they were emigrating would be asked additional questions to ascertain whether they had final tax clearance. So that this requirement would not unduly delay travel, it would be possible to waive such questioning at border crossing points during periods when there is substantial commuter traffic.

Exchange of Information. Canada's tax treaties now provide for the exchange of tax information and for the transmittal by each country to the other of certain routine information on an annual basis. The Canadian tax authorities should discuss with their counterparts in countries using electronic equipment for processing tax returns various ways in which such equipment might be utilized to provide routine information in a more effective form than is now done. For example, copies of all Canadian withholding slips on payments to United States residents are currently supplied to the United States authorities. We would also recommend that while Canada should be prepared to negotiate with other governments concerning the exchange on request of further available tax information, it should be a condition to the supplying of information that it be made available on a confidential basis to tax officials only.

## THE TAX TREATIES

The discussion in this chapter relates basically to the Canadian statute law and jurisprudence, reference having been made only occasionally to the effect of the tax treaties into which Canada has entered with other countries. What follows is a brief discussion of their major points.

The treaties, of which Canada now has thirteen (not counting three additional treaties which have been signed but not proclaimed in force), are an important international fiscal device. As a negotiated arrangement, a treaty provides a flexible means of reconciling otherwise conflicting features of the basic tax systems of individual countries; at the same time, they have presented the opportunity for developing rules of international tax behaviour which have become embodied in "model" treaties sponsored by organizations such as the League of Nations, the United Nations and the Organization for Economic Cooperation and Development. Frequently, the effect of a treaty is to substitute some of these "model" concepts for the basic national tax statute, since the treaty terms override the provisions of the domestic law.

Canada's oldest treaties were with the United States (1936) and the United Kingdom (1946). The treaty with the United States was replaced by a broader one in 1941. The treaty with the United Kingdom was terminated effective January 1, 1965, and a new, more limited treaty came into effect at that time. Subsequently a new treaty was signed but has not yet been proclaimed in force. In addition, there are income tax treaties with Australia, Denmark, Finland, France, Germany, Ireland, Japan, The Netherlands, New Zealand, Sweden and South Africa. A new treaty with Ireland and treaties with Norway, Belgium and Trinidad and Tobago have been signed but have not yet been proclaimed in force. Canada also has treaties regarding estate tax with five countries.

The main purpose of the treaties is to facilitate world trade and investment by avoiding double taxation or discriminatory tax practices and also to prevent tax avoidance and evasion by providing for the exchange of information and other forms of co-operation.

Prevention of Double Taxation

The treaties often give more precise definitions than the domestic tax legislation. They remove uncertainty by such means as specifying the taxes levied by each country which will be regarded as income taxes; by defining such concepts as "person", "company" and "resident"; and by establishing an agreed basis for the taxation of profits. Usually it is agreed that the taxation of the profits of an entity of the other country will be limited to the "industrial

and commercial" profits of a "permanent establishment", the latter term being extensively defined but in essence being a fixed place of business.

The treaties also exempt certain forms of income. Where it is administratively more convenient to exempt income than to require taxpayers to go through the process of reporting and claiming a tax credit, countries having approximately the same weight of taxation will frequently adopt this device. Provision is often made for the exemption of the profits of international shipping and aircraft companies. Frequently, annuities, pensions and similar income are exempted from withholding tax, and remuneration of employees of the other government is also dealt with. Where residents of one country earn income during short visits to the other country, exemption is also frequently extended as an administrative simplification.

The treaties provide a limitation of the right to tax. Most often restricted is the right to withhold tax on dividends, interest and similar payments. Under some of Canada's treaties, the 15 per cent rate has been reduced and, in one or two cases, completely eliminated on a reciprocal basis.

The contracting parties undertake to allow a tax credit in respect of income taxed at source in the other country. This feature of Canada's treaties, often of great significance in treaties of other countries, has been of minimal importance as far as Canadian tax is concerned because Canada has allowed a tax credit for foreign taxes almost from the beginning of the income tax.

