APPENDIX A

A COPY OF THE LETTER RECEIVED BY THE CANADIAN INSTITUTE OF CHARTERED ACCOUNTANTS FROM ITS COMMITTEE ON ACCOUNTING AND AUDITING RESEARCH 1/

June 27, 1963

Mr. A.J. Little, F.C.A.,
Chairman,
Special Taxation Committee,
Canadian Institute of Chartered Accountants.

Dear Mr. Little:

In your letter of April 26, 1963, you asked for an expression of opinion from the Committee on Accounting and Auditing Research that would assist your Committee in its presentation to the Royal Commission on Taxation. Your specific question was whether the Income Tax Act would be improved if it were provided in Section 4 of the Act that, subject to the other provisions of the Part, income from a business or property should be determined in accordance with generally accepted accounting principles, or alternatively in accordance with generally accepted accounting practices. We considered your request at some length at a meeting of the Research Committee on May 6 and 7 and again at a Sub-committee meeting held on June 20, and the following represents the views of the majority of the members of the Committee.

Accounting is directed toward the fair measurement of income on a basis that has some historical acceptance. It must, however, remain sufficiently flexible to reflect changes in economic conditions and concepts without the restrictions of legislative or judicial pronouncements and without the inherent pressure resulting from the natural desire to minimize taxes.

On the other hand, the Income Tax Act is directed towards the measurement of income in such a way that it can be taxed. Legislated rules and judicial interpretations are bound to play an important part in determining this income. Such conditions, if linked by statutes with accounting principles and practices, could detrimentally affect their natural development.

Further, we believe that if the taxing system is to work surely and simply, the Act should be specific rather than based on a statement of general principles.

In reaching this conclusion, the Committee was influenced by the following facts:

(1) Over the history of accounting, substantial changes have occurred in recognized accounting principles and practices. The process of change is continuous and there is no reason to expect that it will not continue in the future. On the contrary, there are at present many challenges (for example, the problem of accounting for changes in the value of money) that could well lead to substantial changes in accounting principles over a period of years.

(2) Partly because of this process of change, and partly because of differences in individual circumstances and opinions, there exists at any one time some diversity in accounting practice. The diversity exists not only at the level of theory or principle, but also at the level of practical accounting methods (for example, a wide choice exists as to the method of calculating the cost of inventories).

(3) There are now, and probably will continue to be, in the income tax statutes, specific departures from recognized accounting practices to facilitate the administration of the Act, for the purposes of equity and to provide special incentives.

In spite of the above-mentioned differences and uncertainties, it is obvious that the principles governing the determination of income for taxation and accounting should not be widely apart. Accounting principles attempt to provide a fair determination of income; if the income tax is to be a tax on income and not a tax on wealth or receipts or some other base, the tax statute and, equally important, its interpretation by the administration and the courts, must conform fairly closely to proper accounting principles. Such conformity would have avoided certain past inequities such as the total disallowance of many necessary business

expenditures on the grounds that they provided a long-term benefit and therefore were capital expenditures, but at the same time were not such as qualified for capital cost allowance.

The question then is, what is the best way to obtain substantial conformity between accounting principles and the tax statute? The method under consideration is to enact that for tax purposes, subject to the specific departures set out in the Act and mentioned in point 3 above, income from a business or property shall be determined in accordance with generally accepted accounting principles or practices. If this were done, it has been suggested that many detailed sections of the Act could be discarded since they exist simply to spell out what should or should not be included in computing income. In addition, inequities, such as those mentioned in the previous paragraph, would be largely avoided.

In spite of these potential benefits, it is the opinion of the majority of the members of the Committee that the proposed change, by itself, would be largely ineffective in improving the working of the Act and would probably have some undesirable side consequences. Because of the diversity in accounting principles and the even greater diversity in accounting practices, and the changes that occur in both principles and practices over time, we think that a considerable degree of uncertainty would result from a simple provision of this nature. There would then follow a demand for the enactment of specific sections to clarify the areas of uncertainty (unless they were clarified by judicial decisions).

An important disadvantage to this process lies in its potential influence in the development of accounting principles. Where differences in accounting principles now exist, attempts can be made to resolve them on their merits. If, however, income subject to tax were to be based more directly on reported accounting income, the arguments in favour of the most conservative of the possible accounting treatments would be powerfully reinforced. The total effect of these tendencies, together with judicial

pronouncements as to what are accounting principles or practices, might well be prejudicial to the future development of accounting.

In short, it is the Committee's view that any advantage from this possible change in the Income Tax Act would be more than offset by the difficulties in its application and the potential dangers to the future development of the accounting art. In our view, improvement in the Act must come from a careful and detailed redrafting of the Act. Those responsible for redrafting the Act must keep in view the overriding objectives of a fair and workable determination of taxable income. In this they should be guided by the best accounting practices. However, in the opinion of the Committee it would not be satisfactory merely to amend the Act to incorporate a reference either to generally accepted accounting principles or to generally accepted accounting practices.

Yours very truly,

(Signed) J.R. Church, F.C.A.,
Chairman,
Committee on Accounting and
Auditing Research.

REFERENCE

1/ This letter is referred to in Chapter II of the Submission by the Canadian Institute of Chartered Accountants to the Commission.

APPENDIX B

THE FOREIGN TAXATION OF TRUST INCOME

United Kingdom

Trustees are taxable as "the persons receiving or entitled to receive the income from the trust corpus", and the standard rate of tax is payable. Trustees are not generally liable for surtax and are not entitled to personal allowances, these being claimed by the beneficiary. Trustees are not taxable on foreign income if the beneficiary would not have been taxed had he received the income directly. There is no gift tax in the United Kingdom, so inter vivos settlements or gifts in trust are not taxed. Estates held in trust will have borne estate tax.

Income which is distributable and income which is to be accumulated are both subject to the standard rate of tax, which is usually paid by the trustee, although it may be assessed directly to the beneficiary. When the beneficiary receives income, the payment is treated as having already borne the standard rate of tax and is grossed-up at the standard rate and included in the beneficiary's income. Personal allowances and surtax are computed on the grossed-up total income.

The treatment of income which is accumulated in the trust is more complex than the treatment of income which is distributed currently. Accumulated income which is vested, that is, which the beneficiary is entitled to claim as it arises, but which he either does not claim or cannot claim because, being an infant, he cannot give a good receipt, is treated as the beneficiary's income. If the beneficiary has only a contingent interest in income, that is, if he is not entitled to the income when it arises, but only at some later date, the income is taxable on receipt by the trustee at the standard rate of tax, but is not subject to surtax. The income then becomes capital and the beneficiary, on becoming entitled to it, receives it as such. There is, however, a special provision which enables a beneficiary whose interest was contingent on age or marriage to claim back

his personal reliefs over the period of accumulation, but this does not make it his income for surtax purposes over that period.

The treatment of income from an estate under administration is governed by other rules which have much the same effect, namely, that a beneficiary is treated as having an aliquot share in the income arising during the administration on which he is taxable, but here he would have to pay surtax. Distributions from limited interests, such as life interests, are grossed-up for income tax on a provisional basis, but when the administration is complete, the income received is allocated over the period and any appropriate adjustments are made.

An annuity received by a beneficiary is income, whether it is paid out of income or capital of the trust. Other income interests are, in general, treated on the "conduit" principle according to which the source of the payment governs its treatment in the hands of the beneficiary.

The United Kingdom legislation has complex provisions to prevent tax avoidance by the use of transfers of income or property, including transfers in trust, which are technically also referred to as "dispositions" and "settlements". The general method is to treat the income transferred, or the income from the transferred property, as the income of the transferor. The results vary. Sometimes it is only surtax which the transferor must pay, and sometimes it is the standard tax as well. In some cases, particularly where the transferor does not personally benefit, the burden of the increased tax is on the transferee. This method of preventing avoidance of the progressive features of the rate structure by the "attribution of income" is also to be found in the taxing statutes of Canada and the United States.

United States

In the United States, the taxation of trusts, both inter vivos and testamentary, is essentially the same as in Canada, that is, the trust is

taxed on its income in the same manner as an individual, but with provision for the deduction of income which is distributable to beneficiaries. Such income is taxable to the beneficiary, but treated under the conduit principle as if received by the beneficiary directly. Thus, it has the same tax character in his hands as it had when received by the trust. For example, if the trust receives tax-exempt interest which is distributable, it will be regarded as tax-exempt interest as respects the beneficiary. In general, the treatment of estates is the same. The trustee or executor files a fiduciary return and pays the tax due. The return provides for a schedule of the beneficiaries and for the amounts payable to each.

An estate is entitled to a personal deduction of $600, but a trust is entitled only to a limited personal exemption of $300 if all income is distributable currently, or $100 otherwise. Estates and trusts are also entitled to deductions for net operating losses and for depreciation and depletion. Depreciation allowances are apportioned as provided in the trust instrument, or, if there are no such provisions, on the basis of the allocation of the trust income. Credits for partially tax-exempt interest and foreign tax, and an unlimited deduction for payments to charity, are also allowed.

Under the concept of "distributable net income", a beneficiary will not be taxed on more than he receives or is entitled to receive but may be taxed on less. Any distribution in excess of distributable net income is treated as a distribution of corpus, both in determining the amount taxable to the beneficiary and the amount deductible by the trust. Generally, "distributable net income" is equal to the taxable income of the trust, but there are statutory adjustments. For example, to give a beneficiary the advantage of tax-exempt income, thus preserving the conduit principle, tax-exempt interest is added to distributable net income. Capital gains are generally excluded from distributable net income except to the extent that they may be distributable to the beneficiary in the year. For simple

trusts, extraordinary dividends and taxable stock dividends are also excluded if allocated bona fide by the trustee to the trust corpus. Deductible expenses are deducted entirely from distributable net income, even though under trust law a part of the expense, for example, the trustee's fees for taking care of the principal, would be charged against the corpus.

A distinction is made between simple trusts, in which all the income is currently distributable, and discretionary or complex trusts, in which there may be distributions of accumulated income and of the corpus of the trust as well. There are special statutory provisions to settle how much of the aggregate distributable net income should be attributed to each beneficiary where the distributions exceed distributable net income, and the trustee has discretion in the distribution 1/.

The system is known as the "tier" system, and it determines the priority on which aggregate distributable net income of the trust for the year is allocated against the actual distributions made under the trust instrument or trust law. The general principle is that distributable net income is allocated, first, to amounts which are considered income by the law of the trust, such as interest and dividends, and which are required to be distributed currently, whether distributed or not, and are thus taxed to the beneficiaries as gross income (first tier). If these first-tier amounts are equal to or exceed the distributable net income for the year, then any other distributions will not be added to the beneficiaries' gross income, except where the throwback rule, discussed below, applies. If first-tier amounts are less than the distributable net income as defined, then second-tier amounts are required to be added to a beneficiary's gross income for the year up to the beneficiary's share of the distributable net income remaining after allocation to the first tier. Second-tier amounts are any amounts in excess of first-tier amounts which are "paid, credited or required to be distributed" to the beneficiary, such as current income which the trustee has discretion to distribute or accumulate, accumulated income

and corpus other than specific bequests. Substantially separate and independent shares of different beneficiaries in the trust are treated as separate trusts in determining distributable net income of the trust to prevent unfair allocations of distributable net income, as where one beneficiary receives distributions of part of the current income plus corpus, and the balance of current income is accumulated for another beneficiary.

In addition, the Internal Revenue Code contains special provisions to prevent tax minimization by the accumulation of income in a trust when the tax rate of the trust is less than that of the beneficiaries, followed by the distribution of it in a subsequent year free of tax. The provisions apply only to complex trusts and not to estates under administration. In essence, where a distribution is made from income accumulated within the preceding five years, it is taxable to the beneficiary. But, if the beneficiary chooses (as he usually will), the tax payable on the accumulation distribution is determined as if the beneficiary had received it in the year it was received by the trust. The beneficiary is given credit against his tax liability for taxes which have been paid by the trust on this accumulated income. There are a number of exceptions to this "five-year throwback rule", for example, income accumulated until the beneficiary reaches 21.

The use of multiple trusts has given rise to an avoidance problem which is still being tested by litigation. Proposals made to Congress in 1960 to solve the multiple trust problem along the lines of section 63(2) of the Canadian Income Tax Act were not adopted.

The United States has also found it necessary to prevent tax avoidance by the making of a gift to a trust in which the grantor retains some benefit or advantage. There is now a set of rules in the Internal Revenue Code and the Regulations which attributes the income of the trust to the grantor where any of the following situations applies:

1. The grantor retains an interest in the income of the trust.

2. The corpus of the trust may revert to the grantor within 10 years.

3. The grantor retains, or vests in a non-adverse party, the power to control the beneficial enjoyment of the trust.

4. The grantor retains certain self-serving administrative powers over the trust.

5. The grantor retains the power to revoke the trust.

6. The trust income may be applied to pay premiums on insurance on the life of the grantor.

7. The trust income is actually used to discharge a legal obligation of the grantor for support 2/.

REFERENCES

1/ The provisions, which are contained in sections 661 and 663 of the Internal Revenue Code, are quite complex and provide for the treatment of a variety of items. The description in the text must be taken as a very general summary.

2/ It should be noted that the discussion above deals only with income tax consequences. The results for estate and gift taxes may be different. For an excellent discussion of these problems, see Federal Estate and Gift Taxes: A Proposal for Integration and for Correlation with the Income Tax, Washington: United States Government Printing Office, 1947.

APPENDIX C

BUSINESS TRUSTS

The business trust, which we refer to in Chapter 21 as a unit holders' trust, is a form of organization that lies somewhere between the partnership and the corporation and has certain attributes of each. Legally it is a trust, but the very flexibility of the trust form permits it to be adapted to many situations and to imitate other types of organization. This form of organization was widely used in England up to the passage of the early Companies Acts in the nineteenth century, and went under the name of a joint stock company. After 1880, it was infrequently used in England until it was revived in 1930 as the modern unit trust. Today the unit trust is widely employed in many areas of British business.

On this side of the Atlantic, the business trust found great favour in the United States, and especially in Massachusetts, in the early part of this century. It was used at first primarily to avoid the stigma attached to corporations. Because of the widespread use made of it in Massachusetts as a medium for developing real estate, it has been called the "Massachusetts" trust. A good deal of jurisprudence exists in the United States on the legal incidents attaching to this form of organization.

In Canada this type of arrangement has been bypassed in favour of the corporation. It is fair to say that, in general, it is unknown and untried except for use in investment trusts, oil and gas development and real estate, especially among small private groups. Recently the business trust has acquired some popularity as a method of avoiding the associated-corporation provisions of the Income Tax Act.

In the United States, on the contrary, the business trust has been used to operate oil wells, gas stations, laundry businesses, mercantile agencies, distributing companies, real estate development projects, motion picture productions and a myriad of other businesses.

General Legal Incidents of Business Trusts

Unlike a corporation, a trust as such does not have a separate legal personality. The general view of the nature of a trust is stated in the following excerpt from a Massachusetts case:

> "Speaking generally a trust is not a legal personality. With the exception later to be dealt with [a statute], it cannot be sued. It is represented by the trustee. He embodies it. He holds title. He deals with the property in which trust rights exist.
>
> "Contracts with regard to the rights and property affected by trusts are the contracts of the trustee. He, in person, is liable upon them. He is not acting as representative or agent of another. He is acting for himself, but with fiduciary obligations to others." 1/

A business trust differs somewhat from an ordinary trust. It may be said that the most basic, and indeed the essential, difference is that it has for its main purpose the conduct and carrying on of business. It is in this regard a very flexible kind of organization because it may be created for any purpose for which a contract may be made.

A workable definition of a business trust has been stated in these terms:

> "It is a combination of capital vested in trustees who issue transferable certificates for shares and execute a declaration of trust designed to provide for the shareholders all the immunities of corporate shareholding." 2/

There is in this definition the same essential characteristics which are found in any trust, namely, a settlor, a trustee, a beneficiary and trust property.

It has been said that a business trust lies somewhere between a partnership and a corporation and displays characteristics of each. But the prevailing attitude now in United States and British law is that the business trust is sui generis, and that it is to be dealt with in law as a separate legal concept that is distinct from a partnership and a corporation.

A tabulation of differences between the business trust and the corporation will highlight some of the principal legal features of a business trust:

	Corporation	Business Trust
1.	Owes its existence to statute.	Owes its existence to the law of equity.
2.	Created by authority of the government by a charter, letters patent, or memorandum of association.	Created by agreement.
3.	Is a separate legal entity.	Is not a legal entity.
4.	Corporation shareholders exist as a body mutually bound by the corporate rules and with powers to collectively control the company.	A trust estate consists simply of property without human elements. Equitable title to the estate is held by beneficiaries bearing no contractual relation, one with another. They may or may not have power to direct the trustee.
5.	Shareholders have limited liability created by statute.	Limited liability of a trustee may only be obtained through proper notice to creditors.
6.	Directors deal with corporate funds and property as agents.	Trustees deal with trust estate as fiduciaries subject to equitable obligation to account.
7.	Directors are not personally liable for their acts on behalf of the company, with certain exceptions created by statute or the corporate charter or by-laws.	A trustee is personally liable for his acts as trustee except as he may be relieved of liability by the trust instrument.

Some of the tests for distinguishing between partnerships and business trusts which have been developed in the United States are stated below in summary form:

1. Sharing Profits. Mere sharing of profits is not a conclusive test of partnership. The courts will look to the provision for distribution of losses and other provisions of the trust instrument to determine whether the parties intended to become partners.

2. Control Test. The control test refers to the manner in which the business is to be conducted and the repository of the ultimate power of control over the affairs and property of the trust. If, under the trust agreement, the trustees have complete title to the property with exclusive right to manage the business and affairs of the trust, free

from the control of the beneficial owners, the organization is treated as a business trust. If, on the other hand, the beneficial owners exercise or have power to exercise control, the organization is treated as a partnership.

The courts have said that they look to the trust instrument to determine whether control exists. In other words, a de facto test is not applied. The control must be found within the four corners of the trust instrument. It is interesting to note some powers which have been retained without creating a partnership. For example, it has been held that the power to amend or terminate a trust, but only with the consent of the beneficiaries, does not convert the organization to a partnership. It has also been said that where trustees have complete freedom of judgment, the bare power of the beneficiaries to remove them does not create a partnership. On the other hand, the power to amend the trust, remove trustees, appoint other trustees, fill vacancies, terminate the trust, hold regular meetings, and amend by-laws and regulations have been held to be sufficient control by beneficiaries to create a partnership.

The control test may be likened to the right of the beneficiary of a personal trust to call for the termination of the trust, in which case the trust property would be regarded as belonging to him in equity. This would be the case when the beneficiary was of full legal competence and the trustee had no powers of management or discretion. In these circumstances, the court would, on application, terminate the trust and direct the property to be transferred to the beneficiary.

The Use of Business Trusts

It may be asked why taxpayers would use a business trust when incorporation was available. There are a number of advantages which may be derived from the use of business trusts. These advantages can be summarized conveniently as follows:

1. Minimal regulation by government and freedom from corporate taxation, Laws relating to security issues, the doctrine of ultra vires, complicated and involved accounting procedures, annual reporting, and business registration frequently do not apply to a business trust.

2. Freedom of members from personal liability such as is imposed on partners. In the United States, it has been held that this freedom from liability depends primarily on the degree of control which the beneficiaries may exercise over the trustees.

3. Continuity of existence in that the trust does not dissolve as does a partnership upon the transfer of a share or upon the death, insanity, or bankruptcy of a member.

4. Lower costs of organization.

On the other hand, certain disadvantages attach to the business trust and may be summarized as follows:

1. Possible liability of the beneficiaries for the debts and torts of the trust. As already noted, this liability may depend in large measure on the degree of control which the beneficiaries exercise over the trustees.

2. Uncertainty of the legal rights and liabilities created by a business trust. In Canada, there is virtually no law dealing specifically with this type of organization, so that many questions involving the rights, duties, liabilities, or immunities of the trustees, the beneficiaries and third parties are unanswered.

Why has the business trust form of organization not found the same favour in Canada as it has in other countries? Possibly this is because of a preoccupation with the notion of "incorporation", the relative ease of incorporation, and the lack of any specific impetus to the use of trusts such as led to the development of the Massachusetts trust. Whatever the reasons

may be, it is clear that in Canada the law is not well developed in this area. There are, of course, general principles of trust law which have been worked out and accepted for many years. The development of new concepts related specifically to business trusts would probably require Canadian courts to draw on English and United States experience.

It would appear probable that the business trust will not become a major form of organization in Canada. Nevertheless, because of its flexibility of form, if any substantial tax advantage was available to business trusts, many enterprises now operated by partnerships and corporations could be carried on by business trusts.

REFERENCES

1/ Larson v. Sylvester, (1933), 185 N.E. 44, pp. 45-46. See also Smith v. Anderson, (1880), 15 Ch. D. 247.

2/ S.R. Wrightington, "Voluntary Associations in Massachusetts", (1911-12) 21 Yale Law Journal 311.

APPENDIX D

A MAJOR WEAKNESS OF THE PRESENT SYSTEM OF TAXING CORPORATIONS—"SURPLUS-STRIPPING"

Under the present method of taxing corporate source income in Canada, with certain exceptions, no personal tax is levied on such income until it is distributed, or deemed to be distributed, to resident individual shareholders or to non-residents. However, the undistributed corporate income carries with it a potential liability to personal tax at such time as it may be distributed. In widely held corporations it is relatively easy for shareholders to realize a tax-free benefit of at least some proportion of the undistributed income by the simple expedient of selling shares. The sale of shares also transfers to the purchaser the potential liability to personal tax associated with the undistributed income, but the significance of this liability is usually discounted because the tax can be deferred.

The prices at which shares of widely held corporations sell in the open market are determined by the interaction of many factors and of many buyers and sellers. The value of the underlying assets representing the undistributed income and the potential tax liability associated with that undistributed income are only two of the factors, and they, in many instances, will be outweighed by other factors as determinants of price. The potential tax liability associated with the undistributed income will vary as between buyers and sellers. At the extremes, one of the parties to the transaction might have a marginal tax rate of 80 per cent, or 60 per cent after allowing for the dividend tax credit, whereas the other might not be subject to tax on receipt of a dividend. In normal situations it must be assumed that the market price does not reflect the relative tax positions of individual purchasers and sellers but rather some composite effect. It is apparent, however, that where a distribution of corporate income was to be made, a shareholder who was subject to a very low rate of tax, or one who was not subject to any tax on receipt of Canadian dividend income, would retain more of the dividend after tax than a shareholder who was subject to high rates of tax. If, prior to the distribution of any substantial

amount of corporate income, the latter shareholder sold his shares at a price which reflected most of the undistributed corporate income, he would benefit to the extent of most of the personal income tax he might otherwise have paid 1/. If the purchaser was not subject to tax on receipt of Canadian dividend income, he would also benefit to the extent that the amount of the distribution was not fully reflected in the purchase price. Such complete mutuality of interest between purchaser and seller, combined with a substantial distribution of corporate income, is rare in the case of widely held corporations but, where it does arise, 2/ both purchaser and seller gain by the type of sale previously described, and the potential tax liability on distribution substantially or completely disappears. It is easy to imagine that the shareholders of a closely held corporation, heavy with undistributed income and facing liquidation, would have every incentive to seek a purchaser who could receive the corporation's liquidating distribution free of tax. A sale could then be arranged at a mutually profitable price, the shared profit being realized from the reduction in the tax liability that would have arisen had the distribution been made to the selling shareholders.

Where a substantial corporate distribution is known to be imminent and a shareholder has no good reason to retain his interest in the company, it is normal that he should wish to sell his shares to another party whose tax circumstances are such that a mutual benefit can result. Where this is done for the purpose of reducing the tax liability, the action taken may be regarded as tax avoidance.

It was inevitable that some shareholders would seek to achieve the same tax saving while retaining control of the corporation, or retaining control of the business carried on by the corporation. In effect, they sought to arrange a tax-free distribution from a continuing business which, if made in the normal manner, would have been a taxable dividend. To this end, various schemes were contrived or arrangements entered into in such a

way that the shareholders would receive in non-taxable form what were in effect distributions of income 3/.

These tax avoidance practices became known as "surplus-stripping". This term is not capable of precise definition, and the dividing line between surplus-stripping and sophisticated tax planning is a very narrow one. In January 1963, the Minister of National Revenue stated:

> "There is no specific definition of the term 'surplus strips'. It is frequently used to refer to any procedures that have been followed for the purpose of transferring surpluses from corporations to their shareholders with a minimum of tax payment." 4/

Obviously, this very general description could be interpreted to include procedures which were provided for in the Income Tax Act and which would not be considered surplus-stripping by either the taxpayer or the Department of National Revenue, for example, the use of an election under section 105. In the bulk of surplus-stripping schemes, sales or redemptions of shares are made in such a way that some part of the non-taxable proceeds is, in essence, a disguised dividend. The definitional difficulty is in distinguishing a normal sale from a sale which is part of a contrived scheme, particularly as the schemes assume a multiplicity of forms depending on circumstances peculiar to the corporation and its shareholders. It is not necessary to describe the many methods by which undistributed income could be extracted with minimal or no tax cost, for they have been the subject of many articles and speeches over the past few years.

Tax avoidance of this nature is not peculiar to the Canadian tax system but is common to all tax systems that do not tax capital gains, or tax them at low rates, and that impose a tax on corporate distributions which is payable at the time of distribution. The succeeding sections of this appendix review the history of the Canadian anti-avoidance legislation, and the anti-avoidance legislation adopted by some other countries faced with the same problem.

CANADIAN LEGISLATION TO PREVENT SURPLUS-STRIPPING

Because Canadian income tax legislation was completely redrafted with effect from January 1, 1949, it is convenient to review surplus-stripping legislation prior to that date separately from that in effect subsequently.

Pre-1949 Legislation

By 1924, the intention that corporate income should be subject to personal tax on ultimate distribution had been clearly established. The exemption from income tax of intercorporate dividends which was introduced in 1926 would, in the absence of preventive legislation, have provided an easy means whereby the corporate assets representing its undistributed income could have been made available to the shareholders tax free. In its simplest form, this result could have been achieved by selling all the shares of the corporation with undistributed income to a second corporation owned by the same shareholders for a price that included the value of the underlying assets representing the undistributed income. Cash, or other liquid assets, could have been transferred from the first to the second corporation as a tax-exempt intercorporate dividend and then paid to the original shareholders in partial satisfaction of the liability to them in respect of the purchase price of the shares in the original corporation. To prevent this, the 1926 legislation provided that shareholders selling shares in those circumstances would be taxable on the intercorporate dividend as if it had been received by them. In the same year, further anti-avoidance legislation relating to corporate distributions was enacted to prevent the distribution of capital without first distributing, or at least paying tax on, undistributed income, and to deem that certain transactions should result in dividends to the extent of the corporation's undistributed income. Such transactions included certain advances or loans to shareholders, the payment of a premium on redemption of shares and the declaration of stock dividends.

By 1936, it was found necessary to strengthen still further that part of the 1926 legislation that was designed to prevent tax avoidance by the sale of shares and the utilization of tax-free intercorporate dividends, but this also proved to be inadequate. The struggle to prevent the tax-free extraction of undistributed income in the pre-1949 period culminated in the enactment in 1938 of section 32A of the Income War Tax Act. Section 32A vested in the Treasury Board the power to direct the tax consequences of transactions in those cases where it was felt that the main purpose of the transaction was the reduction or avoidance of taxes. As finally amended, it contained one subsection couched in such general terms as to apply to any tax-motivated transaction and this provision, in somewhat modified form, continues in the present Act as section 138. The powers conferred by it were never exercised after 1949 and it came to be regarded by sophisticated taxpayers and their advisers as something of a "paper tiger". Two of the subsections of section 32A that were added in 1943 and were more specifically directed at surplus-stripping were not carried forward into the new Act. One of those subsections was aimed at a specific set of circumstances but the other, couched in broad terms, was directed at payments or benefits received directly or indirectly from a corporation having undistributed income on hand. Although section 32A gave sweeping powers to the Treasury Board it also contained a provision to the effect that, on appeal from an assessment made pursuant to these powers, the Exchequer Court of Canada had jurisdiction to determine whether the main purpose of the transactions was tax avoidance.

Post-1948 Legislation

The introduction of the Income Tax Act in 1948 resulted in major changes in tax legislation, including the elimination of most ministerial discretion. Those subsections of section 32A directed specifically at surplus-stripping and certain other sections dealing with that subject were withdrawn and subsequently replaced by the new concept of "designated surplus". In general

terms, the new legislation provided that where one corporation acquired control of another at a time when the acquired corporation had undistributed income on hand, such undistributed income would become "designated surplus", and that dividends paid out of this surplus would not be exempt from tax in the hands of the controlling corporation. The prohibitive tax that would ordinarily result from applying normal corporation tax rates to such a dividend indicates that the legislation was intended to prevent avoidance rather than raise revenue.

As taxpayers sought and found means to circumvent these provisions, the periodic introduction of amendments directed at specific schemes was resumed. In 1955, legislation was introduced to deal with the situation where the dividend paid from designated surplus was received by a non-resident corporation, by exempt persons or by traders or dealers in securities 5/. Because, in most cases, those recipients of a dividend paid from designated surplus would pay little or no tax thereon, the legislation imposed a special tax on the paying corporation. The rate of tax is nominally 20 per cent in the case of a dividend paid by a corporation controlled by a dealer in securities and 15 per cent in the case of the other described persons, but because the tax payable reduces the paying corporation's undistributed income, the effective rates of tax on the amount of designated surplus can be reduced to 16.66 per cent and 13.05 per cent respectively. The enactment in 1958 of a provision to deal with statutory amalgamations 6/ opened another major break in the already vulnerable wall of legislation constructed to prevent surplus-stripping. In 1959, further legislation was enacted to buttress the designated surplus concept where a statutory amalgamation has taken place 7/. In general terms, it imposed a flat rate of tax, in this case 20 per cent, on the amount of undistributed income of the predecessor corporations which was not represented by net assets of the new corporation formed as a consequence of the amalgamation. This legislation was amended in 1960, but has continued to be relatively ineffective, mainly because of deficiencies in the provisions.

In addition to those more obvious weaknesses, the definition of designated surplus was in itself susceptible of circumvention. Without entering into a detailed technical discussion, it can be said that two of the vulnerable points concerned the definition of control and the definition of the amount of undistributed income that was to be "designated". Given the existing flexibility of corporate and intercorporate organization and reorganization, it appeared possible to avoid the intent of the legislation by intelligent planning, or, failing that, by subsequent reorganization of capital structures or intercorporate relationships. The efficacy of this legislation may be judged from the fact that the practice of surplus-stripping became widespread.

The legislative response to this obvious avoidance of the intent of the statute came in 1963 with the introduction of section 138A. The major portion of this section is addressed to the problem of surplus-stripping and, in general terms, it provides that where an amount has been received by a taxpayer as consideration for the sale or other disposition of shares, or in consequence of a corporation having redeemed, acquired, reduced, or converted its capital stock, or as exempt income, the Minister can direct that all or part of the amount be included in the taxpayer's income if, in his opinion, it was received as part of a surplus-stripping scheme. As a safeguard, the section allows the taxpayer to take an appeal against the direction to the Tax Appeal Board or the Exchequer Court. The tribunal may confirm or vary the direction, or, if it determines that none of the purposes of the transaction or series of transactions was to strip surplus, it may vacate the direction.

There is a striking similarity in the history of the legislation to prevent surplus-stripping in the two periods. In each case, attempts were made originally to enact legislation that detailed the then known methods of surplus-stripping and detailed the tax consequences of using the particular method. In each case, the attempts failed and the subsequent amendments

to extend or strengthen the legislation were equally unsuccessful, until, ultimately, resort was had to discretionary legislation. In the pre-1949 period the discretionary power was vested in the Treasury Board, whereas in the subsequent period it was vested in the Minister of National Revenue. In each case the taxpayer was given protection in that the courts were given jurisdiction to review the exercise of the discretionary power.

The Effects of Canadian Legislation
to Prevent Surplus-Stripping

Section 138A(1). The enactment of section 138A(1), granting certain discretionary power to the Minister of National Revenue to deal with this particular form of tax avoidance, has undoubtedly inhibited the practice to a very substantial degree and may have halted it completely. Insufficient time has elapsed to establish whether taxpayer ingenuity will find a means of surmounting this most recent and formidable barrier against the tax-free extraction of undistributed corporate income, but, if past history is any guide, attempts will probably be made. The efficacy of this legislation is primarily dependent on whether the conditions precedent to the exercise of ministerial discretion are sufficiently broadly drawn to cover all possible surplus-stripping schemes. This we have reason to doubt, but where an omission is discovered or anticipated, prompt legislative action to bring it within the scope of the section should be adequate to restore its potency. To a considerable extent, the efficacy of this legislation will also depend on how assiduously the Minister makes use of this section and on the breadth of interpretation given to its provisions by the courts when taxpayer appeals are made from directions by the Minister.

Section 138A(1) reflects Parliament's decision that, at least as a temporary measure pending a better solution, it will not attempt to specify precisely all the transactions which are subject to tax in a very broad area but instead will empower the Minister to do so. Basically, the Minister is empowered to collect tax which he believes has been avoided

through technicalities. Uncertainty must exist, therefore, until the Minister decides and issues an assessment, which he can do until a day four years after the date of issue of the original assessment for the year in which the taxpayer received "an amount" considered taxable under this section. Such decisions can be extremely difficult, because the Minister ordinarily cannot see beyond the currently completed or proposed transactions. In cases where the intentions of taxpayers as to future transactions are obscure, the Minister quite naturally might be reluctant to give an advance ruling, simply because he is unable to determine the real purposes of the transactions.

Section 138A(1) stipulates that certain factual conditions must exist before the Minister can use his discretion. A taxpayer must have received "an amount", which has a wide meaning under the Act, as consideration arising out of, or in consequence of, specified transactions. If an amount of this kind has been received, the Minister can add all or part of the amount to the taxpayer's income if he believes that one of the purposes of the transaction or transactions was surplus-stripping. The section could operate to tax persons who had no thought of carrying out a surplus-stripping operation, 8/ and could apply to transactions not normally visualized as surplus-stripping. Plainly, the scope of the section cannot be determined with certainty from its wording and there is no provision in the present law to require the Department to give an advance ruling 9/. However, officials of the Department have indicated that the section will not be applied to transactions where all the undistributed income extracted or capable of being extracted from the corporation is subjected to tax under section 105 or under some other provision. It is also understood that the Department will give non-binding opinions favourable to the taxpayer in cases where there is a transaction at arm's length and the Department is satisfied that the transaction is bona fide and that none of its purposes is surplus-stripping. In most other cases the Department has been unwilling to give a favourable ruling.

Taxpayers and practitioners have expressed great concern over this extension of ministerial discretion and the uncertainty that accompanies it. The legislation has had an inhibiting effect on many transactions which have not generally been regarded as surplus-stripping. It must be considered, for example, in every case in which a corporation purchases a substantial interest in the shares of another corporation. In such a case, the vendor of the shares may be subject to the risk of taxation by reason of some action subsequently taken by the purchaser over which he has no control. Thus, uncertainty as to the tax consequences of a transaction arises from lack of knowledge of both what practices will be regarded as surplus-stripping and what course of conduct another party may pursue.

Further uncertainty exists because, even if section 138A(1) is applied, the taxpayer has no assurance that some other section of the Act will not be subsequently applied to tax the same undistributed income. This could be the case when it is eventually distributed. That no attempt was made by Parliament to integrate the provisions of section 138A(1) with the remainder of the Act reflects the temporary stop-gap nature of the measure.

Although section 138A(1) was enacted as the ultimate weapon, the other legislation directed at surplus-stripping is still in force and certain of its effects will be considered in the ensuing paragraphs under separate captions.

The Choice of Multiple Tax Rates on Withdrawal of Undistributed Income. As we have stated, as early as 1924 it was intended to tax corporate income at personal rates on ultimate distribution. Certain provisions of section 105 have substantially diminished the progressiveness of the tax levied on the distribution of corporate income. A consequence of certain of the anti-avoidance provisions previously discussed is that they have provided means of withdrawing corporate income on payment by the corporation of a variety of flat rates of tax. To some shareholders, although not all, these rates are substantially less than would be paid if normal dividends were distributed

and are more attractive than even the effective rates obtainable through the use of those provisions of section 105 dealing with post-1949 corporate income. Table D-1 illustrates the comparative tax costs of extracting corporate income by certain specified methods 10/.

TABLE D-1

THE COMPARATIVE TAX COST OF WITHDRAWING CORPORATE INCOME NET OF NORMAL CORPORATION INCOME TAX
(all figures in percentages)

	Tax Cost on Marginal Dollar a/				
		Section 105 b/	Section 105B		Section 105C
Shareholder's Marginal Tax Rate (1)	Cash Dividend (2)	(3)	Dealer in Securities (4)	Tax-Exempt Persons (5)	Amalgamations c/ (6)
0	-	7.5	16.66	13.05	20
20	-	7.5	16.66	13.05	20
40	20	17.5	16.66	13.05	20
60	40	27.5	16.66	13.05	20
80	60	37.5	16.66	13.05	20

a/ In addition to the tax cost, certain transaction costs would be incurred in the procedures contemplated under columns 3, 4, 5 and 6. However, where any substantial amount of undistributed income is concerned, the only such costs which would be a material factor would be the profit allowed to the dealer in securities or to the tax-exempt person in the cases of columns 4 and 5 respectively.

b/ One half of the distribution is taxed as a cash dividend and the other half at 15 per cent.

c/ This tax would not ordinarily be applicable to the amount distributed, but rather to the amount by which undistributed income ceased to be represented by tangible net assets. See also the following section for a description of an anomaly resulting from the provisions of section 105C.

It is an interesting commentary on sections 105B and 105C, which presumably were enacted to thwart tax avoidance, that their use is beneficial to certain taxpayers, and that the comparatively low flat-rate tax resulting from their application has come to be used by certain taxpayers as an argument,

based on both "equity" and acceptability to the government, in support of proposals that dividend income should be excluded from the personal progressive tax rate structure and subjected to a modest flat rate of tax.

Designated Surplus. As we have seen, the designated surplus concept proved to be an unsuccessful means of preventing surplus-stripping although it may well have prevented certain taxpayers from engaging in the practice. Unfortunately, its provisions can also ensnare taxpayers who have no intention of surplus-stripping and whose lack of such an intention is, in some cases, apparent from the nature of the transaction. Where one corporation acquires all or substantially all of the shares of another corporation, either widely or closely held, by the issuance of its own common shares can it be said that this is part of a surplus-stripping operation? It is true that if the acquired corporation is closely held and the acquiring corporation is widely held and its shares actively traded, the previous shareholders of the acquired corporation now own a liquid asset and can in effect realize some portion of the acquired corporation's undistributed income in the same manner as any other shareholder of a widely held corporation. But is this surplus-stripping? The combined undistributed income remains intact, is represented by the same assets, and if distributed will be subject to taxation. It may well be advantageous for the operations of the two corporations to be merged, but the subsidiary cannot be liquidated into the parent without substantial tax cost. As a consequence, many such subsidiary corporations exist as shells only. Their operations and assets have been taken over, by somewhat artificial means, by the parent, and the only reason for their continued existence, until such time as the designated surplus is completely eroded, 11/ is to preserve the legal fiction that no distribution of the designated surplus has been made to the parent corporation. In this and other situations, the somewhat indirect approach 12/ of the designated surplus concept has interfered with normal and very often desirable corporate reorganization while at the same time failing in its principal purpose.

It has been suggested that the designated surplus concept puts non-resident corporations in an advantageous position as compared with resident corporations when competing for the acquisition of a Canadian corporation which has a substantial surplus. In the event that the acquired corporation was to continue its operation in its present form and not to make distributions in excess of current earnings, the complaint would not be valid because no immediate tax on the surplus would be incurred by either party. However, in the event that the acquired corporation was to be wound up, the tax cost could be 26.1 per cent of the surplus for the non-resident corporation, 13/ and 50 per cent of the surplus for the resident corporation 14/. But it is not likely that the resident corporation would submit to the 50 per cent tax. Instead, one of the other methods of distribution for which provision is made in the Act would probably be used so that the tax cost would be less than that of the non-resident corporation.

Anomalies Resulting from Canadian Legislation
to Prevent Surplus-Stripping

Although a number of those sections of the Income Tax Act that are directed at preventing the tax-free extraction of corporate income result in anomalies, we believe that only two of the anomalies are sufficiently significant to warrant mention in this appendix.

It has been stated earlier that the immunity from tax granted to intercorporate dividends is withdrawn where the dividend is deemed to be paid from designated surplus. A dividend is not deemed to be paid from designated surplus if the "control period earnings" 15/ are such that the dividend could have been paid from them. The rules for computing control period earnings make no provision for the deduction of provincial income taxes paid, charitable donations made or losses sustained after control was acquired. As a result, the aggregate intercorporate dividends that may flow tax-free can exceed the aggregate net after-tax earnings of the controlled corporation subsequent to control having been acquired with a

consequent erosion of designated surplus. As the share of the corporation income tax going to the provinces has increased, the omission of any provision for deducting provincial income taxes from control period earnings has become more significant.

The second anomaly concerns the computation of the base for the tax imposed by section 105C on any amount of undistributed income deemed to be distributed as a result of the amalgamation of corporations. The general policy followed in the Act is that distributions to shareholders are deemed to be made first from undistributed income, and only when that is exhausted is it possible to make tax-free distributions from capital gains or by way of return of capital. Under the provisions of section 105C it is possible to distribute assets of the newly created amalgamated corporation without incurring tax, thereby achieving the effective tax-free distribution of capital gains and the repayment of capital prior to the distribution of undistributed income.

FOREIGN LEGISLATION RELATING TO "SURPLUS-STRIPPING"

A review of the legislation of certain selected foreign countries whose tax systems permit a similar suspension of income within the corporate form indicates a variety of approaches to the problem.

France, Germany and The Netherlands impose special taxes on gains on disposal of shares in corporations in which the taxpayer owns a substantial interest. Generally speaking, ownership of a substantial interest is considered to exist where the taxpayer and certain close relatives own an aggregate of at least 25 per cent of the corporate share capital. This type of legislation reflects the ability of shareholders owning substantial interests in closely held corporations to influence distribution policies to the shareholders' tax advantage. Other countries have approached this particular aspect by enacting legislation that seeks to prevent "unreasonable" accumulations of corporate income. In some countries this result is

sought by levying an almost confiscatory tax on the amount unreasonably retained in order to force distribution, and in others the amount unreasonably retained is imputed to the shareholders. Depending on the country, the reasonableness of the retention may be determined by formula, by the courts, or at the discretion of the taxing authorities.

Although the legislation of most countries contains provisions to prevent the tax-free extraction of undistributed corporate income by the more obvious methods, our interest was centred on those parts of the legislation that might prevent the more complex type of avoidance we have described as surplus-stripping. Because it would not be fruitful to examine anti-avoidance legislation in isolation from the legal and judicial system within which it operates, we concentrated on those countries with legal traditions somewhat similar to those in Canada.

The United Kingdom attempted at various times to prevent surplus-stripping by enacting legislation describing specific circumstances in which what otherwise would be a capital gain would be treated as income. This legislation had similarities with that in Canada, for it was directed at sales to security dealers and exempt persons among others. As in Canada, this detailed legislative approach proved to be unsuccessful. In 1960, legislation was introduced aimed at securities transactions specifically, but it was couched in reasonably general terms rather than spelled out in an attempt to cover all the specific situations in which it would apply. This legislation gave discretionary power to the Revenue to nullify any tax advantage obtained as a result of the transactions. It was apparently with considerable reluctance that Parliament accepted the view that such a provision was necessary to deal effectively with tax avoidance in this area. A number of safeguards were enacted including granting the taxpayer the right to obtain from the Revenue, within specified time limits, notification as to their view of the taxability of either proposed or completed transactions. Assessments made under this legislation were subject to appeal to the Special Commissioners and to a special tribunal set up for this purpose.

In Australia, the so-called "annihilating provision" 16/ has been contained in income tax legislation since 1915, but it was considered to have few teeth until the Commissioner won a resounding success in the Newton case 17/. After this case, a vigorous campaign utilizing this section was launched by the taxing authorities against arrangements that were considered to be substantially motivated by the opportunity of tax avoidance, and a number of lower court judgments favourable to the Crown resulted. However, it may be some time before it is finally determined how effective section 260 is as a means to halt surplus-stripping. As was stated in the judgment in the Newton case, if "...the transactions are capable of explanation by reference to ordinary business or family dealing, without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section".

In the United States, in contra-distinction to Canada and the United Kingdom, the anti-avoidance legislation has been buttressed by a sympathetic judicial response to the tax avoidance problem. A number of doctrines have emerged to supplement the intention of the legislature. These take into account such factors as the business purpose of a transaction, whether a distribution is substantially equivalent to a dividend, continuity of a proprietary interest, and compliance with the basic purposes rather than merely the form of the statute. In the United States, capital gains are taxable at special rates so that the amount of tax sought to be avoided is the difference between tax at progressive rates and a lower tax on capital gains, whereas in Canada it is the difference between tax at progressive rates and no tax.

Germany and South Africa have general anti-avoidance provisions not specifically directed at surplus-stripping. In Sweden, the intercorporate dividend exemption is denied to closely held corporations where the receiving corporation has failed to pay dividends to a reasonable degree; the denial is at the discretion of the National Tax Board.

CONCLUSIONS

Although it is not possible to determine the amounts of tax being avoided by surplus-stripping practices in Canada, this is not the prime consideration. Of considerable importance is the probability that the continued existence of widespread avoidance in this area will bring the entire tax system into such disrepute as to undermine the principles of self-assessment and voluntary compliance which form the foundation on which it operates.

Given the present flexibility of corporate organization and reorganization; given a tax system which permits the retention, within the corporate framework, of income potentially taxable on distribution; given the application of progressive personal tax rates to corporate distributions and the absence of tax on capital gains; given the traditional Canadian judicial approach to the interpretation of taxing statutes, it would probably be impossible to devise effective anti-avoidance legislation by particularizing in the statutes all types of transactions and their tax consequences. Such legislation would require the powers of a clairvoyant to foresee, let alone spell out, all possible combinations and permutations of circumstances and transactions which should result in the payment of tax. This type of approach, while reducing the extent of surplus-stripping, is likely to trap the innocent, to interfere with economically desirable corporate reorganizations and to provide to the sophisticated a catalogue of pitfalls that should be avoided. The only justification for detailed particularization and its associated complexity is that it provides some degree of certainty and denies to the tax administrators the power to make arbitrary assessments.

It seems clear that the anti-avoidance legislation enacted between 1949 and 1963, when section 138A was introduced, departed from the principle of personal progressive taxation of all income, and that it failed to pass the test of success that might have justified such a deviation.

Failing a basic change in the method of taxing income derived through the corporate form, some form of anti-avoidance legislation similar to that contained in the present section 138A(1) will be necessary, but it will have to be supplemented by procedures to provide speedy advance rulings to taxpayers contemplating transactions that might fall within its ambit. Such rulings should be binding on the Revenue provided full disclosure of all material facts was made by the taxpayer. It would also have to be supplemented by procedures to provide taxpayers with a speedy and final determination of tax liability where a transaction that might fall within the terms of the section had been consummated.

The only real answer to the problem of surplus-stripping is a basic change in the approach to the taxation of corporate source income. Only by eliminating the anomalies and inconsistencies inherent in the present system will it be possible to achieve freedom of action and flexibility in the carrying out of corporate transactions and reorganizations while not leaving room for widespread tax avoidance. The best way of accomplishing these ends would be to adopt the proposal for integration as recommended in Chapter 19, along with the taxation of capital gains at full rates as recommended in Chapter 15.

REFERENCES

1/ The gain made on a sale of shares is, generally speaking, a non-taxable "capital" gain.

2/ Occasionally, when the raison d'être of a widely held corporation has disappeared, it becomes public knowledge that it will be wound up and the directors indicate the date and amount of the liquidation distribution and how much of it represents undistributed corporate income. Because such an investment then becomes relatively more attractive to exempt organizations than to taxable shareholders, the market price should adjust to the point where it is mutually advantageous for many taxable shareholders to sell and for exempt organizations to buy.

3/ Because many of these schemes are unmanageable, and probably unnecessary, for widely held corporations, the practice is, as a general rule, confined to closely held corporations.

4/ House of Commons Debates, January 28, 1963, p. 3150.

5/ Income Tax Act, section 105B.

6/ Income Tax Act, section 85I.

7/ Income Tax Act, section 105C.

8/ This can happen because the vendors of the shares may have no control over what the purchasers do with the corporation.

