THE REPORT OF THE ROYAL COMMISSION ON TAXATION: AN ANALYSIS

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I. INTRODUCTION

The report of the Royal Commission on Taxation (named the *Carter Commission* after its chairman Mr. K. Lem Carter F.C.A.) which contains some 2,600 pages was tabled in the House of Commons on February 24th, 1967. In addition to the actual report itself, the Commission is publishing 27 economic and industrial studies.

The Commission inquired into every facet of the economy of the country affected by taxation and concluded that fundamental changes were required to create the tax structure that would provide for both equity and expansion. In order to have any kind of an understanding of what the Commission's recommendations attempt to do it is first necessary to fix in one's mind the two main bases from which the Commission worked. The first is a conceptual one and the second is what might best be described as structural.

Before attempting to erect the tax structure it is imperative that some funadmental decisions be made. These decisions are not so much concerned with the technical aspects of taxation but are philosophic or moral in nature.

Presenting the problems as questions we can ask:

(1) Should taxes be levied on the basis of the benefit the individual tax payer receives from the state or should it be based on his ability to contribute?

(2) If abiltiy to contribute is considered appropriate, what is the best measure of that ability?

(3) Who should be required to contribute?

Considering these questions in turn:

1. *Bases of Taxation*

With the concept of the welfare state so firmly established and general acceptance given to the concept that one of the functions of the government is to redistribute wealth, in the Commission's opinion the "benefit theory" is unacceptable. There is not much point in providing welfare payments to certain taxpayers and then taking it away by taxes because they had received a benefit of that amount.

Consequently the decision must be in favour of taxation based on some form of ability to contribute, but at this point we move into a much less certain area. On what *basis* can it be stated that one man is able to contribute more than another and to what *extent* is one man more able to contribute than another? These are obviously value judgments and, given the variety of factors that must be taken into account,

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it is suspected that if the question was posed to each person individually, the general trend of the answers would be the same, but each person's estimates of the degree to which a man is more able to contribute than another would cover a very wide range. For instance, one might observe that his own ability to contribute is certainly no greater than another person in somewhat similar circumstances and, in his opinion, is considerably less.

2. *The Commission's Concept of Ability to Pay*

The Commission has recommended that ability to pay taxes be measured in terms of "discretionary economic power" and this is the first major departure from our existing tax system. This term "discretionary economic power" is defined to mean the total power to command goods and services for personal use minus an allowance for what is required to maintain the taxpayer. This total power (or the "comprehensive tax base") is something quite different from our present concept of income. Anything that increases this power falls into the "comprehensive tax base" is therefore in addition to what is presently considered to be income, it would include capital gains, gifts and inheritances, windfall gains, gambling gains, etc.

It is interesting to note that both the United States and now the United Kingdom have preferential rates for capital gains and it is equally interesting to observe that they reach this situation from opposite directions. The early U.S. tax concept was somewhat similar to that now recommended by the Commission (i.e., full taxation of all gains). However, it was not too long before they introduced preferential rates for capital gains. The U.K., on the other hand, excluded capital gains from taxation but recently brought them into tax at preferential rates.

Be that as it may, the Commission recommends that all gains be brought into the "comprehensive tax base" and taxed at the same rate.

Before discussing the principles behind the rates, consideration should be given to how much of this total economic power represents discretionary power. Faced with this decision, the Commission concluded that discretionary economic power varied according to the taxpayer's marital status, and that with a given income an unattached individual—the happy carefree bachelor—had a greater discretionary power than a married person with the same income. Being a member of the army in the latter category, is a patent example of this greater discretionary power. This concept introduced another new idea "the family taxpaying unit" and it is recognized on the basis that in most families, incomes are pooled, major decisions are collective and responsibilities are shared. Basically "the family taxpaying unit" includes husband, wife and minor children. This "family unit" is treated as a collective taxpayer and any transaction within the family unit is ignored for tax purposes. This idea will have a major impact on both income tax and estate planning. This facility to transfer property tax free is only available within the family unit and, effectively, only in a lateral direction between husband and wife because, if it should move vertically downwards to the next generation (e.g., minor children) it will be subject to tax as income when they leave the family unit.