The treaties usually provide that where double taxation exists in the case of an individual taxpayer the "competent authorities" of the two countries may consult in an effort to relieve the problem.

Prevention of Fiscal Evasion

Usually the provision for exchange of information is very broadly phrased and stresses the purpose of preventing fraud and evasion.

Where an enterprise in one country has a permanent establishment in the other country, a general procedure is sometimes set out for the rectification of the accounts of the latter so as to reflect the profit it might have derived if it had been an independent enterprise.

Provision is usually made for joint consultation and administrative co-operation in the carrying out of the terms of the treaty.

Appraisal

We approve of the present extent of Canada's treaty arrangements and suggest that further treaties be negotiated with other countries with which Canada has close or growing trade and financial relations, such as Italy, Switzerland, Mexico, Venezuela, India and Brazil. We also find encouraging the trend toward the adoption of model treaty arrangements, although we have some reservations as to the extent to which any one model, such as that promulgated by OECD, can be adapted to the needs of all countries. It is obvious that changes in international taxation are rapid and complex, and Canada's treaties must be kept constantly under review to cope with new concepts and conditions. We have already proposed administrative changes to this end.

Much can also be gained from the fullest exchange of information under Canada's treaties, and we have proposed administrative changes that will facilitate such exchange. Canada's treaty with the United States should provide that any information supplied by Canada should be restricted to the use of the Internal Revenue Service, a feature of several United States treaties with other countries.

An aspect of the treaties that calls for improvement is the "competent authority" provision. The present arrangements are unsatisfactory, resting as they do on the sufferance of the contending tax authorities. In our opinion, the determination of the existence and degree of double taxation should be made the responsibility of a tribunal consisting of a representative from each country and a third member chosen by them. This tribunal should have power, on a finding of double taxation, to allocate income between the two countries or even to allow a rebate on equitable principles.

It is also our opinion that a serious lack in the international area is the absence of co-operation in the enforcement of tax liabilities to other countries. We have proposed in Chapter 33 that arrangements be entered into by treaty, under which, on a reciprocal basis, Canadian courts would enforce liabilities owing to another country by persons over whom they had jurisdiction.

## CONCLUSIONS AND RECOMMENDATIONS

### OBJECTIVES

1. The proposed domestic tax system is radically different from the tax systems in effect in other countries. It is therefore of prime importance to develop provisions for the taxation of international income flows which would be consistent with our proposed domestic reforms and which:

    a) would not adversely affect our economic ties with the rest of the world;

    b) would maintain and preferably increase the net economic benefit which Canada derives from foreign investment; and

    c) would not abrogate our treaty obligations or offend against the normal standards of international taxation.

2. It is also essential to tax foreign source income of Canadians, like other kinds of income, at full progressive rates, develop procedures that minimize tax deferment and close the loopholes in the present system which are exploited by the use of tax havens.

3. The differences in the rates of tax that apply to different kinds of Canadian source income of non-residents provide avenues for avoidance and so reduce the net economic benefit derived by Canada from foreign investment. Reducing these disparities would be desirable.

4. International tax neutrality is probably unattainable and perhaps not even desirable while there exist other economic barriers such as tariffs, immigration laws, foreign investment guidelines and foreign exchange controls.

5. Although it is in Canada's long-run interest not to erect new international economic barriers or induce other countries to do so, it is virtually impossible to establish principles for the taxation by Canada of international income flows in order to achieve the best possible allocation of world resources. For this reason, it is necessary to take a more pragmatic approach in the international field than in domestic taxation.

GENERAL CONCLUSIONS

6. Canada should not extend the benefits of the proposed integration of personal and corporation tax to non-residents.

7. The level of tax on foreign shareholders of Canadian corporations should not be raised except where necessary to carry out domestic tax reforms.

8. To increase the net economic benefit to Canada and to reduce the avenues for tax avoidance, the withholding tax on payments other than dividends which are made from Canada to non-residents should be increased.