9/ The following statement by the Minister of National Revenue was made on the matter:

> "For the proper exercise of discretion it is necessary for the minister to know all the circumstances surrounding the transaction or series of transactions, and this can only be known after the facts have been determined and each transaction has been completed. It will be recognized that the minister cannot exercise his discretion in advance or even find [sic] himself to exercise his discretion in a certain way in advance of the event. On the other hand, the

officials of the taxation division are prepared, within limits, to discuss informally proposed transactions with taxpayers and their lawyers and accountants, but conclusions cannot be reached which will be binding on either the minister or the taxpayer."

House of Commons Debates, November 8, 1963, p. 4556.

10/ Because the normal corporation tax payable on a dividend paid out of "designated surplus" is usually prohibitive, and because the provisions of section 105A, which sets out the tax consequences of redeeming shares at a premium, were infrequently used, neither of these methods has been illustrated.

11/ For expansion of this comment see the section immediately following.

12/ The approach is indirect in that it levies a tax, at least potentially, on the purchaser of the shares in an attempt to reach the seller and presumed recipient of the benefit of the undistributed income.

13/ Based on tax under section 105B at 15 per cent, and ordinary non-resident withholding tax of 15 per cent on the balance.

14/ This assumes that all the dividend received would be taxed at the higher corporation tax rate of 50 per cent.

15/ In very general terms, the undistributed income accumulated since control of the corporation was acquired.

16/ Section 260 of the Income Tax and Social Services Contribution Assessment Act. This is a general anti-avoidance section not specifically directed at surplus-stripping.

17/ Newton and Others v. Commissioner of Taxation of the Commonwealth of Australia [1958] A.C. 450.

APPENDIX E

INCIDENCE OF TAXATION ON INDIVIDUAL SHAREHOLDERS UNDER THE PRESENT SYSTEM OF TAXING CORPORATE SOURCE INCOME

A common complaint about the present system of taxing corporate source income is that it results in the double taxation of corporate distributions. While the present dividend tax credit provides some relief, it is argued that the relief is inadequate and has inequitable application among shareholders.

Double taxation is nearly always criticized as being unjust and discriminatory, with the implication that it is to the shareholder's disadvantage in all circumstances. If it is accepted that the income of a corporation is the income of its individual shareholders whether or not distributed to them, then the portion distributed will form the base for two levies of tax, one levy on the corporation by means of corporation income tax and another levy on shareholders when they receive dividends. The existence of these two levies appears to be responsible for the objections concerning double taxation. However, an examination of the effects of these taxes is necessary before it can be conceded that double taxation is quite as opprobrious as is sometimes asserted. To determine the effects, calculations were made of double taxation under a variety of corporate and shareholder circumstances on the assumptions that it is the same income that is being taxed twice, 1/ and that shareholders bear all the corporation income tax. The problem of the incidence of the corporation income tax is discussed at length in the Report, but for this particular purpose it is assumed that it is borne by the shareholders.

It is evident that the term "double taxation" is not at all precise in describing the actual tax situation. For example, it does not adequately describe the extreme inequity that arises where corporate income is subjected to a 50 per cent corporation income tax and the shareholder is a low income individual not liable for tax. More precise and less emotional terms

suggested by an authority in assessing this problem are "relative undertaxation" and "relative overtaxation" 2/. If the total of corporation and personal income taxes levied on a given amount of distributed corporate income exceeds the personal tax that would have been levied on an equivalent amount of income received directly by the shareholder, relative overtaxation is said to result, and where it is less, relative undertaxation results. These terms will be used to better explain the results of double taxation in various circumstances.

In the case of closely held corporations whose shareholders are actively employed in the business (these corporations might be considered as incorporated proprietorships or partnerships), there need never be relative overtaxation, and above a certain income level, there can always be relative undertaxation by withdrawing the corporate income by the optimum mix of salaries, dividends and elections under section 105 of the Income Tax Act. This is illustrated in Table E-1 in the case of an incorporated proprietorship. This table assumes full distribution and therefore no further liability for tax exists. In the event that full distribution does not take place, further saving in the amount of tax immediately payable can be achieved. This saving is only a postponement of the tax, but postponement of payment in itself has a value, particularly where the postponement is to the remote future.

Shareholders of a closely held corporation who are not employed by the corporation do not have the same flexibility in withdrawing corporate income as do the employee-shareholders described in the preceding paragraph but, where their tax circumstances are somewhat similar, advantage can be taken of the election available under section 105. In these circumstances they may withdraw the corporate income either as a dividend or as a combination of dividend and section 105 election in the optimum amounts. It should also be noted that, to some extent at least, the payment of directors' fees in reasonable amounts can bring their situation closer to that of the shareholder who is a full-time employee.

TABLE E-1

COMPARISON OF TAXES PAYABLE BY AN UNINCORPORATED PROPRIETORSHIP OR SALARIED EMPLOYEE AND BY AN INCORPORATED PROPRIETORSHIP USING DIFFERENT METHODS OF DISTRIBUTION

Income	Tax Payable by an Unincorporated Proprietor or Salaried Employee	Tax Payable By Incorporated Proprietorship: If Corporate Income is Withdrawn By a Combination of Salary and Dividends	Tax Payable By Incorporated Proprietorship: If Corporate Income is Withdrawn By a Combination of Salary, Dividends and an Election Under Section 105	Amount and Percentage of Relative Undertaxation Under (3)		Amount and Percentage of Relative Undertaxation Under (4)	
(dollars) (1)	(dollars) (2)	(dollars) (3)	(dollars) (4)	(dollars) (5)	As a percentage of column (2) (6)	(dollars) (7)	As a percentage of column (2) (8)
7,100	1,140	1,140	1,140	-	-	-	-
8,000	1,374	1,371	1,371	3	.22	3	.22
10,000	1,930	1,891	1,891	39	2.02	39	2.02
15,000	3,720	3,394	3,394	326	8.76	326	8.76
20,000	5,915	5,114	5,114	801	13.54	801	13.54
25,000	8,165	7,103	6,840	1,062	13.01	1,325	16.23
35,000	13,110	11,255	10,235	1,855	14.15	2,875	21.93
40,000	15,610	13,755	12,045	1,855	11.88	3,565	22.84
60,000	26,555	24,333	22,681	2,222	8.37	3,874	14.59
100,000	50,945	47,987	44,454	2,958	5.81	6,491	12.74
200,000	119,640	116,315	109,249	3,325	2.78	10,391	8.69
300,000	193,335	189,702	174,684	3,633	1.88	18,651	9.65
400,000	268,335	264,643	240,119	3,692	1.38	28,216	10.52
500,000	348,280	344,220	305,554	4,060	1.17	42,726	12.27

Note: An incorporated proprietorship is a closely held corporation whose shareholders are actively employed in the business. In this table it is assumed that the incorporated proprietorship has only one shareholder, that the optimum mix of salary, dividends and section 105 elections has been utilized, that full distribution has taken place and that the taxpayer-shareholder is entitled to a standard deduction of $1,100. The tax rates used were those in effect in 1963.

Because the circumstances of individual shareholders of closely held corporations may vary so greatly, it is not always possible to illustrate the situation as simply as was done in Table E-1, where it is assumed that the shareholder's main source of income was the corporation. Table E-2 shows the incidence of combined corporation and personal income taxes in the case of shareholders of a closely held corporation who are not employees. It is assumed that the shareholders have other income and accordingly the personal tax is calculated at the marginal rate indicated. It is also assumed that the income is distributed by the best possible mix of dividends and elections under section 105. Table E-3 shows the incidence of corporation and personal taxes in the case of a publicly traded corporation. It differs from Table E-2 in that it assumes that the 50 per cent corporate rate is applicable to all of the income, and that all distributions (either all or one half of the income after tax) are by way of cash dividends. The tables show for each personal income bracket the degree of relative overtaxation or undertaxation as compared with taxation of all the income at the personal rate.

It will be seen from Table E-2 that relative overtaxation is suffered at the lower income end of the scale whether the corporation is subject to tax at 21 per cent or 50 per cent, and that the degree of relative overtaxation gradually diminishes as the shareholder's other income increases until a point is reached when the high income shareholder is subject to relative undertaxation. It is obvious that the degree of relative overtaxation at the 50 per cent corporate rate will be much greater than at the 21 per cent corporate rate, and that the personal income level at which relative overtaxation changes to relative undertaxation in the case of the 21 per cent rate will be much below that at which it occurs in the case of the 50 per cent rate.

Table E-2 has been prepared on the basis that the entire corporate income is distributed and that no further tax is exigible thereon. This is, of course, an unrealistic assumption because full distribution is a rarity. To the extent that distribution does not take place some tax is postponed,

TABLE E-2

COMPARISON OF TAX PAYABLE ON $100 OF ADDITIONAL INCOME FROM A CLOSELY HELD CORPORATION

Personal Income Bracket	Tax Payable By Unincorporated Proprietor or Salaried Employee a/	If Received Through a Corporation Taxable at 21 per cent			If Received Through a Corporation Taxable at 50 per cent		
		Combined Corporation And Individual Income Tax Payable	Relative Overtaxation or (Undertaxation) as Compared With (2)		Combined Corporation And Individual Income Tax Payable	Relative Overtaxation or (Undertaxation) as Compared With (2)	
				As a percentage			As a percentage
(dollars) (1)	(dollars) (2)	(dollars) (3)	(dollars) (4)	of column (2) (5)	(dollars) (6)	(dollars) (7)	of column (2) (8)
No taxable income	-	21.00	21.00	-	50.00	50.00	-
1 - 1,000	14.00	16.26	2.26	16.14	47.00	33.00	235.71
1,000 - 2,000	17.00	18.63	1.63	9.59	48.50	31.50	185.29
2,000 - 3,000	20.00	21.00	1.00	5.00	50.00	30.00	150.00
3,000 - 4,000	19.00	20.21 b/	1.21	6.37	49.50 b/	30.50	160.53
4,000 - 6,000	22.00	22.58	.58	2.64	51.00	29.00	131.82
6,000 - 8,000	26.00	25.74	(.26)	(1.00)	53.00	27.00	103.85
8,000 - 10,000	30.00	28.90	(1.10)	(3.67)	55.00	25.00	83.33
10,000 - 12,000	35.00	32.85	(2.15)	(6.14)	57.50	22.50	64.29
12,000 - 15,000	40.00	34.83 c/	(5.17)	(12.92)	58.75 c/	18.75	46.88
15,000 - 25,000	45.00	36.81	(8.19)	(18.20)	60.00	15.00	33.33
25,000 - 40,000	50.00	38.78	(11.22)	(22.44)	61.25	11.25	22.50
40,000 - 60,000	55.00	40.76	(14.24)	(25.89)	62.50	7.50	13.64
60,000 - 90,000	60.00	42.73	(17.27)	(28.78)	63.75	3.75	6.25
90,000 -125,000	65.00	44.71	(20.29)	(31.22)	65.00	-	-
125,000 -225,000	70.00	46.68	(23.32)	(33.31)	66.25	(3.75)	(5.36)
225,000 -400,000	75.00	48.66	(26.34)	(35.12)	67.50	(7.50)	(10.00)
400,000 and over	80.00	50.63	(29.37)	(36.71)	68.75	(11.25)	(14.06)

a/ Tax rate schedule for 1963.

b/ It has been assumed that to this level it has been possible to utilize the dividend tax credit against tax on other income.

c/ At this point it is assumed that the corporation after-tax income has been distributed one half by cash dividend and one half by election under section 105.

TABLE E-3

COMPARISON OF TAX PAYABLE ON $100 OF ADDITIONAL INCOME FROM A WIDELY HELD CORPORATION

Personal Income Bracket	Tax Payable By Unincorporated Proprietor or Salaried Employee a/	Tax Payable if Received Through a Corporation Taxed at the 50 per cent Corporate Rate					
		Where All Corporate After-Tax Income is Distributed			Where Only One Half of Corporate After-Tax Income is Distributed		
		Combined Corporation And Personal Income Tax	Relative Overtaxation or (Undertaxation)		Combined Corporation And Personal Income Tax	Relative Overtaxation or (Undertaxation)	
(dollars)	(dollars)	(dollars)	(dollars)	As a percentage of column (2)	(dollars)	(dollars)	As a percentage of column (2)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
No taxable income	-	50.00	50.00	-	50.00	50.00	-
1 - 1,000 b/	14.00	51.50	37.50	268.0	50.75	36.75	262.5
1,000 - 2,000 b/	17.00	51.50	34.50	203.0	50.75	33.75	198.5
2,000 - 3,000 b/	20.00	51.50	31.50	157.5	50.75	30.75	153.7
3,000 - 4,000 b/	19.00	50.00	31.00	163.2	50.00	31.00	163.2
4,000 - 6,000	22.00	51.00	29.00	131.8	50.50	28.50	129.6
6,000 - 8,000	26.00	53.00	27.00	103.9	51.50	25.50	98.1
8,000 - 10,000	30.00	55.00	25.00	83.3	52.50	22.50	75.0
10,000 - 12,000	35.00	57.50	22.50	64.3	53.75	18.75	53.6
12,000 - 15,000	40.00	60.00	20.00	50.0	55.00	15.00	37.5
15,000 - 25,000	45.00	62.50	17.50	38.9	56.25	11.25	25.0
25,000 - 40,000	50.00	65.00	15.00	30.0	57.50	7.50	15.0
40,000 - 60,000	55.00	67.50	12.50	22.7	58.75	3.75	6.8
60,000 - 90,000	60.00	70.00	10.00	16.7	60.00	-	-
90,000 - 125,000	65.00	72.50	7.50	11.5	61.25	(3.75)	(5.8)
125,000 - 225,000	70.00	75.00	5.00	7.1	62.50	(7.50)	(10.7)
225,000 - 400,000	75.00	77.50	2.50	3.3	63.75	(11.25)	(15.0)
400,000 and over	80.00	80.00	-	-	65.00	(15.00)	(18.7)

a/ Tax rate schedule for 1963.

b/ It has been assumed that the taxpayer is unable to use the full dividend tax credit against tax on other income.

and, if the shares can be sold at a price which reflects all or part of these retained earnings, this postponed tax liability will not have to be met by the vendor. Although one of the characteristics of this type of corporation is that there is not normally a ready market for the shares, particularly where they represent a minority interest, nevertheless the postponed tax liability is often avoided by surplus-stripping.

Table E-3 illustrates the extent of relative overtaxation or undertaxation in respect of income from widely held corporations. The shareholder may well be described as the portfolio-type investor. He has little or no influence in the affairs of the corporation, and the corporation's shares are readily marketable either because they are listed on a recognized stock exchange or are actively traded over the counter. Because the individual shareholder has little influence in the affairs of the corporation and because of the diversity of tax circumstances of the many shareholders, it is unlikely that the shareholder will be able to obtain the benefit of the corporation's earnings except by way of dividend or, to the extent that retained earnings are reflected in share prices, by sale of the shares.

Table E-3 shows that the greatest relative overtaxation takes place where the shareholder has no taxable income and only one tax is levied. The amount of relative overtaxation diminishes as the income rises. Where all corporate after-tax income is distributed as a dividend, relative undertaxation is never reached. Where only one half of corporate after-tax income is distributed as a dividend, relative undertaxation results when the individual is at or over the $90,000 personal income bracket, and it becomes greater as the personal income bracket becomes higher.

The validity of the complaints about overtaxation must be judged, therefore, from the various findings above. In summary, it can be said that the so-called double taxation works to the advantage of some taxpayers and to the disadvantage of others, depending on a number of circumstances. Generally, the disadvantage falls most heavily on the low income shareholders of large income corporations.

REFERENCES

1/ This approach is in keeping with the comprehensive concept of income used in the Report which does not call for the taxation of organizations other than as a means of reaching the individuals who own the organization.

2/ Richard Goode, The Postwar Corporation Tax Structure, New York: New York Tax Institute Inc., 1947.

APPENDIX F

ALTERNATIVE METHODS OF TAXING CORPORATE SOURCE INCOME

The present Canadian method of taxing corporate source income is not satisfactory. In this appendix a number of alternative methods of taxing income derived through the corporate form are considered from the point of view that the best solution would be one that resulted in corporate source income bearing the same burden of tax as income derived through any other method of doing business. Neutrality of tax treatment, however impossible of complete attainment, should be the objective.

The broad concept of income adopted in the Report recognizes income as being attributable to individuals only, and not to artificial entities or organizations. The annual income (or loss) that an individual derived from ownership of an interest in a corporation would be measured, ideally, as the sum of the dividends and other distributions received during the year and the annual change in market value of his shares in the corporation. His total income (or loss) over time would be the sum of the dividends received throughout his period of ownership and the difference between his original cost and the amount ultimately realized on the final sale of his share. The current income of a corporation would only be one of the determinants, albeit an important one, of the income of a shareholder-individual under this broad concept 1/. If the annual income of the shareholder-individual was measured on this ideal basis, and if all shareholders were resident in Canada, there would be no necessity to levy income tax either on the corporation or at the corporate level.

To apply this concept completely, however, would require an annual valuation of all shares. In the case of actively traded shares, this would be relatively easy, but in the case of closely held family corporations no active market exists and the valuation of shares of such corporations would be a contentious, time-consuming process producing such approximate results as to render annual measurement of income on this basis impractical.

Once it is conceded that income from holding corporate shares cannot be taxed on a complete annual accrual basis, it becomes necessary to prevent the undue postponement of tax liability which would result if individuals were taxed on dividends received and therefore caused income to accumulate in the hands of corporations.

The ensuing sections of this appendix will examine various methods by which corporate source income can best be related to the various shareholders in such a way as to prevent postponement of tax, and to ensure that each shareholder's income derived from the ownership of corporate shares is charged with its appropriate burden of taxation as far as possible.

From our review of the existing Canadian system of taxing corporate source income, it is evident that if a deferment of distribution resulted in a delay in the application of any material additional tax levy, corporate profits would tend to be retained within the corporate vehicle whether they were required for the particular business or not.

One method of preventing postponement of tax would be the application of incentives or inducements to encourage distribution and, consequently, the integration of corporation and personal income and taxes. However, it is apparent that whatever would induce actual distributions by a corporation, whether it be a special tax on retained earnings or a lower rate of tax on distributed earnings, would likely be regarded as a penalty on retentions and would result in an undesirable tax bias toward distributions. For these reasons, such a solution would be inferior to one that was not dependent on actual distributions, that provided an incentive toward integration of the personal and corporation tax structures, and that was relatively neutral at the corporate level as between distribution and retention.

The Full Attribution or Partnership Method

Under this method, the corporate source income, whether or not distributed, would be attributed annually to the various shareholders. Shareholder-

individuals would include in income their attributed portion of the corporate source income, and would pay tax thereon at their appropriate personal progressive rates. Shareholder-corporations would also include in income their attributed portions of such income so that they would in turn be further attributed until ultimately attributed to individual shareholders. Dividends would not be relevant in computing annual income. To this point the method is somewhat similar to that currently accorded to the income of a partnership or of a personal corporation. However, to conform to the comprehensive tax base adopted in the Report, a final adjustment would be required on ultimate realization, or deemed realization, of the corporate shares. To determine this final adjustment, it would be necessary for each shareholder, both corporate and individual, to maintain records showing the cost of acquisition of the particular corporate shares, to which would be added the amounts of corporate source income attributed, 2/ and from which would be deducted the dividends received in respect of those shares. The difference between this adjusted cost and the proceeds or deemed proceeds of realization would represent the amount of the final adjustment.

At first sight, this method appears to be an ideal solution. It would result in corporate source income being taxed at the same rates as other forms of income, there would be no difference in treatment between distributed and undistributed income, a tax at the corporate level would be unnecessary, and the deviations from the comprehensive tax base that were occasioned by the annual use of corporate source income as a measure of the increase in value of corporate shares would be adjusted on realization.

Such a method is feasible for certain corporations which have small numbers of shareholders and simple capital structures and resemble incorporated partnerships, and for these corporations we have recommended an option to be taxed as a partnership. However, it presents administrative and compliance problems of alarming proportions when considered in relation to corporations with complex capital structures and large numbers of shareholders.

Apart from the complexities arising in connection with non-resident shareholders, such problems include the necessity of allocating the corporate source income to myriads of shareholders. Some shares may be registered in the names of nominees such as banks and brokers, and the same nominee may hold shares for many different taxpayers. The conflicting interests of different classes of shareholders could create either serious re-allocation problems or inequities. Unless the corporation consistently made profits sufficient to cover the contractual dividend entitlement of all classes of shares other than the most junior, it might be necessary to pay dividends to preferred shareholders out of funds taxed in the hands of common shareholders. The alternative of re-allocating prior years' corporate source income on some equitable basis, particularly where shareholdings are subject to rapid turn-over, presents insuperable difficulties. Intercorporate shareholdings introduce additional complexities in the determination of corporate source income and could make timely allocation and information to shareholders impossible 3/. No useful purpose would be served by cataloguing other problems associated with this method. But even if the administrative problems could be solved, it may be questioned whether public acceptance could be achieved for a method that could require a shareholder in a widely held corporation to make a cash payment for tax on corporate source income from which he had received no distribution.

It is not necessary to consider in any detail the additional problems that would be associated with non-resident share ownership but these would include problems of collection and of determining the rates of tax appropriate to particular non-residents.

Therefore, despite its theoretical attractions, it is apparent that the full attribution or partnership method is not practicable.

No Tax at the Corporate Level

The only other general approach that does not involve the imposition of a tax at the corporate level would require that dividends and gains or losses

on realization of shares be included in the income of shareholders. In computing income, the individuals would include dividends received and realized gains or losses and would pay tax thereon at progressive personal rates. No tax would be exigible in respect of either dividends received or gains on shares realized by corporations until they were distributed by way of dividend to individuals, or until an individual realized on his shares in the corporate shareholder.

Although such an approach would eliminate many of the difficulties associated with the full attribution method, it would permit postponement of the recognition of income for tax purposes at the option of the taxpayer. Apart from the obvious inequity that the option would not be available to all taxpayers, the effect on government revenues would be serious. On average, corporate surpluses increased by approximately $1,250 million per annum from 1952-61. The additional incentive of being able to retain income free of tax within the corporate structure would undoubtedly cause this figure to increase, and theoretically all tax in respect of undistributed corporate source income could be postponed during the lives of resident shareholders. Of even greater concern would be the probability that unless some method could be devised for collecting tax from non-resident shareholders in respect of gains on realization of shares, the undistributed corporate source income attributable to their period of ownership would escape Canadian taxation entirely. For Canada, with such a large degree of non-resident ownership of corporations, the loss of revenue would be considerable.

Consequences of a Tax at the Corporate Level

The above alternatives do not involve the imposition or collection of a tax at the corporate level. With their rejection, the collection of some form of tax at the corporate level becomes unavoidable. At a minimum, this tax must prevent the tax-free accumulation of corporate income. Whether it

is levied in respect of the undistributed portion of corporate source income only or in respect of both distributed and undistributed corporate source income, it is implicit in the concept of the comprehensive tax base that the tax be imposed at the corporate level only as a means of reaching the individual to whom the benefit of the corporate source income ultimately accrues. Thus, the levy of a tax at the corporate level requires that, in equity, this tax should also be related to the relevant shareholders and that credit should be given for it to the extent possible.

Quite apart from the structural problems associated with relating corporate source income to individuals and integrating a tax at the corporate level with personal income tax, a corporation income tax raises the problem of the double taxation of corporate source income. As Appendix E to this Volume demonstrates, the question is not simply one of double taxation. Furthermore, the economy has adjusted to the presence of an unintegrated or, at best, partially integrated corporation tax. However, the integration of the corporation tax with the personal tax rate structure would be desirable because this action would eliminate the distortions in the allocation of resources caused by an unintegrated corporation tax.

This decision calls for an examination of various methods whereby, not only would corporate source income be attributed to the various shareholders, but the tax levied at the corporate level would also be integrated with personal income taxes. The various alternatives are outlined below.

Deductibility of Dividends

Although a tax levy at the corporate level is essential in respect of undistributed corporate source income, it may be questioned whether it is necessary in respect of distributions from a current year's income. If dividends paid were made deductible in computing the tax to be levied at

the corporate level and recipients of the dividends were required to include those amounts in income, taxation at personal progressive rates would be achieved for the distributed portion of the corporate source income and the problems of integration in respect of that portion would be solved.

In principle, a strong case can be made for this proposal. It would tax currently distributed corporate source income in the same manner as other types of income, and, by placing loan interest and dividend payments on a similar footing would apparently remove or at least reduce any bias that may exist in favour of financing corporate expansion by debt rather than equities.

However, the proposal has a number of disadvantages quite apart from the revenue implications that arise from the high degree of non-resident ownership of Canadian corporations. The use of a year as the period for measurement of income would produce imperfect results if losses were to be carried back and forward over a reasonable period. The same rationale would require that a similar type of provision should be made for carrying back or carrying forward dividends paid in excess of corporate source income to those years where this income exceeded dividends paid. This would create certain administrative difficulties and could result in the wrong shareholder receiving benefits, but the difficulties should not in themselves prove insuperable. The proposal could have more serious consequences, however, because it could easily come to be regarded as a form of penalty tax on retained earnings, particularly if on a subsequent distribution the tax on retained earnings was not fully integrated with the personal income tax 4/. Such a belief would result in pressure for increased distributions. The proposal would also be open to criticism on the ground that it would bear more heavily on expanding corporations whose financial needs were greater than those of more mature corporations, although this latter objection could be partially overcome if stock dividends were treated as distributions for tax purposes 5/.

However, the most convincing argument against acceptance of this proposal

as suitable for Canada results from the high degree of non-resident ownership of Canadian corporations. Deductibility of dividends would, in the absence of other compensating legislation, result in the collection of only a withholding tax in respect of dividends distributed to non-residents. Any attempt to increase non-resident withholding taxes to recoup the loss of tax revenue associated with non-resident ownership of corporate shares would have widespread repercussions. That this could be so, even though the increased non-resident withholding tax did not exceed the total of the present corporation tax plus the non-resident withholding tax in respect of distributed corporate income, is evidenced by the following statement:

"In several recent negotiations the United States has been presented with the need to consider the relationship of the standard treaty withholding provision on dividend income to a variety of domestic tax policies of the other treaty countries. These tax policies have caused the other contracting parties to seek a treaty withholding rate on dividends going to the United States which would be higher than the United States rate on dividends going to the foreign country. For example, in Germany the tax policy involved is that of a split rate corporation tax under which distributed profits are taxed at a substantially lower rate than undistributed profits. Such an internal policy is said to require a higher withholding rate on dividends paid by a German subsidiary to its foreign parent than is customary under standard treaties and the OECD Draft—which is 5% in certain parent-subsidiary cases and 15% on other dividends. In other situations, as in Belgium, the problem may arise from an opposite approach to the internal double taxation of dividends, under which the domestic shareholder receives a tax credit for a part of the corporate tax, and from the internal development of that policy. In other cases, as in Canada, the problem may arise from a desire to differentiate between domestic subsidiaries with a high degree of foreign ownership and those with greater domestic participation.

"Whatever the cause of the issue, the United States has found itself in the position of being asked to agree to a treaty provision under which our withholding rate on dividends to a particular country would be less than the rate levied by that country on dividends moving to the United States. We have in these cases—in order to protect our investors from an increased level of foreign taxation and to protect the United States from revenue loss under the foreign tax credit—taken the firm position that international withholding rates should be reciprocal and hence we cannot agree to an upward adjustment by other countries to accommodate to their internal tax policies. In the simplest case, for example, the fact that a foreign country may have a corporate tax rate of 30% compared to the U.S. 48% rate does not warrant a non-reciprocal set of withholding rates under which the rate of the foreign country would be higher than ours. Moreover, we do not prefer a solution which makes the rates reciprocal through an

> increase in our rate as well, since that course is both contrary to the OECD Draft and to the policy behind that Draft of relieving double taxation and granting more freedom to international capital movements." 6/

As an indication of the revenue loss that might be sustained in the non-resident sector if dividends were made deductible and a compensating increase in non-resident withholding tax was not imposed, dividends paid to non-residents in the years 1959-63 averaged in excess of $540 million 7/. On a reasonable assumption that these dividends were paid out of profits that had first been subjected to corporation tax at an average rate of 40 per cent, they represent before-tax corporate income of some $900 million on which $360 million of corporation tax was paid. Given that the present retention policies of Canadian corporations are adequate, it is likely that if dividends were made deductible, dividend payments would be increased to at least $900 million with a consequent loss of some $300 million in annual tax revenue 8/. Where the domestic tax situation of non-resident shareholders was such that tax advantages could be obtained from increased dividend payments by Canadian corporations, it is likely that dividend payments by foreign-controlled Canadian corporations would increase, resulting in a higher revenue loss. Such funds, withdrawn by way of dividend, as were required for adequate financing of the Canadian subsidiary corporation could be returned to Canada by way of loan or new equity capital but, in general, there would be a tendency for these increased dividends to remain abroad. It is impossible to estimate what the effect of this would be on Canada's balance-of-payments position.

Therefore, despite its apparent attractions, the deductibility of dividends in computing corporate income is a method that would be quite unsuitable for Canada.

This conclusion makes an income tax at the corporate level inevitable. The remainder of this appendix reviews methods whereby this tax at the corporate level in respect of distributed corporate earnings may be integrated

with the personal tax rate structure by means of various forms of dividends-received credit.

Forms of Dividends-Received Credit

Gross-Up and Credit at the Prevailing Corporate Rate for the Year on All Distributions Whether Out of Taxed or Untaxed Income. Essentially this method calls for a flat rate of tax on income at the corporate level, which tax would be deemed to have been paid on account of shareholders, but no attempt would be made to relate either the income or the tax to shareholders until distribution took place. When a distribution took place or was deemed to take place, as in the case of a stock dividend, it would be assumed to have been paid from income that had borne tax at the prevailing corporate rate, whether or not it had done so, and the resident taxable shareholder would be required to include in income the gross equivalent of the actual distribution received. He would also be given credit for the tax assumed to have been paid on his behalf 9/. On final computation of the shareholder's personal tax liability for the year in question an appropriate adjustment would be made. Where the tax assumed to have been paid on the shareholder's account proved to be above his personal rate, a refund would be made; if it proved to be below his personal rate the shareholder would make up the deficiency 10/. Although this method is not identical with the system recently discontinued in the United Kingdom, 11/ there is sufficient similarity that their experience and the criticisms levelled at their system are useful.

Given ideal conditions, this proposal would almost completely integrate the corporation and personal income tax rate structures and would result in the distributed portion of corporate source income bearing tax at appropriate personal progressive rates. However, such ideal conditions could only be attained where the corporate rate of tax did not fluctuate significantly and under which all sources of corporate surplus were subject to taxation at the full corporate rate. Even under

ideal conditions, personal progressive rates would only apply to distributed corporate source income, particularly if the corporate rate was lower than the top personal rate. The progressive rates applied would not necessarily be those of the shareholders who owned the shares when the income was earned, although the full taxation of share gains and losses would remove most of the possibilities of tax avoidance.

Examined in the light of current conditions and practices and the accepted use of taxation as an economic tool, this method would be attractive only if accompanied by a number of other specific provisions to prevent its misuse and overcome its defects. The principal requirement would be that any corporate income which was not taxed at the full rate when earned be subject to an additional tax at the time it was distributed. This is the approach recommended in the Report, in conjunction with the inclusion in the computation of income of capital gains and losses. It is dealt with at length in Chapter 19 and Appendix H to this Volume.

The introduction of a system of gross-up and credit irrespective of the effective rate of corporation tax borne by the income from which the dividend was paid could produce some anomalies. In the absence of restricting legislation, credits would be given and refunds made in respect of dividends derived from foreign source income that had borne little or no Canadian tax and that might indeed have borne no tax, Canadian or foreign. It would be possible to enact legislation to deny refunds except to the extent that Canadian tax had been paid on foreign source income, 12/ but this would introduce further complexity. Controversy could arise where, as a result of incentive legislation, no tax had been paid at the corporate level but credits were given and refunds made in respect of dividends paid out of that untaxed income. This very situation was the cause of public criticism in the United Kingdom where there was no limitation on the credit for dividends paid out of foreign source income.

The remission of corporation tax on income can sometimes be justified as an economic incentive to influence business activity in a desired direction, but whether the remission of tax should be extended to the shareholders when the income is distributed depends on the purpose of the incentive and whether that purpose can be achieved only by retention of funds within the corporate structure. A gross-up and credit at the prevailing corporate rate where no tax had been paid assumes the nature of a subsidy to shareholders, a result that might well be the intention of some incentives.

The Dividend Tax Credit. Under the method now prescribed in the Income Tax Act of giving credit for corporation income tax, the shareholder includes in his income the actual dividend received and deducts from his liability for income tax a flat percentage of the dividends received from a taxable Canadian corporation. There is no provision for refund where the amount of the dividend tax credit exceeds the income tax otherwise payable.

Ignoring the actual rates in effect in Canada 13/ and assuming a single flat rate of corporation tax of 50 per cent which is regarded as having been paid on behalf of its shareholders, the effect of a 50 per cent dividend tax credit is illustrated in Table F-1 for taxpayers with varying marginal rates of tax.

It will be observed that progressiveness in relation to the personal rate structure is greatly reduced and the integration effect is only partial.

As a means of integrating corporation and personal income taxes, the Canadian method of dividend tax credit, despite the attractions of its simplicity, is inferior to the "gross-up and credit at the prevailing rate" referred to above. It is also subject to many of the criticisms to which that method is subject in the absence of specific provisions to prevent its misuse.

TABLE F-1

ILLUSTRATION OF THE EFFECT OF A DIVIDEND TAX CREDIT

	Individual Marginal Rate				
	10 per cent	20 per cent	30 per cent	40 per cent	50 per cent
Actual dividend received (assumed to derive from $100 of corporate source income less 50 per cent tax)	$50.00	$50.00	$50.00	$50.00	$50.00
Personal tax thereon at the marginal rate	5.00	10.00	15.00	20.00	25.00
Add: Tax levied at the corporate level	50.00	50.00	50.00	50.00	50.00
	55.00	60.00	65.00	70.00	75.00
Deduct: Dividend tax credit a/ of 50 per cent of dividend received	25.00	25.00	25.00	25.00	25.00
Net tax payable	$30.00	$35.00	$40.00	$45.00	$50.00

Note:

a/ For our purposes, it has been assumed that refunds are permissible to the extent that the dividend tax credit exceeds the tax otherwise payable in respect of the dividend. To prohibit refunds would result in no tax at the personal level and a flat 50 per cent at the corporate level, thereby eliminating all progressiveness.

Partial Exclusion of Dividends Received From Shareholder's Income. This method gives a measure of tax relief to the individual shareholder by excluding from his income either a percentage of the dividends received from Canadian corporations or, alternatively, all dividends received from Canadian corporations up to a maximum amount. It is evident, even on a cursory examination, that this proposal is inferior to a dividend tax credit.

REFERENCES

1/ This total income would represent, among other things, changes in the market assessment of the goodwill of the corporation and, possibly, an adjustment for the difference between the undepreciated capital cost of fixed assets and their estimated value.

2/ "Corporate losses" attributed would be deducted.

3/ Circular intercorporate shareholdings would require the use of mathematical formulae.

4/ Because this problem is also common to alternatives to be discussed later, it will not be developed further at this point.

5/ Under the present Income Tax Act stock dividends are so treated only to the extent of undistributed income on hand.

6/ S. S. Surrey, "The United States Tax System and International Tax Relationships", Canadian Tax Journal, Vol. XII, 1964, p. 460 at p. 463. Mr. Surrey is Assistant Secretary of the United States Treasury.

7/ Derived from Table I, National Accounts, Income and Expenditure 1963, Dominion Bureau of Statistics, Ottawa: Queen's Printer, 1964.

8/ A loss of $360 million in corporation tax minus a gain of approximately $54 million in non-resident withholding tax.

9/ Given that the average rate of corporation tax is presently about 45 per cent, the recipient of a dividend of $55 would be required to include $100 in income and would take credit for $45 deemed to have been paid by the corporation on his account.

10/ Where the shareholder was another tax-paying Canadian corporation, no additional tax would be exigible but refunds might result. This could occur where either the receiving corporation sustained a trading loss

or where it had tax-exempt status and no legislation existed denying refunds of tax in such circumstances.

11/ The reference here is to the standard rate of income tax and does not take into consideration the corporation profits tax. This latter tax was an unintegrated corporation tax. See Appendix G to this Volume.

12/ In the United Kingdom refunds were limited in this manner.

13/ The existence of a dual rate of corporation tax limits the percentage of credit for dividends included in income to the lower of the two rates thereby severely limiting its potential as a means of integration.

APPENDIX G

THE FOREIGN TAXATION OF CORPORATE PROFITS

The taxation of corporate profits by various economically advanced countries reveals no consistency of treatment, either of corporations or their shareholders. In some instances, the provisions of the law find their roots in history and have not kept pace with changes in the theoretical conception of the corporation or in other provisions of the tax law. In other cases, the rules for the taxation of corporations are instruments of economic policy and are moulded to advance that policy so that they take their character from the national setting in which they are to function.

In this appendix an examination is made of the provisions for the treatment of corporate profits of the United Kingdom, France, West Germany and the United States. This is a somewhat arbitrary selection, but it is representative of different schools of thought. The laws of the United Kingdom and France are of current interest because of major changes in their methods of taxing corporate source income that have recently been enacted.

United Kingdom

Tax Treatment of Corporate Profits and Dividends Prior to 1965. Prior to the fundamental reforms in the tax treatment of corporate profits enacted in the Finance Act, 1965, the essential features of the British system of taxing corporations and their shareholders may be stated as follows.

Corporations were subject to a profits tax which was imposed at a rate of 18 per cent on profits in excess of £2,000 and up to £12,000, and at the rate of 15 per cent on profits in excess of £12,000. The taxable profits included investment income, except for "franked investment income", that is, dividends received directly or indirectly out of corporate profits which were themselves subject to profits tax. The effect was that dividends received from resident corporations were not ordinarily subject to profits tax.

In 1947, as a result of the financial and economic conditions then prevailing, provision was made for the imposition of profits tax at differential rates; distributed profits attracted tax at a rate significantly higher than the rate applicable to undistributed profits. The United Kingdom Royal Commission on the Taxation of Profits and Income was highly critical of this innovation on the grounds that it caused inequity to certain shareholders, complexity in the legislation, and largely failed to accomplish the main economic purposes which it was intended to serve, namely, to restrain inflation and encourage productive investment in the form of ploughed-back profits 1/. The Commission recommended that the differential rates be brought to an end and that the tax be converted into a flat-rate tax on total profits. These recommendations were adopted in 1958. 2/

Corporations were also chargeable to income tax at the standard rate, that is, the flat rate which is fixed annually in the Finance Act, in the same way as individuals, but without benefit of any of the personal reliefs and allowances. They were not, however, liable to surtax, which is an additional tax charged at graduated rates in respect of the income of individuals in excess of a specified amount, except in the case of certain closely controlled corporations which were utilized to accumulate income so as to avoid surtax on their shareholders.

When a corporation paid a dividend to shareholders, it was entitled, but not obliged, to deduct and retain a sum equivalent to tax at the standard rate in force for the year in which the dividend was due. Whether tax was withheld or not, the dividend was not chargeable with standard tax in the hands of the shareholder, because it was derived from a fund that ordinarily had borne income tax in the corporation's hands. However, for personal allowance and surtax purposes, the shareholder's total income included the "grossed-up" amount of the net sum received, that is, that amount which, when reduced by the standard tax thereon, equalled the net dividend paid. In this way, standard tax was paid on corporate profits

only once, by the corporation. Therefore, to the extent that the profits were distributed as dividends, the income tax paid on them by the corporation was treated as tax of the shareholder, so that if he was exempt or entitled to some relief, he might recover the sum that he lost by way of deduction; and if he was liable to surtax, the gross dividend was assessable in common with his income from other sources. Thus, it was only the income tax on the undistributed profits which was really borne by the company. There was no similar system for passing on a company's profits tax payments.

Where a corporation, by reason of capital allowances (including investment allowances), paid no tax on its profits, it was still allowed to pay a net dividend and keep the tax. This gave the shareholder a credit for tax which the corporation had not paid. If the shareholder was an exempt taxpayer, for example, a charity, he was entitled to recover tax from the Revenue which had never, in fact, been paid. The same position applied where a corporation had a loss carried forward so that it paid no tax but was entitled under company law to distribute its subsequent profits by way of dividend. A further feature of the former law was that a corporation which had made a capital profit that was tax free could distribute that profit in a non-taxable form to the shareholders.

Reasons for the 1965 Reforms. In the opinion of the Chancellor of the Exchequer, the system for taxing corporate profits described above was deficient in the following respects: 3/

1. It did not provide sufficient incentive to companies to plough back profits for growth rather than distribute them as dividends.

2. It was unnecessarily complicated because of the existence of two taxes, income tax and profits tax, levied broadly on the same income, but according to different rules.

3. It was a patchwork system and did not stand up to the strains that resulted from the efforts of government to use the tax system for economic purposes.

4. It led to abuses and anomalies, such as recovery by companies or individuals of large sums from the Revenue by way of repayment of tax, although no corresponding sum had ever reached the Exchequer.

On a historical plane he pointed out that the method of taxing corporate profits had failed to keep pace with the fundamental changes in the concepts underlying the system which the passage of time had wrought. The British system dated back to the early nineteenth century when the incorporated company was a rarity which tended to be looked upon as a very large partnership, and income tax was a flat-rate tax applying to the incomes of companies and individuals alike. When a company paid a dividend this could be regarded as a distribution to the shareholders of profits which had already borne income tax in the hands of the company, so that no fresh assessment need be levied. Since those days, however, the personal income tax had become a graduated tax, differentiated according to the circumstances of each taxpayer; and company taxation had been altered by the introduction of a profits tax, which was imposed on the whole profits of a company. It differed from the income tax in that the company could not pass it on to the shareholder by deductions from the dividends it paid to him, and the shareholder could not claim any credit for the profits tax in his personal tax return.

According to the Chancellor, these changes made obsolete the idea that companies and individuals should be treated for tax in the same way, and to separate formally the tax on corporations and the tax on individuals was to be regarded as carrying this process to its logical conclusion.

While the changes introduced into the old tax system as it gradually developed were mainly inspired either by the wish to make it more equitable or by the need for greater revenue, the new corporation tax was introduced for essentially economic reasons. An increase in the tax burden on dividends would encourage the growth of dynamic companies by providing an incentive to them to plough back profits for growth rather than to distribute

the profits as dividends. The changes would also remove anomalies and make unnecessary some of the complicated anti-avoidance legislation of the old system.

Tax Treatment of Corporate Profits After 1965. The corporation tax system, which came into full operation on April 6, 1966, separates the taxation of companies from that of individuals. A company, that is, any body corporate or unincorporated association excluding a partnership, is liable to the new flat-rate corporation tax on its total profits at the rate of 40 per cent, but is not, in general, liable to income tax. Companies are no longer subject to profits tax. Income for corporation tax purposes is generally computed in accordance with the existing income tax legislation and relevant income tax rules. A company's gains are not charged separately to the capital gains tax but are included in the total profits on which it pays corporation tax.

Dividends Paid to Residents. Dividends and other distributions are now defined much more widely than the term "dividends" as it was formerly understood. Such dividends and distributions of a company resident in the United Kingdom paid to resident individuals are subject to income tax, which is withheld at the source under the new Schedule "F", and also in certain circumstances, to surtax, with no credit for any part of the corporation tax paid by the distributing company. The latter must account monthly to the Revenue for the tax deducted.

Dividends received by one company resident in the United Kingdom from another company resident in the United Kingdom are referred to in the new legislation as "franked investment income", and are not chargeable to corporation tax in the hands of the recipient, but are subject to withholding of income tax at the source. The income tax so deducted from franked investment income is available in the hands of the recipient company for set-off against income tax which it is in turn required to account for under Schedule "F" on its own distributions. The income tax on dividends

received is also available for repayment if offset by trading losses of the recipient but it is not otherwise repayable. When a company has an excess of franked investment income for any year over the amount of its distributions for that year, the excess may be carried forward and set against future distributions.

If a company receives other income, such as bond interest, from which income tax has been deducted, this tax is available as a set-off against the tax deducted from the dividends it pays. If this set-off is not available, the company can obtain a credit for such income tax against its corporation tax.

Dividends Paid to Non-Residents. Under the 1965 reforms, income tax at the standard rate, currently 41.25 per cent, is deductible from dividends paid by a British company to a non-resident shareholder in the absence of any other provision. Where this withholding rate is applicable, the total tax to which corporate profits paid as dividends to non-residents will be subject is currently 64.75 per cent (corporation tax of 40 per cent and standard tax of 41.25 per cent). However, the rate of withholding tax may be reduced under a double taxation agreement or under a temporary provision in the 1966 Finance Bill to the effect that the United Kingdom will only charge a withholding tax against a foreign resident to the same extent as the country of that resident charges withholding tax against a United Kingdom resident.

France

Tax Treatment of Corporate Profits and Dividends Prior to 1965. For France, as for the United Kingdom, the year 1965 marked a milestone in the evolution of its laws for the taxation of corporate profits 4/.

Until the fundamental revision of the French corporation tax structure under Law No. 65-566 of July 12, 1965, corporate profits were doubly taxed. That is to say, taxation was imposed on corporate income at a flat rate of 50 per cent, regardless of whether the profits were distributed, and dividends

were taxed in full to shareholders with no credit for any part of the corporation income tax. As a collection device, withholding tax on dividends was imposed at the source at the rate of 24 per cent. In computing taxable income, the shareholder "grossed-up" the net receipt for this withholding tax and reported dividend income at the "grossed-up" amount. After his tax liability for the year had been computed on income from all sources, the shareholder could credit the tax withheld against his final liability. If the sum withheld at source exceeded his final tax liability for the year, the excess was refunded.

Dividends received by a French resident from a foreign corporation through a paying agency, such as a bank in France, were subject to French withholding at the same rate of 24 per cent. So, too, dividends paid by French corporations to foreign shareholders were taxed at the rate of 24 per cent at the French source, although this rate might be reduced under taxation treaties with other countries.

Dividends received by a French corporation from a domestic or non-resident corporation were partially exempt from corporation income tax, the extent of the exemption varying according to the degree of ownership by the recipient of the payor's stock: the greater the percentage of ownership, the larger the exemption.

Reasons for the 1965 Reforms. This system of double taxation of corporate profits did not advance certain basic economic policies of the Fifth Republic. A major government objective is to encourage growth by stimulating investment and savings in the private sector and restraining consumption. The high tax on corporate distributions did not serve to make the ownership of shares in French corporations attractive. As M. E. Laxan, Director General of Taxation in the French Ministry of Finance pointed out, "...to transfer to the shareholder a dividend of Frs. 100, a French company would have to allocate Frs. 200 for distribution, while Frs. 130.60 are sufficient for a German corporation and Frs. 117.60 for a Belgian corporation. This double

taxation thus greatly burdened the yield of capital and went counter to the efforts of businesses to increase their own funds in resorting to the capital market." 5/ The relatively higher rates of French taxation gave rise to the fear that French capital might migrate to more attractive tax climates in neighbouring countries, and result in an artificial depreciation of French security prices, which would facilitate take-overs of French industries by foreign investors.

The corporation tax reforms of 1965 substantially lightened the tax burden on dividend income and thereby adapted the corporation tax to the requirements of the national economy and served also to harmonize the French tax system with that of the surrounding industrialized countries, especially Germany.

Tax Treatment of Corporate Profits After 1965. The new system, which becomes fully effective as of January 1, 1967, operates in the following way:

1. At the corporation level, profits will continue to be taxed at a flat rate of 50 per cent, with no differential rates for distributed or undistributed profits, such as exist under the German income tax law which is discussed below.

2. The withholding tax at source on the distribution of dividends to resident shareholders will be abolished.

3. A resident shareholder receiving a dividend will be entitled to a tax credit against his income tax equal to half the cash dividend received. In computing his taxable income, the shareholder will be required to "gross-up" his dividend and to report as income both the dividend proper and the tax credit relating thereto.

The difference in the treatment of dividends under the old system and under the 1965 reforms, which use the tax-credit technique, may be demonstrated in the following examples:

"Before the 1965 reform, the shareholder's tax credit (24 per cent) represented (omitting special situations) an amount actually withheld from his dividend. If the corporation declared a gross dividend of 100 F per share, for example, the corporation withheld 24 F from the dividend as preliminary tax and paid the 24 F to the tax administration. The shareholder received only the balance, 76 F. In computing taxable income, the shareholder 'grossed up' the net receipt and reported dividend income of 100 F. After his tax liability for the year had been computed, on income from all sources, the shareholder received a credit (or refund) of the 24 F actually withheld at the source.