3. *Who Should Pay Taxes?*

Up to now taxpayers as people have been discussed, but, under our existing tax structure, we have other taxpayers, namely the legal entities, including corporations, trusts, mutual organizations, co-operatives, etc. Should they be subject to tax? Referring back to the Commission's concept of ability to pay it was defined as the power to command goods and services for personal use. Personal use is a human attribute not applicable to legal entities and, at least in theory, are not as a result proper subjects for taxation. Any increase in economic power arising from the activity of the entity ultimately accrues to the benefit of people and it is they who should pay the tax. When we get to the structural problems, we find that the Commission was forced to recommend that the tax be levied at the entity level, at least in the first instance. This of course is a derivation from the conceptual idea enunciated above.

Looking now at the structure the Commission has developed to collect the necessary tax we find at this point that the conceptual or philosophical decisions are brought face to face with the practicalities of an efficient tax system. This is where departures from the ideal must be made to produce a structure that will stand up and yet at the same time stay as close to the basic postulates as possible.

4. *Structural Problems*

One of the first structural problems, although not in the writer's opinion in itself a serious one, is to determine the period over which the increase in economic power is to be measured. Conventionally, we have measured fiscal results annually, and have prepared income tax returns annually. There is no magic to the term of one year but it is convenient. The question of postponement of tax is one that appears to have given the Commission a great deal of concern. If one may speculate it probably arises from the conditioned thinking of the members arising over many years from the concept of undistributed income. On page 21 of Vol. I there is the following statement:

> It is essential to recognize that the postponement of taxes is equivalent to the reduction of taxes; indefinite postponement is equivalent to the elimination of a tax.

It seems to the writer that this quotation contains the essential element that influenced the proposed tax structure and that created the interrelationship between the various provisions from a structural point of view.

With the above in mind the tax structure proposed by the Commission is designed to determine income and consequently taxes payable, annually where possible. Where it is not possible to do so annually, it should prevent lengthy postponement because this has the same effect as reduction in taxes, and it must prevent deferment of income between one generation and the next because indefinite postponement of tax is equivalent to no tax.

With this thought in mind, it is almost inevitable that the proposed structure would develop along the lines recommended. To measure the increase in economic power (or the comprehensive tax base as defined) would require an annual valuation of all of the tax paying unit's assets.

To carry out such an annual valuation is obviously impossible. At this point, therefore, the first compromise is made. Because it is not possible to value all assets for all taxpayers on an annual basis, the determination of the increase or decrease in value must move from an annual accrual basis to a realized basis. For equity this must apply equally to all assets whether readily capable of valuation or not. The ultimate block is placed on postponement by deeming that realization will take place at death or on leaving the country.

This first departure from principle leads to another. With a progressive rate structure, the inclusion in one year's income of a gain on realization that accrued over many years would result in a tax greater than would have been the case on an accrual basis. The ideal solution would be to average the gain over the holding period of the asset and recompute the income of the years affected. It would be an administrative nightmare to average back over 30 or 40 years but obviously some relief is necessary and the second compromise is reached. A five-year period is selected for averaging as providing some reasonable relief within the bounds of administrative feasibility and, subject to certain limitations this average is available for all forms of income including the receipt of an inheritance which is now to be considered income.

To ease the situation further, the Commission has also suggested another new concept—"the income adjustment account". Essentially taxpayers in receipt of large "lumps" of income in one year could make deposits in a government account and withdraw it gradually over a time thus averaging the income forward in addition to averaging it backwards under the block-averaging provision. This has the effect of postponing tax and, as previously mentioned, this appears to concern the Commission more than a little. To compensate for this postponement, it is recommended that deposits in the income adjustment account be non-interest bearing so that the taxpayer foregoes any income that might have been earned on these funds. To prevent this postponement becoming indefinite it is also recommended that amounts deposited must be withdrawn before age 60 (for an individual) or before the youngest member of a family unit reaches age 60.

Before leaving the subject of averaging, in addition to the two methods previously mentioned, there is a third method proposed for spreading income. This is the registered retirement income plan. Provisions for one's old age is obviously a desirable practice and should be encouraged. This is reflected in our existing system by the permitted deductions for registered pension plans, registered retirement savings plans, and deferred profit sharing plans. Under the Commission's recommendation all of the existing legislation for separate plans would be replaced by one type of plan and the limitations on annual contributions withdrawn. The safeguard against postponement would be that deductions for contributions would cease when a sufficient amount had been deposited in the plan to purchase a single life annuity of $12,000 payable from age 65 and guaranteed for ten years.

