CANADA

REPORT

OF THE

ROYAL COMMISSION ON

TAXATION

VOLUME 5

SALES TAXES AND GENERAL TAX ADMINISTRATION

Part A - Sales and Excise Taxes and Duties
Part B - General Tax Administration

1966

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C A N A D A

REPORT

of the

ROYAL COMMISSION ON TAXATION

COMMISSIONERS

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Mr. J. Harvey Perry
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ROYAL COMMISSION ON TAXATION

VOLUME 5

C O N T E N T S

PART A

SALES AND EXCISE TAXES AND DUTIES

CHAPTER 27

INTRODUCTION

Sales taxes have been widely adopted throughout the world. They are imposed at various levels—on the manufacturer, the wholesaler and the retailer; in various forms—single and multiple stage; and markedly different exemptions are provided—food, clothing, services, producer goods. Probably the main reasons for the widespread and heavy reliance on such taxes is the fact that they are capable of raising substantial revenues with comparatively low administrative costs and, after the initial upset following their adoption, are thought to be as popular as any tax can be. In Canada, at the present time (May 1966), a federal tax at the manufacturer's level is imposed at a rate of 11 per cent (including Old Age Security tax). In addition, eight provinces impose retail sales taxes at rates varying from 3 per cent to 6 per cent. It should be noted here that our discussion of sales taxes does not reflect the changes proposed by the Excise Tax Resolutions introduced in the House of Commons on March 29, 1966. The Resolutions provide for the removal of sales taxes on production machinery and apparatus in two steps.

As we have frequently stated in this Report, equity requires that taxes be allocated in accordance with ability to pay. We believe this can only be achieved when those with larger incomes bear relatively heavier taxes. Unless income is taken into account in the sales tax system, either by exempting "necessities" or by allowing credit and refunds against personal income tax liabilities for sales taxes paid, general sales taxes are, by our definition, inequitable. This follows because it is reasonable to assume that most general sales taxes, regardless of their level or form, are ultimately borne by consumers of goods and services. Consumption expenditures are not a constant proportion of income. The proportion is lower the greater the income of the individual or family. A general sales tax on all consumer goods and services, without exemptions or, alternatively, without credits against personal income tax liabilities,

would therefore be regressive. It would impose relatively heavier tax burdens on those with low incomes. This is the antithesis of taxation according to ability to pay.

We do not recommend, however, that the federal government abandon a general tax on sales. Our reasons may be briefly stated.

1. It is possible to design a sales tax system that is not regressive.

2. We could not countenance the increase in rates that would be necessary to raise through the personal income tax all the revenues that are now raised through the personal income tax and the manufacturer's sales tax.

3. We think it would be desirable for the federal government to have a revenue source that it can turn over to the provinces, in part, in exchange for some provincial direct tax revenues.

Moreover, while we hope there will be a gradual reduction in the proportion of the revenues of all governments raised through sales taxes, we believe that fiscal responsibility would be better maintained if each level of government were primarily responsible for the collection of at least one major tax. The provinces seem to be particularly well suited to act as the collection agency for sales taxes. It seems to us, therefore, that sales taxes should have a permanent place in the Canadian tax structure, but that sales tax revenues should constitute only a nominal part of total federal revenues and the provinces should act as sales tax collection agents for the federal government.

However, we would not wish to see the federal government withdraw entirely from the field of sales taxation. In times of national emergency it may be necessary to sharply increase federal sales tax rates. The federal government must have access to the administrative machinery that would make such an emergency tax change possible. In periods of incipient inflation it may be necessary to impose special temporary excise taxes on certain broad

classes of goods, such as consumer durables, to reduce private demand for them. This could be more quickly achieved if the federal government were imposing a general sales tax. Finally, but not of the least importance, we recommend later that the provinces be given the power, if necessary by constitutional amendment, to levy indirect retail sales taxes if they accepted a common base that was in turn acceptable to the federal government. Because an indirect retail sales tax could be used to tax interprovincial movements of goods and services, we are convinced that the federal government must be able to veto a sales tax change proposed by one province that would beggar neighbouring provinces. If the federal government has to be concerned about the provincial indirect retail sales tax base, and if the federal government is to be able to impose high sales taxes quickly for economic reasons, we think it desirable that the federal government should maintain a general retail sales tax even if the rate were only fractional as long as it did not involve duplicating administrative machinery with the provinces.

We recommend later that the federal government should replace the manufacturer's sales tax with a tax at the retail level; it should adopt a sales tax base that removed the regressiveness of the tax by exempting food, shelter, and producer goods; it should try to negotiate arrangements under which the provinces adopted the same sales tax base and acted as sales tax collection agents for the federal government; and it should try to negotiate an exchange of more sales tax room for the provinces for more direct tax room for the federal government.

We are fully aware that the exemption of food and shelter would be, at best, a rough and ready way of reducing the regressive characteristics of a sales tax. However, if the relative weight of sales taxes in the revenue mix is gradually reduced, as we have recommended in Chapter 6, and if these exemptions were gradually replaced by a system of refundable credits against personal income tax liabilities for sales taxes paid, greater equity could be achieved without running the risks that would be involved in abolishing sales taxes and recouping the revenues through a massive increase in income tax.

We want to make our position quite clear. As we said in Chapter 4, we are convinced that the increase in personal saving that might result from a tax mix that placed greater weight on sales taxes could be more effectively and equitably achieved in other ways, assuming that an increase in saving were thought necessary. We can see no economic justification for placing greater weight on sales taxes. We have no doubt that, from an equity point of view, income taxes are superior to sales taxes, unless sales taxes are treated as a method of collection of tax rather than as an independent levy. If we could be reasonably certain that there would be no adverse economic effects from a sudden and massive increase in income tax rates, and if we did not believe there was merit in the provinces taking prime responsibility for one of the major revenue sources, we would recommend that sales taxes be replaced by higher federal income taxes.

We recommend that the federal government should try to negotiate a transfer of sales tax room to the provinces in exchange for more federal direct tax room. If the federal sales tax were at the retail level, such an exchange would be greatly facilitated. But our purpose in recommending that the federal sales tax collections should be moved from the manufacturer's level to the retail level is not only to facilitate this exchange. It would also eliminate a bad tax. We have no hesitation in recommending that the manufacturer's sales tax should be replaced simply because of its many defects.

A sales tax imposed at any level prior to the retail level inevitably lacks neutrality. The effective rate of tax, that is, the ratio of tax to final selling price, can differ widely because the value added to a particular good after the imposition of the tax may be great or small, depending upon the particular channels of distribution and the particular mark-ups applied at each stage as the goods move from producer to consumer.

The imposition of a sales tax at any point before the point of sale to the final consumer would only result in a constant ratio of tax to final selling price if the increase in the value of goods, that is, the value added to them, between the point of imposition of the tax and the point of final sale were proportionately the same for all kinds of goods. This principle applies regardless of the point in the process of manufacturing or distribution at which the tax is imposed. In the case of a tax on services, it should be noted that the production and distribution of services are concentrated at one moment of time so that it is impossible to impose a tax at other than the point of final sale. Finally, the principle given above applies to imported goods and services as well as to those produced domestically. Imported goods and services should bear the same rate of tax as domestic goods. At whatever point the tax is imposed, the value added between the point of imposition of the tax and the point of final sale must be proportionately the same for imported goods as for domestically processed goods if the neutrality test is to be met.

The retail tax automatically and simply achieves the neutrality that a tax levied at earlier levels in the process of production and distribution cannot achieve. Regardless of the distributional channels used, of who advertises, packages or imports, etc., the cost elements that ultimately determine the selling price of an article to the consumer converge at the point of imposition of a retail tax. Only at this tax level can it be said that neutrality is achieved without sacrificing simplicity, or that simplicity is achieved without sacrificing neutrality.

Two additional advantages of a retail tax merit comment at this point. First, a retail tax avoids the alleged pyramiding effect, that is, the marking-up of the tax element in the price of goods as they pass through the distributional stages, about which a number of participants have complained

to this Commission. Second, only a tax at the retail level can avoid the inequities that inevitably arise with a tax at any other level because some entrepreneurs must hold tax-paid inventory. Examples of such inequities are the sale of obsolescent or damaged tax-paid goods, the loss by breakage of such goods, and the gains made, or the losses incurred, when the tax on such goods is raised or lowered.

We also hope to make clear that by recommending a sales tax at the retail level we intend that it should apply to the selling prices of consumer goods and services without any prior sales tax. To be quite explicit, we do not believe that a sales tax should be imposed on producers' equipment or construction materials used in the process of production, nor should it be imposed on goods exported from Canada. To impose a tax on sales of producers' equipment and construction materials used in further production results in relatively heavier taxes being borne by goods and services produced by capital-intensive methods. Moreover, to the extent that taxes on producer goods were not shifted through higher consumer prices, the costs of modernization and expansion of Canada's productive facilities are increased, thereby reducing the rate of capital formation and the rate of growth of output. The capricious tax element introduced into the selling price of goods produced with tax-paid machinery, equipment and buildings would, under a fixed exchange rate, tend to reduce the competitive position of Canada's exporters in world markets, because it would be impossible to remove all such built-in sales tax elements from the prices of goods exported.

In principle, we believe that a federal retail sales tax should be imposed on all services rendered to consumers. Many tax jurisdictions tax services but none taxes the complete range. There are insurmountable administrative problems in taxing all services and, even in those areas where we believe taxation would be possible, the government should move cautiously in what would be a new tax field for Canada. We recommend later that the application of the sales tax should be made initially only to a selected list of services, but that the list should be gradually expanded.

In addition to the manufacturer's sales tax of 11 per cent, special excise taxes are now imposed on tobacco products and on a list of so-called luxury goods, and excise duties are levied on alcoholic beverages and tobacco products.

Taxes on alcoholic beverages and tobacco products are sometimes justified on the ground that, by raising the prices of these commodities, consumption is reduced and the public interest thereby served. It is also argued that expenditures on these goods rise more than proportionately with income, so that they increase the progressiveness of the tax system. Neither of these arguments is entirely convincing. Smoking and drinking are not confined to those with substantial incomes; the chain smoker and the serious drinker are not deterred for many days or weeks by higher prices. However, excise duties and special excise taxes on tobacco products are bountiful revenue sources, are easily administered, and are well accepted, even by those who pay them. These are strong supporting arguments for these levies, and we cannot conceive of their being repealed whatever reasoning we might advance.

The special excise taxes on so-called luxury goods are another matter. The higher taxes on such things as radios, cosmetics and playing cards have nothing in common but their arbitrariness. While some would consider these goods "non-essential", there are thousands of other items that are equally "non-essential" but are not subject to extra taxation. As a rough and ready method of eliminating the regressiveness of a retail sales tax, we recommend later that all food and shelter be exempt. We single out these "necessities" for special treatment only because we do not think it would be practical to adopt an income tax credit system at this time. To draw a line between "luxuries" and other goods and services is both unnecessary and, we believe, unacceptably arbitrary. Therefore, we recommend later that these special excise taxes should be repealed.

In this part of the Report we do not discuss, except in passing, rates of sales tax or revenues from sales tax. Consideration of these matters is

postponed to Chapter 35. Consideration of the issues involved in moving part of the sales tax into provincial hands, both with respect to administration and with respect to revenue, is postponed to Chapter 38.

CHAPTER 28

FORM OF COLLECTION OF SALES TAXES

There is no doubt in our minds that a single-stage retail sales tax is superior to other forms of sales taxes and we recommend that the federal government should abandon the manufacturer's sales tax and adopt a single-stage retail sales tax in its place. The retail sales tax is the most neutral form of sales tax and, as we have said in the previous chapter, if the federal sales tax were at the retail level, an exchange of sales tax room for direct tax room between the federal and provincial governments would be facilitated.

We are not unmindful of the political problems that this recommendation poses. The manufacturer's sales tax is well hidden and most Canadians are probably unaware that the tax is even imposed. Moving the tax to the retail level would no doubt be thought of by some as an increase in taxes, even if there were no change in federal revenue. Eight of the ten provinces now impose retail sales taxes. While there can be no doubt that the federal government has the power under the British North America Act to impose any form of taxation, the provinces may argue that for the federal government to impose a tax at the retail level with a rate of 7 per cent to 8 per cent would pre-empt this field, at a time when the provinces are desperately searching for more revenue. Because we are fully aware of all these considerations we deal with the sales tax in relatively greater detail than other taxes.

Our usual approach has been to concentrate on our proposal and only briefly to consider alternatives. In this chapter we consider the alternatives at some length. Each of the major alternatives is evaluated in terms of its advantages and disadvantages relative to the retail sales tax. This approach has the advantage that if our retail sales tax recommendation is not accepted the Report will still be relevant; for we outline what we think would be the best method of taxing goods and services at the

manufacturer's and wholesaler's levels. We also discuss how a value-added tax should be structured and the conditions under which it should be imposed.

MANUFACTURER'S LEVEL: NEUTRALITY CONSIDERATIONS

Our first task is to discuss the reasons why, and the extent to which, the manufacturer's sales tax fails to achieve neutrality relative to a retail sales tax.

Taxable Value— Actual Price to Consumer

If it were possible to collect tax from manufacturers computed as a fixed percentage of the actual final selling price of goods to the consumer, the manufacturer's tax would be as neutral as a retail tax. That is, there would be a constant tax to final selling price ratio. The choice between them could then be made on the basis of their respective administrative advantages and disadvantages. However, the actual selling price of a consumer product to the consumer may not be known at the time of its sale by the manufacturer, and therefore it would be impossible to obtain directly under a manufacturer's tax the neutrality of a retail tax. Accordingly, we considered whether it would be possible to achieve neutrality with a tax at the manufacturer's level by some indirect method.

Taxable Value at Earlier Stages

Consumer price is the sum of a number of "cost elements". An article is manufactured or produced. It may or may not subsequently be packaged, assembled, blended, or diluted by a different entrepreneur; there are frequently several warehousing or stocking stages. It is transported, usually by stages, to the consumer; it is advertised and subjected to other forms of selling functions; it may incorporate servicing, financing, warranty, technical service, and installation costs. There are profit elements. It should be stressed that many of these elements or functions are interchangeable,

that is, they may be performed in varying degrees at each level of the production and distribution process, and in some cases they may not be performed at all. For example, a manufacturer may sell to a wholesaler who first warehouses the goods and then ships them to a retailer's warehouse; a manufacturer may sell directly to a retailer who maintains warehousing facilities; a manufacturer may warehouse his products and ship them directly to consumers according to directions received from the retailer. Again, a manufacturer may promote his own "national brand"; he may instead sell a "private brand" to a wholesaler or retailer who bears the advertising cost; the manufacturer may sell his product with little or no advertising, or he may sell a private brand to a wholesaler or retailer who undertakes little or no advertising. In this advertising maze, it may not even be possible to apportion advertising costs by individual product or even by groups of products.

It follows, therefore, that any attempt to achieve a constant tax to final selling price ratio under a sales tax payable at any stage in the distribution process earlier than the point of retail sale must be frustrated by the variations in the cost elements or functions which add value to the product after the point at which the tax is applied.

Actual Sale Price. The application of tax on actual sale price by the manufacturer would be the most haphazard and discriminatory of all bases because of the variety of prices at which manufacturers sell the same goods. Therefore, we have rejected it, as has the present administration.

Level of Trade in the Distribution Process. The manufacturer's sales tax could be applied to the "pure manufacturer's price", that is, manufacturer's selling price less all expenses of distribution. We reject this alternative because it would ignore the wide disparities in distribution costs between the end of the production line and sale to the consumer. The resulting inequities would be compounded by the higher rate of tax needed to yield a similar amount of revenue from a smaller base. Furthermore, such a tax level

would be criticized for the lack of certainty that would result in estimating the distribution costs to be eliminated.

The present system of administering the federal manufacturer's tax, which, as we indicate below, is partly "equalized" at the level of actual or equivalent of actual price to wholesalers, appears to represent a compromise between the need to find a common level in the distribution process, and the need to relate taxable value as closely as possible to the final price to the consumer.

Even if all manufacturers' sales were made to wholesalers, at best only a rough measure of neutrality could be achieved because of the variety of distribution costs which enter into the ultimate price to the consumer. However, we estimate that less than one third of manufacturers' taxable sales of fully manufactured goods pass through the hands of wholesalers. This means that any general tax equalization at the price-to-wholesalers, that is, "wholesale value" level, must substantially rest, not on the actual price to wholesalers, which itself offers a slippery valuation surface, but on a notional concept of the price goods would have been sold for had they been sold to wholesalers—a concept difficult to apply. Where a manufacturer does not sell his goods to wholesalers, the determination of an appropriate wholesale value for tax should depend on two factors.

1. The measurement of the wholesale function.
2. The extent to which this wholesale function has been performed by the manufacturer, or has disappeared.

The difficulties of making an accurate measurement are obvious.

The Department of National Revenue, Customs and Excise Division, applies a practical "wholesale value" tax equalization concept in the following circumstances 1/.

1. Where a firm makes sales in representative quantities to independent wholesalers, the price to wholesalers may be used by that firm as the

value for tax on sales of similar goods to retailers and consumers, that is, "established wholesale price".

2. Where, in an industry as a whole, sales are made by manufacturers to wholesalers in representative quantities, a representative discount determined by the Minister may be applied on sales to retailers and consumers by all manufacturers in that industry to yield a "determined wholesale value".

A wholesale value for tax purposes is not allowed to manufacturers, assuming they do not themselves make sales in representative quantities to wholesalers, if in their industry there are no sales to wholesalers in representative quantities. Nor is a wholesale value for tax allowed in such an industry even if there is a representative wholesale situation for similar imported goods.

The Department attempts in this way to achieve approximate intra-firm equality, and also a rough measure of intra-industry equality, for all firms selling to wholesalers and their competitors selling directly to retailers and consumers. Wholesale value discounts are established with averaging procedures, using actual wholesale situations, and then individual manufacturers may apply them on their sales to retailers and consumers. It is, of course, possible to achieve only the roughest justice, using an average of several discounts, and this roughness is further compounded by continually changing merchandising patterns.

The Department does not attempt to determine wholesale value for tax in industries where there is no representative wholesale situation. The difficulties of computing completely notional values are thought to be too great, and the position of directly competing products within an industry is not affected by the lack of a determined wholesale value in any event.

The Department generally excludes from its consideration the existence of a representative wholesale situation for imported goods. If, within an industry, sales of domestic products are not made in representative quantities

to independent wholesalers, but the combined market for both domestic and imported goods reveals a representative wholesale situation, the domestic industry is nevertheless barred from tax equalization at the wholesale level.

In summary, the Department's tax equalization method uses actual wholesale prices either within a firm or within an industry. This method eliminates some of the more extreme departures from a neutral tax that would otherwise result if tax were applied to actual sale price in all cases. But because price to wholesalers as a ratio of price to consumers varies, the method can achieve only an administratively feasible, rough measure of neutrality within the industries concerned. Furthermore, in denying a notional wholesale value for industries without representative sales to wholesalers, and industries with actual wholesale situations for imported goods only, though there may be strong arguments for so doing on administrative grounds, the method fails to achieve neutrality between industries.

We also examined a number of other tax equalization methods that might be applied under a manufacturer's tax, but none would achieve neutrality. Undoubtedly the best that could be achieved at this level of distribution would be to equalize taxable value at prices at which the goods are or would have been sold to a wholesaler.

Transportation, Erection or
Installation Costs

Transportation cost is a significant element in the cost of goods to the final consumer in Canada. To tax the value of the goods and services consumed it would be as necessary to include these costs of transportation as to include other distribution charges and the costs of production.

Because consumers are generally located close to the retailer's doorstep virtually all transportation costs are within the tax base under a retail tax; but this clearly does not apply under a manufacturer's tax. However, it should be mentioned that even under a retail tax there would still be some problems with transportation costs where purchasers who were regarded

as taxable consumers made substantial purchases, for example, contractors buying building materials, and entrepreneurs buying taxable producer goods.

If, under a manufacturer's tax, outward freight costs incurred on shipments of taxable goods from licensed manufacturers were taxed, numerous difficulties and inequities would arise. Licensed manufacturers who did not themselves incur the costs of long distance transportation of their products, but who sold to local distributors or wholesalers, would avoid the payment of tax on the transportation element. This would discriminate against licensed manufacturers who incurred all the transportation costs of delivering their products to the ultimate consumers. It would not be feasible to estimate and include an equitable freight factor for tax purposes on sales by the former category of manufacturers.

On the other hand, if outward freight costs incurred in shipments from licensed manufacturers were not taxed, other serious difficulties and inequities would arise.

In seeking neutrality one must compare the competitive positions as they would be without tax against the positions when tax is levied. The goods of a distant manufacturer or importer, and a manufacturer located at the market, would be competitive when their total costs, including transportation to the local market, were about equal. If this were so before the application of tax, it could only remain so after tax if the tax rate were applied to values that were equal or proportionate to the total cost of placing goods on the local market. The omission from the tax base of freight on the goods shipped from a distance would therefore place the goods of local manufacture at a disadvantage. This particular form of inequity would be particularly significant for manufacturers situated close to their consumer market where inward freight costs are considerable and the value added by their manufacturing operations is small 2/. But to attempt to restore this imbalance by reducing the tax base of local manufacturers by the amount of freight costs on their purchases would bring new inequities and administrative complexities.

There would also be difficulties in measuring the amount of the freight deduction that should be allowed where a manufacturer transported in his own or leased vehicles.

In conclusion, neutrality would require including in the taxable value an element that reflected the varying transportation costs incurred in distributing goods. However, any practical attempt to adjust the tax base in this way would create a new jumble of inequities. With a tax at the manufacturer's level, the current practice of exempting freight charges from taxable value where they were separately itemized and readily verifiable would appear to be the best solution to a most complex problem 3/.

In important respects the problem of equitable tax treatment of the installation or erection of goods by a manufacturer is similar to that of transportation costs. Again, to achieve neutrality, such charges should be included in the taxable value; but this would require the taxation of similar installation charges made by retailers, servicemen, contractors, etc., which would not be feasible under a manufacturer's tax. This difficulty is common to a tax on goods at all levels where firms specializing in the provision of services are not regarded as taxable persons, and the current practice of exempting readily verifiable costs of installation and erection seems a fair compromise 4/.

Private Brands and
"Marginal" Operations

Other difficulties arise with a tax imposed at the manufacturer's level where entrepreneurs, who are not regarded as manufacturers and are therefore beyond the point of imposition of the tax, incur costs in performing functions that are frequently performed by manufacturers and taxed as part of the sale price. In a sense, this difficulty is the other side of the coin we have just been discussing. The question turns from the merits of eliminating cost elements from the taxable value, to the merits of adding certain cost elements to the taxable value. The complaints of tax inequity

are particularly important in two areas: private brands and "marginal" physical manufacturing operations, such as assembling, repackaging, blending, mixing and diluting.

The cost of promotion of a "national brand" by its manufacturer may be a varying element of a manufacturer's sale price. If a similar product is purchased by a distributor, wholesaler, or retailer and is then promoted as a "private brand", the promotion costs, which again may vary, currently escape tax, except in the case of pharmaceuticals and cosmetics purchased by entrepreneurs other than retailers, for which there is specific statutory provision 5/. As a result there are substantial departures from neutrality.

The remedy, however, does not appear to lie in licensing all private brand merchants as taxable persons. In the case of private brand retailers, for example, apart from the difficulties in apportioning special brand promotion to particular products and in administering such a tax at the retail level, there would be a conflict in terms of neutrality. The licensing of such retailers, that is, requiring them to pay tax on their sales, would achieve the desired result of bringing into the taxable value their private brand promotion costs; but it would also bring into the taxable value their other retail costs of operation which, in the main, do not enter into the taxable sale price of a manufacturer. The alternative of allowing retailers a "notional" discount off the price to the consumer in order to determine their taxable value on such sales would require the widespread licensing of retailers and would generate substantial compliance difficulties. To a lesser extent, difficulties would result if special brand wholesalers were licensed as taxable persons, and they paid tax on their discounted sale price to retailers. On balance, however, the licensing of private brand wholesalers and distributors of both domestic and imported manufacturers as taxable persons, coupled with similar tax equalization measures as those accorded to physical manufacturers in the same industry, would appear to be the best available solution to this problem. The provisions in the Regulations requiring the taxing of retailer private brands upon the full sale

price to those retailers, without any tax equalization at the level of sale to wholesalers, appears to be the best compromise under the manufacturer's sales tax 6/.

As a general rule, however, retailers carrying on marginal manufacturing operations should not be deemed to be manufacturers except where the value added by their manufacturing operations in retail stores was substantial and where there might be competitive inequities if they were not licensed, for example, remodelling and repairing of fur coats 7/ and the manufacturing of drapes. The provision of similar treatment for the marginal manufacturing operations of wholesalers and distributors would also achieve equality of taxation with products of regular manufacturers. In general, this is the current departmental practice.

Imports of Fully Manufactured Goods

Under a tax at the manufacturer's level, duty-paid value, which is the value on which imported fully manufactured goods are currently taxed, 8/ is not directly comparable with the value on which domestically manufactured goods are taxed.

Imported manufactured goods are taxed on the sale price which is deemed to be the duty-paid value; 9/ that is, no equalization is permitted for tax purposes regardless of whether the importer is purchasing the goods at the distributor, wholesaler, or retailer level. Because most imported, fully manufactured goods are purchased at the distributor or wholesaler level, while comparable domestic goods are taxed at a number of levels in the distribution process, it is not surprising that tax inequities arise between the two. For example, imported, fully manufactured goods generally escape tax on the advertising and other selling costs incurred by the importer in promoting their sales in Canada; domestic products may or may not escape tax on such costs, depending on whether these costs are incurred before the point of imposition of tax. Transportation costs incurred in shipping goods

to Canada, which may be very substantial for some imports, generally escape tax; similar costs incurred by Canadian manufacturers are exempt to varying extents.

The problem of achieving equity between imports and domestic products is part of the fundamental problem of a tax imposed at a stage considerably earlier than the point of sale to the consumer.

We do not doubt that there are many instances of imports gaining a competitive advantage over Canadian products as a result of differing tax burdens and, indeed, examples were brought to our attention; we are also aware that the opposite is possible. On balance, we believe that the advantage is in favour of imported goods under the present manufacturer's sales tax.

MANUFACTURER'S LEVEL: GENERAL ADMINISTRATIVE CONSIDERATIONS

A manufacturer's tax is relatively easy to administer. Compared with taxes at the wholesale and retail levels, the number of taxpayers is smaller, 10/ the typical taxpayer is larger, his records are probably more satisfactory, and evasion is minimal. The administrative inconveniences of refund procedures arising from the substantial movement of goods from the manufacturer to the wholesaler and on to another manufacturer may be reduced significantly by the widespread licensing of wholesalers.

With rising rates of tax, however, it is apparent that the increasing need for neutrality in the computation of the manufacturer's tax results in growing uncertainty and complexity. Attempts to improve the neutrality of the manufacturer's sales tax create valuation problems because of the complex and continuously changing production and distribution patterns. In a highly competitive economy, small differences between firms in the application of an 11 per cent tax to the costs of packaging, transportation, assembling, warehousing, sales promotion, servicing, installation, and to transactions not at arm's length or involving rights to goods being

manufactured, are of great concern to the taxpayer. We found no generally satisfactory solution to the dilemma of choosing between measures which would achieve simplicity and certainty at the expense of neutrality, and measures which would achieve approximate neutrality at the expense of certainty and simplicity. Even the argument that cost of collection is low under a manufacturer's sales tax loses its validity in the broader federal-provincial context of duplicate administrative organization and taxpayer compliance responsibilities.

WHOLESALE LEVEL: NEUTRALITY CONSIDERATIONS

A single-stage sales tax might be applied to the sale price of goods delivered to retailers, rather than to the sale price of goods delivered to wholesalers which would be the best base under a manufacturer's tax. We will call a tax applied to the sale price of goods delivered to retailers a wholesale tax.

A manufacturer's tax and a wholesale tax have a number of common characteristics: both are hidden taxes in the sense that the retailer buys tax-paid goods; both are incapable of achieving the neutrality of a retail tax; both stop short of entry into a sales tax field already occupied by the provinces; both can use the present administrative machinery; and both involve a limited number of taxpayers, generally with good record keeping. In the following pages we compare the relative merits of the manufacturer's and the wholesale tax in greater detail, and also compare the wholesale tax with the retail tax from the point of view of neutrality.

Level of Application

The very fact that a wholesale tax would be one stage closer to the point of final consumption than a tax at the manufacturer's level means that it would approach closer to the neutral level, that is, the price to the consumer.

Another important advantage would be that, whereas under the manufacturer's tax the administration must determine notional and approximate values for tax on many sales which bypass the wholesaler, under a wholesale tax the administration could collect tax to a much greater extent on actual sale prices because most consumer goods do pass through the hands of retailers. Furthermore, under a wholesale tax, inter-industry tax differentials would be considerably reduced; because so many goods are sold directly to retailers by manufacturers they would be taxed on approximately a comparable basis without price adjustment.

"Retailer" Concept

Even if all sales of consumer goods were channelled through retailers, under a wholesale tax there would still be departures from neutrality because of the variety and diversity of functions performed, and services offered, by retailers in selling goods to the final consumer. For example, a retailer's purchasing price may vary with the extent to which he undertakes warehousing, distribution or advertising functions usually performed by the manufacturer or wholesaler 11/. By the same token, retailers may buy at the same price but sell at different prices, for example, some retailers may use "loss-leaders", may not have a "satisfaction-or-money-refunded" policy, or may rely on a lower mark-up with a larger turn-over.

Because a wholesale tax cannot adjust automatically to differences in retail or selling functions, as does a retail tax, a means of arriving at a value that included all producing and wholesaling functions would have to be found. Unfortunately, as we have pointed out in our comments on the manufacturer's tax, these functions are varied. There can be no clear-cut distinction between wholesale and retail functions.

Adjustments to wholesale prices must be a compromise between neutrality and administrative feasibility, and an attempt would have to be made to include in the value for tax all wholesaling functions performed by retailers.

We recognize that any attempt to apply highly refined measures of neutrality would increase the degree of uncertainty and complexity to a point which would not be justifiable at a low or moderate rate of tax.

To illustrate what would be involved, two forms of retailing, multiple stores and department stores, merit examination. Do they perform wholesaling functions that would justify some adjustment in the value for tax of their purchases?

A multiple store organization which owns, manages or controls a number of retail stores, and which centralizes its purchasing and warehousing, probably performs substantial wholesale functions. To tax such organizations under a wholesale tax at the general statutory rate on their purchase price would give them a tax advantage and would result in a tax to final selling price ratio that would be lower than the norm in the general retail trade. Accordingly, their purchases would have to be taxed at a fractionally higher rate. This rate would have to reflect the wholesale functions performed by the typical or average multiple store, or equivalently, the purchases of multiple stores could be taxed at the general tax rate plus an "uplift" percentage.

Some multiple store organizations often achieve the economies of centralized quantity purchasing but do not route the goods through central warehousing facilities; the goods move directly from the supplier to the individual retail outlets. Under these circumstances "uplift" would be merited also. In the determination of an appropriate "uplift" it would be important not to over-compensate for the wholesale function, for this would penalize efficiency.

A multiple store organization may be defined to include a firm with two or more stores. To deem a wholesale function to be performed by an organization consisting of two stores, and to apply a price "uplift", would probably create more inequities than it would resolve. Clearly, the drawing

of a demarcation line for tax purposes on the basis of the number of stores would necessarily be an arbitrary measure, but some such line would have to be drawn. At some point it would probably be necessary to apply "uplift" if rough neutrality was to be achieved.

The "uplift" could be applied either at the time of sale to such multiple store organizations, which would involve licensed vendors in the administrative complications of a multiple tax rate structure, or tax could be made payable by the multiple store organizations upon transfer of the goods to the retail outlets, which would involve an increase in the number of licensees. The second course probably would be preferable. Such a procedure would be more equitable in terms of the time at which the tax becomes payable. The records maintained by multiple store organizations would be adequate for this purpose.

We also considered the question of the appropriate tax treatment of sales to department stores. Where such stores form part of a multiple store organization, as discussed above, "uplift" would of course also have to apply to them. However, where such stores were not part of a multiple store organization no special treatment would be feasible. Drawing the dividing line between a department store and other retail outlets for purposes of applying "uplift" would involve highly arbitrary distinctions. Size would not be material in distinguishing between the two. An administratively feasible distinction would probably reduce rather than increase neutrality.

Manufacturer-Retailers and
Wholesaler-Retailers

Under a wholesale tax, a considerable problem would arise in establishing a value for tax purposes where manufacturers or wholesalers sell exclusively to consumers.

As we have said, under a manufacturer's tax, with tax equalization at

the point of sale to the wholesaler, there are inequities and administrative difficulties created where entrepreneurs bypass or carry out the wholesale function. Because less than one third of domestically manufactured taxable goods pass through the hands of independent wholesalers, "notional" valuations are widespread and create considerable difficulties.

There would be few valuation problems under a wholesale tax where manufacturers sell similar products both to retailers and to consumers because the manufacturers would be able to establish a representative value for tax based on their selling price to retailers. Nor would there be many valuation problems where manufacturers who sold principally to wholesalers or distributors made some sales directly to consumers. However, where a manufacturer sold exclusively to private consumers, completely notional tax equalization measures would be required. However, under a wholesale tax the desired notional point of tax equalization would be closer to the consumer price, and it would be easier to arrive at a fair price basis than under a manufacturer's sales tax.

Sales made by a wholesaler directly to private consumers, thus bypassing the stage at which the wholesale tax applies, would present the most difficult valuation problem under a wholesale tax 12/. Probably the best method of handling this problem would be to license those firms that were primarily engaged in wholesale activities, that is, where over 50 per cent of their sales were made to retailers. These licensed firms would then be required to account for tax on sales to independent retailers at actual prices and at an "established price" where the goods sold directly to private consumers were similar to those sold to retailers. Where goods sold directly to private consumers were not also sold to independent retailers, "notional" tax equalization measures probably would be necessary; only rough justice could be achieved because in some instances such a firm may purchase goods as a retailer.

For ease of administration, firms that made few sales to retailers, say,

less than 10 per cent, probably would have to be regarded as retailers for tax purposes and be taxed upon their purchase price. They would not be required to account for tax on any of their sales.

The remaining firms, those making between 10 per cent and 50 per cent of their sales to retailers, would have to be charged tax on their purchases. They would then be required to account for tax on their selling price in respect of their sales to other retailers. Such firms would then deduct the tax they paid upon purchase of the goods subsequently sold to retailers. These firms would have to register with the tax-collecting authority for auditing and collection purposes. In some cases, where a clear separation of wholesale and retail functions were feasible, distinctive licensing might be adopted.

At best, the procedures outlined above would achieve an approximate measure of neutrality and represent a compromise between the conflicting requirements of administrative ease and neutrality.

Non-Personal Consumption

Where taxable sales are made by licensed firms for non-personal consumption, for example, where goods are sold to institutional purchasers, and industrial and commercial firms for their own use, the general practice in many jurisdictions that have adopted a wholesale tax has been to tax such sales on actual sale price. Even though these sales are made at a price lower than the selling price to the retailer, the use of actual price as the taxable value does not result in much discrimination and is the simplest administrative method.

Transportation, Erection or Installation Costs

The equitable tax treatment of transportation costs as an element of value for tax would remain a difficult problem under a wholesale tax. The substantial measure of neutrality achieved under a retail tax could not be

attained at the wholesale level, any more than at the manufacturer's level.

If outward freight costs incurred in shipments from licensed vendors to retailers were not taxed, the discrimination between licensed vendors would be considerable. Competing goods, that would be equally priced in the absence of a general sales tax, would sell at different tax-included prices, depending on the freight cost and who incurred the cost. For example, manufacturer A in Ontario may ship his product to wholesaler B in Vancouver (freight element taxed), who ships to retailer C in Vancouver (freight element exempt); manufacturer D in Ontario may ship his competing product directly to retailer E in Vancouver (freight element exempt). Manufacturer F in Vancouver who, in the absence of any general sales tax, would sell his product at a fully competitive price to retailers in Vancouver, would have virtually no outward freight costs and therefore under a wholesale tax would be unable to take any tax deduction for freight. This inequity might lead to exemption for inward freight costs to licensed firms. This would create administrative difficulties, and would depart even further from the neutrality of a retail tax.