"After the reform, the result will be this: if the corporation declares a dividend of 100 F a share, the shareholder will receive 100 F a share. Nothing will be withheld at the source. But the shareholder will nevertheless be entitled to a tax credit (avoir fiscal) equal to half the dividend—in this case, 50 F. Under the general principle that if A (in this case, the corporation) pays for the account of B (in this case, the shareholder) a tax legally due from B, B has enjoyed taxable income, this tax credit is considered taxable income to the shareholder. The shareholder must therefore 'gross up' his dividend by the amount of the credit, reporting as income (1) dividend proper, 100 F; (2) tax credit, 50 F; total, 150 F. Against his final income tax liability, the shareholder will be entitled to a credit (or, if he is an individual, a refund) for the 50 F—even though nothing had been withheld at the source from his dividend.

"Since the corporation income tax continues to be levied at 50 per cent, the result is that half the corporation income tax imposed on the corporation earnings from which the dividend is paid is treated as though that tax had been paid for the account of the shareholder." 6/

The tax-credit system rests on the assumption that one half the corporation income tax paid by the corporation on the earnings used by it to pay the dividend is paid for the shareholder's account, and that the shareholder is entitled to claim this half by way of credit. If the shareholder is a resident individual, and the credit exceeds his tax liability on income from all sources, the excess will be refunded. The corporation is not entitled to a refund of any unused credit, nor may it carry over any unused credit to another year.

Supplemental Tax Payments. Where the amounts distributed originate from income which has not been subject to income tax at the ordinary rate, such as income derived from business carried on abroad, the basis for a shareholder tax credit is wanting. However, on administrative grounds it was

decided to grant shareholders the usual credit of 50 per cent of the dividend, and to require the distributing corporation to make a supplementary tax payment in the same amount, that is, one half the dividend. This procedure allows all dividends, without regard to their origin, to benefit from the tax credit and also avoids the complications attached to a system which recognizes two types of dividends.

A corporation is also required to make the supplementary tax payment in the amount of 50 per cent of the dividend if the dividend is paid out of profits earned during fiscal years which ended before January 1, 1965, or out of profits earned by the corporation during a fiscal year which closed more than five years before the year of distribution. The rationale here is to encourage the prompt distribution of earnings.

Dividends to Non-Residents. The benefit of the tax credit is reserved to French residents. After January 1, 1967, there will be no withholding from French dividends to French resident shareholders, but withholding of tax from French dividends to non-resident shareholders will be increased from 24 per cent to 25 per cent. Therefore, the effective total tax on non-residents is 62.5 per cent. The purpose of this treatment of non-residents is to encourage investment by Frenchmen in France, and it greatly favours the resident as against the non-resident. The rate of withholding is, of course, subject to tax treaties between France and the country of the shareholder's residence.

Dividends from Foreign Corporations. The French withholding tax on a dividend distributed by a foreign corporation to a resident of France and collected when the dividend is cashed in France, is increased from 24 per cent to 33.33 per cent, although the taxpayer will be entitled to a tax credit of 50 per cent of the net dividend receipt. For example, an individual shareholder receives a foreign dividend of 1,200 F through a French bank. The bank withholds 33.33 per cent or 400 F. The shareholder receives a net dividend of 800 F, but must gross-up the dividend to 1,200 F for the

computation of his income tax. The credit to which he is entitled is one half of 800 F (the net dividend) or 400 F. Thus, the increase to 33.33 per cent does not increase the tax ultimately due with respect to the dividend, but simplifies the procedure for filing returns because this credit will in effect be equal to one half of the net dividends received, as in the case of domestic dividends.

Germany 7/

Split-Rate Tax on Corporation Profits. Resident commercial corporations, which may take a variety of forms of commercial law entities, such as the stock corporation, the limited liability company, and the partnership limited by shares, are taxed at the rate of 51 per cent on their undistributed profits and at the rate of 15 per cent on the portion of their profits paid out as dividends if the distribution is in the nature of a "qualifying distribution", which is discussed below.

Reasons for the Split-Rate System. The introduction of a split rate of corporation tax in the mid-1950's was prompted by certain domestic economic objectives of the federal government. First, to encourage a more liberal dividend policy on the part of domestic corporations so as to promote a wide distribution of property ownership through the popularization of share ownership, in addition to the encouragement of home building and regular savings. Second, to reduce to a more normal level self-financing through the retention and ploughing back of profits in the business 8/.

The split rate of corporation income tax has not led to an appreciable reduction in the rate of profits retention in German industry, although it has probably prevented it from growing. However, it has provided a reduction of the burden of double taxation on corporate profits, providing relief at the corporate level rather than at the shareholder level 9/.

Qualifying Distributions. Not all types of corporate distributions are eligible for taxation at the 15 per cent rate. It is in fact limited to a

dividend in the nature of a "qualifying distribution", which is a distribution of profits made by a resident corporation pursuant to a formal resolution passed in conformity with the rules of the commercial law, and made for a business year whose results are considered in the assessment of the year for which the distribution is made. Hence, constructive dividends, that is, benefits other than dividends which a corporation distributes to its members by reason of their capacity as members, cannot be the subject of a qualifying distribution because they are not paid pursuant to a formal dividend resolution. Excluded are such benefits as the payment of an excessive salary to an officer who is also a shareholder; a loan made by a company to a shareholder free of interest or at a low rate of interest; a loan by a shareholder to a company at a high rate of interest; a sale between a company and a shareholder at an unusual price or on unusual conditions; and the cancellation of a valid claim against a shareholder by a corporation. The split rate effectively penalizes such constructive dividends by subjecting them to the full rate of 51 per cent. The limited application of the lower tax rate reflects the intention of the government to restrict the relief from double taxation to those distributions which, like dividend payments, stimulate the development of the capital market.

Once the income realized by the corporation in its last preceding business year has been computed, the tax rate to be applied depends on the amount of the qualifying distribution, which is determined by the annual meeting of shareholders who are obliged by law to decide on the disposition of profits of the preceding business year. This disposition can be made, in general, in one of three ways. The general meeting can decide to distribute the profits to the shareholders, to carry them forward to the next following business year as unappropriated surplus, or to assign the profits to a reserve. Only dispositions of the first-named type benefit from the reduced tax rate applying to distributed profits. Profits assigned to surplus or to a reserve are taxed at the full corporation income tax rate.

It is important to note that a distribution from the profits of a given business year can be a qualifying distribution for that year only, with the result that when retained earnings which have borne income tax in earlier years at full corporate rates are distributed, a re-assessment in respect of those years with the object of claiming the reduced rates for the earnings then retained but subsequently distributed is not possible 10/. Hence, if a corporation wishes to take maximum advantage of the reduced rate, it must distribute currently all of its profits for a business year.

Dividends Paid to Resident Shareholders. Two different situations apply in the case of dividends paid to resident shareholders.

1. In general, resident individual and corporate shareholders are subject to withholding of income tax at source in respect of dividends paid by German corporations. The taxpayer can claim a credit or refund of the withholding tax when the tax assessed for the year of distribution is less than the amount of the tax withheld. The rate of the withholding tax is 25 per cent of the gross amount of the distribution if the tax is borne by the recipient, or 33.33 per cent of the amount actually paid out if the tax is borne by the distributing entity. If a dividend is paid in property, the withholding tax is computed on the price which the recipient would have to pay for similar property at his domicile under normal conditions.

   Withholding of income tax at the source is required not only for dividends and other formal distributions of profits, but also for payments or other benefits which a corporation makes available to its shareholders in addition to, or in lieu of, dividends. The principal example of such distributions is constructive dividends, some of which are described above. The tax rate of 33.33 per cent always applies to these distributions, because the tax is borne by the distributing entity.

2. Dividends received by a resident corporation from another resident corporation are excluded from the taxable income of the recipient if the recipient (the holding company) owns 25 per cent or more of the issued share capital of the distributing entity (the affiliated company). The exemption applies only to the extent that the recipient corporation in turn distributes the dividend received to its own shareholders. Otherwise, the recipient corporation becomes liable for the payment of a "supplementary tax", the rate of which is equal to the difference between the corporation income tax rate on undistributed profits and the tax rate on distributed profits, that is, 51 per cent minus 15 per cent, or 36 per cent.

   The purpose of the supplementary tax is to prevent affiliated companies from shifting profits from one member of the group to another without ever paying tax on the profits at the full corporate rate and without making a distribution to individuals. Otherwise, an affiliated corporation would have a real tax advantage over other corporations because it could distribute its profits to the holding company and pay tax at only 15 per cent, and the holding company could reinvest the amount distributed in the affiliated company without further taxation, whereas other corporations would have paid tax at 51 per cent on profits retained in the business.

Dividends Paid to Non-Residents. Dividends paid to non-residents on shares of a corporation having its domicile, seat, or place of management in Germany, are subject to withholding tax at source. The tax liability of the non-resident is finally settled with payment of the withholding tax, the rates of which are 25 per cent of the gross amount of the distribution if the tax is borne by the non-resident, or 33.33 per cent of the amount actually paid out if the tax is borne by the distributing corporation.

Dividends Received from Foreign Corporations. Individuals and corporations resident in Germany are taxed on a world-wide basis. Hence, dividends

received from foreign corporations are included in income in the same manner as domestic dividends. Where the recipient is a corporation, the corporation income tax rates on undistributed profits or those on distributed profits apply, depending on whether the dividend is retained by the recipient or redistributed to its own shareholders.

United States 11/

The Corporation as a Taxable Entity. Corporations are, in general, treated as separate taxable entities under the federal income tax. Thus, a corporation is required to determine its annual taxable income on the basis of the activities which it carried on during the taxable year, and to pay a tax on such income, quite independently and apart from the activities and tax obligations of its shareholders. The shareholders are likewise independent of the corporation for income tax purposes because the corporate earnings are taxed only to the corporation and are not included in the income of a shareholder until distributed as dividends or in some other form.

The Internal Revenue Code contains a special rate structure which is applicable to corporations only. At the present time, corporations are taxed at the rate of 22 per cent on the first $25,000 of income and at 48 per cent on the balance. The taxable income of a corporation is computed in much the same manner as that of an individual.

Dividends Paid to Residents. A dividend for tax purposes is any distribution made by a corporation to its shareholders out of its earnings and profits. However, a distribution in complete or partial liquidation of the corporation is treated as a sale of the stock and any gain is taxed at the reduced capital gains rates. Under certain circumstances which involve a continuity of business interests in new corporate forms, a shareholder may exchange his shares for stock in a continuing enterprise without recognition of taxable gain or loss 12/.

A dividend represents gross income to the shareholder and is subject to tax at the regularly applicable rates. Because a corporation cannot

deduct from its gross income the amount of the dividends distributed to its shareholders during the taxable year, any distributed earnings are necessarily taxed twice: at the corporate level when included in the corporation's taxable income, and again at the shareholder level when received as a dividend. This two-level taxing arrangement has been a fixed characteristic of the federal revenue system for many years, but has been subject to recurring criticism on the ground that it unfairly discriminates against persons doing business in corporate form. The quantum of corporation income tax that is passed on in the form of higher prices is open to debate by economists. In the case of an individual shareholder, a degree of relief is provided by the exclusion of the first $100 of dividends received from domestic corporations. Until 1964, the exclusion was $50. Individual shareholders were also entitled to a 4 per cent dividend tax credit which was reduced to 2 per cent for 1964 and eliminated entirely for 1965 and subsequent taxation years. This credit was eliminated on the grounds that it gave undue relief from double taxation to high bracket shareholders as compared to low bracket shareholders and that rate reductions were a more equitable solution to the problem.

In the case of a corporate shareholder, a deduction is allowed for 85 per cent of all dividends received from domestic corporations. Affiliated groups defined as parents and at least 80 per cent owned subsidiaries, may achieve a 100 per cent intercorporate dividend deduction by a special election or by filing a consolidated return. Without some elimination, successive taxation of the dividend as it passed from corporation to corporation in a chain of corporations would result in repeated taxation of the same income and would leave very little for the ultimate individual shareholder.

Dividends Paid to Non-Residents. Dividends paid to non-resident aliens not engaged in trade or business within the United States at any time during the taxable year and the amount of whose fixed or determinable annual or periodic income from United States sources, plus taxable excess capital gains from

United States sources, is $21,200 or less are subject to withholding tax at a flat rate of 30 per cent. If their income is in excess of this amount, they are taxed under the regular rates of the individual income tax, that is, the progressive rates of the individual income tax; and the special reduced rate on capital gains is applicable, rather than the 30 per cent flat rate. In many cases, however, the withholding rate has been reduced by treaty. Changes in these provisions were under consideration at the time of writing as part of a programme to encourage non-resident investment in the United States.

REFERENCES

1/ Royal Commission on the Taxation of Profits and Income, Final Report, London: H.M.S.O., 1955, Cmd. 9474, p. 155.

2/ Finance Act, 1958, Chapter 56, section 25.

3/ See Hansard, Parliamentary Debates, Vol. 701, November 11, 1964, col. 1941, and Vol. 710, April 6, 1965, col. 254. The economic reasons underlying the enactment of the corporation tax are discussed by the Rt. Hon. James Callaghan, M.P., Chancellor of the Exchequer, in an article, "The New United Kingdom Tax Structure in Relation to the Needs of the Economy", (1965) 5 European Taxation 212.

4/ For a detailed discussion of the pre-1965 laws and the 1965 reforms, see Harvard Law School, Taxation in France, World Tax series, Chicago: Commerce Clearing House, 1966, and M. Norr, "The French Reform of Dividend Taxation and Common Market Tax Harmonization", (1966) 44 Taxes—The Tax Magazine 320.

5/ "The Recent Evolution of the French Tax System", (1965) 5 European Taxation 264, p. 265.

6/ M. Norr, op. cit., footnote 4, pp. 323-24.

7/ For a detailed discussion of the taxation of corporate profits in Germany, see Harvard Law School, Taxation in the Federal Republic of Germany, World Tax Series, Chicago: Commerce Clearing House, 1963, and Rädler and Edwards, "The Split Rate of Corporation Income Tax in Germany —A Taxation Advantage for Foreign-Owned Subsidiaries" (1963), C.C.H. Common Market Reports, Transfer Binder, section 9051.

8/ The latter economic objective is, of course, precisely the opposite of the new United Kingdom corporation tax which is intended to encourage the ploughing back of profits by placing a heavier tax burden on distributions.

9/ See Rädler and Edwards, op. cit., footnote 7, pp. 7764-65 and 7769.

10/ There is an indirect way in which this aim can be achieved provided the enterprise is currently earning a taxable profit. See Rädler and Edwards, op. cit., footnote 7, pp. 7761-62.

11/ For a detailed discussion of the tax treatment of corporate profits and dividends under United States income tax laws, see Harvard Law School, Taxation in the United States, World Tax Series, Chicago: Commerce Clearing House, 1963.

12/ The tax treatment of the many forms of corporate distributions to shareholders is exceedingly complex. The problems all trace back to the separation of shareholder and corporation and the desire of shareholders to obtain the earnings from the corporation as capital gains, which are subject to reduced rates of tax. Ibid., pp. 715-864.

APPENDIX H

ACCOUNTING AND REPORTING PROCEDURES FOR THE INTEGRATION OF CORPORATION AND PERSONAL INCOME TAXES

Since the proposal contained in the Report for the integration of corporation and personal income taxes is a major departure from the present tax system, it is essential to set forth in some detail a description of procedures which could be followed in its operation. While this appendix will repeat some material already contained in Chapter 19, it should help to explain the more technical aspects of the proposal.

However, it should be emphasized that this appendix does not attempt to illustrate how all the potential problems in the proposal would be met. Instead, it gives a number of examples of situations that might be thought to pose major difficulties, but in fact can be fairly readily resolved within the general framework of the integration proposal. Many technical difficulties were raised when the integration proposal was examined by the Commission and its research staff. In all cases it was possible to develop procedures to resolve what at first had appeared to be serious problems. This does not mean that all the possible problem areas have been dealt with, but it does mean that in all those examined the difficulties were resolved. This appendix then is a brief review of some of these situations and how they might be dealt with.

BASIC ELEMENTS OF THE PROPOSAL

The basic objective of the integration of corporation and personal income taxes is to enable the income of Canadian residents derived through corporations to be taxed at personal rates. Integration is achieved by regarding the income of a corporation as income of its shareholders and the income tax paid by the corporation as having been paid on behalf of its shareholders, so that upon a distribution or deemed distribution to a shareholder the corporation income tax is assumed to have been paid on his behalf and the amount of the distribution (or deemed distribution) plus such corporation tax represents the income to be taxed at his personal rate. If a Canadian

shareholder sells his shares before the income, accrued during his period of ownership, is distributed or deemed to be distributed, it is assumed that in his selling price he will attempt to recover (among other things) the amount of income so accrued before corporation tax. With the full taxation of share gains, the amount he recovers will be taxed at his personal rate. As will be illustrated later in this appendix, the purchaser should be able to pay such a price because he will be entitled to the credit for the corporation tax when the distribution takes place.

Regular Types of Distribution or Allocation
Which Would Carry a Tax Credit

As is indicated in Chapter 19, there would be four procedures by which credit for corporation tax could be passed to shareholders, three of which, dividends in cash or in kind, stock dividends and other capitalizations of surplus, would follow the regular corporate procedures. The fourth would be an allocation of undistributed income for tax purposes without a legal capitalization. Except where otherwise specifically stated, the first three procedures will be included in any subsequent use of the word "distribution", and the fourth will be referred to as an "allocation".

The shareholder would not report as income the amount of the distribution or allocation, which would be calculated on the after-tax income of the corporation, but rather the amount of the distribution or allocation plus the amount of the credit for the corporation tax 1/. In practice, this grossing-up of the distribution or allocation would be calculated by the issuing corporation, and the shareholder would merely be informed of the income to be reported, the tax which could be claimed as a credit, and the net amount of the distribution or allocation 2/. The shareholder would then be taxed on the grossed-up amount at his personal rate and would receive credit for the corporation income tax paid. If the credit exceeded his personal tax, he would receive a refund of the excess. The procedure could therefore be compared with the treatment of employment income at the present

time, which requires the inclusion in income of the amount of taxes already paid on behalf of the employee.

Cash Dividends. If $50 was paid out to a shareholder as a cash dividend and the rate of tax credit was 50 per cent, the grossed-up amount of the dividend to be included in income would be $\frac{100}{100-50}$ x $50, or $100, and the shareholder would report it as follows:

	Shareholder's Tax Bracket		
	10%	30%	50%
Shareholder's income	$100	$100	$100
Shareholder's tax liability	(10)	(30)	(50)
Corporation tax credit	50	50	50
Net tax refund to shareholder	$ 40	$ 20	-

When the net tax refund was added to the cash dividend actually received, the total proceeds to the shareholder would equal the grossed-up income less the shareholder's tax rate applied thereto:

	Shareholder's Tax Bracket		
	10%	30%	50%
Net tax refund, as above	$40	$20	-
Actual cash dividend received	50	50	50
Total received by shareholder	$90	$70	$50

The foregoing examples would also be applicable where a corporation paid a dividend in kind rather than in cash.

Capitalization of Earnings. Where a corporation paid a dividend in its own shares rather than in cash, the procedure would be similar to that for a cash dividend in that the amount of the stock dividend would be grossed-up to include the corporation tax credit, and the shareholder would report the grossed-up amount as income and claim the credit for the corporation tax. However, to reflect the capitalization of earnings by the corporation, the shares issued as a stock dividend would have a cost basis equal to the amount

of the stock dividend. When these shares were later sold, the portion of the price representing the capitalized earnings would then not bear further tax. If the shareholder did not recover the amount of the capitalized earnings upon subsequent sale, there would be a deductible loss on the shares.

The same procedures would be followed where earnings were capitalized by some corporate action without a stock dividend. For example, capitalization would occur where earnings were appropriated to the capital stock account of no par value shares of a particular class. The amount capitalized and added to the cost basis would then be spread over the issued shares of that class. The amount attributed to a particular shareholder would be included in his income and grossed-up to include the tax for which he would receive credit.

Allocation of Earnings. While a stock dividend or other form of capitalization procedure would involve the actual transfer of after-tax surplus to the capital stock account and therefore a change in the legal form of the capital structure of the corporation, the allocation procedure contemplated here would be a method of integrating corporation and personal income taxes without any change in the capital structure. The allocation would be effective for tax purposes only. The objective of the allocation would be to enable the corporate earnings to be taxed at the individual income tax rates of Canadian shareholders, without requiring a stock dividend or other capitalization procedure and without affecting non-resident shareholders. A Canadian shareholder would then report the grossed-up corporate income allocated to him and claim a credit for his proportion of the corporation tax already paid on that income.

The actual procedure to be followed would require the directors to determine the amount to be allocated, and the information slip sent to the shareholder at the end of the year would reflect this amount in the same way as it would reflect the declaration of a stock dividend, even though the after-tax earnings retained would remain as surplus and would not be legally

capitalized. Thus, as in the case of non-cash distributions, the share cost basis would be increased by the amount of the after-tax earnings allocated to the shareholder. If this income was subsequently distributed, a resident shareholder would treat the amounts distributed to him as a return of capital and would reduce the cost basis of his shares.

This procedure would be quite simple where there was only one class of shares, or where the classes of shares participated equally in earnings and on liquidation (although the voting rights may differ), or where any additional classes of shares were only eligible to receive a fixed and preferential dividend and did not have a residual participation in earnings. However, where there were two or more classes of shares and the ratio in which the classes would participate in earnings varied from time to time or was different on liquidation than on the distribution of dividends, it would probably be necessary to have restrictive provisions to ensure that it would not be possible to defer or avoid tax by permitting an allocation to the holders of one class of shares of amounts which would subsequently be distributed to the holders of another class of shares. We reviewed the capital structures of most of the publicly traded companies and found very few examples that currently could lead to this kind of difficulty. Therefore, legislation to limit allocations when there were two or more classes of shares outstanding that participated to a different extent in profits and on liquidation would inhibit the actions of only a few companies. A corporation which was unduly restricted by the legislation could revise its capital structure so as to be able to take advantage of the allocation procedure. This could be done without adverse tax consequences, having regard to our proposals in Chapter 15 with respect to corporate reorganizations.

Where income was allocated to one shareholder and was later distributed to another person who had subsequently acquired the shares, there would ordinarily

be no deferment or avoidance of tax because of the proposed full taxation of capital gains and full allowance of losses. This is explained more fully later in this appendix. However, if the shares were sold at an artificial price, either in a non-arm's-length transaction or under an option or other agreement, there might be such a deferment or avoidance, particularly if the transaction was between a resident and a non-resident. This problem would exist in the case of a capitalization of surplus, particularly a capitalization which did not involve a stock dividend, as well as in the case of allocations. In Chapter 19 we have suggested some provisions with respect to allocations which should prevent most such avoidance and deferment of tax. Similar provisions may also be necessary with respect to capitalizations.

Other Types of Distribution

The types of distribution or allocation described above would be the usual methods used to pass credit for the corporation income tax to Canadian shareholders. Under the present tax system, additional tax is usually exigible on all corporate distributions, and accordingly the legislation is drafted in such a way as to ensure that anything which could amount to a distribution of income is taxed. However, under the proposed tax system, distributions of corporate income to residents would ordinarily result in no further tax and in many cases a refund of tax. This change in emphasis suggests that the legislative approach to defining what constituted a distribution of income could be more restrictive. Possibly only certain described types of distribution would be permitted to carry a tax credit.

However, there would be instances where additional tax would be payable upon a distribution of surplus by the corporation. For resident shareholders this could arise in respect of distributions of income untaxed to the corporation because of incentive legislation but taxable on distribution. Similarly, if the corporation had foreign direct investment income, under our proposals in Chapter 26 an additional tax would be payable on distribution.

In Chapter 19 we have suggested the tax treatment which we consider should apply in the case of the most common types of distribution. However, this would have to be considered carefully when drafting the legislation.

Non-resident shareholders would not be affected by allocations of income and would continue to be subject to withholding tax on distributions. The present provisions for determining the taxability of distributions to non-residents seems appropriate and should be continued in substantially its present form, subject to our recommendations in Chapter 26.

Sale of Shares Before
Distribution or Allocation

This section describes how integration would operate if the shareholder sold his shares after income had accrued but before it had been distributed or allocated.

The shareholder who was selling his shares would wish to obtain a price which, in respect of earnings to date, would give him the same result as if he had waited for the distribution or allocation. As is indicated above, if he waited to receive a distribution or allocation he would obtain a benefit measured by reference to the corporation income before tax less his personal tax thereon. Because share gains would be fully taxable, he would therefore expect his selling price to reflect the before-tax corporate income accrued and not distributed or allocated at the time he sold the shares.

Assume that an individual purchased a share for $1,000 and held it for a year, during which time his share of the before-tax corporate income accrued but not distributed amounted to $100. If he was going to sell his share he would wish to obtain a price equal to the same amount after tax as

if a distribution had been made. Because on a distribution he would recover $100 less his personal tax, he would seek to sell his share at a price of $1,100, which would equal his original investment of $1,000 plus the corporate income before tax.

For his part, the potential purchaser would expect to pay no tax and possibly to obtain a refund of tax on the forthcoming distribution.

	Tax Bracket of Purchaser		
	10%	30%	50%
Income distribution (grossed-up)	$100	$100	$100
Personal tax	10	30	50
Corporation tax credit	(50)	(50)	(50)
Net tax refund or credit	$(40)	$(20)	$ -

However, if as a result of the distribution, the value of his share decreased by $100 and if he resold it immediately for $1,000, the loss of $100 would be deductible and would "wash" out the income distribution. In the end result, he would obtain a refund of the full corporation tax on the income accrued in the purchase price.

	Tax Bracket of Purchaser		
	10%	30%	50%
Tax refund on distribution, as above	$ 40	$ 20	$ -
Tax reduction from loss of $100 on resale of share	10	30	50
Total tax refund or credit	$ 50	$ 50	$ 50

Another way to illustrate the overall result for the purchaser is as follows:

	Tax Bracket of Purchaser		
	10%	30%	50%
Income distribution (grossed-up)	$100	$100	$100
Loss on sale of share immediately after distribution	100	100	100
Income for tax purposes	-	-	-
Corporation tax credit	50	50	50
Cash dividend	50	50	50
Total proceeds, equal to price paid for the undistributed income and equal to loss on resale of share	$100	$100	$100

Under these conditions the purchaser could therefore pay a price which included the corporate income before tax and the corporate income reflected in the sale price would have been taxed at the rate of the individual who owned the share during the period the income accrued. However, it can be argued that ordinarily the conditions assumed above would not exist. The purchaser might not know the amount and time of the next distribution, and might not intend to resell the share in the near future. More important, the market price of the share would depend so much on other factors, such as expected earning power, that it would not merely reflect earnings to date. Nevertheless, an equitable tax result should also obtain under these conditions.

Assume that the selling price of the share was not $1,100, but rather $1,070, and that, as before, the purchaser later received a distribution of $50 and resold the share for $1,000. Assume further that the tax brackets of the selling and the purchasing shareholders were 30 per cent and 10 per cent respectively. The total tax collected on the $100 of corporate income would then be as follows;

From the Corporation		
Income of $100 taxed at 50 per cent		$50
From the Selling Shareholder		
Gain on sale of share	$70	
Personal income tax at 30 per cent		21
From the Purchasing Shareholder		
Income distribution (grossed-up)	$100	
Loss on resale of share	(70)	
Taxable income	$30	
Personal income tax at 10 per cent	$ 3	
Credit for corporation income tax	(50)	(47)
		$24

Because the $100 of income bore a tax of $24 even though it was earned during ownership by a shareholder in the 30 per cent bracket, it might appear that the income was undertaxed. However, the fact of the matter is that the 30 per cent shareholder only realized $70; a profit equal to the remaining $30 was realized by a taxpayer in the 10 per cent bracket and the total tax was therefore reduced by $6. Whether the income should have been realized by these individuals in this way is not relevant to the tax system; the important thing is that the tax was imposed equitably on the gain finally realized by each individual.

This illustration demonstrates that the taxation of the income of the corporation is only an interim step to the taxation at personal rates of the gain actually realized by the individual Canadian shareholder. With the full taxation of share gains and full deduction of share losses, combined with a full credit for the corporation tax, such a result can be achieved.

It is true that temporary overpayments of tax would occur in two different sets of circumstances. First, a delay between the sale of a share and the distribution or allocation of income which was included in the price

of the share would result in overpayment, for in that interval both corporation and personal income taxes could have been paid on the same income. However, with a high level of distribution or allocation, this delay would usually be for less than a year and the temporary overtaxation should not be serious. As already explained in Chapter 19, far from inhibiting a high level of distribution or allocation, the proposed system would encourage it.

In the second place, temporary overpayment of tax would arise from a lapse of time between the distribution or allocation of the income to the purchasing shareholder and the subsequent resale of the shares. During that period personal income tax would have been charged to the purchaser on an amount of corporate income, even though this income was reflected in the purchase price of the shares and accordingly when distributed it could be said to represent a recovery of part of the purchase price. The offsetting reduction in personal income tax would not take place until the share was resold. At the same time as the purchaser was waiting for a deduction for the loss in share value in this respect, he would not, of course, have to accrue offsetting increases in the value of his shares. If there were no such offsetting increases and if he chose to revalue his shares as proposed in Chapter 15, he would not have to await the time of disposal for recognition of the loss.

It therefore appears that the income of corporations accruing to resident shareholders can be taxed in an equitable manner, particularly where the shares are publicly traded and there is an established market value for them. Furthermore, this process does not require that corporate income and corporation tax thereon be identified with the shareholder who owned the shares at the time the income accrued.

For resident shareholders, the achievement of the desired objective depends on the full taxation of share gains, the full deduction of share losses and a full credit for the corporation income tax. However, where non-resident shareholders are involved, the conditions change. It does not

seem practicable for Canada to tax share gains realized by non-residents. However, it would be of concern to the Revenue if the corporation tax on income which accrued to non-resident owners was actually refunded upon subsequent distribution of the income to residents who purchased the shares. This avoidance problem is discussed in Chapter 19 and recommendations are made there to resolve it.

Sale of Shares After Allocation
But Before Distribution

Shareholders would often sell their shares after income had been allocated to them but before it was actually distributed. The shareholder to whom the allocation was made would include the allocation in his income on a grossed-up basis and would obtain credit for the corporation income tax. The purchaser would receive a distribution out of the amount previously allocated and would not include this distribution in his income but would treat it as a realization of capital, that is, as a reduction in the cost basis of the shares. Accordingly, the amount which he received on the distribution would be added to the profit which he would make on the eventual disposition of the shares. However, if he purchased the shares at their fair market value, which took into account the previously allocated income, there would not be an undue deferment of tax liability.

Assume that a corporation with one shareholder had paid-up capital of $100 and earned profits of $1,000 which had been subject to corporation tax of $500. Assume also that the remaining after-tax income of $500 was allocated to the shareholder, and that he then sold the shares for $600, which was equal to the book value of the assets of the company. The position of the vendor would be as follows:

	Tax Bracket of Vendor		
	10%	30%	50%
Income allocation (grossed-up)	$1,000	$1,000	$1,000
Personal tax	$ 100	$ 300	$ 500
Less corporation tax credit	500	500	500
Net tax refund or credit	$ 400	$ 200	-
Proceeds from disposal of shares	$ 600	$ 600	$ 600
Less original cost of shares	100	100	100
Less increase in the cost basis on allocation	500	500	500
Gain or loss on sale	-	-	-

Assume that after the sale was completed the corporation distributed its after-tax income of $500. The position of the purchaser would be as follows:

Cost of shares	$ 600
Less return of capital on distribution of previously allocated income	500
Revised cost basis	$ 100

If the shares had been transferred at an artificially low price, for example at $300, the vendor would have realized a loss of $300 on the sale. In the absence of special provisions, he would have been entitled to deduct this loss from other income. The purchaser would have acquired the shares at $300 and would then have received a distribution of $500 by way of a return of capital. This would have resulted in $200 being included in his income and the cost basis of his shares being reduced to zero. Accordingly, tax on an amount of $100, which would have been the value of the shares following the distribution, would have been deferred. This is equal to the difference between the loss claimed by the vendor ($300) and the amount included in the income of the purchaser ($200). The following rules should be applicable in these circumstances:

1. If the shares were transferred in a transaction which was not bona fide and at arm's length, the transfer should be deemed to have taken place at the fair market value, and the vendor should then be deemed to have made a gift to the purchaser equal to the difference between the fair market value and the sale price. Accordingly, in the last example, the sale would be deemed to have taken place at $600 and the vendor would not be entitled to deduct the loss arising on the sale. The purchaser would be in the same position as if the shares had been purchased for $600, but in addition he would be required to include a gift of $300 in his income.

2. If shares owned by a resident shareholder were acquired by another resident under an option or agreement in an arm's length transaction at a price that was less than their fair market value, the purchaser on acquiring the shares should be deemed to have disposed of them immediately at the fair market value and to have then reacquired them at the same price. The purchaser would then be immediately subject to tax upon the profit which arose on the exercise of the option or on the completion of the agreement ($600 less $300), which would be the amount of the loss deducted by the vendor. Upon receiving the distribution of $500, his cost basis would be reduced to $100, which would be the assumed value of the shares. In this example, it is assumed that the fair market value of the shares would be the same as the book value of the assets. If this was not the case, the application of this rule would nevertheless give a reasonable and consistent result for tax purposes.

3. If the purchaser was a non-resident who acquired the shares under an option or agreement or other right, the tax position of the vendor should be adjusted so that allocations made to him while the non-resident had a right to acquire the shares less amounts distributed to him during that period as a return of capital would be disregarded for tax purposes. If there was a firm agreement for the sale to a non-resident,

these allocations should be disregarded in the first place, since the non-resident would be in effect the beneficial or equitable owner of the shares. If a non-resident had an option to acquire the shares, the accounts of the vendor should be adjusted only when the option was exercised, since until then it would not be known whether the option would be exercised. However, if the option was exercised, interest should be charged on the net tax refunds or credits which had been obtained by the vendor while the option was outstanding. A person whose shares were under option to a non-resident should have the right to leave the amount of such net refunds or credits on deposit with the government to avoid such interest being charged.

Suppose that in the above case, when the corporation was originally formed a non-resident obtained an option to acquire the shares for $300 and that this option was exercised after the corporation had earned before-tax income of $1,000. After adjustment under the rule outlined above, the position of the vendor would be as follows:

Cost basis to vendor (unadjusted by allocations)	$100
Personal tax	-
Corporation tax credit	-
Sale price	300
Gain on sale	$200

This gain would be subject to tax at the vendor's personal rate. No credit would be allowed for the corporation tax, this being consistent with what the position would have been if the non-resident had owned the shares throughout the period. However, if the vendor had received a taxable dividend during the period, it should be included in his income on a grossed-up basis and he should receive credit for the corporation tax in the same way as any other resident, since he would have enjoyed the benefit of that income. This treatment should also apply

to any amounts allocated to him which were subsequently actually distributed to him as a return of capital, since this combination of events in substance would be equivalent to the payment of a cash dividend.

The rules referred to above would also be necessary in the case of a capitalization since it would have the same effect for tax purposes as an allocation.

A METHOD OF ACCOUNTING AND REPORTING

A variety of procedures is available for recording transactions under the proposed integration of corporation and personal income taxes. The procedure actually adopted would depend on the purposes to be served and on practical considerations such as convenience and enforcement. The purpose of the following exposition will be to demonstrate <u>one</u> method of dealing with some of the circumstances which are likely to arise. Improvements could be made after further study and experience, and limited variations might be necessary to accommodate particular incentive policies of the government.

Certain basic alternative methods would be available for accomplishing the integration of the two levels of tax, and the choice of method would affect the accounting procedures to be followed by the corporation and the nature of the reporting to shareholders. One method would involve tracing through to the shareholder the various sources from which the distribution was made, such as regular income taxed at the full corporate rate, income taxed at incentive rates and foreign direct investment income 3/. Such a procedure would give the shareholder detailed information about the sources of the corporation's income, and might enable certain objectives of the tax system to be carried through to the individual shareholder. For example, foreign direct investment income could be taxed at the individual rate of the shareholder with a credit for the actual or deemed foreign tax paid, or income eligible for an incentive could be taxed at a reduced personal rate.

However, such a procedure would obviously require complex accounting and detailed reporting to the shareholder and would probably create compliance problems.

Another alternative would be to combine the various sources of the distribution, which may have been taxed at different rates or not taxed at all, to calculate the average rate of tax paid, and to report to the shareholder a combined amount of income on which the average rate of tax could be claimed as a credit by the shareholder. The rate of tax credit applicable to distributions would then vary from one corporation to another, depending on the particular mix of various types of income. In addition, any material difference between the tax rate based on final assessment and the estimated rate reported to shareholders for tax gross-up and credit purposes would imply a reopening of shareholders' tax returns 4/. This would not be practical. Consequently, shareholders of different classes and successive holders of the same shares could be materially affected by any inaccuracies in a corporation's first estimate of the tax rate. This would place too high a premium on tax estimates. Moreover, it could give rise to manipulations as well as errors.

We think it is important that corporate distributions and allocations should carry a uniform rate of tax credit, equal to the current statutory rate of corporation tax. The simplest way of achieving this would be to treat every allocation and every distribution other than a return of capital as carrying a tax credit at the current rate of corporation tax and to control the tax credits passed to shareholders by keeping a record of the corporation tax paid by the corporation. While this method is fairly simple and should operate satisfactorily, it presents some problems. Distributions or allocations out of some types of income which had not borne tax at the full rate, such as income from foreign direct investment, would necessarily be subject to a further tax on distribution or allocation to the shareholders. Furthermore, certain distributions, such as a dividend out of financial surplus, where there was no surplus for tax purposes, might better be treated as a reduction of the cost basis of shares than as income.

The accounting and reporting procedures which follow should not be read as precluding the adoption of an alternative procedure. Their primary purpose is to demonstrate that modifications can be made which will meet these problems and yet at the same time maintain a uniform rate of tax credit for the shareholder.

We would expect that the provisions could be designed in such a way that there would be basically two types of distributions:

1. Distributions of income which had been subject to corporation tax (or were deemed to have been subject to corporation tax) when earned or, in some instances referred to above, at the time of distribution. These distributions would be included in the incomes of the shareholders on a grossed-up basis and credit would be allowed for the corporation tax as outlined above.

2. Distributions which represented a return of capital. These would include distributions made on a redemption of shares, dividends paid out of income previously allocated but not distributed and distributions out of surplus accrued as at the effective date of the legislation or out of any other financial surplus of the corporation. Such distributions would not be included in the shareholder's income but would be applied to reduce his cost basis of the shares. If any such distribution should exceed the cost basis of the shares the excess would be included in his income.

By their very nature, all allocations would be from income as described in 1 above. Later in this appendix we discuss the order in which these types of distributions would be made.

Accounting by the Corporation

The financial accounts and the financial statements of the corporation would be along much the same lines as at present, with the corporation income

tax being a deduction in arriving at both the final amount of income for the year and the accumulated surplus. Additional accounts could be provided, and the balance reported, 5/ largely for the information of shareholders and investors generally, so that they would be aware of the tax status of surplus and the tax credits available in respect of future distributions or allocations.

The additional accounts to be maintained by the corporation might include the following:

1. A record of the income of the corporation subsequent to the effective date of the legislation which had been subject to corporation tax at the full rate and which had not been allocated or distributed to shareholders. This would be the grossed-up income applicable to the Corporation Tax account referred to below. This account will be referred to as the Taxed Income account.

2. A record of corporation tax payments at the full corporate rate which were available as a credit to shareholders upon distribution or allocation. This account will be referred to as the Corporation Tax account.

3. A record of untaxed income which, under incentive legislation, was not to be taxed at the corporate level but was to be taxed in whole or in part upon distribution to shareholders. This account will be referred to as the Incentive Income account.

4. A record of foreign direct investment income that had been received but not yet allocated or distributed to shareholders. This account will be referred to as the Foreign Income account.

5. A record of tax paid or deemed to have been paid in respect of foreign income from direct investment, which was available for credit on distribution. This account will be referred to as the Foreign Tax account.

6. A record of surplus which had been allocated to shareholders or had accumulated prior to the effective date of the legislation or was otherwise available for distribution to the shareholders as a return of capital. This account will be referred to as the Non-Taxable Surplus account.

To provide an analysis of the financial surplus, it would be necessary to maintain these accounts. A record of "Reconciling Items" for other differences between the tax accounts and financial surplus might also be needed. Such differences could arise, as they do now, from claiming capital cost allowances which differed from the depreciation recorded in the financial statements or from revaluation of fixed assets.

The procedures in respect of foreign income would pertain only to those corporations which had direct investment abroad. The Foreign Income and Foreign Tax accounts would be used in a manner similar to the Taxed Income and Corporation Tax accounts, and accordingly will not be referred to specifically in the examples appearing later in this appendix.

Order of Distribution

The order in which distributions would be considered to come from these various accounts is also of concern. There would be some attraction in allowing discretion as to the order, and in most cases where all the corporate income had been fully taxed this could probably be done. However, where there were significant amounts of income from foreign direct investment or income untaxed as a result of incentive legislation that called for tax on distribution, reporting of distributions from these sources would tend to be unduly postponed, with a resulting deferment of tax.

A required order for determining the source of distributions would therefore seem necessary. The logical starting point would be income which had been fully taxed. Because distributions from this source would carry a claim on the government for the full corporation tax, this would be a natural

choice for the shareholder in any event. Where a corporation had income from foreign direct investment, the grossed-up amount of such income should be regarded as being distributed pro rata with the fully taxed income; this would not only seem logical, but would prevent postponement of the additional tax which might be payable on distribution of income from abroad. Further distributions of surplus should then be considered to come from income which was untaxed as a result of incentive legislation that called for tax on distribution; this would permit postponement of tax thereon as long as distributions of income with full credit were being made, but not when distributions were made by way of return of capital. Any further distributions would come out of non-taxable surplus and would be treated by resident shareholders as a return of capital and applied in reducing the cost basis of their shares.

In determining the order of distribution, the income of the corporation for the fiscal year in which the distribution was made probably should be taken into account. If this were done and if a corporation made a distribution which exceeded the total of its income for the year and all prior income which remained undistributed and unallocated, the exact division of the distribution as between the part which represented a distribution of income and the part which represented a return of capital would not be known until after the end of the year. This should not present a serious problem because the distribution would be made on the basis of an estimate and the exact breakdown for use by the shareholder in preparing his tax return would be reported to him after the end of the year. If the income of the corporation was subsequently varied by reason of re-assessment, then the corporation should be responsible for making the necessary adjustments at that time. There should not be an unduly large number of adjustments to the returns of shareholders because corporations would normally make distributions or allocations out of the Taxed Income account and this would not often be reduced on assessment. For purposes of administrative convenience it might be provided that minor changes in corporate income on re-assessment, not

exceeding a stipulated percentage of such income, say, 5 per cent, would not need to be reflected in amended returns of the shareholders but could be taken into account in the subsequent year in which the corporation's liability for tax was ultimately determined.

At the time of distribution the corporation would make any additional tax payments which might be necessary to enable the uniform rate of tax credit (equal to the rate applicable to corporate income) to be available to the resident shareholder. For example, such additional payments might be necessary for distributions or allocations out of untaxed incentive income or out of income from foreign direct investment.

Where a corporation received a taxable distribution or an allocation from another taxable Canadian corporation, it would include the grossed-up amount in its Taxed Income account, and the tax credit in its Corporation Tax account.

Reporting to the Shareholders

Because the integration of corporation and personal income taxes would apply only to resident shareholders, the changes in reporting would apply mainly to distributions or allocations to residents.

The form for reporting distributions or allocations to resident shareholders could contain five items:

1. The income before tax, that is, the "grossed-up amount" of the distribution.

2. The tax already paid or deemed to have been paid thereon.

3. The net amount of income represented by cash.

4. The amount of the distribution which was considered to be a return of capital and was to be applied to reduce the cost basis.

5. Where the distribution was a stock dividend or other capitalization of surplus, or where there was an allocation of surplus without a capitalization, the amount that was to be added to the cost basis.

With the uniform rate of tax credit, it would be possible for a corporation to issue only one reporting form each year, as is now done, although shareholders would wish to be informed currently of the details of any distribution or allocation involving an adjustment of cost basis so they could calculate the taxable gain on a sale of their shares. A form for annual reporting to shareholders is shown in the following illustration:

Resident Shareholder			
Report as Income	Claim as Tax Credit	Change Cost Basis (+ or -)	Cash Payment

In practice, further details supporting the cost basis adjustment would be given on the form or in an attached letter.

For non-resident shareholders, the reporting would be much the same as at present because actual or deemed distributions would continue to be subject to withholding tax. The reporting form for non-residents could therefore be as follows:

Non-Resident Shareholder		
Gross Distribution	Withholding Tax	Net Distribution

This form would be used for a cash dividend, a stock dividend or any other capitalization of surplus. It obviously would be necessary for a cash dividend to be paid in addition to any stock dividend or other capitalization

in order that the non-resident tax could be withheld. An allocation of surplus to shareholders without a capitalization would not need to be reported to non-resident shareholders, because its purpose would be solely to enable the portion of corporate income accruing to resident shareholders to be taxed at the appropriate rates of those shareholders. However, non-resident withholding tax would apply to any subsequent distribution or capitalization of such allocated surplus.

ILLUSTRATIONS

Presumably, the bulk of corporate distributions would be derived from business income taxed at regular corporate rates. Distributions in cash would no doubt continue to be important, but distributions by way of stock dividend or other capitalization of surplus and allocations of surplus without its capitalization could be expected to come into wide use. The following illustrations deal first with ordinary business income distributed or allocated in these various ways, and then with modifications which would be required for special features. A 15 per cent rate of non-resident withholding tax is used in the examples.

Ordinary Business Income Taxed
at Regular Corporate Rate

Cash Distribution. If a corporation earned taxable income of $500, paid corporation tax thereon of $250, and then paid a cash dividend of $200, the entries in its tax and surplus accounts would be as follows:

Item	Taxed Income	Corporation Tax	Other Accounts	Financial Surplus
Income	$500	$250		$250
Cash Dividend	(400)	(200)		(200)
Balances	$100	$ 50		$ 50

The dividend would be reported to shareholders as follows:

Resident Shareholder			
Report as Income	Claim as Tax Credit	Change Cost Basis (+ or -)	Cash Payment
$400	$200		$200

Non-Resident Shareholder		
Gross Distribution	Withholding Tax	Net Distribution
$200	$30	$170

Stock Dividend or Other Capitalization of Surplus. If the distribution was by way of stock dividend or other capitalization of surplus, the entries in the corporation's tax and surplus accounts would be the same.

Item	Taxed Income	Corporation Tax	Other Accounts	Financial Surplus
Income	$500	$250		$250
Stock Dividend	(400)	(200)		(200)
Balances	$100	$ 50		$ 50

The only difference in the corporation's accounts would be an increase in the capital instead of a decrease in cash. Management could supplement the reporting form with details of the capitalization, including instructions to resident shareholders concerning the cost basis adjustment. For a stock dividend, the increase in cost basis would be assigned to the new shares issued, unless the stock dividend was in the same class of shares, in which case the increased cost basis would be spread over the increased number of shares of that class. For a capitalization without a stock dividend, the increase in cost basis would be spread over the existing number of shares of the particular class. The distribution would be reported to resident shareholders as follows:

Resident Shareholder			
Report as Income	Claim as Tax Credit	Change Cost Basis (+ or -)	Cash Payment
$400	$200	+ $200	

As was indicated earlier, where there were non-resident shareholders it would be necessary that a cash dividend accompany any stock dividend or other capitalization, so that tax might be withheld from the non-residents. If the stock dividend or other capitalization referred to above was accompanied by a cash dividend of $40 to all shareholders, the distribution would be reported to non-residents as follows:

Non-Resident Shareholder		
Gross Distribution	Withholding Tax	Net Distribution
$240	$36	$204

The net distribution to non-residents, assuming a 15 per cent non-resident withholding tax, would include $4 in cash.

Allocation of Surplus Without Capitalization. If there was an allocation of surplus without capitalization, the corporation's tax accounts would reflect the allocation but there would be no change in the financial surplus.

Item	Taxed Income	Corporation Tax	Other Accounts	Financial Surplus
Income	$500	$250		$250
Allocation	(400)	(200)	$200	-
Balances	$100	$ 50	$200	$250

The corporation's records would reflect a transfer of $200 from ordinary surplus to Non-Taxable Surplus instead of a decrease in cash of that amount.

Resident shareholders would be instructed in the reporting form to increase the cost basis of their shares by the net amount of the allocation. For tax purposes, a portion of the corporation's surplus would thus be allocated to the shareholders, and when they subsequently realized upon it by selling their shares it would not be taxed again. If realization of this amount took the form of a cash distribution out of the Non-Taxable Surplus, the cost basis of shares would of course be correspondingly reduced.