5. *Tax Treatment of Corporations and Other Intermediaries*

Earlier, in discussing the concepts, it was stated that legal entities were not proper subjects for taxation and that, in theory, no tax need be levied on them. For simplicity the writer will consider corporations but the principles are equally applicable to trusts and other entities.

This idea that no tax need be levied on corporations would stand up from a structural viewpoint but for two reasons. The first and far more important is related to the departure from the accrual basis of computing gains on shares. If shares were valued annually to determine gain or loss, tax would be levied on the shareholder annually so the tax on corporations would be unnecessary. However, once the move is made to the realized basis of determining share gains, the absence of tax at the corporate level would lead to massive postponement of tax. By funnelling all his income through a corporation, the taxpayer could postpone until death all tax other than on the amount he withdrew to live on. In view of the expressed views of the Commission on postponement, this would be unacceptable.

The other reason for requiring a tax at the corporate level results from the international aspects of investment. The tremendous degree of non-resident ownership of Canadian industry coupled with the inability to tax non-resident shareholders at personal progressive rates and the impossibility of greatly increasing withholding rates would cause a tremendous drop in tax revenues.

These two factors force another departure from the ideal, and require a tax to be levied at the corporate level. This tax should not be confused with a corporation tax as such but should be regarded as a convenient collection technique to prevent postponement and to obtain tax from the shareholders. As soon as the amount of corporate income can be related to resident shareholders a recomputation of the tax liability will be made and refunds given to the shareholder if appropriate. In other words, the tax at the corporate level is essentially the equivalent of a withholding tax much as it would be imposed on salaries and wages. This is referred to as the "integration" proposal.

The rate of tax to be levied on corporate income appears to have been conditioned largely by structural considerations and the desire to prevent postponement once more. Earlier the problems of undistributed income under our existing system were mentioned, where the distribution of corporate source income can result in the imposition of personal tax rates up to 60% (80% minus 20% dividend tax credit). This situation provides a positive inducement not to relate the corporate source income to the shareholder—in others words there is a definite incentive to postpone tax. To increase the dividend tax credit to 50% (equal to the corporate rate) would reduce but not eliminate this bias against relating the corporate source income to the shareholder. To eliminate this bias it is essential that the top personal rates do not exceed by much the corporate rate and, in turn, the corporate rate cannot be allowed to get out of line with those in competing countries. Given these limitations it is evident that from a structural viewpoint the top personal rate cannot much exceed 50%. There is also a conceptual reason that the top personal rate should not exceed 50% and that is the disincentive effect on effort where the government takes more than half of every dollar earned. In fact the Commission suggested that the only reason the existing top rate of 80% is tolerable is that it is so easily avoided. Given these two considerations it is perhaps interesting to speculate which carried the greater weight in the Commission's deliberation—the conceptual limitation or the structural limitation.

II. SOCIAL AND ECONOMIC OBJECTIVES

The Commission's recommendations should be considered in the light of their conclusions concerning desirable social and economic objectives. The line of thinking followed by the Commission is that the tax system should be designed with four fundamental objectives in view:

(a) To ensure the equitable distribution of output.

(b) To maximize the growth of output.

(c) To protect the liberties and rights of the individual.

(d) To maintain and strengthen the Canadian federation.

Where a conflict amongst these objectives arises the Commission has given priority to the achievement of equity.

1. *Equity*

The Commission concluded that the achievement of equity was a function of the tax-transfer-expenditure system. It recommended a study of the whole question of redistribution with particular reference to existing transfer payment programs. In the area of taxation it concluded that equity demands:

(a) The inclusion in income of all forms of economic gain—the comprehensive tax base.

(b) Taxation according to ability to pay, defined as the application of progressive marginal rates of tax to the comprehensive base.

(c) Recognition of families as well as individuals as taxpayers.

(d) Reduction of tax burden in respect of special responsibilities (children, medical expenses, etc.).

(e) The avoidance of special tax concessions to particular industries or certain kinds of income.

The Commission concluded that the present fiscal system is inequitable and that its recommendations would achieve a more equitable distribution of output without impairing growth. Some recommendations that might impair growth would be compensated for by other proposals (such as integration); in other cases, compensation should be provided by other means (e.g. subsidies).