Under a wholesale tax it would clearly be preferable, on neutrality grounds, to tax all freight costs incurred in placing goods in the hands of retailers, whether those goods originated in Canada or in foreign countries. Administratively this would be relatively simple to achieve where goods were delivered to a retailer's premises at a price which included delivery. However, difficulties would arise chiefly in the following kinds of transaction.

1. Where the licensed vendor (or exporter) shipped goods to an unlicensed person f.o.b. origin.

2. Where the unlicensed customer collected goods from the premises of the licensed vendor in his own or leased vehicles.

3. Where goods were shipped to a central warehouse of an unlicensed person, that is, a retailer, whence they were in turn shipped to individual retail stores.

In the first two situations it would not be feasible in general for the licensed vendor to add to his selling price the actual transportation cost for the purpose of determining the value on which tax should be computed. Any attempt to compute with precision the estimated freight cost would be fraught with administrative complexities. The development of freight formulae to achieve a measure of certainty and simplicity might be required under a wholesale tax. Licensees might be allowed the option of using actual freight cost if satisfactory evidence were available and the actual cost was less than that derived under the formula. It is probable that in many instances licensed vendors' customers would wish to furnish the necessary transportation documents.

In the third situation the major difficulties would be substantially resolved if multiple store organizations were licensed as taxable persons, as suggested above.

It is our opinion that it would be possible to achieve rough neutrality with respect to transportation costs under a wholesale tax. A wholesale tax would be less satisfactory than a retail tax, but superior to a manufacturer's tax, in dealing with transportation costs. It is impossible to achieve even approximate neutrality under the latter.

The problem of equitable tax treatment of the erection or installation of goods, which has been described in connection with the manufacturer's tax, would remain substantially unchanged under a wholesale tax. The least unacceptable compromise would be to exempt readily verifiable costs. As we have stated earlier, this difficulty exists with a tax on goods at all levels where service entrepreneurs are not regarded as taxable persons.

Private Brands and
"Marginal" Operations

Under a manufacturer's tax there are substantial deviations from neutrality where merchants who are not regarded as manufacturers, and are therefore beyond the point of imposition of the tax, perform functions that

are frequently performed by manufacturers. We have concluded that under a manufacturer's tax a possible solution would be to license as taxable persons wholesalers and distributors who market private brands, or who assemble, re-package, blend, mix or dilute taxable goods. However, because the licensing of such firms as manufacturers for sales tax purposes could result in the substitution of one form of non-neutrality for another if they were required to account for tax on their sale price, we recommend that such firms should be permitted similar tax equalization rights to those accorded to physical manufacturers, which would mean, of course, that they would face similar valuation complications.

Under a wholesale tax, wholesalers and distributors who performed such near-manufacturing operations would automatically be liable to sales tax on their sale price to retailers without the administrative and compliance difficulties entailed under a manufacturer's tax.

The problem of achieving near-neutrality where such operations were performed by retailers would remain a difficult one with respect to private brands under both tax levels. To require retailers of private brands to be licensed and to account for the wholesale tax at the general statutory rate on their retail prices would result in a greater departure from neutrality than to tax them on their purchases. The alternative of allowing retailers a discount off price to consumers as their taxable value on such sales would require the widespread licensing of retailers, as we have already pointed out in our comments on the manufacturer's tax. This would pose substantial compliance problems. It would be difficult to determine an appropriate "uplift" on sales of private brands to retailers because retailers' private brand promotion functions are often impossible to measure, and vary widely in extent between products and between retailers. Taking into account considerations of both neutrality and administrative feasibility, we do not think that any specific action to bring into the tax base retailers' special brand promotion costs would be warranted at a moderate rate of tax.

Retailers would have to become taxable persons in certain specified manufacturing activities where the value added by their manufacturing operations was substantial and where there would be competitive inequities if these retailers were not licensed, for example, in the remodelling and repairing of fur garments and the making of drapes. The licensing of such entrepreneurs as taxable persons would also require that they be allowed a notional value for tax to give them a taxable value equivalent to the level of sale to a retailer. It will be recalled that we consider that comparable licensing and tax equalization measures are required under a manufacturer's tax. These comments are not intended to apply to the separate category of "industrial" manufacturers who undertake their own retailing. They would, of course, always be licensed.

Imports of Fully Manufactured Goods

The inequities which arise in applying a manufacturer's tax to imports would be reduced considerably under a wholesale tax. Importer-wholesalers would become taxable persons, in the same way as wholesalers of domestic products. Their inward transportation and their promotional costs would enter into their taxable value so that both imported and domestic goods would be taxed on the same "converged" basis, namely, selling price to retailers. However, it is only at the retail level that complete neutrality could be achieved with regard to imports.

WHOLESALE LEVEL: TRANSITIONAL CONSIDERATIONS

If the manufacturer's tax were changed to a wholesale tax, refunds of tax previously paid on inventories on hand would have to be made to wholesalers and to licensed manufacturers who operate unlicensed wholesale branches.

For a number of reasons, the determination of the tax refund to individual firms would be less difficult than in a transition from a manufacturer's

tax to a retail tax. Fewer firms would be affected because retailers' inventories would not be involved. Indeed, approximately one third of the wholesalers concerned are already licensed under the current manufacturer's sales tax, and have tax-exempt inventories. It is probable that the records kept by wholesalers 13/ and manufacturers who operate unlicensed wholesale branches 14/ would generally be more satisfactory for this purpose than those maintained by retailers. The determination of the actual amount of tax to be refunded on specific goods would be more certain because licensed manufacturers would have satisfactory records of the tax with respect to their unlicensed branch stocks, and wholesalers would have been in most cases charged tax at the current statutory rate on their actual purchase price. However, freight adjustments would create difficulties. Finally, the present tax administration is already experienced in this task, for, when a wholesaler applies for a sales tax licence under section 35 of the Excise Tax Act, it is necessary to establish and refund the sales tax already paid on inventories at the date of issuance of the licence 15/.

A change in the tax level would result in some changes in prices. This would occur even with a wholesale tax rate that was equivalent, in terms of total revenue yield, to the manufacturer's tax. Manufacturers who are not currently allowed a wholesale value for tax on their sales to retailers, for example, sales of automobiles or furniture, would find their taxable value unchanged, but the rate of tax lower. For manufacturers in an industry with an above average wholesale mark-up, and who are currently entitled to a wholesale value for tax, there would be an increase in the tax as a percentage of price to the retailer.

There would be a temptation for manufacturers selling to wholesalers to maintain prices at their previous tax-included level under the manufacturer's tax, and for manufacturers who were not allowed a wholesale value for tax under the manufacturer's tax to retain the windfall arising from the small reduction in the rate of tax on their sales to retailers. The less

the competitive pressures in an industry the more likely that some increase in consumer price levels would occur in the short run. However, compared with the transition to a retail tax, where retailers frequently do not know how much manufacturer's tax is buried in their purchase price, wholesalers can generally deduce that, subject to freight deductions, the manufacturer's tax represents 11/111 of their purchase price. Wholesalers would therefore be able to detect any attempt by manufacturers to reduce their prices by less than the manufacturer's tax element. In the long run, competition would substantially eliminate these price effects.

Refunds on tax-paid inventories in the hands of manufacturers (unlicensed wholesale branches) and wholesalers would, of course, have an effect on the flow of revenue. We found it impossible to compute with accuracy the amount of tax that would have to be refunded or deducted from current revenues. Taking into account that a number of major industries, for example, toilet goods, pharmaceuticals, radios, television broadcast receiving sets, and breweries, already have tax-exempt stocks in licensed wholesale branches, that many industries largely bypass the wholesale trade, and that over 3,300 wholesalers are already licensed, the amount of refundable tax has been estimated by our research staff at less than $50 million, 16/ or roughly 3 per cent of total annual federal sales tax revenues. This would be considerably less than the effect on the revenue flow of a transition to a retail tax; for, in that case, refunds of tax would also have to be allowed on all retailers' inventories of taxable goods.

WHOLESALE LEVEL: GENERAL ADMINISTRATIVE CONSIDERATIONS

From an administrative point of view, we believe the wholesale tax is clearly superior to the manufacturer's tax.

A wholesale tax would require an increase of 20 per cent to 25 per cent in the number of firms required to collect tax, and the costs of collection would rise accordingly. On the other hand, even if the

manufacturer's tax were retained, we would recommend a considerable increase in the number of licensed wholesalers, primarily to reduce the number and inconvenience of refund claims. During the fiscal year ending March 31, 1964, the Audit Branch, Customs and Excise Division, Department of National Revenue, processed 44,000 refund claims 17/ under the manufacturer's sales tax, over half of which, would probably have been eliminated had all wholesalers been licensed.

Less reliance on notional values for tax, and the bypassing of many of the troublesome areas of the manufacturer's tax, such as imports, private brand wholesalers, and "marginal" manufacturers would more than compensate for the "uplift" and wholesaler-retailer problems encountered under a wholesale tax.

The compliance difficulties of licensed manufacturers who also acted as unlicensed jobbers of goods would be reduced considerably under a wholesale tax. The tax application complexities which arise under a manufacturer's tax for transactions not at arm's length would, in our opinion, be substantially reduced with the movement of the tax level to a stage nearer to the consumer.

Under a manufacturer's tax the introduction of exemptions and of tax rate reductions impose varying penalties on tax-paid inventories in manufacturers' unlicensed wholesale branches, and in the hands of wholesalers and retailers. Because the wholesale tax would be imposed at a later point in the distribution process, these penalties would be eliminated except in connection with retailers' inventories. These penalties could be effectively removed only under a retail tax.

The administration of exemptions conditional on end-use, for example, equipment for use on the farm for farm purposes only, would be simplified under a wholesale tax, both because the general point of tax incidence would be closer to the point of end-use and because, where tax has been paid, the actual amount of tax would be more easily determined by the unlicensed vendor.

Taking all factors into account, we anticipate that a wholesale tax would achieve greater certainty and simplicity than a manufacturer's tax, without any increase in the costs of administration.

RETAIL LEVEL: NEUTRALITY CONSIDERATIONS

If the federal government converted the manufacturer's tax into a tax at the retail level as we recommend, the fact that this type of tax is already used by eight of the ten provinces would have important consequences for both the method of administration and coverage of the tax. However, in the following pages we have confined our comments, as far as possible, to a federal tax at the retail level, leaving the separate issues concerning federal and provincial occupation of the same tax field for discussion in Chapter 38.

We have stated that a sales tax should be "neutral" in its effect on the spending patterns of consumers, using as our practical measure of neutrality the tax to final selling price ratio. We have so far compared, in turn, the manufacturer's tax and the wholesale tax with the retail tax, employing the latter as our standard because it would undoubtedly achieve neutrality in greatest degree.

In our examination of the manufacturer's tax and the wholesale tax, we stated that the departures from a neutral tax, and the attendant complexities in endeavouring to achieve a rough measure of neutrality, would arise both from differences in the relative importance of different cost elements in different goods, and from differences in the stages of the distribution process at which these costs were incurred. Regardless of the distributional channels used, of who advertises, packages or imports, these cost elements that ultimately form part of the selling price of an article to the consumer converge at the point of imposition of a retail tax. At this tax level the goals of neutrality and simplicity would be achieved, for the tax would be a constant ratio of expenditures on taxable goods by all consumers.

We have also said that there would be additional advantages in the retail tax. It would avoid the pyramiding effect, the marking-up of the tax element in the price of goods as they pass through the distributional stages, about which a number of participants have complained to this Commission. We believe, however, that this effect is frequently overstated. While various degrees of pyramiding can occur under a manufacturer's tax, and to a lesser extent under a wholesale tax, competitive conditions tend to reduce its impact over the long run.

Only a tax at the retail level could avoid the inequities that arise from the inclusion of tax in inventories at any other level. Examples of such inequities are the sale of obsolescent or damaged tax-paid goods, losses by breakage, and losses incurred when the tax is lowered or eliminated. A retail sales tax would provide the broadest base and so would require the lowest rate for a given revenue; and at this level there would be the greatest taxpayer awareness, because there would be full disclosure of the tax burden.

RETAIL LEVEL: ADMINISTRATIVE CONSIDERATIONS

Number and Nature of Taxpayers

Canadian taxpayers now bear the cost of the complicated machinery of the federal sales tax and also of eight provincial sales taxes.

The main objection generally raised to a retail sales tax is that it is collected through a large number of retailers, some of whom are not well organized for this purpose. A study was made by our research staff to determine whether, in fact, the retailers of the country were capable of administering a federal retail sales tax.

On the assumption that food would be exempt, it was found that the sales information essential to accurate accounting for sales tax was probably compiled in a satisfactory fashion by retailers who are responsible

for well over 90 per cent of the total retail sales volume. The smallest retail units, who would be most troublesome from a tax administration standpoint, account for a diminishing proportion of total sales volume, but they are increasingly adopting reasonably reliable accounting systems. The larger units now have the capacity to maintain adequate sales tax accounts and their efficiency will probably increase. There is, accordingly, every reason to believe that the Canadian retailer would be competent to collect federal sales tax.

Cost and Effectiveness of Collection

Even after examining the costs of collection of the various provincial retail sales taxes, it is difficult to estimate with complete certainty the costs of collection of a federal tax at the retail level. Compared with a tax at the manufacturer's level, the added costs of auditing about seven times as many taxpayers would be partially offset by increased simplicity and certainty, and by a substantial reduction in the use of notional valuations and end-use exemptions. Costs of collection at the retail level would depend on a number of variables: the audit programme, because an inadequate audit programme may be cheap to operate, but fail to produce maximum revenue; the range and nature of exemptions; and the number, nature and geographical distribution of the taxpayers. Furthermore, if costs of collection were expressed as a percentage of revenue collected, this ratio would vary significantly according to the tax rate. If the tax rate were doubled, even though it would be reasonable to anticipate that audit programmes may need to be more thorough and more costly, certainly costs of collection should not double.

At a tax rate of 7 per cent to 8 per cent on the recommended retail tax base which would yield approximately the same amount of revenue as the present rate of 11 per cent at the manufacturer's level, 18/ we believe that, with a thorough audit programme, the cost of collection would increase from the present 0.4 per cent of tax revenue to approximately 0.7 per cent. On

the other hand, under a composite federal-provincial retail tax where the maximum rate would at present be 14 per cent, collection costs, as a percentage of tax revenues, would be approximately the same as for the manufacturer's tax. At combined rates higher than 14 per cent, we are uncertain about both the extent to which evasion would increase and the cost of combating it.

We have been unable to reach any positive conclusion about the problem of evasion with a rate of nearly 14 per cent, for general retail sales taxes at rates as high as this have not been imposed in Canada or in other countries. We doubt that, at a rate of about 14 per cent, retail tax collection must become less effective 19/. Given an efficient enforcement policy, adequate and competent auditing, appropriate penalties, the requirement of security bonds where necessary, and the general administrative capability of the great majority of Canadian retailers, it appears reasonable to anticipate that, at least after the initial short-run adjustment period, retail taxes of 14 per cent could be administered with a high degree of effectiveness without inordinate cost.

Tax Computation

Notwithstanding the exclusion of the provinces from the field of "indirect" taxation by virtue of the British North America Act, provincial sales taxes have been upheld as constitutional when the taxes are levied "directly" upon the consumer, but the retailer is designated as the official collection agent. One consequence of this has been the requirement, though it is unofficially waived for some firms in a few provinces, that firms remit the precise amount of their tax collections. This has meant that some retailers have been required to keep more detailed accounting records than otherwise would have been necessary and this has imposed extra costs on them.

On the other hand, constitutional provisions do not preclude the choice of the most advantageous form of retail tax by the federal government. Our

investigations suggest that simplicity would be achieved by permitting vendors to apply the tax rate to their total sales of taxable goods, including sales that were below the minimum taxable amount. This would mean that some vendors accounting for tax on total taxable sales might collect on their individual sales more or less than the total they were required to pay to the tax collection authorities. We think this small difference should be ignored. However, vendors who make numerous sales in amounts below the minimum taxable sale would be out of pocket if they remitted on an aggregate basis. They should be permitted to account for tax on an individual sales collection basis 20/.

The constitutional implications of such a method of tax computation for a combined federal-provincial retail tax are discussed in Chapter 38.

Vendors' Allowances

It has been the practice of the provinces in administering their sales taxes at the retail level to permit licensed vendors to deduct various specified proportions from their periodic sales tax remittances as "compensation" for acting as the agent of the government in collecting and remitting sales taxes. The federal government, on the other hand, has never adopted this practice.

Whatever justification may once have existed for encouraging the cooperation of retailers, little remains now. Retailers and other former opponents of the retail sales tax have long since made their peace with it; moreover, the allowances provided have, generally speaking, never borne any clear relation to vendors' costs of collecting, accounting for, and remitting the taxes. They certainly do not do so now. Yet the revenue losses to the various provinces involved are considerable. Professor Due has shown that in each province the allowance is much greater, expressed as a percentage of revenues, than all other government costs of collection 21/.

These considerations suggest that introducing this practice under a federal retail sales tax would not be justified.

RETAIL LEVEL: TRANSITIONAL IMPLICATIONS

We have given some consideration to the transitional problems that might be expected to arise if the base of the federal sales tax were moved from the manufacturing to the retail level. Three problems received particular attention: losses to firms holding tax-paid inventories, effects on the flow of revenue, and higher tax-included retail prices.

Tax-Paid Inventories

Under the manufacturer's tax, there are tax-paid retail inventories, wholesale inventories, and the "unlicensed wholesale branch" inventories of those manufacturers who operate under this method. There are also inventories of imported manufactured goods that have been subjected to federal sales tax. It is evident that, without some specific relief, moving the tax base to the retail level would mean that a great many firms would suffer material financial losses on the inventories that they hold, unless consumers of goods on hand bore the tax already paid as well as the new federal sales tax to be imposed. This would appear to be an impossible imposition on consumers, and we believe that every effort should be made to ensure that holders of tax-paid inventories do not suffer financial hardship because of a change in the sales tax base. Unfortunately it is far easier to state this principle than to design a method of relief.

A basic problem arises because of the difficulty that most Canadian vendors, particularly retailers, would encounter in computing the tax content of the value of their inventories. Goods manufactured in Canada are distributed through various distribution channels, and the current federal manufacturer's sales tax is characterized by a maze of ad hoc, non-statutory regulations and discounts, all designed to achieve a measure of tax equalization. Further complications arise from the taxation of imported goods on a special base of "fair market value" for duty, plus duty. These problems are further compounded by the fact that, under certain conditions, some

elements of intermediate selling prices, for example, transportation charges, are not subject to sales tax. Consequently, the holders of tax-paid inventories composed of heterogeneous goods would be compelled to deal with a host of effective tax rates that often vary substantially.

In addition, problems would arise from the wide variation in the ways in which the amount of sales tax may be reflected on the sales invoices of licensed vendors, and from the invoicing practices of subsequent vendors. The techniques of licensed vendors range from showing on invoices the taxable sale price, the rate of tax applicable, and the amount of tax, to showing only the tax-included, that is, tax-paid, price, with no indication as to the amount of tax, its effective rate, or its basis of computation. Moreover, there would be the problem of how to deal with those goods included in retail inventories that were purchased from unlicensed wholesalers who, when billing the retailer, made no reference whatever to the sales tax charged them by the manufacturer, or the basis on which it was computed.

We considered alternative means that might be adopted by vendors to determine the tax content of their inventories that would be acceptable both to themselves and to the taxation authorities; or, alternatively, that would enable vendors to carry minimum inventories on the date of the change of base without unduly disrupting the efficient flow of merchandise from producers to consumers. We found no single technique, formula or device, or combination thereof, that could be prescribed as being generally reliable and efficacious under current Canadian conditions. This should not, however, be taken to mean that we regard the problem as insoluble. While we found no definitive solution, we did find specific methods that could be applied in certain types of situations and circumstances. These methods include: the use of stock turn-over rates as a basis of inventory inference; the use of a tax "holiday", representative of inventory turn-over periods in major retail trade categories; and the mutual collaboration of licensed vendors,

their immediate customers, and the tax authorities, whereby tax-paid inventories were confined to very low levels during the brief transitional interval. Nevertheless, it must be recognized that all these measures would, at best, fall short of perfection.

We think it more important to emphasize the need for flexibility on the part of the taxation authorities than to dwell further on the means they might employ to that end. We are satisfied that the government's legitimate rights to preserve revenues could be reconciled with the equally valid rights of tax-paid inventory holders to be spared financial injury as the result of changes in tax policy. There already exists an elaborate federal sales tax mechanism for determining industry discounts and the like, that should be adaptable to part of this complex but non-recurring task. On balance, then, we have concluded that the hurdle of tax-paid inventories, though involving short-term difficulties and only amenable to rough justice in many cases, would not be insurmountable.

Effects on the
Flow of Revenue

Moving the sales tax to the retail level would inevitably reduce federal tax revenues during the transitional period if, as we have suggested, substantial double taxation were to be avoided. The effect would be comparable to extending an existing pipeline; there is a waiting period before there is a resumption of the flow from the end of the new line. This revenue postponement effect must occur whatever the method used to deal with the problem. It is difficult to estimate with precision the amount of the manufacturer's sales tax at an 11 per cent rate that would be included in tax-paid inventories at the time of transition; but we believe that approximately $175 million would be involved, or the equivalent of less than one and a half months of federal sales tax revenues 22/. This revenue postponement may be considered a substantial price for the federal government to pay for moving the sales tax to the retail level; but it would be justifiable

in terms of the overall long-run gains in administrative ease and neutrality to which we refer in this chapter.

Price Effects

The Retail Council of Canada suggested to us that competition in the Canadian economy is not sufficient to ensure that, in the event of a change of base, there would be an immediate and corresponding reduction in prices 23/. While we recognize that the Canadian economy is subject to a variety of factors that often tend to restrict competition, we consider that, except in the short run, this undesirable result is unlikely to occur. We are assuming that a federal retail sales tax would be levied at a rate to produce about the same total revenue as that now yielded by the manufacturer's tax. The full blaze of national publicity that would accompany the change of the sales tax base should exert a restraining influence on those manufacturers who have the market power to raise prices and who would be tempted to capitalize on the transition.

However, the combination of necessary price increases on certain goods, and the uncertainty of retailers as to the precise amount of tax that had been concealed in their purchase prices under the manufacturer's tax, could encourage some manufacturers and merchants to increase their prices. It is also possible that the prices of certain types of goods, notably goods that have traditionally carried a specific retail price, and those that are commonly subject to "suggested retail prices", might be rigid enough to continue beyond the transitional interval, thereby imposing higher costs on consumers. It seems reasonable to expect, however, that competition would force the appropriate price adjustments within a relatively short period of time. Nevertheless, we feel that a concerted public information programme, to inform individuals and firms as to the substance and mechanics of the change of base, would be necessary to increase the competitive pressures.

VALUE-ADDED TAXES

The adoption of a value-added form of taxation by France and two other taxing authorities during the past twelve years, and its contemplated adoption by a number of Western European countries, have focused widespread attention on this form of taxation 24/. However, proposals for its adoption date back as far as 1917. The method is no novelty.

The purpose of a value-added tax is to tax each entrepreneur on the value he adds in the manufacturing or distribution process. It may be described in simple terms as a turn-over tax from which the "cascading" or cumulative tax element is removed by taxing each successive transaction only in respect of that element of the sale value not previously taxed. The value added by the entrepreneur is equivalent to his payments of wages, salaries, rent and interest plus his profit, or to the sale price of his output less the cost of materials and other articles purchased by him for use in production or for distribution.

The tax collected by the value-added method, assuming the same rate, would amount to the same as that collected under a single-stage retail tax. Under the former method, tax is collected each time goods are traded at a rate applied to the amount of value added; under the latter, tax is collected only once, at the same rate applied to the total value. In general, therefore, the time of collection differs but the tax revenue is the same 25/.

Income and Consumption Variants

If producer goods were to be relieved of the sales tax burden it would be possible to treat the purchase of such goods in two ways under a value-added tax.

Under the "income variant", the tax would be payable either on wages, salaries, interest and profits (net of depreciation), or on sales receipts less purchases (except capital equipment) and depreciation.

Under the "consumption variant", the tax would be payable either on wages, salaries, interest and profits (before depreciation), minus purchases of capital equipment, or on sales receipts, less purchases (including capital equipment).

The consumption variant, applied throughout the production and distribution process, would therefore be equivalent to a retail sales tax on consumers' expenditures; the difference between the two variants being represented by net capital formation. Under a deduction method of value-added tax computation, for which we express our preference later in this section, immediate deduction of capital equipment under the consumption variant would appear to be easier to administer than the income variant.

Forms of Value-Added Taxation

We turn now to the two basic ways of applying a value-added tax, dealing first with the addition method and then the deduction method.

Because the value added by a firm equals the sum total of its factor costs, the tax base could be computed by adding all the firm's factor payments: wages, salaries, rent, interest and profit. While it is true that under this method the taxpayer could use most of the data already shown on his income tax return, it is equally true that these data, because they are governed by income tax regulations, would not always be suited to an accurate calculation of the value added by his enterprise. Exemptions, including exemptions on exports, and differentiated tax rates would render the addition method almost impossible because of the difficulties of accurately apportioning the firm's factor payments. Furthermore, the addition method would seem to make tax payments on an annual basis almost imperative, because monthly profit and loss statements would not be generally available for such a purpose. This would give rise to difficulties in setting prices and to uneven shifting of the tax. Because of the difficulties of administration, we consider that this addition method is clearly inferior to the deduction method 26/.

Under the deduction method, also called the subtraction or the direct method, inter-firm outlays would be deducted from gross sales in order to arrive at the value added by the firm. The deduction could be limited to a "physical" basis, or extended to include a "financial" basis. Under the "physical" basis, deduction would be confined to purchases of items entering physically into a taxable product or consumed in its manufacture; the "financial" basis would extend the deduction to include overhead costs and capital equipment (or depreciation) costs, and thereby would eliminate a significant cumulative taxation element.

To eliminate or reduce the cumulative tax element by the deduction method, there are two ways of computing tax liability: the "base-from-base" and "tax-from-tax" methods.

Base-from-Base. Under this system, the tax rate would be applied to the difference between the total sales of a firm and its deductible purchases. This would mean that the value-added tax would not be separately itemized on sales invoices. In setting their prices, businessmen would have to estimate in advance the amount of tax that would accurately reflect their value added, and for many firms this would generate an element of uncertainty. Conceptually, the method is simple and accurate, as long as the tax rates on the inputs of the firm were uniform and so long as there were no exemptions.

Tax-from-Tax. Under this system the tax rate would be applied to the value of each sale, and from the total tax so collected on a firm's sales a rebate would be allowed of the total tax paid on the deductible purchases of the firm.

In contrast with the base-from-base system, the tax must be clearly shown on the invoice, which would permit the accurate shifting of the tax and would avoid the uncertainties associated with predicting the tax factor in advance under the base-from-base method. Furthermore, the tax-from-tax system could fully "recapture" tax where exemptions and different rates were

a feature of the tax base; exporters would not be faced with complications in determining the amount of tax rebate required to obtain full relief. It should be pointed out, however, that although exempt goods, and exempt services, need not create serious obstacles under the tax-from-tax method, exempt entrepreneurs do. Interposing an exempt entrepreneur within the taxable chain of distribution would effectively prevent the next succeeding entrepreneur from taking deduction of the tax which had accumulated on successive transactions up to the point of sale to the exempt entrepreneur. Accordingly, if, for example, large numbers of small entrepreneurs should become taxable persons because of the scope of the tax and the trade level at which the tax was levied, the tax legislators would face the predicament of either licensing them, and thereby imposing the detailed record-keeping requirements of the tax-from-tax method, or of regarding them as non-taxable persons, and thereby erecting barriers in the tax deduction chain. In practice, we believe that this problem of exempt entrepreneurs, if confined to small entrepreneurs, would be of less significance under a tax-from-tax method than would be the problem of exemptions and differentiated rates under the base-from-base method.

It would appear that under both the tax-from-tax and base-from-base methods, in comparison with single-stage taxes on sales, taxpayers would have a stronger incentive to keep accurate records of both purchases and sales. Over and above this advantage, under the tax-from-tax method, a businessman would be anxious to ensure that his predecessor in the chain of production and distribution showed on his invoice the exact amount of tax paid, so that he could in turn deduct it from the tax liability on his sales. The above features are frequently stressed as the superior self-enforcement features of a value-added tax. Furthermore, under both deduction methods, the scope for evasion of tax on sales would be limited to the tax on the value added by a firm; under a single-stage tax the scope for evasion would extend to the tax on total turn-over.

In comparing the two deduction methods, the tax-from-tax method for the computation of the taxpayer's liability would in our opinion be superior to the base-from-base method. The latter does not appear to be practicable, except under the circumstances of uniform tax rates and an almost complete absence of exemptions.

Value-Added and Single-Stage Taxes: A Comparison

Because we reject the turn-over form of tax collection later in this chapter, it is appropriate that we should compare the value-added form with the single-stage form of tax collection at each of the tax levels.

In taxing consumption both the value-added and the single-stage forms of tax collection would achieve a similar result; they would yield tax in an amount derived from the taxable value and the rate of the tax applied to it. The value-added form would yield this revenue in the form of "fractional payments" at each transaction stage, which would add up to the same amount as the "one-shot" yield under a single-stage tax.

Administrative Aspects. The elimination of the cumulative or "cascading" element in a transactions tax would be achieved under a value-added form because a taxpayer would deduct his purchases (or the tax thereon) from his sales (or the tax thereon). It would be necessary for each taxpayer to keep full records in respect of both purchases and sales in order to substantiate the deductions; and, in some cases, where a substantial proportion of exempt sales were made, for example, by exporters, the tax administration would have to process tax refund claims.

The accumulation of tax would be avoided under a single-stage tax by a technique generally described as "suspension". A manufacturer would be licensed to purchase his raw materials, parts, etc., exempt from tax, that is, in suspension and the cost of these materials in turn would enter into the selling price of his goods. Under a wholesale tax, these goods would

then be sold tax free (in suspension) to a licensed wholesaler, who would account for tax on his sale price. This would mean that considerably fewer taxable transactions would be recorded by businesses than under a value-added tax, and, in the case of exports, no tax payments (or refunds) may be recorded at all. The tax administrators would then verify whether purchases made in suspension were legitimate over large areas of the purchasing field, for example, purchases of raw materials and partly manufactured goods. This would be a relatively simple task.

Where a government intends that there should be residual "double tax" elements in the tax structure, as, for example, is currently the case with production machinery in Canada, then under a value-added tax the administrators must check that no deductions have been taken on such purchases, and under single-stage suspension that no exemptions have been claimed upon purchase. The value-added procedure would, in our opinion, place a heavier record-keeping burden on the taxpayer, and a heavier administrative burden on the tax collector.

Exports. The value-added form would have no intrinsic advantages over the single-stage form in offering incentives or eliminating disincentives to exports. Under a single-stage tax, most exports would be made in suspension, the remainder being allowed a tax refund; any residual tax elements buried in the export price, for example, if producer goods were taxed, would be there because the law did not provide for their exemption. Under a value-added tax, with no change in the scope of the tax base, a similar exemption for exports could be achieved by deduction, and the same residual tax elements would remain in the export price. The single-stage form would involve less administrative inconvenience for refund claims than would occur under the value-added tax 27/.

Effectiveness. We referred earlier to the enforcement features of the value-added tax, and we believe that this form of tax would offer, at the cost of more onerous record keeping, an effective control over tax revenues.

However, evasion would not be a serious problem in Canada under a manufacturer's sales tax or under a wholesale tax because of the relatively small number of taxpayers involved and the quality of the records they keep. The additional administrative and business costs necessitated by the fractional tax payments technique would seem to outweigh the enforcement advantages of the method under these two levels.

However, we observed earlier that a retail tax at rates in excess of 14 per cent might result in a significant evasion problem. Should this occur, the case for a value-added form of collection would be strengthened. Any consideration of its adoption must take into account the large number of taxpayers involved, the increased cost and complexity of administration, and the more onerous record-keeping burdens placed on taxpayers, particularly on retailers. We think that it would be unrealistic to consider instituting a value-added tax, rather than a federal retail tax, at a rate of 7 per cent to 8 per cent which would be equivalent to the present manufacturer's sales tax rate of 11 per cent, for in our opinion such a rate would not be high enough to encourage significant evasion of a retail tax. However, it must be assumed that the provinces would continue to levy their retail sales taxes. Federal and provincial combined rates that totalled 14 per cent or more, and significant evasion at such rates, would constitute in our opinion the only circumstances in which a value-added form of collection could be justified for Canada.

If such evasion occurred, a federal value-added tax should be considered up to, and including, the retail level. This would collect the federal tax and at the same time safeguard the provinces' rights to their retail taxes on a single-stage "destination" basis. It would provide the enforcement mechanism of the federal value-added tax to the advantage of both levels of government.

Scope or Coverage. Exemptions or rate differentials introduce administrative difficulties into any tax structure, and the value-added tax is no exception

to this rule. Indeed, a single-stage levy would be better suited to provide for the exemptions or rate differentials usually considered desirable on social grounds. The main appeal of the value-added form of taxation lies in its extremely broad base.

A value-added tax on services would form an appropriate component of a value-added tax on goods, but would unnecessarily complicate tax administration if it were instituted in conjunction with a single-stage tax on goods. Therefore, the adoption of a value-added tax on services would be dependent on its adoption in the taxation of goods. In Chapter 29 we reach the conclusion that the taxation of services would best be accomplished in conjunction with a tax on goods at the retail level.

CUMULATIVE TURN-OVER TAX

Like the value-added and single-stage taxes, a cumulative or "cascade" turn-over tax is a form of collection that may be used to tax transactions up to any of the basic trade levels. In contrast with the pure form of single-stage sales tax at, for example, the retail level, which applies to commodities, and sometimes to services, only once in the production and distribution process, the pure form of cumulative turn-over tax applies at the full rate to every transaction through which goods pass on their path from the earliest stage of production through to the final consumer.

The German cumulative turn-over tax, forms of which were introduced by a number of European governments at the end of World War I, was the prototype of this kind of tax. In Canada, a modified form of cumulative turn-over tax was introduced in 1920 but, after many complaints about its discriminatory effects, it was withdrawn in 1923, and no serious consideration seems to have been given since that time to reintroducing such a tax. At present, turn-over taxes are in use in Germany, Austria, Italy, Luxembourg and The Netherlands. A non-cumulative form of turn-over tax, that is, the value-added form, is in operation in France and Finland, and a bill proposing

its introduction is at present before the German Parliament. Because the effect of a value-added tax is similar to that of a single-stage tax, and has been considered earlier in this chapter, we examine here only the cumulative form of turn-over tax.

A turn-over tax has several merits. Because it may apply to all transactions at every stage of production and distribution, the extremely broad base would permit very considerable revenues to be raised at a low rate of tax. In contrast with a single-stage tax in which the technique of "suspension" was used to eliminate the multiple application of the sales tax as goods move through the production and distribution process, a turn-over tax could avoid the administrative and compliance difficulties arising from the need to separate taxable from non-taxable transactions. In practice, however, the modifications usually introduced into turn-over taxes for the purpose of reducing the inherent inequities result in considerable administrative complications.

In our view, the defects of a turn-over tax outweigh its merits. It produces a variable tax element in final consumer prices. Because the tax "cascades" on each successive transaction as goods move through the production and distribution process, the proportion of tax in the final price to the consumer may vary widely from product to product. A commodity produced, and perhaps distributed, within an integrated firm may bear considerably less tax than a competing product that has passed through a considerable number of transactions on its way through the various production and distribution stages to the consumer. The resulting competitive inequities are self-evident.

Under a turn-over tax on all transactions, firms have a powerful incentive to eliminate as many independent transactions as possible. While vertical integration may not be economically harmful, indeed it may in some instances lead to increased efficiency, the encouragement of integration by the turn-over tax is improper. Certainly the tax would have the effect of discouraging specialization.