The allocation would be reported to resident shareholders as follows:

Resident Shareholder			
Report as Income	Claim as Tax Credit	Change Cost Basis (+ or -)	Cash Payment
$400	$200	+ $200	

Here again management would presumably wish to supplement the reporting form with an explanation of what had occurred. There would be no reporting to non-resident shareholders because the allocation of surplus for tax purposes would only relate to resident shareholders. It should be noted, however, that in the corporation's tax accounts the amount deducted from the Taxed Income and Corporation Tax accounts in respect of the allocation would be the full amount allocated including the amount allocated to shares held by non-residents. If this was not done, then the corporation tax on income accruing to non-residents could be refunded to residents on a subsequent allocation.

Distributions Out of Opening Surplus
and Other Differences Between
Financial and Tax Surplus

The financial surplus of a corporation will frequently exceed the amount in the Taxed Income account. The difference would include the surplus existing at the time of implementation of the proposed system. It would also include amounts allocated but not distributed to the shareholders. In

addition, differences may result because the income shown in the corporation's accounts differs from the income as determined for tax purposes.

We have recommended that distributions in excess of the balance in the Taxed Income account should be treated as a return of capital and applied to reduce the cost basis of the shares owned by resident shareholders. Assuming that a corporation with no amount outstanding in its Taxed Income account makes a distribution of $5,000 out of its financial surplus, there would be no entries in the corporation's tax accounts but only a reduction of cash in the amount of $5,000 and a similar reduction in financial surplus. The reporting to shareholders would be as follows:

Resident Shareholder			
Report as Income	Claim as Tax Credit	Change Cost Basis (+ or -)	Cash Payment
-	-	- $5,000	$5,000

Assuming that the distribution was by way of dividend or under a procedure which would result in a deemed dividend, the reporting to non-resident shareholders would be the same as under the present law and would be as follows:

Non-Resident Shareholder		
Gross Distribution	Withholding Tax	Net Distribution
$5,000	$750	$4,250

Accelerated Capital Cost Allowances

As is indicated in Chapter 22, the regular capital cost allowances for tax purposes are often in excess of the depreciation considered necessary for financial reporting, and it is therefore common for financial surplus as recorded in the accounts to be greater than the surplus measured by tax rules. Furthermore, special acceleration of the capital cost allowances may

be considered an appropriate type of tax incentive in some circumstances. Examples are the recommended incentive for new and small businesses and the accelerated write-offs for the mining and petroleum industries, as well as the accelerated write-offs which are now allowed in designated areas. The system for integrating corporation and personal income taxes must therefore be designed to deal with distributions out of financial surplus which represent the excess of the total capital cost allowances taken, including accelerated capital cost allowances, over the maximum capital cost allowances which could have been taken on the normal basis.

One possible approach would be to regard distributions from this financial surplus as advance distributions of income, to be subjected to the regular corporation tax rate upon distribution.

To do this would appear on one hand to be a reversal of the rules established for the measurement of business income. On the other hand, it can be argued that the purpose of the incentive was to provide additional funds to the corporation and once the corporation was in a position to distribute these funds then it would only be reasonable to "recapture" the reduction in tax resulting from the incentive. In addition,there would be some advantage to taxing a "distribution" at the time the shareholder received the cash from which the tax would be paid. However, this recapture could not be applied to accelerated capital cost allowances that were equally available to unincorporated businesses. Moreover since it would not be practical to subject such unincorporated businesses to equivalent treatment, to do so in the case of corporations would be to treat different kinds of business organization differently for tax purposes. A major goal of the integration proposal is to provide neutral tax treatment between different kinds of business organization to the fullest extent practicable.

Another approach would be to regard a distribution from this source as being a partial realization of the cost basis of the shares, since it would be made out of surplus which did not yet exist for tax purposes. We prefer this latter approach and it is illustrated below.

In due course the capital cost allowances for tax purposes would become less than the normal capital cost which could have been taken if there had been no accelerated depreciation, and the surplus for tax purposes would come closer to that for financial purposes. For resident shareholders the applicable personal tax would not be payable until accumulated book allowances became equal to accumulated tax allowances or until the shareholders disposed of their shares. Non-resident withholding tax would be payable on any distributions to non-residents, but the applicable corporation income tax would not be payable until accumulated book allowances became equal to accumulated tax allowances.

Assume that in one year a corporation, after claiming capital cost allowances, had income for tax purposes of $8,000, but that if it had claimed only the maximum normal capital cost allowances its income would have been $15,000. Assume that a cash dividend of $6,000 was then paid. As only $4,000 was available for payment out of taxed income, the remaining $2,000 would be regarded as a return of capital. The entries in the corporation's tax accounts would be:

Item	Taxed Income	Corporation Tax	Other Accounts	Financial Surplus
Taxable Income	$8,000	$4,000	$7,000	$11,000
Cash Dividend	(8,000)	(4,000)	(2,000)	(6,000)
Balances	-	-	$5,000	$ 5,000

Note that, as we indicated earlier, the distribution would be deemed to have been made out of taxed income first. The reporting to shareholders would be as follows:

Resident Shareholder			
Report as Income	Claim as Tax Credit	Change Cost Basis (+ or -)	Cash Payment
$8,000	$4,000	- $2,000	$6,000

Non-Resident Shareholder		
Gross Distribution	Withholding Tax	Net Distribution
$6,000	$900	$5,100

If the distribution of financial surplus arising from accelerated capital cost allowances was in the form of a stock dividend or other capitalization of surplus, the entries in the corporation's tax accounts would be unchanged. The reporting to resident shareholders would no longer show a net realization of the cost basis of shares, since the additional $2,000 would be a capitalization of surplus not yet measured for tax purposes:

Resident Shareholder			
Report as Income	Claim as Tax Credit	Change Cost Basis (+ or -)	Cash Payment
$8,000	$4,000	+ $4,000	

For a stock dividend in the same class of shares, the increased cost basis would have to be spread over the greater number of shares of that class. For a stock dividend in a different class of shares, a cost basis equal to $6,000 would be assigned to the shares issued and $2,000 would be deducted from the cost basis of the shares on which the dividend was declared.

A non-resident shareholder would still be subject to withholding tax on the full amount of the stock dividend or capitalization (assuming that the corporation had undistributed income on hand of at least that amount), since the amount capitalized could eventually be realized by the non-resident without withholding tax. Again a portion of the distribution would have to be in cash in order to provide for the withholding tax. The reporting to the non-resident shareholder would be the same as in the case of a cash dividend.

Incentives Other Than Accelerated
Capital Cost Allowances

It is emphasized in this Report that tax incentives are not usually the most appropriate means of attaining a desired goal and that they should be used infrequently. One type of tax incentive that might be used is the acceleration of capital cost allowances, which has already been illustrated. Under certain circumstances the government might consider that the postponement of income tax provided by the acceleration of capital cost allowances was not sufficient and that a greater incentive was required. We have suggested that an investment tax credit would be one of the best types of incentive for this purpose; a subsidy which did not depend for its effect on the offsetting of a tax liability would be another possibility.

The funds provided by an investment tax credit would ordinarily be related to a tax liability and would produce a saving in tax, thereby improving the yield from an investment. Under the proposed corporation tax system, a useful procedure would be to provide that a particular type or amount of income was not subject to corporation income tax, but that corporation income tax would be deemed to have been paid thereon. It could also be provided that upon distribution to the shareholders of the amount deemed to have been paid as corporation income tax, the corporation would be subject to tax on that amount. The effect would be the same as if the corporation tax had been paid and a subsidy received for the same amount, with a provision that on distribution of the subsidy to the shareholders, corporation tax would be payable thereon.

For example, assume a total investment tax credit of 10 per cent of $500,000, or $50,000, available for offsetting the annual corporation

income tax liability until the income resulting from the saving in tax was distributed. Assume also that the corporation earned income of $100,000, was deemed to have paid corporation tax of $50,000 and subsequently paid cash dividends of $50,000 and $25,000. The corporation's tax accounts would be as follows:

Item	Taxed Income	Corporation Tax	Other Accounts	Financial Surplus
Income	$100,000	$50,000	$50,000	$100,000
Cash dividends:				
1. $50,000	($100,000)	($50,000)		($50,000)
2. $25,000			($50,000)	($50,000)
Balances	-	-	-	-

The first cash dividend, which would represent a full distribution of the regular income of $100,000, would carry a tax credit for $50,000 even though no tax was paid. The additional asset of $50,000 created by the investment tax credit has been treated in this example as income which upon distribution would be subject to 50 per cent corporation income tax and reported as income of the shareholder. The cash dividend from this source would be therefore only one half of $50,000, with the other $25,000 being paid in tax by the corporation at the time of distribution.

The reporting to shareholders would be as follows:

Resident Shareholder			
Report as Income	Claim as Tax Credit	Change Cost Basis (+ or -)	Cash Payment
1. $100,000	$50,000		$50,000
2. $ 50,000	$25,000		$25,000

Non-Resident Shareholder		
Gross Distribution	Tax Withheld	Net Distribution
1. $50,000	$7,500	$42,500
2. $25,000	$3,750	$21,250

It will be noted that the following effects would be achieved by this special tax measure:

1. The corporation would have been able to maintain a full distribution of its regular income with ordinary tax credits to shareholders and yet its tax payment to the government would have been reduced by $50,000, thereby supplying it with more funds.

2. When the corporation later distributed the corporation income tax saving to shareholders, the net return to the resident shareholders would increase by the amount of that saving less their respective tax rates. From $100,000 of corporation income, a resident shareholder in the 50 per cent bracket would have an after-tax yield of $75,000 rather than $50,000, and a shareholder in the 20 per cent bracket would have an after-tax yield of $120,000 rather than $80,000.

A stock dividend or other capitalization of surplus from the Incentive Income account would call for the same modifications in accounting and reporting procedures. However, it should be noted that, to the extent that

capitalizations were made from this source, there would have to be a cash payment on account of corporation tax equal to one half of the amount capitalized. In addition, a cash dividend might have to be declared to provide for non-resident withholding tax. An allocation of surplus would not likely be made from this source, because the corporation would be subject to a tax at the corporate rate on making the allocation.

There are other possible procedures for dealing with an investment tax credit or a subsidy. For example, it might be provided that the corporation tax saving or subsidy could be distributed to the shareholders free of tax, without adjustment of the cost basis of their shares or with a reduction in the cost basis equal to all or part of the amount distributed. The latter method would permit postponement of tax on a resident shareholder until his shares were disposed of, and would result in complete freedom from tax, both corporation and withholding, on the income for non-residents.

There are many other possible measures which could be adopted for incentive purposes, and further variations in the procedures for dealing with them. From the discussion above it should be evident that they could all be incorporated into the proposed integration of corporation and personal income taxes. However, it is our view that incentive measures should be used with care, for otherwise they may create undue reduction or postponement of taxes, and may lead to a complexity of rules which would make them difficult to administer and to understand.

Investment Tax Debits

An additional tax to discourage capital investment could take the form of a special excise tax on defined capital investment. Such a tax would represent merely an additional cost of investment, and no modification in the ordinary procedures for integrating corporation and personal income taxes would be required.

Business Losses

The general recommendation in the Report is that losses should be available for carry-back against any income for the previous two years and for carry-forward indefinitely against any income in future years.

Under the proposal for integration of corporation and personal income taxes, it would be important to ensure that the loss carry-back could not result in a refund to the corporation of taxes which had already been credited to the shareholders. Control over this would be exercised by using the Taxed Income and Corporation Tax accounts. The suggested rule would be that the loss carry-back would be limited to the lesser of (a) the total of the additions to Taxed Income account in the previous two years, or (b) the balance in the Taxed Income account at the time the loss carry-back was claimed. A refund of the corresponding corporation tax could then be made to the corporation. Any portion of the loss not carried back would be applied against income in the future, and no further corporation tax would be paid until it was fully absorbed.

Year	Item		Taxed Income	Corporation Tax	Other Accounts	Financial Surplus
1	Income of	$2,000	$2,000	$1,000		$1,000
2	Income of	$3,000	3,000	1,500		1,500
	Dividend of	$2,000	(4,000)	(2,000)		(2,000)
3	Loss of	$3,000	(1,000)	(500)	($2,000)	(2,500)
4	Income of	$6,000	4,000	2,000	$2,000	4,000
Balances			$4,000	$2,000	-	$2,000

Note that the loss carry-back would be allowed only to the extent of $1,000 and would result in a tax refund of only $500, because the rest of the tax for the previous two years would already have been allowed as a credit to shareholders who received the dividend in year 2. The remainder

of the loss ($2,000) would be carried forward and this would result in no corporation tax being charged on that amount of the income of year 4.

Disallowed Expenses

No distinction would have to be made between unallocated personal benefits and disallowed expenses of the business. The former would be deductible in arriving at business income under our proposals, but would be grossed-up at the top personal rate and would be subject to a special tax in the hands of the corporation rather than in the hands of the recipient. This special corporation income tax would be deductible in determining the corporation's taxable income. This is explained in Chapter 14. The end result would be that taxes paid would be the same as would have applied had the person receiving the benefit received the income necessary to acquire it out of income taxed at the top personal rate. Disallowed expenses could be treated in the same manner, since under our proposals all expenses relating to the income earning process would be deductible at some time, and, generally speaking, the only disallowed expenses would be those which were unreasonable or were unrelated to the earning of income.

To illustrate the treatment of unidentified personal benefits and disallowed expenses, assume that a corporation had business income of $20,000 and that the expenses deducted in arriving at this income included $2,000 of such benefits or expenses. The corporation would pay a special tax of $2,000, that is, 50 per cent of the benefits or expenses grossed-up to $4,000. The tax of $2,000 would then be allowed as a deduction, and this would reduce the corporate income to $18,000. In the tax accounts of the corporation, the entries would be as follows:

Item	Taxed Income	Corporation Tax	Other Accounts	Financial Surplus
Income	$18,000	$9,000		$9,000

A shareholder in the top personal rate bracket would then net $9,000 on a distribution of the entire surplus, so that he would be in the same position as if he had received a distribution of surplus arising from business income of $22,000, had paid $11,000 tax thereon and had paid $2,000 from his tax-paid income to acquire a personal benefit.

Changes in Corporation Tax Rate

As explained in the Report, the corporation income tax rate and the top marginal personal rate should remain the same or virtually the same under the proposed integration method. Furthermore, any changes in these rates should be infrequent and not substantial. For resident shareholders, the level of the corporation tax rate would lose much of its significance because the corporation tax would be in effect a withholding tax. However, for non-resident shareholders the level of the corporate rate would retain its present significance.

When changes in the corporation tax rate took place, some variation in the procedures outlined above would have to be made if the gross-up and credit was to be at all times directly related to the current statutory rate of corporation tax. For example, if there was an increase in the corporation income tax rate and the top marginal personal rate remained unchanged, one possible procedure would be to withhold extra tax on distributions from income taxed at the former corporate rate in order to maintain a uniform rate of tax credit for residents. However, this would constitute retroactive taxation for non-residents, and to avoid such retroactivity by withholding the extra tax from distributions to residents only, would add an administrative complexity.

A practical approach would be to use the Corporation Tax account as a control on the total of past taxes available for credit, and adjust the Taxed Income account to reflect the new rate of corporation tax, which would be the rate at which tax credits would be issued. Assume, for example, that

at a time when the corporate rate increased from 50 per cent to 55 per cent, a corporation had on hand surplus of $200 resulting from income of $400 taxed at 50 per cent. Its tax accounting could then be as follows:

Item	Taxed Income	Corporation Tax	Other Accounts	Financial Surplus
Balance on hand	$400	$200		$200
Balance adjusted to 55 per cent rate	$364	$200	$36	$200
Balances	$ 36	-	$36	-

For resident shareholders, this would mean that $164 could be distributed carrying a 55 per cent credit, and that the balance of $36 would, upon distribution, be treated as a return of capital to be deducted from the cost basis of the shares and eventually taxable as a gain on disposal of the shares. For non-residents, all distributions would be subject to withholding tax as usual, and the increase in the corporate rate would have no retroactive effect.

Similarly, if the corporate rate should be reduced from 50 per cent to 45 per cent, the corporation tax accounting would be as follows:

Item	Taxed Income	Corporation Tax	Other Accounts	Financial Surplus
Balance on hand	$400	$200		$200
Balance adjusted to 45 per cent rate	$364	$164		$200
Balances	$36	$ 36		-

In this case both the Taxed Income and Corporation Tax accounts would be adjusted, so that the net amount would not exceed the surplus on hand. As a result the income to be reported by the shareholder upon distribution would be reduced by $36, and corporation tax available to the shareholder as a

credit would be reduced by the same amount. While it might be thought that the Corporation Tax account should remain at $200 and the Taxed Income account should be grossed-up on the basis of a 45 per cent rate to $444, this would permit the corporation to allocate a total of $244 to the shareholders and would permit them to increase the cost basis of their shares by that amount, even though the corporation had paid tax on only $200. Accordingly, the appropriate treatment would be that shown above, which would adjust both the Taxed Income account and the Corporation Tax account to amounts which, when the Corporation Tax account was grossed-up at the new rate, would leave the financial surplus unchanged.

REFERENCES

1/ The proposal calls for a tax credit to the shareholder who receives a distribution or allocation equal to the corporation tax applicable to the amount distributed or allocated. It also calls for a tax refund where the amount of the applicable corporation tax exceeds the total income tax payable by the shareholder. In this appendix we refer to the excess of the corporation tax over the shareholder's personal income tax on the distribution or allocation as a "refund", although in practice it would usually be applied against the liability of the shareholder for tax on his other income.

2/ The ratio to be applied to the distribution or allocation for determining the amount to be reported as income, which could be called the "grossing-up ratio", would be 100 divided by the difference between 100 and the percentage rate of tax credit. For example, if the rate of tax credit was 40 per cent and the amount of the distribution or allocation was $72, then the amount to be reported as income would be

$$\frac{100}{100-40} \times \$72 = \$120$$

3/ In Chapter 26 we recommend that in the case of income from foreign direct investment, a credit for foreign tax should be allowed at the rate of 30 per cent and that if the rate of foreign tax was less than this, sufficient additional Canadian tax should be payable to bring the rate up to 30 per cent.

4/ The likelihood of this occurring would be greater where there was a series of intercorporate shareholdings.

5/ On notes to the financial statements.

APPENDIX I

THE DUAL RATE OF CORPORATION INCOME TAX

One of the main features of the present taxation of corporate income is the existence of a dual rate of corporation tax. With certain exceptions to be discussed later in this appendix, corporations are presently subject to tax at the rate of 21 per cent (18 per cent normal corporation income tax plus 3 per cent imposed by the Old Age Security Act) on the first $35,000 of taxable income, and at 50 per cent (47 per cent normal corporation income tax plus 3 per cent imposed by the Old Age Security Act) on the remainder.

The dual rate was first introduced into the Canadian corporation tax structure in 1949. Its purpose was explained by the then Minister of Finance as follows:

> "At present we have a flat rate tax of 30 per cent on all corporate profits. I am recommending that this 30 per cent be reduced to 10 per cent on profits up to $10,000 and increased to 33 per cent on profits in excess of $10,000. The house will at once recognize this as tax relief for small businesses and will, I trust, be heartily in accord with the policy. Our country as a whole owes a great deal to the small family type of business. They have to struggle along, grow and develop in competition with large and well financed corporations whose activities may be nation-wide. My own belief is that small businesses should be encouraged and it seems to me that a useful way to do this is to lower the tax and take less out of the funds they need for growth and expansion." 1/

Since 1949, numerous changes have taken place in both the rates of corporation income tax and the amount of taxable income which is eligible for the low rate, the most recent being an increase to $35,000 in the eligible amount for 1961 and subsequent taxation years. In introducing this proposed change the Minister of Finance indicated that it was designed to aid small corporations to enlarge the scope of their operations, particularly those corporations which were not large enough to have ready access to the securities markets. He also stated that it would extend the benefit of the low rate of tax to an additional 4,000 corporations and that, out of approximately 62,000 corporate income taxpayers, 55,000 had incomes below $35,000 and would in future pay no more than 21 per cent 2/.

It would be an over-simplification to assume that the purpose and effect of the dual rate can be determined and its significance measured solely, or even primarily, by comparison of the lower rate of tax on corporate income below a certain level with the higher rate on corporate income above that level.

When the rate of 10 per cent on the first $10,000 of corporate income was instituted in 1949 there was introduced concurrently a 10 per cent dividend tax credit; and when the rate on the first part of corporate income was increased later to 21 per cent, the dividend tax credit was increased to 20 per cent. It is logical to infer that, on corporate income below a certain level, the intention was to integrate almost fully the corporation tax with the personal tax on distributed earnings.

Because encouragement was to be given "to the small family type of business", two further conclusions may be drawn:

1. The businesses to be encouraged were generally ones that, for practical purposes, need not be conducted in the corporate form.

2. Earnings retained in the business, as well as those distributed, generally could be integrated for tax purposes with personal rates by the fairly simple expedient of distribution and recommittal to the business.

Because small family type businesses generally can disincorporate if it is advantageous to do so, one result of the lower corporation tax rate coupled with the dividend tax credit was to make it unnecessary to do so for tax purposes.

ANALYSIS OF EFFECTS

We have examined the purpose and effect of the dual rate of corporation tax from a number of aspects which are discussed in the following sections of this appendix.

Applicability to Corporate
Business Only

The purpose of the dual rate, as evidenced by the previously quoted statement of the Minister of Finance, is to encourage the small family type business by taking less out of the funds they need for growth and expansion, but it is immediately apparent that a reduction in the rate of corporation tax as a means of achieving this intention can only be of benefit to businesses conducted in the corporate form.

It is not known what proportion of small businesses was conducted in the corporate form in 1949, but it has been estimated that in 1959 there were some 440,000 small businesses in Canada 3/. A "small business" in this estimate was a business with assets of under $1,000,000, and it was stated that most of such businesses were unincorporated, had assets of under $100,000 and were engaged in retail trade, services and construction. For the 1961 taxation year, there were 97,355 corporations with assets of less than $1,000,000, of which 62,104 earned a profit. For the same year there were 52,136 corporations with assets of less than $100,000, of which 29,980 earned a profit 4/.

On the basis of the previously quoted figures the maximum number 5/ of small corporate businesses which would benefit from the low rate would be 62,104 if assets of $1,000,000 were used as a criterion of "small", and 29,980 if assets of $100,000 were used. These represent approximately 14 per cent and 6.8 per cent of the estimated small businesses in Canada, assuming no material change in numbers since 1959. The remainder could obtain no benefit from the low rate of corporation tax because they made no profit or because they were unincorporated.

The low rate undoubtedly takes less of the funds of those corporations that can benefit from it, but its effect is limited to a comparatively small proportion of the small businesses in Canada.

However, it can be considered to discriminate against businesses conducted in unincorporated form, and it should be noted that it is available to corporations in respect of their investment income as well as their business income.

Availability to all Corporations

Subject to the restrictions placed on associated corporations to be dealt with later, the low rate of corporation tax is available to all corporations irrespective of size, need of financial assistance, and actual or potential growth. The Honourable D.C. Abbott acknowledged that size was in no way determinative when introducing the original legislation, but at the same time stated that the combined effect of the low rate of 10 per cent on the first $10,000 and the increase of 3 per cent in what had previously been the flat rate resulted in a decreased tax burden on those corporations whose profit was less than $77,000 and an increased burden on those with greater profits 6/. The change in total revenue from the taxation of corporations was negligible. It is interesting to note that, if a flat rate of tax had been introduced in 1961 which raised approximately the same revenue as the existing dual rate, corporations with profits of approximately $200,000 would have broken even. It would probably be unwise to conclude that the measure of a small corporation has changed from one with a profit of less than $77,000 in 1949 to one with a profit of less than $200,000 in 1961.

The maximum dollar benefit that can be obtained from the dual rate is $10,150, and this is available to all corporations with taxable income of $35,000 and up. As the amount of taxable income decreases below $35,000 the dollar benefit decreases proportionately. Expressed as a percentage of the tax that would be payable at a flat rate of 50 per cent, the benefit is 58 per cent for all corporations with taxable incomes of up to $35,000 and gradually decreases to 4 per cent at $500,000. No benefit accrues to the corporation that does not make a profit, though it might well be argued that such a corporation is in greater need of assistance.

By making the benefit available to all corporations and relating it to the amount of profit, the problem of defining small business is avoided but, as evidenced by the associated-corporation legislation, definitional problems are not eliminated. By making the benefit available to all corporations, its cost is greater than would be the case if the benefit were restricted to small corporations (however defined). In 1961, there were 7,374 corporations with taxable incomes in excess of $35,000. 7/ Not all of them would be entitled to the low rate of tax because of the rules respecting association, but, assuming that 6,500 are so entitled, the benefit to them costs in excess of $65,000,000, or rather more than one third of the total cost of the low rate. However, to avoid anomalies, a notch provision would be necessary if the low rate were to be withdrawn from corporations with profits in excess of $35,000.

Availability Irrespective of
Disposition of Profit

Since its introduction in 1949, the low rate of corporation tax has been a significant factor in assisting small corporate businesses to expand. This is so because such businesses have had the power to retain a greater portion of their profits for reinvestment. It is not mandatory, however, for the profits to be used for business expansion and, as a result, it is possible for corporations to use the increased profits for purposes unrelated to the business or to increase the amount of their distribution to shareholders. In these latter cases the reduction in corporation tax is not used in accordance with the underlying intention of the legislation.

For the 1961 taxation year there were 59,864 profitable corporations with incomes of less than $35,000. Their aggregate profits totalled $590.7 million which includes $82.7 million of Canadian dividends received. These corporations paid cash dividends of $131.9 million, or approximately 22 per cent of the aggregate profits.

Introduction of Progressiveness Into the Corporation Tax Structure

The dual rate introduces a degree of progressiveness into the corporation tax structure above the $35,000 level of corporate taxable income. The degree of progressiveness rises very sharply from $35,000 taxable income to about $100,000 and very gradually above $100,000. Table I-1 illustrates this feature.

TABLE I-1

PROGRESSIVENESS OF THE DUAL RATE OF CORPORATION TAX

Taxable Income ($)	Tax on First $35,000 ($)	Remaining Taxable Income ($)	Tax on Remainder ($)	Total Tax ($)	Effective Tax Rate (%)
1,000	210	-	-	210	.210
35,000	7,350	-	-	7,350	.210
50,00C	7,350	15,000	7,500	14,850	.297
75,000	7,350	40,000	20,000	27,350	.365
100,000	7,350	65,000	39,850	44,850	.398
250,000	7,350	215,000	107,500	114,850	.459
500,000	7,350	465,000	232,500	239,850	.480
1,000,000	7,350	965,000	482,500	489,850	.490
5,000,000	7,350	4,965,000	2,482,500	2,489,850	.498

Equity

It was suggested above that the low rate discriminated against businesses conducted in unincorporated form, but it may also be said to discriminate against income derived from other sources. To the extent that the low rate is intended as an incentive to business growth and expansion this is inevitable, but earlier the low rate was criticized on the ground that it was

available even if all the profit was withdrawn. Table I-2 shows the effect of the low rate of corporation tax in certain selected circumstances.

TABLE I-2

COMPARISON OF THE TAXES PAYABLE
ON AN ADDITIONAL $100 OF INCOME

Marginal Personal Tax Rate	When Earned by Corporation: Corporation Tax Paid	Personal Tax Paid a/	Total Tax Paid	Unincorporated Business or Employee Remuneration
10	$ 21.00	$(7.90)	$ 13.10	$ 00.00
20	21.00	00.00	21.00	20.00
40	21.00	15.80	36.80	40.00
60	21.00	31.60	52.60	60.00
80	21.00	47.40	68.40	80.00

a/ This is the personal tax on the dividend received of $79.00 ($100.00 of corporate income less $21.00 corporation tax paid) less the dividend tax credit of $15.80 (20 per cent of $79.00). It is assumed that for taxpayers with a marginal personal tax rate of under 20 per cent the dividend tax credit can be fully utilized against tax on other income. Old age security tax is ignored in the application of the dividend tax credit.

The effect of the low rate of corporation tax combined with that of the dividend tax credit is to increase the total tax payable over what it would be at the personal rates when the shareholder's marginal rate is 20 per cent or lower and to decrease the total tax payable where the shareholder's marginal rate exceeds 20 per cent. At a marginal rate of 80 per cent the decrease in total taxes payable is $11.60 or 14.5 per cent.

Because in the ultimate analysis all corporations belong to individuals, any increase in the wealth of a corporation must affect the wealth of

individuals. The low rate of tax is available to corporations irrespective of the number of shareholders, and it follows that the fewer the shareholders the greater the benefit that accrues to each. For example, if a corporation is owned by one person, that person derives the full benefit of the low rate of tax up to a maximum of $10,150 a year, but for a similar corporation with ten equal shareholders the benefit to each shareholder would amount only to a maximum of $1,015 a year. To this extent also, the low rate produces very uneven consequences.

Complexity of the Law: Associated Corporations

When the dual rate of corporation tax was introduced in 1949, it was foreseen that the benefit (at that time a maximum of $2,300 per annum) to be obtained from the low rate might provide taxpayers with sufficient inducement to create new corporations or to divide existing corporations to increase the amount of income taxable at the low rate, and that preventive legislation would be required. Because the intent of the low rate was to encourage small businesses, it might have been anticipated that the anti-avoidance legislation would not be directed at corporations whose existence could be justified for sound business reasons, but only at those created for tax-reduction reasons. As enacted, however, the associated-corporation legislation provided that, where two or more corporations were related to each other in a taxation year, the income of those corporations should be aggregated for tax purposes so that only one low rate of tax would be available irrespective of the number of corporations involved. The rules for determining relationship were as follows:

> "...one corporation shall be deemed to be related to another in a taxation year if, at any time in the year, (a) it, directly or indirectly, controls the other, (b) it is, directly or indirectly, controlled by the other, or (c) both corporations are controlled, directly or indirectly by the same person." 8/

As a result of taxpayer complaints 9/ this test of relationship was repealed retroactively and was replaced by a test based on ownership of 70 per cent

or more of all the issued common shares of the capital stock of the relevant two or more corporations at any time in the year 10/. It is not necessary to analyze the supporting legislation to establish that the required percentage of ownership was the only test for denial of the low rate, even where the corporations were conducting entirely dissimilar business at opposite ends of the country. It can be said that the supporting legislation was complex and occasioned numerous judicial decisions particularly concerning the concepts of "direct or indirect ownership" and "arm's length". Despite the introduction of further complex legislation, the ingenuity of taxpayers was such that the intent of the legislation was being thwarted. In 1960, therefore, the legislation dealing with associated corporations was substantially amended. One of the major changes was that the 70 per cent ownership test was abandoned and replaced by the test of control. The legislation dealing with associated corporations up to 1963 was detailed, lengthy, complex and, in some areas, uncertain. Despite this, the intent of the legislation was still being circumvented.

This struggle between the taxpayer and the Revenue culminated in the enactment in 1963 of section 138A(2) of the Income Tax Act which reads as follows:

> "(2) Where, in the case of two or more corporations, the Minister is satisfied
> (a) that the separate existence of those corporations in a taxation year is not solely for the purpose of carrying out the business of those corporations in the most effective manner, and
> (b) that one of the main reasons for such separate existence in the year is to reduce the amount of taxes that would otherwise be payable under this Act
> the two or more corporations shall, if the Minister so directs, be deemed to be associated with each other in the year."

This section is noteworthy in that it introduces an element of ministerial discretion and formulates the dual test of business purpose and tax reduction purpose. However, it should not be assumed that the formulation of the new tests represents a change in policy toward eligibility for the low rate. It merely represents an additional hurdle to be surmounted by the

taxpayer when he has first passed the test of control imposed by section 39 of the Income Tax Act. The introduction of this type of legislation carries with it the admission that detailed legislation spelling out the circumstances in which the benefit from more than one low rate allowance will be denied has not been successful.

The taxpayer has the right to appeal a direction under section 138A(2), but in deciding whether to vacate the direction it is provided that the Tax Appeal Board or the Exchequer Court may only do so if it has determined that "...none of the main reasons...is to reduce the amount of tax..." otherwise payable. The appeal provision contains no reference to the extent, if any, to which the appropriate forum may consider whether the separate corporate existence is explicable on the ground that it most effectively carries out the business of the corporations.

In summary, the legislation, as it presently exists, permits only one allowance of taxable income at the low rate of tax to a group of corporations that are under common control or whose separate existence is not solely for the purpose of carrying out their business in the most effective manner and when one of the main reasons for such separate existence is to reduce taxes. The former of these two tests of association is contained in complex, lengthy and, in some parts, obscure technical legislation.

There is, as yet, no indication as to the manner in which section 138A(2) will be applied, but there seems to be an implied dual standard for eligibility for more than one low rate allowance. Thus, where the degree of control of the various corporations falls within the technical rules of section 39 and supporting legislation it is automatic that only one low rate allowance will be granted. But where the taxpayers have been sufficiently fortunate or sophisticated to escape these technical rules (but presumably not the intent), the test for denial of more than one low rate allowance will be lack of business purpose and presence of tax reduction intention.

The presence of the dual standard referred to in the preceding paragraph has led us to consider whether a better standard could be introduced. Because it may be impossible to draft specific detailed legislation in such a way as to eliminate all presently known means of avoiding association, let alone new methods which will probably be devised, we considered whether the basis for denial of the low rate to a corporation could be encompassed in a general statement leaving the interpretation of particular cases to the courts. For example, the tests embodied in section 138A(2), with ministerial discretion removed, might be enacted as the sole tests for denial of the low rate to a corporation. This might appear to conform more closely to the original intent of providing assistance to small businesses because no consideration would be given to who the shareholders of these businesses are in determining eligibility for the low rate.

In considering the possibility of recommending a radical change such as that described in the preceding paragraph one is faced with the difficult task of attempting to evaluate the unknown. Among the questions that flow out of a consideration of such a proposal and to which definitive answers are clearly not available, are the following. Would the introduction of such subjective tests of business and tax reduction purposes lead to excessive litigation? Do these tests lack the desired level of certainty? Would the Department of National Revenue be placed in a very difficult position if, on appeal and notwithstanding the deemed correctness of an assessment, the Department was required to adduce evidence to discharge the burden of proof that might be shifted to it? While these questions cannot be decided in the absence of the experience that would be gleaned over years of actual implementation, it must be remembered that the scheme currently in effect is not perfect. Consequently, any defects that might arise in any contemplated new legislation, such as those alluded to in the questions previously posed, would not necessarily represent a deterioration from the status quo. Indeed, the existing legislation has produced a substantial amount of litigation and it is doubtful that it can be held out as a good example of the desirable

level of certainty. On the other hand, it is believed that while the subjective elements in the contemplated proposal might tend to weaken the position of the Department in any instance where the onus of proof was shifted to it, the Department manages to administer and enforce other sections of the Act in which similar problems arise such as, for example, where reasonableness is an issue.

In view of these previously discussed uncertainties and in an attempt to maintain an acceptable level of administrative and enforcement facility, some variation of the business and tax reduction purposes test, possibly less liable to taxpayer abuse, could be substituted. This could provide that, where common ownership was in excess of a certain percentage, only one allowance of income taxable at the low rate was available, and where common ownership fell below the prohibited percentage but still provided control, the business and tax reduction purposes test would come into play with the onus of proof being shifted to the taxpayer. Such a modification would be, in principle, somewhat similar to the present position. The percentage level at which the automatic denial of the low rate would be established would be conditioned by the desire to reduce litigation, to increase certainty, and to balance the relative strengths of the taxpayer and the fisc. Because some of these considerations work in opposite directions, the decision as to the appropriate percentages would not be one of principle but of pragmatic judgment.

The dual rate of corporation tax is largely responsible for the existence of the associated-corporation legislation, but in the years since its introduction other incentive legislation has made use of the same associated-corporation rules. The elimination of the dual rate would remove the major need for the associated-corporation rules, and, if other tests to prevent abuse of incentive legislation were devised, the retention of associated-corporation rules would be unnecessary.

As a Barrier to Tax Reform

The low rate of corporation tax may well act as a barrier to the reform of the present system of taxation. Many suggested changes to the present tax structure could not be implemented, or would be rendered excessively complicated, if the low rate of corporation tax was to continue at its present level. Thus, further integration of the corporation tax with the personal tax rate structure would be difficult with the low rate at the present level, and some of the proposals made to eliminate surplus-stripping would be emasculated.

EFFECTS OF WITHDRAWAL OF THE LOW RATE OF CORPORATION INCOME TAX

As a result of our examination of the effects of the dual rate of corporation income tax, we concluded that, although it permitted certain small businesses to retain funds which could be used for expansion and growth, it seemed to be a relatively inefficient method of doing so. Although any form of incentive legislation directed at special sectors of the economy results in anomalies and inequities, the low rate of corporation income tax applies to all forms of corporate business activity and its consequences are, therefore, more widespread than other incentives. For these reasons and because its continuation inhibits tax reform, we considered the effects of its withdrawal.

In broad terms, the abolition of the lower rate would increase tax revenues from the corporate sector by approximately $185 million. If this amount was applied to the reduction of corporation income tax it would be possible to levy a single rate of corporation income tax of somewhat less than 45 per cent. However, this broad approach does not demonstrate the impact that the withdrawal would have on corporations of different income classes. The maximum increase in the tax burden to any one corporation would be $10,150 if the single rate was maintained at 50 per cent, or $8,400 if the single rate was 45 per cent, but the following table showing

the effect at various levels of corporate income illustrates the results with greater clarity.

It will be observed from Table I-3 that for corporations with taxable incomes up to $35,000 the tax burden is more than doubled whether the single rate of corporation tax is set at 45 per cent or 50 per cent. This would reduce the present after-tax income of these corporations by 36.7 per cent, at a 50 per cent corporation income tax rate, and 30.4 per cent, at a 45 per cent corporation income tax rate.

It will also be observed that, at a 45 per cent corporation income tax rate, there is little difference in the tax burden of corporations with taxable incomes of $200,000, and that for corporations with incomes in excess of that figure there is a reduction in the tax burden.

We do not believe that the withdrawal of the low rate of corporation income tax would have any serious effect on corporations with incomes in excess of $100,000, particularly if the single rate was set at approximately 45 per cent, but these companies numbered only 2,907 out of a total of 67,238 companies which earned a profit in the 1961 taxation year.

For corporations with incomes of less than $100,000, it is probable that a sudden increase in the tax burden of the magnitude indicated by Table I-3 would have serious results. For example, many of these corporations have indebtedness, and the agreed conditions of repayment may well have been computed on the basis of cash flows predicated on continuation of the low rate of corporation tax. It is true that tax rates are never constant and are subject to continual change, but seldom are changes of this order made, except in times of national stress, and even then the impact is not confined to one specific sector of the economy. In addition, there are certain economic considerations which are discussed in Chapter 22.

Thus, the removal of the dual rate, without some compensating provision for new and small businesses, would not appear to be a reasonable proposition.

TABLE I-3

COMPARISON, AT VARIOUS LEVELS OF CORPORATE INCOME, OF THE PRESENT CANADIAN TAX BURDEN WITH THAT UNDER A SINGLE CORPORATION TAX RATE OF 50 PER CENT AND 45 PER CENT

Corporate Income Level	Present Canadian Tax Burden	Flat-Rate Tax At 50 Per Cent	Increase (3) Over (2)	Flat-Rate Tax At 45 Per Cent	Increase (Decrease) (5) Over (2)
(1)	(2)	(3)	(4)	(5)	(6)
$ 5,000	$ 1,050	$ 2,500	$ 1,450	$ 2,250	$ 1,200
10,000	2,100	5,000	2,900	4,500	2,400
20,000	4,200	10,000	5,800	9,000	4,800
30,000	6,300	15,000	8,700	13,500	7,200
35,000	7,350	17,500	10,150	15,750	8,400
75,000	27,350	37,500	10,150	33,750	6,400
100,000	39,850	50,000	10,150	45,000	5,150
200,000	89,850	100,000	10,150	90,000	150
1,000,000	489,850	500,000	10,150	450,000	(39,850)
5,000,000	2,489,850	2,500,000	10,150	2,250,000	(239,850)

Note: In the case of corporations whose shareholders are either employees or directors the increase in tax can in many cases be reduced by payment of increased salaries or fees. Assuming that the optimum salaries or fees are presently being paid, the final result will be an increase in overall tax but less severe than indicated in the above table.

ALTERNATIVES TO THE DUAL RATE OF CORPORATION TAX

Because of criticisms of the dual rate of corporation tax discussed above, and because its sudden withdrawal could cause considerable hardship to many small corporations, we examined a number of alternative methods within the tax structure of easing the burden on low income corporations.

Option to Elect to be Taxed as a Partnership

To mitigate the increased tax burden on small corporations, an option could be extended to the shareholders to elect to be taxed in the manner in which a partnership is presently taxed. To prevent abuse, to make it administratively feasible, and to prevent loss of revenue from the non-resident sector such an option would have to be conditional. Thus, there would have to be a restriction on the number of shareholders, the shareholders of the electing corporation would have to be individuals resident in Canada, there would have to be restrictions in the case of a complex capital structure and the election would have to be consented to by the holders of most of the shares. It might also be necessary to withhold the right of election where shares are transferred during the corporation's fiscal year, or at least establish special rules to deal with such transfers. An option which is subject to restrictions along these lines is recommended in Chapter 19.

This proposal has certain advantages. It can be justified on the premise that the form in which a business is conducted should not be unduly influenced by tax considerations. Such an option would also permit corporate losses to be "passed through" to the shareholders. This may be of particular value in the early years of the life of a business.

However, corporations whose shareholders are all employees or possibly directors effectively have this option available to them now in their ability

to fix levels of remuneration. However, it would be of advantage to small corporations where the shareholders are not employees. In most cases the net result of this option would be an increase in the overall tax burden but not as severe as that indicated in Table I-3.

The partnership option does not by itself appear to provide a sufficient amelioration of the serious results of complete withdrawal of the low rate of corporation tax.

Deferment of Payment
of Income Tax

The rationale of this suggestion is that the main reason for assistance to small businesses is to compensate them for their inability to raise capital to assist in their expansion. In its simplest form, it would tax all corporations at a flat rate of tax but, except for associated corporations, the payment of that portion of the tax representing the difference between the present low rate and the flat rate could be deferred subject to payment of a moderate rate of interest. The total amount of tax which could be deferred could be limited to the lesser of, say, $50,000, or the amount of the shareholders' equity, and would be subject to immediate payment on winding up, on ceasing to carry on an active business, or on becoming non-resident. It should be observed that the amount deferred would at all times be a liability of the corporation. It is possible, of course, to add further qualifications to such a proposal, but each additional qualification is likely to result in more complex legislation and further anomalies.

Because the deferred tax payment would be a liability of the corporation, it would result in a reduction in the surplus available for dividends and should influence retention of the funds within the business. It would also substitute indefinite deferment of a limited amount of corporation tax liability for what might currently be regarded as a remission of an amount of corporation tax that is subject to an annual limitation only. In effect, it would withdraw the benefit of the low rate of tax and would substitute a $50,000 maximum loan of indefinite duration.

It would moderate the effect on the cash flow of small profit corporations because the lower the profit the longer it would take to reach the maximum amount of deferment. For a corporation with a taxable income of $5,000 per annum the limit on deferment of $50,000 would not be reached for over 30 years. For corporations with taxable incomes of $35,000 and up the maximum limit would be reached in 5 years.

It is subject to many of the criticisms levelled at the dual rate of corporation tax. In particular, the necessity of associated-corporation legislation would remain, it would be available only to corporations, it would not assist unprofitable corporations, and to a more limited extent it would discriminate against other forms of income.

The existence of the deferred tax liability, particularly if it had priority over other claims in bankruptcy, may have adverse effects on the ability of small businesses to arrange other financing.

The suggested limit on the amount of tax deferment might be insufficient to avoid some hardship to those corporations that had geared repayment of long-term debt to a cash flow computed on the basis of the continued existence of the low rate of corporation tax.

Because the reduction in tax payments would be subject to a limit, it would be available for a variable but limited period. To this extent, it may be considered an aid to new corporations rather than small profit corporations.

The Creation of an Investment Reserve

In its most generous form, this proposal envisages that corporations should be permitted to build non-taxable reserves to a maximum amount at an annual rate which would result in the same reduction in tax payable as does the present low rate. If the amount of the reserve was not used within a prescribed period for new investment in plant, equipment, mineral exploration,

export promotion, or other approved expenditure it would be brought back into the corporation's income and taxed accordingly.

In essence, this plan would permit the corporation to provide for expenditures before they were incurred, and it carries with it the implication of approval of the appropriate expenditure by the tax authorities.

It is subject to many of the same criticisms that have been raised against the dual rate and introduces some further administrative complexities and problems.

Free Depreciation Policy

This proposal, which would be available to corporations with an upper income limit, would result in a deferment of income tax and would relate the benefit to retention of funds within the business. The free depreciation policy proposal has a bias in favour of "depreciable asset" intensive industries, but as discussed in Chapter 22 it is in this area that a capital market bias may exist. The associated-corporation problem would remain. However, it would be possible to extend the benefit of these proposals to unincorporated businesses. In order to avoid inequality of tax circumstances between businesses just above and those just below the upper income limit for eligibility, it might be desirable to have a notch provision.

Increased Personal Tax Credit

Another method of mitigating the effects of eliminating, or of increasing, the low rate of tax would be to increase the present dividend tax credit. Although the effect of an increase in the low rate of tax would be to impose an additional burden of taxation on the corporation, this would be compensated to some extent by an increase in the dividend tax credit available to shareholders on distribution. It would be essential that the dividend tax credit be made available for refund to the individual shareholder if its benefit was not to be denied to the shareholder whose need was greatest, that is, the

comparatively low income shareholder of the low income corporation.

The total personal and corporation income tax burden imposed on corporate income could be held at the approximate personal tax liability of its shareholders on an equivalent amount of income, provided the corporate income was distributed. It is true that, to achieve this result, the income must be distributed and this may be considered to defeat the purpose of the low rate particularly if the income was not reinvested in the corporation. However, if the assistance was directed at the family-owned small business, then the closer the identification of the shareholders with the business the more likely that reinvestment in the business would follow if the funds were required for expansion and growth.

To the extent that it resulted in an increase in the lower rate of corporation tax, it would permit greater flexibility in the area of tax reform but an increase in the dividend tax credit,as discussed in Chapter 19 and Appendix F to this Volume, would reduce the degree of progressiveness of personal tax in respect of corporate distributions.

CONCLUSIONS

1. The low rate of corporation tax gives small profitable corporate businesses the power to retain a greater portion of their profits for reinvestment in the business and, to this extent, can be a significant factor in their ability to expand.

2. The dual rate of corporation tax is an imperfect means of providing assistance to small business because:

    a) It is inefficient in that it is available only to a minor segment of the small business community, that is, profitable businesses conducted in the corporate form.

    b) It is available whether or not the profits are retained or used for expansion of the corporate business.

c) It is available to all corporations irrespective of size, growth potential or need of financial assistance.

d) It is inequitable in that it discriminates against unincorporated businesses.

e) It is inequitable in that it is unrelated to the taxable capacity of individuals to whom any benefit must ultimately accrue (the associated-corporation legislation relates the benefit to shareholders but not to their taxable capacity).

f) It is largely responsible for the complex associated-corporation legislation.

g) It inhibits tax reform.

3. The immediate and complete withdrawal of the low rate of corporation tax could create serious financial problems for many small profit corporations whose very creation was predicated on the existence of a low rate of corporation tax. Accordingly, the effects of the withdrawal of the low rate, or an increase in its level, should be mitigated in some appropriate way.

4. All of the alternative tax methods of assisting small or new businesses examined were subject, to a greater or lesser degree, to similar criticisms as are levelled against the dual rate of corporation tax.

5. The associated-corporation legislation is both complex and to some extent unsatisfactory. If the dual rate of corporation tax was retained, taxpayer ingenuity and the flexibility of corporate organization are such that detailed and specific legislation to combat successfully the avoidance of the intent of the associated-corporation legislation is unlikely, if not impossible, of achievement.

REFERENCES

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

2/ Budget Speech, Ottawa: Queen's Printer, 1960, p. 11.

3/ Royal Commission on Banking and Finance, Report, Ottawa: Queen's Printer, 1964, p. 44.

4/ Department of National Revenue Taxation Statistics, 1963, Ottawa: Queen's Printer, 1963, fully tabulated companies only, pp. 156-157.

5/ Some of the companies which earned a profit would not be subject to tax because of the application of prior year losses, and others, because of "associated" status, would not be eligible for the low rate but it is not possible to establish how many.

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

7/ Department of National Revenue Taxation Statistics, 1963, op.cit., fully tabulated companies only, pp. 160-161.

8/ Statutes of Canada, 1949, 2nd Sess., Chapter 25, section 18(1).