2. *Economic growth*

The objective of maximizing the growth of output comprises these specific goals:

1. To maintain full utilization of Canadian resources. A national unemployment rate of 3.5% is the suggested present target.
2. To maximize the rate of growth in the productivity of Canadian resources. This requires a neutral tax system to allow market mechanisms to allocate resources. Where the workings of the market and other policy instruments are inadequate, the tax system should be used to modify the allocation of resources.

3. To ensure stable but flexible prices—consumer prices should not rise by more than 1.5%-2%a year.

The Commission concluded that a long-term fiscal policy is needed for economic growth. Within this framework the Commission concluded that:

1. Income taxes are the most effective single tax instrument and their weight in the tax mix should be increased.
2. Federal and provincial governments should develop joint fiscal policies.
3. Increases in the labour force can be achieved by the greater entry of married women into the work force and by reducing emigration to the United States. Reduced taxes may achieve both of these ends.
4. High marginal tax rates reduce labour, managerial and professional efforts.
5. The Commission favours subsidies rather than tax incentives for such programs where special treatment is warranted.
6. Further study of the benefits and costs of regional development and research should be made.
7. A policy for inter-regional transfers of resources should be developed.
8. Present incentives to natural resource industries are too liberal, extremely inefficient and bonus investments that would have taken place in any event.

3. *Capital and savings*

The Commission concluded that the present tax system has not always allocated savings efficiently. Present imperfections include:

1. The dual corporate tax rate.
2. The failure to tax capital gains and allow the deduction of capital losses.
3. Inadequate treatment of business losses.
4. Special provisions for certain activities.
5. A bias towards the retention of corporate earnings in the corporation.

The Commission states that its recommendations are designed to overcome these deficiencies and improve the allocation of savings, and that they would not reduce the rate of savings and investment.

4. *International economic relations*

The Commission believes that foreign investment in any form confers a net economic benefit on the host country. Canada has gained and will continue to gain from foreign trade, imported knowledge, immigration and inflows of foreign capital.

In order not to impair relations with foreign investors, Canada should not make frequent minor changes in tax policy but should seek to establish a system consistent with its best long run interests and then hold to it. The tax that Canada can impose on income flowing to non-residents without impairing foreign investment depends on the amount of credits that foreign governments give their residents against Canadian taxes. Canada should avoid action that might invite retaliatory measures.

The Commission emphaizes that it does not advocate any Canadian tax changes that would worsen the absolute position of foreign investors in Canada or of Canadian investors abroad except to eliminate some blatant tax avoidance schemes and to remove inefficient industry incentives. The Commission recommends that the tax system should encourage Canadian equity investment by Canadians.

III. PROPOSED TAX SYSTEM

In order to achieve the stated objectives noted above, the Commission recommends adoption of a revolutionary new tax system. The system would integrate corporation and personal income taxes. In effect, taxes levied on corporations would be regarded as prepayments of tax on behalf of the shareholders. The same would be true for trusts. Both corporations and trusts would be regarded as "intermediaries". All income and gains realized by Canadian residents would be included in a "comprehensive tax base" and tax would be paid on this base at progressive rates. The comprehensive tax base would be computed for each taxpaying unit which might consist of an individual, or a group of individuals in a family unit. Different rate schedules are proposed for each of the two types of tax-paying units.

In the summary of recommendations which follows it has been attempted to follow the flow of income from the time it is received by an intermediary through to the comprehensive tax base of the tax-paying units. Later in the memorandum specific recommendations for tax changes in respect of certain types of corporations and certain industries are dealt with. Also set out are recommendations concerning the imposition of a retail sales tax on goods and some services to replace the present manufacturers' sales tax.

1. *Corporations and Trusts*

(a) Corporations

The corporate tax base would include all of the items included in the "comprehensive tax base" which is discussed in a separate section below. Briefly the comprehensive tax base would include all income from business and property, gains or losses on property disposition, gifts and windfall gains.

The Commission has not suggested any sweeping changes in the computation of business income but did recommend that:

1. There should be no capital cost allowance for an asset until it is put into use. Other minor modifications to the present capital cost allowance system are proposed.
2. "Nothings" (business expenditures not now deductible in any way) should be either deductible or depreciable. Property such as goodwill or other intangibles with an indefinite life should be deducted only on disposition or when a significant loss in value is proven.