Furthermore, there would be difficulties in applying exemption to exports and in taxing imports, where products pass through a number of transactions before being exported, the tax would become buried in the price, and the refund to the exporter could not be made with precision. Any refund formula could be, at best, only an average of the tax in numerous transactions. Such an average would therefore be subject to the complaints of those exporters who believed that, in their case, the refund was inadequate; on the other hand, those exports which would benefit from the average might draw complaints of export subsidization. Similarly, it would be impossible to allocate precisely to imports a tax rate comparable with the tax borne by competitive, domestically produced goods because the latter would bear varying amounts of tax.

The significance of the above defects mounts as the rate of tax increases. We reject a cumulative turn-over tax as being an unsuitable form of sales taxation for Canada.

CONCLUSIONS AND RECOMMENDATIONS

1. The federal government should impose a single-stage sales tax at the retail level in place of the manufacturer's sales tax.

2. The federal government should ensure that a variety of generous transitional provisions were made available in order to ensure that no firm suffered financial hardship through inadequate adjustments for the tax-paid inventories that it carried.

3. No compensation should be made to retailers for collecting the sales tax.

4. Only if the problem of administrative control of a single-stage retail tax became too great should a value-added tax be adopted.

REFERENCES

1/ Department of National Revenue (Excise), General Excise and Sales Tax Regulations, Circular ET 1, April 1961, Regulation 21.

2/ A further complication is introduced where tax is equalized at the level of sale to a wholesaler. It is necessary to ensure that manufacturers selling to retailers at a delivered price, and accounting for tax on an "established wholesale price", are limited to a freight deduction that would result in a value for tax not lower than the value on which they account for tax on sales to wholesalers.

3/ Department of National Revenue (Excise), Circular ET 1, op. cit., Regulation 27.

4/ Ibid., Regulation 22.

5/ Excise Tax Act, R.S.C. 1952, Chapter 100, section 2(1)(aa)(iv).

6/ Department of National Revenue (Excise), Circular ET 1, op. cit., Regulation 21(2)(g).

7/ Ibid., Regulation 35.

8/ Excise Tax Act, section 30(1)(b).

9/ Ibid., section 29(1)(f).

10/ Approximately 46,000 manufacturers are licensed under the Excise Tax Act for sales tax purposes and there are, in addition, 3,300 wholesaler's sales tax licenses. Under a wholesale tax, we believe that approximately 12,000 additional licences would be required. Under a retail tax, some 340,000 licensed firms would be involved, according to an estimate by Professor J. F. Due based on a retail tax similar to those currently operative in the Canadian provinces. Memorandum submitted to this Commission by Professor Due. See also J. F. Due,

Provincial Sales Taxes, Canadian Tax Papers No. 37, Canadian Tax Foundation, 1964.

11/ Under the British purchase tax it became necessary to increase some wholesale prices to reflect these functions not included in the wholesale price; this is referred to as "uplift".

12/ The same problem also arises, but is less important, under a manufacturer's tax.

13/ We understand that many unlicensed wholesalers currently use the reconstructed trading account method, and should therefore be able to determine the tax on their inventory without excessive complexity.

14/ The "unlicensed wholesale branch" method is one whereby sales tax is paid by a manufacturer on an established wholesale price or a determined wholesale value at the time he sells goods or ships them to his own warehouse. The procedure is established in Department of National Revenue (Excise), Circular ET 1, op. cit., Regulation 21.

15/ Ibid., Regulation 13(1)-(10).

16/ It should be noted that tax-paid inventories in central warehouses of chain store organizations are not included in this figure.

17/ Information supplied to this Commission by the Department of National Revenue.

18/ See J. F. Due, Provincial Sales Taxes, Canadian Tax Papers No. 37, Canadian Tax Foundation, 1964, p. 193.

19/ See, however, Lief Muten, "The Value-Added Tax - A New Weapon in the Fiscal Armoury?" Skandinaviska Banken Quarterly Review No. 2, 1963, p. 45.

20/ Of course, the higher the tax rate, the less the practical significance

of the minimum taxable sale. For example, if, in the calculation of the tax, fractions of tax of one-half cent or more are regarded as one cent, then at a retail tax rate of 10 per cent, all sales of five cents value or more would bear tax. At a 13 per cent rate, all sales of four cents value or more would bear tax.

21/ J. F. Due, Provincial Sales Taxes, op. cit.

22/ In making our estimate, we took into account an average retail inventory turn-over (foodstuffs excluded) of approximately two months. We also compensated for the substantial proportion of goods which bypass the retail trade, either because of the nature of the purchaser, for example, governments and other large institutions, or because of the nature of the goods, for example, machinery and apparatus and construction materials. Accordingly, our revenue estimate is considerably lower than the approximately $300 million estimate of the Retail Council of Canada in its submission to the Commission.

23/ This is a separate issue from the price increases (and decreases) which would arise from changing from a variable tax to final selling price ratio under the manufacturer's tax to a constant tax to final selling price ratio under a retail tax. Under the current manufacturer's sales tax, the tax as a percentage of the final price to consumer varies. Accordingly, with a retail tax, in which the amount of tax was a constant percentage of price to the consumer, those products which previously had a "favourable" value for tax at the manufacturer's level should become more costly to the consumer, and those products which had an "unfavourable" value for tax should become less costly.

24/ The State of Michigan introduced the value-added form of taxation in 1953 and France in 1954. In January 1964, a form of value-added tax was introduced in Finland. In 1949, the Shoup Mission proposed the

value-added levy as the principal source of revenue for the Japanese prefectures; although the Local Tax Bill introducing the tax was enacted into law in 1950, the measure was never put into effect and it was finally repealed in 1954.

25/ This statement is an over-simplification to the following extent. The additional costs of having tax-paid inventories and tax-paid equipment under a value-added tax must, to varying extents, depending on the form of value-added tax, affect the price structure of firms, and, in turn, the tax payable on these prices.

26/ It may be noted that the current French and Michigan taxes, as well as the proposed German tax, are of the deduction method; only under the proposed Japanese tax was the taxpayer to be given the option of adopting either method.

27/ It is interesting to note in this regard that under the French value-added tax, exporters are permitted to adopt the mechanics of the single-stage tax, namely, they may purchase goods for export under "suspension".

CHAPTER 29

THE SCOPE OF SALES TAXES

In the previous chapter we concluded that the retail level would be the most satisfactory point at which the federal government could collect sales tax. In this chapter we discuss the goods and services that should form the tax base at the retail level. Comments on the scope of taxes at the manufacturing and wholesale levels appear in the appendices to this Volume.

CONSUMER GOODS

On grounds of neutrality and administrative feasibility all consumer goods should be taxed. Exemptions make the administration of a tax more difficult and more costly because of the added record keeping necessary to segregate taxable from tax-exempt sales. They also make enforcement more difficult. Exemptions discriminate among consumers with different preferences for taxable and exempt goods. This discrimination is more intense the wider the range of exemptions and the higher the rate of tax required to maintain the same revenue. Closely related to this is the distortion in the demand for goods and services caused by exemptions. Generally speaking, tax-induced changes in relative prices alter the allocation of resources among various possible uses. Unless these changes compensate for market imperfections the presumption is that the allocation of resources is distorted and Canadians are thereby less well off.

However, a general sales tax on goods without exemptions would be a regressive tax because the proportion of income spent decreases as the level of income rises. But services form a larger proportion of the total expenditure of upper income groups than of the lower income groups, and their taxation would tend to counter the regressiveness of the tax on goods. The inclusion of services in the tax base would support the two methods of countering the regressiveness of a general sales tax we have already touched on briefly, that is, the exemption of selected classes of expenditure

necessarily incurred regardless of the income of the taxpayer, or the granting of refunds to consumers for part of sales tax paid on these goods or credits for these taxes against personal income tax liabilities.

The Use of Exemptions

If virtually all consumer goods, including food and commodities entering into the cost of shelter, such as building materials, fuel and electricity, were taxed, the sales tax would be regressive. If food alone were exempt, the regressiveness of sales taxes would be virtually eliminated. This is because food is generally the largest item in the budget of low income families, and the proportion of its cost to total expenditure falls as income rises. If, in addition, shelter were exempt, the taxable expenditure pattern would be moderately progressive over a substantial part of the income range. Under each of the three alternatives mentioned above, but to a diminishing extent, the taxable expenditure curve would be regressive in the over $7,000 income range (see Appendix A to this Volume). It is acknowledged that a general sales tax would be incapable of eliminating regressiveness at high income levels. This limitation, however, must be viewed in the perspective of the tax system as a whole.

Food. Consumption statistics reveal that expenditures on food are regressive because they represent a substantial proportion of the total expenditures of the lower income groups. If food were exempt from tax the most regressive element in a general sales tax would be eliminated. It is clear that the need for sales tax exemption of food is strong and that the need increases with family size. Moreover, a tax on food would create administrative difficulties where farmers sell produce directly to consumers (a difficulty that would be even more serious under taxes at the manufacturing or wholesale level).

We believe that, to avoid regressiveness, there should be no sales tax on food. Furthermore, we consider that, to avoid discrimination between food

products and for ease of administration, the exemptions contained in Schedule III to the Excise Tax Act should be extended to the remaining taxable food products, including margarine, confectionery products and soft drinks (but not including alcoholic beverages) 1/. Our research staff has estimated that the current annual revenue loss arising from this widening of the food exemption would be approximately $33 million, as compared with the approximate annual revenue forgone under the present foodstuffs exemption of $400 million at a rate of 11 per cent. Restaurant meals above a stated minimum value should, however, be taxed.

Shelter. As with food, expenditures on shelter, that is, housing, fuel and electricity, are regressively distributed, and constitute an important element in consumer expenditures, particularly for those with low incomes. If these expenditures, as well as food, were exempt from tax, the regressiveness of the general sales tax would be more than eliminated. Accordingly, the argument for removing sales tax from such expenditures is strong.

We discuss later in this chapter the taxation of expenditures on construction. We conclude that the exemption of building materials, both for residential and non-residential use, would be the ultimate solution. After detailed consideration of many alternative schemes we have reached the conclusion that, if all building materials for all uses cannot be exempt, then all building materials for all purposes should be taxed. There is no administratively feasible middle ground. We also conclude later in this chapter that completed residential buildings should not be taxed, and that the question of taxability or exemption should be considered in relation to materials only.

In contrast with past administrative experience with the building materials exemption, current exemptions for fuel (including natural gas) and electricity are administered with little difficulty. The estimated revenue forgone on current personal and commercial consumption at 11 per cent is approximately $100 million per annum. We recommend that fuel and

electricity should be exempt as long as exemptions rather than credits are used to counter regressiveness under a general sales tax.

Clothing. Expenditures on clothing are not regressively distributed and, accordingly, exemption is not justifiable on that ground. It is sometimes argued that an exemption for clothing is justifiable on the grounds that it is a "necessity". We reject this argument for two major reasons. First, while some items of clothing are undoubtedly necessities, many are not. Any attempt to distinguish between them is almost impossible because the interpretation of the word "necessity" is a subjective one; a purchase of one dress may be a "necessity", but a purchase of five or ten may not. Second, the purchase of some items of clothing may be less of a necessity than the purchase of a stove or an automobile. Even if it were a practical possibility to define the term "necessity" as applied to clothing, such a definition would result in new inequities as against other products which merit exemption on comparable grounds. Alternatively, to exempt all classes of goods which may sometimes be necessities would destroy the general sales tax as an important revenue source.

We were unable to determine whether the expenditures for children's clothing differ, in any significant manner, from expenditures on clothing in general. However, in view of the definitional complications that would arise with an exemption for such goods and, of the far simpler alternative offered by family allowances, we do not recommend exemption.

Refundable Credits Versus Exemptions

An alternative to the use of exemptions would be compensatory payments or allowances outside the sales tax structure. We have considered whether such measures could be used to counter the regressiveness of a general sales tax with greater precision and administrative simplicity than would the use of exemptions. It is of interest that three states of the United States, Indiana, Colorado and Hawaii, now grant such credits.

Under this compensatory method there would be no sales tax exemptions for "necessities". Tax, as a general rule, would be paid on all sales of consumption goods, but part of the tax would be refunded to consumers through any one of a number of schemes.

We considered the use of stamps or coupons which would either be issued by retailers to consumers in proportion to their purchases and would be redeemable up to a certain sum annually, or would be issued directly to consumers by the federal government. We rejected both schemes on administrative grounds. We also considered a third alternative, the payment by the federal government of allowances to single persons above a certain age, and to heads of families, to help them meet their sales tax liabilities of a given period. Such a system would operate in much the same way as the present family allowance programme and would be an improvement over the stamp or coupon system. However, for this Commission to recommend such a scheme would take us into areas we have not considered in detail.

There is a fourth alternative that is worthy of consideration. This would be to use the existing personal income tax machinery to allow individuals and families a credit for sales tax up to a certain specified amount, with a refund of sales tax paid if the credit exceeded the income tax liability. Such an approach would mean that everyone who wished to claim a credit or refund would have to file an income tax return. By granting the first credit or refund in advance of the elimination of the sales tax exemptions the timing problem could be met.

Abolishing the exemption of "necessities" would substantially broaden the tax base and would increase sales tax revenues. This would be largely offset by the proposed income tax credits which could be set at amounts about equal to the additional revenue from the taxation of necessities. It is possible that the revenue should gain under such treatment because the credits should not exceed the necessary portion of expenditures on food, whereas to a considerable extent family purchases of food far exceed the most generous definition of necessary.

The basic problems with this scheme would be administrative. The refundable credits would require that every individual and every family in the country submit an income tax return. The Canada Pension Plan administration moves Canada closer to this result, but we think it premature to recommend a credit refund system until the number of individuals and families not submitting income tax returns is less than is now the case.

Expenditures Caused by Ill Health

The desire to counter the regressiveness of a sales tax is not the only justification for the exemption of some consumer goods. It is sometimes argued that a sales tax should not tax the personal misfortunes of consumers. While some outlays on drugs and medicaments have to be made by most consumers, these normally account for a relatively modest portion of expenditures. However, there are a few people who are compelled, by circumstances over which they have no control, to spend very considerable amounts on these products. Without the exemption of drugs, these consumers would have to bear a disproportionate share of the general sales tax burden because of their state of health, irrespective of their financial circumstances.

Objections may be raised against the exemption of drugs and medicaments from sales tax on the ground that a general exemption could extend into the area of cosmetics and "fringe" pharmaceuticals, and we do not believe that these goods should be made exempt from sales tax. We therefore recommend an exemption only for goods sold under prescription. Drugs and medicaments sold without prescriptions should not be exempt. Appliances and devices for the use of the handicapped merit exemption on similar equity grounds. We believe that this exemption should, therefore, be retained.

Expenditures for Printed Materials

Taxation of newspapers and magazines presents administrative problems because of the practical difficulties of taxing the very substantial quantities of these goods purchased by direct subscription from foreign sources.

Because the tax could only be fully enforced at high cost, we believe that exemption would be the best alternative. The exemption for newspapers should be restricted to those regular publications that offer both news coverage and editorial content, and in which advertising was clearly a supporting rather than a prime feature. This would serve to eliminate from exemption the single purpose advertising sheets and publicity bulletins that currently pretend, often with success, to the status of newspapers for sales tax purposes.

The taxation of books runs into similar administrative obstacles, and accordingly we recommend that they should be exempt.

The seldom used power of ministerial discretion as it relates to the exemptions for printed materials should be removed; differences between taxpayers and tax officials in this area could and should be settled by the judiciary rather than by the taxing authorities.

A number of administrative difficulties and anomalies which arise under the present manufacturer's sales tax are described in Appendix B to this Volume.

SERVICES

A number of participants before this Commission recommended the taxation of services because it would be productive of revenue and because the expansion of the tax base to include services would achieve greater economic neutrality.

Although federal and provincial sales taxes are applied to a wide range of goods, the taxation of services, which represent a large and expanding proportion of total consumption, has been largely neglected in Canada. It has been confined, at both levels of government, to a very limited number of specific consumer services.

Appendix C to this Volume indicates that personal expenditures on services amounted to nearly $10 billion in 1962. The potential tax base is substantial, even if, because of economic, social and political considerations, such items as purchased transportation, medical care and death expenses, education, rent for shelter both imputed and direct, and a number of the miscellaneous services listed in the Appendix were not taxed.

The rationale for taxing services is simple; retail sales taxation is consumption taxation and, because consumers may buy either goods or services, there is no justification for distinguishing between the two types of expenditure. In fact, to reduce the regressiveness of a sales tax there is every reason to include services, for expenditures on services form a larger proportion of total expenditures of the higher than of the lower income groups. That it would be feasible to tax some services is demonstrated by the fact that they are successfully taxed in a number of countries. The question is what services can be effectively and efficiently taxed.

The Taxable Unit

The taxation of services should be limited to those rendered by businesses and institutions on a continuous basis. However, because of the relatively large number of sole proprietors, many of whom operate on a small scale, it might be necessary, for the purpose of increasing the effectiveness and efficiency of collection, to exempt persons whose annual turn-over was below a stated minimum.

The ideal application of the tax on services would be to tax Canadian residents on all services received, whether from other Canadian residents or from non-residents. However, such a comprehensive tax would not be practical because it would be impossible to collect tax from non-residents for services rendered to Canadian residents abroad. For example, a tax on hotel services rendered to a Canadian staying in a New York hotel could not be collected because the supplier of the service would be outside the jurisdiction of the Canadian taxing authorities.

The best that could be done, therefore, would be to tax all services used or exploited in Canada, whether rendered by Canadians or by non-residents. Even this modified approach would not entirely escape from the problem that non-resident suppliers would be outside the Canadian tax jurisdiction. A Canadian resident could, for example, engage the services of an American architect to design his house, and receive the plans from him through the mail; the services would then be rendered by a non-resident to a Canadian resident in Canada, but tax could not be collected from the non-resident. This might be offset by requiring resident businesses to pay tax in respect of such services, but this would be virtually impossible to enforce for purchases of services by Canadian individuals from non-residents if the non-resident does not have to physically come into Canada. The only enforceable alternative we can see would be to exclude from sales tax those services that could be easily rendered to an individual situated in Canada by a non-resident, where the physical presence in Canada of the non-resident was not required and there was little, if any, tangible evidence that the service had taken place.

The above problem would not arise in the case of services purchased by businesses because they would generally not be subject to tax.

General Versus List Approach

There are basically two approaches to the taxation of services. Under one approach all services would be taxed and the compounding of tax would be avoided by exempting services when rendered to businesses. Alternatively, only a list of specific services that were predominantly consumed by individuals and families would be taxed; when used by businesses, these listed services would be exempt, that is, subject to an end-use exemption using the suspension technique described in the previous chapter.

Under the list approach far fewer businesses would require licensing than under a general approach, and there would thus be a saving in auditing

costs to both the government and the taxpayers. From the point of view of accounting, the list approach appears to be immensely better; the number of bookkeeping transactions that would be required to exempt businesses from the taxation of services would be greatly reduced. Moreover, in many cases it would be possible to apply the tax to gross receipts, thus making compliance and enforcement simpler. While the general approach would yield greater revenues at a given rate and would be more neutral, in our view the advantages of the list approach would be of greater importance in introducing a new tax. We recommend that it be followed with a gradual extension of the list, as experience is acquired, from those services predominantly used by consumers to those services used by consumers and businesses.

The following services could be taxed with no exemptions to businesses purchasing them: laundry, dry cleaning, pressing, dyeing, etc.; barber and beauty parlours; places of amusement and entertainment; rental of transient accommodation, furniture and household appliances; shoe repairs, jewellery repairs and engraving; auto repairs and maintenance; radio, television and household appliance repairs; household furniture repairs and private parking charges.

Telephone and telegraph services might be taxed with or without exemption when rendered to a business.

Some services, of the general type listed below, should be taxed with an exemption when purchased by a business: storage of goods, custom fabrication of goods, and the rental (other than the above), repair (other than the above), and installation of goods. Any extension of this list to include less tangible services, and such services as the architect's plans already referred to, would obviously create enforcement difficulties. In accordance with the principle we have emphasized throughout this Report, that a good tax is one that can be effectively administered, no attempt should be made to carry the taxation of services beyond the point where it could be fully enforced.

It would be desirable to exempt specifically some services from tax so that businesses and institutions supplying these services could purchase both goods and services free of sales tax. Just as we would not wish to tax the machinery and equipment used to produce an exempt good, such as bread, so we would not wish to tax the X-ray equipment purchased by a radiologist if medical services were not to be taxed. Among the services that might be explicitly exempt from sales tax, the following seem particularly meritorious: medical, dental, nursing, hospital, legal, educational, and undertaking services. If this approach were not taken, those businesses providing services that were not subject to sales tax, or explicitly exempt from tax, would not be exempt from sales tax on their purchases of goods and services.

The Rate of Tax

The taxation of services on a list approach has proved successful in the United States with rates of about 4 per cent. Taxation of a list of services at such a rate would no doubt prove equally successful in Canada. However, if the federal government should abolish the manufacturer's tax on goods and enter the retail tax field in co-operation with the provinces, combined retail tax rates at substantially higher rates may be imposed. While the absence of experience in other countries except France precludes firm conclusions, it is our opinion that the application of these higher rates to a list of consumer services would not create as many problems as the attempt to tax these services at a lower rate than goods. We therefore recommend that a uniform rate should be applied to goods and listed services.

PRODUCER GOODS

When tax is levied on producer goods, that is, goods used in the production and distribution of consumer goods and services, the effective tax burden will vary between different goods and services because the relative importance of the cost of producer goods in final selling prices is not

constant. Taxing producer goods will, if the tax is passed on in higher consumer prices, reduce sales of goods and services produced by capital-intensive methods, relative to the sales of goods and services produced with labour-intensive methods. If the tax on producer goods is not passed on in higher consumer prices, the expected rate of return on capital-intensive projects will be reduced. In either case, the value of Canada's future output is likely to be reduced. On the other hand, the exemption of producer goods raises difficulties in those cases where such goods can either be consumed directly by individuals or used to produce other goods and services.

For our purposes, producer goods may be divided into three broad categories.

1. Raw materials and partly manufactured goods.

2. Producer capital goods used in manufacture or production but not in distribution.

3. Capital goods used in the distribution of goods and in the performance of services.

If sales of goods in the first category were taxed, the cascading of tax would be substantial. In many instances there are numerous production stages between the extraction of a raw material and the assembly of a finished product. If these intermediate goods were not exempt, there would be a powerful incentive for vertical integration. These goods have been exempt from federal sales tax since 1923, and we have no doubt that they should continue to be exempt.

If sales of goods in the second category were taxed, as goods moved through the production phases between various manufacturers and from manufacturers to distributors, they would accumulate tax. When tax was paid on the sale of the finished consumer goods they would be taxed again. This tax-on-tax effect, which would usually be far less significant than in the

case of a tax on raw materials and partly manufactured goods, would vary according to the degree to which production was capital or labour intensive. Taxing these goods would penalize mechanization and hence productive efficiency. Furthermore, with a fixed exchange rate the taxation of these producer goods could have an effect on the international competitive position of Canadian producers exporting particular goods and services and competing against particular imported products that had not borne this extra burden. In general, we recommend their exemption from sales tax.

In the third category we include capital goods used:

1. In the distribution of other producer goods, for example, raw materials and partly manufactured goods, and in the performance of services for taxable persons, that is, licensees.

2. In the distribution of fully manufactured goods for personal consumption.

3. In the performance of consumer services.

With a tax at the retail level, particularly if combined with the taxation of a wide range of consumer services, the taxing of these capital goods used in distribution would also have a "cascading" effect. If all manufacturers, wholesalers and retailers, and a substantial range of service businesses were allowed to purchase these goods tax free, although subject to audit, the tax-on-tax problem would be virtually eliminated. Only where there would be a substantial risk of diversion to consumer use, for example, automobiles, fuel for internal combustion engines, and office furniture and supplies, would it be necessary to withhold exemption of these capital goods.

On similar grounds, we consider that manufacturers, producers and firms engaged in distribution should be relieved of sales tax on their expenditures on the construction of factories, warehouses and other structures used in distribution. Later in this chapter we discuss the taxation of expenditures on construction, and conclude that construction materials should be eventually exempt.

Several of the industrialized countries of the world make use of general sales taxes that apply to wide ranges of capital goods, including plant, machinery and equipment; but the most important international traders provide comprehensive relief from such levies to producers for goods that are exported. Although the remission of income taxes to exporters involves the risk that retaliatory measures would be taken by other countries, it is accepted that a nation can, without risk of retaliation, refund sales taxes that are levied on export goods.

Table 29-1 provides some information for some of the industrialized countries that levy a general sales tax.

TABLE 29-1

SALES TAX TREATMENT OF EXPORTS OF MAJOR TRADING NATIONS WITH GENERAL SALES TAXES

Country	Type of Sales Tax	Exemption of Production Machinery and Equipment	Refund of Sales Tax Paid on Capital Goods Used in the Production of Exported Goods
France	value-added	yes	not applicable
West Germany	turn-over a/	no	yes
The Netherlands	turn-over	no	yes
Italy	multiple stage with multiple rates	no	yes
Australia	wholesale	yes	not applicable
Norway	retail	no	no
Switzerland	wholesale b/	no	no
Canada	manufacturer	no	no c/

a/ Under the value-added tax proposed for West Germany, the effect on production machinery will be comparable (for the purposes of this table) with that of France.

b/ Over time, the Swiss tax has almost become a retail sales tax. The rate applicable to production machinery in Switzerland is only 3.6 per cent.

c/ There is a drawback of the sales tax paid in respect of exported goods in Canada but it does not cover production machinery and equipment.

Refunds of tax on capital goods cannot be established accurately for turn-over taxes, and the adjustments are highly arbitrary. Other than Canada, only two countries, Norway and Switzerland, tax production machinery and equipment, and do not provide relief from such imposition for goods that are exported. The rate of tax for Switzerland is considerably lower than for Canada. Of the eight largest exporting nations (excluding the Soviet Union), that is, the United States, West Germany, the United Kingdom, France, Canada, Japan, The Netherlands and Italy, only Canada imposes, without relief, a general sales tax on machinery used in the production of goods for export. However, in Canada, most machinery and equipment used by farmers and fishermen is exempt from federal sales tax.

The application of sales tax to production goods may also handicap Canadian producers in competing with imports in the domestic market because the equipment used to produce the domestic product is taxable while that used to produce the competing import, as we have mentioned above, has not in most cases borne an equivalent levy. Levying countervailing taxes on imports to achieve the same purposes would be extremely unpalatable.

It has been argued that the taxation of producer goods at a rate of, say, 11 per cent, does not decrease profits because the tax is passed on in higher prices. However, the assumption that the tax is always quickly and fully shifted is clearly unwarranted for firms faced with prices determined outside Canada. Marginal firms could be forced out of business when most of their output is exported or when they compete with imported goods not subject to the tax.

Finally, even if it were administratively feasible, it is argued that the wide exemption of producer capital goods would mean a narrowing of the tax base and therefore a substantial loss of revenue 2/. However, we consider that an increase in the tax rate on consumer goods, either with or without a widening of the base for consumer taxation, would be preferable to the general taxation of producer capital goods. Furthermore, such an

increase would be partially offset by the removal of tax-on-tax effects. Exempting producer capital goods would make it possible to attain a greater uniformity of tax burden on consumers (or to achieve any desired departure from that uniformity with greater precision), to reduce the hidden tax element in exports and import competing goods, and to reduce or eliminate a distorting effect on the choice of production methods.

We therefore recommend that the exemption of all production machinery and apparatus should be restored immediately.

In Appendix E to this Volume we comment on the taxation of producer goods at the present manufacturer's level or at a wholesale level.

CONSTRUCTION EXPENDITURES

Two types of construction expenditures may be distinguished: expenditures on residential construction (consumer goods) and expenditures on production and distribution facilities, such as plants, warehouses and stores (producer goods).

Prior to June 14, 1963, most building materials were exempt from sales tax. These exemptions were eliminated in the 1963 Budget. Almost all construction materials are now taxed. Houses, apartments, plants and other facilities themselves are not taxed.

On economic grounds, we believe, as we have already stated, that all goods and services used to produce or distribute goods and services for final use by individuals should be exempt from sales tax. To remove the regressive features of a sales tax we have argued that shelter should also be exempt from tax. There is, therefore, neither economic nor social justification for the taxation of building materials. Because the tax on building materials used in residential construction has a relatively small impact on the cost of shelter, and because a tax on shelter has a relatively small impact on the regressiveness of a sales tax, and because the tax on

building materials used to construct producer goods can result in substantial tax-on-tax when final goods and services are also taxed, we feel that the exemption of building materials used in the construction of producer goods is more urgent and more important than the exemption of building materials used in residential construction.

However, if materials for use in the construction of dwellings were to be taxed, the exemption of construction materials when used for producer or distributor goods would be extremely difficult to administer. There would be great administrative difficulties in refunding tax when such materials were used in the construction of factories and other producer or distributor facilities. It would be a costly and difficult task to verify the amount of tax actually paid, for there are a multitude of construction contracts involving large numbers of contractors and subcontractors and a great variety of materials.

An alternative would be to tax the value of completed residential construction. This would make it easier to exempt producer and distributor goods; but new complexities would be created. Under this approach, persons and firms engaged in construction activities would be regarded not as the ultimate consumers of building materials but as businesses who, because they would be required to account for tax on the value of their construction, could purchase goods and services tax free. A large number of new sales tax licences would be required, probably over 50,000. With a tax at the retail level, the number of licensees would not be a major concern; however, over 60 per cent of the firms in the construction industry are one-man proprietors, many of whom do not maintain a place of business in the usual sense, and part-time construction activity is not uncommon. Obviously, there would be great enforcement problems.

Nor would this be the end of the difficulties encountered in taxing completed residential construction. To tax residential construction as such would require a separation of the value of the house or apartment building,

from the value of the land, for only the former is "consumed". This separation of the value of a property would be difficult and expensive. Building materials constitute only a fraction of residential construction costs. To tax the completed building at the general sales tax rates (unless that rate were substantially reduced) would, of course, mean a substantial increase in taxation. Moreover, because residential properties are frequently resold, it would be necessary to give the vendor of a used residence partial credit for sales taxes paid, and to tax the purchase of a used residence. Because a residence can last a long time and be resold only infrequently, it would be difficult to determine how much sales tax should be credited to the vendor.

After carefully weighing these and other alternatives we have concluded that it would not be administratively feasible to exempt some construction expenditures and to tax others. If construction is to be taxed we believe the present federal and provincial approach of taxing virtually all building materials is the only workable system, although some refinements in the treatment of producers of prefabricated construction components would be desirable. The alternative would be to exempt all building materials and all finished construction. For the economic and social reasons we have already given, we recommend that building materials and finished construction should eventually be fully exempt from sales tax.

As already stated, we favour the complete exemption of construction materials and producer distribution goods. The amount of such exemptions is large and would have a substantially adverse effect on revenues. While we are prepared to recommend an immediate exemption of manufacturers' production machinery irrespective of revenue considerations, we hesitate to make a similar recommendation for construction materials and distribution goods. We consider that exemption of construction materials and distribution goods should be deferred until such time as future revenues can support this objective.

We emphasize that the recommended change to the retail level would achieve an immediate reduction of the tax on most construction materials of about 30 per cent. This results because these goods are generally purchased directly from manufacturers and under our recommendations the tax on such purchases would drop from 11 to 7-8 per cent.

If at some future time an income tax credit system, rather than the exemption procedure, were adopted to counter the regressiveness of sales taxes, the simplest method would be to maintain the exemption for all building materials and finished construction, and provide a smaller credit against personal income taxes.

USED GOODS

In our view, the practice followed in some provinces of taxing the sale of used goods and allowing adjustments for trade-ins would be the most satisfactory treatment, subject to the qualification that casual sales should not be taxed on the ground that enforcement would be impossible. We therefore recommend that a federal retail sales tax be levied on used goods in the manner just described.

EXEMPTION FOR PURCHASES BY OTHER GOVERNMENTS AND THEIR AGENCIES

Generally speaking, one level of government in Canada does not tax another. Legal opinion is by no means unanimous on the power of the federal government to tax the sales of other Canadian governments and their agencies. We do not feel compelled to take a position on this contentious issue. We do recommend, however, that whether the federal government proceeds on the basis of a view of its rights or on the basis of negotiation with the provinces, an attempt should be made to abolish the sales tax exemptions for the provinces and their agencies. If desirable or necessary, the federal government could compensate the provinces and their agencies through increased grants, more tax room, or some other fiscal arrangement. Presumably,

if our recommendation were followed, the provinces and municipalities would wish to tax sales to the federal government. The federal compensation would, of course, be determined on a net basis. This subject is discussed in more detail in Appendix F to this Volume.

CONCLUSIONS AND RECOMMENDATIONS

EXEMPTIONS VERSUS CREDITS

1. To counter the regressive features of a sales tax it would be preferable to provide a refundable credit against personal income taxes for sales taxes deemed to have been paid rather than to exempt "necessities". In the long run, such a refundable credit system would be workable and would avoid the administrative complexities and lack of neutrality created by a system of exemptions. To be equitable, however, these credits would have to be refundable and made in advance of the removal of the sales tax exemption for "necessities". All individuals and families would have to submit income tax returns in order to claim the tax credit. The basic problems with this scheme are administrative and we do not recommend that it be adopted at this time. However, as more and more individuals and families submit returns under the Canada Pension Plan administration, and as control techniques improve with the use of modern data processing equipment, the refundable alternative should be re-examined.

CONSUMPTION GOODS

2. All consumer goods should be taxed with the following exceptions.

   a) All food products, other than restaurant meals over a stated minimum.

   b) Fuel and electricity and eventually building materials entering into the cost of shelter.

c) Goods on which expenditures are made because of ill health or physical handicap, specifically drugs and medicaments sold on prescription, and appliances and devices for the use of the handicapped.

d) Magazines, books and newspapers that could not be taxed without serious administrative difficulty.

SERVICES

3. Three classes of services should be distinguished.

a) Listed services that were to be taxed.

b) Services that were to be explicitly exempt from sales tax.

c) Other services.

4. Sales tax should be confined to services used or exploited in Canada.

5. The same rate of tax should apply to listed services as to goods.

6. Among the services that should be explicitly exempt from sales tax we would suggest the following.

a) The rental of shelter, other than transient accommodation.

b) Medical, dental, nursing, hospital, legal, educational and undertaking services.

7. Among the listed services, those that are rarely used by businesses or institutions and are capable of being diverted to personal use, should be taxed to those who buy them.

8. Among the listed services other than those described in 7, services used extensively both by consumers and businesses should be taxed to consumers but, where administratively feasible, there should be a tax exemption for purchases of these services when they were to be

used to produce or distribute goods and services that were either subject to sales tax or explicitly exempt from sales tax.

PRODUCER GOODS

9. Where there was a substantial risk that particular kinds of goods, if purchased by businesses or institutions free of tax, would be diverted to personal use, these goods should not be exempt from tax even when purchased by businesses for the purpose of producing or distributing taxable goods and services, or goods and services explicitly exempt from sales tax.

10. With the exception of those kinds of goods described in 9, all raw materials, partly manufactured goods, machinery, equipment, apparatus, parts and supplies should be exempt from tax when purchased for the production of taxable goods and services, or for the production of goods and services explicitly exempt from sales tax. As already discussed, distribution goods should be taxed only as dictated by revenue requirements.

11. The tax treatment of building materials as producer goods should depend upon the treatment of these materials for all uses.

CONSTRUCTION

12. On no account should finished residential, industrial, commercial, and institutional buildings and structures be subject to sales tax.

13. Building materials should be either:

    a) exempt from tax when purchased by any or all businesses, institutions and consumers; or

    b) subject to tax without any exemptions whatsoever.

    Partial exemptions would not be administratively feasible.

14. The complete exemption from tax of all building materials would be desirable both on economic and social grounds, but may have to be deferred for the present time and reconsidered in the future in the light of revenue requirements.

GOVERNMENTS AND INSTITUTIONS

15. The federal government should attempt to eliminate sales tax exemptions for other governments and their agencies and, if necessary and desirable, to compensate them through increased grants or other fiscal arrangements that would not change their net position, but would eliminate costly administrative problems and the discrimination that would arise when government agencies using tax-exempt goods and services competed with businesses that were not exempt from sales tax.