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

10/ Statutes of Canada, 1950, Chapter 40, section 15.

APPENDIX J

A POSSIBLE TRANSITION TAX ON CORPORATE SOURCE INCOME

In Chapter 19 it was pointed out that the implementation of the recommendations for corporate source income, although they would lead to an increase in total tax revenues (from residents and non-residents) in the long run, would result in a deficiency in tax revenues over the transitional period. One means of meeting this deficiency, although it is not our primary recommendation, would be to impose a special temporary tax on shareholders. The tax would be sufficient to raise the necessary revenue from corporate source income in the transitional period to offset the initial revenue loss from integration. In the long run this revenue loss would be more than compensated by the other changes in the taxation of corporate source income that we have proposed.

We are satisfied that there is no general transition tax that would be both completely equitable for the shareholders of every corporation and administratively feasible. It is impossible to determine now whether the shareholders in a particular corporation relative to shareholders of other corporations would gain or lose as a result of integration. Nor would it be possible to do so after implementation of our proposals. While it may be possible to ascertain, for example, that the low income shareholders of a particular corporation are treated unfairly under the present law relative to upper income shareholders of the same corporation, it is usually impossible to determine whether the shareholders of a particular corporation as a group are being unfairly treated relative to the shareholders of another corporation.

Special Transition Tax

If there is to be a special transition tax on corporate source income, it could be determined and applied in the following way:

1. An amount, known as the "transition surplus", would be determined by

measuring the increase in the undistributed income of the corporation for the period of, say, five years 1/ preceding the date of the introduction of the integration system (the "transition date"). The undistributed income would be computed in accordance with the normal procedures now used under the Income Tax Act. Thus, all dividends paid in this period, including stock dividends and other deemed distributions, whether from tax-paid undistributed income or otherwise, would serve to reduce the transition surplus. From this aggregate there would be deducted the amount of any tax-paid undistributed income of the corporation at the transition date, whenever created, resulting from elections under section 105 of the Act or otherwise. In addition, as discussed below, the corporation should be allowed to make further elections similar to the present section 105 election on up to one half its transition surplus.

2. When each distribution or allocation was made subsequent to the transition date by the corporation to its shareholders (whether out of income on which corporation tax had been paid or as a return of capital), each resident individual shareholder would be deemed to have received additional income equal to the lesser of his portion of the transition surplus or the amount distributed or allocated to him. This deemed income would be included in the resident individual's income for tax purposes and taxed at full rates. Although it would be possible to allow the 20 per cent dividend tax credit on this deemed income, we do not so recommend because it would have a substantial effect on revenue that would have to be made up by increasing the number of years of undistributed income to be included in the transition surplus. The amount of the distribution or allocation on which the deemed income figure would be based would be the net distribution or allocation and not the grossed-up amount. If the shareholder was another resident corporation, it would not be subject to the special tax, but would include the deemed income in its own transitional surplus for allocation

to its own shareholders. The special tax would not be payable by non-residents because they would derive no benefit from integration and would continue to be subject to withholding tax on distributions in the same manner as at present.

3. It is not intended that the imposition of a transition tax should increase the total taxes on distributions over what would be payable under the present system. Therefore, we believe that an election similar to the present section 105 should continue to be available during the transitional period of, say, seven years. Although the use of this election by a corporation would result in its having to remit part of the transition tax, this appears to be the most equitable procedure for allowing shareholders to elect the manner in which they wish to pay the transition tax. Thus, we suggest that a corporation be permitted to elect to pay 15 per cent on one half of its transition surplus and thereby relieve its shareholders from having to bring that portion of the transition surplus into their income.

4. The special tax would be imposed as long as any transition surplus was on hand. However, to ensure that the period of time concerned did not become extended, and to prevent the undue deferment of the payment of this tax, the government might wish to provide that all transition surplus must be paid or allocated by some final date, say, seven years from the transition date.

5. The transition tax would be based on a deemed figure, even though the amount would be calculated by reference to actual distributions or allocations. It would be a special tax and would not in any way affect the other tax consequences of making a distribution or allocation as outlined in Chapter 19 and would not affect the basic tax accounts of the corporation. Thus, it would not involve any adjustment to the cost basis of the shares. The tax would be a form of arbitrary fee levied on shareholders which, only for purposes of the computation,

would be related to corporate distributions and allocations. Relating it in this fashion would also ensure that most shareholders would pay less tax and that no shareholders would pay substantially more tax on corporate distributions than they would have paid under the present legislation. The taxes payable are shown in Table J-1.

6. Many of the present "surplus-stripping" problems would remain in connection with the transition tax. It would probably be necessary to have special rules for the imposition of the tax on a sale of shares by a resident to a non-resident, to an exempt organization or to a security dealer.

While this description is rather specific, the details of the transition tax and the number of years to be taken into account in computing the transition surplus would be determined by the government after further study of the probable effect on revenue of the introduction of the proposed changes in the tax system.

A special tax in this form has a number of implications. The tax would essentially be based upon undistributed income accumulated over recent years. Therefore, it would amount to a tax on surplus. However, we do not believe that this would be inequitable because it would only take the surplus of recent years into consideration and most shareholders have anticipated that the withdrawal of this surplus through dividends would eventually involve some tax liability. We believe that it would be advantageous for the economy as a whole to have the full benefits of integration immediately available to new, to recently formed and to rapidly expanding corporations. Basing a transition tax on recently acquired undistributed income would minimize the tax on these three groups. In addition, the "capitalizing" of all the undistributed income on hand would benefit the old established companies with large surpluses by limiting the tax liability on distribution of their surpluses. However, it is reasonable to collect some tax from the shareholders of these corporations. Because surplus accumulated up to the

TABLE J-1

EXAMPLES OF THE TOTAL TAX ON A $100 POST-TRANSITION DIVIDEND OR ALLOCATION FROM A CORPORATION WITH AT LEAST AN EQUIVALENT AMOUNT OF TRANSITION SURPLUS ON HAND

Resident shareholder with 20 per cent marginal tax rate	
Ordinary dividend or allocation	$100.00
Grossed-up	200.00
Personal tax at 20 per cent	40.00
Credit for corporation tax	100.00
Refund	60.00
Transition Tax	
Deemed income of $50 at 20 per cent	10.00
Section 105 type election by corporation on $50 at 15 per cent a/	7.50
Personal tax (as above)	40.00
Total tax paid	57.50
Resident shareholder with 50 per cent marginal tax rate	
Ordinary dividend or allocation	100.00
Grossed-up	200.00
Personal tax at 50 per cent	100.00
Credit for corporation tax	100.00
Refund	-
Transition tax	
Deemed income of $50 at 50 per cent	25.00
Section 105 type election by corporation on $50 at 15 per cent a/	7.50
Personal tax (as above)	100.00
Total tax paid	$132.50

Note:

a/ It is assumed that the corporation elects to pay the 15 per cent tax on one half of the transition surplus.

transition date would not be subject to any further tax on distribution to the shareholders other than the special transition tax, most shareholders of corporations with accumulated earnings would be in a much improved situation even after payment of the tax.

This transition tax does not purport to be equitable in any absolute sense to the shareholder of a particular company relative to another shareholder in the same or another company. However, even though the impact of the tax might weigh relatively more heavily on some companies than on others, the potential inequities are much less serious than might otherwise appear because most shareholders have some diversification in their portfolios, often through investments in mutual funds and pension plans. High income individuals holding shares in private companies that have had low pay-out ratios in order to defer personal tax are less likely to have this diversification than others. The transition tax would be relatively heavy in the case of this group. This feature of the tax seems to us to be desirable.

Because the transition tax would not be imposed on the company and the undistributed income would, in effect, be attributed to shareholders, non-resident shareholders should, in general, be unaffected. We do not favour the imposition of a new tax on non-residents to recoup revenues lost in making a change from which they would not benefit.

Shareholders in private companies that in recent years have paid substantial dividends or have made section 105 distributions, even if these distributions were in effect made from surplus accumulated many years before, would pay little additional tax. This is desirable because these shareholders have already distributed and paid tax on a substantial portion of their corporate income. Also, if a corporation had acquired tax-paid undistributed income that it had not distributed, this would benefit its shareholders. This too appears equitable, because otherwise the shareholders would obtain no benefit from the payment of this tax on the corporation's undistributed income. In addition, because the right to a section 105

election would remain available for a limited period of time, many companies would be able to reduce the effective tax burden to their shareholders by making such an election.

Many small companies that could qualify for the accelerated capital cost allowance would be able to reduce or eliminate their ordinary income tax liability on corporate source income in the years immediately following the transition date, so that they should have available liquid funds with which to pay the special tax.

Shareholders in mining and petroleum companies or life insurance corporations would be subject to little, if any, transition tax as the undistributed income of these companies is usually relatively small. This would be a desirable result as our other proposals would generally increase the level of tax on these shareholders.

The cash position of most shareholders who did not realize share gains during the transitional period would, on balance, be improved relative to their current position, despite the necessity of paying the special tax. The tax refund on allocated corporate income would, on average, more than offset the special tax.

REFERENCE

1/ As a single time period would place a relatively new corporation in the same position as an older corporation that had been accumulating undistributed income for many years, it might be more equitable to also provide an alternative time period of, say, ten years. A company choosing the alternative would be permitted to reduce the transition surplus by an arbitrary amount of, say, 40 per cent to arrive at a figure similar to that obtained under the shorter time period. This alternative would be available even if the company had not been in existence for the full period of time in order to ensure that the newer companies would not be taxed relatively more heavily than the established corporations. The actual number of years that would be included in both of these computations would depend upon the amount of revenue required in the transitional period.

APPENDIX K

TAX CONCESSIONS TO THE MINING AND PETROLEUM INDUSTRIES

Historical Development

Although the three-year exemption from income tax for new mines, the depletion allowances and the deduction of exploration and development costs which are enjoyed by the mining and petroleum industries are difficult to justify at the present time when virtually all costs are deductible, a review of the historical development of these tax concessions gives some insight into the reasons for their existence.

Depletion Allowance. The depletion allowance was introduced in the Business Profits War Tax Act of 1916, and in general terms was intended to allow for exhaustion of the resource. No reference was made to an allowance for the cost of developing the resource; rather it was justified in terms of the value of the resource. This may be partly explained by the fact that the profits tax was to be levied only on profits in excess of a certain percentage of capital, and it was recognized that in an industry such as mining or petroleum the real capital values at the inception of the tax might be quite different from the costs recorded in the accounts. The depletion allowance might also have been justified as an indirect allowance for cost, since it does not appear that exploration and development costs were allowed at that time as a deduction in computing income. Once this concept was established for mining and petroleum companies in existence at the time of the introduction of the income tax, presumably it was difficult not to grant a similar allowance to new companies, even though no attempt has ever been made to tax these companies on the difference between the cost and the real value of the capital. Experience in the United States was similar and probably influenced the Canadian approach.

Under the Income War Tax Act of 1917, the Minister of National Revenue was given discretion to establish such an allowance for exhaustion as he deemed just and fair. Some time after 1928, the allowance was established

at 25 per cent of gross revenue, of which an amount calculated at 25 per cent of net revenue was viewed as a depletion allowance and the balance as an allowance in respect of development costs, although the meaning of these terms is not clear. In 1939 the first direct form of capital cost allowance emerged, a separate deduction being allowed by the Minister for a percentage of development costs, decreasing from 30 per cent to 10 per cent until the cost was fully written off. The Minister continued to grant a depletion allowance of 25 per cent of the net income remaining after deduction of the development costs. In 1941 the depletion allowance for operators was increased to 33.33 per cent at which level it has remained to the present day.

In 1949 the calculation of the depletion allowances was set out in the Regulations. In their application to the petroleum industry, controversy ensued as to whether the depletion allowance was to be based on a "well-by-well" calculation, in which case only the profits of profitable wells would be considered, or whether it would be based on an "overall" calculation, in which case losses of unprofitable wells would have to be deducted as well as exploration, development and other operating expenses not related to the profitable wells. The Regulations were amended several times as the government attempted to ensure the latter treatment, and the result was that only in the years 1949 and 1950 could a well-by-well basis be used.

Despite the changes which occurred after 1939 in the treatment of costs, referred to below, there was no basic change in the depletion allowance aside from an increase in the rate for operators from 25 per cent to 33.33 per cent. The liberalization of the allowance of costs did, of course, have an effect on the depletion allowances which are based on income after deduction of costs. In addition to this operator's depletion allowance, there has been a "non-operator's" depletion allowance of 25 per cent of gross revenue and also a depletion allowance granted to shareholders varying from 10 per cent to 20 per cent of the dividend, depending upon the proportion of the company's income directly or indirectly derived from oil and mining operations.

Three-Year Exemption for New Mines. The three-year exemption of the income of new mines was introduced in 1936 as a measure to encourage the development of the mining industry. At the time of its introduction, the Minister of Finance stated:

> "Exploration and development require expenditure of large amounts of capital over a considerable period of time. Private enterprise, therefore, can only be induced to enter the field if the prizes to be gained for the relatively few successes are attractive." 1/

Originally intended for a period of only a few years, it has been in the legislation in roughly the same form ever since.

Deduction of Exploration and Development Costs. In 1943, tax credits were introduced for certain drilling and exploration petroleum expenditures. In introducing this measure the Minister of Finance referred to the emergency conditions of the day and stated that it was the government's desire to remove as far as possible any barriers which taxation may impose in the way of the search for oil. The tax credit rates corresponded to the corporation tax rates (in some cases exclusive of excess profits tax) of the time, and accordingly the tax treatment was equivalent to allowing the expenditures as a deduction in arriving at taxable income.

When amendments to the tax legislation were considered in 1945, it was contended by some that the write-off of mining depreciation and pre-production costs tended to defeat the purpose of the three-year exemption, and in 1947 gold mines were permitted to defer deducting certain expenses during the exempt period. With the introduction of the present depreciation system in 1949, the claiming of all capital cost allowances became permissive, and an incidental effect of this change was to permit mining companies to defer claiming capital cost allowances until after the three-year exemption had expired.

A further major change in the treatment of costs came in 1948 when all exploration and development costs other than the costs of rights, bonus

payments and purchased properties became deductible immediately to the extent of the income of the taxpayer, any unabsorbed balance being available for indefinite carry-forward. The last major change occurred in 1962 when the costs of oil rights and properties became deductible in the same manner as exploration and development costs.

Anomalies and Technical Difficulties

There are a number of features in the provisions for the three-year exemption which present anomalies, loopholes and problems in administration. For example, there is considerable imprecision in the definition of what constitutes a new mine, and some of the mines which qualify may be in an ore body already known to exist and from which ores are being extracted at a nearby location, or the ore taken from the ground may be processed by an existing plant.

It may be noted that the income which is exempt under the legislation may be considerably greater than the income determined under ordinary business principles, because capital cost allowances and the amortization of pre-production costs may be deferred until after the exempt period. While the results from the Mining Survey 2/ in this respect were incomplete and revealed wide fluctuations in experience, on the average the income for corporate purposes was about 72 per cent of the tax-exempt reported income. This would indicate that the three-year exemption is in effect at least a four-year exemption in terms of normal business profits. In addition, mining income for this purpose is treated as including income from a refining operation carried on by the taxpayer, but not the income from a refining operation carried on by another taxpayer. The exemption of income also provides an incentive for changing operating procedures in order to maximize income during the exempt period, although it is extremely difficult to determine the extent to which this has affected actual operations and, as far as we have been able to ascertain, it is not a material factor.

As in the case of the three-year exemption, income eligible for the 33.33 per cent depletion allowance may include income from a refining operation carried on by the taxpayer, but not income from such an operation carried on by another taxpayer. In addition, it is somewhat anomalous that all exploration costs must be deducted in arriving at the income subject to depletion even though they may bear no necessary relation to the mine or petroleum well. This does not, however, seem to be a matter of contention in the mining industry, probably because the exploration costs are relatively smaller than in the oil industry, and a mine is often operated by a separate company that is not engaged in outside exploration.

One of the inherent difficulties in the tax concessions granted to the oil industry is the conflict between the two main concessions—the depletion allowance on production income and the fast write-off of costs. For example, the fast write-off of exploration and development costs has to be made against income subject to a lower rate of tax because of the depletion allowance. On the other hand, the effect of the depletion allowance is reduced because the fast write-off of exploration and development costs means that income, and therefore an effective claim for depletion allowance, is deferred.

Taxpayers have resorted to various methods of deriving the maximum benefit from these two incentives by separating them. For the years 1949 and 1950, the Home Oil Company was able to establish that the depletion allowance should be calculated on a well-by-well basis, 3/ which meant that exploration and development costs not related to the producing well were not deductible in computing the income subject to depletion. Another taxpayer, Imperial Oil Ltd., was unsuccessful in its attempt to establish such a basis for 1951 under the Regulations as amended 4/. We understand that an integrated oil company is able to organize separate corporations in such a way that exploration costs can be deducted against refining and marketing income which would otherwise be taxed at full rates, and

can claim depletion allowance on the production income without deduction of such exploration costs. Although this use of separate corporations would effectively defeat the general basis for calculating depletion as set out in the Regulations, no action has been taken by the government to require consolidation of related corporations for the purpose of determining the depletion allowance.

Problems Arising from Present
Tax Concessions

The relation between the depletion allowances and the fast write-off of costs was the basis of various proposals to us. One was that 150 per cent of exploration costs should be deductible. Another was that the depletion allowance should be based on 25 per cent of gross revenue, that is, before operating expenses and exploration and development costs. Based on future projections submitted to us by the Canadian Petroleum Association, this suggestion would, in the case of an oil company with a continuing exploration programme, virtually eliminate the taxation of any income from the exploration and production of oil. Their projected figures for calculating the income from a barrel of crude oil were as follows:

Selling price		$2.40
Royalty		.35
		2.05
Operating expenses		.49
		1.56
Exploration costs	$ .67	
Development costs	.30	.97
Income		$ .59

The suggested 25 per cent gross depletion allowance would give an extra deduction of 51 cents (25 per cent of $2.05) per barrel, reducing the income per barrel to 8 cents.

Since we have recommended that the depletion allowances be discontinued, it is not necessary to assess the merits of these proposals. An incidental result of our recommendation would be to bring the existing problems to an end.

A significant anomaly has emerged in respect of potash development. One method of extraction which involves drilling holes into the earth is considered an oil well operation, whereas another which involves extraction on the surface is considered an open pit mining operation, eligible for the three-year exemption for new mines. This difference in treatment has arisen merely from the physical characteristic of the operation, which bears no relation to need for tax relief. With the adoption of our recommendation for removal of the three-year exemption for new mines, this anomaly would be ended.

The tax advantage which an integrated mining or petroleum company enjoys in relation to an unintegrated company reflects the fact that, under the income tax system, the taxpayer with income against which to offset costs of developing new ventures is in an advantageous position, because he can have his costs immediately recognized for tax purposes. This inherent discrimination of the tax system is accentuated in the natural resource industries because of the basic nature of the industries and the special tax provisions which have been adopted to date.

Because there is a long delay between the outlay of expenditures to find mining and petroleum reserves and the resulting income, and because there is a continuing need to find new reserves for the future, deductibility of the expenditures as they occur can be extremely important. For companies engaged solely in production, the acceleration of the write-off of expenditures beyond a certain degree is of little significance, because even a moderate degree of acceleration will permit income tax to be deferred for many years. Furthermore, if provision is made for the accelerated write-off of expenditures, a special incentive based on income, such as a percentage depletion allowance, is not of much consequence for such companies because their income, and therefore their right to claim depletion, may be deferred until far into the future. For an integrated company, however, it may be possible to absorb immediately expenditures that will produce

long-term benefits and also to claim a depletion allowance relatively quickly. This is especially true where the form of corporate organization has enabled expenditures to be charged against income other than production income and depletion allowances to be calculated on the production income. Thus, while the tax provisions have enabled the unintegrated producing company to defer payment of tax for a long time, they have provided an even greater advantage to the integrated company.

The recommendations for removal of the percentage depletion allowances will serve to reduce this sharp discrimination between the integrated and unintegrated companies.

Representations have often been made that the United States operator has an advantage in carrying out oil operations in Canada compared with the Canadian operator, because of the operation of United States income tax laws. Where a United States corporation is operating in Canada through a branch, this advantage appears to arise from the possibility of writing off costs of the Canadian operations against other income in the United States, and from the fact that United States law provides for depletion at 27.5 per cent of gross revenue, subject to a maximum of 50 per cent of net income, on a property-by-property basis. These advantages are not unlike the advantages of a Canadian integrated company over a Canadian unintegrated company. For a United States individual, the relative advantage arises from his ability to deduct costs incurred outside the United States against all his income, and from certain anomalies inherent in the United States method of taxation which permit a tax advantage to be gained through the generous allowances of costs and the preferential treatment of proceeds from oil properties. On the other hand, a United States corporation or individual is not allowed, under United States tax laws, the immediate deduction of all exploration and development costs which is generally permitted to a Canadian corporation engaged in oil operations.

REFERENCES

1/ House of Commons Debates, May 1, 1936, p. 2386.

2/ See Chapter 23, Reference 11/.

3/ Home Oil Ltd. v. M.N.R. [1955] S.C.R. 733.

4/ Imperial Oil Ltd. v. M.N.R. [1960] S.C.R. 735. Imperial Oil claimed that the income subject to depletion amounted to $39,071,000, whereas the Minister contended, and the Supreme Court held, that the income subject to depletion was only $2,370,000. Of the difference, $20 million related to exploration and development costs and the balance to the treatment of loss wells and the unrealized profit on oil and gas produced and retained in inventory.

APPENDIX L

TAXATION OF FOREIGN INCOME UNDER THE UNITED STATES INTERNAL REVENUE CODE

This is an outline of certain aspects of the taxation of foreign income under the United States Internal Revenue Code. Paramount attention is given to recent legislation, particularly the Revenue Act of 1962 which introduced new and extensive rules governing international business. Certain complex rules have been reduced to generalizations which necessarily disregard many qualifications and special rules. All references are to the Internal Revenue Code of 1954 and Regulations thereunder, as amended to April 30, 1966.

BASIC RULES

World Income

Citizens, residents and corporations incorporated in the United States ("domestic corporations") are subject to tax on income from all sources whether domestic or foreign 1/.

Foreign Tax Credit or Deduction

A taxpayer may elect to deduct foreign income taxes paid on foreign source income or to credit the foreign taxes against United States taxes otherwise payable on the foreign source income 2/. A credit for foreign taxes has been provided in the Code in some form since 1918. Foreign taxes creditable include provincial and municipal income taxes.

A United States corporation, but not an individual, is also permitted an indirect credit for foreign taxes under section 902. This section permits a United States corporation in calculating its United States tax on dividends from a foreign corporation to apply the United States tax rate to the profits, calculated by United States rules, of the foreign corporation before foreign income taxes and then to deduct from the United States taxes otherwise payable all the foreign taxes paid, to the extent that the dividend received is deemed to have been paid out of the income of a foreign corporation subject to foreign tax.

The indirect credit is available only to a domestic corporation which owns 10 per cent or more of the voting stock of the foreign corporation. A corporation may also credit its share of eligible taxes if the foreign corporation in turn owns 50 per cent or more of the voting stock of a subsidiary of the foreign corporation, that is, a second-tier corporation. No credit is available for taxes paid by third and more remote tiers.

A United States taxpayer is further entitled to elect whether to take an "overall limitation" or a "per country limitation" on the foreign tax credit claimed 3/. If the former is elected, all foreign source income is lumped together and one calculation is performed which includes all foreign income taxes paid on the income in question. If the latter is elected, a separate calculation is performed for each country. The overall limitation may not be applied to certain interest income, generally, interest not derived from the active conduct of trade or business or from a corporation in which the taxpayer owns at least 10 per cent of the voting stock. This qualification was added by the Revenue Act of 1962. Any excess of credit over United States taxes payable, which the credit utilized in any one year may not exceed, may be carried back to the two taxable years next preceding the one in which the excess credit is generated and carried forward for five succeeding taxable years.

Source of Income

Determination of the source of income is basic to the United States system of taxation of income having a connection with the United States. It is specially important in the operation of the foreign tax credit rules because of the possibility that a foreign country may tax income which is regarded under United States law as being United States source income. In such a case, the United States taxpayer may be subject to double taxation, unless relieved by a tax convention, because he will not be allowed credit under United States tax law for taxes paid on income which is deemed by United States law to arise from United States sources.

The source rules are briefly as follows 4/. The source of interest income is ordinarily the place of residence of the payor. For this purpose, all

domestic corporations are residents of the United States whether or not they do business or own property in the United States, and foreign corporations are residents if they are engaged in trade or business in the United States. There are three exceptions to the payor test. One takes into account the possibility of tracing the source of interest to the source of the income of the payor and the other two exceptions apply to certain aspects of the banking business.

In determining the source of dividend income, the place of incorporation and of the source of the income of the paying corporation are taken into account in the application of certain relatively complex rules. The source of rent and royalty income is generally the place of location of the property giving rise to the income or the place where the property is used or is usable under licence. Services are deemed to give rise to income in the place where the services are performed. The source of income from the sale of real property is where the property is located, and income derived from the purchase and sale of personal property is deemed to be derived from the place where title to the goods passes to the buyer under the contract. If bare legal title is retained by the seller, the sale takes place where beneficial ownership and risk of loss is passed 5/. The source rule on the purchase and sale of personal property applies to the sale of securities as well as to goods and a sale includes an exchange. However, income from the production and sale of personal property is generally treated as derived partly from the place of production and partly from the place of sale.

SOME SPECIAL RULES— EXEMPTIONS AND LIMITATIONS

Earned Income of Citizens Resident Outside the United States

A United States citizen resident abroad is not subject to United States tax on foreign source income for personal services:

1. Up to $20,000 if he has been a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year; and

2. Up to $25,000 after three consecutive years of bona fide residence.

A taxpayer who has not established residence abroad may exclude from income subject to United States tax up to $20,000 of compensation earned abroad if he has been present in a foreign country for 510 full days (17 months) in a period of 18 consecutive months. If the 18-month period begins or ends during a taxable year, the exemption is limited to the proportionate part of $20,000. Special provisions cover other situations involving partial tax years 6/.

Western Hemisphere Trade Corporations

The law includes several qualifications to the general rule that a United States corporation is fully taxable currently on all its income from whatever source. For example, a United States corporation which is a "western hemisphere trade corporation" is granted, under provisions introduced in 1942, a deduction of approximately 14 percentage points for specified types of operations in the western hemisphere outside the United States. Briefly stated, a western hemisphere trade corporation is a United States corporation all of the business of which (other than incidental purchases) is done in any country or countries in North, Central or South America or in the West Indies, 95 per cent or more of the gross income of which for the three-year period immediately preceding the close of the taxable year was derived from sources outside the United States and 90 per cent or more of the gross income of which for the same period was derived from the active conduct of a trade or business 7/. A western hemisphere trade corporation subsidiary may be included in a consolidated return with a fully taxable United States parent corporation 8/ and, as a result of the 1964 amendments to the Code, is enabled to pass dividends to the parent without additional tax on the dividend, when it is included in a consolidated return. The credit for foreign taxes is available, but the credit is reduced to prevent the spread of the benefit or the preferential tax rate accorded to the western hemisphere trade corporation to other corporations in the group when an overall limitation is used and the taxable income of the western hemisphere trade corporation is derived from different countries than

is the income of the other corporations 9/. Dividends may also be paid to the parent without tax when an election is made by the parent to take a full deduction for dividends received 10/. Both the election to take the "100 per cent dividends received" deduction and the election to file a consolidated return result in loss of the separate surtax exemption of the western hemisphere trade corporation.

Possessions Corporations

Another provision of long standing grants certain exclusions from income for United States corporations engaged primarily in earning income from United States possessions 11/.

SOME SPECIAL RULES—INCLUSIONS

Foreign Personal Holding Companies

The foreign personal holding company provisions of the Code were enacted in 1937, primarily to prevent citizens and residents from avoiding United States tax by transferring their securities to a foreign holding company. Section 551 of the present Code provides that the undistributed foreign personal holding company income of a foreign personal holding company shall be included in the gross income of citizens or residents of the United States and domestic corporations to the extent of the dividend which would have been distributed to them had the undistributed foreign personal holding company income been paid out as dividends. A company is a foreign personal holding company if at least 60 per cent of its gross income, as defined for that purpose for a taxable year, is foreign personal holding company income (50 per cent in taxable years subsequent to the first taxable year in which the 60 per cent test is met) and more than 50 per cent in value of its outstanding stock is owned directly or indirectly at any time during its taxable year by or for not more than five individuals who are citizens or residents of the United States.

Foreign personal holding company income is defined as that portion of gross income which consists of dividends, interest, royalties, annuities, gains from the sale or exchange of stock or securities, gains from futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange, certain income relating to estates and trusts, income from personal service contracts where the individual who is to perform the services is designated in the contract or may be designated by some person other than the corporation in certain circumstances, income from the use of corporation property by shareholders, and rents which do not constitute 50 per cent or more of the gross income of the corporation. It is to be noted that the 60 per cent (50 per cent) requirement relates to the gross income of the foreign company. If that test is met, the United States shareholder must include in his gross income his allocable share of the entire taxable income, which is computed as if the corporation were a United States taxpayer.

The Revenue Act of 1962 —
"Controlled Foreign Corporation"

The scope of United States income tax law prior to the 1962 Revenue Act may be summarized as follows. Apart from the taxation of income from United States sources, and subject to the foreign personal holding company provisions of the Code, United States individuals and United States corporations could engage in business outside the United States through the instrumentality of a foreign corporation without subjecting the profits from such operation to United States taxes until the profits were repatriated. If they were repatriated in the form of dividends, they would be taxed as ordinary income subject to foreign tax credit. In the event of the sale or exchange of stock of a foreign corporation, which includes the liquidation of the foreign corporation except in special circumstances, the gain would be taxed at the special capital gain rate. The Revenue Act of 1962 made substantial changes in the taxation of the foreign activities of United States persons, both individuals and corporations, and the provisions of that Act will be set out somewhat more extensively than the prior law.

Subpart F Income 12/. Certain types of income of controlled foreign corporations ("subpart F income"), even though undistributed, are included in the income of United States shareholders in the year the income is earned by the foreign corporation. In these cases, the shareholders are permitted to take the foreign tax credit to the same extent as if actual distribution had been made. United States shareholders are defined as "U. S. persons" with a 10 per cent stock holding. "U. S. persons", generally speaking, are United States citizens or residents and domestic corporations, partnerships, and estates or trusts. Each United States shareholder to be so taxed must either actually or constructively have at least a 10 per cent interest in the voting power of all classes of stock of a controlled foreign corporation. A foreign corporation is a controlled foreign corporation for this purpose only if more than 50 per cent of the combined voting power of all classes of stock is owned directly or constructively by these United States shareholders each having a 10 per cent or greater stock interest. To bring the provisions into play, a foreign corporation must be a controlled foreign corporation for a period of 30 days or more during any taxable year beginning after December 31, 1962, and only a person who is a United States shareholder on the last day such corporation is a controlled foreign corporation in any year is subject to United States tax on his pro rata share of subpart F income.

Two categories of undistributed income are taxed to the United States shareholders of controlled foreign corporations. The first category involves income derived from the insurance or reinsurance of United States risks and was designed to avoid practices resulting from the Life Insurance Company Income Tax Act of 1959. These provisions are not thought relevant to Canadian experience and will, therefore, not be discussed herein. The other category is referred to as foreign base company income. Foreign base company income is broken down into foreign personal holding income, foreign base company sales income and foreign base company services income. Collectively, the income derived from insurance or reinsurance of United States risks and foreign base company income is referred to as "subpart F income". The amount

of this which may be taxed in any year is limited to the earnings and profits of the controlled foreign corporation for the taxable year less deficits of that and other controlled foreign corporations not offset since 1959.

Earnings Invested in United States Property 13/. In addition to certain types of undistributed earnings being treated as if they were distributed to the United States shareholders of controlled foreign corporations, the Act also provided that increases in earnings invested in United States property, with certain exceptions, are to be taxed to United States shareholders. In general terms, United States property includes tangible property located in the United States, stock of a United States corporation, an obligation of a United States person and patents, copyrights and technical data acquired or developed for use in the United States. Earnings invested in United States property are treated first as arising out of subpart F income which means that, to the extent that subpart F income is taxed to United States shareholders, the income of the corporation will not again be taxed to the United States shareholders because of investments in United States property. Similarly, actual dividend distributions are treated first as being paid out of earnings invested in United States property, then out of subpart F income, and only finally, if any balance remains, out of the accumulated earnings and profits of the corporation which have not already been taxed to the shareholders. Only when actual dividends are treated as paid out of this latter category do they represent taxable dividends to the shareholders.

The earnings of a corporation classified as subpart F income or as investments in United States property give rise to taxable income to the United States shareholders only with respect to the portion of the earnings represented by the portion of the year in which the corporation was a controlled foreign corporation and the shareholders are taxed only on their allocable shares of the earnings. However, the provision applicable to increases in earnings invested in United States property is operative with respect to the total earnings of the controlled foreign corporation irrespective of when they are earned.

Foreign Base Company Income 14/. Foreign base company income consists of foreign personal holding company income, foreign base company sales income and foreign base company services income which are discussed below. Excluded from foreign base company income are dividend and interest income from 10 per cent related persons (and gains from the sale or exchange of the underlying investments) which are attributable to certain investments in less developed countries. Also excluded is certain income from shipping. Special rules apply where gross income giving rise to the foreign base company income represents less than 30 per cent or more than 70 per cent of the controlled foreign corporation's gross income. A further exception is provided for a foreign corporation where it is established to the satisfaction of the Treasury Department that the foreign corporation is not utilized to reduce taxes. The exclusions and special rules are discussed briefly below.

Foreign Personal Holding Company Income 15/. This category involves income which under other provisions of the Code already is defined as "foreign personal holding company income". Generally speaking, this is income which is passive in character. It includes income from dividends, interest, most royalties, annuities, etc. In this connection, the Senate Committee on Finance said:

> "Your committee, while recognizing the need to maintain active American business operations abroad on an equal competitive footing with other operating businesses in the same countries, nevertheless sees no need to maintain the deferral of U. S. tax where the investments are portfolio types of investments, or where the company is merely passively receiving investment income. In such cases there is no competitive problem justifying the postponement of the tax until the income is repatriated." 16/

Three modifications are made in the definition of foreign personal holding company income for the purposes of determining foreign base company income. First, all rental income is included in foreign base company income whereas under section 553 of the Code rental income is included as foreign personal holding company income only if it constitutes less than 50 per cent

of the gross income of the corporation. Second, rents and royalties received from an unrelated person and derived from the active conduct of a trade or business are excluded from foreign base company income, as are dividends, interest and gains from the sale or exchange of stock or securities derived in the conduct of a banking, financing or similar business, and also dividends, interest and gains from the sale of stock or securities derived from the investment made by an insurance company of its unearned premiums or reserves necessary for the proper conduct of its insurance business. In this second category, only income from unrelated persons will qualify for the exemption. The third type of exception is made for income received from related parties. This is designed to avoid taxing the United States shareholders on dividends received by a controlled foreign corporation from a related party where the United States shareholder would not have been taxed if he had owned the stock of the related party directly. For this reason, dividends and interest received from a related corporation, which is organized under the laws of the same foreign country as the controlled corporation and has a substantial part of its assets used in its trade or business located in that foreign country, are not included in the foreign base company income. Rents, royalties and similar payments received from a related party, whether or not incorporated in the same jurisdiction, are also excluded from foreign base company income if these amounts are received for the use of property within the country in which the controlled foreign corporation is incorporated. Also excluded from foreign personal holding company income in determining foreign base company income is interest received by a banking or financing business firm from a related person also engaged in the banking or financing business, if the business of each is predominantly with unrelated persons. Therefore, foreign base company income will not arise merely because of normal business transactions between two or more related financial institutions.

Foreign Base Company Sales Income 17/. Foreign base company sales income is derived from the purchase and sale of personal property if the property is either purchased from a related person or sold to a related person and is

manufactured, produced, grown or extracted outside of the country where the controlled foreign corporation is organized and the property is also sold for consumption or use outside of that country. The provisions also cover similar cases where the controlled foreign corporation does not take title to the property but acts on a fee or commission basis. The definition does not include cases where any significant amount of manufacturing, major assembling or construction activity is carried on with respect to the product by the selling corporation. However, activities such as minor assembly, packaging, repackaging or labelling are not sufficient to exclude the profits from the definition 18/.

The Senate Committee stated:

> "The sales income with which your committee is primarily concerned is income of a selling subsidiary (whether acting as principal or agent) which has been separated from manufacturing activities of a related corporation merely to obtain a lower rate of tax for the sales income. This accounts for the fact that this provision is restricted to sales of property to a related person, or to purchases of property from a related person. Moreover, the fact that a lower rate of tax for such a company is likely to be obtained only through purchases and sales outside of the country in which it is incorporated, accounts for the fact that the provision is made inapplicable to the extent the property is manufactured, produced, grown, or extracted in the country where the corporation is organized or where it is sold for use, consumption, or disposition in that country. Mere passage of title or the place of the sale are not relevant in this connection." 19/

Also included in foreign base company sales income are operations handled through a branch rather than a corporate subsidiary operating outside the country in which the controlled foreign corporation is incorporated, if the combined effect of the tax treatment accorded the branch by the country of incorporation of the controlled foreign corporation and the country of operation of the branch is to treat the branch substantially the same as if it were a subsidiary of a foreign corporation organized in the country in which it carries on its trade or business.

<u>Foreign Base Company Services Income</u> 20/. Foreign base company services income is derived from the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial or similar services,

but only where they are performed for or on behalf of a related person and are performed outside the country under the laws of which the controlled foreign corporation is created or organized. Not included is income derived in connection with the performance of services which are directly related to the sale or exchange by the controlled foreign corporation of property manufactured, produced, grown or extracted by it and which are performed prior to the time of the sale or exchange, or of services directly related to an offer or effort to sell or exchange such property.

As in the case of sales income, the purpose of including foreign base company services income is to deny tax deferment where a service subsidiary is separated from the manufacturing or similar activities of a related corporation, and is organized in another country primarily to obtain a lower rate of tax for the service income.

The 30-70 Rule 21/. The three categories of income described above which are called foreign base company income are taxed to the United States shareholder of a controlled foreign corporation only if the foreign base company income amounts to at least 30 per cent of the gross income of the corporation. If gross income giving rise to the foreign base company income exceeds 70 per cent of gross income, the entire gross income (reduced by certain deductions) of the corporation is treated as foreign base company income. Between these limits, only the actual foreign base company income is taken into account.

Qualified Investments in Less Developed Countries 22/. Although otherwise classified as foreign base company income, dividend and interest income and gains from the sale or exchange of qualified investments in less developed countries are excluded from subpart F income to the extent that these amounts are reinvested in qualified investment in less developed countries 23/. Provision is also made for an increase in the income taxable to the United States shareholders whenever there is a decrease in qualified investments in less developed countries, to the extent they were initially attributable to dividends, interest or gains of the type referred to above.

Qualified investments in less developed countries consist of stock of a less developed country corporation and obligations of such corporations which at their time of acquisition by the controlled foreign corporation had a maturity of one year or more. However, for either the stock or obligations to qualify, the controlled foreign corporation must own 10 per cent or more of the voting power of all classes of stock of the less developed country corporation and the investment must be held for six months. Qualified investments also include obligations of a less developed country.

Less developed country corporations fall into two categories. One category includes foreign corporations incorporated in the less developed country which are engaged in the active conduct of a trade or business, which derive 80 per cent or more of their income from sources within less developed countries and which have 80 per cent or more in value of their assets in property generally used in a trade or business in less developed countries or in certain other specified types of associated property. The other category is foreign corporations, not necessarily incorporated in a less developed country, receiving 80 per cent or more of the gross income from shipping or airline activities connected with less developed countries.

To the President of the United States is delegated the power to designate a country or territory a less developed country for the purposes of the Code. However, expressly excluded from the category are 21 countries, generally the most highly developed economically. Countries within the Sino-Soviet Bloc are also excluded. The President may not terminate such designation unless at least 30 days prior to such termination he has notified the Senate and the House of Representatives of his intention to terminate the designation.

The concept of less developed country corporations is also used, as noted above, in connection with the indirect credit for foreign taxes and, as will be noted, in connection with the United States tax treatment of the gain from the sale or exchange (including the liquidation) of a controlled foreign corporation.

<u>Schedule of Minimum Distribution</u>. A domestic corporation need not include subpart F income in its gross income if the foreign corporation generating the subpart F income has paid a substantial rate of foreign income tax, or made a substantial current distribution of earnings to the United States shareholders, or some combination of these factors exists. The object of the provision is to bring the overall United States and foreign tax rates up to 90 per cent of the United States rate. To qualify for the exception, the domestic parent corporation must make an election prior to the last date for filing a return and must determine whether the election will cover:

1. A single controlled foreign corporation;
2. A chain of controlled foreign corporations;
3. All controlled foreign corporations;
4. All controlled foreign corporations other than less developed country corporations.

The required distribution from one or more controlled foreign corporations depends upon the effective foreign tax rate and, generally, as the rate increases the percentage of profits required to be distributed decreases. For example, for taxable years beginning after December 31, 1964, if the effective foreign tax rate is under 9 per cent, the required minimum distribution of earnings and profits is 83 per cent; if the effective foreign tax rate is at least 43 per cent, no earnings or profits need be distributed.

For the purposes of the minimum distribution schedule, taxpayers may treat foreign branches of United States corporations as if they were wholly owned foreign subsidiaries distributing 100 per cent of their earnings. Special rules apply to certain United States possessions. Further, a taxpayer in computing the minimum distribution may omit income from a foreign corporation if it is established to the satisfaction of the Treasury Department that its earnings were blocked because of currency or other restrictions imposed by the laws of a foreign country.

The effective foreign tax rate referred to in the minimum distribution schedule is determined by expressing the income taxes, paid or accrued to the foreign countries or possessions of the United States by the foreign corporation or corporations involved, as a percentage of the earnings and profits of the foreign corporation or corporations plus the foreign taxes themselves. The earnings and profits must be determined according to rules substantially similar to those applicable to domestic United States corporations.

A distribution may be treated as being made in the year if paid within 180 days after such year 24/. If a United States shareholder in making its return applies the minimum distribution schedule and subsequently it is found that for reasonable cause it has not met the minimum schedule, subsequent distributions may be made by the controlled foreign corporation, as prescribed by regulations, and may be treated as if they had been made in the earlier qualifying period.

Export Trade Corporations 25/. Certain income of export trade corporations is excluded from subpart F income. To qualify for the deduction of export trade income, 90 per cent or more of the controlled foreign corporation's gross income for the three-year period preceding the close of the current taxable year must have been derived from sources outside the United States, and 75 per cent of the corporation's gross income must have reflected export trade income which is defined as the net income from one or more of the following transactions:

1. The sale to unrelated persons for export from the United States of goods manufactured, grown, produced or extracted in the United States ("export property"), and services in respect of the installation or maintenance of such export property.

2. Services performed in connection with the use outside of the United States of certain types of intangible property.

3. Commissions, fees or similar compensation from the use by an unrelated person of export property or from the rendering of technical, scientific or engineering services to unrelated persons and attributable to the use of export property.

4. Interest from evidences of indebtedness executed in connection with the payment for purchases of export property.

If 50 per cent or more of the gross income of the controlled foreign corporation is derived from income from agricultural products grown in the United States, the 75 per cent requirement does not apply.

The deduction is further limited to the lesser of (a) one and one-half times export promotion expenses properly allocable to the export trade income, or (b) 10 per cent of the gross receipts, accruing to the export trade corporation from the sale, installation, operation, maintenance, or use of property in respect of which the corporation derives export trade income, properly allocable to the export trade income which constitutes foreign base company income. Furthermore, the reduction may not exceed an amount which bears the same ratio to the increase in the investment in assets connected with the export trade as the export trade income which constitutes foreign base company income bears to the entire export trade income of the corporation for a year.

Foreign Tax Credit 26/. United States shareholders who are taxed on subpart F income, on a decrease in investments in less developed countries, or on the increase in earnings invested in United States property may take credit for foreign taxes paid by the foreign corporation if the shareholder is the person to whom such foreign credit would be allowed in the case of an actual distribution. Taxes so allowed as credit will not again be allowed as credits when actual distributions are made, nor will the distributions be taxable. However, where the foreign country imposes a tax directly on dividend distributions, such tax would not initially be taken into account when the shareholder at an earlier date was taxed on undistributed earnings of a controlled foreign corporation. These taxes on actual dividend payments will be allowed

as credits in the year in which the actual dividends are paid even though these dividends are not taxable to the United States taxpayer receiving them because of an earlier inclusion of these amounts in income. Adjustments are made in the overall and per-country limitations to keep these limitations from reducing the creditable taxes in such cases below what could be credited if the income taxed and taxes attributable to this income had been taken into account in the same year. If the taxpayer has insufficient United States income tax against which to offset such credits in the year of the actual distribution, refunds are allowed.

Adjustment to Basis of Stock 27/. Because a United States taxpayer will be subject to taxes on the gain from the sale or exchange of stock in a controlled foreign corporation (including a liquidation), it is necessary, where amounts not actually distributed to a taxpayer are nevertheless taxed to him, to increase his basis for the stock in the controlled foreign corporation by the amounts so taxed to him. If subsequently actual distributions are made which do not result in any tax to the shareholder because of the prior tax payments by him, the basis of the stock is reduced accordingly.

Election of an Individual to be Treated as a Corporation 28/. An individual shareholder who is subject to the subpart F rules may elect to be taxed on that portion of his income as if he were a corporation. This is designed to equate his position to that which would have obtained if he had invested through a domestic corporation rather than directly in a foreign corporation.

Gain from Sale or Exchange of Stock 29/. Prior to the 1962 Revenue Act, it was possible to distribute to a United States shareholder earnings accumulated by a foreign corporation merely by paying tax at capital gain rates on such earnings included in the gain. This could be accomplished either by the sale or exchange of the stock in the foreign corporation or by the liquidation of the company. It was also theoretically possible to realize on earnings accumulated by a foreign corporation without payment of any income tax at all in the United States by the use of a tax-free reorganization 30/ or through the

use of a tax-free liquidation 31/. However, to achieve this end, it was necessary to obtain from the Commissioner of Internal Revenue an advance ruling that the transaction was not "in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes" 32/. Generally, the Commissioner was unwilling to grant such approval where an appreciable amount of earnings and profits had been accumulated in a foreign corporation.

The 1962 Revenue Act added section 1248 of the Code which applies to any shareholder who owns 10 per cent or more of the total combined voting power of the stock of a foreign corporation at any time during the five-year period ending on the date of sale or exchange, but only if the corporation was a controlled foreign corporation at any time during the period that the stock was owned by the shareholder. The 10 per cent ownership is determined under the constructive ownership stock rules which apply to subpart F income and are contained in section 958 of the Code. Section 1248 applies to any sale or exchange or to any surrender of stock to the corporation for redemption in a transaction which would be treated as a sale or exchange under sections 302 or 331 of the Code (a buy-out or a total or partial liquidation). When there is a gain on the transaction, there is included, as a dividend, in the gross income of the person surrendering the stock the portion of such gain attributable to the earnings and profits of the foreign corporation allocable to the stock surrendered, accumulated while the shareholder held the stock during the period in which the corporation was a controlled foreign corporation in taxable years beginning after December 31, 1962.

If the shareholder surrendering the stock is a corporation, it is entitled to a credit for foreign taxes paid by the foreign corporation in the same manner and to the same extent as it would be entitled to such credit in the case of any other dividend received from a foreign corporation. If the shareholder is an individual, the tax to be paid by him is not to be greater than the sum of the following amounts:

1. The excess of the United States income taxes which would have been paid by the foreign corporation with respect to its income if it had been a domestic corporation over the foreign income taxes actually paid by such corporation.

2. The amount of capital gains which would have resulted to the shareholder on the surrender of his stock, if the amount actually received by him on such surrender were diminished by the first amount described above.

The limitation does not apply unless the taxpayer establishes the amount of foreign taxes to be taken into account.

The earnings and profits for the purposes of this section do not include any amount attributable to gains on sales made in the course of a liquidation if these sales would have been treated as tax-free sales on liquidation had the corporation been a domestic corporation. Further, the section does not apply to earnings and profits accumulated by a foreign corporation while it was a less developed country corporation if the stock sold or exchanged was owned for at least ten years by the United States person before the date of the sale or exchange. A transfer of stock by death is viewed as not interrupting the continuous ownership.