3. The general test of reasonableness should continue to apply to business expenses.
4. Income tax legislation should not prescribe the use of accounting principles and practices in determining profits for tax purposes.
5. The present general prohibition on the deduction of reserves and the specific provisions for the deduction of reserves for bad debts and unearned or unrealized profits should be repealed.
6. Provisions for estimated losses in respect of guarantees, warranties and indemnities should be allowed.
7. In valuing inventory reliance should be placed on accounting and business practices and guidelines established by the tax authorities.
8. A modified LIFO method should be permitted under prescribed conditions.
9. The present provisions respecting unpaid amounts between non-arm's length taxpayers should be changed to deny deduction of any expense unless the non-arm's length creditor takes the amount into income in the same year. The deduction would be allowed when the amount is in fact paid.
10. Business losses should be offset against any form of income and should be carried back two years and forward indefinitely.
11. There should be a restriction on the deduction of losses. In general, once a business had incurred losses in three years during a five-year period, it would be described as a "hobby business". Subsequent losses incurred would be offset only against income from the same business. Once cumulative incomes from that business exceeded cumulative losses, any further losses would be fully deductible against all income until the three-year rule again applied.
12. Losses of "hobby businesses" would be regarded as personal expenditures and would not reduce the value of shares of the company for purposes of the comprehensive tax base.
13. Losses should not be transferable from one taxpayer to another. Loss carry-forward should be denied to a corporation where there has been a change in its control.
14. Consolidated returns for tax purposes should be permitted to enable companies with common ownership to aggregate their incomes and losses for tax purposes.
15. Where there must be an allocation of price between more than one type or class of property each party to the transaction should be permitted to make an allocation that is reasonable from his own point of view.
16. The fair market value test with some exceptions should be applied to all transactions not at arm's length including transactions in depreciable assets. Adjustments made should be applied to both parties to the transaction.
17. All businesses having a gross income in excess of $10,000 should be required to compute income on an accrual basis.
18. New and small businesses (those with gross revenues under $10 million and net assets under $1 million) to be allowed to write

off the cost of depreciable assets at any time to a cumulative maximum of $250,000. This privilege would be available only to businesses in which Canadians held a beneficial interest of at least 70% and would be subject to some restrictions in respect of related companies.

The Commission recommended changes in the taxation of foreign source income. A distinction is to be made between "foreign direct investment" and "foreign portfolio investment" . "Foreign direct investment" is defined to include ownership of a 10% or greater interest in a foreign business enterprise, corporation or property. Any interest of less than 10% in such foreign assets is considered to be "foreign portfolio investment". Income from a "foreign portfolio investment" would be taxed in the same way as at present, with a credit given only for taxes imposed directly on the Canadian investor such as withholding taxes.

In the case of a foreign direct investment, the Commission has recommended the following:

1. The provision exempting dividends received from 25% or more owned foreign companies (section 28 (1) (d)) should be repealed.
2. Each year the Canadian investor would be required to compute the foreign income tax levied on the income of each foreign business, property or corporation. Subsidiaries and subsubsidiaries, etc., of 10% or more owned foreign corporations would be considered to be direct investments of the Canadian investor.
3. If foreign income taxes actually incurred were less than 30% of the foreign income the Canadian investor would be required to pay the difference between the actual foreign tax and 30% of the foreign income to the Canadian government as a special tax. Foreign income would be the income reported to the foreign tax authority or shown by the audited financial statements, where no foreign return was made. This income would be subject to certain adjustments (e.g. to include capital gains and eliminate depletion allowances). Foreign taxes would include normal income taxes and certain other taxes specified by the regulations to be income taxes (including taxation by political sub-divisions of the foreign country).
4. Income earned in the United States and in the United Kingdom would be regarded automatically as having borne a 30% tax.
5. The special Canadian tax, (if any) would be refundable to the Canadian investor to the extent of any foreign withholding tax levied on remittance of the income to Canada.
6. Income received in Canada by a corporation would not be subject to further taxes until the time of distribution or allocation at which time a further Canadian tax of 20% would be imposed on distribution or allocation to residents.
7. In the case of dividends received from a foreign company the Canadian recipient would be required to gross up the dividend less withholding tax at a 30% rate (100/70 x the net dividends received). The dividend would be deemed to have been subjected

to a 30% tax so that no further tax would be payable by the corporation at the time of receipt.