REFERENCES

1/ Although such a broad exemption would eliminate many of the tax inequities and tax demarcation difficulties associated with the present exemptions, some new difficulties would arise at the fringe between food and pharmaceuticals, particularly with dietary supplements and other pharmaceuticals which are taken orally. Nevertheless, we consider that on balance it would be preferable not to extend the food exemption into the pharmaceutical area, in order to avoid opening up new areas of tax conflict between competing pharmaceuticals. However, we recommend that foods of a dietetic nature should be exempt.

2/ Our research staff has estimated that a restoration of the pre-1963 exemption for production machinery and apparatus would involve a revenue loss of approximately $145 million per year at an 11 per cent rate on manufacturer's sales.

CHAPTER 30

EXCISE TAXES AND EXCISE DUTIES

Excise taxes are levied under the Excise Tax Act, 1/ and excise duties under the Excise Act 2/.

The Excise Tax Act provides for a number of special excise taxes, in addition to the general sales taxes, on a prescribed list of goods. The Excise Act levies duties on alcohol, alcoholic beverages (other than wine) and tobacco products. Unlike excise taxes, which apply to both domestic and imported products, excise duties are not levied on imported goods (with the exception of spirits taken into a bonded manufactory); but the Customs Tariff 3/ provides for a levy corresponding with the duties levied on domestic products.

In our examination of a general sales tax we have frequently referred to the important criterion of economic neutrality. Excise taxes and excise duties, being taxes on arbitrarily selected commodities, do not conform to this criterion.

Likewise, the taxation of selected commodities cannot be reconciled with the basic notion of equity that persons in similar circumstances should be treated similarly. Admittedly, it can be argued that no taxation scheme in existence is perfectly consistent with this criterion, and the limitations of the criterion itself can be indicated on the grounds that it tells us nothing about how to treat persons in dissimilar circumstances. But these arguments, however valid in the abstract, do not relieve our present difficulties. The fact remains that to tax commodities in such a way as to discriminate among them is also to discriminate among the persons who both produce these commodities and consume them. Discrimination for sumptuary reasons (regulating consumption) is a matter of social policy.

EXCISE LEVIES ON PRODUCTS OTHER THAN ALCOHOLIC BEVERAGES AND TOBACCO

Products other than alcoholic beverages and tobacco that are subject to excise tax may be grouped into three classes.

1. Television sets, radios, phonographs, electronic tubes.
2. Cosmetics and toilet goods, clocks and watches, jewellery, playing cards, coin-, disc-, or token-operated games and amusement devices.
3. Lighters, matches, tobacco pipes, cigar and cigarette holders and cigarette-rolling devices.

The ad valorem excise taxes on the first class of goods were imposed after the war as an anti-inflationary measure. The revenues derived from this tax are minor, being in the vicinity of one third of 1 per cent of total budgetary revenue (see Appendix G to this Volume). On the other hand, the costs of collection are negligible, because excise taxes, unlike excise duties, are administratively integrated with the manufacturer's sales tax.

The excise tax on the first class of goods was the successor to the radio licences that users of receiving sets were once obliged to buy annually, the proceeds going toward the financing of the Canadian Broadcasting Corporation. The original intention has, however, become academic, for revenues received from this tax are quite inadequate to sustain the Canadian Broadcasting Corporation and, in fact, are not now earmarked for that purpose. The argument is also made that television sets, phonographs and radios are luxury goods, and are therefore appropriate subjects for discriminatory tax treatment. Without necessarily contending that life is insupportable without these things, it is obvious that there are a great many other goods in our modern industrial civilization that are non-essential, and yet are not subjected to selective excise taxes. We see little justification for this particular levy, even by the above narrow standards. Furthermore, it seems a realistic guess that this tax is regressive as to disposable personal income.

We also find it difficult to justify the special levies on the second class of goods. The development of an argument on "non-essential" grounds is fraught with difficulties of assessment and comparison, and must rest heavily on subjective evaluation. There are numerous inconsistencies in the present list of articles subject to excise taxes. For example, playing cards are taxed but poker chips are not; a diamond ring is taxed but a mink coat is not; hair curling or waving solutions are taxed but hair curlers are not; a pocket watch is taxed but a pocket compass is not. With any selective approach, the problem of analogous products arises. Again, there seems little justification for excise taxes on these products.

It may be argued that, as with alcoholic and tobacco products, there is a moral justification for the excise taxes on playing cards and on coin-, disc-, or token-operated games or amusement devices. The same problem arises here, however: if playing cards should be taxed on these grounds, the same might be said of cribbage boards, comic books, theatre equipment or admissions, and so on. Any further extension of the excises on similar moral grounds faces the problem of defining the boundaries: wherever the excise line was drawn, new discriminations and demarcation problems would arise between analogous but differently taxed products.

Presumably the excise taxes on the goods in the third category might be rationalized in much the same terms as those on the various tobacco products, although in relative terms the revenue yield is very small. On the same grounds it is reasonable to argue that other smokers' and drinkers' accessories, for example, cocktail shakers, wine and cocktail glasses, should be similarly taxed. Our comments are similar to those made in the preceding paragraph.

We can see little justification for any of the above excises, and we therefore recommend that they should be repealed.

EXCISE LEVIES ON ALCOHOLIC BEVERAGES AND TOBACCO PRODUCTS

Spirits, beer, cigarettes, tobacco and cigars have long been subjected to Canadian excise duties, and in more recent times, cigarettes, tobacco and cigars have also borne excise taxes. The revenue derived from these levies on a narrow range of consumer goods is enormous, verging on 10 per cent of the total budgetary revenue of the federal government (See Appendix G to this Volume), and the costs of collecting it are relatively very small.

Both the general public and the firms producing these goods have become accustomed to the existence of these taxes which are, and for a considerable time have been, common in most western countries. Their acceptance has been facilitated by the prevailing attitude that these goods are injurious and should be expensive. The discriminatory effects on consumers are in effect intended to restrict consumption.

The rates of these taxes that are likely to be tolerated depend on relative prices in markets to which Canadians have access; for experience has shown that, if prices exceed certain limits, smuggling becomes active. Finally, there is some reason to believe that these taxes are progressive at very low income levels, but tend to become regressive at higher income levels, though only mildly so except at the very highest 4/.

With such a large amount of revenue being collected from a small number of producers who keep good records, the cost of collection as a percentage of revenue yield is very low. Moreover, the levying of these excise duties and excise taxes at the manufacturer's level permits a superior measure of control, and lower costs of administration and compliance, than would similar levies at any subsequent trade level.

In summary, given their sumptuary purpose, the widespread public acquiescense in these extraordinarily heavy levies, both in Canada and in the western world as a whole, and taking into account the very substantial

revenues that they yield, we conclude that despite their heavy burden these particular excises should continue as acceptable levies.

Wines are subject to excise tax though not to excise duty. It is reasonable that wines should also be subject to the same treatment as other alcoholic beverages.

Specific or Ad Valorem Rates

We have considered whether it might be desirable to replace the current specific excise duties and excise taxes on these products, and concomitantly, duties on imports, with equivalent taxes in ad valorem form. Assuming that it were possible to determine a set of appropriate ad valorem rates to apply to the goods involved at their various prices, it is clear that such rates would be extremely high. It has been estimated that the average rate, including the 11 per cent sales tax, on liquor would be 197 per cent of manufacturer's selling price; the average rate on beer would be 42 per cent; and on cigarettes 194 per cent.

There does not appear to be any precise correspondence between the quantities of the taxable inputs and the selling prices of the various brands of the products involved. Therefore, unless a highly complicated and variable structure of rates were established, the existing price structure, in terms of tax-included consumer costs, would be drastically altered under the impact of an ad valorem rate, and it is almost certain that the current allocation of the productive capacities of the industry among the various brands would be markedly changed.

In magnifying the price differences between products at the manufacturer's level, the heavy ad valorem rates that would be required on tobacco products could intensify some of the valuation inequities inevitable in a sales tax levied at the manufacturer's level. We have referred before to the tax inequities that arise under an 11 per cent manufacturer's tax because of the various distribution functions that may be performed by manufacturers and

enter into their taxable sale price, or may instead be performed by other entrepreneurs, including importers, beyond the point at which the tax applies, for example, advertising, transportation and packaging. With a tax rate of almost 200 per cent, these valuation inequities would be far more serious 5/.

There seems little possibility that the conversion to an ad valorem rate of the excise duty on beer would produce benefits for the brewing industry, the government, or the general public.

Excise Duties or Excise Taxes or Both?

If, as we recommend, the burden of excise levies should be confined to alcoholic and tobacco products, it may be questioned whether these levies should continue to be imposed in their current forms. Alcoholic products (except wines) are subject to excise duties, wines are subject to excise tax, and tobacco products are subject to both excise duties and excise taxes.

In the case of those alcoholic and tobacco products that are subject to excise duties, although administrative procedures may be simplified, supervisory staffs of excise officers would continue to be required. Furthermore, we have found it difficult to see any benefits in a conversion from the present specific to ad valorem rates. It is therefore appropriate to assume the continuation of excise duties on alcoholic products (excluding wines) and tobacco products.

We now examine the feasibility of merging the excise taxes on wines and tobacco products with the excise duties.

First, excise duties are associated with close supervision over the production process, while excise taxes are collected on a self-assessment basis. However, this is not an essential distinction between the two forms of excise. We see no reason why the substitution of an excise duty for an excise tax on wines necessitates the instituting of excise supervision over the production process. Tobacco products are already subject to excise duty, so the merging of the present excises would not require any change in excise supervision over production.

Secondly, both the excise duties and the excise taxes on alcoholic and tobacco products are at specific, not ad valorem, rates, except for the 15 per cent excise tax on cigars. Accordingly, except for cigars, no tax valuation changes are involved. The substitution of a specific excise duty on cigars, graduated according to weight, for an ad valorem excise tax might be considered; but we see no compelling administrative reason why a product already subject to a specific excise duty, and subject to excise supervision, should not in addition bear a special ad valorem excise duty computed on the sale price.

Thirdly, excise duties are at present paid at various stages of production and warehousing, while excise taxes are paid at the end of the month following sale. Producers of wines and tobacco products might therefore protest the additional excises incurred as a result of a switch to excise duty. However, although an excise duty is imposed at a selected stage of production or warehousing, we do not consider that it is essential that the duty should be paid at that point of time. The exact timing of payment, which at high rates of excise is important to the producer in terms of financing his sales and to the government in terms of revenue flow, can be varied.

This Commission received representations from the Brewers Association of Canada that the payment of excise duty be deferred to permit producers to escape the heavy burdens of financing these levies while they await payment from their customers. Distilleries pay the duty assessed daily as spirits are withdrawn for shipment. At the end of each day, when the total shipments have been verified, a cheque is forwarded covering the assessed duty. Shipments to most provincial liquor agencies are therefore "duty paid" and, since such agencies typically operate on terms of thirty days, the distilleries are compelled to carry this substantial excise burden for that period. The breweries are required to make payment of excise duty on beer produced long before it is shipped for consumption. Excise duty is imposed at what is known as the fermenter stage, which is some six weeks before the beer is

bottled and shipped. The manufacturer of tobacco products pays excise duty at the time of purchase of excise stamps to place on his products and must therefore bear the excise burden while the goods are in the warehouse and during the interval between sale and payment. By contrast, in the case of wines (and in the case of the excise tax on tobacco products) the excise tax is payable at the end of the month following sale.

We find it difficult to develop acceptable guides or criteria in examining this complaint. If, on public policy grounds, certain industries and, in turn, the consumers of their products, are intended to bear a discriminatory tax burden, it is difficult to present a satisfactory argument that one element of this discrimination, namely, the cost to these producers of early revenue collection by the government, should be eliminated. Furthermore, the elimination of this additional burden would in any case be only partial, for vendors at later stages in the distribution process would continue to bear it.

Fourthly, although it is true that an excise duty is included in the value on which sales tax is computed, while excise tax is excluded and therefore avoids an element of tax-on-tax, we believe that, given the intended combined tax burden, this consideration is inconsequential.

Fifthly, with respect to the excise taxes that currently apply also to imported tobacco products, technical redrafting would be required to transfer this levy to the Customs Tariff.

Accordingly, we consider the conversion of the excise taxes under the Excise Tax Act on tobacco products and wines into excise duties under the Excise Act to be feasible without necessarily affecting the amount of administrative supervision, the appropriate timing of tax payment or the amount of the tax payable. Statutory consolidation of the two forms of excise should, in our opinion, be given serious consideration if the federal government were to move the level of imposition of the general sales tax

from the manufacturer's to the retail level. The centre of gravity of government administration of sales tax licensees would shift to retailers, and the administration of excise taxes, which for reasons of revenue control and ease of administration should remain at the manufacturer's level, would become a separate and relatively more costly operation. It would then appear advisable that both excise levies at the manufacturer's level should be consolidated under the Excise Act, with appropriate revisions in that statute and adjustments in the administration.

Multiple Taxation Effects with Excise Duties

The submission of the Association of Canadian Distillers to this Commission criticized the multiple taxation effect of levying the sales tax on the excise duty. This is illustrated in the following example using 1965 rates of tax applied to a case of one dozen 25-ounce bottles of whisky.

	Under Present "Pyramiding" of Sales Tax on Excise Duty	If "Pyramiding" is Eliminated
Distillery price	$ 8.40	$ 8.40
Excise duty	17.04	17.04
	25.44	25.44
11 per cent sales tax	2.80	.93
Sale price including federal sales tax and excise duty	$28.24	$26.37
Difference arising from the levying of sales tax on the excise duty		$ 1.87

Because it is intended that certain products bear an additional commodity tax burden, we do not think it matters whether the combined levy (sales tax and excise duty) of $19.84 consists of $17.04 excise duty plus 11 per cent sales tax "pyramided" on that duty ($1.87) plus 11 per cent sales tax on distillery price (93 cents), or consists of $18.91 in excise duty and 93 cents sales tax, with no "pyramiding" of sales tax on the excise duty.

CONCLUSIONS AND RECOMMENDATIONS

Excise levies on alcoholic and tobacco products should be continued. The remaining excise taxes and duties should be repealed.

REFERENCES

1/ R.S.C. 1952, Chapter 100.

2/ R.S.C. 1952, Chapter 99.

3/ R.S.C. 1952, Chapter 60.

4/ U.S. House of Representatives, Committee on Ways and Means, Excise Tax Compendium, Washington: U.S. Government Printing Office, 1964, p. 84.

5/ The scope for similar inequities on spirits, however, is circumscribed by the substantial control over distribution exercised by provincial government vending boards.

PART B

GENERAL TAX ADMINISTRATION

CHAPTER 31

TAX ORGANIZATION

In the following four chapters we deal with some aspects of the processes by which the tax system functions, loosely described here as "tax organization". Our terms of reference require us to look at "the changes that may be made to achieve greater clarity, simplicity and effectiveness in the tax laws and their administration", and we are enjoined to "make recommendations for improvements in the tax laws and their administration". Although some of the issues in this area were studied by the Royal Commission on Government Organization, we have regarded these matters as of major concern if only because shortcomings in the tax organization can frustrate the best tax policy. In a sense tax policy can be no better than the instrument designed to carry it out.

With this in mind we commissioned a study of the general character of the administrative organisms of the federal government in the tax area by members of the Institute of Public Law of the University of Montreal. We have drawn heavily on this study in the following chapters, although we have not adopted all the proposals which resulted from it. It contains more detailed discussion of many matters that are dealt with only in summary fashion in this and the following three chapters, and is being reproduced in full as one of the supporting studies of the Report. We also established a small division in our research staff to carry out a more detailed examination of administrative arrangements and have drawn equally on the findings of this group.

The general outcome of all this research and of our public hearings is that we are able to give federal tax organization a fairly clean bill of health. Many defects have been found, and we make several recommendations for change, some of them of a fairly fundamental character. However, these do not reflect any basic malaise in the operating side but are attributable more to the fact that possibilities for betterment can be discovered in any organization or institution when subjected to sufficient scrutiny.

The interpretation we have placed on the operational side of taxation is a fairly broad one and runs the gamut from the origination of tax changes in the Department of Finance to their authorization by Parliament, tax collection by the Department of National Revenue, and tax adjudication by the courts. We have divided the subject into three main parts in our treatment to reflect these principal phases.

1. Tax Formation, with subheadings for (a) Origination and (b) Authorization.
2. Tax Administration.
3. Tax Adjudication.

The present chapter presents a brief description of the background and a summary of the issues involved; the following three chapters give our recommendations in each area.

While most of our discussion deals with organizational and institutional factors, as a philosophical aside at the outset we must concede that success in the operation of the tax system will depend heavily on some very intangible considerations. The subject is fraught with dilemmas and contradictions. The general character of the tax system must reflect the basic inclinations of the people at large, and the Minister of Finance and Parliament must bow to those wishes when expressed. Yet the cheapest path to glory—and to the grave—would be for a Minister of Finance or a Parliament to accede to every petition for change. The ship of state would soon come to a stop for lack of fuel. The work of tax collection is admittedly one of the least envied of occupations, offering few opportunities for winning the warm support and loyalty of those who suffer its ministrations; yet only with voluntary public co-operation will it work. Further, a large element in the achievement of co-operation is an open-handed and above-board dispensation of justice, but the very context invites by its complexity infinite hair-splitting, endless possibilities of unintended inequity, and frequently settlements of a private and confidential character.

These and other elusive aspects of the subject are fully apparent to us and remind us that the most essential job of tax administration calls for a rare combination of talents, disciplines and attitudes. We have little to contribute regarding these intangibles, but we do feel that some of the institutional and procedural changes we suggest will ease the role of both the tax authorities and the taxpayers in their unique relationship.

TAX FORMATION

As was mentioned previously, this subject divides into two subheadings: (a) Tax Origination and (b) Tax Authorization.

Tax Origination

In the Canadian system of responsible government based on the British model, taxes originate, both by law and by custom, with proposals made to Parliament by a member of the government, in this case the Minister of Finance. The question therefore is by what process does the Minister of Finance arrive at the proposals he puts forward.

One of the saving graces for the Minister is that he never begins or ends with an absolutely clean slate; in other words, the whole of the tax system is not up for review every year. A good deal of it rides along unchanged and without serious challenge. At the same time, such is the desire of members of the public that their individual burdens be no more than is equitable, and so complex is the social and economic system in which the tax structure operates, that an enormous volume of representations for change is addressed to the Minister and a very long list of amendments of both major and minor importance is in fact made in most years. These representations come to the Minister by mail, by written brief, by delegation, by word of mouth, by speeches in Parliament, and in various other ways at almost any time throughout the year, with the tide reaching a peak in the few months preceding the budget speech. During this period he will for some weeks receive a steady stream of delegations presenting briefs large and small, for

changes general and particular in the tax system. He will meet personally as many groups as possible for as long as his schedule will allow, and then turn the discussion over to his officials for their more concentrated attention. Naturally most briefs or representations advance only the interests of the person or organization concerned, without much knowledge of or regard for the broader implications of the requested change. It is left to the Minister and his small group of advisers on taxation to put these requests into the broader context of the whole tax system, the government's requirements for revenue, the economic outlook for the year, and so on.

The other main source of raw material for the Minister's proposals is the research carried on by and the advice originating from his own departmental officials. This work is of a highly specialized character requiring a broad knowledge of law, economics, industries and products, and a fair familiarity with the tax systems not only of Canada but of other leading countries as well. These advisory officials in the Taxation Division of the Department of Finance (not to be confused with the Taxation Division of the Department of National Revenue) have most of the current tax problems constantly under review in consultation with the officials of the tax administration agencies when necessary. They also draw on information and views from the Bank of Canada, the Department of Trade and Commerce, the Department of Industry, the Economic Council of Canada, the Dominion Bureau of Statistics and other agencies. The studies and proposals of this group are conducted in relative secrecy in view of the confidential character of most of the work, although the officials are by no means excluded from public contact. They have constant visits from taxpayers and also attend and participate in public meetings and conferences where tax and related problems are discussed.

From the public representations, the studies of his officials and his own thoughts on taxes, the Minister each year decides on a programme of changes to embody in his budget speech for presentation to Parliament. The process by which he has reached his decisions is highly secretive and for the most

part is carried on behind closed doors. Even the Minister's Cabinet colleagues are frequently not informed of the contents of the budget in detail until a very short time before its presentation.

In our public hearings concern was expressed that the processes of tax origination did not permit adequate public examination of the issues at stake; that the process of representation to the Minister and his officials, while consistent with the general scheme of representation in a responsible government, had serious disadvantages in tax matters, among them being the limited time available for appearing before the Minister, the apparent haste in which complex questions were considered and settled, the secrecy which surrounded the decision-making process and the restrictions this placed on consultation with taxpayers whose interests were often deeply involved, with the grave risk that decisions were made in ignorance of essential facts.

To this catalogue of complaints were also added expressions of honest doubt that the tax research staff of the Department of Finance was adequate in size to keep under constant surveillance the vast range of complexities that arises under the main federal taxing acts. Suggestions were received that the Division should be bolstered by the addition of further members, that its activities might be conducted in closer co-operation with taxpayers, and that greater use should be made of outside expertise and information.

One or two recent instances also have called into question the fairly complete prerogative of the Minister of Finance over matters of tax policy. Suggestions were made that other members of the Cabinet should be brought into the Minister's confidence more completely and at an earlier stage in the budget-making process.

The main issues in the area of tax origination are self-evident from the preceding paragraphs. We propose to discuss two in the following chapters.

1. The extent to which the process of representation for tax changes could be conducted in a more formal way and with greater publicity.

2. The extent to which budget proposals could be made public in advance of the budget speech.

Tax Authorization

The imposition of taxes is a closely guarded right in our democratic system and can be undertaken solely under the authority of an enactment of Parliament. In our system only a Minister of the Crown may propose the levying or changing of taxes and, as we have seen, this duty falls on the Minister of Finance, using for this purpose the annual budget speech.

As a result of the historic development of the tradition of parliamentary independence in matters of money raising, the procedure for approval of the tax proposals made by the Minister in his budget speech is a long and complicated one designed to prevent arbitrary action by affording opportunity for full debate. The budget speech itself is made on a motion that the House go into Committee of Ways and Means. This motion is debatable and in the course of adopting it the House has an opportunity to discuss almost any issue of national importance. The time so spent is now limited, however, to a maximum of six days.

Following adoption of the motion, the House considers "resolutions" that have been submitted with the budget speech. These are general statements of the changes proposed in the taxing statutes but do not necessarily cover all the amendments, nor are they ordinarily presented in wording as complete as the final sections of the law. Each of these resolutions must be voted upon and adopted by the House, and when this is done bills are introduced to implement the changes by precisely worded amendments to the statutes. These are "read" three times in the House of Commons, with a detailed clause-by-clause consideration on second reading. Occasionally, where a whole new statute or some very major revisions are under way, the House will refer the "bill" to a committee for consideration and public hearings. This is rarely done. For the most part, complaints of taxpayers regarding the effect of

changes are expressed to the Minister of Finance, to his officials and to members of Parliament, in person or by mail, and where they are strong enough and the issue is a popular one they will occupy a large part of the discussion in the House.

Frequently the Minister will introduce changes as a result of representations made to him or following speeches made by members in the House. Occasionally he is forced by popular opposition to withdraw a proposal completely.

Following third reading by the House of Commons the amending bills go to the Senate, where approximately the same procedure is repeated, the exception being that it is customary for the Senate Finance Committee to hold limited hearings on the bills at which the main witnesses are usually government officials.

Tax measures come into effect on Royal Assent like other statutes on completion of the parliamentary processes. Unlike most other statutes, however, tax laws are often retroactive either to the date of the budget or the commencement of the taxation year.

It is not surprising that the complaints we have heard about the process of tax authorization and the suggestions for their remedies are somewhat similar to those relating to tax origination. Of greatest concern is the problem the taxpayer encounters in obtaining access to the process of authorization in a way that will at least enable him to register a strong and public protest against changes which he feels affect him unfairly.

This complaint appears to stem from taxpayers' sense of frustration with their inability to make an impact on a machine as cumbersome and complex as the federal government and the legislature, concerning a matter as delicate and involved as a piece of tax legislation. This problem can arise from a variety of causes: distance from Ottawa; inability to spend sufficient time with the Minister or his officials to explain a problem and develop a solution

for it; a feeling that tax legislation is far too complex and that the law presented to Parliament should be in broader and more readily understood terms so that its essential principles would be clear; lack of time and opportunity in the often unpredictable schedule of Parliament to give adequate study to a new piece of legislation before enactment; a sense that few Members of Parliament have had the rather specialized experience that would enable them to see a fault themselves or to seize on a fault brought to their attention and in turn to bring it forcefully to the notice of the government; a tendency on the part of the Minister of Finance (natural enough in the circumstances) to pilot his legislation with the minimum of change; the absence of a regular procedure for public hearings before parliamentary committees, which would permit public representations on complex legislative matters; a concern that delegated authority, for example, in the form of the right to make regulations, is not subject to sufficient scrutiny and control by the legislature; and a general feeling of unease with legislation which evokes ministerial discretion.

We shall not attempt to evaluate all these complaints. A fair proportion of them no doubt arise from the natural sense of disappointment experienced when the taxpayer is unable to avert any change that will have an unfavourable effect on him, or when a minority group of taxpayers is able to thwart a desirable tax change they do not like. For the rest, however, a few basic issues do emerge which we feel are worthy of consideration.

In particular we shall discuss the following two main issues in the area of tax authorization.

1. The possibility of supplementing the existing means of recourse to the Minister of Finance and to Parliament on legislation submitted following the budget speech. This could be done by public hearings before a parliamentary committee before enactment.

2. The implications for Parliament and the subsequent processes of administration and adjudication of:

a) legislation expressed in more general language; and

b) greater use of delegated authority through the issuance of regulations, rulings, interpretations, etc., in support of general legislation.

TAX ADMINISTRATION

At the federal level in Canada the tax system is "administered", that is, laws are applied and taxes collected, by a separate department with its own Minister—the Department of National Revenue.

The Department is divided into two sections, the Taxation Division and the Customs and Excise Division, each headed by a Deputy Minister responsible to the Minister. The role of the former is to collect the taxes on income, both personal and corporate, and the less important gift and estate taxes. The role of the latter is to collect the taxes on transactions and commodities, including customs duties imposed by the tariff. Both Divisions have a Head Office in Ottawa and branches throughout the country, the bulk of the staff being employed in the branches.

According to the Department, the full-time establishment of the two Divisions at March 31, 1965, was as follows:

	Head Office	Branches	Total
Taxation Division	591	6,621	7,212
Customs and Excise Division	1,002	7,112	8,114
	1,593	13,733	15,326

The Taxation Division

The Taxation Division comprises a Head Office in Ottawa and 29 District Offices covering the whole country. There is also a Taxation Data Centre in Ottawa which has the same relation to Head Office as a District Office, although performing a different function. The Director of each district is answerable to the Deputy Minister in the same way as a head of a branch at

Head Office. In all some 36 senior officers of the Division report directly to the Deputy Minister.

The Division in the 1964 fiscal year collected in total nearly $4,150 million. It had on its tax rolls some 6.7 million individuals and 136,000 corporations, of whom 4.9 million were taxable. In its operations it acts not only on behalf of the federal government but also for those provincial governments for whom it is the collecting agent (all provinces but Quebec have some arrangement with the Taxation Division). Head Office is subdivided into five main branches, the Legal Branch, the Administration Branch, the Assessments Branch, the Inspection Branch, and the Planning and Development Branch, each with a function as suggested by its name. Each District Office has three sections, Personnel, Administration and Assessment, but generally not the Legal, Inspection, or Planning and Development Branches which are Head Office functions. However, a division of the Legal Branch has recently been established in the Toronto District Office and another is expected soon in the Montreal District Office.

Compared with a staff of some 500 at Head Office, the District Offices range in size from just over 900 in Toronto to 6 in Whitehorse.

The Canadian income tax is a self-assessed tax, that is, one in which the primary responsibility falls on the taxpayer to declare his income and pay his tax rather than on the administration to seek out the taxpayer and establish his tax liability. The distinction is to some extent one of degree, since even under a self-assessment system much of the tax is now collected without the initiative of the taxpayer; tax is deducted from his wages, or else his income is reported to the tax authorities by others, as for example through information statements that employers and others must file directly with the Taxation Division.

Briefly outlined, the process of direct tax collection is that, for some forms of income, deductions at source are made or instalments of tax are paid

throughout the year in anticipation of the final tax liability. After the close of the year the taxpayer, individual or corporate, must file a return reporting the total income, calculating the tax thereon and paying the balance owing, if any, or claiming a refund, as frequently happens. The returns used for this purpose are: the T1 Short, for simple forms of personal income; the T1 General, for more complicated forms of personal income; and the T2, for corporate incomes. The T3 form is an income tax return for estates and trusts. Various information returns are also filed by the taxpayer using copies of returns submitted to the Taxation Division by his employer or other persons who have paid him income, such as interest and dividends.

Returns are "assessed" by the Division to determine whether the right tax has been paid. All taxpayers throughout Canada file their T1 Short and T1 General forms at the Data Centre. Here simple and complex returns are sorted out, the former to be dealt with summarily and the latter with greater attention. The use of computers at the Data Centre has greatly speeded all work of the Division but the complex return or the return of a high income person must be subjected to detailed examination if time permits. This latter process is done by coding returns by various indicia to determine the extent of detailed examination required. Most returns receive a "quick" assessment, and no further examination is likely to take place. Others are classified for further investigation, which might range from a desk examination of other information related to the taxpayer to a detailed study by a team of experts in the Division. These audits are classified as nominal, desk and field. Most of the detailed assessment work is done in the District Office after the returns have been sent to it by the Data Centre.

Where an understatement of tax is revealed by the examination process the taxpayer is assessed on a revised basis, or is re-assessed if he has already been assessed. In many instances notice is given the taxpayer that he is to be re-assessed and an opportunity afforded to discuss the matter beforehand, but this practice is not uniform. On receipt of the assessment

or re-assessment the taxpayer may pay the additional tax, may discuss it with the assessor, or may file a Notice of Objection. In either of the latter events he must by law pay the tax within 30 days of receipt of the assessment, even though he proposes to appeal the case in court. A Notice of Objection must be filed within 90 days of the receipt of the assessment notice and this usually means that attempts to settle the assessments in informal discussions with the assessors have failed. There are informal procedures for further discussion with administrative appeal officials in the Division, after filing the Notice, but if differences remain after these discussions the case is likely to proceed to the Tax Appeal Board. In recent years the ratio of Notices of Objection to increased assessments has been rising, which indicates that settlements within the administrative system prior to the time for taking this formal step have been declining.

Tax collection, enforcement and special investigation are essential routine functions following on the examination processes. The bulk of personal income tax is now paid either by deduction at the source from wages and salaries or by quarterly instalments. Corporations pay tax on a monthly basis with a lag of four months behind the actual earning of the income. Although substantial amounts are still paid with the annual return, for over three million taxpayers the deduction and instalment system results in overcollection of over $200 million, and a refund is given after filing of the return. Special investigations are carried out mainly where fraudulent practices are suspected and are normally intended to lead to a court prosecution or a fine if the evidence is sufficient.

The administration of estate tax is on roughly similar lines to that just described for income tax but has special characteristics attributable to the nature of the tax.

Customs and Excise Division

The essential functions of the Customs and Excise Division are the same as those of the Taxation Division, that is, maintaining offices and staffs

throughout the country for levying the tax, giving rulings and information to taxpayers on their taxable status, auditing to assure that the correct tax is paid, conducting investigations to detect or forestall evasion, considering disputed assessments, and so on. The fact that the Division is dealing with commodities, both imported and produced in Canada, and in some cases bearing an exceptionally high tax, such as liquor and tobacco, dictates differences in procedure which in some cases are marked.

The excise side of the Division (we deliberately omit the customs side, which is beyond our terms of reference) is divided between excise tax and excise duty. Under excise tax there are three directors who report to the Assistant Deputy Minister and are in charge respectively of Administration, Collections and Audit. Ten field offices, one in each province, are maintained for excise tax collection and there are 25 field offices for excise tax audit. Administration is a head office function.

The excise duties administration operates through a Director of Excise Duty at Ottawa to whom three regional directors in Montreal, Toronto and Vancouver report. Actual field operations are in the charge of nine district surveyors located in the principal cities having large excise duty activities.

Excise Tax Administration. A basic and useful device in excise tax administration is that of licensing. It is an offence under the Excise Tax Act 1/ for any manufacturer or producer to manufacture any taxable article without obtaining a licence from the Division. The licence is the foundation of the Division's procedures, however, because it becomes an automatic policing device for which there is no counterpart in direct taxation. This results mainly from the fact that a manufacturer of an article collects tax on a sale of that article to any other person who does not have a licence, unless the article concerned or the purchaser are specifically exempt from tax. Only qualified companies and individuals are permitted to have licences, so that the onus is on the manufacturer to come forward voluntarily to identify himself in order to obtain a licence.

The audit procedure is also of a basically different character. Where the income tax auditor works almost entirely with financial statements and other written evidence, the excise auditor is frequently reviewing the taxpayer's classification of a certain physical commodity as being either taxable or exempt, or reviewing the treatment of raw materials or other ingredients consumed in a manufacturing process, or in the construction of a plant or office. These functions call for a different training and experience from that of purely financial auditing.

Payment of tax is on a monthly basis, with responsibility placed on the taxpayer for filing the appropriate return.

Enforcement and investigation procedures are also different. Evasion of commodity taxation sometimes takes the form of smuggling or bootlegging, so that policing is frequently a matter of seizing the goods or of patrolling avenues that lend themselves to evasion tactics. The Royal Canadian Mounted Police do much of this work for the Division.

The many rulings issued by the Division have been required by the nature of the statutes under which it operates and are extremely broad. The Excise Tax Act is drawn in such a way that a strict interpretation and application of its provisions would be very onerous and unfair. The Division has developed a mass of regulations and rulings designed to overcome this problem and to assist in the application of the law to a multitude of circumstances. The regulations or excise tax circulars purport to be issued under the statutory authority of section 38 of the Excise Tax Act, but they are of questionable validity since they often modify the terms of the statute. Because these circulars are generally remedial, no taxpayer is likely to appeal them, for if he were successful his tax liability would probably be increased. The circulars are really extra-legal. The statutory authority is to make regulations for "carrying out the provisions" of the Act, and it might be argued that the circulars are supportable by virtue of this provision. However, most lawyers agree that the base of authority provided by this section of the Act is narrow.

Information available to taxpayers is generally limited to the statute and such regulations, rulings and circulars as apply to him. There is a lack of general explanatory literature for the information of new taxpayers regarding excise taxes and duties and, what is sometimes more important, information on practices and concessions.

Excise Duties Administration. The administration of the excise duties levied on liquor and tobacco is quite the most rigid of all forms of tax collection, being conducted under conditions of nearly complete security. Officials of the Division who are either permanently located in the plant or make regular visits keep a very close watch on the operations of all breweries, distilleries and tobacco plants.

It is an offence for any manufacturer or producer of taxable goods to operate without a licence 2/. Tax must be paid monthly, generally by the purchase of a stamp to be affixed to the goods.

Problems in the Processes of Tax Administration

In considering the issues of tax administration we have first of all enquired into the merits of the present arrangement under which administration and tax policy are divorced, the Department of National Revenue having the administrative function separate from that of tax policy making in the Department of Finance. We have also enquired into the merits of the present arrangement under which the head of the tax administration organization is an elected minister, and have studied the possibility of delegating all tax administration to a separate Board of Revenue Commissioners with no political head and having a considerable degree of autonomy, subject to parliamentary scrutiny. In the actual structure and operation of the administrative organizations we have studied such questions as the development of standards of performance by which to measure their effectiveness; the extent to which a fairly highly centralized system should be decentralized; the means by which the taxpayer should be provided with full information of a general type on

his tax liability, and with regulations and rulings on aspects requiring more detailed explanation; the nature and extent of reporting on tax administration; the recruiting and training of staffs; the intensity of auditing programmes; the effort directed to enforcement; the procedures for administrative appeals; and the need for ministerial discretion.

We have not been able to pursue all these subjects to their full limits, but we comment in the succeeding chapters in particular on the following issues.