The section also provides that any item of gross income of the foreign corporation treated as income derived from sources within the United States is not to be included in the earnings and profits to be taken into account. Also, earnings taxed under subpart F will not be taxed a second time under this section. The provision does not apply to distributions to pay death taxes 33/ or to gain realized because of "boot" on a reorganization exchange 34/. It likewise does not apply to any amount which is treated under any other section of the Code as a dividend, as a gain from the sale of an asset which is not a capital asset, or as a short-term gain. Unless the taxpayer establishes the amount of the earnings and profits of the

foreign corporation to be taken into account, the entire gain from the sale or exchange is considered a dividend.

Sale or Exchange of Patents, Copyrights and Similar Property. Section 1249 of the Code, added by the Revenue Act of 1962, provides that gain from the sale or exchange after December 1962 of a patent, invention, model or design (whether or not patented), a copyright, a secret formula or process or any other similar property right to any foreign corporation by a United States person which controls such foreign corporation is to be treated as ordinary income rather than as capital gain if, but for the section, the gain would be entitled to capital gain treatment under the Code. The provision does not apply to gains from the sale or exchange of trade marks. For the purposes of the section, control means the ownership directly or indirectly of stock possessing more than 50 per cent of the total combined voting power of all classes of stock and ownership may be determined by the constructive ownership rules of section 958.

Allocation of Income and Deductions

Section 482 of the Code provides:

> "In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses."

Existing regulations introduce the concept of "true taxable income" to apply in the case of a controlled taxpayer and to mean the taxable income which would have resulted to the controlled taxpayer had it in the conduct of its affairs dealt with the other member or members of the group at arm's length 35/. The Regulations state that the purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining according to the standard of an uncontrolled taxpayer

the true taxable income from the property and business of a controlled taxpayer 36/. Further, the Regulations state:

> "Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes. In determining the true taxable income of a controlled taxpayer, the district director is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to a case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances. The authority to determine true taxable income extends to any case in which either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." 37/

More extensive regulations have been proposed to deal with specific classes of cases, as follows: 38/

1. An arm's length interest rate must be charged on loans between members of a controlled group. The proposed regulations list as pertinent factors the amount of the loan, the security involved, the credit standing of the borrower, the interest rate prevailing at the situs of the lender or creditor for comparable loans, and other relevant facts. If the creditor was not regularly engaged in the business of lending to unrelated parties, and if the taxpayer cannot establish to the satisfaction of the district director an appropriate rate, a rate fixed by the parties between 4 per cent and 5 per cent will be acceptable or, if they have not fixed such a rate, a rate of 5 per cent will be deemed to be appropriate.

2. The price for services performed by one member of a controlled group for another may be determined on the basis of their cost. No allocation will be made under the proposed regulations if the party rendering the services has itself made an allocation to reflect these services "by employing in a consistent manner a method of allocation which is reasonable and in keeping with sound accounting practice". The costs to be taken into account are set out in detail.

3. An arm's length rental charge must be made for the use of tangible property supplied by one member of a controlled group to another. The approach taken to establish an arm's length rental charge is similar to that applied to determine an arm's length interest rate.

It is expected that regulations will be proposed shortly to deal with inter-company pricing of goods and the transfer of intangibles. Litigation which promises to lay down important principles in connection with inter-company pricing for goods is presently under way in the United States Court of Claims.

TRANSFER OF PROPERTY TO FOREIGN CORPORATIONS

Under section 351 of the Code, no gain or loss is recognized for tax purposes if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in the corporation and immediately after the exchange such person or persons are in control of the corporation. Control is defined to mean the ownership:

1. Of stock having 80 per cent of total voting power, and

2. Of 80 per cent of all other stock 39/.

However, under section 367 transfers to a foreign corporation do not qualify for this treatment unless, before such exchange, a ruling has been obtained that the "exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes" 40/. Property for this purpose includes patents, trade marks, copyrights, plans, drawings, designs, specifications, secret processes, secret formulae and other like property, as well as other assets. Where the Internal Revenue Service is satisfied that there is a bona fide business purpose for the transfer, or that the income tax in the foreign country will be at least as high as the United States income tax if the operation were conducted through a domestic corporation, the Internal Revenue Service will generally grant a favourable ruling. In the absence of

a ruling, any difference between the fair market value of the property transferred and its tax base to the transferor is taxable at the capital gain rate or the income rate, depending on the nature of the property. Section 367 is designed to prevent avoidance of United States taxes in various ways, including transferring property to a foreign corporation and then selling it at a gain free of United States tax.

TRANSFER OF SECURITIES TO FOREIGN ENTITIES

Following the principle of section 367, the Code also provides that the transfer of stock or securities by a citizen or resident of the United States or by a domestic corporation or partnership or by a trust which is not a foreign trust to a foreign corporation as paid in surplus or as a contribution to capital or to a foreign trust or partnership is subject to an excise tax of 27.5 per cent on the excess of the value of the stock or securities over their tax base in the hands of the transferor 41/. The tax does not apply if, before the transfer, it has been established to the satisfaction of the Internal Revenue Service that such transfer is not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes 42/. It is also provided that the tax may be abated, remitted or refunded if, after the transfer, it is established that the transfer was not in pursuance of such a plan 43/.

FOREIGN TRUSTS CREATED BY UNITED STATES GRANTORS

Prior to the Revenue Act of 1962, foreign trusts could be used to accumulate income free of United States tax if their income was not from United States sources. Tax-free distribution of the accumulated income of a trust was possible in several situations. The 1962 Act provided for taxing United States beneficiaries on distributions received from foreign trusts, which are created by United States grantors, settlors, or transferors, in substantially the same manner as if the income had been distributed to the beneficiary currently as earned, instead of being accumulated in the trust. The

new provision applies to foreign trusts to the extent money or property has been transferred directly or indirectly by United States persons or under the will of a decedent who was a United States citizen or resident. The amendments are effective for trust distributions made after December 31, 1962, out of income accumulated after 1953, regardless of the time the trust was created. The rules are set out in several sections applicable to trusts and estates.

INFORMATION RETURNS

Foreign Personal Holding Companies 44/

Officers, directors and 50 per cent shareholders must file annually an information return which covers identification of shareholders, plans for liquidation, and organizations and reorganizations which have taken place. Officers and directors must also report annually gross income, taxable income, and total and undistributed foreign personal holding company income.

Controlled Foreign Corporations 45/

Citizens, residents and domestic corporations, partnerships, trusts and estates that control a foreign corporation (more than 50 per cent in value of stock or more than 50 per cent of voting power) are required to report annually extensive information about the foreign corporation and its subsidiaries, including current earnings and profits, foreign taxes paid or accrued, distributions, balance sheet and profit and loss statement, certain transactions with related persons and a list of United States persons owning 5 per cent or more in value of any class of stock. In addition to the usual penalties for failure to file and for filing false returns, such default may be penalized by a reduction of credit for foreign taxes under section 6038. This section, which existed in the Code prior to the 1962 Act, was subtantially stiffened and expanded as part of the new legislation affecting foreign corporations.

Under section 6046, each United States citizen or resident who is or becomes an officer or director of a foreign corporation, 5 per cent or more

in value of the stock of which is owned by a United States person, and each United States person who owns 5 per cent or more in value of the stock of a foreign corporation, or adds 5 per cent or more in value to such stockholding, or reduces the holding to less than 5 per cent, must report within 90 days of the time that he acquires the status information as to certain shareholders, the organization or reorganization of the corporation, business activities, financial statements and assets transferred to the corporation. This section was also stiffened and expanded by the Revenue Act of 1962.

Transfer of Securities to
Foreign Entities 46/

A transfer of securities to a foreign entity must be reported at the time of the transfer.

Foreign Trusts 47/

Returns are required, within 90 days after the event, in connection with the creation of foreign trusts by a United States person and a transfer of money or property to such a trust. This requirement was added by the 1962 Act.

TREATIES

The United States has treaties with 22 countries for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income. Several other treaties have been signed but not ratified, or are in preparation. United States tax treaties are entered into by the President of the United States with the advice and consent of the United States Senate. Treaties receive further legislative implementation in the Code, which provides that income of any kind, to the extent required by any treaty obligation of the United States, is not included in gross income and is exempt from income tax 48/. Further, another section of the Code states that no provision of the Code applies in any case where its application would be contrary to any treaty obligation of the United States in effect on the date of the enactment

of the Code 49/. The Revenue Act of 1962 provided that the latter provision is to be inapplicable in respect of any amendment made by that Act. However, it is thought that the only treaty affected was the Greek Estate Tax Treaty which has subsequently been modified.

Generally speaking, the tax treaties have their effect on the taxation of foreign corporations and persons doing business in the United States or investing in the United States, but do not affect the taxation of foreign income described in this appendix.

FOREIGN INVESTORS TAX ACT OF 1966

"The foreign investors tax bill of 1966...is designed to provide more equitable tax treatment for foreign investment in the United States." 50/ Therefore, it does not generally touch on the subject of this appendix. However, certain of the rules will be affected in some degree if the bill is passed in its present form and these are noted briefly.

The form of the bill at the date of this writing is as reported to the House of Representatives by the Committee on Ways and Means, April 26, 1966. Before it becomes law, it remains for the bill to be considered and approved by the House of Representatives, considered and approved by the Senate, in the usual course, after full consideration and report by the Senate Committee on Finance, the differences between the House and the Senate resolved and the bill signed into law by the President.

In the context of this appendix, the principal feature of the proposed Act is the provision which will subject to United States tax income which is presently regarded as foreign source income of a foreign corporation but which is effectively connected with the conduct of a trade or business within the United States, that is, which is earned by a foreign corporation which has a fixed place of business in the United States and which is attributable to the place of business. The provision applies only to three types of income from sources without the United States, namely, rents and royalties derived from the active conduct of a licensing business; dividends, interest

or gains on stock or debt obligations derived in the active conduct of a banking, financing, or similar business; and certain sales income attributable to a United States sales office. The sales income is not to be considered as effectively connected with a United States trade or business if the property is sold for use outside of the United States and an office of the foreign person outside the United States contributes materially to the sale. Thus, in this case foreign source sales income will be attributed to the United States trade or business only when the United States office is the primary place of the activity giving rise to the income. In the case of foreign source income where the products are destined for the United States, the income will be treated as effectively connected with a United States business to the extent the sales activity is carried on by the United States office. Income which is "subpart F income" is excluded from the operation of the provision.

REFERENCES

1/ Sections 1, 11 and 61.

2/ Section 901.

3/ Section 904.

4/ Sections 861 - 864.

5/ Regulation 1.861-7(c).

6/ Section 911.

7/ Sections 921 and 922.

8/ Sections 1501 - 1504.

9/ Section 1503(b).

10/ Section 243(a)(3).

11/ Section 931.

12/ Sections 951 - 972.

13/ Section 956.

14/ Section 954.

15/ Section 954(c).

16/ Report of the Senate Committee on Finance, Report No. 1881, 1962, p. 83.

17/ Section 954(d).

18/ Regulation 1.954-3(a)(4).

19/ Op. cit., footnote 16, p. 84.

20/ Section 954(e).

21/ Section 954(b)(3).

22/ Section 955.

23/ Section 954(b)(1).

24/ Regulation 1.963-3.

25/ Sections 970 - 972.

26/ Section 960.

27/ Section 961.

28/ Section 962.

29/ Section 1248.

30/ Sections 354 and 368.

31/ Section 332.

32/ Section 367.

33/ Section 303.

34/ Section 356.

35/ Regulation 1.482-1(6).

36/ Regulation 1.482-1(b).

37/ Regulation 1.482-1(c).

38/ Proposed Treasury regulations 1.482-1(d) and 1.482-2.

39/ Section 368.

40/ Section 367.

41/ Section 1491.

42/ Section 1492.

43/ Section 1494.

44/ Section 6035.

45/ Sections 6038, 6046 and 6679.

46/ Regulation 1.1494-1.

47/ Sections 6048 and 6677.

48/ Section 894.

49/ Section 7852(d).

50/ *Report of the Committee on Ways and Means, House of Representatives,* Report No. 1450, April 26, 1966, p. 1.

APPENDIX M

COMPARISONS OF TAX LIABILITIES ON CORPORATE SOURCE INCOME FROM SHARES FOR TAX UNITS AT DIFFERENT INCOME LEVELS AND WITH DIFFERENT FAMILY CHARACTERISTICS UNDER ALTERNATIVE ASSUMPTIONS UNDER THE CURRENT AND PROPOSED TAX SYSTEMS

The tax payable by, or on behalf of, resident individuals and families with only Canadian corporate source income from shares (plus family allowances where applicable) under the current and proposed systems is shown in the tables provided in this appendix.

Three comparisons are made:

Case 1: A typical public company distributing one half of its after-tax income as dividends.

Case 2: A typical private company distributing one half of its after-tax income as dividends.

Case 3: A typical private company distributing one half of its after-tax income as dividends and the balance under section 105.

A company's income is used to pay its taxes and to pay dividends to shareholders with the balance being saved or reinvested within the company. Shareholders therefore benefit both from receiving dividends and from the corporate savings, which add to the wealth of the company and increase the value of its shares. Shareholders also benefit from another increment in share value attributable to improved prospects for earnings. We refer to this increment as "goodwill" gains. Under our proposals corporation taxes paid by a company would benefit resident shareholders, as they could apply the corporation taxes against their personal tax liabilities. In summary, under the comprehensive definition of income a resident tax unit's income from holding equities would consist of four components:

1. Dividends;
2. Undistributed income of the corporation;
3. Realized goodwill gains; and
4. Corporation taxes paid.

In each of the three cases referred to in the tables which follow, assumptions are made about the relative importance of each of these components. These assumptions are specified in Table M-1.

Goodwill gains under our proposals would be taxable only upon realization, but as it is not practical to estimate when they would be realized we have computed the tax liabilities as though such gains were realized annually. For public companies we have assumed that goodwill gains are equal to cash dividends and we have taken cash dividends to be one half of profits after taxes. Primarily because of the limited marketability of the shares of private companies we have assumed that their goodwill gains are one half of those of public companies.

To assist the reader in interpreting the results shown in the computer-generated tables, 1/ an example is provided of the calculations made for a tax unit with given income and family characteristics for each of the three cases. These examples are given in Tables M-2 to M-4 inclusive. The example in Table M-2 corresponds to the result given in Table M, 1-1, column 1, in the row for a gross corporate source income of $10,000. The example given in Table M-3 corresponds to the result given in Table M, 2-1, column 4, in the row for a gross corporate source income of $8,000. The example given in Table M-4 corresponds to the result given in Table M, 3-1, column 5, in the row for a gross corporate source income of $100,000.

For each of the three cases, three computer tables are provided. The first table shows the difference in taxes under the current and proposed systems. The second shows the effective average rates under the current and proposed systems. The effective average rate is simply the ratio of taxes paid to income. The third provides estimates of the effective marginal rates under the current and proposed systems. The effective marginal rates are computed as the rate of tax on an additional $500 of income assuming that

the rate of tax paid by the corporation on this income is 50 per cent.

In Cases 1 and 2 it is assumed that one half of the after-tax corporate income is undistributed. This undistributed income would be subject to further tax under the current tax law if subsequently distributed. However, this tax may be deferred indefinitely and shareholders can avoid it by the sale of their shares. To give some indication of what this further liability might be, we show at the end of each example the amount of undistributed income remaining after the stipulated distribution. This figure appears only in the column under current tax law as, under our proposals, it is assumed that all of the corporate income is distributed or allocated to shareholders. In Case 3 it is assumed that a full distribution of income has been made under the current tax law so that no further taxes are payable under any circumstances.

The results of Case 3 should be interpreted with caution. Section 105 distributions are only attractive to shareholders with marginal rates in excess of 35 per cent, that is, with taxable incomes in excess of $12,000 under the current system. This corresponds to corporate source income of over $50,000 under the comprehensive tax base.

All of the results in the computer tables are presented in terms of gross corporate source income, which is comprehensive tax base income from the holding of corporate shares. This is not synonymous with cash dividends. To interpret the computer tables in terms of cash dividends, cash dividends should be multiplied by certain factors to obtain gross corporate source income. These factors are derived from the assumptions and estimates given in Table M-1. The factors are as follows:

Case 1 : $\frac{1.00000}{0.20192} = 4.9524$

Cases 2 and 3 : $\frac{1.00000}{0.27957} = 3.5769$

To be more concrete, if an unattached individual received annual cash dividends of $2,019.15 from a public company, and no other income, it is assumed that his gross corporate source income under the comprehensive tax base would be $2,019.15 x 4.9524 = $10,000. As shown in the example given in Table M-2 and in Table M, 1-1, column 1, in the row for a gross corporate source income of $10,000, the current tax liability on this income is $3,979. Under the proposal it would be $1,942. Both personal and corporation taxes are taken into account in all of these calculations.

All of the comparisons given in this appendix are based on the assumption that the full corporation tax is borne by the shareholders and that no part of any reduction in the tax on corporate source income would be shifted in the form of lower prices for goods and services sold or higher prices for goods and services purchased.

All of the comparisons given in this appendix assume that the shareholder is a resident with only Canadian corporate source income from shares.

REFERENCE

1/ The tables were produced using programmes presented in General Income Tax Analyzer by John Bossons, a study published by the Commission.

TABLE M-1

ASSUMED PRESENT COMPOSITION OF A SHAREHOLDER'S CORPORATE SOURCE INCOME DERIVED FROM TYPICAL PUBLIC AND PRIVATE COMPANIES a/

	Expressed as Fractions c/ of After-Tax Corporate Income	Expressed as Fractions of Comprehensive Corporate Source Income b/
Case 1: Typical Public Company		
Dividends	.5	.20192
Undistributed corporate income	.5	.20191
Goodwill gains on corporate stock held by the taxpayer	.5	.20192
Corporation tax paid	-	.39425
Total		1.00000
Cases 2 and 3: Typical Private Company		
Dividends	.5	.27957
Undistributed corporate income (section 105 distributions for Case 3)	.5	.27957
Goodwill gains on corporate stock held by the taxpayer	.25	.13978
Corporation tax paid	-	.30108
Total		1.00000

a/ Based on an assumed current average corporation tax rate on before-tax corporate income of 49.4 per cent for a typical public company and 35 per cent for a typical private company. This assumption has regard to the dual rate of corporation tax and the generally larger incomes of public companies.

b/ The exact relationship between the ratio of a particular income component to total comprehensive corporate source income and the ratio of the component to after-tax corporate income may be determined under the formula set out below. Let r be the ratio of after-tax corporate income to total comprehensive corporate source income; let d, g and s be the ratios of dividends, goodwill gains and section 105 capitalizations respectively to after-tax corporate income; let f be the fraction of dividends and section 105 capitalizations carrying credit for corporation tax under our integration proposals; and let c be the average corporation tax rate. Then

$$r = \frac{1 - c}{1 + [1 - c] [g + (1 - f) (s + d)]}$$

The ratio to comprehensive income of any component expressed as a fraction of after-tax corporate income can be obtained by multiplying that fraction by r.

c/ For a discussion of the assumptions underlying these fractions see Appendix A to Volume 6.

TABLE M-2

CASE 1 EXAMPLE:

CALCULATION OF TAXES UNDER THE CURRENT AND PROPOSED SYSTEMS FOR AN UNATTACHED INDIVIDUAL WITH $10,000 OF COMPREHENSIVE TAX BASE INCOME DERIVED EXCLUSIVELY FROM SHARES IN A TYPICAL PUBLIC COMPANY a/

	Tax Base and Taxes Under the Current System		Tax Base and Taxes Under the Proposed System	
Tax Base	At Corporate Level b/	At Personal Level	At Corporate Level	At Personal Level
Income from corporate sources:				
Dividends	$2,019.15	$2,019.15	$2,019.15	$2,019.15
Other corporate income, before corporation tax	5,961.70 c/	N.A.	5,961.70	5,961.70
Goodwill gains on corporate stock held by taxpayer	-	N.A.	-	2,019.15
Total corporate source base	$7,980.85	$2,019.15	$7,980.85	$10,000.00
Family allowances	-	N.A.	-	-
Total income	$7,980.85	$2,019.15	$7,980.85	$10,000.00 d/
Deductions:				
Family exemptions	-	1,000.00	-	N.A.
Standard deduction	-	100.00	-	50.00
Total deductions	-	$1,100.00	-	$50.00
Net tax base	$7,980.85	$ 919.15	$7,980.85	$9,950.00
Taxes				
Gross tax (before credits)	$3,942.54	$101.11	$3,990.43	$1,942.00
Non-refundable tax credits:				
Credits for dependants	-	N.A.	-	-
Dividend tax credit	-	$403.83	-	N.A.
		$403.83		-
Tax after credits	-	-	-	$1,942.00
Refundable credit on corporation taxes	-	N.A.	-	3,990.43
Personal income tax	-	-	-	($2,048.43)
Old age security tax	-	$ 36.77	-	N.A.
Total tax	$3,942.54	$ 36.77	$3,990.43	($2,048.43)
Total taxes	$3,979.31		$1,942.00	
Undistributed or unallocated income	$2,019.15		-	

a/ Numbers enclosed in parentheses are negative. "N.A." means non-applicable.

b/ The relationship among the components of corporate source income is that specified in Table M-1, column 2, for a typical public company.

c/ Consists of undistributed income of $2,019.15 and corporation tax of $3,942.54 (49.4 per cent of $7,980.85).

d/ This is the income of the taxpayer considered in this example.

TABLE M-3

CASE 2 EXAMPLE:

CALCULATION OF TAXES UNDER THE CURRENT AND PROPOSED SYSTEMS FOR A MARRIED COUPLE WITH TWO CHILDREN WITH A COMPREHENSIVE TAX BASE INCOME OF $8,000 DERIVED EXCLUSIVELY FROM SHARES IN A TYPICAL PRIVATE COMPANY NOT MAKING USE OF SECTION 105 a/

	Tax Base and Taxes Under the Current System		Tax Base and Taxes Under the Proposed System	
Tax Base	At Corporate Level b/	At Personal Level	At Corporate Level	At Personal Level
Income from corporate sources:				
Dividends	$2,236.56	$2,236.56	$2,236.56	$2,236.56
Other corporate income, before corporation tax	4,645.16 c/	N.A.	4,645.16	4,645.16
Goodwill gains on corporate stock held by taxpayer	-	N.A.	-	1,118.28
Total corporate source base	$6,881.72	$2,236.56	$6,881.72	$8,000.00 d/
Family allowances	-	N.A.	-	144.00
Total income	$6,881.72	$2,236.56	$6,881.72	$8,144.00
Deductions:				
Family exemptions	-	2,600.00	-	N.A.
Standard deduction	-	100.00	-	50.00
Total deductions	-	$2,700.00	-	$50.00
Net tax base	$6,881.72	-	$6,881.72	$8,094.00
Taxes				
Gross tax (before credits)	$2,408.60	-	$3,440.86	$1,066.74
Non-refundable tax credits:				
Credits for dependants	-	N.A.	-	160.00
Dividend tax credit	-	447.31	-	N.A.
	-	$447.31	-	$160.00
Tax after credits	-	-	-	906.74
Refundable credit on corporation taxes	-	N.A.	-	3,440.86
Personal income tax	-	-	-	($2,534.12)
Old age security tax	-	-	-	N.A.
Total tax	$2,408.60	-	$3,440.86	($2,534.12)
Total taxes	$2,408.60		$906.74	
Undistributed or unallocated income	$2,236.56		-	

a/ Numbers enclosed in parentheses are negative. "N.A." means non-applicable.

b/ The relationship among the components of corporate source income is that specified in Table M-1, column 2, for a typical private company.

c/ Consists of undistributed income of $2,236.56 and corporation tax of $2,408.60 (35 per cent of $6,881.72).

d/ This is the income of the taxpayer considered in this example.

TABLE M-4

CASE 3 EXAMPLE:

CALCULATION OF TAXES UNDER THE CURRENT AND PROPOSED SYSTEMS FOR A MARRIED COUPLE WITH THREE CHILDREN WITH A COMPREHENSIVE TAX BASE INCOME OF $100,000 DERIVED EXCLUSIVELY FROM SHARES IN A TYPICAL PRIVATE COMPANY CAPITALIZING EARNED SURPLUS UNDER SECTION 105 a/

	Tax Base and Taxes Under the Current System		Tax Base and Taxes Under the Proposed System	
Tax Base	At Corporate Level b/	At Personal Level	At Corporate Level	At Personal Level
Income from corporate sources:				
Dividends	$27,956.99	$27,956.99	$27,956.99	$27,956.99
Section 105 distributions	27,956.99	N.A.	27,956.99	27,956.99
Other corporate income, before corporation tax	30,107.53 c/	N.A.	30,107.53	30,107.53
Goodwill gains on stock held by taxpayer	-	N.A.	-	13,978.49
Total corporate source base	$86,021.51	$27,956.99	$86,021.51	$100,000.00 d/
Family allowances	-	N.A.	-	$ 216.00
Total income	$86,021.51	$27,956.99	$86,021.51	$100,216.00
Deductions:				
Family exemptions	-	2,900.00	-	N.A.
Standard deduction	-	100.00	-	50.00
Total deductions	-	$ 3,000.00	-	$ 50.00
Net tax base	$86,021.51	$24,956.99	$86,021.51	$100,166.00
Taxes				
Gross tax (before credits)	$30,107.53	$ 8,530.65	$43,010.76	$38,760.00
Additional tax on section 105 distributions	4,193.55	-	N.A.	-
Non-refundable tax credits:				
Credits for dependants	-	N.A.	-	220.00
Dividend tax credit	-	$ 5,591.40	-	N.A.
		$ 5,591.40		$ 220.00
Tax after credits	-	$ 2,939.25	-	$38,540.00
Refundable credit for corporation taxes	-	N.A.	-	$43,010.76
Personal income tax	-	$ 2,939.25	-	($ 4,470.76)
Old age security tax	-	120.00	-	N.A.
Total tax	$34,301.08	$ 3,059.25	$43,010.76	($ 4,470.76)
Total taxes	$37,360.33		$38,540.00	
Undistributed or unallocated income	-		-	

a/ Numbers enclosed in parentheses are negative. "N.A." means not applicable.

b/ The relationship among the components of corporate source income is that specified in Table M-1, column 2, for a typical private company.

c/ Consists of corporation tax only (35 per cent of $86,021.51).

d/ This is the income of the taxpayer considered in this example.

TABLE M, 1-1

CHANGES IN TAX LIABILITIES UNDER THE PROPOSED TAX SYSTEM (INCLUDING TAXES PAID BY CORPORATIONS) FOR A TAX UNIT WITH INCOME FROM A TYPICAL PUBLIC COMPANY

GROSS CORPORATE SOURCE INCOME		STATUS OF TAXPAYER: UNATTACHED INDIVIDUAL	MARRIED COUPLE — NUMBER OF CHILDREN: 0	1	2	3	5	8
1500	CURRENT TAX (1966 RATES)	591.	591.	591.	591.	591.	591.	591.
	TAX UNDER OUR PROPOSALS	54.	0.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	-537.	-591.	-591.	-591.	-591.	-591.	-591.
2000	CURRENT TAX (1966 RATES)	789.	789.	789.	789.	789.	789.	789.
	TAX UNDER OUR PROPOSALS	128.	0.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	-661.	-789.	-789.	-789.	-789.	-789.	-789.
2500	CURRENT TAX (1966 RATES)	986.	986.	986.	986.	986.	986.	986.
	TAX UNDER OUR PROPOSALS	212.	46.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	-774.	-940.	-986.	-986.	-986.	-986.	-986.
3000	CURRENT TAX (1966 RATES)	1183.	1183.	1183.	1183.	1183.	1183.	1183.
	TAX UNDER OUR PROPOSALS	297.	111.	21.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	-886.	-1072.	-1162.	-1183.	-1183.	-1183.	-1183.
3500	CURRENT TAX (1966 RATES)	1380.	1380.	1380.	1380.	1380.	1380.	1380.
	TAX UNDER OUR PROPOSALS	395.	189.	101.	52.	4.	0.	0.
	INCREASE OR DECREASE IN TAX	-985.	-1191.	-1279.	-1328.	-1376.	-1380.	-1380.
4000	CURRENT TAX (1966 RATES)	1577.	1577.	1577.	1577.	1577.	1577.	1577.
	TAX UNDER OUR PROPOSALS	495.	269.	181.	134.	87.	0.	0.
	INCREASE OR DECREASE IN TAX	-1082.	-1308.	-1396.	-1443.	-1490.	-1577.	-1577.
5000	CURRENT TAX (1966 RATES)	1971.	1971.	1971.	1971.	1971.	1971.	1971.
	TAX UNDER OUR PROPOSALS	714.	448.	361.	315.	269.	176.	37.
	INCREASE OR DECREASE IN TAX	-1257.	-1523.	-1610.	-1656.	-1703.	-1795.	-1934.
6500	CURRENT TAX (1966 RATES)	2571.	2563.	2563.	2563.	2563.	2563.	2563.
	TAX UNDER OUR PROPOSALS	1063.	737.	651.	606.	560.	469.	332.
	INCREASE OR DECREASE IN TAX	-1508.	-1826.	-1911.	-1957.	-2002.	-2094.	-2230.
8000	CURRENT TAX (1966 RATES)	3175.	3154.	3154.	3154.	3154.	3154.	3154.
	TAX UNDER OUR PROPOSALS	1423.	1037.	952.	907.	862.	772.	637.
	INCREASE OR DECREASE IN TAX	-1752.	-2117.	-2202.	-2247.	-2292.	-2382.	-2517.
10000	CURRENT TAX (1966 RATES)	3979.	3943.	3943.	3943.	3943.	3943.	3943.
	TAX UNDER OUR PROPOSALS	1942.	1457.	1372.	1328.	1284.	1195.	1063.
	INCREASE OR DECREASE IN TAX	-2037.	-2486.	-2571.	-2615.	-2659.	-2747.	-2880.
12000	CURRENT TAX (1966 RATES)	4784.	4744.	4732.	4731.	4731.	4731.	4731.
	TAX UNDER OUR PROPOSALS	2501.	1896.	1812.	1770.	1727.	1641.	1513.
	INCREASE OR DECREASE IN TAX	-2283.	-2848.	-2920.	-2961.	-3004.	-3090.	-3218.
15000	CURRENT TAX (1966 RATES)	5991.	5951.	5939.	5927.	5915.	5914.	5914.
	TAX UNDER OUR PROPOSALS	3400.	2615.	2533.	2492.	2452.	2371.	2249.
	INCREASE OR DECREASE IN TAX	-2591.	-3336.	-3406.	-3435.	-3463.	-3543.	-3665.
20000	CURRENT TAX (1966 RATES)	8003.	7963.	7951.	7939.	7927.	7903.	7885.
	TAX UNDER OUR PROPOSALS	4999.	3964.	3884.	3846.	3808.	3733.	3620.
	INCREASE OR DECREASE IN TAX	-3004.	-3999.	-4067.	-4092.	-4118.	-4170.	-4265.
25000	CURRENT TAX (1966 RATES)	9976.	9974.	9962.	9950.	9938.	9914.	9878.
	TAX UNDER OUR PROPOSALS	6748.	5512.	5435.	5400.	5365.	5296.	5191.
	INCREASE OR DECREASE IN TAX	-3229.	-4463.	-4528.	-4550.	-4573.	-4619.	-4687.
30000	CURRENT TAX (1966 RATES)	11948.	11948.	11948.	11948.	11948.	11926.	11890.
	TAX UNDER OUR PROPOSALS	8597.	7260.	7185.	7153.	7120.	7055.	6957.
	INCREASE OR DECREASE IN TAX	-3351.	-4688.	-4762.	-4795.	-4828.	-4871.	-4933.
40000	CURRENT TAX (1966 RATES)	15890.	15890.	15890.	15890.	15890.	15890.	15890.
	TAX UNDER OUR PROPOSALS	12496.	11058.	10986.	10956.	10927.	10867.	10778.
	INCREASE OR DECREASE IN TAX	-3395.	-4832.	-4904.	-4934.	-4963.	-5023.	-5112.
50000	CURRENT TAX (1966 RATES)	19833.	19833.	19833.	19833.	19833.	19833.	19833.
	TAX UNDER OUR PROPOSALS	16694.	15256.	15187.	15158.	15130.	15073.	14988.
	INCREASE OR DECREASE IN TAX	-3139.	-4577.	-4646.	-4674.	-4703.	-4759.	-4844.
70000	CURRENT TAX (1966 RATES)	28155.	27755.	27718.	27718.	27718.	27718.	27718.
	TAX UNDER OUR PROPOSALS	25692.	24254.	24187.	24160.	24133.	24080.	23999.
	INCREASE OR DECREASE IN TAX	-2463.	-3501.	-3531.	-3558.	-3584.	-3638.	-3719.
100000	CURRENT TAX (1966 RATES)	41398.	40948.	40813.	40678.	40543.	40273.	39868.
	TAX UNDER OUR PROPOSALS	40091.	38653.	38588.	38564.	38540.	38492.	38420.
	INCREASE OR DECREASE IN TAX	-1308.	-2296.	-2225.	-2114.	-2003.	-1781.	-1448.
200000	CURRENT TAX (1966 RATES)	86586.	86086.	85936.	85786.	85636.	85336.	84886.
	TAX UNDER OUR PROPOSALS	90090.	88652.	88588.	88564.	88540.	88492.	88420.
	INCREASE OR DECREASE IN TAX	3504.	2566.	2652.	2778.	2904.	3156.	3534.
350000	CURRENT TAX (1966 RATES)	156767.	156167.	155987.	155807.	155627.	155267.	154727.
	TAX UNDER OUR PROPOSALS	165090.	163652.	163588.	163564.	163540.	163492.	163420.
	INCREASE OR DECREASE IN TAX	8323.	7485.	7601.	7757.	7913.	8225.	8693.
600000	CURRENT TAX (1966 RATES)	277024.	276374.	276179.	275984.	275789.	275399.	274814.
	TAX UNDER OUR PROPOSALS	290090.	288652.	288588.	288564.	288540.	288492.	288420.
	INCREASE OR DECREASE IN TAX	13066.	12278.	12409.	12580.	12751.	13093.	13606.
1000000	CURRENT TAX (1966 RATES)	474861.	474161.	473951.	473741.	473531.	473111.	472481.
	TAX UNDER OUR PROPOSALS	490090.	488652.	488588.	488564.	488540.	488492.	488420.
	INCREASE OR DECREASE IN TAX	15229.	14491.	14637.	14823.	15009.	15381.	15939.

Note: See assumptions in Table M-1.

TABLE M, 1-2

EFFECTIVE AVERAGE TAX RATES UNDER THE CURRENT AND PROPOSED TAX SYSTEMS (INCLUDING TAXES PAID BY CORPORATIONS) FOR A TAX UNIT WITH INCOME FROM A TYPICAL PUBLIC COMPANY

GROSS CORPORATE SOURCE INCOME		STATUS OF TAXPAYER						
		UNATTACHED INDIVIDUAL	MARRIED COUPLE					
			NUMBER OF CHILDREN					
			0	1	2	3	5	8
1500	CURRENT TAX (1966) RATES)	0.394	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.036	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	−0.358	−0.394	−0.394	−0.394	−0.394	−0.394	−0.394
2000	CURRENT TAX (1966 RATES)	0.394	0.394	0.394	0.394	0.394	0.394	−0.394
	TAX UNDER OUR PROPOSALS	0.064	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	−0.331	−0.394	−0.394	−0.394	−0.394	−0.394	−0.394
2500	CURRENT TAX (1966 RATES)	0.394	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.085	0.018	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	−0.310	−0.376	−0.394	−0.394	−0.394	−0.394	−0.394
3000	CURRENT TAX (1966 RATES)	0.394	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.099	0.037	0.007	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	−0.295	−0.357	−0.387	−0.394	−0.394	−0.394	−0.394
3500	CURRENT TAX (1966 RATES)	0.394	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.113	0.054	0.029	0.015	0.001	0.000	0.000
	CHANGE IN EFFECTIVE RATE	−0.281	−0.340	−0.366	−0.379	−0.393	−0.394	−0.394
4000	CURRENT TAX (1966 RATES)	0.394	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.124	0.067	0.045	0.033	0.022	0.000	0.000
	CHANGE IN EFFECTIVE RATE	−0.271	−0.327	−0.349	−0.361	−0.373	−0.394	−0.394
5000	CURRENT TAX (1966 RATES)	0.394	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.143	0.090	0.072	0.063	0.054	0.035	0.007
	CHANGE IN EFFECTIVE RATE	−0.251	−0.305	−0.322	−0.331	−0.341	−0.0359	−0.387
6500	CURRENT TAX (1966 RATES)	0.396	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.164	0.113	0.100	0.093	0.086	0.072	0.051
	CHANGE IN EFFECTIVE RATE	−0.232	−0.281	−0.294	−0.301	−0.308	−0.322	−0.343
8000	CURRENT TAX (1966 RATES)	0.397	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.178	0.130	0.119	0.113	0.108	0.097	0.080
	CHANGE IN EFFECTIVE RATE	−0.219	−0.265	−0.275	−0.281	−0.287	−0.298	−0.315
10000	CURRENT TAX (1966 RATES)	0.398	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.194	0.146	0.137	0.133	0.128	0.120	0.106
	CHANGE IN EFFECTIVE RATE	−0.204	−0.249	−0.257	−0.261	−0.266	−0.275	−0.288
12000	CURRENT TAX (1966 RATES)	0.399	0.395	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.208	0.158	0.151	0.147	0.144	0.137	0.126
	CHANGE IN EFFECTIVE RATE	−0.190	−0.237	−0.243	−0.247	−0.250	−0.257	−0.268
15000	CURRENT TAX (1966 RATES)	0.399	0.397	0.396	0.395	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.227	0.174	0.169	0.166	0.163	0.158	0.150
	CHANGE IN EFFECTIVE RATE	−0.173	−0.222	−0.227	−0.229	−0.231	−0.236	−0.244
20000	CURRENT TAX (1966 RATES)	0.400	0.398	0.398	0.397	0.396	0.395	−0.394
	TAX UNDER OUR PROPOSALS	0.250	0.198	0.194	0.192	0.190	0.187	0.181
	CHANGE IN EFFECTIVE RATE	−0.150	−0.200	−0.203	−0.205	−0.206	−0.208	−0.213
25000	CURRENT TAX (1966 RATES)	0.399	0.399	0.398	0.398	0.398	0.397	0.395
	TAX UNDER OUR PROPOSALS	0.270	0.220	0.217	0.216	0.215	0.212	0.208
	CHANGE IN EFFECTIVE RATE	−0.129	−0.179	−0.181	−0.182	−0.183	−0.185	−0.187
30000	CURRENT TAX (1966 RATES)	0.398	0.398	0.398	0.398	0.398	0.398	0.396
	TAX UNDER OUR PROPOSALS	0.287	0.242	0.240	0.238	0.237	0.235	0.232
	CHANGE IN EFFECTIVE RATE	−0.112	−0.156	−0.159	−0.160	−0.161	−0.162	−0.164
40000	CURRENT TAX (1966 RATES)	0.397	0.397	0.397	0.397	0.397	0.397	0.397
	TAX UNDER OUR PROPOSALS	0.312	0.276	0.275	0.274	0.273	0.272	0.269
	CHANGE IN EFFECTIVE RATE	−0.085	−0.121	−0.123	−0.123	−0.124	−0.126	−0.128
50000	CURRENT TAX (1966 RATES)	0.397	0.397	0.397	0.397	0.397	0.397	0.397
	TAX UNDER OUR PROPOSALS	0.334	0.305	0.304	0.303	0.303	0.301	0.300
	CHANGE IN EFFECTIVE RATE	−0.063	−0.092	−0.093	−0.093	−0.094	−0.095	−0.097
70000	CURRENT TAX (1966 RATES)	0.402	0.396	0.396	0.396	0.396	0.396	0.396
	TAX UNDER OUR PROPOSALS	0.367	0.346	0.346	0.345	0.345	0.344	0.343
	CHANGE IN EFFECTIVE RATE	−0.035	−0.050	−0.050	−0.051	−0.051	−0.052	−0.053
100000	CURRENT TAX (1966 RATES)	0.414	0.409	0.408	0.407	0.405	0.403	0.399
	TAX UNDER OUR PROPOSALS	0.401	0.387	0.386	0.386	0.385	0.385	0.384
	CHANGE IN EFFECTIVE RATE	−0.013	−0.023	−0.022	−0.021	−0.020	−0.018	−0.014
200000	CURRENT TAX (1966 RATES)	0.433	0.430	0.430	0.429	0.428	0.427	0.424
	TAX UNDER OUR PROPOSALS	0.450	0.443	0.443	0.443	0.443	0.442	0.442
	CHANGE IN EFFECTIVE RATE	0.018	0.013	−0.013	0.014	0.015	0.016	0.018
350000	CURRENT TAX (1966 RATES)	0.448	0.446	0.446	0.445	0.445	0.444	0.442
	TAX UNDER OUR PROPOSALS	0.472	0.468	0.467	0.467	0.467	0.467	0.467
	CHANGE IN EFFECTIVE RATE	0.024	0.021	0.022	0.022	0.023	0.024	0.025
600000	CURRENT TAX (1966 RATES)	0.462	0.461	0.460	0.460	0.460	0.459	0.458
	TAX UNDER OUR PROPOSALS	0.483	0.481	0.481	0.481	0.481	0.481	0.481
	CHANGE IN EFFECTIVE RATE	0.022	0.020	0.021	01021	0.021	0.022	0.023
1000000	CURRENT TAX (1966 RATES)	0.475	0.474	0.474	0.474	0.474	0.473	0.472
	TAX UNDER OUR PROPOSALS	0.490	0.489	0.489	0.489	0.489	0.488	0.488
	CHANGE IN EFFECTIVE RATE	0.015	−0.014	0.015	0.015	0.015	0.015	0.016

Note: See assumptions in Table M–1.

TABLE M, 1-3

EFFECTIVE MARGINAL TAX RATES UNDER THE CURRENT AND PROPOSED TAX SYSTEMS (INCLUDING TAXES PAID BY CORPORATIONS) FOR A TAX UNIT WITH INCOME FROM A TYPICAL PUBLIC COMPANY

GROSS CORPORATE SOURCE INCOME		STATUS OF TAXPAYER						
		UNATTACHED INDIVIDUAL	MARRIED COUPLE					
			NUMBER OF CHILDREN					
			0	1	2	3	5	8
1500	CURRENT TAX (1966 RATES)	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.147	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.252	−0.399	−0.399	−0.399	−0.399	−0.399	−0.399
2000	CURRENT TAX (1966 RATES)	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.168	0.091	0.000	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.231	−0.308	−0.399	−0.399	−0.399	−0.399	−0.399
2500	CURRENT TAX (1966 RATES)	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.170	0.130	0.041	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.229	−0.269	−0.358	−0.399	−0.399	−0.399	−0.399
3000	CURRENT TAX (1966 RATES)	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.197	0.157	0.160	0.104	0.007	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.202	−0.242	−0.239	−0.295	−0.392	−0.399	−0.399
3500	CURRENT TAX (1966 RATES)	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.200	0.160	0.161	0.164	0.167	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.199	−0.239	−0.238	−0.235	−0.232	−0.399	−0.399
4000	CURRENT TAX (1966 RATES)	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.218	0.178	0.180	0.180	0.180	0.166	0.000
	CHANGE IN MARGINAL RATE	−0.181	−0.221	−0.219	−0.219	−0.219	−0.233	−0.399
5000	CURRENT TAX (1966 RATES)	0.400	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.229	0.189	0.190	0.190	0.190	0.190	0.191
	CHANGE IN MARGINAL RATE	−0.171	−0.210	−0.209	−0.209	−0.209	−0.209	−0.209
6500	CURRENT TAX (1966 RATES)	0.407	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.240	0.200	0.200	0.200	0.200	0.200	0.200
	CHANGE IN MARGINAL RATE	−0.167	−0.199	−0.199	−0.199	−0.199	−0.199	−0.199
8000	CURRENT TAX (1966 RATES)	0.407	0.399	0.399	00.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.258	0.209	0.210	0.210	0.210	0.210	0.210
	CHANGE IN MARGINAL RATE	−0.149	−0.190	−0.189	−0.189	−0.189	−0.189	−0.189
10000	CURRENT TAX (1966 RATES)	0.407	0.401	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.278	0.219	0.220	0.220	0.220	0.220	0.220
	CHANGE IN MARGINAL RATE	−0.129	−0.182	−0.179	−0.179	−0.179	−0.179	−0.179
12000	CURRENT TAX (1966 RATES)	0.407	0.407	0.407	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.298	0.238	0.240	0.240	0.240	0.240	0.240
	CHANGE IN MARGINAL RATE	−0.109	−0.169	−0.167	−0.159	−0.159	−0.159	−0.159
15000	CURRENT TAX (1966 RATES)	0.407	0.407	0.407	0.407	0.407	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.318	0.267	0.270	0.270	0.270	0.270	0.270
	CHANGE IN MARGINAL RATE	−0.089	−0.140	−0.137	−0.137	−0.137	−0.129	−0.129
20000	CURRENT TAX (1966 RATES)	0.404	0.407	0.407	0.407	0.407	0.407	0.399
	TAX UNDER OUR PROPOSALS	0.347	0.306	0.310	0.310	0.310	0.310	0.310
	CHANGE IN MARGINAL RATE	−0.057	−0.101	−0.097	−0.097	−0.097	−0.097	−0.089
25000	CURRENT TAX (1966 RATES)	0.399	0.403	0.407	0.407	0.407	0.407	0.407
	TAX UNDER OUR PROPOSALS	0.368	0.346	0.350	0.350	0.350	0.350	0.350
	CHANGE IN MARGINAL RATE	−0.031	−0.057	−0.057	−0.057	−0.057	−0.057	−0.057
30000	CURRENT TAX (1966 RATES)	0.399	0.399	0.399	0.399	0.399	0.407	0.407
	TAX UNDER OUR PROPOSALS	0.388	0.377	0.380	0.380	0.380	0.380	0.380
	CHANGE IN MARGINAL RATE	−0.011	−0.022	−0.019	−0.019	−0.019	−0.027	−0.027
40000	CURRENT TAX (1966 RATES)	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.417	0.416	0.420	0.420	0.420	0.420	0.420
	CHANGE IN MARGINAL RATE	0.018	0.017	0.021	0.021	0.021	0.021	0.021
50000	CURRENT TAX (1966 RATES)	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.438	0.438	0.440	0.440	0.440	0.440	0.440
	CHANGE IN MARGINAL RATE	0.039	0.039	0.041	0.041	0.041	0.041	0.041
70000	CURRENT TAX (1966 RATES)	0.439	0.439	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.460	0.460	0.460	0.460	0.460	0.460	0.460
	CHANGE IN MARGINAL RATE	0.021	0.021	0.061	0.061	0.061	0.061	0.061
100000	CURRENT TAX (1966 RATES)	0.450	0.450	0.450	0.450	0.450	0.450	0.450
	TAX UNDER OUR PROPOSALS	0.499	0.499	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	0.049	0.049	0.050	0.050	0.050	0.050	0.050
200000	CURRENT TAX (1966 RATES)	0.460	0.460	0.460	0.460	0.460	0.460	0.460
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	0.040	0.040	0.040	0.040	0.040	0.040	0.040
350000	CURRENT TAX (1966 RATES)	0.480	0.480	0.480	0.480	0.480	0.480	0.480
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	0.020	0.020	0.020	0.020	0.020	0.020	0.020
600000	CURRENT TAX (1966 RATES)	0.490	0.490	0.490	0.490	0.490	0.490	0.490
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	0.010	0.010	0.010	0.010	0.010	0.010	0.010
1000000	CURRENT TAX (1966 RATES)	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	0.000	0.000	0.000	0.000	0.000	0.000	0.000

Note: See assumptions in Table M–1.