8. Where the Canadian direct investor together with other investors not at arm's length held less than a controlling interest and was unable to obtain information on which to base calculations of income and foreign taxes he would be permitted to pay tax as though the investment were a portfolio investment.
9. Portfolio investors would be permitted to elect and pay tax as direct investors.

The most important aspect of the recommendations concerning corporation tax is the proposal for integration of corporation tax and personal tax. The corporation is looked on as an intermediary which receives income and pays tax on behalf of resident shareholders. Thus, a resident shareholder receiving a dividend would be regarded as having received the before-tax income of the corporation from which the dividend was paid. The resident shareholder would be regarded as having borne the corporation tax already paid on this income and would be entitled to a refund of the tax to the extent it exceeded his personal tax on the income. There would be no integration of the tax in the case of non-resident shareholders who would continue to be taxed in the same manner as at present.

The details of the proposed corporation tax and the integration proposal are set out below:

1. A flat 50% tax would be levied on the corporate comprehensive tax base—excluding income from foreign direct investments. The present provision for a lower rate of tax on the first $35,000 of income would be repealed.
2. In addition to a regular distribution in the form of cash dividends or capitalization of earnings and stock dividends, resident shareholders would be deemed to have received a distribution if the corporation made a formal allocation of undistributed earnings to shareholders.
3. Earnings distributed or allocated to shareholders would be deemed to have been paid pro rata out of domestic and foreign source direct investment income. An additional tax of 20% on the grossed up foreign income would be paid at that time on the portion of the foreign source direct income distributed or allocated to Canadian resident shareholders. Thus, the total tax paid or deemed paid with respect to both domestic and foreign income would be 50%.
4. When a distribution was made either by a cash dividend, capitalization of earnings or a formal allocation the resident shareholder would be required to include in his comprehensive tax base the grossed up value of the distribution. In effect the shareholder would include twice the amount of the distribution in the tax base.
5. The resident shareholder would be deemed to have paid a tax at the rate of 50% on the grossed up distribution. If the share-

holder were taxable at a lower rate he would receive a refund of the excess tax.

6. Dividends on preferred shares and interest on income bonds would be treated in the same manner as common share dividends.
7. Allocations and distributions (other than cash dividends), including the distribution of debt obligations, would increase the basis of the shares held for purposes of computing gains or losses in respect of the shares.
8. Allocations could be made by corporations only to shareholders entitled to receive dividends.
9. Cash dividends paid out of previously allocated income would be regarded as a return of capital and would reduce the basis of the shares.
10. Distribution of surplus accumulated prior to the new rules would not be taxed but instead applied to reduce the basis of the shares. This income would be deemed distributed only after all income taxed under the new rules had been distributed or allocated. However, distributions of this surplus to non-residents should be treated as a dividend and subject to withholding taxes. Provisions dealing with avoidance of tax on distributions of corporate surplus would be removd.
11. Distributions on a reduction of share capital would be treated as a return of capital to the extent of paid-up capital. Any excess would be treated as a distribution of income taxed under the new rules to the extent of the shareholder's portion of such income. Any further amount would be considered to be the proceeds of realization.
12. Conversion of shares from one class to another would not result in a realization unless accompanied by capitalization of earnings. Conversion of capital to debt would be treated as a redemption of the shares in question.
13. A corporation with a relatively small income and a small number of shareholders would be entitled to be treated in the same manner as a partnership, if it complied with certain prescribed conditions.
14. Losses realized by a corporation could not be allocated to shareholders and could not be carried back by the corporation against previously allocated income.
15. Intercorporate dividends or allocations would be accorded the same treatment as dividends or allocations received by an individual with full gross-up and credit provisions.
16. The personal corporation and investment corporation provisions of the Income Tax Act would be unnecessary.
17. The rules regarding the taxation of distributions to non-residents would remain much as they are at present. However, provisions should be introduced to preclude the undue postponement of allocations or distributions of profits where a substantial number of shares were held by non-residents.