1. The nature and status of the administrative organization.
2. Tax information and advance rulings.
3. Standards of efficiency.
4. Administrative procedures; staffing; training; etc.
5. The exercise of ministerial discretion.

TAX ADJUDICATION

At present, three courts of first instance, the Tariff Board, the Tax Appeal Board, and the Exchequer Court, have jurisdiction in disputes on taxation matters. The first two, as originally conceived, were to operate on a quasi-judicial basis, but they do in fact exercise fully judicial functions, particularly when they are called upon to pronounce final and conclusive judgment, subject to appeal to a superior court, on questions of fact or of law relating to taxation matters coming within their jurisdiction. Original jurisdiction in taxation matters is shared by the two Boards and the Exchequer Court.

The Exchequer Court also exercises appellate jurisdiction from these Boards but this jurisdiction is much broader on appeals from the Tax Appeal Board than from the Tariff Board. With minor exceptions, Exchequer Court decisions may be appealed to the Supreme Court of Canada, whose decision is final.

The Tariff Board

The Tariff Board was first established under the Tariff Board Act 3/ in 1931, when it comprised three members, one of whom was Chairman and another Vice-Chairman. It acts as both an advisory and a judicial body. Membership was increased to seven in 1961.

No qualifications are required in the Tariff Board Act 4/ for appointment to the Board, although membership ceases on reaching the age of seventy years. At the present time three of the members are lawyers but anyone can be appointed, no matter what his qualification, experience or profession. Ordinarily, appointment is for a term not exceeding ten years, as fixed by the Governor in Council at the time of the appointment.

In view of the extensive research work required of the Board in its advisory capacity, it employs a supporting staff of a dozen or so economists and statisticians.

In its advisory capacity, the Board is responsible for collecting the data the Minister of Finance may require to enable him to determine his policy in the matter of customs. Inquiries under subsections (1) and (2) of section 4 of the Tariff Board Act are always initiated by the Minister of Finance. The Minister usually asks the Board to include in its report appropriate recommendations concerning the classification of the goods in question and the rates of duty applicable to them. Notwithstanding initiation of the inquiry by the Minister of Finance, the Board, of course, acts independently of him and conducts the inquiry in a free and impartial manner. The Board is authorized to hear evidence and to obtain information confidentially for its own purposes when acting in either its advisory or its judicial capacity.

The judicial functions of the Board are derived from the Excise Tax Act and the Customs Act 5/. In the exercise of these functions it acts as a court of record to which appeals may be taken from certain decisions of the Department of National Revenue.

For excise taxes the Tariff Board is competent to determine whether, in any particular set of circumstances, an article is subject to sales tax, to excise tax or to both. It may also determine whether an article is exempt from sales tax or excise tax, and if so whether a refund is in order. Finally, the Board is competent to settle differences that may arise over the rate of tax payable or over the classification of particular items for excise purposes. It is not competent to decide whether a person is liable for payment of the tax nor is it competent to adjudicate on sale price. From this brief description it is evident that the right of appeal to the Tariff Board is very limited.

The Tax Appeal Board

The Exchequer Court of Canada held exclusive original jurisdiction in regard to income tax appeals until 1946, when the Income Tax Appeal Board was established following recommendations of a Senate Committee for an informal and inexpensive tribunal. The first members of the Board were appointed in December 1948, and the Board heard its first appeal on February 12, 1949. The title of the Board was changed in 1958 to the Tax Appeal Board. The jurisdiction of the Board is limited to income and estate tax cases and it can only hear appeals against assessments made by the Minister of National Revenue.

The Board is also a court of record, and comprises a Chairman and at least two and not more than five other members, one of whom may be appointed Assistant Chairman. The law does not specify any particular qualifications, except for the Chairman and Assistant Chairman, who must be either a judge of a superior court of Canada or of a superior, county or district court of a province, or a barrister or advocate of at least ten years' standing at the bar of a province.

The law is silent on qualifications for other members of the Board, but all except one have been lawyers. Accountants were invited to serve on the

Board when it was first constituted but, with the exception of one who sat for eight months, all declined the position. The Governor in Council (Cabinet) appoints the members and sets the length of their term of office, which may not exceed ten years but which may be renewed.

Certain obstacles to the recruitment of members are inherent in the constitution and organization of the Board itself. Some people are disinclined to serve with the Board for financial reasons, or because of the insecurity of tenure, or because the office itself lacks sufficient prestige. Doubtless, the salary of a Board member will never compare with the financial rewards of a remunerative profession. The lack of any security of office for more than a ten-year period is also a deterrent, as is the failure to provide the members with the status of a judge.

The Tax Appeal Board requires the services of an administrative staff. The Income Tax Act, 6/ under which it is constituted, provides specifically for the appointment of the principal officers, namely, the Registrar and the Deputy Registrar, and it describes their duties.

The Board travels from one area of the country to another, as required, to deal with the appeals which are ready for hearing. It decides the time and place for the hearing of each appeal, having regard to circumstances and notably the question of expenses and convenience in so far as the appellant is concerned, but in practice it holds its hearings in the major cities and in most cases this suits both parties.

Since it is very seldom that more than one member of the Board sits at a hearing, most of the appeals are heard and determined by a single member acting in the name of the Board. Most decisions take the form of a written judgment handed down several months after the hearing, but in about 15 per cent of the cases an oral decision is given at the close of the hearing. The Board does not publish its own decisions.

The Exchequer Court

The Exchequer Court was established in 1875 to hear and determine actions in which the government is a party. It is a court that can sit and act anywhere in Canada, though in practice it sits in the larger cities only. Under the Exchequer Court Act, 7/ this Court has exclusive original jurisdiction in some matters and a concurrent jurisdiction with the provincial courts in other fields. Some acts, in particular the Income Tax Act, the Estate Tax Act 8/ and the Excise Tax Act, recognize in the Exchequer Court both original jurisdiction and jurisdiction in appeal.

In income tax matters the Exchequer Court has original jurisdiction to hear appeals from assessments made by the Minister. This jurisdiction is now concurrent, being shared with the Tax Appeal Board. However, on an appeal from an assessment made pursuant to a Treasury Board direction under section 138 of the Income Tax Act, the Exchequer Court alone has original jurisdiction, subject to the provisions of section 92(2) of the Act.

In appeals to the Exchequer Court, the Estate Tax Act grants the same jurisdiction to the Court and lays down an identical appeal procedure.

The Excise Tax Act does not expressly lay down any procedure for appealing from a decision of the Minister directly to the Exchequer Court, and it is doubtful that the right of direct access to that Court is of great practical significance to the taxpayer.

The Income Tax Act makes no mention of the form which an appeal from a decision of the Tax Appeal Board to the Exchequer Court should take. The Exchequer Court, however, had to give a ruling on this question in 1951 in Goldman v. M.N.R. 9/. In this judgment Mr. Justice Thorson, noticing the absence of a specific provision whereby it is possible to discover the exact nature of the appeal before the Exchequer Court, decided that the creation of the Tax Appeal Board had in no way affected the jurisdiction of the Exchequer Court. An appeal to the Exchequer Court is therefore a completely new trial, that is, a trial de novo, in income tax appeals.

Unlike appeals from decisions of the Tax Appeal Board, appeals from Tariff Board decisions are confined to questions of law.

The Supreme Court

The legal principles governing appeals to the Supreme Court of Canada are set forth in sections 82 to 86 of the Exchequer Court Act. Under sections 83 and 84 a judgment of the Exchequer Court can be appealed in any action in which the actual amount involved exceeds five hundred dollars. When the amount is less, appeal may still be made to the Supreme Court if a judge of that Court authorizes it, and if the action involves the constitutional validity of an act or relates to a matter which may affect future rights. A judgment of the Supreme Court is final.

Problems in the Processes of Tax Adjudication

Tariff Board. We heard little comment in our public hearings regarding the Tariff Board and, were it not involved in the appeal processes for the excise taxes, would not feel obliged to concern ourselves with it. The most obvious questions that arise are whether the Board should be asked to act in the dual role of both adviser to the Minister of Finance on policy matters and later on of judge in appeals on the interpretation and application of the same laws, and whether the Board might not deserve the security of more permanent appointment and greater security of tenure. Another important issue is whether the Board's jurisdiction should be expanded so that it would have authority to consider appeals from assessments, in place of the very limited jurisdiction it now enjoys.

Tax Appeal Board. The Tax Appeal Board was the subject of a good deal of comment. As a new entity operating in the contentious and pressing area of income tax, it has faced a very considerable challenge. On the whole there was agreement that the Board has fulfilled the original expectation that it would be an inexpensive court for the hearing of a multitude of appeals, both great and small. The main complaints were directed against the

relatively long period between the hearing of cases and the delivery of judgments (many solutions were proposed, ranging from an expansion of the size of the Board to the delivery of verbal judgments from the bench); the possible infringement on the independence of the Board, arising from the fact that the Minister of National Revenue is both a litigant before the Board and the member of the government most directly responsible for its general composition and its rules of practice and procedure (appointments are made and procedures approved by the Governor in Council); and the problem encountered in attracting men for positions on the Board because of the insecurity of tenure and the lack of the status of judges. There was also a feeling that the status of the Board had been lowered by the position taken by the Exchequer Court that an appeal from the Board to it was a trial de novo.

Later, we address ourselves particularly to the issues of the efficiency of operation of the Board, and the independence of the Board.

REFERENCES

1/ R.S.C. 1952, Chapter 100.

2/ R.S.C. 1952, Chapter 99.

3/ S.C. 1931, Chapter 55.

4/ R.S.C. 1952, Chapter 261.

5/ R.S.C. 1952, Chapter 58.

6/ R.S.C. 1952, Chapter 148.

7/ R.S.C. 1952, Chapter 98.

8/ S.C. 1958, Chapter 29

9/ [1951] Ex. C.R. 274.

CHAPTER 32

TAX FORMATION

Having reviewed the general scope of the area of tax organization and discussed some of the main problems that arise in its various phases, we now set forth our recommendations for changes designed to alleviate the more obvious of the difficulties.

TAX ORIGINATION

A More Formal and Public Procedure for Representations for Tax Changes

We view with sympathy the request of several of our witnesses for an official agency for reviewing shortcomings of the tax system that would operate in a more formal and public manner than is the case at present. The level of tax representation in this country, particularly as evidenced by the briefs of professional and other associations and the studies issued by tax research organizations, is of a very high order. The submissions presented to the Commission were further demonstration of the high calibre of study devoted to this complex subject. The raw material of public discussion is abundant, therefore, and what appears to be most conspicuously lacking is official machinery that will satisfy the public at large and the interests particularly concerned that consideration of tax changes is being carried out in the full knowledge of all the issues at stake.

This is not to say that the present procedure has not worked reasonably well in the past. The Minister of Finance and his officials are among the most accessible of the groups of official Ottawa, and we have heard no one complain that a hearing has been denied him. The origin of the problem appears rather to be in the fact that in an increasingly complex society it has become almost impossible for any small group of tax experts, restricted in their contacts largely to those who seek them out, to foresee even the major implications of a proposal for tax reform, particularly one of a highly technical character. This problem becomes acute in a country as widely dis-

persed as Canada. The government might be persuaded to make a tax change to suit the needs of one industry or section of the country without being aware of its impact elsewhere, simply because other taxpayers were in ignorance of the proposal and had no chance to make their position known. Public examination of the proposal would reduce this possibility.

Official public examination of tax problem areas is not new in Canada. There is precedent for it in the hearings and studies of the Tariff Board on matters of a technical nature referred to it by the Minister of Finance for study. It may be this precedent that the business and professional public has in mind in its proposals, although a variety of forms of organization was suggested.

We are in sympathy with the spirit of these proposals and recommend later on, as part of a comprehensive new organization for tax administration, that specific provision should be made for public discussion, under official auspices, of current tax problems and solutions therefor. We deal with this later in putting forward our proposal for a Board of Revenue Commissioners.

Another device that has been used quite extensively by the United States Treasury, and that we feel could be adopted with advantage here, is that of the informal advisory committee. Such committees are composed of representatives of a variety of interests—business, academic and professional—and meet periodically with senior Treasury officials to discuss in a confidential and objective way a range of issues submitted to the Treasury. The purpose is to provide a sounding board and not to produce decisions. The Treasury is not bound in any way by the views of such a committee.

No doubt much of this sort of contact with the outside world now occurs in the Department of Finance in an informal and unorganized way. We feel that exposure of this type is of mutual benefit and we would recommend that the Department of Finance should establish a small advisory committee in the area of taxation and fiscal policy to function in the manner of the United States committees.

Budget Secrecy

The suggestion that the Minister of Finance might adopt some device for public examination of his budget proposals before they were presented to the House of Commons appears to stem also from the feeling that only good would come from greater publicity for changes of serious consequence for the whole country. It seems to be assumed that with public examination the possibility of a mistake being made by the Minister would be greatly reduced.

While this may or may not be so, it is quite clear that there are other considerations which must also be given weight. General public discussion of desirable tax changes is one thing; advance knowledge of specific proposals for change is quite another and involves serious issues of confidence, responsibility and accountability. The tradition of budget secrecy is an old and respected one that is not lightly to be abandoned. In considering how far there might be a departure from it, we have concluded that some fairly rigid tests would have to be applied. We would rule out advance disclosure of any change having a pecuniary advantage or disadvantage to any specific individual or group. We would also exclude any change of such a nature that foreknowledge would permit the taking of steps to frustrate its effect. We would also question whether a change should be made known which, despite the best efforts at publicity, might not become the knowledge of every taxpayer involved. In addition, of course, there would be an obvious general prohibition against advance revelation of any change in rates, particularly of those on commodities, which might be exploitable information.

The above tests would probably rule out publicity for most of the budget changes of any real importance. Assuming, however, that some subjects, possibly of a highly technical nature, might be eligible, there remains the question of the manner in which public discussion would be carried out. Adequate public discussion would require general open hearings with invitations to all interested parties to attend. This would be a slow process and could

hardly be carried on as part of the regular budget-making procedure in which time is frequently of the essence. The best possibility would seem to be that the Board of Revenue Commissioners, whose establishment we propose later, after conducting public hearings on a subject, might be asked to hold a further inquiry on any proposed legislation of a highly technical character designed to deal with that subject, and this inquiry could be held before the legislation was introduced to Parliament.

No doubt a Minister of Finance might also feel that there are occasions when it would be advantageous to all concerned to consult privately with the representatives of an industry or any other group on the detailed provisions for implementing a tax reform the general nature of which had already been made public. The scope of this type of consultation would be entirely in the discretion of the Minister.

On the whole we are sceptical of the possibility of much deeper public participation in the budget-making process than has been traditional. In our system the government and its Ministers have primary responsibility for decision making, and this process can hardly be conducted with the public "sitting in", as it were. Nevertheless, we are persuaded that there could be more public involvement in the total process of making tax law, and we feel that many of the general complaints we have heard would be met by the proposal that we make below for greater public participation in the parliamentary review of tax legislation.

TAX AUTHORIZATION

Public Hearings on Proposed Tax Legislation

As a parliamentary document, the budget has both political and technical implications. The broad issues of policy and the proposals for tax changes are matters of general concern to the public at large and their representatives in the legislature. On the other hand, the technical and detailed tax

legislation that arises out of the general proposals is of immediate interest only to a small segment of the public and often is of little concern to the Member of Parliament uninitiated in the mysteries of tax legislation.

On the first aspect, the political side, we do not presume to make recommendations. The pre-eminent authority of Parliament in financial matters and the right of access of the citizen to Parliament both through his Member and through Ministers of the Crown are ample general safeguards for the public good, and the internal machinery for keeping open the lines of communication is obviously a matter for Parliament to settle.

In the second area, that of technical review of the details of tax legislation, we feel that we do have a right to offer comment. This is an area not of general accountability but rather of detailed administrative arrangement which, as matters now stand, we feel could be improved.

On the introduction of the taxing bills, it is now the right of any group or individual to communicate with his Member, or with the Minister of Finance or his officials to complain of shortcomings in the proposal; and much of this is done in fact from the introduction of the resolution. The Minister of Finance, whose legislation is at stake, is anxious to rectify unforeseen consequences of his proposals, subject always to the overriding condition of having his legislation make progress through the legislative mill. It is also fair to assume that in the vast majority of cases reasonable corrections have been made. At the same time we can hardly overlook the fact that responsible organizations appearing before us were critical of the present arrangements and proposed various changes that would allow greater opportunity for public examination of legislation before Parliament.

The essential feature of proposals we received was that tax legislation should be referred by the House of Commons to a small standing committee, similar to the Committee of Ways and Means of the United States House of Representatives, which would hold public hearings, receive briefs and report

back to the House on its findings. This is not a new principle, since it is regularly followed in several other areas of legislation and indeed by the Senate in its consideration of tax bills. It was urged that such a committee would in time achieve a degree of expertise in tax matters beyond the grasp of the Member of Parliament exposed for a few hours a year to general debate on the tax bills, would provide an opportunity for more detailed public examination of complex provisions than is now available and, being public, would serve to elicit a detailed explanation of the measure and broader public understanding of its purposes than is now the case. By employing a small staff of experts for the duration of its hearings, the assistance of a well qualified tax lawyer and tax accountant for a few days or weeks should be sufficient, it would be assured of technical competence in areas frequently of extreme complexity.

We support proposals for parliamentary examination of this character. If the examination were limited to matters of a technical character, we see no danger to the principle of ministerial responsibility and indeed see no reason to believe that taxpayers would not continue to address themselves directly to the Minister of Finance as they have in the past. We would favour a committee of the House of Commons as the natural focus of interest and responsibility, but there would be no reason for not continuing the activities of the Senate Finance Committee, which have been very helpful in the past. It may be making best use of the talents available in both Houses to establish a joint committee, as frequently has been done in other areas and, if this were feasible, we would favour it as being the most promising possibility of all.

To sum up, the advantages we see in the additional procedure we suggest are threefold: it would ensure that time was allowed for full and adequate consideration of complex legislation; it would in time produce a corps of legislators having particular familiarity with taxation; and it would not only help ensure that justice was being done but would also give the public

evidence that this was the case.

Legislation in More General Language

By far the most frequently expressed complaint about tax law, from legislators and public alike, is of its complexity. To a degree this is a reflection of the intricate social and economic relationships in a modern society. All laws are so affected, not just those relating to taxation.

This observation tends to explain the need for a large and detailed body of written rules and guidelines of some sort for tax compliance, but is not in itself a justification for involved tax laws. There are various facets of what is essentially an exercise in communicating to the taxpayer a precise statement of rules for determining his tax liability. Ultimately, unless the taxpayer is able to obtain an answer to every question related to his liability, he cannot pay his proper amount of tax. And because it is desirable that any answer given one taxpayer be given to all taxpayers having the same problem, and that this answer be a matter of public record, the need for written and published rules is self-evident. At present a variety of means is available for this purpose, including the basic statute itself, the forms, returns, rulings, and regulations issued under the statute, and the written or recorded interpretations of the statute by the courts. In a sense all these are steps in the essential process of communication, and variations in emphasis are possible at each stage. The more detailed the law the less the need for detailed regulations, and possibly the less the need for litigation, although the latter does not necessarily follow. The more general the law, the greater the likelihood of more need for "delegated" legislative powers, such as authority to make regulations and rulings, and so on.

It is our view that at the present juncture Canada suffers from an unhappy compromise in its tax legislation under which it appears to have, in one area or another, the disadvantages of all worlds. The legislation in the commodity tax area is of such a general character that the actual operation

of the taxes, carried out through the exercise of discretion and a multitude of rulings and regulations, can hardly be recognized from an inspection of the statute itself. On the other hand, the direct tax legislation, particularly that on income tax, is becoming overgrown with detailed or semi-detailed provisions that neither set forth a general intent, nor cover all or nearly all the situations that arise.

Our preference, and we believe that of our legislators and most of our witnesses, would be for a law that stated in fairly general terms the purpose to be achieved or the rule to be applied, and left it to regulations or rulings given under legislative authority to clothe those general provisions with meaning for the infinitely varied and complex situations of individual taxpayers.

Again this is not a new principle, but is merely the extension of a practice already found in very wide use in Canada's tax legislation. Under the Income Tax Act, for example, one of the most important of allowances, that for depreciation, is granted by regulations issued under the authority of section 11(1)(a), that provides a deduction for "such part of the capital cost to the taxpayer of property, or such amount in respect of the capital cost to the taxpayer of property, if any, as is allowed by regulation". Other examples are the amplification under Part IV, section 700, and Parts XX and XXVI, of very general principles stated in the Income Tax Act.

We recognize at once the difficulties of drafting simple general tax legislation and that it is easier to state than to give effect to the principle, but we believe that legislation in more general terms would permit the Members of Parliament to understand more clearly the nature of the amendment they were approving, would enable taxpayers to grasp the basic purpose more clearly, and would give scope for greater flexibility in the promulgation of detailed rules by regulation. Where anomalies appeared or changes in the detailed rules were required for any other reason, the regulations could be amended promptly, and in a much less cumbersome way than

would be required to amend the statute. These are substantial advantages worth striving for. To achieve them, however, would carry the requirement of closer scrutiny by the legislature of the exercise of delegated authority to make regulations, extreme care in the adoption and exercise of ministerial discretion, and a willingness on the part of the administration to give advance rulings. We believe the drafting of legislation in more general terms may also encourage a broader approach by the court to the interpretation of tax legislation. We discuss each of these below.

Control of Delegated Powers

Regulations. Control of delegated legislation may be entrusted to a judicial body, the courts, or to a political body, Parliament. Judicial control is exercised over both the authority for and the content of delegated legislation. The role of the courts is to determine whether the agency that initiated the legislation had the necessary authority, and if so, whether it acted within the bounds of that authority. If the answer to both these questions is "yes", the court may have to determine whether the legislation extends to the facts before it. Judicial control functions satisfactorily at present and it is not advisable to try to enlarge its scope.

For supervision other than judicial, the requirement is for a form of control and scrutiny having two main aspects, one involving the holding of public hearings on proposed regulations to be issued under delegated powers, and the other involving subsequent scrutiny by the legislature of the actual exercise of the delegated powers.

Prior public consultation, publication, and hearings could be entrusted to an administrative agency adaptable to this purpose, possibly the agency we propose later. It would be charged with responsibility for advance publication and distribution of the proposed regulation, for conducting hearings and receiving briefs, and for submitting a report to the responsible authorities. We also propose that all regulations should be made by the Governor in Council

and not by any single minister, and should continue to be made public in accordance with present procedure. We recognize that in some cases it may be necessary to have the regulation become operative before public hearings are held. These cases would indeed be exceptional, but in such circumstances we would recommend immediate adoption of the regulation for a specified period, say, six months or a year. At the end of this period the regulation, if not confirmed, would automatically expire.

Political scrutiny, as revealed by experience in the United States and the United Kingdom, can take many forms. We would favour a system in which a standing committee of the House of Commons, possibly that which would consider tax bills, would review regulations from time to time. The purpose of this review would not be to reconsider general policy, but rather to ensure that the regulations were in accordance with the policy contemplated in the Statute, that there had been no unreasonable delay in publication, and other questions of this order. Having reviewed the legislation, the committee would then be in a position to recommend to Parliament its amendment, annulment or continuation.

Generally then, we recommend the following steps for the exercise and control of delegated authority to make regulations.

1. Prior publication of a draft.
2. Public hearings on the draft.
3. Regulation by Governor in Council.
4. Publication in the Canada Gazette and submission to the House of Commons according to present procedures.
5. Scrutiny by a standing committee of the House of Commons.

Ministerial Discretion. Both Canadian and British experience show that it is difficult, if not impossible, to eliminate the granting of discretionary power completely from tax legislation. There have been some situations in which it has been demonstrated by repeated efforts that it is futile to attempt

to devise a written rule or rules to achieve a desired result. It is agreed that this extraordinary device should be used as little as possible, but if it is agreed that it must be used even occasionally, then the real problem is to determine the measures of protection or control that must be introduced to ensure that the rights of the citizen are respected.

The control of ministerial discretion, like that of delegated legislation, may be judicial or political.

Judicial control of ministerial discretion is limited to the examination of whether the discretion was properly exercised, and not whether the judge would have acted in the same way as the person exercising the discretion if faced with the same facts. In our legal system, Parliament is supreme; thus Parliament, in conferring discretion on a Minister, has named that Minister, or his deputy duly constituted for the purpose, to exercise the discretion. Therefore, in essence, the court has no power to intervene unless it can be shown that the Minister, in exercising his discretion, acted on erroneous legal principles, was influenced by irrelevant or improper considerations, or acted arbitrarily.

In view of the limited scope of the authority of the courts, they cannot be relied upon to provide the taxpayer with all the protection he requires against the dangers inherent in the exercise of ministerial discretion.

Political control must therefore make up for the limitations of judicial review. Several forms of political control may be used. Question time in the House of Commons may be used for this purpose, but here the specific procedures essential to any good control are lacking; nor can one rely altogether on the interest of the Members. We have also considered the establishment of an Advisory Board on Ministerial Discretion to assist the Minister in the exercise of his discretionary powers, but have rejected it as being a cumbersome and unwieldy device that offers no final solution to the problem. The Minister would be free to accept or reject the advice of

that Board so that ultimately the responsibility would be exactly where it is now.

We feel that a much more effective approach would be to require that advance rulings be given by the Minister under any discretionary authority granted him, in order to remove the element of uncertainty which is now the main complaint. We also propose that the parliamentary committee which reviewed the exercise of powers to make regulations, could also examine the departmental officials on the manner in which the ministerial discretions were being used. To protect the interests of the taxpayers involved, these meetings could be held in camera if the committee so decided. Also, if the committee deemed it advisable, it could call for presentations from taxpayers who were willing to discuss the use of ministerial discretion in their individual cases. A report to the House by the committee each year, setting out the number of times a ministerial discretion had been invoked, the general nature of the context, and any views the committee might have formed on the continuing need for the discretion, would keep the exercise of this power under constant public scrutiny.

We are confident that the introduction of these proposals would allay most fears on the subject of discretionary powers. We attach equal importance, however, to the fact that the basic revision of the tax structure we recommend should substantially eliminate the need for resort to this device.

Information and Rulings

We recommend that efforts be made in all phases of tax administration to provide the taxpayer with the maximum amount of information bearing on the determination of his tax liability, and that a system for granting advance rulings in specific areas of tax should be instituted, particularly in the Taxation Division. We consider these proposals in further detail in later discussions of the functions of the Taxation Division and the Customs and Excise Division.

More Liberal Interpretation
by the Courts

It is the frequent practice of the Canadian courts to interpret tax legislation literally, rather than by reference to purpose and intent. They often exclude from consideration factors which are extrinsic to the letter of the law, but which would assist in the development of an equitable and sensible body of law.

Application of the rule of literal construction has often had two results. One is that tax advisers have felt secure in devising tax minimization arrangements which simply skirted the precise language of the law. The other is that official draftsmen have been drawn into a continuing and largely futile attempt to write increasingly involved annual amendments designed to make the law more precise and foolproof. We have stated our views above on the need for drafting tax legislation in general language which deals with principles rather than rules. Possibly, in the process of this evolution, some new principles could be devised which would enable the courts to free themselves from undue emphasis on literal construction of the statute, and to have greater regard for the purpose and intent of the provisions being interpreted.

This subject is discussed at greater length in Appendix A to Volume 3 which deals with tax avoidance.

CONCLUSIONS AND RECOMMENDATIONS

1. Provision should be made for formal and public hearings, under official auspices, on general and technical problems in federal taxation. Such hearings would be a function of the Board of Revenue Commissioners proposed later, and would be held prior to submission of specific legislation to Parliament.

2. The Department of Finance should establish an advisory committee of non-governmental experts for informal discussion of general tax and fiscal policies.

3. A parliamentary committee should conduct public hearings on the details of tax legislation following introduction of tax measures in the House of Commons. Such a committee might be a joint committee drawn from both the House and the Senate.

4. Tax legislation should be drafted in general language, and more detailed provisions governing the application of the broad principles of the statute should be set out in regulations approved by the Governor in Council.

5. A system of public examination of proposed taxation regulations should be instituted, involving publication and hearings by the Board of Revenue Commissioners prior to adoption, and scrutiny by a parliamentary committee after adoption.

6. Ministerial discretion should be kept to a minimum in tax legislation; where it is employed, the taxpayer should have the right to require an advance ruling on stated facts, and a parliamentary committee each year should examine the manner in which the discretionary powers have been used and report on the continuing need for the discretion.

7. The courts should adopt a less literal rule of interpretation of taxing statutes.

CHAPTER 33

TAX ADMINISTRATION

In this chapter we shall deal with several matters relating to the performance of the tax administrative organization and make some recommendations. These involve questions about the general form and status of the organization; public information and advance rulings; and, standards of administrative performance in such matters as assessing, auditing, staff recruitment and training, enforcement, the exercise of ministerial discretion and other related subjects. The treatment of these is necessarily brief. The present comments are also intended mainly for the direct tax area, since observations on the administration of the present indirect taxes would be of limited relevance if our main proposals in this field are adopted. It should also be pointed out that in the particular area of tax administration, other proposals appear throughout this Report in the context of individual subjects, for example, international taxation, and the taxation of employment income. These have not been repeated in this chapter.

In view of the possible effect its adoption would have on some of the detailed phases of tax administration, we have thought it desirable to introduce at the very outset of our examination of tax administration our proposal for a wholly new form of organization for this function. The new form of organization would be a Board of Revenue Commissioners.

BOARD OF REVENUE COMMISSIONERS

We have arrived at our proposal by a process of examining alternative possibilities. The alternative of leaving the present arrangements wholly undisturbed is not an undesirable one, because on the whole we are satisfied that they have worked reasonably well. The allocation of policy-making functions to the Department of Finance and of administrative functions to the Department of National Revenue could possibly give rise to a hiatus between the formation of tax policy and its administration, but we have found that in

practice relations between the two departments are sufficiently close to make it unnecessary to consider placing the administration of the taxing statutes directly under the Minister of Finance. The resulting organization would be unwieldy and the burden placed on the Minister of Finance, who already carries a heavy load, would in our view be intolerable. Rather than amalgamating the Departments of National Revenue and Finance, we favour the idea of a separate, independent, non-political agency for tax administration, and this on two main grounds. First, we see great possibilities for a much closer integration of all the functions of tax administration if they were to be brought together in one independent entity administered by a Board of Revenue Commissioners. Second, by placing the collection of tax under such a Board, impartiality would be assured and any attempt to exert political influence on the collecting authority would be negated.

In suggesting that an agency independent of political control would be preferable to the present arrangement, we do not imply that any disturbing shortcomings have been found in the existing organizations. On the contrary, we are convinced that the officials of the Department of National Revenue are carrying out their duties in a dedicated and conscientious way. Rather, our views are based on a judgment that, whereas the political factor is an essential element in the policy-making function, it need have no role in the administrative side, and to the extent that it does operate, an uneven application of the law is likely to result. We are not unaware that the political influence will normally be a tempering one, easing the application of what might be a harsh provision when applied to individual cases. It is not our wish that harsh provisions cease to be tempered, but rather that the procedures by which this desirable result is achieved should operate openly and independently and in the full knowledge of all taxpayers. An administration that is basically free of political influence should raise morale among the people working in it.

Our proposal might seem more concrete if its details were given at this time. We recommend that the functions of the present Department of National Revenue be vested in a Board of Revenue Commissioners constituted by statute in the same manner as other independent commissions, such as the Board of Transport Commissioners or the Civil Service Commission. The functions and responsibilities of the Board should be clearly set out in the statute.

As far as the day-to-day administration of the revenue Acts and dealings with individual taxpayers are concerned, the Board would be completely independent. The Board would be responsible to Parliament, of course, and we would recommend that it report directly to Parliament through the Minister of Finance 1/. We would stress the necessity for close co-ordination in revenue matters between the policy-making function carried out by the Department of Finance and the administrative function to be assumed by the proposed Board. We have assumed that a working co-operation would continue between the Department of Finance and the new Board as it has in the past with the Department of National Revenue. Nevertheless, because the Minister of Finance is responsible for taxation policy, we think it would be placing an unfair burden on the Minister not to allow him some supervisory power over general administrative policy in seeing that taxation policies were made effective.

We have sought a way to give the Minister some general power of issuing directives to the Board while preserving its complete independence in day-to-day tax administration. We have concluded that the relationship of the Minister of Finance to the Governor of the Bank of Canada offers a useful analogy. We therefore recommend that the Minister of Finance should be empowered to issue directives to the Board on matters of administrative policy, which should be made in writing and published, probably by tabling in the House of Commons.

The Board would be obliged to follow such directives, and in the event

of a refusal of the Board to follow a directive, the Board would be obliged to resign. We do not expect the Minister would need to use the power to issue directives very often because of the co-operation we expect between the Board and the Department of Finance, but we believe that in the event of disagreement over administrative policy the Minister of Finance must have authority to match his responsibility. We believe the requirement of publication of any directives would be sufficient safeguard against any erosion of the Board's independence in dealing with taxpayers.

Because the Department of Finance has responsibility for tax policy, it is important that there should be a strong section in the Department responsible for tax analysis on a continuing basis. This section would need to maintain the closest liaison with the Board so that developments in tax policy could be readily reviewed as to their feasibility. Unless such close liaison were maintained, desirable tax policies may fail to be implemented, or if implemented fail to achieve their full effect because of difficulties in administration. With the greater formal independence of the Board would come the need for greater informal collaboration with the Department of Finance.

We feel that such a Board of Revenue Commissioners must be headed by a strong and respected Chairman, or a Chief Revenue Commissioner, as chief executive officer, and that there should be three panels of commissioners: Commissioners of Income Tax, Commissioners for Transactions Taxes (the present sales and excise taxes and excise duty), and Commissioners of Customs Tariff. The number of commissioners to be appointed would be determined by the tasks assigned to the Board. The Chairman would need to be a man of unique qualities whose status and salary should be at a level at least equal to the presidents of crown corporations or other important independent agencies of government.

The Minister of Finance could be relieved of considering all tax

representations of a technical, that is, non-policy character, for such representations from the public would be heard by the Board. Its duties would include public hearings on matters referred to it by the Minister of Finance and on proposals for regulations, and in some situations on proposed draft legislation as well. The Board should inform Parliament and the Minister of the views expressed by the public and provide an evaluation of the tax laws through its annual reports. Briefs and representations of a policy nature would continue to be presented to the Minister of Finance, unless the Minister specifically directed the briefs to the Board's attention.

The new Board, to be effective, must be adequately staffed and, in particular, there should be competent technical tax research carried out on a continuing basis. We also recommend, as we have for the Department of Finance, that the Board avail itself of the advice of informal committees of non-governmental experts. Such committees would be particularly helpful in areas of organization, methods, recruiting and training, as well as in specialized areas of taxation such as the international field.

The nucleus of the new Board would, of course, be the present Department of National Revenue. While we have not looked into or studied the matter in depth, we assume that its creation would mean some reorganization of the Department; for example, certain service functions which are now provided by the two Divisions of the Department might be shared, with possible resultant administrative saving, thus implementing a proposal of the Royal Commission on Government Organization. The basic structure might not require adjustment beneath the senior levels, but this could all be the subject of study by competent analysts.

The creation of such a Board, together with the Tax Court we propose later, would, we think, guarantee to the taxpayers of Canada unquestionable independence for those persons who administer and adjudicate the tax statutes, and would spread responsibility for tax administration among a larger group, to the advantage of all concerned. The government, in accordance with

democratic principles, and particularly the Minister of Finance, would still retain responsibility for tax policy, an arrangement with which we are wholly in accord.

By way of comparison, in the United Kingdom there are two groups of commissioners, the Board of Customs and Excise, and the Board of Inland Revenue, to carry out the functions which we are here recommending be placed under the jurisdiction of one Board of Revenue Commissioners. While we feel one board is all that would be necessary, we can raise no objections to a division of the functions as in the United Kingdom, if this appeared to be a better grouping of responsibilities.

PUBLIC INFORMATION AND ADVANCE RULINGS

Whether or not a new tax organization is introduced there are certain fundamentals of good tax administration that are unchanging. High in priority among these is a good system of communication between the administration and the public. To the individual or the corporation there must be provided all the information necessary for meeting the tax liability. To the public at large there must be given sufficient information on the operation of the tax authority that its efficiency and integrity may be subject to full examination.