TABLE M, 2-1

CHANGES IN TAX LIABILITIES UNDER THE PROPOSED TAX SYSTEM (INCLUDING TAXES PAID BY CORPORATIONS) FOR A TAX UNIT WITH INCOME FROM A TYPICAL PRIVATE COMPANY NOT MAKING USE OF SECTION 105 CAPITALIZATIONS

GROSS CORPORATE SOURCE INCOME		STATUS OF TAXPAYER: UNATTACHED INDIVIDUAL	MARRIED COUPLE — NUMBER OF CHILDREN: 0	1	2	3	5	8
1500	CURRENT TAX (1966 RATES)	452.	452.	452.	452.	452.	452.	452.
	TAX UNDER OUR PROPOSALS	54.	0.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	−398.	−452.	−452.	−452.	−452.	−452.	−452.
2000	CURRENT TAX (1966 RATES)	602.	602.	602.	602.	602.	602.	602.
	TAX UNDER OUR PROPOSALS	128.	0.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	−475.	−602.	−602.	−602.	−602.	−602.	−602.
2500	CURRENT TAX (1966 RATES)	753.	753.	753.	753.	753.	753.	753.
	TAX UNDER OUR PROPOSALS	212.	46.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	−541.	−707.	−753.	−753.	−753.	−753.	−753.
3000	CURRENT TAX (1966 RATES)	903.	903.	903.	903.	903.	903.	903.
	TAX UNDER OUR PROPOSALS	297.	111.	21.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	−607.	−793.	−883.	−903.	−903.	−903.	−903.
3500	CURRENT TAX (1966 RATES)	1054.	1054.	1054.	1054.	1054.	1054.	1054.
	TAX UNDER OUR PROPOSALS	395.	189.	101.	52.	4.	0.	0.
	INCREASE OR DECREASE IN TAX	−659.	−865.	−953.	−1002.	−1050.	−1054.	−1054.
4000	CURRENT TAX (1966 RATES)	1205.	1204.	1204.	1204.	1204.	1204.	1204.
	TAX UNDER OUR PROPOSALS	495.	269.	181.	134.	87.	0.	0.
	INCREASE OR DECREASE IN TAX	−710.	−935.	−1023.	−1070.	−1117.	−1204.	−1204.
5000	CURRENT TAX (1966 RATES)	1517.	1505.	1505.	1505.	1505.	1505.	1505.
	TAX UNDER OUR PROPOSALS	714.	448.	361.	315.	269.	176.	37.
	INCREASE OR DECREASE IN TAX	−803.	−1057.	−1144.	−1191.	−1237.	−1329.	−1468.
6500	CURRENT TAX (1966 RATES)	1986.	1957.	1957.	1957.	1957.	1957.	1957.
	TAX UNDER OUR PROPOSALS	1063.	737.	651.	606.	560.	469.	332.
	INCREASE OR DECREASE IN TAX	−923.	−1220.	−1306.	−1351.	−1397.	−1488.	−1625.
8000	CURRENT TAX (1966 RATES)	2454.	2414.	2409.	2409.	2409.	2409.	2409.
	TAX UNDER OUR PROPOSALS	1423.	1037.	952.	907.	862.	772.	637.
	INCREASE OR DECREASE IN TAX	−1031.	−1377.	−1457.	−1502.	−1547.	−1637.	−1771.
10000	CURRENT TAX (1966 RATES)	3079.	3039.	3027.	3015.	3011.	3011.	3011.
	TAX UNDER OUR PROPOSALS	1942.	1457.	1372.	1328.	1284.	1195.	1063.
	INCREASE OR DECREASE IN TAX	−1137.	−1582.	−1655.	−1687.	−1727.	−1816.	−1948.
12000	CURRENT TAX (1966 RATES)	3703.	3663.	3651.	3639.	3627.	3613.	3613.
	TAX UNDER OUR PROPOSALS	2501.	1896.	1812.	1770.	1727.	1641.	1513.
	INCREASE OR DECREASE IN TAX	−1202.	−1767.	−1839.	−1870	−1900.	−1972.	−2100.
15000	CURRENT TAX (1966 RATES)	4636.	4600.	4588.	4576.	4564.	4540.	4516.
	TAX UNDER OUR PROPOSALS	3400.	2615.	2533.	2492.	2452.	2371.	2249.
	INCREASE OR DECREASE IN TAX	−1236.	−1985.	−2055.	−2083.	−2112.	−2169.	−2267.
20000	CURRENT TAX (1966 RATES)	6142.	6142.	6142.	6137.	6125.	6101.	6065.
	TAX UNDER OUR PROPOSALS	4999.	3964.	3884.	3846.	3808.	3733.	3620.
	INCREASE OR DECREASE IN TAX	−1143.	−2178.	−2258.	−2291.	−2317.	−2368.	−2445.
25000	CURRENT TAX (1966 RATES)	7647.	7647.	7647.	7647.	7647.	7647.	7626.
	TAX UNDER OUR PROPOSALS	6748.	5512.	5435.	5400.	5365.	5296.	5191.
	INCREASE OR DECREASE IN TAX	−899.	−2135.	−2212.	−2247.	−2282.	−2351.	−2435.
30000	CURRENT TAX (1966 RATES)	9152.	9152.	9152.	9152.	9152.	9152.	9152.
	TAX UNDER OUR PROPOSALS	8597.	7260.	7185.	7153.	7120.	7055.	6957.
	INCREASE OR DECREASE IN TAX	−556.	−1893.	−1967.	−2000.	−2032.	−2097.	−2195.
40000	CURRENT TAX (1966 RATES)	12163.	12163.	12163.	12163.	12163.	12163.	12163.
	TAX UNDER OUR PROPOSALS	12496.	11058.	10986.	10956.	10927.	10867.	10778.
	INCREASE OR DECREASE IN TAX	332.	−1105.	−1177.	−1207.	−1236.	−1296.	−1385.
50000	CURRENT TAX (1966 RATES)	15579.	15186.	15174.	15174.	15174.	15174.	15174.
	TAX UNDER OUR PROPOSALS	16694.	15256.	15187.	15158.	15130.	15073.	14988.
	INCREASE OR DECREASE IN TAX	1115.	70.	13.	−15.	−44.	−100.	−185.
70000	CURRENT TAX (1966 RATES)	22893.	22443.	22308.	22173.	22038.	21768.	21363.
	TAX UNDER OUR PROPOSALS	25692.	24254.	24187.	24160.	24133.	24080.	23999.
	INCREASE OR DECREASE IN TAX	2799.	1811.	1879.	1987.	2096.	2312.	2636.
100000	CURRENT TAX (1966 RATES)	34115.	33615.	33465.	33315.	33167.	32897.	32492.
	TAX UNDER OUR PROPOSALS	40091.	38653.	38588.	38564.	38540.	38492.	38420.
	INCREASE OR DECREASE IN TAX	5976.	5038.	5123.	5249.	5373.	5595.	5928.
200000	CURRENT TAX (1966 RATES)	73350.	72800.	72635.	72470.	72305.	71975.	71480.
	TAX UNDER OUR PROPOSALS	90090.	88652.	88588.	88564.	88540.	88492.	88420.
	INCREASE OR DECREASE IN TAX	16740.	15852.	15953.	16094.	16235.	16517.	16940.
350000	CURRENT TAX (1966 RATES)	135364.	134714.	134519.	134324.	134129.	133739.	133154.
	TAX UNDER OUR PROPOSALS	165090.	163652.	163588.	163564.	163540.	163492.	163420.
	INCREASE OR DECREASE IN TAX	29726.	28938.	29069.	29240.	29411.	29753.	30266.
600000	CURRENT TAX (1966 RATES)	244166.	243466.	243256.	243046.	242836.	242416.	241786.
	TAX UNDER OUR PROPOSALS	290090.	288652.	288588.	288564.	288540.	288492.	288420.
	INCREASE OR DECREASE IN TAX	45924.	45186.	45332.	45518.	45704.	46076.	46634.
1000000	CURRENT TAX (1966 RATES)	423184.	422434.	422209.	421984.	421759.	421309.	420634.
	TAX UNDER OUR PROPOSALS	490090.	488652.	488588.	488564.	488540	488492.	488420.
	INCREASE OR DECREASE IN TAX	66906.	66218.	66379.	66580.	66781.	67183.	67786.

Note: See assumptions in Table M-1.

TABLE M, 2–2

EFFECTIVE AVERAGE TAX RATES UNDER THE CURRENT AND PROPOSED TAX SYSTEMS (INCLUDING TAXES PAID BY CORPORATIONS) FOR A TAX UNIT WITH INCOME FROM A TYPICAL PRIVATE COMPANY NOT MAKING USE OF SECTION 105 CAPITALIZATIONS

GROSS CORPORATE SOURCE INCOME		STATUS OF TAXPAYER						
		UNATTACHED INDIVIDUAL	MARRIED COUPLE					
			NUMBER OF CHILDREN					
			0	1	2	3	5	8
1500	CURRENT TAX (1966 RATES)	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.036	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	−0.265	−0.301	−0.301	−0.301	−0.301	−0.301	−0.301
2000	CURRENT TAX (1966 RATES)	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.064	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	−0.237	−0.301	−0.301	−0.301	−0.301	−0.301	−0.301
2500	CURRENT TAX (1966 RATES)	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.085	0.018	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	−0.216	−0.283	−0.301	−0.301	−0.301	−0.301	−0.301
3000	CURRENT TAX (1966 RATES)	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.099	0.037	0.007	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	−0.202	−0.264	−0.294	−0.301	−0.301	−0.301	−0.301
3500	CURRENT TAX (1966 RATES)	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.113	0.054	0.029	0.015	0.001	0.000	0.000
	CHANGE IN EFFECTIVE RATE	−0.188	−0.247	−0.272	−0.286	−0.300	−0.301	−0.301
4000	CURRENT TAX (1966 RATES)	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.124	0.067	0.045	0.033	0.022	0.000	0.000
	CHANGE IN EFFECTIVE RATE	−0.178	−0.234	−0.256	−0.268	−0.279	−0.301	−0.301
5000	CURRENT TAX (1966 RATES)	0.303	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.143	0.090	0.072	0.063	0.054	0.035	0.007
	CHANGE IN EFFECTIVE RATE	−0.161	−0.211	−0.229	−0.238	−0.247	−0.266	−0.294
6500	CURRENT TAX (1966 RATES)	0.305	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.164	0.113	0.100	0.093	0.086	0.072	0.051
	CHANGE IN EFFECTIVE RATE	−0.142	−0.188	−0.201	−0.208	−0.215	−0.229	−0.250
8000	CURRENT TAX (1966 RATES)	0.307	0.302	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.178	0.130	0.119	0.113	0.108	0.097	0.080
	CHANGE IN EFFECTIVE RATE	−0.129	−0.172	−0.182	−0.188	−0.193	−0.205	−0.221
10000	CURRENT TAX (1966 RATES)	0.308	0.304	0.303	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.194	0.146	0.137	0.133	0.128	0.120	0.106
	CHANGE IN EFFECTIVE RATE	−0.114	−0.158	−0.165	−0.169	−0.173	−0.182	−0.195
12000	CURRENT TAX (1966 RATES)	0.309	0.305	0.304	0.303	0.302	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.208	0.158	0.151	0.147	0.144	0.137	0.126
	CHANGE IN EFFECTIVE RATE	−0.100	−0.147	−0.153	−0.156	−0.158	−0.164	−0.175
15000	CURRENT TAX (1966 RATES)	0.309	0.307	0.306	0.305	0.304	0.303	0.301
	TAX UNDER OUR PROPOSALS	0.227	0.174	0.169	0.166	0.163	0.158	0.150
	CHANGE IN EFFECTIVE RATE	−0.082	−0.132	−0.137	−0.139	−0.141	−0.145	−0.151
20000	CURRENT TAX (1966 RATES)	0.307	0.307	0.307	0.307	0.306	0.305	0.303
	TAX UNDER OUR PROPOSALS	0.250	0.198	0.194	0.192	0.190	0.187	0.181
	CHANGE IN EFFECTIVE RATE	−0.057	−0.109	−0.113	−0.115	−0.116	−0.118	−0.122
25000	CURRENT TAX (1966 RATES)	0.306	0.306	0.306	0.306	0.306	0.306	0.305
	TAX UNDER OUR PROPOSALS	0.270	0.220	0.217	0.216	0.215	0.212	0.208
	CHANGE IN EFFECTIVE RATE	−0.036	−0.085	−0.088	−0.090	−0.091	−0.094	−0.097
30000	CURRENT TAX (1966 RATES)	0.305	0.305	0.305	0.305	0.305	0.305	0.305
	TAX UNDER OUR PROPOSALS	0.287	0.242	0.240	0.238	0.237	0.235	0.232
	CHANGE IN EFFECTIVE RATE	−0.019	−0.063	−0.066	−0.067	−0.068	−0.070	−0.073
40000	CURRENT TAX (1966 RATES)	0.304	0.304	0.304	0.304	0.304	0.304	0.304
	TAX UNDER OUR PROPOSALS	0.312	0.276	0.275	0.274	0.273	0.272	0.269
	CHANGE IN EFFECTIVE RATE	0.008	−0.028	−0.029	−0.030	−0.031	−0.032	−0.035
50000	CURRENT TAX (1966 RATES)	0.312	0.304	0.303	0.303	0.303	0.303	0.303
	TAX UNDER OUR PROPOSALS	0.334	0.305	0.304	0.303	0.303	0.301	0.300
	CHANGE IN EFFECTIVE RATE	0.022	0.001	0.000	0.000	−0.001	−0.002	−0.004
70000	CURRENT TAX (1966 RATES)	0.327	0.321	0.319	0.317	0.315	0.311	0.305
	TAX UNDER OUR PROPOSALS	0.367	0.346	0.346	0.345	0.345	0.344	0.343
	CHANGE IN EFFECTIVE RATE	0.040	0.026	0.027	0.028	0.030	0.033	0.038
100000	CURRENT TAX (1966 RATES)	0.341	0.336	0.335	0.333	0.332	0.329	0.325
	TAX UNDER OUR PROPOSALS	0.401	0.387	0.386	0.386	0.385	0.385	0.384
	CHANGE IN EFFECTIVE RATE	0.060	0.050	0.051	0.052	0.054	0.056	0.059
200000	CURRENT TAX (1966 RATES)	0.367	0.364	0.363	0.362	0.362	0.360	0.357
	TAX UNDER OUR PROPOSALS	0.450	0.443	0.443	0.443	0.443	0.442	0.442
	CHANGE IN EFFECTIVE RATE	0.084	0.079	0.080	0.080	0.081	0.083	0.085
350000	CURRENT TAX (1966 RATES)	0.387	0.385	0.384	0.384	0.383	0.382	0.380
	TAX UNDER OUR PROPOSALS	0.472	0.468	0.467	0.467	0.467	0.467	0.467
	CHANGE IN EFFECTIVE RATE	0.085	0.083	0.083	0.084	0.084	0.085	0.086
600000	CURRENT TAX (1966 RATES)	0.407	0.406	0.405	0.405	0.405	0.404	0.403
	TAX UNDER OUR PROPOSALS	0.483	0.481	0.481	0.481	0.481	0.481	0.481
	CHANGE IN EFFECTIVE RATE	0.077	0.075	0.076	0.076	0.076	0.077	0.078
1000000	CURRENT TAX (1966 RATES)	0.423	0.422	0.422	0.422	0.422	0.421	0.421
	TAX UNDER OUR PROPOSALS	0.490	0.489	0.489	0.489	0.489	0.488	0.488
	CHANGE IN EFFECTIVE RATE	0.067	0.066	0.066	0.067	0.067	0.067	0.068

Note: See assumptions in Table M–1.

TABLE M, 2–3

EFFECTIVE MARGINAL TAX RATES UNDER THE CURRENT AND PROPOSED TAX SYSTEMS (INCLUDING TAXES PAID BY CORPORATIONS) FOR A TAX UNIT WITH INCOME FROM A TYPICAL PRIVATE COMPANY NOT MAKING USE OF SECTION 105 CAPITALIZATIONS

GROSS CORPORATE SOURCE INCOME		STATUS OF TAXPAYER						
		UNATTACHED INDIVIDUAL	MARRIED COUPLE					
			NUMBER OF CHILDREN					
			0	1	2	3	5	8
1500	CURRENT TAX (1966 RATES)	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.147	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	–0.283	–0.430	–0.430	–0.430	–0.430	–0.430	–0.430
2000	CURRENT TAX (1966 FATES)	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.168	0.091	0.000	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	–0.262	–0.339	–0.430	–0.430	–0.430	–0.430	–0.430
2500	CURRENT TAX (1966 RATES)	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.170	0.130	0.041	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	–0.260	–0.300	–0.389	–0.430	–0.430	–0.430	–0.430
3000	CURRENT TAX (1966 RATES)	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.197	0.157	0.160	0.104	0.007	0.000	0.000
	CHANGE IN MARGINAL RATE	–0.233	–0.273	–0.270	–0.326	–0.423	–0.430	–0.430
3500	CURRENT TAX (1966 RATES)	0.432	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.200	0.160	0.161	0.164	0.167	0.000	0.000
	CHANGE IN MARGINAL RATE	–0.232	–0.270	–0.269	–0.266	–0.263	–0.430	–0.430
4000	CURRENT TAX (1966 RATES)	0.441	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.218	0.178	0.180	0.180	0.180	0.166	0.000
	CHANGE IN MARGINAL RATE	–0.223	–0.252	–0.250	–0.250	–0.250	–0.265	–0.430
5000	CURRENT TAX (1966 RATES)	0.441	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.229	0.189	0.190	0.190	0.190	0.190	0.191
	CHANGE IN MARGINAL RATE	–0.212	–0.241	–0.240	–0.240	–0.240	–0.240	–0.240
6500	CURRENT TAX (1966 RATES)	0.441	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.240	0.200	0.200	0.200	0.200	0.200	0.200
	CHANGE IN MARGINAL RATE	–0.201	–0.230	–0.230	–0.230	–0.230	–0.230	–0.230
8000	CURRENT TAX (1966 RATES)	0.441	0.441	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.258	0.209	0.210	0.210	0.210	0.210	0.210
	CHANGE IN MARGINAL RATE	–0.183	–0.232	–0.220	–0.220	–0.220	–0.220	–0.220
10000	CURRENT TAX (1966 RATES)	0.441	0.441	0.441	0.441	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.278	0.219	0.220	0.220	0.220	0.220	0.220
	CHANGE IN MARGINAL RATE	–0.163	–0.222	–0.221	–0.221	–0.210	–0.210	–0.210
12000	CURRENT TAX (1966 RATES)	0.441	0.441	0.441	0.441	0.441	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.298	0.238	0.240	0.240	0.240	0.240	0.240
	CHANGE IN MARGINAL RATE	–0.143	–0.203	–0.201	–0.201	–0.201	–0.190	–0.190
15000	CURRENT TAX (1966 RATES)	0.430	0.441	0.441	0.441	0.441	0.441	0.430
	TAX UNDER OUR PROPOSALS	0.318	0.267	0.270	0.270	0.270	0.270	0.270
	CHANGE IN MARGINAL RATE	–0.112	–0.174	–0.171	–0.171	–0.171	–0.171	–0.160
20000	CURRENT TAX (1966 RATES)	0.430	0.430	0.430	0.439	0.441	0.441	0.441
	TAX UNDER OUR PROPOSALS	0.347	0.306	0.310	0.310	0.310	0.310	0.310
	CHANGE IN MARGINAL RATE	–0.083	–0.124	–0.120	–0.129	–0.131	–0.131	–0.131
25000	CURRENT TAX (1966 RATES)	0.430	0.430	0.430	0.430	0.430	0.430	0.441
	TAX UNDER OUR PROPOSALS	0.368	0.346	0.350	0.350	0.350	0.350	0.350
	CHANGE IN MARGINAL RATE	–0.062	–0.084	–0.080	–0.080	–0.080	–0.080	–0.091
30000	CURRENT TAX (1966 RATES)	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.388	0.377	0.380	0.380	0.380	0.380	0.380
	CHANGE IN MARGINAL RATE	–0.042	–0.053	–0.050	–0.050	–0.050	–0.050	–0.050
40000	CURRENT TAX (1966 RATES)	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.417	0.416	0.420	0.420	0.420	0.420	0.420
	CHANGE IN MARGINAL RATE	–0.013	–0.014	–0.010	–0.010	–0.010	–0.010	–0.010
50000	CURRENT TAX (1966 RATES)	0.486	0.474	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.438	0.438	0.440	0.440	0.440	0.440	0.440
	CHANGE IN MARGINAL RATE	–0.048	–0.036	–0.010	–0.010	–0.010	–0.010	–0.010
70000	CURRENT TAX (1966 RATES)	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	TAX UNDER OUR PROPOSALS	0.460	0.460	0.460	0.460	0.460	0.460	0.460
	CHANGE IN MARGINAL RATE	–0.040	–0.040	–0.040	–0.040	–0.040	–0.040	–0.040
100000	CURRENT TAX (1966 RATES)	0.514	0.514	0.514	0.514	0.510	0.500	0.500
	TAX UNDER OUR PROPOSALS	0.499	0.499	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	–0.015	–0.015	–0.014	–0.014	–0.010	0.000	0.000
200000	CURRENT TAX (1966 RATES)	0.528	0.528	0.528	0.528	0.528	0.528	0.528
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	–0.028	–0.028	–0.028	–0.028	–0.028	–0.028	–0.028
350000	CURRENT TAX (1966 RATES)	0.556	0.556	0.556	0.556	0.556	0.556	0.556
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	–0.056	–0.056	–0.056	–0.056	–0.056	–0.056	–0.056
600000	CURRENT TAX (1966 RATES)	0.570	0.570	0.570	0.570	0.570	0.570	0.570
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	–0.070	–0.070	–0.070	–0.070	–0.070	–0.070	–0.070
1000000	CURRENT TAX (1966 RATES)	0.584	0.584	0.584	0.584	0.584	0.584	0.584
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	–0.084	–0.084	–0.084	–0.084	–0.084	–0.084	–0.084

Note: See assumptions in Table M–1.

TABLE M, 3-1

CHANGES IN TAX LIABILITIES UNDER THE PROPOSED TAX SYSTEM (INCLUDING TAXES PAID BY CORPORATIONS) FOR A TAX UNIT WITH INCOME FROM A TYPICAL PRIVATE COMPANY CAPITALIZING HALF ITS EARNINGS UNDER SECTION 105

GROSS CORPORATE SOURCE INCOME		STATUS OF TAXPAYER: UNATTACHED INDIVIDUAL	MARRIED COUPLE — NUMBER OF CHILDREN: 0	1	2	3	5	8
1500	CURRENT TAX (1966 RATES)	515.	515.	515.	515.	515.	515.	515.
	TAX UNDER OUR PROPOSALS	54.	0.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	-461.	-515.	-515.	-515.	-515.	-515.	-515.
2000	CURRENT TAX (1966 RATES)	686.	686.	686.	686.	686.	686.	686.
	TAX UNDER OUR PROPOSALS	128.	0.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	-559.	-686.	-686.	-686.	-686.	-686.	-686.
2500	CURRENT TAX (1966 RATES)	858.	858.	858.	858.	858.	858.	858.
	TAX UNDER OUR PROPOSALS	212.	46.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	-646.	-812.	-858.	-858.	-858.	-858.	-858.
3000	CURRENT TAX (1966 RATES)	1029.	1029.	1029.	1029.	1029.	1029.	1029.
	TAX UNDER OUR PROPOSALS	297.	111.	21.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	-733.	-919.	-1009.	-1029.	-1029.	-1029.	-1029.
3500	CURRENT TAX (1966 RATES)	1201.	1201.	1201.	1201.	1201.	1201.	1201.
	TAX UNDER OUR PROPOSALS	395.	189.	101.	52.	4.	0.	0.
	INCREASE OR DECREASE IN TAX	-806.	-1012.	-1100.	-1148.	-1197.	-1201.	-1201.
4000	CURRENT TAX (1966 RATES)	1373.	1372.	1372.	1372.	1372.	1372.	1372.
	TAX UNDER OUR PROPOSALS	495.	269.	181.	134.	87.	0.	0.
	INCREASE OR DECREASE IN TAX	-878.	-1103.	-1191.	-1238.	-1285.	-1372.	-1372.
5000	CURRENT TAX (1966 RATES)	1727.	1715.	1715.	1715.	1715.	1715.	1715.
	TAX UNDER OUR PROPOSALS	714.	448.	361.	315.	269.	176.	37.
	INCREASE OR DECREASE IN TAX	-1013.	-1267.	-1354.	-1400.	-1447.	-1539.	-1678.
6500	CURRENT TAX (1966 RATES)	2258.	2230.	2230.	2230.	2230.	2230.	2230.
	TAX UNDER OUR PROPOSALS	1063.	737.	651.	606.	560.	469.	332.
	INCREASE OR DECREASE IN TAX	-1195.	-1493.	-1578.	-1624.	-1669.	-1761.	-1897.
8000	CURRENT TAX (1966 RATES)	2790.	2750.	2744.	2744.	2744.	2744.	2744.
	TAX UNDER OUR PROPOSALS	1423.	1037.	952.	907.	862.	772.	637.
	INCREASE OR DECREASE IN TAX	-1367.	-1713.	-1792.	-1837.	-1882.	-1972.	-2107.
10000	CURRENT TAX (1966 RATES)	3498.	3458.	3446.	3434.	3430.	3430.	3430.
	TAX UNDER OUR PROPOSALS	1942.	1457.	1372.	1328.	1284.	1195.	1063.
	INCREASE OR DECREASE IN TAX	-1556.	-2001.	-2074.	-2106.	-2147.	-2235.	-2367.
12000	CURRENT TAX (1966 RATES)	4206.	4166.	4154.	4142.	4130.	4116.	4116.
	TAX UNDER OUR PROPOSALS	2501.	1896.	1812.	1770.	1727.	1641.	1513.
	INCREASE OR DECREASE IN TAX	-1705.	-2270.	-2342.	-2373.	-2403.	-2475.	-2603.
15000	CURRENT TAX (1966 RATES)	5265.	5229.	5217.	5205.	5193.	5169.	5145.
	TAX UNDER OUR PROPOSALS	3400.	2615.	2533.	2492.	2452.	2371.	2249.
	INCREASE OR DECREASE IN TAX	-1865.	-2614.	-2684.	-2713.	-2741.	-2798.	-2896.
20000	CURRENT TAX (1966 RATES)	6980.	6980.	6980.	6976.	6964.	6940.	6904.
	TAX UNDER OUR PROPOSALS	4999.	3964.	3884.	3846.	3808.	3733.	3620.
	INCREASE OR DECREASE IN TAX	-1981.	-3017.	-3096.	-3130.	-3155.	-3207.	-3284.
25000	CURRENT TAX (1966 RATES)	8695.	8695.	8695.	8695.	8695.	8695.	8675.
	TAX UNDER OUR PROPOSALS	6748.	5512.	5435.	5400.	5365.	5296.	5191.
	INCREASE OR DECREASE IN TAX	-1948.	-3184.	-3261.	-3295.	-3330.	-3400.	-3484.
30000	CURRENT TAX (1966 RATES)	10410.	10410.	10410.	10410.	10410.	10410.	10410.
	TAX UNDER OUR PROPOSALS	8597.	7260.	7185.	7153.	7120.	7055.	6957.
	INCREASE OR DECREASE IN TAX	-1814.	-3151.	-3225.	-3258.	-3290.	-3356.	-3453.
40000	CURRENT TAX (1966 RATES)	13840.	13840.	13840.	13840.	13840.	13840.	13840.
	TAX UNDER OUR PROPOSALS	12496.	11058.	10986.	10956.	10927.	10867.	10778.
	INCREASE OR DECREASE IN TAX	-1345.	-2782.	-2854.	-2884.	-2914.	-2973.	-3063.
50000	CURRENT TAX (1966 RATES)	17676.	17282.	17271.	17271.	17271.	17271.	17271.
	TAX UNDER OUR PROPOSALS	16694.	15256.	15187.	15158.	15130.	15073.	14988.
	INCREASE OR DECREASE IN TAX	-982.	-2026.	-2084.	-2112.	-2140.	-2197.	-2282.
70000	CURRENT TAX (1966 RATES)	25828.	25378.	25243.	25108.	24973.	24703.	24298.
	TAX UNDER OUR PROPOSALS	25692.	24254.	24187.	24160.	24133.	24080.	23999.
	INCREASE OR DECREASE IN TAX	-136.	-1124.	-1056.	-948.	-840.	-624.	-299.
100000	CURRENT TAX (1966 RATES)	38308.	37808.	37658.	37508.	37360.	37090.	36685.
	TAX UNDER OUR PROPOSALS	40091.	38653.	38588.	38564.	38540.	38492.	38420.
	INCREASE OR DECREASE IN TAX	1782.	844.	930.	1056.	1180.	1402.	1735.
200000	CURRENT TAX (1966 RATES)	81737.	81187.	81022.	80857.	80692.	80362.	79867.
	TAX UNDER OUR PROPOSALS	90090.	88652.	88588.	88564.	88540.	88492.	88420.
	INCREASE OR DECREASE IN TAX	8353.	7465.	7566.	7707.	7848.	8130.	8553.
350000	CURRENT TAX (1966 RATES)	150041.	149391.	149196.	149001.	148806.	148416.	147831.
	TAX UNDER OUR PROPOSALS	165090.	163652.	163588.	163564.	163540.	163492.	163420.
	INCREASE OR DECREASE IN TAX	15049.	14261.	14392.	14563.	14734.	15076.	15589.
600000	CURRENT TAX (1966 RATES)	269327.	268627.	268417.	268207.	267997.	267577.	266947.
	TAX UNDER OUR PROPOSALS	290090.	288652.	288588.	288564.	288540.	288492.	288420.
	INCREASE OR DECREASE IN TAX	20763.	20025.	20171.	20357.	20543.	20915.	21473.
1000000	CURRENT TAX (1966 RATES)	465119.	464369.	464144.	463919.	463694.	463244.	462569.
	TAX UNDER OUR PROPOSALS	490090.	488652.	488588.	488564.	488540.	488492.	488420.
	INCREASE OR DECREASE IN TAX	24971.	24283.	24444.	24645.	24846.	25248.	25851.

Note: See assumptions in Table M-1.

TABLE M, 3-2

EFFECTIVE AVERAGE TAX RATES UNDER THE CURRENT AND PROPOSED TAX SYSTEMS (INCLUDING TAXES PAID BY CORPORATIONS) FOR A TAX UNIT WITH INCOME FROM A TYPICAL PRIVATE COMPANY CAPITALIZING HALF ITS EARNINGS UNDER SECTION 105

GROSS CORPORATE SOURCE INCOME		STATUS OF TAXPAYER: UNATTACHED INDIVIDUAL	MARRIED COUPLE — NUMBER OF CHILDREN: 0	1	2	3	5	8
1500	CURRENT TAX (1966 RATES)	0.343	0.343	0.343	0.343	0.343	0.343	0.343
	TAX UNDER OUR PROPOSALS	0.036	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	−0.307	−0.343	−0.343	−0.343	−0.343	−0.343	−0.343
2000	CURRENT TAX (1966 RATES)	0.343	0.343	0.343	0.343	0.343	0.343	0.343
	TAX UNDER OUR PROPOSALS	0.064	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	−0.279	−0.343	−0.343	−0.343	−0.343	−0.343	−0.343
2500	CURRENT TAX (1966 RATES)	0.343	0.343	0.343	0.343	0.343	0.343	0.343
	TAX UNDER OUR PROPOSALS	0.085	0.018	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	−0.258	−0.325	−0.343	−0.343	−0.343	−0.343	−0.343
3000	CURRENT TAX (1966 RATES)	0.343	0.343	0.343	0.343	0.343	0.343	0.343
	TAX UNDER OUR PROPOSALS	0.099	0.037	0.007	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	−0.244	−0.306	−0.336	−0.343	−0.343	−0.343	−0.343
3500	CURRENT TAX (1966 RATES)	0.343	0.343	0.343	0.343	0.343	0.343	0.343
	TAX UNDER OUR PROPOSALS	0.113	0.054	0.029	0.015	0.001	0.000	0.000
	CHANGE IN EFFECTIVE RATE	−0.230	−0.289	−0.314	−0.328	−0.342	−0.343	−0.343
4000	CURRENT TAX (1966 RATES)	0.343	0.343	0.343	0.343	0.343	0.343	0.343
	TAX UNDER OUR PROPOSALS	0.124	0.067	0.045	0.033	0.022	0.000	0.000
	CHANGE IN EFFECTIVE RATE	−0.219	−0.276	−0.298	−0.310	−0.321	−0.343	−0.343
5000	CURRENT TAX (1966 RATES)	0.345	0.343	0.343	0.343	0.343	0.343	0.343
	TAX UNDER OUR PROPOSALS	0.143	0.090	0.072	0.063	0.054	0.035	0.007
	CHANGE IN EFFECTIVE RATE	−0.203	−0.253	−0.271	−0.280	−0.289	−0.308	−0.336
6500	CURRENT TAX (1966 RATES)	0.347	0.343	0.343	0.343	0.343	0.343	0.343
	TAX UNDER OUR PROPOSALS	0.164	0.113	0.100	0.093	0.086	0.072	0.051
	CHANGE IN EFFECTIVE RATE	−0.184	−0.230	−0.243	−0.250	−0.257	−0.271	−0.292
8000	CURRENT TAX (1966 RATES)	0.349	0.344	0.343	0.343	0.343	0.343	0.343
	TAX UNDER OUR PROPOSALS	0.178	0.130	0.119	0.113	0.108	0.097	0.080
	CHANGE IN EFFECTIVE RATE	−0.171	−0.214	−0.224	−0.230	−0.235	−0.246	−0.263
10000	CURRENT TAX (1966 RATES)	0.350	0.346	0.345	0.343	0.343	0.343	0.343
	TAX UNDER OUR PROPOSALS	0.194	0.146	0.137	0.133	0.128	0.120	0.106
	CHANGE IN EFFECTIVE RATE	−0.156	−0.200	−0.207	−0.211	−0.215	−0.223	−0.237
12000	CURRENT TAX (1966 RATES)	0.351	0.347	0.346	0.345	0.344	0.343	0.343
	TAX UNDER OUR PROPOSALS	0.208	0.158	0.151	0.147	0.144	0.137	0.126
	CHANGE IN EFFECTIVE RATE	−0.142	−0.189	−0.195	−0.198	−0.200	−0.206	−0.217
15000	CURRENT TAX (1966 RATES)	0.351	0.349	0.348	0.347	0.346	0.345	0.343
	TAX UNDER OUR PROPOSALS	0.227	0.174	0.169	0.166	0.163	0.158	0.150
	CHANGE IN EFFECTIVE RATE	−0.124	−0.174	−0.179	−0.181	−0.183	−0.187	−0.193
20000	CURRENT TAX (1966 RATES)	0.349	0.349	0.349	0.349	0.348	0.347	0.345
	TAX UNDER OUR PROPOSALS	0.250	0.198	0.194	0.192	0.190	0.187	0.181
	CHANGE IN EFFECTIVE RATE	−0.099	−0.151	−0.155	−0.156	−0.158	−0.160	−0.164
25000	CURRENT TAX (1966 RATES)	0.348	0.348	0.348	0.348	0.348	0.348	0.347
	TAX UNDER OUR PROPOSALS	0.270	0.220	0.217	0.216	0.215	0.212	0.208
	CHANGE IN EFFECTIVE RATE	−0.078	−0.127	−0.130	−0.132	−0.133	−0.136	−0.139
30000	CURRENT TAX (1966 RATES)	0.347	0.347	0.347	0.347	0.347	0.347	0.347
	TAX UNDER OUR PROPOSALS	0.287	0.242	0.240	0.238	0.237	0.235	0.232
	CHANGE IN EFFECTIVE RATE	−0.060	−0.105	−0.107	−0.109	−0.110	−0.112	−0.115
40000	CURRENT TAX (1966 RATES)	0.346	0.346	0.346	0.346	0.346	0.346	0.346
	TAX UNDER OUR PROPOSALS	0.312	0.276	0.275	0.274	0.273	0.272	0.269
	CHANGE IN EFFECTIVE RATE	−0.034	−0.070	−0.071	−0.072	−0.073	−0.074	−0.077
50000	CURRENT TAX (1966 RATES)	0.354	0.346	0.345	0.345	0.345	0.345	0.345
	TAX UNDER OUR PROPOSALS	0.334	0.305	0.304	0.303	0.303	0.301	0.300
	CHANGE IN EFFECTIVE RATE	−0.020	−0.041	−0.042	−0.042	−0.043	−0.044	−0.046
70000	CURRENT TAX (1966 RATES)	0.369	0.363	0.361	0.359	0.357	0.353	0.347
	TAX UNDER OUR PROPOSALS	0.367	0.346	0.346	0.345	0.345	0.344	0.343
	CHANGE IN EFFECTIVE RATE	−0.002	−0.016	−0.015	−0.014	−0.012	−0.009	−0.004
100000	CURRENT TAX (1966 RATES)	0.383	0.378	0.377	0.375	0.374	0.371	0.367
	TAX UNDER OUR PROPOSALS	0.401	0.387	0.386	0.386	0.385	0.385	0.384
	CHANGE IN EFFECTIVE RATE	0.018	0.008	0.009	0.011	0.012	0.014	0.017
200000	CURRENT TAX (1966 RATES)	0.409	0.406	0.405	0.404	0.403	0.402	0.399
	TAX UNDER OUR PROPOSALS	0.450	0.443	0.443	0.443	0.443	0.442	0.442
	CHANGE IN EFFECTIVE RATE	0.042	0.037	0.038	0.039	0.039	0.041	0.043
350000	CURRENT TAX (1966 RATES)	0.429	0.427	0.426	0.426	0.425	0.424	0.422
	TAX UNDER OUR PROPOSALS	0.472	0.468	0.467	0.467	0.467	0.467	0.467
	CHANGE IN EFFECTIVE RATE	0.043	0.041	0.041	0.042	0.042	0.043	0.045
600000	CURRENT TAX (1966 RATES)	0.449	0.448	0.447	0.447	0.447	0.446	0.445
	TAX UNDER OUR PROPOSALS	0.483	0.481	0.481	0.481	0.481	0.481	0.481
	CHANGE IN EFFECTIVE RATE	0.035	0.033	0.034	0.034	0.034	0.035	0.036
1000000	CURRENT TAX (1966 RATES)	0.465	0.464	0.464	0.464	0.464	0.463	0.463
	TAX UNDER OUR PROPOSALS	0.490	0.489	0.489	0.489	0.489	0.488	0.488
	CHANGE IN EFFECTIVE RATE	0.025	0.024	0.024	0.025	0.025	0.025	0.026

Note: See assumptions in Table M-1.

TABLE M, 3-3

EFFECTIVE MARGINAL TAX RATES UNDER THE CURRENT AND PROPOSED TAX SYSTEMS (INCLUDING TAXES PAID BY CORPORATIONS) FOR A TAX UNIT WITH INCOME FROM A TYPICAL PRIVATE COMPANY CAPITALIZING HALF ITS EARNINGS UNDER SECTION 105

GROSS CORPORATE SOURCE INCOME		STATUS OF TAXPAYER						
		UNATTACHED INDIVIDUAL	MARRIED COUPLE					
			NUMBER OF CHILDREN					
			0	1	2	3	5	8
1500	CURRENT TAX (1966 RATES)	0.472	0.472	0.472	0.472	0.472	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.147	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	-0.325	-0.472	-0.472	-0.472	-0.472	-0.472	-0.472
2000	CURRENT TAX (1966 RATES)	0.472	0.472	0.472	0.472	0.472	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.168	0.091	0.000	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	-0.304	-0.381	-0.472	-0.472	-0.472	-0.472	-0.472
2500	CURRENT TAX (1966 RATES)	0.472	0.472	0.472	0.472	0.472	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.170	0.130	0.041	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	-0.302	-0.342	-0.431	-0.472	-0.472	-0.472	-0.472
3000	CURRENT TAX (1966 RATES)	0.472	0.472	0.472	0.472	0.472	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.197	0.157	0.160	0.104	0.007	0.000	0.000
	CHANGE IN MARGINAL RATE	-0.275	-0.315	-0.312	-0.368	-0.465	-0.472	-0.472
3500	CURRENT TAX (1966 RATES)	0.474	0.472	0.472	0.472	0.472	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.200	0.160	0.161	0.164	0.167	0.000	0.000
	CHANGE IN MARGINAL RATE	-0.274	-0.312	-0.311	-0.308	-0.305	-0.472	-0.472
4000	CURRENT TAX (1966 RATES)	0.483	0.472	0.472	0.472	0.472	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.218	0.178	0.180	0.180	0.180	0.166	0.000
	CHANGE IN MARGINAL RATE	-0.265	-0.294	-0.292	-0.292	-0.292	-0.306	-0.472
5000	CURRENT TAX (1966 RATES)	0.483	0.472	0.472	0.472	0.472	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.229	0.189	0.190	0.190	0.190	0.190	0.191
	CHANGE IN MARGINAL RATE	-0.254	-0.283	-0.282	-0.282	-0.282	-0.282	-0.282
6500	CURRENT TAX (1966 RATES)	0.483	0.472	0.472	0.472	0.472	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.240	0.200	0.200	0.200	0.200	0.200	0.200
	CHANGE IN MARGINAL RATE	-0.243	-0.272	-0.272	-0.272	-0.272	-0.272	-0.272
8000	CURRENT TAX (1966 RATES)	0.483	0.483	0.472	0.472	0.472	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.258	0.209	0.210	0.210	0.210	0.210	0.210
	CHANGE IN MARGINAL RATE	-0.225	-0.274	-0.262	-0.262	-0.262	-0.262	-0.262
10000	CURRENT TAX (1966 RATES)	0.483	0.483	0.483	0.483	0.472	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.278	0.219	0.220	0.220	0.220	0.220	0.220
	CHANGE IN MARGINAL RATE	-0.205	-0.264	-0.263	-0.263	-0.252	-0.252	-0.252
12000	CURRENT TAX (1966 RATES)	0.483	0.483	0.483	0.483	0.483	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.298	0.238	0.240	0.240	0.240	0.240	0.240
	CHANGE IN MARGINAL RATE	-0.185	-0.245	-0.243	-0.243	-0.243	-0.232	-0.232
15000	CURRENT TAX (1966 RATES)	0.472	0.483	0.483	0.483	0.483	0.483	0.472
	TAX UNDER OUR PROPOSALS	0.318	0.267	0.270	0.270	0.270	0.270	0.270
	CHANGE IN MARGINAL RATE	-0.154	-0.216	-0.213	-0.213	-0.213	-0.213	-0.202
20000	CURRENT TAX (1966 RATES)	0.472	0.472	0.472	0.481	0.483	0.483	0.483
	TAX UNDER OUR PROPOSALS	0.347	0.306	0.310	0.310	0.310	0.310	0.310
	CHANGE IN MARGINAL RATE	-0.125	-0.166	-0.162	-0.171	-0.173	-0.173	-0.173
25000	CURRENT TAX (1966 RATES)	0.472	0.472	0.472	0.472	0.472	0.472	0.483
	TAX UNDER OUR PROPOSALS	0.368	0.346	0.350	0.350	0.350	0.350	0.350
	CHANGE IN MARGINAL RATE	-0.104	-0.126	-0.122	-0.122	-0.122	-0.122	-0.133
30000	CURRENT TAX (1966 RATES)	0.472	0.472	0.472	0.472	0.472	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.388	0.377	0.380	0.380	0.380	0.380	0.380
	CHANGE IN MARGINAL RATE	-0.084	-0.095	-0.092	-0.092	-0.092	-0.092	-0.092
40000	CURRENT TAX (1966 RATES)	0.472	0.472	0.472	0.472	0.472	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.417	0.416	0.420	0.420	0.420	0.420	0.420
	CHANGE IN MARGINAL RATE	-0.055	-0.056	-0.052	-0.052	-0.052	-0.052	-0.052
50000	CURRENT TAX (1966 RATES)	0.528	0.516	0.472	0.472	0.472	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.438	0.438	0.440	0.440	0.440	0.440	0.440
	CHANGE IN MARGINAL RATE	-0.090	-0.078	-0.032	-0.032	-0.032	-0.032	-0.032
70000	CURRENT TAX (1966 RATES)	0.542	0.542	0.542	0.542	0.542	0.542	0.542
	TAX UNDER OUR PROPOSALS	0.460	0.460	0.460	0.460	0.460	0.460	0.460
	CHANGE IN MARGINAL RATE	-0.082	-0.082	-0.082	-0.082	-0.082	-0.082	-0.082
100000	CURRENT TAX (1966 RATES)	0.556	0.556	0.556	0.556	0.552	0.542	0.542
	TAX UNDER OUR PROPOSALS	0.499	0.499	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	-0.057	-0.057	-0.056	-0.056	-0.052	-0.042	-0.042
200000	CURRENT TAX (1966 RATES)	0.570	0.570	0.570	0.570	0.570	0.570	0.570
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	-0.070	-0.070	-0.070	-0.070	-0.070	-0.070	-0.070
350000	CURRENT TAX (1966 RATES)	0.598	0.598	0.598	0.598	0.598	0.598	0.598
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	-0.098	-0.098	-0.098	-0.098	-0.098	-0.098	-0.098
600000	CURRENT TAX (1966 RATES)	0.612	0.612	0.612	0.612	0.612	0.612	0.612
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	-0.112	-0.112	-0.112	-0.112	-0.112	-0.112	-0.112
1000000	CURRENT TAX (1966 RATES)	0.626	0.626	0.626	0.626	0.626	0.626	0.626
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	-0.126	-0.126	-0.126	-0.126	-0.126	-0.126	-0.126

Note: See assumptions in Table M-1.

APPENDIX N

COMPARISONS OF TAX LIABILITIES ON CORPORATE SOURCE INCOME FROM SHARES FOR TAX UNITS AT DIFFERENT INCOME LEVELS AND WITH DIFFERENT FAMILY CHARACTERISTICS UNDER OUR PROPOSALS AND UNDER THE PROPOSALS OF THE COMMITTEE OF FOUR AS MODIFIED

This appendix provides comparisons of corporation and personal income taxes payable by, or attributable to, tax units with income only from shares under our proposals and under the proposals of the Committee of Four as discussed and modified in Chapter 19. 1/ The comparisons presented show the differences between the total taxes payable under each proposed method of taxation by taxpayers with income only from corporate shares. Differences in average and marginal rates of tax are also shown.

Two comparisons are made:

Case 1: A typical public company distributing one half of its after-tax income as dividends. This corresponds to Case 1 in Appendix M. The results can be found in Tables N, 1-1, N, 1-2 and N, 1-3 provided in this appendix.

Case 2: A typical private company distributing one half of its after-tax income as dividends. This corresponds to Case 2 in Appendix M. The results can be found in Tables N, 2-1, N, 2-2 and N, 2-3 provided in this appendix.

In each case the composition of income is the same as that assumed in the comparable cases in Appendix M, as specified in Table M-1 of that appendix.

The tables are calculated in the same manner as are the tables presented in Appendix M. The figures entered for our proposals in this appendix are in fact identical with those presented in the corresponding tables provided in Appendix M.

The method by which total taxes are computed under each system of taxation is shown in two examples. Table N-1 shows the way in which total

taxes are calculated for a family with two children with a comprehensive tax base income of $10,000 derived exclusively from corporate shares of a typical public company. The taxes derived through this calculation are shown in the fourth column of Table N, 1-1 in the row for a gross corporate source income of $10,000. Table N-2 presents the corresponding tax calculations for a family with two children with a comprehensive tax base income of $100,000 derived exclusively from a typical private company. The resultant taxes are shown in the fourth column of Table N, 2-1 in the row for a gross corporate source income of $100,000.

Under the modified Committee-of-Four proposals the 15 per cent tax would not apply to all corporate income but only to distributions or capitalizations. In all of the calculations we have assumed the same level of distributions as in Appendix M (one half of corporate after-tax income distributed). However, if the modified Committee-of-Four proposals were adopted distributions probably would increase. Most shareholders would prefer to have the corporate income distributed so as to reduce their share gains, which would be subject to tax at higher rates for shareholders with lower income who would be entitled to refunds of the 15 per cent tax and shareholders with marginal tax rates of over 30 per cent. The distribution or capitalization of the remaining balance would increase the figures shown for total taxes by 15 per cent of the amount shown as undistributed income at the bottom of each example given in Tables N-1 and N-2.

In the calculations under the modified Committee-of-Four proposals we have used the same rates of personal income tax for family units and the same credits as under our proposals. We have also assumed the same treatment of family allowances and the same standard deduction as under our proposals. The corporation tax is computed under the dual rate presently in effect, using the average corporation tax rates referred to in note a/ to Table M-1 in Appendix M.

REFERENCE

1/ The principal modification is to bring into a shareholder's income the gains on realization of shares and to apply tax to such gains at one half of personal rates.