18. It is recommended that interest payments by a Canadian corporation to non-resident investors with whom it was not dealing at arm's length should be deemed to be dividends, thus non-deductible and subject to withholding tax at the rate applicable to dividends, in circumstances to be defined.
19. Foreign direct investment income distributed to non-residents would not be subject to the additional 20% tax imposed on distribution to residents.
20. Allocations to non-residents would not be subject to withholding tax.
21. Rules would be introduced to prevent the avoidance of tax by the transfer of shares.
22. Shareholders would be provided annually with T5 statements listing amounts to be included in income, tax credits, amounts of cash distributions, the amount of non-cash distributions and the amount that was distributed representing the return of capital. Substantial penalties for non-compliance should be imposed.
23. The shareholder would be required to report in his income tax return the securities he owned at the end of the year as well as transactions he had during the year.

(b) *Trusts*

Trusts, like corporations, would be considered as intermediaries. The principal proposals for the taxation of trusts are as follows:

(i) *Income*

1. Trust income (including gifts and bequests and unrealized gains on property distributed to beneficiaries) should be subject to an initial rate of tax to the trust except in specific circumstances. The initial rate of tax should be 50% (30% in the case of direct foreign investment income) except
   (a) where the income was distributable in the year, a resident beneficiary could elect that he, rather than the trust, should be subject to tax on his income,
   (b) where amounts were accumulated by the trust for a resident prospective beneficiary, he could elect that the initial tax be the amount that would have been paid had the amount been paid to him directly.
2. Gifts received by trusts where the donor and beneficiary of the income or corpus are members of the same family unit (including reversionary trusts), would not be subject to tax. No gain or loss would be recognized when the trust property was transferred to the beneficiary, although gains realized while held by the trust would be taxed.
3. Where the election in 1 (a) above was made, the individual rather than the trust would be entitled to refunds of taxes in respect of dividend income, interest income or foreign income.
4. Where an election, as contemplated in 1 (b) above, was not filed by the residual beneficiary of a trust to reduce the initial tax on a

gift or bequest, the income beneficiary of the gift would be entitled to annual interest from the government at 5% or 6% on the difference between the initial tax (at the 50% rate) on the gift or bequest and the additional tax that would have been paid by the income beneficiary had the gift been included in his income for the year it was received.

5. The initial tax on any income would be deemed to have been paid by the trust on behalf of the beneficiary who ultimately became entitled to the income, in the same way as a withholding tax.
6. Losses by a trust would be taken into account with the same rules as for other taxpayers. However, losses on properties received by way of gift or bequest could be carried back more than two years, if necessary, to reduce the initial tax paid with respect to this property.

(ii) *Distributions*

1. Amounts distributed by a trust would be considered to be distributed in the following order (without regard to the form of the distributions in trust law):

   (a) out of income of the trust for the current year,

   (b) out of accumulations on which the trust had been subject to initial tax,

   (c) out of gifts which were free of initial tax because they were received for the benefit of a member of the donor's family unit, and

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

2. All amounts, (except those in (c) and (d) above) distributed by trusts (income or corpus) would be included in the beneficiary's tax base, grossed up for the initial tax paid by the trust. In the case of distributions out of accumulated income (rather than current income an annual calculation of the cumulative average rate of initial tax (reduced by amounts previously distributed) would be made and would apply to determine the initial tax paid with respect to distributions made in that year. The beneficiary would be entitled to a refund where the initial tax attributed to the amount exceeded his tax otherwise payable.

(iii) *Business or investment trusts*

Special rules have been proposed which deal with investment and unit trusts. Gains or losses realized on the disposal or redemption of units of such trusts should be taken into the income of the beneficiaries. The trust itself should be taxed in the same manner as a corporation with a 50% initial tax rate, for which the unit holders would receive credit when the trust income was received or allocated to them. Such trusts can elect to be taxed as a partnership, in the same way as corporations.

(iv) *Residence rules*

1. A trust would be considered to be resident in Canada if the majority of its trustees were residents, if the trust carried on busi-

ness in Canada, or if substantially all of its property was situated in Canada.