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Information for Taxpayers. Although we commend the Taxation Division for its past efforts in devising tax forms, in supplying information to the public, and particularly for the formation of a new Information Service, nevertheless we are of the opinion that the proposed Board of Revenue Commissioners could go further in this direction. The publication of guides such as the Farmers' and Fishermen's Guide is highly commendable, but further special and general guides of this type should be issued. The Board should also extend its use of mass media to explain to the citizen his duties regarding filing and payment of income tax. Moreover, information such as that contained in the Assessors' Guide that is now available only to departmental officials,

showing how the Department interprets the Act, Regulations and practice, could be made public.

We have been particularly impressed with the information programme of the United States Internal Revenue Service. A selection of material provided the Commission by the Service included a very comprehensive general income tax guide Your Federal Income Tax; a kit for the businessman which gives him a tax calendar and all of the tax forms he will need; guides for small businesses and other special classes of taxpayers; a variety of circulars dealing in detail with such subjects as personal exemptions and deductions, sale of home and other assets, income averaging, and so on. We were also given some of the material of a broader educational character, including a teacher's kit for use in schools. These and other items cover basic fundamentals in each area and give the taxpayer a grasp of the background information not easily available in Canada. We commend this example to the Canadian tax authorities.

Annual Report. We have examined the reporting on income tax administration and have found it adequate in some respects and seriously lacking in others.

The Taxation Division has for some years been publishing a mass of data on incomes, both individual and corporate, derived from an analysis of tax returns, and for this it is to be commended. The publication of Selected Tax Data, now restricted to internal circulation, would round out this statistical information. Where the Division has been most lacking, however, is in regard to information on the conduct of its own activities as an important public function.

In the annual reports of the Department of National Revenue, for example, the Taxation Division occupies two or three pages, and only the barest details of collections are given. We have examined the annual reports of the United Kingdom Commissioners of Inland Revenue, the United States Commissioner of Internal Revenue, and the Australian Commissioner of Taxation and have found them all a great deal more informative than the totality of information

published by the Taxation Division. These reports typically contain sections on scope of activities, organization, staff, salaries, cost of collection, details on assessment, collection, valuation, rulings, public information programmes, personnel training and recruitment, legislation, international developments, breaches or evasions of the Acts, tax delinquencies and cancellations of tax liabilities, activities of regional offices, and a long list of other matters. This listing alone is sufficient to give an idea of the type of data we have in mind. Almost nothing of this sort is to be found in the reports of the income tax administration in Canada. We urge that in future the reports of the proposed Board of Revenue Commissioners fill this serious gap in our public information.

Advance Rulings. We are of the opinion that advance rulings are an excellent device for fostering and encouraging the self-assessment system, and would contribute to good relations between the income tax administration and the tax-paying public. From a taxpayer's point of view, rulings are most desirable because they give more assurance of certainty prior to entering into a transaction, and guarantee more uniformity in the application of the tax legislation. They also appear desirable for the administration, for they minimize controversy and litigation, reduce the time spent in answering questions from taxpayers, and help to achieve a fair and co-ordinated tax administration. We propose that the approach to a system of advance rulings be a gradual one, leading eventually to a system as extensive as that of the United States. To introduce the innovation, we recommend the following.

1. The Board of Revenue Commissioners should be required by law to issue rulings directly to taxpayers at their request in the few cases where ministerial discretion is involved, and should be permitted and encouraged to issue rulings in other cases.

2. Where these advance rulings have general application and do not reveal confidential or secret information they ought to be published, to the benefit of all.

The introduction of an advance rulings procedure would require the establishment of a staff for this purpose with special talents and training. With a gradual approach the problem so presented should not be a serious one, but even if it presents a challenge, we urge that this not be allowed to impede the institution of an advance rulings procedure.

Transactions Taxes

The proposals for the administration of transactions taxes made below are based on the assumption of the introduction of a federal retail sales tax and the institution of a Board of Revenue Commissioners, and would be quite different if neither of these steps were proposed.

Information for Taxpayers. In our opinion the proposed Board of Revenue Commissioners should give a good deal more attention to informing the taxpayer of his rights and responsibilities regarding transactions taxes than has been given in the past. For this purpose it would be necessary to provide more than the statute, the regulations, and the relevant circulars. A simple, non-technical guide to the transactions taxes, indicating the source of additional technical information, would remove much uncertainty. The Board should also set up an information unit to edit, co-ordinate and distribute taxpayer information in this area.

Regulations. All regulations will require review in the light of our main recommendations for a federal retail sales tax. In future they should, of course, be subjected to the procedure we have outlined previously involving public hearings and review by Parliament.

Circulars. We have concluded that the difficulty of distributing circulars has perhaps discouraged frequent revisions and additions, and we recommend that the head office listing of licensees, which includes the industrial classification, be coded for an automatic data processing system, and that a sorting process be used when circulars or bulletins of general interest must be distributed, and that these be sent from the head office.

Bulletins. We feel that the practice of issuing bulletins is a commendable step toward fuller information for the taxpayer, and we urge that the proposed Board continue to extend the practice of issuing bulletins as soon as possible after budget changes are announced.

Local Information and Assistance. We have concluded that at present the information function exercised by the local offices is not defined sufficiently clearly. The function has become an important one, occupying much of the time of District Directors and, in larger districts, all of the time of one or more collections officers. The functions of interviewing and educating taxpayers and answering letter and telephone enquiries demands a thorough knowledge of the law, administrative procedure and interpretative rulings, and should be clearly assigned to officers in each district office who have been trained for the purpose.

Rulings. The history of rulings in the transactions tax administration in particular has been so unique that we feel that it offers little precedent or guidance for the future. To a very considerable degree the Customs and Excise Division has been forced in the past to make up for the deficiencies of a very inadequate statute by issuing instructions to taxpayers through rulings and regulations, many of the latter probably ultra vires, simply in order to have the taxes applied with reasonable equity. We recommend strongly elsewhere that a firm statutory foundation be provided and that the general position of all taxpayers be made more certain within the terms of the legislation itself. This step, and even more the adoption of a retail sales tax, which we also recommend, should remove the need for many of the existing rulings.

Nonetheless, we would urge that the proposed Board continue efforts to make known to the taxpayer the detailed application of the law. In the case of rulings, arrangements should be made to inform the public of the policy and procedure of the Board on their issuance; written procedural guides should be prepared for officials involved in processing rulings or objections

to rulings, and these officials should be specifically trained for this job; arrangements should be made for publication of all rulings, except those having a narrow application, through a commercial publishing house or at government expense on a subscription basis, and the necessary staff should be made available for the informational side of the rulings service. We would also urge that even in the cases of non-published rulings, information should be made public that a ruling had been given.

STANDARDS OF EFFICIENCY

We introduce the subject of standards of efficiency in tax administration with some misgivings. We have not felt that it was within our terms of reference to carry out studies that would have established criteria by which performance could be measured, and we have been unable to discover any ready-made standards that would be suitable. We therefore speak only from observations based on rather superficial evidence, and from a feeling that standards of performance in any function of government are likely to be elusive and difficult to formalize without very considerable study.

As a general statement we would say that insufficient attention has been paid to the development of a guiding philosophy of tax administration at the federal level. The approach appears to have been dictated largely by a short-sighted attempt to achieve the maximum amount of revenue for a given amount of expenditure. This result no doubt largely reflects the attitude of the elected representative, who is usually oblivious of the highly involved and exacting nature of tax administration, and who seldom realizes that the tax-collecting authority of a large government handles more revenue than any other organization in the country, and encounters special problems of staff training and office management. Particularly is it seldom realized that in very few operations are such high marginal returns to be gained from relatively small additional expenditures. We feel strongly that a new approach is needed in which an attempt is made to measure the size of the

job that should be done and an adequate organization provided to do it, whether it be called a Board, a Commission, or a Department.

As we see it, the necessary standards of performance for this purpose would involve both external and internal measurements.

1. There should be measurements of the extent to which the maximum potential amount of tax is being collected, both in the aggregate and in individual regions, businesses, professions, and so on.

We have found that in the past neither the Taxation Division nor the Customs and Excise Division has established adequate criteria by which to measure the degree of tax compliance being achieved. Indeed statistics do not appear to be available at the present time by which to make such measurements. These are likely to be easier to formulate in the area of indirect taxation than of direct, and we would particularly urge that steps be taken by the proposed new Board to establish, with the assistance of such outside expert advice as is necessary, some measurements of the present degree of tax compliance and a long-range programme for improving compliance where it is found to be most lagging.

2. There should be detailed and comprehensive measurements of the marginal yield of additional effort and expense on office organization, forms, assessment, auditing, enforcement, special investigations, automation, and so on.

Despite the restrictions imposed by a rule of minimum outlay on tax administration, some real progress has been made in recent years in improving the efficiency of both the Taxation and the Customs and Excise Divisions. Both have moved toward increased automation, and in the Taxation Division the new Data Centre gives promise of further remarkable developments in the centralized handling of forms, accounting, and the tabulation of data. Notwithstanding this progress we have seen little evidence in either Division of an overall long-term plan for defined objectives of performance, and such

a plan will not be possible until much more detailed standards are established than are now available. We most strongly urge that attention be concentrated on the development of such standards and objectives, and the achievement of an organizational structure to meet them at the earliest possible date.

It may be necessary to repeat that we have not ourselves developed such standards in our studies. We urge that they be developed in the full assurance that they can only result in a marked improvement over performance based on the present philosophy of minimum expenditure. A new approach would be particularly important if the income tax administration were to be faced with the new tax measures we recommend elsewhere in this Report.

For the immediate future we have a few proposals which we feel would result in administrative improvements. These, of course, are proposals which should be viewed in the context of a Board of Revenue Commissioners. They should be implemented as part of the overall revision of the administrative structure prior to or concurrently with establishment of the Board.

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Organization. We have concluded that the two-tier organization at the District and Head Office level, though it might have been adequate in the past, is in need of review. For purposes of administrative control we recommend the establishment of a three-tier organization. Thirty district offices might well be better supervised by regional offices rather than by one head office. We also feel that the administration of tax laws would be improved if the central office were relieved to the fullest possible extent of details to concentrate on co-ordination and policy making. Tax administration details should be settled in the regions. We recommend that there should be five regional offices.

Assessment and Returns. We have concluded that the self-assessment system

is working reasonably well in Canada and should be retained and extended to cover members of the armed forces, who at present are not required to submit returns. Moreover, in our opinion, the tax returns now being used by Canadians are generally satisfactory. We would urge that additional information be reported on interest and dividend income by reducing the reporting limit for T5 returns from $100 to $10. We also recommend that the so-called "quick assessment" be labelled "provisional assessment", or be given some other name that would indicate its inconclusive character. On behalf of the taxpayer, we recommend that the statutory limitation on the right to assess or re-assess be calculated from the due date of the return, or the date on which the return is actually filed, whichever is the later. We also recommend that within the four-year limitation period the taxpayer should have rights equal to those of the tax authorities by ensuring that during the same period in which the Minister is entitled to re-assess, the taxpayer should be entitled to file a revised return and to lodge an appeal in respect of that revised return on assessment.

In M.N.R. v. Taylor 2/ it was held that the words "any misrepresentation" include innocent misrepresentation. Thus under section 46(4) of the Income Tax Act, the Minister may re-assess for fraud or for innocent or fraudulent misrepresentation. We recommend that re-assessment beyond the four-year period should be limited to those cases where there has been fraud or fraudulent misrepresentation.

We have considered the possibility of proposing a change in the requirements for filing of personal income tax returns that must now be filed on or before April 30 to produce a more even flow of returns throughout the whole year. The peak load of the activity now falls in a relatively short period, and any relief would be most desirable on grounds of efficiency. Various ideas that have been submitted to the administration for study as to technical feasibility were found to have serious disadvantages, and we were forced to conclude that the concentration of filing in the early part of the year

would be difficult to change.

However, as a result of our studies we are satisfied that improvements could be made without drastic alteration in the present arrangements. One possibility, for example, would be to establish March 31 as the date for filing of the T1 Short Forms. A great proportion of these result in refunds and an advance in the filing date would be in keeping with strenuous efforts made by the Taxation Division in recent years to encourage the public to file such returns as early as possible in the year. To facilitate this change it would be necessary also to advance the time for filing of T4 slips to January 31, the date now in effect in the United States. With the time for filing T1 General Forms left at April 30, an appreciable spreading of the flow of returns would be achieved.

Audit. We have concluded that the present audit coverage is inadequate. There not only appears to be an overall shortage of assessors, but there is the possibility that the present staff is not being used to the fullest extent in obtaining consistent coverage through the assessment function.

We have also been impressed with the fact that in the year 1963-64 field assessment, which costs the Division from $8 to $15 per hour depending on the size and complexity of the return, yielded increased tax liabilities ranging up to a maximum of thirty times this cost. Table 33-1 gives the tax increase expressed as dollars per hour for assessing under various conditions.

The figures of Table 33-1 are very revealing even with the caveat that, to the extent that the additional assessments represent taxes moved from one year to the next, the Department has its taxes one year earlier without increasing the total revenue, and that not all increases in assessment are sustained on appeal. Despite these reservations it is evident from the table that more intensive assessing will bring remarkable returns for the outlay involved. We have been particularly concerned to learn that the

Division is aware of the need, but has not been able to meet it because of staff shortages.

We do not presume here to suggest standards for an audit programme. We strongly urge that efforts to develop a selective approach to assessing and auditing be pushed forward as a most essential step in the achievement of standards of internal efficiency for which we have argued earlier.

TABLE 33-1

DOLLARS OF TAX INCREASE PER HOUR OF ASSESSING EFFORT, 1963-64

Gross Income Range ($000)	District Size: Large av.	Large max.	Large min.	Medium av.	Medium max.	Medium min.	Small av.	Small max.	Small min.
CORPORATIONS									
Over 5,000	309	312	280	160	725	27	120	436	20
1,000 - 5,000	96	135	71	66	155	29	57	125	14
100 - 1,000	55	116	38	34	65	16	18	74	7
Under 100	57	88	32	30	65	5	20	60	5
INDIVIDUALS									
100 and over	36	77	22	22	27	12	19	40	6
Up to 100	46	55	33	23	43	7	17	55	7
Professionals	58	132	39	28	55	17	16	70	7
Farmers	30	98	20	20	28	7	18	28	3

Source: Information obtained from the Department of National Revenue, Taxation Division.

Staff Recruitment and Training. Our studies have revealed that the income tax administration suffers from a chronic shortage of experienced staff for key functions because of under-recruiting and high turn-over. In several district offices it has been necessary to fit the standards of checking and

assessing to staff availability rather than to standards of efficiency, with resulting loss of revenue. Frequently young men leave after two or three years in which they have gained sufficient experience to go to private business at more remunerative pay.

We urge that the income tax administration launch a vigorous campaign of recruitment for the key functions; this should be nation-wide in scope, but should be most intensive in those areas where the greatest problems are being encountered. Particular attention should be paid to accountants, for whom departmental salaries are reasonably competitive at the outset but subsequently advance more slowly than in private industry. We repeat the views of the Royal Commission on Government Organization that the federal government should be competitive with employment outside the government, but should not lead in the field of compensation. For professional employees such as lawyers and accountants the pay does not rise nearly as fast as outside the federal public service. Hence, if the tax administration is to attract professional persons, it must have a basis of remuneration that will reflect their development and capacity. In the United States Internal Revenue Service, new recruits are hired at levels which reflect their academic accomplishments, and accelerated accordingly, whereas we are told that in Canada efforts to this end are frustrated by the general restrictions imposed on hiring for the civil service. Capturing the interest of the young man and holding it for several years is essential if the turn-over of staff, and particularly of assessors, is to be reduced. We urge that the proposed new Board of Revenue Commissioners give a high priority to staff recruitment. In particular we think that starting salaries and salary scales should be given close attention and that a review of the recommendations of the Royal Commission on Government Organization should be undertaken for this purpose. There must be a new approach to remuneration of professional staff in the taxation service.

We also have concluded that more can be done in training staff for

income tax administration. The introductory course and occasional conference now given should be developed into an integrated programme with increased emphasis on regional courses in co-operation with educational institutions or through teaching staff hired for this purpose. An integrated training programme would have introductory courses of a general sort for background, followed by more specialized courses for particular functions and later by more selective courses for administrative personnel destined for the higher positions in the administration. Again we feel strongly in putting forward this suggestion that Canada has much to gain from the example of other countries. We have not found that there is serious fault in Canada; only that more attention to some of these details will yield good returns.

Under the following subheadings we deal with the general problem of enforcement, and we propose several specific changes relating to collections, assessments, special investigations and the administration of penalties.

Collections. Collection effort is aimed at the unpaid tax bill. The Department of National Revenue, Taxation Division, has informed us that early in 1964 about $194 million was owed on some 92,000 accounts. Of this, $138 million was in 1,603 accounts, each in excess of $10,000.

This relatively high total of receivables is due to several factors, including: the absence of any statutory law that would automatically cancel debt; an over-retention of tax debt as being collectible, or put another way, the absence of any organized procedure for write-off, the present procedure requiring a report to Parliament for debts over $1,000; and inadequate enforcement of collections from accounts over $10,000, particularly where assets can be moved out of Canada. Nearly one third of the receivables is owing on cases under appeal, where there is a natural reluctance on the part of the tax authorities to liquidate a taxpayer's assets for payment of a liability which the court might reverse. Even deducting this proportion of receivables, however, leaves a figure which in our view is high by any standards by which we have been able to measure it.

As a very important step toward expediting the payment of tax liabilities and reducing the amount of unpaid balances, we propose that the instalment system for payment of corporation income tax should be moved gradually to coincide with the year of taxation. At the present time there is a four-month lag between the beginning of the monthly instalment payments, the lag having been reduced from a period of six months in recent years. We propose that by a minimum of a further two reductions the instalment period should be brought wholly into line with the taxation year.

We further recommend that the collections organization should be expanded and established as a separate Collections Branch rather than as a section of the Administration Branch. We also recommend that for uncollectible debts there should be an automatic barring of all accounts unpaid six years after the assessment, with the right given the administration to preserve any particular account for a further six years by entering it as a judgment of the court. We also urge that publicity be given to the amount of outstanding tax debt, the statement appearing in the Report of the Auditor General for 1963-64 being a good start, and that the write-off of individual accounts in excess of the prescribed amount be made public in detail.

We also recommend institution of the "offer of compromise" procedure, available to United States taxpayers, under which a taxpayer owing more than his net worth may institute proceedings requesting that a settlement be made for a lower amount. Any such settlement should be made public, being filed in a registry and available for inspection. Publicity would be a full safeguard against abuse of such a system. In our view the offer of compromise procedure should not be available to any taxpayer who had knowingly understated his income.

We are concerned about the evasion of tax which can be effected by a taxpayer who owes a considerable amount of tax through leaving Canada and becoming resident in another country. We suggest that this problem be given close and continuing attention by the tax authorities.

In these days international taxation has become an important subject and, in view of the close relations between the Canadian tax administration and many foreign tax administrations, we think it would be advisable to provide for reciprocal enforcement of tax judgments within defined limits. Any provision for such enforcement should not be so broad as to allow the enforcement of arbitrary or retroactive foreign taxes, but should permit the government of the other country to collect taxes from a person who had been resident or employed or carrying on business in that country. Such a provision should be limited to the enforcement of taxes in respect of income arising, events occurring, or operations carried on in the other country or while the person was resident in the other country, which taxes were incurred under the laws in force in that country at that time.

We recognize that a constitutional problem would exist in any reciprocal arrangement, because reciprocal enforcement of judgments is a matter of property and civil rights. However, because most provinces are in fact levying income tax (collected by the federal government), it might be to their benefit to help in the implementation of reciprocal enforcement arrangements, and we presume they would do so. The principles set out in provincial statutes dealing with the reciprocal enforcement of judgments would serve as useful guides in the construction of any scheme to implement this suggestion.

Reciprocal enforcement should only be provided for where arrangements for such enforcement are established by a tax treaty. Any taxes imposed by the other country which are contrary to the provisions of the treaty should, of course, not be enforceable.

Net Worth Assessment. We have reviewed the practice of "net worth assessment" and have concluded that it has a role in income tax collection. The administration should enforce the requirement to keep records, and would be able better to do so if a penalty were provided. But the net worth procedure will be needed for some time until the ideal of complete and adequate records for tax purposes is achieved. We would recommend two changes to strengthen the

hands of the administration in making a conservative assessment and to discourage taxpayers from attempting to exploit the net worth procedure.

1. That the net worth as determined at the end of the taxation period be considered binding for any possible future net worth assessments.

2. That where a taxpayer is assessed on a net worth basis for a second or subsequent time the tax payable should be 150 per cent of that assessed.

Special Investigations. In our opinion, investigations of the affairs of taxpayers suspected of fraud should be continued. The restriction of special investigations to contemplated prosecution cases appears to us to be sound, but we would urge that investigation work should lead to more prosecutions than is now the case. Specifically, we urge that there should be prosecution wherever warranted by the facts, and where the offence has been substantial as regards the amount of tax. The threat of prosecution should never be used to coerce payment from a taxpayer. We recommend that decisions regarding prosecutions should be based on consistent and established standards and with adequate review procedures.

The reorganization of the Special Investigations Section in 1963 is too recent for us to pass judgment on its effect, but in keeping with our general recommendations for decentralization, we recommend that the present review units be placed on a regional basis with a supervisory section at Head Office.

Some of the present powers of investigation could be curtailed without loss. We recommend that a search and seizure be made specifically conditional on the approval of a judge, as now required by section 126 of the Income Tax Act, but that the application be supported by an affidavit setting out reasonable grounds therefor; and that the approval of the judge be subject to review by the appropriate court in accordance with the right to review the Minister's purpose stated in Canadian Bank of Commerce v. Attorney-General of Canada 3/. We further recommend that the law should be amended to ensure that investigations by Commissioners would be conducted in a judicial

manner, that seizures during the course of audits should be conditional on there being reasonable grounds for suspecting a serious violation of the Act; that where anything was seized a general list should be given the taxpayer within seven days and that a taxpayer have reasonable access to all seized documents and the right to make copies thereof; that any seizure should be subject to judicial review and that anyone called to testify should be entitled to legal counsel. We are informed that these practices are now followed for the most part by the Division, but we see no reason for not safeguarding the taxpayer's rights by statute. We further recommend that, after a formal inquiry, the taxpayer should be supplied with a copy of the transcript of evidence as well as a complete list of all exhibits put in evidence.

Secrecy. In general we approve of the principle that information furnished by an individual or corporate taxpayer to the tax authorities should be secret, as required by section 133 of the Income Tax Act. An important element in tax compliance is a sense of assurance on the part of the taxpayer that his business or personal affairs will not become public property. However, we believe that secrecy would not be breached, and statistical information of great value would be gained, if a limited and specifically defined group within the staff of the Dominion Bureau of Statistics had access to all income tax returns. The group should be restricted to those who were directly involved in preparing statistical material that required the use of individual tax return data. The group should on no account provide any information to others that would make it possible to identify individual taxpayers. We are firmly convinced that access to individual taxpayer returns to any other department of government should be prohibited.

The Bureau of Statistics has developed over the years a very strong tradition and an excellent reputation for maintaining the secrecy of the information it receives from both individuals and companies. In addition, section 34 of the Statistics Act provides for secrecy of information furnished

under the Act that is as binding, and at least as stringent, as the requirements under the Income Tax Act. Any alternative method of satisfying the ever-increasing demands on the Bureau for detailed statistical data would not only be cumbersome and very expensive, but would impose heavy additional reporting burdens on taxpayers.

Sanctions. Sanctions under the Act take the form of penalties, fines and imprisonment. Penalties are levied through the assessment process; fines and imprisonment follow from criminal prosecutions.

We have observed that under some statutory provisions a taxpayer can be subject to criminal prosecution where there was no guilty intent, or mens rea. We recommend that mens rea should be required in all criminal prosecutions under the Act.

Having reviewed the nature of the duties imposed, we have concluded that all breaches should be subject to some form of monetary sanction, and that imprisonment should be imposed as an additional sanction only in cases of wilful evasion or failure to remit taxes which were withheld. We have also concluded that on balance the advantage lies with imposition of all monetary sanctions by way of assessment, with the usual right of appeal. To add to the effectiveness of sanctions, a list should be published of those who have been adjudged subject to penalty which had not been disputed successfully or settled within a fixed number of years.

Under the proposed system, because monetary sanctions would be levied by virtue of penalty assessments, they would have to be severe enough to act as an adequate deterrent. For that purpose we propose that penalties should be re-examined and where deemed necessary should be increased.

In consonance with our proposals for decentralization, we recommend that decisions to prosecute should originate in the regional offices with the final decision resting, as now, with the Department of Justice.

Finally, we recommend a ban on prosecutions imposing a sanction after five years from the date of the wrongful conduct, or within two years of the time the Department first acquired knowledge indicating an offence, whichever is later, and that officers of corporations should, as at present, be subject to the same sanctions as corporations if they knowingly participate in wrongful conduct.

Transactions Taxes

The organization and procedures for transactions taxes would be drastically affected by the adoption of the recommendations we make elsewhere for an overhaul of these taxes. The following comments are therefore not developed in as great detail as those for income tax. We have attempted to deal mainly with aspects of the transactions taxes which would be of continuing concern under a very different tax structure.

Organization. We have concluded that, regardless of the general administrative setting of the transactions tax administration or of the types of taxes it administers, serious thought should be given to a review of its form of organization. While we were unable to make any extensive study, it does appear that more effective administration might be possible if the total operations of the administration were to be organized on a regional basis, as we have proposed for the income tax.

Returns and Payment of Tax. The ministerial discretion to extend the time for filing of returns and payment of tax should be abolished, but no penalty for late filing or payment should be imposed if the lateness, as established by the facts, was not the fault of the taxpayer. Remission of penalty should be achieved by a formal and publicized procedure under regulations made by the Governor in Council.

Audit. We have found that it is difficult to assess the effectiveness of the audit policy and programme for transactions taxes because of a scarcity of statistical information, and we are uncertain whether the best results

are being obtained for the cost expended, or whether a greater proportion of tax deficiencies would be uncovered if a different programme were followed. The proposed Board of Revenue Commissioners should study the efficiency and effectiveness of audit programmes, indeed we understand that this is planned by the present administration. A review would have to be carried out on a long-range basis, and one result may be the need for an annual tax return in which greater information would be provided by the taxpayer, in addition to the monthly return. We do think that some limitation provision on assessment of tax should be enacted, preferably in the same terms as applicable to income tax. This limitation would give a compromise between the obvious need to have finality in all matters and the desire that evasion should not be profitable.

Refunds. On the assumption that a refund procedure of some sort would be continued under a retail sales tax, the administration should be given power to determine in particular instances whether the direct, the exemption certificate, or the refund method were to be used to achieve an exemption, and the exercise of this power should be by way of published regulations. Refund claims should be subject to a limitation period fair to both the Crown and the taxpayer, to commence from the date of filing of the entry upon which the tax was paid. However, a refund should be mandatory and not subject to any such limitation when the taxpayer could conclusively show that an amount of tax had been erroneously paid. In all cases, the administration should be permitted to grant an amount which approximated as closely as possible the taxes erroneously paid.

Certificates of Exemption. Certificates of exemption regarding partly manufactured goods should be of less importance under a retail sales tax, but if they were retained they should be reworded to reflect the exemption provided by the Act, and licensed purchasers should be liable if they provide erroneous or faulty certificates of exemption, with no responsibility placed on the vendor for detecting the error.

In the case of exemption certificates supplied by non-licensed persons, possibly the vendor could be made liable where he had knowledge that the certificate did not support an exemption, or he had information which would reasonably lead to that conclusion.

Under the following subheadings we deal with the general problem of enforcement. Persons who purchase conditionally exempt goods tax free should be required to keep a record of such purchases and be subject to inspection, and the right of inspection in every case should extend to a person's business premises and property where taxable goods may be found. The search and seizure rights should be subject to the same conditions as those we recommend for the Income Tax Act.

Collections. After a notice of intention to assess has been sent, and after the period allowed for appeal, or after the termination of appeal proceedings, the tax payable should be formally assessed; the assessed tax should ipso facto be certifiable in the Exchequer Court as a judgment of that Court. Criminal proceedings should not be utilized for collection for tax purposes, and ministerial discretion to apply the penalties collected against taxes owing should be abolished 4/.

Further study should be made of the problem of loss of revenue caused by the assignment of accounts receivable by licensees, and the write-off policy for transactions taxes should follow the pattern we recommend for the income tax.

Sanctions. The enforcement problem under transactions taxes is, relatively speaking, not difficult, and consequently the stress on sanctions is not as heavy. We feel, however, that where possible the sanction provisions for transactions taxes should follow those we recommend for the income tax, for the sake of uniformity in approach to tax matters.

Excise Act

The above recommendations apply generally to the general transactions taxes. The Excise Act, which levies special charges on liquor and tobacco, is a very different type of statute providing for a unique type of administration.

We commend the Department of National Revenue for the new programme in connection with streamlining procedures, and for decreasing on-the-spot personnel at breweries and distilleries which has been carried out in close co-operation with the manufacturers over the last few years. We recommend that this co-operation should be continued, that wherever possible the administration should streamline its methods, and that in order to assist in this aim the Excise Act should be completely revised at an early date.

Ministerial Discretion. In view of the earlier discussion of the use of ministerial discretion and the safeguards we have suggested for it, there is little need to add further to the subject here. We introduce it again only to reaffirm that the structure of the excise tax administration, which is now an inverted pyramid of a mass of ministerial rulings and regulations resting on a slender base of statute law, must be completely replaced. A statute must be substituted that would set out in definite terms the basis of liability for tax, and would give the taxpayer full rights to contest the application of the law in the courts.

CONCLUSIONS AND RECOMMENDATIONS

GENERAL

1. A Board of Revenue Commissioners should be established as a separate, non-political agency to administer all federal taxes. The Board would report to Parliament through the Minister of Finance, and under individual Commissioners would administer the income and related taxes, the transactions taxes, and the customs tariff. The Board should also hold public hearings on tax problems and on proposed tax regulations.

ON PUBLIC INFORMATION, RULINGS, AND OTHER MATTERS

2. Official information available to taxpayers and the general public on the application of individual taxes should be substantially increased.

3. The Board of Revenue Commissioners should issue a detailed annual report on its performance comparable to those issued in the United States and the United Kingdom.

4. A system of advance rulings should be instituted on a limited basis and should be extended gradually to a wide range of subjects.

5. The transactions taxes legislation should be completely revised to provide a legal basis for the many rulings and regulations now in effect.

ON ADMINISTRATIVE EFFICIENCY
AND ENFORCEMENT

6. Standards of performance with regard to the extent of taxpayer compliance and the internal functions of the tax administration should be established and a programme should be developed to achieve these standards.

7. Direct tax administration should be decentralized, with most functions being performed in District Offices and five new Regional Offices, leaving the Head Office with the duty of general management, control, and policy co-ordination.

8. Staff recruitment and training programmes should be revised and extended, and the remuneration of professional staff in particular be made more competitive, as recommended by the Royal Commission on Government Organization.

9. Audit, enforcement, and collection functions should be strengthened and extended; information returns should be made more comprehensive; corporations should be brought to a current basis for payment of

corporation tax; penalties for tax evasion should be revised; and there should be no hesitation in launching prosecutions when these are warranted on the facts.

STATISTICS

10. Individual income tax returns should be made available to a limited, specifically defined group within the Dominion Bureau of Statistics for statistical purposes.

REFERENCES

1/ Ordinarily government agencies report to a Minister who is then directly responsible for its actions. Independent agencies, such as the Canadian Broadcasting Corporation and the Board of Transport Commissioners, report <u>through</u> a Minister who then is not directly responsible, as it is the agency that is reporting to Parliament.

2/ [1961] Ex. C.R. 318.

3/ [1962] S.C.R. 729.

4/ <u>Excise Tax Act</u>, section 51(2).

CHAPTER 34

TAX ADJUDICATION

In this chapter we discuss the processes of tax adjudication, including the processes of appeal which operate within the tax administration agency, even though in a strict sense the latter are simply a part of the tax collection function rather than of the function of arbitration between taxpayer and tax collector. The internal appeal procedures are the early stages of the total process, and for convenience may appropriately be discussed as part of the general issue of tax adjudication.

In this chapter we recommend a revision of the administrative appeal systems for both income and transactions taxes and the establishment of a new Tax Court to adjudicate on tax appeals.

ADMINISTRATIVE APPEALS

Income Tax

In our opinion the present administrative appeal procedures are not adequate. To expedite tax settlements and avoid overloading the courts, it behooves the taxpayers, their representatives, and the administration to settle their differences without formal recourse to the courts where this can properly be done. We note, however, that the reverse is now happening, as indicated by the steady upward trend in the ratio of Notices of Objection to examined returns resulting in tax increases. This ratio has more than doubled in the past five years, which means that twice as many taxpayers who have differences with the Department of National Revenue are refusing to settle short of Notice of Objection. If this trend continues, the volume of objections may prove overwhelming.

In our opinion, this trend indicates a clear and positive need for a formal administrative appeal procedure prior to the Notice of Objection. We also feel that the administrative appeal procedures after Notice of Objection are not working as well as they might.

Our recommendations are designed to assist the administration and the taxpayer to settle disputed assessments at an early stage without litigation. To this end we recommend that an appeal system should be formally instituted within the income tax administration and that the taxpayer's right of appeal should be made known to him.

We visualize a system having three stages: a pre-assessment conference; a district conference; and a regional conference.

Pre-Assessment Conference. A system of pre-assessment conferences should be created and should be available to the taxpayer in a standardized and formal way in order to establish the facts of the case and clear up any misunderstanding that may exist.

To bring about this conference, the present informal letter of intention to amend the taxpayer's return, sometimes unofficially used by the Division, should become a mandatory part of the administrative appeal procedure, where the proposed amendment is of substance. (Many amendments are trivial and obvious, including changes in arithmetic, minor penalties and so on, which the taxpayer would not challenge.) It should explain the proposed re-assessment to the taxpayer, and give him a limited time, say, fifteen days, in which to request a pre-assessment conference. If a conference is requested, the processing of the assessment should await its outcome. The assessor who made the audit should participate in this conference, together with some other more senior member of the assessing staff, who should decide the dispute. Should fifteen days expire without a request from the taxpayer, the re-assessment would then be processed.

District Conference. We are of the opinion that upon receipt of a re-assessment the taxpayer should have the same right which he now has to file a Notice of Objection. However, when the Notice of Objection is received in the District Office, the taxpayer should be invited to meet the head of the Appeals Section, or his nominee, to seek a just determination of the dispute. To bring this about

we recommend that the Appeals Section should be administratively divorced from the Review Section, and the head of the Appeals Section should report directly to the District Director of Taxation, not to the Chief Assessor. With this done, a district conference should be instituted between the taxpayer and an officer of the Appeals Section, following which it would be the officer's duty to make a recommendation to the District Director as to the disposition of the Notice of Objection. Where District Offices are so small as not to warrant a separate Appeals Section, this function could be concentrated in a centrally located larger District Office.

Regional Conference. We are of the opinion that a taxpayer who is unable to resolve his dispute at the district level should be given a limited period in which to request an appeal at the regional level. In our view, departmental officers should be given wide powers of compromise and settlement similar to those given technical advisers in the Appellate Division in the United States.

We therefore recommend that an Appellate Division at the regional level be instituted, whose officers, subject to the approval of the Regional Director, should have full and final authority to reconsider every Notice of Objection coming before them.

Other Aspects of Administrative Appeals. In our view, both the District Director at the district conference, and the Regional Director at the regional conference, should be empowered to act under section 58(3) of the Income Tax Act, with full authority to vacate, confirm or vary the prior assessment. This same power should be withdrawn from officials at Head Office. This would mean that no dispute would be carried above the regional level. The purpose of Head Office should be to administer the Taxation Division and to control policy; it should not become involved in particular disputes with taxpayers.