9. Canada should not seek to tax non-residents on their Canadian property gains except those realized in connection with a business carried on in Canada (defined to include transactions in real property or an interest in real property which is located in Canada).

10. Canada should give residents credit for foreign withholding taxes and foreign corporation taxes actually paid at a rate that would ensure that the Canadian taxes on such dividends did not increase for most shareholders.

SPECIFIC RECOMMENDATIONS

11. The present exemption from tax of certain foreign dividends received by a Canadian corporation which is provided by section 28(1)(d) should be withdrawn, and a new method devised for taxing foreign direct investment income.

12. A foreign direct investment should be defined as an investment by a Canadian resident or associated group of Canadian residents (a) in a non-resident corporation in which he or the group holds a 10 per cent or greater interest in the voting power, in the profits or in the assets distributed on liquidation of the non-resident corporation, or (b) in a foreign property or business in which he or the group holds a 10 per cent or greater interest.

13. Canadian taxpayers having foreign direct investments should report annually the foreign income earned and the foreign income taxes paid in each foreign jurisdiction. If foreign income taxes were paid at a rate of at least 30 per cent, no further Canadian tax would be payable unless or until the foreign income was received by a Canadian individual. If foreign income taxes paid on this current income were less than 30 per cent of the foreign income earned, the difference should be paid to Canada as a special tax. This procedure would ensure that all foreign source direct investment income would immediately become subject to income taxes of at least 30 per cent on an accrual basis. If the foreign income was subsequently subjected to a withholding tax in the foreign country on distribution to the Canadian investor, the special tax on such income would be refunded to the extent of the withholding tax. If a Canadian taxpayer with less than a controlling interest in a foreign direct investment could establish that he was unable to obtain sufficient information to compute the foreign income, he should be entitled to elect to be taxed as a recipient of portfolio investment income.

14. For the purpose of these computations foreign income should be defined as income reported to the foreign jurisdiction (or in an audited financial statement), subject to certain adjustments to make this figure generally comparable to income as defined for Canadian tax purposes. These adjustments would not be numerous or detailed.

15. To ease the problems of compliance it should in general be deemed that income derived from the United States and the United Kingdom had been taxed at a rate of at least 30 per cent. Therefore, since the special Canadian tax would seldom be payable, the computation of direct investment income from these two countries would not be necessary except possibly in special circumstances specified by regulations.

16. For the purpose of these computations, income taxes would be defined and would include the taxes described in the international tax agreements where applicable. However, certain other taxes might also be deemed to be income taxes. In addition, if as a matter of public policy foreign investment in specified countries was to be encouraged, income taxes could be deemed to have been paid up to a certain amount regardless of the actual amount of tax levied.

17. Dividends or other income (net of withholding taxes) received from a foreign direct investment should be deemed to have been subject to foreign tax at a rate of 30 per cent. The Canadian taxpayer (individual or corporate) should be required to bring into income the grossed-up equivalent of the dividend or other income (the amount that would have been received had the assumed tax of 30 per cent not been paid). This would be $\frac{100}{70}$ of the net dividend actually received.

18. Where the Canadian taxpayer was a corporation receiving income from foreign direct investment, no further tax would be payable at the time of receipt. On the distribution or allocation of the income to

Canadian shareholders of that corporation, credit would be granted on the grossed-up amount of the dividend or allocation for the 30 per cent foreign tax deemed to have been paid. For ease of administration, a withholding tax equal to 20 per cent of the grossed-up amount of the distribution or allocation to Canadian resident shareholders would be paid at the time of distribution or allocation in order to bring the total credit up to the 50 per cent level which would apply in the case of Canadian income and, accordingly, the net distribution or allocation would be grossed-up by the shareholder at the 50 per cent rate. If the credit exceeded the shareholder's Canadian tax liability, he would be entitled to a refund from the Canadian government.