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TABLE N-1

CASE 1 EXAMPLE:

CALCULATION OF TAXES UNDER OUR PROPOSALS AND THE MODIFIED PROPOSALS OF THE COMMITTEE OF FOUR FOR A MARRIED COUPLE WITH TWO CHILDREN WITH A COMPREHENSIVE TAX BASE INCOME OF $10,000 DERIVED EXCLUSIVELY FROM SHARES IN A TYPICAL PUBLIC COMPANY a/

	Tax Base and Taxes Under Our Proposals		Tax Base and Taxes Under Committee-of-Four Proposals	
Tax Base	At Corporate Level	At Personal Level	At Corporate Level	At Personal Level
Income from corporate sources:				
Dividends	$2,019.15	$2,019.15	$2,019.15	N.A.
Other corporate income, before corporation tax	5,961.70	5,961.70	5,961.70 b/	N.A.
Goodwill gains on stock held by taxpayer	-	2,019.15	-	2,019.15
Total corporate source base	$7,980.85	$10,000.00 c/	$7,980.85	$2,019.15
Family allowances	-	144.00	-	144.00
Total income	-	$10,144.00	-	$2,163.15
Standard deduction	-	50.00	-	50.00
Net tax base	$7,980.85	$10,094.00	$7,980.85	$2,113.15
Taxes				
Gross tax (before credits)	3,990.43	1,487.68	3,942.54	-
Additional tax on corporate distributions d/	N.A.	-	302.87	-
Non-refundable tax credits for dependants	-	160.00	-	160.00
Tax after dependant credits	-	$1,327.68	-	-
Refundable credits:				
of corporation taxes	-	3,990.43	-	N.A.
on corporate distributions	-	N.A.	-	302.87
Total tax	$3,990.43	($2,662.75)	$4,245.41	($ 302.87)
Total taxes e/	$1,327.68		$3,942.54	
Undistributed or unallocated income	-		$2,019.15	

a/ Numbers enclosed in parentheses are negative. "N.A." means not applicable. The relationship among the components of corporate source income is that specified in Appendix M, Table M-1, column 2, for a shareholder in a typical public company.

b/ Consists of undistributed income of $2,019.15 and corporation tax of $3,942.54 (49.4 per cent of $7,980.85).

c/ This is the income of the taxpayer considered in this example.

d/ 15 per cent of $2,019.15.

e/ Under the modified Committee-of-Four proposals it is possible that the corporation would distribute or capitalize the full amount of corporate income, to reduce to a minimum the amount that would eventually be subject to the capital gains tax. In this example, however, there would be no increase in the total tax payable as the shareholder would receive a refund of the 15 per cent tax paid.

TABLE N-2

CASE 2 EXAMPLE:

CALCULATION OF TAXES UNDER OUR PROPOSALS AND THE MODIFIED PROPOSALS OF THE COMMITTEE OF FOUR FOR A MARRIED COUPLE WITH TWO CHILDREN WITH A COMPREHENSIVE TAX BASE INCOME OF $100,000 DERIVED EXCLUSIVELY FROM SHARES IN A TYPICAL PRIVATE COMPANY a/

	Tax Base and Taxes Under Our Proposals		Tax Base and Taxes Under Committee-of-Four Proposals	
Tax Base	At Corporate Level	At Personal Level	At Corporate Level	At Personal Level
Income from corporate sources:				
Dividends	$27,956.99	$27,956.99	$27,956.99	N.A.
Other corporate income, before corporation tax	58,064.52	58,064.52	58,064.52 b/	N.A.
Goodwill gains on stock held by taxpayer	-	13,978.49	-	13,978.49
Total corporate source base	$86,021.51	$100,000.00 c/	$86,021.51	$13,978.49
Family allowances	-	144.00	-	144.00
Total income	-	$100,144.00	-	$14,122.49
Standard deduction	-	50.00	-	50.00
Net tax base	$86,021.51	$100,094.00	$86,021.51	$14,072.49
Taxes				
Gross tax (before credits)	$43,010.76	$38,724.00	$30,107.53	$ 863.65
Additional tax on corporate distributions d/	N.A.	-	4,193.55	-
Non-refundable tax credits for dependants	-	160.00	-	160.00
Tax after dependant credits	-	$38,564.00	-	$ 703.65
Refundable credits:				
of corporation taxes	-	$43,010.76	-	N.A.
on corporate distributions	-	N.A.	-	-
Total tax	$43,010.76	($4,446.76)	$34,301.08	$ 703.65
Total taxes e/	$38,564.00		$35,004.73	
Undistributed or unallocated income	-		$27,956.99	

a/ Numbers enclosed in parentheses are negative. "N.A." means not applicable. The relationship among the components of corporate source income is that specified in Appendix M, Table M-1, column 2, for a shareholder in a typical private company.

b/ Consists of undistributed income of $27,956.99 and corporation tax of $30,107.53 (35 per cent of $86,021.51).

c/ This is the income of the taxpayer considered in this example.

d/ 15 per cent of $27,956.99.

e/ Under the modified Committee-of-Four proposals it is possible that the corporation would distribute or capitalize the full amount of corporate income, to reduce to a minimum the amount that would eventually be subject to the capital gains tax. If the 15 per cent were paid on the full corporate income the $35,004.73 of tax would increase to $39,198.28.

TABLE N, 1-1

CHANGES IN TAX LIABILITIES UNDER OUR PROPOSALS FROM THOSE WHICH WOULD ARISE UNDER THE MODIFIED PROPOSALS OF THE COMMITTEE OF FOUR (INCLUDING TAXES PAID BY CORPORATIONS) FOR A TAX UNIT WITH INCOME FROM A TYPICAL PUBLIC COMPANY

GROSS CORPORATE SOURCE INCOME		STATUS OF TAXPAYER						
		UNATTACHED INDIVIDUAL	MARRIED COUPLE					
			NUMBER OF CHILDREN					
			0	1	2	3	5	8
1500	ALTERNATIVE TAX PROPOSAL	591.	591.	591.	591.	591.	591.	591.
	TAX UNDER OUR PROPOSALS	54.	0.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	-537.	-591.	-591.	-591.	-591.	-591.	-591.
2000	ALTERNATIVE TAX PROPOSAL	789.	789.	789.	789.	789.	789.	789.
	TAX UNDER OUR PROPOSALS	128.	0.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	-661.	-789.	-789.	-789.	-789.	-789.	-789.
2500	ALTERNATIVE TAX PROPOSAL	986.	986.	986.	986.	986.	986.	986.
	TAX UNDER OUR PROPOSALS	212.	46.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	-774.	-940.	-986.	-986.	-986.	-986.	-986.
3000	ALTERNATIVE TAX PROPOSAL	1183.	1183.	1183.	1183.	1183.	1183.	1183.
	TAX UNDER OUR PROPOSALS	297.	111.	21.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	-886.	-1072.	-1162.	-1183.	-1183.	-1183.	-1183.
3500	ALTERNATIVE TAX PROPOSAL	1380.	1380.	1380.	1380.	1380.	1380.	1380.
	TAX UNDER OUR PROPOSALS	395.	189.	101.	52.	4.	0.	0.
	INCREASE OR DECREASE IN TAX	-985.	-1191.	-1279.	-1328.	-1376.	-1380.	-1380.
4000	ALTERNATIVE TAX PROPOSAL	1577.	1577.	1577.	1577.	1577.	1577.	1577.
	TAX UNDER OUR PROPOSALS	495.	269.	181.	134.	87.	0.	0.
	INCREASE OR DECREASE IN TAX	-1082.	-1308.	-1396.	-1443.	-1490.	-1577.	-1577.
5000	ALTERNATIVE TAX PROPOSAL	1971.	1971.	1971.	1971.	1971.	1971.	1971.
	TAX UNDER OUR PROPOSALS	714.	448.	361.	315.	269.	176.	37.
	INCREASE OR DECREASE IN TAX	-1257.	-1523.	-1610.	-1656.	-1703.	-1795.	-1934.
6500	ALTERNATIVE TAX PROPOSAL	2563.	2563.	2563.	2563.	2563.	2563.	2563.
	TAX UNDER OUR PROPOSALS	1063.	737.	651.	606.	560.	469.	332.
	INCREASE OR DECREASE IN TAX	-1500.	-1826.	-1911.	-1957.	-2002.	-2094.	-2230.
8000	ALTERNATIVE TAX PROPOSAL	3154.	3154.	3154.	3154.	3154.	3154.	3154.
	TAX UNDER OUR PROPOSALS	1423.	1037.	952.	907.	862.	772.	637.
	INCREASE OR DECREASE IN TAX	-1731.	-2117.	-2202.	-2247.	-2292.	-2382.	-2517.
10000	ALTERNATIVE TAX PROPOSAL	3943.	3943.	3943.	3943.	3943.	3943.	3943.
	TAX UNDER OUR PROPOSALS	1942.	1457.	1372.	1328.	1284.	1195.	1063.
	INCREASE OR DECREASE IN TAX	-2001.	-2486.	-2571.	-2615.	-2659.	-2747.	-2880.
12000	ALTERNATIVE TAX PROPOSAL	4750.	4731.	4731.	4731.	4731.	4731.	4731.
	TAX UNDER OUR PROPOSALS	2501.	1896.	1812.	1770.	1727.	1641.	1513.
	INCREASE OR DECREASE IN TAX	-2249.	-2835.	-2919.	-2961.	-3004.	-3090.	-3218.
15000	ALTERNATIVE TAX PROPOSAL	5970.	5914.	5914.	5914.	5914.	5914.	5914.
	TAX UNDER OUR PROPOSALS	3400.	2615.	2533.	2492.	2452.	2371.	2249.
	INCREASE OR DECREASE IN TAX	-2570.	-3299.	-3381.	-3421.	-3462.	-3543.	-3665.
20000	ALTERNATIVE TAX PROPOSAL	8015.	7885.	7885.	7885.	7885.	7885.	7885.
	TAX UNDER OUR PROPOSALS	4999.	3964.	3884.	3846.	3808.	3733.	3620.
	INCREASE OR DECREASE IN TAX	-3016.	-3922.	-4001.	-4039.	-4077.	-4152.	-4265.
25000	ALTERNATIVE TAX PROPOSAL	10829.	10662.	10614.	10614.	10614.	10614.	10614.
	TAX UNDER OUR PROPOSALS	6748.	5512.	5435.	5400.	5365.	5296.	5191.
	INCREASE OR DECREASE IN TAX	-4082.	-5151.	-5179.	-5214.	-5248.	-5318.	-5422.
30000	ALTERNATIVE TAX PROPOSAL	13038.	12850.	12761.	12736.	12736.	12736.	12736.
	TAX UNDER OUR PROPOSALS	8597.	7260.	7185.	7153.	7120.	7055.	6957.
	INCREASE OR DECREASE IN TAX	-4441.	-5591.	-5576.	-5584.	-5616.	-5681.	-5779.
40000	ALTERNATIVE TAX PROPOSAL	17484.	17257.	17169.	17122.	17075.	16982.	16982.
	TAX UNDER OUR PROPOSALS	12496.	11058.	10986.	10956.	10927.	10867.	10778.
	INCREASE OR DECREASE IN TAX	-4989.	-6199.	-6183.	-6166.	-6149.	-6114.	-6204.
50000	ALTERNATIVE TAX PROPOSAL	21952.	21684.	21597.	21551.	21505.	21412.	21273.
	TAX UNDER OUR PROPOSALS	16694.	15256.	15187.	15158.	15130.	15073.	14988.
	INCREASE OR DECREASE IN TAX	-5258.	-6428.	-6411.	-6393.	-6375.	-6339.	-6285.
70000	ALTERNATIVE TAX PROPOSAL	30917.	30568.	30483.	30437.	30391.	30300.	30163.
	TAX UNDER OUR PROPOSALS	25692.	24254.	24187.	24160.	24133.	24080.	23999.
	INCREASE OR DECREASE IN TAX	-5225.	-6314.	-6296.	-6277.	-6258.	-6221.	-6165.
100000	ALTERNATIVE TAX PROPOSAL	44422.	43931.	43847.	43803.	43759.	43670.	43538.
	TAX UNDER OUR PROPOSALS	40091.	38653.	38588.	38564.	38540.	38492.	38420.
	INCREASE OR DECREASE IN TAX	-4331.	-5279.	-5259.	-5239.	-5219.	-5178.	-5118.
200000	ALTERNATIVE TAX PROPOSAL	89973.	88929.	88851.	88814.	88776.	88701.	88588.
	TAX UNDER OUR PROPOSALS	90090.	88652.	88588.	88564.	88540.	88492.	88420.
	INCREASE OR DECREASE IN TAX	117.	-277.	-263.	-250.	-236.	-209.	-168.
350000	ALTERNATIVE TAX PROPOSAL	159266.	157875.	157802.	157769.	157737.	157672.	157574.
	TAX UNDER OUR PROPOSALS	165090.	163652.	163588.	163564.	163540.	163492.	163420.
	INCREASE OR DECREASE IN TAX	5824.	5777.	5786.	5795.	5803.	5820.	5846.
600000	ALTERNATIVE TAX PROPOSAL	276081.	274643.	274576.	274549.	274522.	274469.	274388.
	TAX UNDER OUR PROPOSALS	290090.	288652.	288588.	288564.	288540.	288492.	288420.
	INCREASE OR DECREASE IN TAX	14009.	14009.	14012.	14015.	14018.	14023.	14032.
1000000	ALTERNATIVE TAX PROPOSAL	465110.	463672.	463608.	463584.	463560.	463512.	463440.
	TAX UNDER OUR PROPOSALS	490090.	488652.	488588.	488564.	488540.	488492.	488420.
	INCREASE OR DECREASE IN TAX	24980.	24980.	24980.	24980.	24980.	24980.	24980.

Note: See assumptions in Appendix M and earlier in this Appendix.

TABLE N, 1-2

EFFECTIVE AVERAGE TAX RATES UNDER OUR PROPOSALS AND UNDER THE MODIFIED PROPOSALS OF THE COMMITTEE OF FOUR (INCLUDING TAXES PAID BY CORPORATIONS) FOR A TAX UNIT WITH INCOME FROM A TYPICAL PUBLIC COMPANY

GROSS CORPORATE SOURCE INCOME		STATUS OF TAXPAYER						
		UNATTACHED INDIVIDUAL	MARRIED COUPLE					
			NUMBER OF CHILDREN					
		0	0	1	2	3	5	8
1500	ALTERNATIVE TAX PROPOSAL	0.394	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.036	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	-0.358	-0.394	-0.394	-0.394	-0.394	-0.394	-0.394
2000	ALTERNATIVE TAX PROPOSAL	0.394	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.064	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	-0.331	-0.394	-0.394	-0.394	-0.394	-0.394	-0.394
2500	ALTERNATIVE TAX PROPOSAL	0.394	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.085	0.018	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	-0.310	-0.376	-0.394	-0.394	-0.394	-0.394	-0.394
3000	ALTERNATIVE TAX PROPOSAL	0.394	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.099	0.037	0.007	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	-0.295	-0.357	-0.387	-0.394	-0.394	-0.394	-0.394
3500	ALTERNATIVE TAX PROPOSAL	0.394	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.113	0.054	0.029	0.015	0.001	0.000	0.000
	CHANGE IN EFFECTIVE RATE	-0.281	-0.340	-0.366	-0.379	-0.393	-0.394	-0.394
4000	ALTERNATIVE TAX PROPOSAL	0.394	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.124	0.067	0.045	0.033	0.022	0.000	0.000
	CHANGE IN EFFECTIVE RATE	-0.271	-0.327	-0.349	-0.361	-0.373	-0.394	-0.394
5000	ALTERNATIVE TAX PROPOSAL	0.394	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.143	0.090	0.072	0.063	0.054	0.035	0.007
	CHANGE IN EFFECTIVE RATE	-0.251	-0.305	-0.322	-0.331	-0.341	-0.359	-0.387
6500	ALTERNATIVE TAX PROPOSAL	0.394	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.164	0.113	0.100	0.093	0.086	0.072	0.051
	CHANGE IN EFFECTIVE RATE	-0.231	-0.281	-0.294	-0.301	-0.308	-0.322	-0.343
8000	ALTERNATIVE TAX PROPOSAL	0.394	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.178	0.130	0.119	0.113	0.108	0.097	0.080
	CHANGE IN EFFECTIVE RATE	-0.216	-0.265	-0.275	-0.281	-0.287	-0.298	-0.315
10000	ALTERNATIVE TAX PROPOSAL	0.394	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.194	0.146	0.137	0.133	0.128	0.120	0.106
	CHANGE IN EFFECTIVE RATE	-0.200	-0.249	-0.257	-0.261	-0.266	-0.275	-0.288
12000	ALTERNATIVE TAX PROPOSAL	0.396	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.208	0.158	0.151	0.147	0.144	0.137	0.126
	CHANGE IN EFFECTIVE RATE	-0.187	-0.236	-0.243	-0.247	-0.250	-0.257	-0.268
15000	ALTERNATIVE TAX PROPOSAL	0.398	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.227	0.174	0.169	0.166	0.163	0.158	0.150
	CHANGE IN EFFECTIVE RATE	-0.171	-0.220	-0.225	-0.228	-0.231	-0.236	-0.244
20000	ALTERNATIVE TAX PROPOSAL	0.401	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.250	0.198	0.194	0.192	0.190	0.187	0.181
	CHANGE IN EFFECTIVE RATE	-0.151	-0.196	-0.200	-0.202	-0.204	-0.208	-0.213
25000	ALTERNATIVE TAX PROPOSAL	0.433	0.426	0.425	0.425	0.425	0.425	0.425
	TAX UNDER OUR PROPOSALS	0.270	0.220	0.217	0.216	0.215	0.212	0.208
	CHANGE IN EFFECTIVE RATE	-0.163	-0.206	-0.207	-0.209	-0.210	-0.213	-0.217
30000	ALTERNATIVE TAX PROPOSAL	0.435	0.428	0.425	0.425	0.425	0.425	0.425
	TAX UNDER OUR PROPOSALS	0.287	0.242	0.240	0.238	0.237	0.235	0.232
	CHANGE IN EFFECTIVE RATE	-0.148	-0.186	-0.186	-0.186	-0.187	-0.189	-0.193
40000	ALTERNATIVE TAX PROPOSAL	0.437	0.431	0.429	0.428	0.427	0.425	0.425
	TAX UNDER OUR PROPOSALS	0.312	0.276	0.275	0.274	0.273	0.272	0.269
	CHANGE IN EFFECTIVE RATE	-0.125	-0.155	-0.155	-0.154	-0.154	-0.153	-0.155
50000	ALTERNATIVE TAX PROPOSAL	0.439	0.434	0.432	0.431	0.430	0.428	0.425
	TAX UNDER OUR PROPOSALS	0.334	0.305	0.304	0.303	0.303	0.301	0.300
	CHANGE IN EFFECTIVE RATE	-0.105	-0.129	-0.128	-0.128	-0.127	-0.127	-0.126
70000	ALTERNATIVE TAX PROPOSAL	0.442	0.437	0.435	0.435	0.434	0.433	0.431
	TAX UNDER OUR PROPOSALS	0.367	0.346	0.346	0.345	0.345	0.344	0.343
	CHANGE IN EFFECTIVE RATE	-0.075	-0.090	-0.090	-0.090	-0.089	-0.089	-0.088
100000	ALTERNATIVE TAX PROPOSAL	0.444	0.439	0.438	0.438	0.438	0.437	0.435
	TAX UNDER OUR PROPOSALS	0.401	0.387	0.386	0.386	0.385	0.385	0.384
	CHANGE IN EFFECTIVE RATE	-0.043	-0.053	-0.053	-0.052	-0.052	-0.052	-0.051
200000	ALTERNATIVE TAX PROPOSAL	0.450	0.445	0.444	0.444	0.444	0.444	0.443
	TAX UNDER OUR PROPOSALS	0.450	0.443	0.443	0.443	0.443	0.442	0.442
	CHANGE IN EFFECTIVE RATE	0.000	-0.001	-0.001	-0.001	-0.001	-0.001	-0.001
350000	ALTERNATIVE TAX PROPOSAL	0.455	0.451	0.451	0.451	0.451	0.450	0.450
	TAX UNDER OUR PROPOSALS	0.472	0.468	0.467	0.467	0.467	0.467	0.467
	CHANGE IN EFFECTIVE RATE	0.017	0.017	0.017	0.017	0.017	0.017	0.017
600000	ALTERNATIVE TAX PROPOSAL	0.460	0.458	0.458	0.458	0.458	0.457	0.457
	TAX UNDER OUR PROPOSALS	0.483	0.481	0.481	0.481	0.481	0.481	0.481
	CHANGE IN EFFECTIVE RATE	0.023	0.023	0.023	0.023	0.023	0.023	0.023
1000000	ALTERNATIVE TAX PROPOSAL	0.465	0.464	0.464	0.464	0.464	0.464	0.463
	TAX UNDER OUR PROPOSALS	0.490	0.489	0.489	0.489	0.489	0.488	0.488
	CHANGE IN EFFECTIVE RATE	0.025	0.025	0.025	0.025	0.025	0.025	0.025

Note: See assumptions in Appendix M and earlier in this Appendix.

TABLE N, 1-3

EFFECTIVE MARGINAL TAX RATES UNDER OUR PROPOSALS AND UNDER THE MODIFIED PROPOSALS OF THE COMMITTEE OF FOUR (INCLUDING TAXES PAID BY CORPORATIONS) FOR A TAX UNIT WITH INCOME FROM A TYPICAL PUBLIC COMPANY

GROSS CORPORATE SOURCE INCOME		STATUS OF TAXPAYER: UNATTACHED INDIVIDUAL	MARRIED COUPLE — NUMBER OF CHILDREN: 0	1	2	3	5	8
1500	ALTERNATIVE TAX PROPOSAL	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.147	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	-0.252	-0.399	-0.399	-0.399	-0.399	-0.399	-0.399
2000	ALTERNATIVE TAX PROPOSAL	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.168	0.091	0.000	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	-0.231	-0.308	-0.399	-0.399	-0.399	-0.399	-0.399
2500	ALTERNATIVE TAX PROPOSAL	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.170	0.130	0.041	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	-0.229	-0.269	-0.358	-0.399	-0.399	-0.399	-0.399
3000	ALTERNATIVE TAX PROPOSAL	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.197	0.157	0.160	0.104	0.007	0.000	0.000
	CHANGE IN MARGINAL RATE	-0.202	-0.242	-0.239	-0.295	-0.392	-0.399	-0.399
3500	ALTERNATIVE TAX PROPOSAL	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.200	0.160	0.161	0.164	0.167	0.000	0.000
	CHANGE IN MARGINAL RATE	-0.199	-0.239	-0.238	-0.235	-0.232	-0.399	-0.399
4000	ALTERNATIVE TAX PROPOSAL	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.218	0.178	0.180	0.180	0.180	0.166	0.000
	CHANGE IN MARGINAL RATE	-0.181	-0.221	-0.219	-0.219	-0.219	-0.233	-0.399
5000	ALTERNATIVE TAX PROPOSAL	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.229	0.189	0.190	0.190	0.190	0.190	0.191
	CHANGE IN MARGINAL RATE	-0.170	-0.210	-0.209	-0.209	-0.209	-0.209	-0.209
6500	ALTERNATIVE TAX PROPOSAL	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.240	0.200	0.200	0.200	0.200	0.200	0.200
	CHANGE IN MARGINAL RATE	-0.159	-0.199	-0.199	-0.199	-0.199	-0.199	-0.199
8000	ALTERNATIVE TAX PROPOSAL	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.258	0.209	0.210	0.210	0.210	0.210	0.210
	CHANGE IN MARGINAL RATE	-0.141	-0.190	-0.189	-0.189	-0.189	-0.189	-0.189
10000	ALTERNATIVE TAX PROPOSAL	0.401	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.278	0.219	0.220	0.220	0.220	0.220	0.220
	CHANGE IN MARGINAL RATE	-0.123	-0.180	-0.179	-0.179	-0.179	-0.179	-0.179
12000	ALTERNATIVE TAX PROPOSAL	0.411	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.298	0.238	0.240	0.240	0.240	0.240	0.240
	CHANGE IN MARGINAL RATE	-0.113	-0.161	-0.159	-0.159	-0.159	-0.159	-0.159
15000	ALTERNATIVE TAX PROPOSAL	0.412	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.318	0.267	0.270	0.270	0.270	0.270	0.270
	CHANGE IN MARGINAL RATE	-0.094	-0.132	-0.129	-0.129	-0.129	-0.129	-0.129
20000	ALTERNATIVE TAX PROPOSAL	0.415	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.347	0.306	0.310	0.310	0.310	0.310	0.310
	CHANGE IN MARGINAL RATE	-0.068	-0.093	-0.089	-0.089	-0.089	-0.089	-0.089
25000	ALTERNATIVE TAX PROPOSAL	0.446	0.442	0.429	0.429	0.429	0.429	0.429
	TAX UNDER OUR PROPOSALS	0.368	0.346	0.350	0.350	0.350	0.350	0.350
	CHANGE IN MARGINAL RATE	-0.078	-0.096	-0.079	-0.079	-0.079	-0.079	-0.079
30000	ALTERNATIVE TAX PROPOSAL	0.448	0.444	0.445	0.429	0.429	0.429	0.429
	TAX UNDER OUR PROPOSALS	0.388	0.377	0.380	0.380	0.380	0.380	0.380
	CHANGE IN MARGINAL RATE	-0.060	-0.067	-0.065	-0.049	-0.049	-0.049	-0.049
40000	ALTERNATIVE TAX PROPOSAL	0.451	0.447	0.448	0.448	0.448	0.447	0.429
	TAX UNDER OUR PROPOSALS	0.417	0.416	0.420	0.420	0.420	0.420	0.420
	CHANGE IN MARGINAL RATE	-0.034	-0.031	-0.028	-0.028	-0.028	-0.027	-0.009
50000	ALTERNATIVE TAX PROPOSAL	0.453	0.448	0.449	0.449	0.449	0.449	0.449
	TAX UNDER OUR PROPOSALS	0.438	0.438	0.440	0.440	0.440	0.440	0.440
	CHANGE IN MARGINAL RATE	-0.015	-0.010	-0.009	-0.009	-0.009	-0.009	-0.009
70000	ALTERNATIVE TAX PROPOSAL	0.454	0.450	0.450	0.450	0.450	0.450	0.450
	TAX UNDER OUR PROPOSALS	0.460	0.460	0.460	0.460	0.460	0.460	0.460
	CHANGE IN MARGINAL RATE	0.006	0.010	0.010	0.010	0.010	0.010	0.010
100000	ALTERNATIVE TAX PROPOSAL	0.458	0.452	0.452	0.452	0.452	0.452	0.452
	TAX UNDER OUR PROPOSALS	0.499	0.499	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	0.041	0.047	0.048	0.048	0.048	0.048	0.048
200000	ALTERNATIVE TAX PROPOSAL	0.465	0.461	0.461	0.461	0.461	0.461	0.461
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	0.035	0.039	0.039	0.039	0.039	0.039	0.039
350000	ALTERNATIVE TAX PROPOSAL	0.469	0.468	0.468	0.468	0.468	0.468	0.468
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	0.031	0.032	0.032	0.032	0.032	0.032	0.032
600000	ALTERNATIVE TAX PROPOSAL	0.476	0.476	0.476	0.476	0.476	0.476	0.476
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	0.024	0.024	0.024	0.024	0.024	0.024	0.024
1000000	ALTERNATIVE TAX PROPOSAL	0.480	0.480	0.480	0.480	0.480	0.480	0.480
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	0.020	0.020	0.020	0.020	0.020	0.020	0.020

Note: See assumptions in Appendix M and earlier in this Appendix.

TABLE N, 2-1

CHANGES IN TAX LIABILITIES UNDER OUR PROPOSALS FROM THOSE WHICH WOULD ARISE UNDER THE MODIFIED PROPOSALS OF THE COMMITTEE OF FOUR (INCLUDING TAXES PAID BY CORPORATIONS) FOR A TAX UNIT WITH INCOME FROM A TYPICAL PRIVATE COMPANY NOT MAKING USE OF SECTION 105 CAPITALIZATIONS

GROSS CORPORATE SOURCE INCOME		STATUS OF TAXPAYER: UNATTACHED INDIVIDUAL	MARRIED COUPLE — NUMBER OF CHILDREN: 0	1	2	3	5	8
1500	ALTERNATIVE TAX PROPOSAL	452.	452.	452.	452.	452.	452.	452.
	TAX UNDER OUR PROPOSALS	54.	0.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	-398.	-452.	-452.	-452.	-452.	-452.	-452.
2000	ALTERNATIVE TAX PROPOSAL	602.	602.	602.	602.	602.	602.	602.
	TAX UNDER OUR PROPOSALS	128.	0.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	-475.	-602.	-602.	-602.	-602.	-602.	-602.
2500	ALTERNATIVE TAX PROPOSAL	753.	753.	753.	753.	753.	753.	753.
	TAX UNDER OUR PROPOSALS	212.	46.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	-541.	-707.	-753.	-753.	-753.	-753.	-753.
3000	ALTERNATIVE TAX PROPOSAL	903.	903.	903.	903.	903.	903.	903.
	TAX UNDER OUR PROPOSALS	297.	111.	21.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	-607.	-793.	-883.	-903.	-903.	-903.	-903.
3500	ALTERNATIVE TAX PROPOSAL	1054.	1054.	1054.	1054.	1054.	1054.	1054.
	TAX UNDER OUR PROPOSALS	395.	189.	101.	52.	4.	0.	0.
	INCREASE OR DECREASE IN TAX	-659.	-865.	-953.	-1002.	-1050.	-1054.	-1054.
4000	ALTERNATIVE TAX PROPOSAL	1204.	1204.	1204.	1204.	1204.	1204.	1204.
	TAX UNDER OUR PROPOSALS	495.	269.	181.	134.	87.	0.	0.
	INCREASE OR DECREASE IN TAX	-709.	-935.	-1023.	-1070.	-1117.	-1204.	-1204.
5000	ALTERNATIVE TAX PROPOSAL	1505.	1505.	1505.	1505.	1505.	1505.	1505.
	TAX UNDER OUR PROPOSALS	714.	448.	361.	315.	269.	176.	37.
	INCREASE OR DECREASE IN TAX	-791.	-1057.	-1144.	-1191.	-1237.	-1329.	-1468.
6500	ALTERNATIVE TAX PROPOSAL	1957.	1957.	1957.	1957.	1957.	1957.	1957.
	TAX UNDER OUR PROPOSALS	1063.	737.	651.	606.	560.	469.	332.
	INCREASE OR DECREASE IN TAX	-894.	-1220.	-1306.	-1351.	-1397.	-1488.	-1625.
8000	ALTERNATIVE TAX PROPOSAL	2409.	2409.	2409.	2409.	2409.	2409.	2409.
	TAX UNDER OUR PROPOSALS	1423.	1037.	952.	907.	862.	772.	637.
	INCREASE OR DECREASE IN TAX	-986.	-1372.	-1457.	-1502.	-1547.	-1637.	-1771.
10000	ALTERNATIVE TAX PROPOSAL	3011.	3011.	3011.	3011.	3011.	3011.	3011.
	TAX UNDER OUR PROPOSALS	1942.	1457.	1372.	1328.	1284.	1195.	1063.
	INCREASE OR DECREASE IN TAX	-1069.	-1554.	-1639.	-1683.	-1727.	-1816.	-1948.
12000	ALTERNATIVE TAX PROPOSAL	3613.	3613.	3613.	3613.	3613.	3613.	3613.
	TAX UNDER OUR PROPOSALS	2501.	1896.	1812.	1770.	1727.	1641.	1513.
	INCREASE OR DECREASE IN TAX	-1112.	-1717.	-1801.	-1843.	-1886.	-1972.	-2100.
15000	ALTERNATIVE TAX PROPOSAL	4516.	4516.	4516.	4516.	4516.	4516.	4516.
	TAX UNDER OUR PROPOSALS	3400.	2615.	2533.	2492.	2452.	2371.	2249.
	INCREASE OR DECREASE IN TAX	-1116.	-1901.	-1983.	-2024.	-2064.	-2145.	-2267.
20000	ALTERNATIVE TAX PROPOSAL	6063.	6022.	6022.	6022.	6022.	6022.	6022.
	TAX UNDER OUR PROPOSALS	4999.	3964.	3884.	3846.	3808.	3733.	3620.
	INCREASE OR DECREASE IN TAX	-1064.	-2058.	-2138.	-2175.	-2213.	-2288.	-2401.
25000	ALTERNATIVE TAX PROPOSAL	8665.	8575.	8575.	8575.	8575.	8575.	8575.
	TAX UNDER OUR PROPOSALS	6748.	5512.	5435.	5400.	5365.	5296.	5191.
	INCREASE OR DECREASE IN TAX	-1917.	-3064.	-3141.	-3175.	-3210.	-3280.	-3384.
30000	ALTERNATIVE TAX PROPOSAL	10433.	10290.	10290.	10290.	10290.	10290.	10290.
	TAX UNDER OUR PROPOSALS	8597.	7260.	7185.	7153.	7120.	7055.	6957.
	INCREASE OR DECREASE IN TAX	-1837.	-3031.	-3105.	-3138.	-3170.	-3236.	-3333.
40000	ALTERNATIVE TAX PROPOSAL	13982.	13804.	13720.	13720.	13720.	13720.	13720.
	TAX UNDER OUR PROPOSALS	12496.	11058.	10986.	10956.	10927.	10867.	10778.
	INCREASE OR DECREASE IN TAX	-1487.	-2746.	-2734.	-2764.	-2794.	-2853.	-2943.
50000	ALTERNATIVE TAX PROPOSAL	17544.	17339.	17250.	17202.	17153.	17151.	17151.
	TAX UNDER OUR PROPOSALS	16694.	15256.	15187.	15158.	15130.	15073.	14988.
	INCREASE OR DECREASE IN TAX	-850.	-2083.	-2064.	-2043.	-2023.	-2077.	-2162.
70000	ALTERNATIVE TAX PROPOSAL	24701.	24439.	24352.	24305.	24259.	24166.	24027.
	TAX UNDER OUR PROPOSALS	25692.	24254.	24187.	24160.	24133.	24080.	23999.
	INCREASE OR DECREASE IN TAX	991.	-185.	-165.	-145.	-126.	-87.	-28.
100000	ALTERNATIVE TAX PROPOSAL	35481.	35136.	35050.	35005.	34959.	34868.	34731.
	TAX UNDER OUR PROPOSALS	40091.	38653.	38588.	38564.	38540.	38492.	38420.
	INCREASE OR DECREASE IN TAX	4609.	3517.	3538.	3559.	3581.	3624.	3689.
200000	ALTERNATIVE TAX PROPOSAL	71696.	70972.	70889.	70847.	70804.	70718.	70590.
	TAX UNDER OUR PROPOSALS	90090.	88652.	88588.	88564.	88540.	88492.	88420.
	INCREASE OR DECREASE IN TAX	18394.	17680.	17699.	17717.	17736.	17774.	17830.
350000	ALTERNATIVE TAX PROPOSAL	126613.	125399.	125321.	125283.	125246.	125170.	125057.
	TAX UNDER OUR PROPOSALS	165090.	163652.	163588.	163564.	163540.	163493.	163420.
	INCREASE OR DECREASE IN TAX	38477.	38253.	38267.	38281.	38294.	163492.	38363.
600000	ALTERNATIVE TAX PROPOSAL	219113.	217675.	217606.	217576.	217546.	217487.	217397.
	TAX UNDER OUR PROPOSALS	290090.	288652.	288588.	288564.	288540.	288492.	288420.
	INCREASE OR DECREASE IN TAX	70977.	70977.	70982.	70988.	70994.	71005.	71023.
1000000	ALTERNATIVE TAX PROPOSAL	368653.	367215.	367148.	367122.	367095.	367041.	366960.
	TAX UNDER OUR PROPOSALS	490090.	488652.	488588.	488564.	488540.	488492.	488420.
	INCREASE OR DECREASE IN TAX	121437.	121437.	121440.	121442.	121445.	121451.	121460.

Note: See assumptions in Appendix M and earlier in this Appendix.

TABLE N, 2-2

EFFECTIVE AVERAGE TAX RATES UNDER OUR PROPOSALS AND UNDER THE MODIFIED PROPOSALS OF THE COMMITTEE OF FOUR (INCLUDING TAXES PAID BY CORPORATIONS) FOR A TAX UNIT WITH INCOME FROM A TYPICAL PRIVATE COMPANY NOT MAKING USE OF SECTION 105 CAPITALIZATIONS

GROSS CORPORATE SOURCE INCOME		STATUS OF TAXPAYER						
		UNAT-TACHED INDIVI-DUAL	MARRIED COUPLE					
			NUMBER OF CHILDREN					
			0	1	2	3	5	8
1500	ALTERNATIVE TAX PROPOSAL	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.036	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	-0.265	-0.301	-0.301	-0.301	-0.301	-0.301	-0.301
2000	ALTERNATIVE TAX PROPOSAL	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.064	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	-0.237	-0.301	-0.301	-0.301	-0.301	-0.301	-0.301
2500	ALTERNATIVE TAX PROPOSAL	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.085	0.018	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	-0.216	-0.283	-0.301	-0.301	-0.301	-0.301	-0.301
3000	ALTERNATIVE TAX PROPOSAL	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.099	0.037	0.007	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	-0.202	-0.264	-0.294	-0.301	-0.301	-0.301	-0.301
3500	ALTERNATIVE TAX PROPOSAL	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.113	0.054	0.029	0.015	0.001	0.000	0.000
	CHANGE IN EFFECTIVE RATE	-0.188	-0.247	-0.272	-0.286	-0.300	-0.301	-0.301
4000	ALTERNATIVE TAX PROPOSAL	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.124	0.067	0.045	0.033	0.022	0.000	0.000
	CHANGE IN EFFECTIVE RATE	-0.177	-0.234	-0.256	-0.268	-0.279	-0.301	-0.301
5000	ALTERNATIVE TAX PROPOSAL	0.301	0.301	00.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.143	0.090	0.072	0.063	0.054	0.035	0.007
	CHANGE IN EFFECTIVE RATE	-0.158	-0.211	-0.229	-0.238	-0.247	0.266	-0.294
6500	ALTERNATIVE TAX PROPOSAL	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.164	0.113	0.100	0.093	0.086	0.072	0.051
	CHANGE IN EFFECTIVE RATE	-0.138	-0.188	-0.201	-0.208	-0.215	-0.229	-0.250
8000	ALTERNATIVE TAX PROPOSAL	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.178	0.130	0.119	0.113	0.108	0.097	0.080
	CHANGE IN EFFECTIVE RATE	-0.123	-0.171	-0.182	-0.188	-0.193	-0.205	-0.221
10000	ALTERNATIVE TAX PROPOSAL	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.194	0.146	0.137	0.133	0.128	0.120	0.106
	CHANGE IN EFFECTIVE RATE	-0.107	-0.155	-0.164	-0.168	-0.173	-0.182	-0.195
12000	ALTERNATIVE TAX PROPOSAL	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.208	0.158	0.151	0.147	0.144	0.137	0.126
	CHANGE IN EFFECTIVE RATE	-0.093	-0.143	-0.150	-0.154	-0.157	-0.164	-0.175
15000	ALTERNATIVE TAX PROPOSAL	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.227	0.174	0.169	0.166	0.163	0.158	0.150
	CHANGE IN EFFECTIVE RATE	-0.074	-0.127	-0.132	-0.135	-0.138	-0.143	-0.151
20000	ALTERNATIVE TAX PROPOSAL	0.303	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.250	0.198	0.194	0.192	0.190	0.187	0.181
	CHANGE IN EFFECTIVE RATE	-0.053	-0.103	-0.107	-0.109	-0.111	-0.114	-0.120
25000	ALTERNATIVE TAX PROPOSAL	0.347	0.343	0.343	0.343	0.343	0.343	0.343
	TAX UNDER OUR PROPOSALS	0.270	0.220	0.217	0.216	0.215	0.212	0.208
	CHANGE IN EFFECTIVE RATE	-0.077	-0.123	-0.126	-0.127	-0.128	-0.131	-0.135
30000	ALTERNATIVE TAX PROPOSAL	0.348	0.343	0.343	0.343	0.343	0.343	0.343
	TAX UNDER OUR PROPOSALS	0.287	0.242	0.240	0.238	0.237	0.235	0.232
	CHANGE IN EFFECTIVE RATE	-0.061	-0.101	-0.103	-0.105	-0.106	-0.108	-0.111
40000	ALTERNATIVE TAX PROPOSAL	0.350	0.345	0.343	0.343	0.343	0.343	0.343
	TAX UNDER OUR PROPOSALS	0.312	0.276	0.275	0.274	0.273	0.272	0.269
	CHANGE IN EFFECTIVE RATE	-0.037	-0.069	-0.068	-0.069	-0.070	-0.071	-0.074
50000	ALTERNATIVE TAX PROPOSAL	0.351	0.347	0.345	0.344	0.343	0.343	0.343
	TAX UNDER OUR PROPOSALS	0.334	0.305	0.304	0.303	0.303	0.301	0.300
	CHANGE IN EFFECTIVE RATE	-0.017	-0.042	-0.041	-0.041	0.040	-0.042	-0.043
70000	ALTERNATIVE TAX PROPOSAL	0.353	0.349	0.348	0.347	0.347	0.345	0.343
	TAX UNDER OUR PROPOSALS	0.367	0.346	0.346	0.345	0.345	0.344	0.343
	CHANGE IN EFFECTIVE RATE	0.014	-0.003	-0.002	-0.002	-0.002	-0.001	0.000
100000	ALTERNATIVE TAX PROPOSAL	0.355	0.351	0.351	0.350	0.350	0.349	0.347
	TAX UNDER OUR PROPOSALS	0.401	0.387	0.386	0.386	0.385	0.385	0.384
	CHANGE IN EFFECTIVE RATE	0.046	0.035	0.035	0.036	0.036	0.036	0.037
200000	ALTERNATIVE TAX PROPOSAL	0.358	0.355	0.354	0.354	0.354	0.354	0.353
	TAX UNDER OUR PROPOSALS	0.450	0.443	0.443	0.443	0.443	0.442	0.442
	CHANGE IN EFFECTIVE RATE	0.092	0.088	0.088	0.089	0.089	0.089	0.089
350000	ALTERNATIVE TAX PROPOSAL	0.362	0.358	0.358	0.358	0.358	0.358	0.357
	TAX UNDER OUR PROPOSALS	0.472	0.468	0.467	0.467	0.467	0.467	0.467
	CHANGE IN EFFECTIVE RATE	0.110	0.109	0.109	0.109	0.109	0.109	0.110
600000	ALTERNATIVE TAX PROPOSAL	0.365	0.363	0.363	0.363	0.363	0.362	0.362
	TAX UNDER OUR PROPOSALS	0.483	0.481	0.481	0.481	0.481	0.481	0.481
	CHANGE IN EFFECTIVE RATE	0.118	0.118	0.118	0.118	0.118	0.118	0.118
1000000	ALTERNATIVE TAX PROPOSAL	0.369	0.367	0.367	0.367	0.367	0.367	0.367
	TAX UNDER OUR PROPOSALS	0.490	0.489	0.489	0.489	0.489	0.488	0.488
	CHANGE IN EFFECTIVE RATE	0.121	0.121	0.121	0.121	0.121	0.121	0.121

Note: See assumptions in Appendix M and earlier in this Appendix.

TABLE N, 2-3

EFFECTIVE MARGINAL TAX RATES UNDER OUR PROPOSALS AND UNDER THE MODIFIED PROPOSALS OF THE COMMITTEE OF FOUR (INCLUDING TAXES PAID BY CORPORATIONS) FOR A TAX UNIT WITH INCOME FROM A TYPICAL PRIVATE COMPANY NOT MAKING USE OF SECTION 105 CAPITALIZATIONS

GROSS CORPORATE SOURCE INCOME		STATUS OF TAXPAYER: UNATTACHED INDIVIDUAL	MARRIED COUPLE — NUMBER OF CHILDREN: 0	1	2	3	5	8
1500	ALTERNATIVE TAX PROPOSAL	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.147	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.283	−0.430	−0.430	−0.430	−0.430	−0.430	−0.430
2000	ALTERNATIVE TAX PROPOSAL	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.168	0.091	0.000	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.262	−0.339	−0.430	−0.430	−0.430	−0.430	−0.430
2500	ALTERNATIVE TAX PROPOSAL	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.170	0.130	0.041	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.260	−0.300	−0.389	−0.430	−0.430	−0.430	−0.430
3000	ALTERNATIVE TAX PROPOSAL	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.197	0.157	0.160	0.104	0.007	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.233	−0.273	−0.270	−0.326	−0.423	−0.430	−0.430
3500	ALTERNATIVE TAX PROPOSAL	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.200	0.160	0.161	0.164	0.167	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.230	−0.270	−0.269	−0.266	−0.263	−0.430	−0.430
4000	ALTERNATIVE TAX PROPOSAL	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.218	0.178	0.180	0.180	0.180	0.166	0.000
	CHANGE IN MARGINAL RATE	−0.212	−0.252	−0.250	−0.250	−0.250	−0.265	−0.430
5000	ALTERNATIVE TAX PROPOSAL	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.229	0.189	0.190	0.190	0.190	0.190	0.191
	CHANGE IN MARGINAL RATE	−0.201	−0.241	−0.240	−0.240	−0.240	−0.240	−0.240
6500	ALTERNATIVE TAX PROPOSAL	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.240	0.200	0.200	0.200	0.200	0.200	0.200
	CHANGE IN MARGINAL RATE	−0.190	−0.230	−0.230	−0.230	−0.230	−0.230	−0.230
8000	ALTERNATIVE TAX PROPOSAL	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.258	0.209	0.210	0.210	0.210	0.210	0.210
	CHANGE IN MARGINAL RATE	−0.172	−0.221	−0.220	−0.220	−0.220	−0.220	−0.220
10000	ALTERNATIVE TAX PROPOSAL	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.278	0.219	0.220	0.220	0.220	0.220	0.220
	CHANGE IN MARGINAL RATE	−0.152	−0.211	−0.210	−0.210	−0.210	−0.210	−0.210
12000	ALTERNATIVE TAX PROPOSAL	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.298	0.238	0.240	0.240	0.240	0.240	0.240
	CHANGE IN MARGINAL RATE	−0.132	−0.192	−0.190	−0.190	−0.190	−0.190	−0.190
15000	ALTERNATIVE TAX PROPOSAL	0.438	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.318	0.267	0.270	0.270	0.270	0.270	0.270
	CHANGE IN MARGINAL RATE	−0.120	−0.163	−0.160	−0.160	−0.160	−0.160	−0.160
20000	ALTERNATIVE TAX PROPOSAL	0.438	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.347	0.306	0.310	0.310	0.310	0.310	0.310
	CHANGE IN MARGINAL RATE	−0.091	−0.124	−0.120	−0.120	−0.120	−0.120	−0.120
25000	ALTERNATIVE TAX PROPOSAL	0.483	0.472	0.472	0.472	0.472	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.368	0.346	0.350	0.350	0.350	0.350	0.350
	CHANGE IN MARGINAL RATE	−0.115	−0.126	−0.122	−0.122	−0.122	−0.122	−0.122
30000	ALTERNATIVE TAX PROPOSAL	0.484	0.472	0.472	0.472	0.472	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.388	0.377	0.380	0.380	0.380	0.380	0.380
	CHANGE IN MARGINAL RATE	−0.096	−0.095	−0.092	−0.092	−0.092	−0.092	−0.092
4 0000	ALTERNATIVE TAX PROPOSAL	0.484	0.481	0.472	0.472	0.472	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.417	0.416	0.420	0.420	0.420	0.420	0.420
	CHANGE IN MARGINAL RATE	−0.067	−0.065	−0.052	−0.052	−0.052	−0.052	−0.052
50000	ALTERNATIVE TAX PROPOSAL	0.486	0.483	0.483	0.483	0.483	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.438	0.438	0.440	0.440	0.440	0.440	0.440
	CHANGE IN MARGINAL RATE	−0.048	−0.045	−0.043	−0.043	−0.043	−0.032	−0.032
70000	ALTERNATIVE TAX PROPOSAL	0.487	0.485	0.485	0.485	0.485	0.485	0.485
	TAX UNDER OUR PROPOSALS	0.460	0.460	0.460	0.460	0.460	0.460	0.460
	CHANGE IN MARGINAL RATE	−0.027	−0.025	−0.025	−0.025	−0.025	−0.025	−0.025
100000	ALTERNATIVE TAX PROPOSAL	0.489	0.486	0.486	0.486	0.486	0.486	0.486
	TAX UNDER OUR PROPOSALS	0.499	0.499	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	0.010	0.013	0.014	0.014	0.014	0.014	0.014
200000	ALTERNATIVE TAX PROPOSAL	0.493	0.489	0.489	0.489	0.489	0.489	0.489
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	0.007	0.011	0.011	0.011	0.011	0.011	0.011
350000	ALTERNATIVE TAX PROPOSAL	0.497	0.494	0.494	0.494	0.494	0.494	0.496
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	0.003	0.006	0.006	0.006	0.006	0.006	0.004
600000	ALTERNATIVE TAX PROPOSAL	0.501	0.501	0.501	0.501	0.501	0.501	0.501
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	−0.001	−0.001	−0.001	−0.001	−0.001	−0.001	−0.001
1000000	ALTERNATIVE TAX PROPOSAL	0.504	0.504	0.504	0.504	0.504	0.504	0.504
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	−0.004	−0.004	−0.004	−0.004	−0.004	−0.004	−0.004

Note: See assumptions in Appendix M and earlier in this Appendix.

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