The three administrative conferences available to the taxpayer should be optional to him. He would not be compelled to confer with the Department at

each level, or at any level. Nor, in our view, would a conference at the district level be a condition precedent to a conference at the regional level. However, once having taken his case to a certain level he would not be able to seek redress at a lower level.

Transactions Taxes

We have concluded that for transactions taxes, as for the income tax, a more formal system of administrative appeals is desirable and necessary, and we make the following recommendations.

1. A taxpayer should be furnished with a notice of intention to assess taxes, with written reasons for the proposed assessment. Such notice should inform the taxpayer of his rights of appeal, both administrative and judicial, and that if he does not file an appeal within a certain period, an assessment of tax liability will follow.

2. An administrative appeal procedure such as that proposed for income tax should be adopted, with whatever revisions are necessary for application to the transactions taxes.

JUDICIAL APPEALS

If the main proposal for a new Tax Court we make below is adopted, the present Tax Appeal Board and Tariff Board would be absorbed into it and disappear as separate entities. If a Tax Court is not introduced, there are some changes in the existing arrangements which we feel should be made.

We have not examined in detail the operations of the Tariff Board, but because of its appellate jurisdiction we make one or two comments. It seems to us, for one thing, that it is inappropriate to give the same entity responsibility for making major recommendations for tariff changes, and later to hear appeals against laws based on these recommendations. It appears to us that the reference and judicial functions of the Board should be separated.

There is the further consideration that, no matter what other changes are made, a judicial appeal system must be established under a completely revised act for transactions taxes. If the Tax Court is not to be given jurisdiction over appeals in this area, a new Appeal Board for Transactions Taxes should be established, and should resemble the existing Tax Appeal Board in composition, jurisdiction and operation.

As regards the Tax Appeal Board, should it remain in being as such, we recommend that it should be removed from its close association with the Minister of National Revenue, possibly to come under the Department of Justice. We feel that several steps should be taken to enhance the prestige of the Board, including granting its members the title, distinction and tenure of judges, enabling it to publish its own decisions, giving it sole original jurisdiction in appeals under the statutes assigned to it, including that now conferred on the Exchequer Court under section 138 of the Income Tax Act (should that section remain in the Act). Provision should be made for discovery of documents and examination for discovery before the Board. To expedite the work of the Board, we also recommend that research assistance for its members should be expanded and that, where possible, oral judgments should be delivered.

A New Tax Court

While these and similar changes would effect needed improvements, we are persuaded that the best arrangement that could be proposed, and one which would match our recommendation for a unified Board of Revenue Commissioners, would be the creation of a single Tax Court or Revenue Court which would be a court of record. We believe that such a Court should be created regardless of any other future changes which might come to pass in the administration of the tax laws. We feel that this Court would greatly strengthen the present revenue appeal procedure, and should provide more adequate and more firmly based facilities for appeal for those subject to tax laws and revenue collection. In our view this Court should combine the functions now performed

by the Tax Appeal Board and the Tariff Board, except that the reference function of the latter should be given to the proposed Board of Revenue Commissioners.

It appears to us that the Tax Court should comprise at least two if not three divisions, each division having sufficient members to carry out its responsibilities with reasonable dispatch. The three suggested divisions are: the Income Tax Court, the Transactions Tax Court (sales, excise taxes and excise duty) and the Customs Tariff Court. Each of these divisions would have original jurisdiction in its respective area. We concede the possibility that the excise and customs cases might be handled by one division, but this is a matter for further study. In our opinion the members of the Court should be lawyers, but it would be highly desirable to draw on the experience of other specialists, as assistants to the Court.

We further recommend that the Court should have power to make its own rules of procedure, that the right of examination for discovery should be afforded all parties, that the divisions of the Court should be itinerant and that a regular assize should be arranged to be promulgated under rules of the Court, that important decisions should be published, that no legal costs should be awarded the winning parties, that the onus of proof should be on the appellant, that hearings may be held in camera if the appellant so requests or the Court so determines, that the Court should proceed with hearings and decisions with all possible expedition and that oral judgments should be given where possible.

The Exchequer Court

We have concluded that Canada does not require more than one court of original jurisdiction in tax matters. In our view original jurisdiction should therefore rest entirely in the new Tax Court. We deplore the appeal by trial de novo, for it constitutes unnecessary duplication. Therefore, we would leave the Exchequer Court only its appellate jurisdiction in tax

cases. Although the Exchequer Court is primarily a trial court, we see no reason why it should not also sit as an appeal court, to hear appeals in tax matters. In such cases, at least three judges should sit together, and, as is customary in a court of appeal, should determine the matter on the basis of the record of evidence before the Tax Court.

The Supreme Court

We have no recommendation regarding appeals to the Supreme Court except to suggest that when the Minister (or the Board of Revenue Commissioners) appeals to the Supreme Court in a case where the amount involved is less than one thousand dollars an ex gratia payment should be made to the taxpayer sufficient to cover his costs.

Lawyers Employed by the Department

Departmental lawyers, or lawyers from the Department of Justice, travel across Canada to appear as legal counsel before the present Tax Appeal Board or the Exchequer Court, and we understand that as a general rule they have limited opportunity to prepare their cases or seek settlement negotiations with a taxpayer's counsel. Undoubtedly, some legal officers will always be required at Head Office. Nevertheless, those counsel engaged in trial practice before the Board or a court in our opinion should be based in the area where the taxpayer lives and carries on his business. Legal offices have recently been added to the staff of the Toronto District Office, and we recommend that the authorities particularly consider whether legal offices located in all recommended regional offices throughout Canada would not be more advantageous than the present centralization.

CONCLUSIONS AND RECOMMENDATIONS

1. To deal with disputed income tax assessments, a decentralized system of administrative hearings should be established, including a pre-assessment conference, a district conference and a regional conference, and a

taxpayer should have the right to each of these conferences before taking his case to the courts.

2. In the administration of the transactions taxes, a formal system of assessment and appeal from assessment should be established, with administrative hearings similar to those for income tax.

3. A new Tax Court should be established to comprise two or possibly three divisions, namely, an Income Tax Court, a Transactions Tax Court, and possibly a Customs Tariff Court. The Tax Appeal Board and possibly the judicial functions of the Tariff Board should be discontinued. The Tax Court would have original jurisdiction in all federal tax cases and its members would have the status of judges.

4. The Exchequer Court should have an appellate jurisdiction in tax cases.

APPENDIX A

A PRESENTATION OF REGRESSIVENESS UNDER A SALES TAX

The basic statistical concept used in this appendix to measure the regressiveness of a federal sales tax is the estimated amount of dollars spent on taxable goods at given levels of income 1/. We used this concept rather than that of amount of sales tax paid because it is impossible to establish the latter on any representative consumer basis. It is necessary to point out, however, that dollars spent on taxable goods at given levels of income measure the regressiveness of the federal sales tax in a very special sense. We were not able to allow for the effects of the portion of the tax that falls on producer goods, although it is expected that most of these taxes should be shifted (in all or in part) to final goods and services, some taxable and some not.

Expenditure categories are broken into principal components in the report of the Dominion Bureau of Statistics, and their breakdown makes it possible to estimate roughly the percentage of expenditures under each heading for the purchase of taxable goods. These percentages are necessary because the components of expenditure categories are not available for each income group but only for the national average. We then used these percentages to estimate how much was spent by the average family in each income group toward the purchase of taxable goods. Our method therefore assumes that the national average breakdown of each expenditure category is an adequate means of arriving at the corresponding breakdown of each expenditure category at the various income levels.

In other words, we have assumed that the income elasticity of consumption outlays on taxable goods is one. While this is admittedly an

over-simplification, it is a reasonable hypothesis that could only be confirmed with the help of adequate data. It also might prove interesting to point out the implications of our assumption. If the income elasticity of consumption outlays on taxable goods were less than one, that is, as income rises, the percentage change in the consumption of taxable goods would be relatively less than the percentage change in income, the pattern of rates would be more regressive than our estimated results. Alternatively, if the income elasticity were greater than one, the pattern of rates would be less regressive than our estimated results.

An over-simplification has been introduced in applying such percentages to estimated expenditures by income group under the respective assumptions that food and shelter are taxed, that food is exempt but shelter is taxed, and that food and shelter are both exempt (although it should be mentioned that the last of these three assumptions is relatively close to the exemptions in force in 1959). For example, if food and fuel for lighting and heating were taxed, consumption expenditure patterns would change; but as we were unable to measure the extent of the expenditure changes which might be anticipated, we felt compelled to assume an unchanged expenditure pattern from the 1959 distribution.

The results of our calculations are shown in Chart A-1.

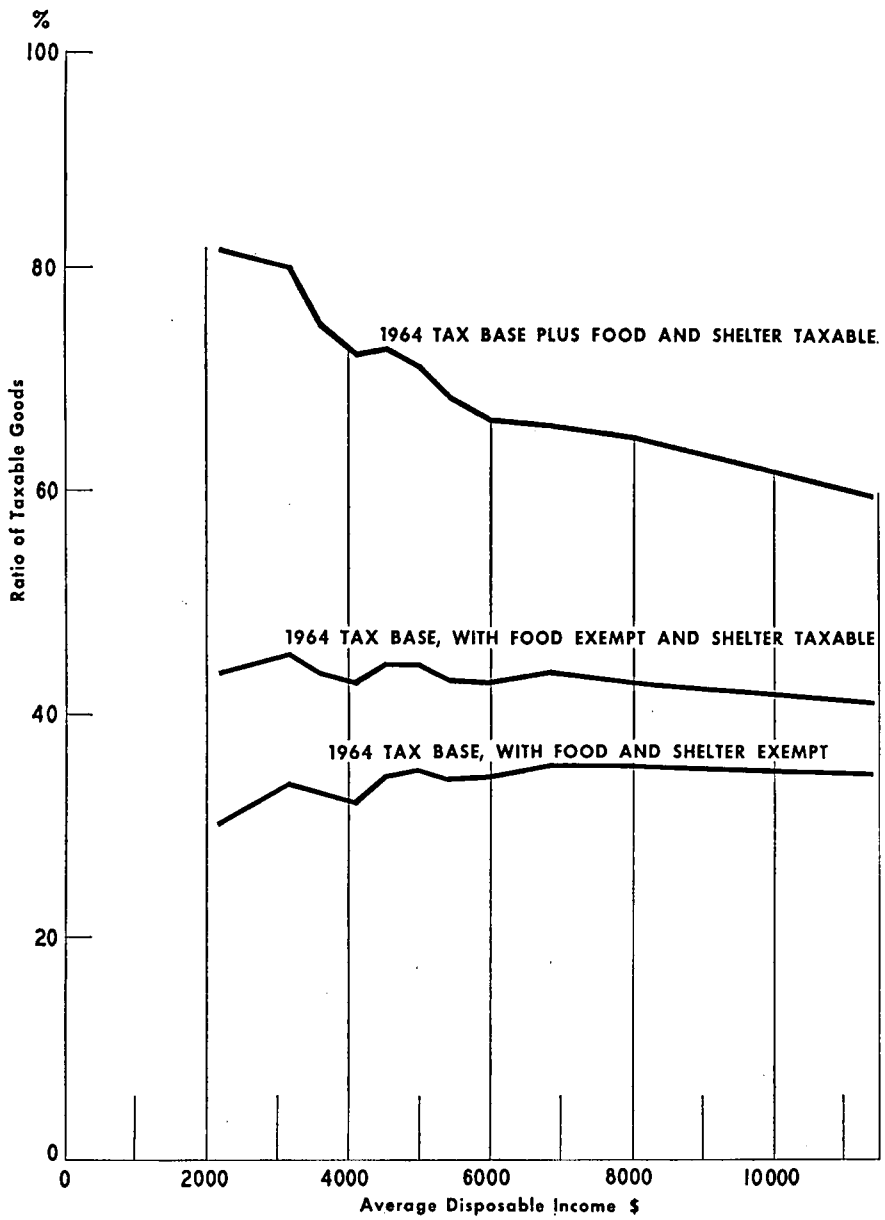
REFERENCE

1/ The statistics of this study have been obtained for the most part from Canada, Dominion Bureau of Statistics, Urban Family Expenditures, 1959, Ottawa: Queen's Printer, 1963. The representative sample used covered 1,672 families in various income groups.

Chart A-1

AVERAGE EXPENDITURES OF CANADIAN URBAN FAMILIES ON TAXABLE GOODS EXPRESSED AS A PERCENTAGE OF THEIR AVERAGE DISPOSABLE INCOME

1959 Statistics



APPENDIX B

SOME ANOMALIES AND AREAS OF ADMINISTRATIVE DIFFICULTY AMONG THE EXISTING SALES TAX EXEMPTIONS FOR CONSUMPTION GOODS UNDER THE PRESENT MANUFACTURER'S SALES TAX

FOODSTUFFS

An exemption which causes the Department of National Revenue considerable difficulty is that for "fruit juices consisting of at least eighty-five per cent of the pure juice of the fruit and concentrates thereof" 1/. Essentially, the difficulty arises because there appear to be no conclusive tests to determine the exact pure juice content of fruit juices. This is because in many instances synthetic ingredients can be used for natural ones and such substitution is not revealed by chemical analysis.

While the Department of National Revenue is able to apply an approximate measure of administrative control over the exemption in the case of fruit juice products which are dealt with under the Regulations to the Food and Drugs Act, 2/ there remains a difficult twilight zone of products. These are products which are not dealt with under the specifications laid down in the Food and Drugs Act Regulations, but may nevertheless qualify for exemption from sales tax because they appear to contain "over 85 per cent of the pure juice of the fruit".

Solutions to the present fruit juice tangle do not include any lowering of the present 85 per cent pure juice demarcation line, partly because that does nothing to resolve the fundamental problem of scientifically measuring pure juice content, and partly because it would create a new "frontier" problem with fruit drinks and soft drinks.

One possible solution is the complete removal of the existing exemption. The cancellation of the present sales tax exemption for fruit juices

consisting of at least 85 per cent of the pure juice of the fruit could hardly be entertained by itself. It would be desirable that the specific exemptions for prune and grape juices be also terminated. In fact such action would be almost imperative because these two juices are made from fruits that are largely imported. They could hardly be allowed to go tax free while juices made from Canadian fruits were taxable. The cancellation of the existing juice exemptions would produce some $3 to $4 million in additional sales tax revenue. The difficulty in this approach, however, is in drawing an equitable tax demarcation line. If fruit juices are made taxable, should not vegetable juices be similarly treated? Should not soups also be taxable?

The alternative solution is to exempt all food, including soft drinks, to avoid inequities of this nature and the many other problems of drawing fine distinctions between kindred products, examples of which will be discussed later. This alternative is clearly preferable with a tax at the retail level, in view of the considerable administrative difficulties that arise if retailers are required to remember product-by-product tax status. Admittedly, administrative problems of product segregation are significantly less when the sales tax is at the manufacturer's level. Discriminatory tax treatment between competing food products should be eliminated, which is best achieved by the widest possible exemption of food products as a category.

Considerable administrative difficulties arise in the drawing of tax demarcation lines between biscuits (exempt), and biscuits which present the physical appearance of chocolate bars or candy bars (taxable); again there are similar difficulties with syrups that may be used to make food beverages (exempt), and with the same syrups that may be used as a topping for sundaes (taxable).

App. B

Examples of this nature strengthen our opinion that the solution to these difficulties lies not in widening the area of taxable foods in order to remove administrative difficulties and direct competitive inequities (and thereby opening up new problem areas), but in exempting the entire category of food.

Before leaving the subject of food, mention must be made of an anomaly which does not create administrative difficulties under a manufacturer's tax but which nevertheless amounts to discrimination of such flagrant character that it cannot be ignored. Butter is exempt from sales tax, but margarine, butter's direct competitor and inexpensive substitute, is taxable in nine of the ten Canadian provinces. Only Newfoundland consumers are allowed to purchase tax-exempt margarine 3/. Hence not only is there discrimination between competing products but there is also discrimination between Canadian consumers, depending on their province of residence. From a neutrality standpoint, it is imperative that both butter and margarine receive the same sales tax treatment.

PRINTED MATERIALS

The sales tax exemptions for books, newspapers, periodicals and various other printed materials are comprehensive but are sufficiently imprecisely worded as to provide potential ground for disagreement between the administration and the taxpayer. The Minister of National Revenue has therefore been armed with the power of ministerial discretion to interpret the more contentious of these exemptions, and to rule without appeal on the eligibility of printed goods for relief; but the administration is apparently reluctant to fall back on this power, as is evidenced by the administrative interpretation of "newspapers", which has become so broad as to allow sheets with the scantiest of news or editorial content to go tax free.

It would be advisable to eliminate ministerial discretion and to provide the administration with sales tax exemptions for printed materials of a less ambiguous or imprecise character.

There is at present a sales tax exemption for "books, bound and unbound, pamphlets, booklets, leaflets, scripture, prayer, hymn and mass cards, and religious mottoes and pictures unframed, for the promotion of religion...." The wording requires officials of the Department of National Revenue to determine whether the above-named articles are "for the promotion of religion", which can be a rather subjective concept. Although, in this age of religious tolerance, officials can be expected to be fairly broadminded on this score, their role is not that of religious experts but of tax administrators and they should not have to decide issues of this nature. This exemption embraces only a portion of goods which are purchased for the promotion of religion. Subject to the qualification which has been introduced regarding books, there is no adequate justification for a selective exemption for the general category of religious goods on the grounds of regressiveness, misfortune, administrative ease or on any other grounds. Accordingly, they should be taxed.

There is also at present a sales tax exemption for "printed books that contain no advertising and are solely for educational, technical, cultural or literary purposes...." There is no need to make an exemption appear so rigid when in fact it can actually cover almost any book that contains no advertising.

The exemption for "National manufacturing, industrial or mercantile trade directories, and materials to be used exclusively in the manufacture thereof, but excluding all other directories, and excluding statistical, financial or biographical surveys, reports, year books or directories, and

transportation, telephone, municipal or street directories, guides or rate books", does not appear to be supportable. Basic equity would warrant the withdrawal of such exemption.

DRUGS

Existing sales tax legislation does not provide a general exemption for drugs. However, the following medicinal products are specifically exempt from sales tax: adrenocorticotrophin, cortisone, insulin, radium, liver extract for use exclusively in the treatment of anaemia, and vaccine for use in the prevention of poliomyelitis. No attempt is made here to discuss the adequacy of these exemptions. Attention instead will be directed to the study of an anomalous situation involving the sales tax exemption for cortisone.

Cortisone was the earliest adrenal corticosteroid to appear on the market, and it was made exempt from sales tax in 1951. Since then, however, many products have followed which are improvements upon cortisone and which are often directly derived from it. These new products are also of the adrenal corticosteroid variety but do not benefit from sales tax exemption. The main obstacle in the path of a general sales tax exemption for all adrenal corticosteroids has been that such exemption would have covered an impressive array of drugs (more than twenty) some of which are used to treat diseases in animals. In view of the existing policy not to provide a general exemption for drugs for human consumption, it would have been difficult to justify relief for drugs used in the treatment of animals.

The present discrimination between adrenal corticosteroids, and indeed between all the drugs for which exemption is provided in the Act and equally important drugs for which no exemption is provided, is without apparent satisfactory justification.

REFERENCES

1/ See Excise Tax Act (R.S.C. 1952, Chapter 100 as amended), Schedule III under the heading "Foodstuffs". The original exemption for fruit juice enacted in 1948 required that the exempt products consist of at least 95 per cent of the pure juice of the fruit. This requirement was lowered to 85 per cent in 1958.

2/ Statutory Orders and Regulations Consolidation, 1955, P.C. 1954-1915, as amended, promulgated pursuant to the provisions of the Food and Drugs Act, S.C. 1952-53, Chapter 38, as amended.

3/ Newfoundland was allowed a sales tax exemption for margarine for consumption within the province at the time it entered Confederation in 1949.

APPENDIX C

PERSONAL CONSUMPTION OF SERVICES IN CANADA, 1962 1/

NAME OF SERVICE		CONSUMER EXPENDITURE
A. Personal Services		
Laundry, Dry Cleaning and Dyeing	$210,491,000	
Dressmaking and Tailoring	22,051,000	
Shoe Repair	26,842,000	
Jewellery Repair and Engraving	14,717,000	
Coin-Operated Laundries and Dry Cleaning	25,000,000	
Total Personal Services		$299,101,000
B. Personal Care		
Barbers and Beauty Parlours	184,161,000	
Miscellaneous Personal Services	40,128,000	
Total Personal Care		$224,289,000
C. Transportation - User-Operated		
Auto Repairs and Maintenance	244,408,000	
Automobile Insurance	85,000,000	
Bridge, Tunnel and Ferry Tolls	10,416,000	
Total Transportation - User-Operated		$339,824,000
D. Transportation - Purchased		
Steam Railways	35,719,000	
Electric Railways and Buses	186,857,000	
Civil Air Carriers	120,780,000	
Steamship Fares	13,561,000	
Taxicabs	77,000,000	
Total Transportation - Purchased		$433,917,000
E. Recreation		
Service Portion of Meals and Liquor 2/	213,300,000	
Other	434,700,000	
Total Recreation		$648,000,000

NAME OF SERVICE		CONSUMER EXPENDITURE
F. Medical Care and Death Expenses		
Physicians and Surgeons	$310,300,000	
Dentists	125,300,000	
Private Duty Nurses	20,600,000	
Miscellaneous Health Services	87,600,000	
Hospitals	942,800,000	
Accident and Sickness Insurance	65,000,000	
Prepaid Medical Care	11,400,000	
Funeral and Burial Expenses	37,000,000	
Cemeteries and Crematoria	12,315,000	
Less: Workmen's Compensation Board	-39,000,000	
Compensation, Steam Railways	-6,300,000	
Total Medical Care and Death Expenses		$1,567,015,000
G. Household Operations and Utilities		
Water 2/	56,500,000	
Janitorial Service	28,200,000	
Furniture and Appliance Rental	20,000,000	
House Maintenance Repairs	46,200,000	
Telephone	353,100,000	
Domestic Service - Cash	123,400,000	
Domestic Service - In Kind (paid for in food and shelter)	65,400,000	
Moving Expenses	19,000,000	
Household Repairs:		
1. Upholstery	10,586,000	
2. Radio and Appliances	32,510,000	
Personal Property Insurance	27,500,000	
Theft Insurance	1,400,000	
Total Household Operations, etc.		$783,796,000
H. Education		
University Fees	166,600,000	
Private Schools	37,900,000	
Other Private Institutions	30,100,000	
Total Education		$234,600,000
I. Shelter		
Rents - Paid	1,079,400,000	
Rents - Imputed	2,611,700,000	
Board and Lodging	204,300,000	
Imputed Lodging, N.E.S.	39,100,000	
Lodging in Universities (40%)	8,000,000	
Total Shelter		$3,942,500,000

NAME OF SERVICE	CONSUMER EXPENDITURE	
J. Miscellaneous		
Financial Charges 3/	$593,300,000	
Stock and Bond Commissions	47,740,000	
Expenses of Insurance Companies	318,700,000	
Lawyers	83,700,000	
Union Dues - Cost of Administration	21,750,000	
Charitable Institutions:		
1. Welfare	37,730,000	
2. Religious and Miscellaneous	89,000,000	
Hotel Rooms 4/	49,971,000	
Cables and Telegrams	12,000,000	
Express	6,492,000	
Postage	54,174,000	
Miscellaneous	25,789,000	
Total Miscellaneous Services		$1,340,346,000
Total Consumer Expenditure in Canada		$9,813,388,000

REFERENCES

1/ Derived from unpublished material made available by the Dominion Bureau of Statistics. The references following are not those of the Dominion Bureau of Statistics.

2/ We regard these items as deliveries of goods rather than renditions of services.

3/ Includes such matters as bank charges—actual and imputed; interest charges for finance companies, etc.

4/ This figure represents only part of the transient-accommodation expenditure by consumers. There are no available figures for consumer expenditure on motels, tourist homes, etc.

APPENDIX D

A TAX ON SERVICES COUPLED WITH TAXES AT LEVELS OTHER THAN RETAIL

A TAX ON SERVICES COUPLED WITH A WHOLESALE TAX ON TANGIBLE PERSONAL PROPERTY

Economic Considerations

If services to all entrepreneurs are exempt, and if a uniform rate is applied to services and deliveries, a discrimination would exist against suppliers and consumers of services. This could be serious for suppliers who custom fabricate or rent tangible personal property, for they compete directly with wholesalers and retailers of the same property.

The weight of the discrimination in any particular case would tend to be the amount obtained by multiplying the tax rate by the retail mark-up (the sum not taxable under the wholesale tax).

It can be clearly seen that the discrimination would vary with each mode of distribution of any particular item of tangible personal property. Thus, any attempt to eliminate the discriminations completely would be destined for failure; only an arbitrary reduction in the discriminations could be achieved.

Alternatively, if the single-stage effect in the taxation of services is attained by exempting services only when they are purchased by firms that are licensed and account for tax on their sales, there would be an incentive for unlicensed firms to have these services performed by employees rather than by outsiders; this would be far more significant with a wholesale tax than with a retail tax, because under a wholesale tax the entire class of retailers would be subject to tax on their outside purchases of services.

Administrative Considerations

First, it would be exceedingly difficult to achieve effectively and efficiently the single-stage effect by exempting services to all entrepreneurs. For the suspension technique to function effectively, persons who are to receive exempt services should be registered, and in receiving services, they should be required to quote their registration numbers and/or grant exemption certificates. Most retailers would not be registered under a wholesale tax; they could therefore only issue exemption certificates. The granting of exemption certificates by persons who would not be registered would be very difficult to police, and as a result there could be evasion on the part of service entrepreneurs. Moreover, if it was necessary to police the granting of exemption certificates by retailers, it would seem rather unusual not to have the tax on goods at the retail level.

Second, if the single-stage effect was to be achieved by exempting services when they became cost factors in taxable deliveries and/or services, the incentive to integration could, as we have stated, be extensive, given a high enough rate. To eliminate this incentive by taxing self-services of entrepreneurs, in these circumstances, could be difficult and costly.

Third, since rates on goods and services might well be different (to reduce the incentive for integration of services and reduce discrimination, services might be taxed at a lower rate), persons who transact in both goods and services would have a heavy burden in differentiating between them, and in keeping separate records for them.

Revenue Considerations

The revenue yielded under this structure for a given rate would be less than under a tax on services coupled with a retail tax.

A TAX ON SERVICES COUPLED WITH A MANUFACTURER'S TAX ON TANGIBLE PERSONAL PROPERTY

Similar comments may be made on the essential economic, administrative and revenue characteristics as are made above with respect to a wholesale tax; however, because under the manufacturer's tax wholesalers may be outside the licensing framework and thus there are more non-taxable entrepreneurs, the economic discriminations and incentives to integration would be greater, and possibly the administration would be more burdensome.

In addition, it should be recognized that the administrative ease of collection through dealing with a small number of taxpayers, which is the main advantage of the manufacturer's sales tax, would be lost if services were taxed.

CONCLUSIONS

In comparing the three alternative tax levels with which a tax on services may be integrated, there emerge the following conclusions.

1. If it is desired to tax services on a single-stage basis, this may be best accomplished, on balance, by taxing services in conjunction with a retail tax on tangible personal property.

2. It would not be desirable to tax services on a single-stage basis if their taxation is to be conjoined with a wholesale or manufacturer's tax, although it would be possible to tax a restricted list of services.

APPENDIX E

AN EXAMINATION OF THE APPLICATION OF THE PRESENT TAX TO PRODUCER GOODS

GENERAL COMMENTS ON THE TAXATION OF PRODUCER GOODS UNDER SALES TAX AT THE MANUFACTURING AND WHOLESALE LEVELS

Producer goods are divided into three broad categories.

1. Raw materials and partly manufactured goods.

   There is little doubt as to the need to continue to exempt these.

2. Producer capital goods used in manufacture or production, but not in distribution.

We recommend the exemption of these production goods. This recommendation is valid for taxes at all levels. Further comment on this category follows in this appendix.

3. Producer capital goods used in the distribution of goods and in the performance of services. In this category are included producer goods used:

   a) in the distribution of other producer goods (e.g., raw materials and partly manufactured goods) and in the performance of services for taxable persons (i.e., licensees);

   b) in the distribution of fully manufactured goods for personal consumption;

   c) in the performance of consumer services.

The ramifications of taxing (or exempting) this category of producer goods are different in some respects under a sales tax at the manufacturing or wholesale levels than at the retail level.

With a tax at the manufacturer's level the taxing of the last two groups of goods (i.e., 3(b) and 3(c)) is not subject to "cascading" of tax; indeed, it offers an inexpensive, although imprecise method of partially taxing distributors' mark-ups 1/. It also offers an inexpensive method of partially taxing the personal consumption of services where other methods are more costly. Furthermore, the taxing of these goods, particularly when sold to non-taxable persons (i.e., persons who do not have sales tax licences and are not audited by Department of National Revenue officials—for example, retailers) avoids substantial problems of diversion to consumption use. Compared with the taxation of goods used in the manufacturing or production process proper (i.e., categories 1 and 2 above), international competitive inequities are much less significant because most exports are made directly by manufacturers and producers, and do not penetrate far into the Canadian distribution channel, while imports converge with domestic products in Canadian distribution.

By contrast, with a tax at the manufacturer's level, the taxing of group 3(a) above (equipment used in the distribution of other producer goods and in the performance of services for taxable persons) does involve a limited amount of tax "cascading" and does result in international competitive inequities. Most of the items in this group (transportation vehicles and fuel, office equipment and supplies) are of a multipurpose nature; firms engaged in distribution activities and using equipment for this purpose do not generally confine the equipment to group 3(a) use.

With a tax at the manufacturer's level, there is no strong argument for a change in the present tax status of the above category of distribution equipment. The administrative separation of group 3(a) from groups 3(b) and 3(c) is not generally feasible, and on balance there is no adequate justification to exempt all three groups.

With a tax at the wholesale level, under which all or most consumer services are not taxed, it would probably be feasible to administer an exemption for warehouse and office equipment purchased by manufacturers and wholesalers, notwithstanding the difficulties which would arise where wholesalers also engage in retailing activities. An exemption for transportation equipment, however, would go well beyond the elimination of double taxation; any attempt to develop a selective exemption (except for certain "direct" production equipment) would be impractical in view of the multipurpose use of so much of this equipment.

Further comments will be largely confined to category 2 (capital goods used in production). The taxation of category 1 (raw materials and partly manufactured goods) would be tantamount to the imposition of a form of "cascade" or turn-over tax, with all the serious defects of that form of tax; further supporting argument for exemption of this category is not in our opinion necessary. The taxation of category 2 (production goods) does entail significant "tax-on-tax" and considerations of international competition.

The following paragraphs are devoted to a category-by-category review of the sales tax application to production goods following the significant changes in the 1963 Budget. Little will be said about materials and other ingredients that become part of final products because few problems arise when these intermediate goods are exempt from sales tax. For federal sales tax purposes, licensed manufacturers who account for the overwhelming portion of the total production of taxable commodities are allowed to purchase the materials that they process or the goods that enter into the composition of their final products on a tax-exempt basis. As stated earlier, these goods should remain exempt. This exemption operates through a certification procedure which appears to meet with little criticism. The

present exemption for materials to be used in the manufacture of tax-exempt goods is justifiable, partly to give full effect to certain consumption goods exemptions, and partly to avoid an uneven tax burden, both between competing domestic products and between domestic and imported products. As with materials for use in the manufacture of taxable goods, there seems to be a general satisfaction with the administration of this exemption.

PRODUCTION MACHINERY AND APPARATUS

It has been said that the taxing of production machinery and apparatus impairs our international competitive potential and has a disincentive effect on the expansion, mechanization and modernization of production facilities. Notwithstanding these considerations, we have conceded in a number of instances that exemption of some categories of production goods is not administratively feasible. However, an examination of the administration of the production machinery and apparatus exemption before it was withdrawn in 1963 reveals that it presented relatively few obstacles in terms of certainty, clarity and simplicity. The exemption was administered with flexibility and intelligence by the Department of National Revenue and, had the policy and decisions of that Department been far more widely publicized to taxpayers, it is probable that there would have been fewer complaints from taxpayers about the administration of the exemption.

Accordingly, it would be desirable that the budget exemption withdrawn in 1963 should be reinstated, including the additional items 2/ that were listed under the machinery and apparatus provision, but with the exception of the item:

> "Structures that are adjuncts to or provide access to the machinery and apparatus mentioned herein."

The inclusion of this particular provision should depend on the tax status of building materials for use as production goods.

While exemption is preferable to refund or repayment of sales tax as the method of relieving purchases of production machinery and apparatus, the latter method may be the least unsatisfactory means of controlling sales tax relief in certain administratively difficult areas, for example, pipes, valves and fittings, and electric wire, cable and fittings. If the refund method is used it would be desirable that its use be condoned by a statutory provision to that effect (somewhat comparable to that existing for purchases by certain institutions).

Ministerial discretion should be eliminated from the exemption. Differences of opinion between taxpayers and tax officials on matters relating to sales tax exemptions are essentially technical in nature and should be settled by an independent third party, preferably the judiciary. If this amendment were made, it would be advisable to insert the words "principally and" before the word "directly" in the exemption for the purpose of closing a possible loophole which at present is controlled by ministerial discretion.

PROCESSING MATERIALS (CONSUMABLE OR EXPENDABLE MATERIALS)

The general sales tax exemption for processing materials that appears in Schedule III of the Excise Tax Act is in the following terms:

> "Materials (not including grease, lubricating oils or fuel for use in internal combustion engines) consumed or expended directly in the process of manufacture or production of goods."

Before proceeding, it should be noted that, under the above heading, we do not propose here to examine the application of sales tax to grease, lubricating oils or fuel for use in internal combustion engines.

The scope of this exemption has become important to manufacturers since the withdrawal of the sales tax exemption for machinery and apparatus used directly in the process of manufacture or production of goods. Before June 1963, there was no need to draw a tax demarcation line between processing materials and articles, that is, machinery and apparatus or complete parts thereof used in production, but this is no longer the case. Manufacturers are now vitally interested in having articles expended in the process of production ruled to be processing materials and declared exempt from sales tax. Officials of the Department of National Revenue have been under constant pressure since the 1963 Budget to recognize such articles as exempt processing materials.

It is clear that the segregation for tax purposes of production machinery and apparatus (and complete parts thereof) from processing materials has confronted the taxpayer and the Department of National Revenue with an administratively difficult "twilight zone" consisting of goods which occupy a middle ground between the two categories. Because of the administrative complexity and uncertainty which have arisen, because of the numerous inequities, and because both categories of goods have a common function, namely, that of being used directly in the manufacture or production of goods, which is not always readily divisible into two separate tax interpretation compartments, both these categories of production goods should be similarly treated for sales tax purposes.

FUELS USED IN PRODUCTION; GREASE AND LUBRICATING OILS

The existing sales tax legislation provides an exemption for fuel for lighting or heating, but not for fuel used in internal combustion engines. The exemption is intended to counter in part the regressiveness of a general sales tax, and exemption applies regardless of whether such fuel is

used for production or consumption purposes. The same can also be said of electricity, which is exempt for all uses.

However, in the area of fuels for internal combustion engines, that is, fuels used as a source of motive power, the situation becomes rather complicated. Fuels for use in internal combustion engines are not exempt when serving a consumption function. Because of the near-impossibility of ascertaining the end-use of fuels for internal combustion engines, they are also taxable when used as production goods. There are, however, exceptions to this rule. Petroleum products and lubricants purchased as ships' stores by bona fide commercial fishermen are exempt from sales tax when the duration of the voyage is not less than five days. Relief is obtained by way of refund, under section 46(3), of the Excise Tax Act or by way of drawback, under section 46(7), depending upon circumstances. This provision in practice discriminates in favour of the better equipped fishermen who have vessels capable of going to sea for periods of five days or more. It might be questioned whether this should be allowed, but because of a combination of international and administrative considerations, it is advisable that it be retained. More obvious examples of preferential treatment, however, are evidenced by the sales tax concessions extended to certain fuels used in internal combustion engines for certain specified purposes in logging and mining operations. The relevant statutory exemptions are:

> "Diesel fuel oil when used in internal combustion engines used in logging operations and in the manufacture of rough lumber."