19. Where the Canadian taxpayer receiving income from foreign direct investment was an individual, the net income after tax would be grossed-up at the 30 per cent rate and credit would be given against Canadian personal income tax for the deemed 30 per cent foreign tax paid; if the credit exceeded the shareholder's Canadian tax liability, he would be entitled to a refund from the Canadian government.

20. Canadian portfolio investors (investors who were not direct investors) should be given an option:

    a) to be taxed on the same basis as direct investors as described above; or

    b) to be taxed as at present with a credit only for withholding taxes paid.

21. The basic withholding tax on most payments to non-residents other than dividends should be increased from 15 per cent to 30 per cent. This withholding tax should be applied to gifts and bequests and the income portion of payments from pension plans. In addition to interest, royalties, etc., it should perhaps be applied also

to income from employment in Canada by non-residents. This 30 per cent rate might be lowered for some specific types of payments (e.g., the present exemption for interest paid to tax-exempt entities), and reduced by treaty for certain payments to specified countries.

22. As we believe that the adoption of our proposal for the integration of the corporation and personal income taxes would encourage the issuance of shares in Canada by the subsidiaries of foreign corporations, the differential withholding tax on dividends based on Canadian share ownership should be abolished. The rate of withholding tax should not be effectively increased, and consideration should be given to fixing the rate at 15 per cent and then reducing it to 10 per cent by treaty with some foreign governments in exchange for appropriate concessions with respect to the withholding taxes to be levied on some other kinds of payments. In addition, the 10 per cent rate should continue to apply to companies which qualified for such rate by the issue or sale of shares subsequent to the time the legislation relating to "degree of Canadian ownership" became effective.

23. The income of trusts, like that of corporations, that was distributable to non-residents or accumulated for their benefit should be subject to a tax of 50 per cent and the net amount distributed would be subject to a further withholding tax at the same rate as was applicable to dividends. However, the non-resident beneficiary should be entitled to elect that instead of the 50 per cent initial tax and the withholding tax, the income payable to him should be subject to tax in an amount equal to the withholding tax that would have been levied if it had been paid to him directly. Gifts and inheritances received by a trust which were distributable to non-resident beneficiaries would be subject to initial tax at the rate of 30 per cent and would not be subject to any withholding tax on distribution.

24. A withholding tax of up to 10 per cent should be imposed on payments for services that were deducted in the computation of business or property income and were not already subject to a withholding tax. These would be services rendered outside Canada, but the benefit from which was obtained in Canada. This withholding tax should be applied only to payments that were deductible for Canadian tax purposes and should not apply to amounts paid in reimbursement of expenses.

25. In certain specific cases, non-residents should be entitled to elect to be taxed as residents of Canada, reporting their world income from all sources and deducting foreign tax credits on the present basis for foreign taxes paid on income from foreign sources. This election should be available in the following cases:

    a) where a Canadian resident became non-resident and elected to be taxed as a Canadian resident for each year after the change of residence; or

    b) where the non-resident received certain specific kinds of income from Canada, including gifts, or inheritances, the income portion of pension and annuity payments and employment income.

26. The provisions relating to foreign business corporations should be repealed, effective after a period of, say, five years in the case of a public company listed on a recognized Canadian stock exchange, and effective immediately or after a short interval in the case of other corporations.

27. The provisions relating to non-resident-owned investment corporations should be withdrawn over a period of years.

ADMINISTRATION

28. Special groups should be established in the Department of Finance and

in the Department of National Revenue (or its successor) to specialize in international taxation matters so as to keep the law and its administration up to date.

29. Detailed reporting should be required with respect to international transactions between taxpayers not dealing with each other at arm's length. Special rules should be developed in the law to prevent tax avoidance through such transactions.

TAX TREATIES

30. Canada should continue to negotiate tax treaties with other countries and should also keep these treaties under review and up to date, as far as possible.

31. Canada should improve its arrangements with other countries for the exchange of information. Such information should be provided on the condition that it is available on a confidential basis to tax officials only.

32. If possible, tax treaties should provide for a tribunal consisting of a representative of each country and a third member chosen by them to resolve disputes and problems of double taxation.

REFERENCES

1/ If individuals, businesses or organizations living or operating in high tax countries had living or operating costs that were correspondingly lower than if they lived and carried on business in low tax countries, all nations would not necessarily have to provide the same public goods and services and welfare payments in order to achieve international tax neutrality. However, it is most unlikely that taxes and private expenditures are perfect substitutes, and that the taxes to finance public expenditures are equal to the costs that would be incurred in the absence of the public expenditure. Taxes are imposed to force people to bear a share of the cost burden they otherwise would not bear.

2/ If nations could agree on the "proper" division of revenues between source and destination countries, this condition could, in principle, be realized by the universal adoption of the following technique (assuming all countries had the same tax base and the same tax rates):

a) Source countries would impose tax at the top personal rate on the income of non-residents.
b) Destination countries would impose tax at full personal rates on the world income of residents.
c) Taxpayers would file a tax return reporting their world income in each source country.
d) Each source country, on the basis of the non-resident's world income, would determine the proportion of the non-resident's total tax to which it had a right and make the appropriate refund to the non-resident.
e) Destination countries would give a full tax credit for the net taxes paid to source countries.

3/ While it can be argued that Canada should reduce or eliminate its dependence on foreign saving, and hence reduce or eliminate the net

capital inflow, there can be little doubt that the elimination of the gross flows (both of investment in Canada by non-residents and of investment abroad by Canadians) would be a serious economic loss; for there are some investments in Canada that could not be profitably undertaken by Canadians, and some investments outside of Canada that are more profitable to Canadians than to other nations.

4/ Further discussion of this United States legislation is contained in Appendix L to this Volume.

5/ We have suggested that any Canadian tax due should in general only become payable when the foreign direct investment income was received by a Canadian resident individual. However, we have recommended that the Canadian tax should be payable by the corporate direct investor, even when the distribution was to a second Canadian corporation, so that all corporate distributions would be eligible for the 50 per cent gross-up and credit.

6/ $100 of corporate income less corporation tax of $50; the balance is taxed to the shareholder in the amount of $25 less a dividend tax credit of $10.

7/ Dividend of $50 ($100 of corporate income before tax) grossed-up to $100 and brought into income and taxed $50 with a credit of $50.

8/ Given no change in foreign taxes, no change in the Canadian treatment of foreign direct investment by Canadians, and the adoption of integration in Canada, $100 of before-tax corporate income would yield $50 to the Canadian shareholder (marginal rate 50 per cent) on corporate assets employed by a Canadian corporation in Canada and $29.75 on the corporate assets employed by the foreign subsidiary of a Canadian corporation. Therefore, corporate assets of $1,000 invested abroad would have to yield $168 before tax to give the Canadian shareholder the same after-tax return he would obtain if $1,000 of corporate assets earned $100 in Canada.

9/ Reverse shifting is likely to take place (to the limited extent it does take place) within the first few years following the adoption of integration. The adjustments brought about through changes in the allocation of investment are likely to involve quinquennia if not decades. There is no danger that there would be a quick and drastic move from Canadian to foreign investment by Canadians.

10/ The average rate of tax applicable to Canadian source corporate income is just under 30 per cent, but it would appear that upper income individuals receive relatively more foreign source corporate income than Canadian source corporate income.

11/ Different bases for the imposition of income tax are discussed in Sherbaniuk, Hutcheon and Brissenden, "Liability for Tax—Residence, Domicile or Citizenship?" 1963 Tax Conference Report (Canadian Tax Foundation) 315.

12/ Income Tax Act, section 139(3).

13/ Bullock v. Unit Construction Co. Ltd., [1959] 3 All E.R. 831.

14/ Section 139(4a).

15/ Section 139(1)(e).

16/ Section 139(7).

17/ Section 106(1)(b)(ii)(C).

18/ Section 63(4b).