> "Diesel fuel oil when used in internal combustion engines at mines to generate electricity for use in mining operations and other purposes connected therewith."

The above exemptions are discriminatory on two grounds: (a) they provide partial relief from tax for the diesel fuel oil used in internal com-

bustion engines by logging and mining concerns while the same fuel used in comparable situations by firms in other sectors of production is fully taxable, and (b) they provide freedom from tax for one fuel used in internal combustion engines in specified circumstances while other motive fuels used in similar circumstances remain taxable.

In view of the administrative difficulties associated with an exemption for fuels for use in internal combustion engines, it is best that except in the case of certain fishing vessels they should not be allowed exemption from sales tax; the present preferential treatment allowed to logging firms and to mines should be withdrawn.

In view of the substantial administrative difficulties which would accompany any provision for exemption of grease and lubricating oils in the "Processing Materials" exemption on a conditional basis, and in view of their wide consumption use, no change should be made in their present taxable status.

TRANSPORTATION EQUIPMENT, OFFICE EQUIPMENT AND OTHER EQUIPMENT USED IN DISTRIBUTION

Prior to the 1963 Budget, a general tax demarcation line was drawn between transportation equipment used directly in manufacturing or production, and transportation equipment used in distribution. Accordingly, a fork-lift truck used in material handling within a plant was exempt, but a similar truck used in loading freight cars (and, of course, the freight cars themselves) was taxable. With the elimination of the production machinery exemption, all such equipment became taxable. The only categories of transportation equipment remaining exempt are certain ships, fishing boats, and certain farm equipment (farm tractors, wagons and sleds and certain self-propelled, self-unloading forage wagons).

Under a manufacturer's tax, an exemption for transportation equipment presents a number of administrative problems. By definition, this kind of equipment is mobile, and it may be used for a very wide range of functions, both for production and for distribution, and in some cases both for moving goods and for moving people. While an overhead crane in a factory may be highly specific in its function, a railway locomotive may be used within the factory premises, for moving partly manufactured goods between factories, for distributing fully manufactured goods, or for passenger service.

Thus, to exempt all transportation equipment for the purpose of ensuring that production use is tax-exempt would appear to be unsatisfactory from the point of view of revenue. To exempt transportation equipment used for inward freight to manufacturers or producers is impractical because of the multipurpose use of most such transportation equipment; to exempt transportation equipment used by licensed manufacturers for shipment of finished products would be impractical for the same reasons, and would furthermore discriminate against the use of similar equipment for similar purposes by distributors and wholesalers.

Accordingly, equipment used to transport goods to and from the site of production and between distant sites of production should be taxed. Transportation equipment used principally and directly in the manufacture or production of goods should be allowed the same tax status as any other production machinery and apparatus, with the exception of motor vehicles. Motor vehicles are capable of so many uses that effective administration of such an exemption would be most difficult. However, in certain cases, it may be possible to provide for specific exceptions to this rule where the revenue may be adequately safeguarded, as, for example, was the case before the 1963 Budget with gasoline-powered and diesel-powered self-propelled trucks for off-highway use exclusively at mines and quarries.

For two principal reasons, office furniture, equipment and supplies purchased by manufacturers or producers should not be exempt as production goods: (a) the danger of abuse through the diversion from tax-exempt use to taxable use, and (b) the difficulty of drawing a practical demarcation line between production and distribution use. Furthermore, the effects of the taxation of these goods on prices are likely to be relatively insignificant.

Under a tax at the wholesale level it would probably be feasible to broaden the scope of exemption to include warehouse and office equipment (not including furniture) purchased by manufacturers and wholesalers. The exemption should not, however, be further extended to include transportation equipment.

Canadian ships compete directly with foreign vessels, particularly in Canada-United States trade. The Excise Tax Act provides an exemption for "ships licensed to engage in the Canadian coasting trade". This exemption obviates the necessity for administering an exemption for Canadian ships that engage in international trade. Most vessels engaged in the Canadian coasting trade also make periodic appearances in United States ports on the Great Lakes and on the eastern and western seaboards. When so doing, they compete against comparable United States vessels for the international shipping trade between Canada and the United States. To protect their competitive position, a sales tax exemption is probably justifiable under a tax at any level. However, even though most Canadian commercial vessels also engage in Canada-United States trade, there are still some that confine themselves entirely to territorial waters. It would be administratively difficult to draw an effective demarcation line at the time the ship is delivered by the builder, and much simpler to tax only those vessels that are not licensed to engage in Canadian coasting

trade, i.e., pleasure craft and naval ships. Furthermore, it should be noted that British registered ships are also permitted to engage in the Canadian coasting trade, that is, to pick up and discharge in Canada. Accordingly, to tax vessels engaged exclusively in the Canadian coasting trade would, in equity, require comparable tax treatment of British registered vessels engaged in this pursuit. No change has therefore been recommended in the current statutory provision.

EQUIPMENT USED BY FARMERS AND FISHERMEN

The numerous sales tax exemptions of production goods for use in farming or fishing that have effectively set the bulk of these commodities in a special tax-free category since the early history of the federal sales tax were not disturbed by the 1963 Budget, except for building materials. Machinery or equipment, the use of which is obviously restricted to farming or fishing operations, is generally exempt from sales tax. In addition, there are also several items the use of which is not restricted to farming or fishing which are not taxable when purchased by bona fide farmers or commercial fishermen.

The sales tax exemptions for farm machinery and equipment are found under the headings "Farm and Forest" and "Goods Enumerated in Customs Tariff Items" in Schedule III of the Excise Tax Act.

The sales tax exemptions for the production goods used by commercial fishermen are listed under the heading "Marine and Fisheries" and "Goods Enumerated in Customs Tariff Items" of Schedule III of the Excise Tax Act. As is the case with farm machinery and equipment, these exemptions have a long history, and are fairly comprehensive, with the result that there are few articles serving a production function in the commercial fisheries that are not exempt from sales tax.

Conditional Exemptions for Equipment

Administrative problems pertaining to production goods used in farming or fishing came to light during discussions with officials of the Department of National Revenue. Conditional tax exemptions for certain of these goods are provided in the tariff items of Schedule III of the Excise Tax Act, and it often happens that the administration of these exemptions is governed more by traditional customs practices than by those developed by excise tax officials for the administration of end-use exemptions on sales by domestic manufacturers and producers. While customs officials may allow certain items of farming or fishing equipment to enter Canada tax free upon importation by wholesalers or distributors if the importer submits evidence that the goods will be used under exempt conditions, the traditional excise procedure with conditional exemptions is to require the payment of tax upon a sale by a Canadian manufacturer to an unlicensed merchant, who may then claim a refund of tax upon proof of sale to an exempt user. In such situations, uniformity in the administration of conditional exemptions should be attained by allowing procedures developed by the excise tax administration governing conditional exemptions to prevail. To this end the statutory basis for such exemptions should be transferred from the customs tariff items to separately worded provisions in Schedule III of the Excise Tax Act. (Under a wholesale tax and even more so under a retail tax, this lack of uniformity in administration is unlikely to be a problem as a result of the broader licensing and control of entrepreneurs by the sales tax administration.)

Parts for Unconditionally Exempt Equipment

A further administrative difficulty arises in connection with those parts for farm equipment for which unconditional exemption is provided in

customs tariff items. These items of farm equipment require no end-use certification in order to qualify for exemption, and many of these exemptions are easy to administer because the equipment is highly specific in function; but the additional provision of exemption in these tariff items for parts for such equipment can give rise to considerable difficulties for excise officials. Many such parts are of a multipurpose nature because they may be used for either farm or non-farm use, and without the protection of an end-use provision adequate safeguarding of the revenue is not possible. In the case of parts for which a conditional exemption would permit adequate safeguarding of the revenue, the relevant exemption should be so provided in separately itemized provisions in Schedule III and in a similar manner to that suggested in the previous paragraph. However, where parts for farm equipment, even when for use by farmers, are of such a multipurpose nature that adequate safeguarding of the revenue is not possible, exemption should be withdrawn completely.

COVERINGS AND CONTAINERS FOR TAX-EXEMPT GOODS

In this section, we examine an exemption for a category of production goods which has no multiple taxation ramifications. Its purpose is to eliminate a tax element in the selling price of tax-exempt goods.

Prior to the 1960 amendment, the exemption for coverings for exempt goods had remained fundamentally unchanged since the early 1930's, that is:

> "Usual coverings to be used exclusively for covering goods not subject to the consumption or sales tax and materials to be used exclusively in the manufacture of such coverings."

The 1960 amendment read:

> "Usual coverings or usual containers to be used exclusively for covering or containing goods not subject to the consumption or sales tax but not including coverings or containers designed for dispensing goods for sale or designed for repeated use other than

a) barrels, boxes, baskets, crates and bags for packaging fruits and vegetables,

b) boxes and crates for eggs,

c) butter and cheese boxes,

d) cans and insulated bags for ice cream,

e) corrugated paper boxes for bread,

f) flour bags,

g) milk and cream bottles, milk and cream cans;

and materials to be used exclusively in the manufacture of the foregoing coverings and containers not subject to consumption or sales tax."

This endeavoured to remove from tax-exempt status usual coverings or containers used repeatedly in the transportation of exempt commodities and usual coverings or containers used mainly for the purpose of dispensing goods for sale; specifically excused from this contraction of the old exemption were usual coverings or containers for vegetables, fruits, eggs, butter, cheese, flour, bread, ice cream, milk and cream.

The intention of the original 1960 Budget had been to hold a position where only those coverings and containers delivered and sold to the user with their tax-exempt content would have been free of sales tax. It was not long, however, before this approach was modified. The exemption, as finally enacted, paraphrased the same basic principle in its first part, but proceeded to breach it in its second part through the provision of unqualified relief for the coverings or containers of the above-named foodstuffs. Not surprisingly, there followed representations from manufacturers of competing coverings or containers and from processors of other food products for the same kind of preferred tax treatment. Thus, in 1961, milk and cream plastic bags were made exempt. In 1962, drums and cahs for honey, barrels and boxes for fish, lobster crates and scallop bags

were added to the exempt list. Representations continue to be made each year for a progressive widening of the area of exemption.

It appears equitable that if it is government policy to exempt certain consumption goods from sales tax, particularly for counter-regressiveness reasons, then usual coverings which contain those goods and form part of the sale should also be exempt from sales tax.

In the application of this principle under a manufacturer's tax, however, important administrative problems may arise.

1. Because coverings for taxable goods, when purchased by unlicensed firms, for example, wholesalers, retailers, are subject to sales tax, there is an incentive to divert packaging materials which have been purchased exempt from tax (as coverings for tax-exempt goods) into taxable uses. As this diversion may be made by firms which are not licensed, and therefore not subject to audit by the Department of National Revenue, policing of end-use cannot be fully effective.

2. Returnable or repeated-use containers, which in some cases have a value considerably in excess of the goods which they contain, are used to transport tax-exempt goods as an addition to, or substitute for single-use packaging materials. Generally speaking, unlike single-use packaging, they remain the property of the supplier, and are not sold with the goods, in which case it may be considered that they are goods for the vendor's own use. While many of these containers are of such a specific nature that they are unlikely to be used for any other purpose, others may be, and are, diverted to other taxable uses.

A number of alternative forms of tax treatment of these goods has been reviewed. First, complete exemption of all coverings for tax-exempt goods is not recommended owing to the significant enforcement problems and inequities which would arise.

The advisability of taxing all coverings for tax-exempt goods was considered. The revenue gain at an 11 per cent manufacturer's rate would be an estimated $18-$20 million per annum. This would eliminate the problems we have referred to above. On the other hand, it would raise new problems with regard to international transactions. To avoid discrimination against Canadian products, the value of coverings on imported exempt goods should be subject to tax, but this would be administratively difficult and would yield little revenue. For exports, a refund of tax should be allowed to compensate for the tax paid on coverings.

The present provision of specific exemption of a limited number of repeated-use containers discriminates against other repeated-use containers which remain taxable, and results in taxable diversion of containers which were originally purchased tax-exempt and which may in some cases be relatively costly in relation to the goods which they contain.

In examining the alternatives, there is no clearly superior solution to the problem. As a compromise between ease of administration and neutrality in relation to competition, it is suggested that the present exemption be retained, but that the specified exceptions for repeated-use containers be deleted from the statutory provision. Furthermore, the addition of a further restriction to confine exemption to usual coverings or containers purchased by manufacturers or producers of tax-exempt goods would substantially simplify the administration of the exemption; under a wholesale tax, wholesalers should be accorded the same exemption on purchases as manufacturers.

Under a retail tax, however, particularly on a wide range of goods and services, problems related to taxable diversion by non-licensed vendors virtually disappear. Adequate administrative control can be exercised over an exemption for single-use containers and coverings; and an exemption for repeated-use containers, subject to one important qualification, could be administered satisfactorily as a producer goods exemption. This qualification concerns certain coverings or containers which, although not of a "repeated-use" nature in the sense of being used over and over again by entrepreneurs, are intended to have a "repeated-use" function in the hands of consumers. For example, jams may be sold in goblets, preserved fruits may be offered in decorative dishes. To exempt such containers when for sale with tax-exempt foodstuffs goes substantially beyond exempting food and indeed offers a backdoor means of exempting goods for which no exemption is intended. Specific exception from the exemption for coverings or containers for tax-exempt goods would continue to be required for these goods under a tax at the retail level.

CONCLUSIONS

In conclusion, it must be said that the sales tax treatment of production goods under the federal manufacturer's sales tax today does not appear to be motivated by either consistency or neutrality considerations. The present situation can only be described as confusing and discriminatory. Examples of confusion are found in the area of processing materials while instances of discrimination are evidenced by the privileged position of farming and fishing implements. Generally recognized principles of single-stage sales taxation, such as tax neutrality and avoidance of multiple taxation, have been ignored in taxing production machinery and apparatus. The situation today is the result of a historical process which on two occasions, in 1933 and 1963, witnessed the withdrawal on revenue

grounds of important sales tax exemptions for production goods. What is more significant, however, is that on both occasions an arbitrary distinction was made between production goods; those used by the farming and fishing sector were allowed to retain a substantial measure of tax-exempt status while those used by the manufacturing sector and the natural resources industries were mostly made taxable 3/. There should be no double sales tax standard applicable to production goods. This does not mean that they should all be exempt from tax or all subject to it, but their tax status as production goods should be governed by broad economic and structural considerations, which should apply as equally as possible to all sectors of manufacture or production. It is, however, recognized that administrative considerations will militate against uniform sales tax treatment of all production goods.

SUGGESTIONS

If the proposal for the adoption of a retail sales tax is not accepted, the following suggestions may be helpful.

1. For reasons of administrative feasibility, processing materials should not be accorded a different tax status from production machinery and apparatus.

2. The exemptions for diesel fuel oil for use in internal combustion engines when sold to logging firms and mines should be withdrawn.

3. Exemption for transportation equipment used in distribution should be restricted under a tax at the manufacturer's level to equipment (not including motor vehicles) used principally and directly in the manufacture or production of goods. Office furniture, equipment and supplies should remain taxable.

Under a tax at the wholesale level, it would probably be feasible to broaden the scope of exemption to include warehouse and office equipment (not including furniture) purchased by manufacturers and wholesalers.

The exemption for ships licensed to engage in the Canadian coasting trade should be retained, regardless of the tax level.

4. The statutory basis for the exemption of certain items of farming and fishing equipment that are subject to end-use qualifications should be transferred from the customs tariff items to separately worded provisions in Schedule III of the Excise Tax Act to ensure uniformity in administration. This relates only to a tax at the manufacturer's level.

The statutory basis for the exemption of parts of unconditionally exempt farm equipment which are of a multipurpose nature should be transferred from the customs tariff items to separately worded provisions in Schedule III, if, by inserting an end-use qualification, the revenue may be adequately safeguarded; however, if the revenue cannot be adequately safeguarded under an end-use qualification, then exemption should be withdrawn completely.

5. Under the manufacturer's tax, the exemption for usual coverings or usual containers for tax-exempt goods presents considerable administrative difficulties and results in numerous inequities. There is no clearly superior solution to the problems which arise. As a compromise between ease of administration and neutrality in relation to competition, the present exemption provision in the Excise Tax Act should be retained, but with the deletion of the specified exceptions for certain repeated-use containers, and with a further restriction

to confine exemption to usual coverings or containers purchased by manufacturers or producers of tax-exempt goods; under a wholesale tax, wholesalers should be accorded the same exemption on purchases as manufacturers. (Under a retail tax, the area of administrative difficulty narrows to the category of repeated-use containers containing tax-exempt goods, which are sold to consumers.)

REFERENCES

1/ Admittedly, this tax burden is in turn distributed between taxable and tax-exempt goods and therefore tends to have a minor regressive effect.

2/ The additional items were:

Coal crushers and stokers;

Structures that are adjuncts to or provide access to the machinery and apparatus mentioned herein;

Repair and maintenance equipment used by manufacturers or producers for servicing their machinery and apparatus mentioned herein;

Safety devices and equipment for the prevention of accidents in the manufacture or production of goods;

Systems installed by manufacturers or producers for exhausting dust and noxious fumes from their manufacturing operations;

Equipment used to carry refuse or waste from production machinery;

Equipment for hospitals and first-aid stations in manufacturing establishments;

Gasoline-powered and diesel-powered self-propelled trucks mounted on rubber-tired wheels for off-highway use exclusively at mines and quarries;

Complete parts of all the foregoing.

3/ It should be stressed that, in pointing to the discrimination in favour of farmers and fishermen, the exemption which they have enjoyed is not opposed: indeed the exemption permits a more complete exemption of the products of these industries. Rather the objection is to the failure to extend the same tax-exempt status to other manufacturers and producers of both tax-exempt and taxable goods.

APPENDIX F

THE INSTITUTIONAL EXEMPTIONS TODAY

Certain institutional purchasers today enjoy varying degrees of exemption from the manufacturer's sales tax on their purchases. These exemptions or reliefs may be general in character or they may be restricted to purchases of certain commodities, but in all cases they are available only to those institutional buyers for which preferential sales tax treatment is authorized by statute. For this reason they will be referred to as the exemptions or reliefs for certain institutional purchasers.

The five main categories of exemptions or reliefs available to institutional purchasers are as follows.

1. An effective exemption for all goods purchased by provincial governments or their departments for purposes other than resale or the manufacture or production of goods for commercial or mercantile purposes.

2. Various exemptions for specific goods sold to or imported by municipalities for their own use and not for resale.

3. A blanket exemption for all purchases by public hospitals certified by the Department of National Health and Welfare when for use exclusively by such hospitals and not for resale.

4. Relief by way of repayment of tax in respect of all taxable purchases for the sole use of public institutions certified by the Department of National Health and Welfare to be institutions whose principal purpose is to provide shelter and care for children or aged, infirm or incapacitated persons who reside therein, provided such institutions

are in receipt of public funds for the maintenance of the above persons.

5. A mixture of exemptions for specific items and of relief by way of repayment of tax paid on other items, on purchases by educational institutions and public libraries.

Sales to the federal government, unlike sales to provincial governments and some sales to municipal governments, are subject to sales tax. While the taxation of these sales is a substantial cost to the federal government, we consider that it is justifiable. It permits licensed vendors to avoid the segregation of such sales from their taxable sales, and unlicensed vendors are relieved of the requirement of making refund claims.

PURCHASES BY PROVINCIAL GOVERNMENTS

Subsection 46(2) of the Excise Tax Act relieves from sales tax all goods purchased by Her Majesty in right of any province of Canada for any purpose other than:

1. Re-sale.

2. To be used by any board, commission, railway, public utility, university, manufactory, company or agency owned, controlled or operated by the government of the province or under the authority of the legislature or the Lieutenant-Governor in Council.

3. To be used by Her Majesty or by Her agents or servants in connection with the manufacture or production of goods or to be used for other commercial or mercantile purposes.

Theoretically, such relief takes the form of a refund of tax to either the provincial government concerned or its supplier. In practice, however, it

often operates much in the way of an exemption as far as the provincial government is concerned. Goods otherwise taxable are purchased directly from manufacturers on a tax-exempt basis; liability for tax accrues upon such sales but is seldom paid, being offset immediately by a valid refund claim for the amount of the tax owing.

Currently the most troublesome aspect of the sales tax exemption for the purchases of provincial governments results from the practice of certain provinces of buying directly on behalf of their own boards, commissions, railways, public utilities, or crown corporations. As we have stated above, the purchases of these public bodies are not relieved of sales tax as are those of provincial governments. It is only reasonable that this be so because they often compete with enterprises that would have no claim to the same privileged sales tax status. In certain provinces, however, these public bodies are successful in obtaining the goods they require on a tax-exempt basis from provincial departments which handle all purchasing for public purposes. At the time of sale, suppliers know only that they are selling to a provincial government department and do not therefore charge sales tax. Thus by channelling purchases of goods out of public funds through provincial purchasing departments, certain provinces have been enjoying exemption from federal sales tax to a far greater extent than others and far beyond the intention of the charging statute.

The solution to this problem, assuming that our recommendation for the complete denial of such exemption is not carried out, lies in removing the statutory permission to refund tax on account of such relief to the vendors selling to provincial governments. The refund in all cases should be made to Her Majesty in right of a province and the relief should operate strictly as a repayment of tax rather than as an exemption as it does today. Thus the purchases of provincial governments would bear sales tax whenever

applicable, but a repayment of the tax monies expended would be made directly to the governments or departments concerned upon certification that the goods thus purchased were for their sole use and not for a purpose ineligible for similar relief. In fact, such action would amount to nothing more than a practical restoration of the intent behind the existing relief. Such a step would make the administration of sales tax relief more cumbersome, but this is a price which must be paid to remove the inequity.

SPECIFIED GOODS PURCHASED BY MUNICIPALITIES

Municipalities benefit from a number of sales tax exemptions for specific goods for their own use and not for resale. The following exemptions are found in Schedule III of the Excise Tax Act under the heading "Municipalities":

> Culverts;
>
> Diesel fuel oil for use in generating electricity;
>
> Equipment, at a price in excess of five hundred dollars per unit, specially designed for use directly for road making, road cleaning or fire fighting, but not including automobiles or ordinary motor trucks;
>
> Fire hose including couplings and nozzles therefor;
>
> Fire truck chassis for the permanent attachment thereon of fire-fighting equipment to be used directly in fire fighting;
>
> Goods for use as part of sewerage and drainage systems, and for the purposes of this exemption any agency operating a sewerage or drainage system for or on behalf of a municipality may be declared by the Minister to be a municipality;
>
> Laminated timber for bridges;

Precast concrete shapes for bridges in public highway systems;

Structural steel and aluminum for bridges;

Articles and materials to be used exclusively in the manufacture of the foregoing.

The specific sales tax exemptions for certain goods purchased by municipalities have generally been provided out of a desire to grant indirect financial assistance to local governments. In the years that followed World War II, there was a considerable upsurge in building construction, with an attendant demand for the extension or improvement of municipal services and facilities. Municipalities, considering their own fiscal means inadequate to meet their growing commitments, turned to the senior levels of government for assistance. They requested repeatedly that their purchases be made exempt from federal sales tax, and their plea was partially heeded. They were not able to obtain complete exemption for their purchases but they were successful in obtaining relief for particular items of substantial expenditure.

Two of the exemptions may be criticized on grounds of discrimination and tax partiality, and, moreover, the second exemption can also be criticized because it does not lend itself well to effective administrative supervision.

First, the sales tax exemption for "equipment, at a price in excess of five hundred dollars per unit, specially designed for use directly for road making...but not including automobiles or ordinary motor trucks" may encourage municipalities to purchase construction equipment such as tractors and compressors to be used in competition with the taxable equipment of private entrepreneurs. We strongly recommend that this discrimination be eliminated. This equipment should be made taxable, by the deletion of

"road making" from the wording of the sales tax exemption. In connection with the administration of this exemption for road-making, road-cleaning or fire-fighting equipment, it came to light during discussions with officials of the Department of National Revenue that the use of the word "directly" in the body of the exemption singularly militated against the more liberal interpretation that could be placed upon it. For instance, radio receiving sets aboard fire trucks are exempt from sales tax but transmitting sets operated from fire stations are taxable because they are not part of the equipment that is used directly for fire fighting. Similarly, breathing apparatus is taxable because it is not used directly for fire fighting. This situation should be rationalized by the substitution of "primarily" for "directly" in the wording of the exemption.

Secondly, the sales tax exemption for "diesel fuel oil for use in generating electricity" is discriminatory on two grounds: (a) it favours diesel fuel while taxing natural gas used for the same purpose, and (b) it exempts this fuel when used by municipalities but when used by other producers for the same purpose it is taxable. Administratively, it is difficult to verify the amounts of taxable and tax-exempt fuel by usage. This exemption should be withdrawn.

It is appreciated that the allowance of sales tax exemptions on certain purchases by municipalities enables the federal government to provide a measure of indirect financial assistance to local governments in a constitutional environment which may hamper direct forms of financial assistance. However, if sales tax exemptions for certain municipal purchases are to be used for this purpose, it is important that they not be discriminatory.

PURCHASES BY CERTIFIED PUBLIC HOSPITALS

Schedule III of the Excise Tax Act exempts from sales tax,

> "Articles and materials for the sole use of any bona fide public hospital certified to be such by the Department of National Health and Welfare, when purchased in good faith for use exclusively by the said hospital and not for resale...."

This general exemption covers not only the furnishings and equipment of a certified public hospital but also the building materials used in its construction.

In addition, exemption applies to goods which qualify under customs tariff items 47605-1 and 47610-1. These tariff items refer to equipment used by hospitals, and, under these two provisions, importers are allowed to import the specified goods exempt from sales tax when for the use of public hospitals.

The exemption of purchases by certified public hospitals originated in the early years of the federal sales tax. Having thus been in existence for more than thirty years, it is a well-entrenched feature of the existing sales tax legislation.

It is questionable whether the sales tax relief accorded to hospital purchases should be maintained in the form of a blanket sales tax exemption. While only difficulties of a secondary nature were experienced by the administration in connection with this exemption prior to 1963, certain more acute problems have developed since the withdrawal of the general sales tax exemption for building materials. Although certified public hospitals are exempt from sales tax on purchases for their own use and not for resale, they can benefit from the exemption of building materials only if

they or their agents purchase the materials themselves, or if the contract and invoices are drawn up in such a manner as to show a separation between materials and labour. This means that contractors are prevented from making use of lump sum or unit-price contracts. These procedures are resented by contractors who encounter considerable complications, particularly in relation to their subcontractors.

The administrative difficulty of allowing sales tax relief on purchases made by hospitals would be lessened if such relief were to take the form of a refund or repayment of tax such as is made to institutions that provide shelter and care for children or aged, infirm or incapacitated persons. Although the administrative work of hospitals would be increased by the operation of such a system, we understand that some of them have expressed interest in its adoption. There is little doubt that administering the relief for hospital purchases via refund or repayment of tax would be preferred by the officials of the Department of National Revenue, who are satisfied with their experience of this method in instances involving purchases made by the other institutions referred to above. From a technical standpoint, this procedure offers the prospect of better control of sales tax relief. Moreover, it is flexible enough to allow, in the case of certain categories of goods such as building materials, for the replacement of detailed claim procedure by a simplified claim procedure based on a representative percentage of the value of the goods purchased.

As it is confined to goods purchased by public hospitals certified by the Department of National Health and Welfare, the exemption discriminates against non-certified private clinics. A similar discrimination occurs under the exemption accorded to institutions for the care and shelter of orphaned children—purchases by children's aid societies have continued to bear tax. From a practical standpoint, it is difficult to avoid this kind

of discrimination, if only because of the near-impossibility of controlling exemptions or reliefs that could be claimed by all health and welfare organizations. In order to prevent large-scale tax avoidance, the type of institution eligible for such relief needs to be tightly circumscribed.

PURCHASES BY CERTIFIED INSTITUTIONS

Section 47 of the Excise Tax Act provides a general relief from sales tax by way of repayment to any institution certified by the Minister of National Health and Welfare to be:

i) a bona fide public institution whose principal purpose is to provide shelter and care for children or aged, infirm or incapacitated persons who reside in the institution, and

ii) in receipt annually of aid from the Government of Canada or a province for the maintenance of persons specified in subparagraph (i).

Applications for such repayment of tax must be made to the Minister of National Revenue by the institution concerned within two years of the date of purchase of the goods in respect of which it is being claimed. This special concession first appeared in the legislation in 1950.

In many respects, these institutions are analogous to hospitals, and should be similarly treated for sales tax purposes. Currently some 450 to 500 of them benefit from the exemption. As has been mentioned in the previous section, it would appear preferable to retain the present procedure of refund rather than to allow exemption upon purchase.

PURCHASES BY EDUCATIONAL INSTITUTIONS AND PUBLIC LIBRARIES

The sales tax reliefs currently extended to educational institutions and public libraries under section 47A and Schedule III of the Excise Tax Act are comprehensive. Educational institutions get relief on a substantial range of equipment, furniture, apparatus, books and printed matter; and public libraries on books and directories. Also, both categories of institution are allowed relief on materials used in the construction of buildings.

The exemptions and reliefs now available to educational institutions purchasing goods destined to serve their official purposes are so broad that they could be combined into a general relief by way of refund of tax without significant attendant revenue loss. Even if the need is felt to exclude certain specific categories of goods from the ambit of such broad relief, it is always relatively easy to so provide in the legislation.

APPENDIX G

EXPLANATORY COMMENTS ON EXCISE TAXES AND EXCISE DUTIES

Excise taxes were first levied in 1915 under the Special War Revenue Act 1/ and they have remained an element of the federal commodity tax structure since that time. They are levied under the Excise Tax Act, and unlike the general sales tax, which is levied on a wide range of goods (under the same Act), they are collected on a narrow range of specified commodities. Where they are subject to ad valorem rates, the excise taxes are computed on the same price or duty-paid value as the general sales tax. In terms of revenue yield, they provided $273 million in the 1964 fiscal year, of which 83 per cent was obtained from cigarettes and other tobacco products. (See Table G-1.)

After their introduction during World War I, the list of goods subject to excise tax was substantially expanded in the 1920 Budget as the government of the day sought to balance the budget and commence reduction of the national debt. Many of these newly imposed excises had a short life, being repealed at the end of the year in which they were introduced. By 1930, the list of commodities subject to excise taxes had become a relatively short one. During the early 1930's a number of new excise taxes were introduced for revenue purposes, but these were relatively insignificant compared with the heavy reliance placed on these taxes during World War II. From a yield of $35 million during the fiscal year ending March 31, 1939, the revenue from excise taxes had increased almost tenfold by 1944. The end of the war prompted a move toward lightening the burden of excises, but in 1947 as a result of exchange difficulties, and again in 1951 as a means of curbing inflationary pressures, the federal government reverted temporarily to a heavier reliance on excise taxes.

Excise duties have a much longer history in Canada than excise taxes. Even before Confederation, several of the provinces levied excise duties, and they have been an important source of federal revenue since 1867. They are levied under a separate Act—the Excise Act 2/—and are more narrowly confined in their scope than excise taxes, being levied only on beer and spirits, and tobacco products. In the 1964 fiscal year, they provided $397 million in revenue ($232 million and $165 million respectively).

In addition to their difference in scope and coverage and the fact that they are levied under different Acts, the two forms of excise differ from each other in a number of respects. First, excise taxes apply to both domestic and imported goods, 3/ while excise duties are levied on domestic goods only, 4/ with the Customs Tariff filling the gap on imports by means of a levy which approximates the duties on domestic production. Secondly, excise duties are levied on goods in the possession of the Crown and which remain in the possession of the Crown until the duty is paid, while excise taxes are generally paid by manufacturers upon sale. Thirdly, excise duties are specific levies by weight or volume, while, generally speaking, excise taxes are levied in an ad valorem form. Finally, there are substantial differences in the manner in which the two excises are administered. Excise taxes on domestic products are collected in a similar manner to that of the general sales tax, by means of a self-assessment method, while excise duties involve very close supervision in bonded premises by excise officers over all aspects of manufacture.

It will be noted that there is an overlap in the respective coverages of the two forms of excise in the area of tobacco products. A combination of excise taxes and excise duties on these products results in the following:

Cigarettes (weighing 3 lbs. or less per 1,000)	$9.00 per thousand (or 18 cents per pack of 20 cigarettes).
Manufactured tobacco	$1.15 per lb.
Cigars	$2.00 per thousand excise duty plus the 15 per cent excise tax.

The 11 per cent general sales tax is levied in addition to the excises and its form of imposition reveals another difference between excise duties and excise taxes: while the general sales tax is computed on the same base as the excise tax, excise duties form an element of the price on which the general sales tax (and the excise tax, where applicable) is levied.

REFERENCES

1/ S.C. 1915, Chapter 8.

2/ R.S.C. 1952, Chapter 99.

3/ Except for wine, on which excise tax is confined to the domestic product, with an equivalent levy on imports under the Customs Tariff.

4/ Except for imported spirits taken into a bonded manufactory.

TABLE G-1

BUDGETARY REVENUE

FISCAL YEARS 1955 AND 1962 TO 1964

(millions of dollars)

	1955	1962	1963	1964
Taxes				
Taxes on Income				
Personal Income Tax a/	1,183.4	1,792.7	1,744.6 b/	1,865.1
Non-Resident Income Tax	61.3	112.3	129.1	124.5
Corporation Income Tax a/	1,020.6	1,202.0	1,182.8 b/	1,259.0
Total e/	2,265.3	3,107.0	3,056.6	3,248.5
Estate Tax (or Succession Duties)	44.8	84.6	87.1	90.7
Excise Duties				
Spirits and Beer	130.1	206.8	220.3	232.3
Cigarettes, Tobacco and Cigars	100.8	160.5	166.5	165.6
Less Refunds	-4.4	-4.5	-4.9	-4.7
Total e/	226.5	362.8	381.9	393.3
Sales Tax a/	572.2	759.7	806.0	946.1
Excise Taxes				
Automobiles	73.2	25.3 c/	-c/	-c/
Cigars		2.8	3.4	3.3
Cigarettes	114.5	185.2	195.3	200.2
Manufactured Tobacco		19.0	19.1	23.5
Phonographs, Radios and Tubes	21.5	8.9	9.9	11.4
Television Sets and Tubes		9.6	10.1	10.6
Electric Power Export Duty		1.0	0.4	0.1 f/
Jewellery, Clocks, Watches, etc.		5.6	5.8	6.4
Lighters		0.5	0.5	0.6
Matches		0.6	0.7	0.7
Playing Cards	43.6	0.9	1.0	1.0
Slot Machines, etc.		0.1	0.2	0.2
Smokers' Accessories		0.1	0.1	0.2
Toilet Articles & Preparations		9.4	10.1	11.1
Wines		3.4	3.7	3.8
Interest and Miscellaneous		0.7	0.5	0.8
Less Refunds	-0.9	-11.0 d/	-0.4	-0.3
Total e/	252.0	262.5	260.3	273.4
Customs Import Duties	397.2	534.5	645.0	581.4
Other Taxes	15.5	.1	-	.1
Total Taxes e/	3,773.5	5,111.2	5,237.0	5,533.5
Non-Tax Revenue				
Post Office	131.3	183.7	192.8	200.7
Return on Investments	133.5	307.5	311.9	366.4
Other	85.2	127.2	137.1	152.5
Total e/	350.0	618.4	641.7	719.7
Total Budgetary Revenue e/	4,123.5	5,729.6	5,878.7	6,253.2
Old Age Security Tax Revenue				
Personal Income Tax	100.9	259.0	273.7	302.6
Corporation Income Tax	46.0	100.1	115.2	115.7
Sales Tax	143.1	284.9	302.2	331.8
Total e/	290.0	644.0	691.1	750.1

a/ Excludes Old Age Security Tax Revenue, which is shown separately below.
b/ Reduction due to new fiscal arrangements with provinces.
c/ Tax repealed June 20, 1961.
d/ Mainly automobile tax refunds.
e/ Does not necessarily add owing to rounding. - Nil or less than $50,000.
f/ Tax repealed July 1963.
Source: Canadian Tax Foundation, The National Finances, 1964-65, Toronto: Canadian Tax Foundation, Table 12. Breakdown of excise tax revenues supplied directly by Department of National Revenue (Customs and Excise).

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