2. If any of the beneficiaries of a non-resident trust are resident in Canada, the trust and beneficiaries would be entitled to elect that the trust be taxed as being resident in Canada, although if it did, the trust would also have to submit to jursidiction of the Canadian courts. A non-resident trust having Canadian beneficiaries becoming resident in Canada, would pay initial tax at the appropriate rate on its accumulated income at that time, subject to credits for Canadian withholding tax and foreign tax previously paid.
3. If a resident trust became non-resident, it would be required to pay an additional tax that would bring the initial tax on its accumulated income (including unrealized gains on property) up to 50%.
4. Amounts distributable to non-resident beneficiaries (other than out of gifts or inheritances or income from direct foreign investment) would be subject to initial tax at the rate of 50%. In addition, these distributions would be subject to withholding tax at the same rate as was applicable to dividends. However, a non-resident beneficiary or prospective beneficiary would be entitled to elect that instead of the 50% initial tax and the withholding tax, the income payable to him would be subject to initial tax in the same amount as the withholding tax that would have been paid had the amount been paid to him directly.
5. Gifts and bequests that were distributable to non-resident beneficiaries would be subject to initial tax at the rate of 30%, and would not be subject to any further withholding tax.
6. It is recommended that a trust which received substantially all of its property from a non-resident of Canada, and all, or substantially all, of the assets were situated outside of Canada and were being held for beneficiaries, the majority of which were non-residents, would be considered to be a non-resident trust even though it was administered by a resident Canadian corporate trustee.

2. *Comprehensive Tax Base*

The definition of income for tax purposes would be substantially broadened to bring into the "comprehensive tax base" of Canadian residents the annual net gains less net losses from virtually every conceivable source. Consideration was given to including imputed income (i.e., imputed rent from use of owner occupied dwellings, etc.) but this was rejected because of administration and valuation problems. Deduction of dwelling mortgage interest and property taxes were rejected as further compounding the present inequity between renting and owning.

Income would include the following:

(a) Income from employment

1. All cash and non-cash benefits (e.g., benefits from discounts on employer goods, free or subsidized meals, transportation, houses and recreation facilities, etc.) would be included. Travel and en-

tertainment expenses in excess of prescribed limits would also be brought into the employee's income.

2. The Report suggests there should be no deduction without current taxation in the area of employee benefits. Employers unwilling or unable to allocate such benefits would be assessed a special tax (at the highest marginal rates of personal tax) which would result in an effective disallowance of the expense.
3. Employees would be permitted to deduct actual expenses incurred in earning their income. An optional deduction of 3% of gross employment income (maximum $500) is suggested.
4. Benefits received from group life insurance plans, unemployment insurance, workmen's compensation, strike pay would all be included. Premiums and other contributions to such plans would be deductible.

(b) Income from property

1. Canadian dividends would be grossed up and included as discussed previously.
2. Foreign income would be taxed essentially on the same basis as discussed in connection with corporations. The same rules respecting foreign portfolio investment and foreign direct investment would apply. The Canadian direct investor would pay the same special tax to bring the actual taxes paid on income earned in a foreign jurisdiction to 30%. Dividends net of foreign withholding tax received from foreign corporations considered as direct investments would be grossed up at 30% rate and credit would be given against Canadian tax equal to the amount of the gross up.
3. Interest would be included when paid or credited (directly or indirectly). Uncashed bond interest coupons, interest credits on investment certificates would be brought into current income.
4. Rents and royalties would be included as received. All persons would be required to report interest and rents paid.
5. All corporations, governments and government organizations would withhold 15% tax on interest paid or credited. Exemption certificates would be issued to resident and non-resident tax-exempt entities.
6. Deductible interest not paid or credited would be subject to a 50% withholding tax.
7. Net losses from property operations would not be deductible against other income but could be carried back two years and forward indefinitely to offset operating income (but not gain on disposal) from the same property.
8. At the taxpayer's option interest and property taxes could be capitalized as an addition to the cost of income producing property.

(c) Income from business

The computation of income from business was described in detail under the heading "corporation".

Gains on property dispositions—

1. Gains on property dispositions and deemed dispositions would be included in income (subject to certain exceptions discussed below).
2. Residents would be taxable on world gains with provision for a foreign tax credit.
3. Non-residents would initially be taxable on gains from dispositions of property employed in a business through a permanent establishment in Canada. Real property and mining and petroleum rights would constitute permanent establishments. Gains on the disposition of shares of closely held companies holding real property in Canada would be taxable to non-residents. Eventually taxation might be extended to other Canadian gains of non-residents.
4. A property disposition would take place and any gain would be taxable if property were disposed of (or deemd to be disposed of) in any of the following ways. (The exception in the case of transfers between members of the same family unit is discussed below.)
   (a) By sale or exchange
   (b) By gift or bequest
   (c) Through death of the owner
   (d) Through the owner ceasing to be resident in Canada
   (e) Through loss by expropriation destruction by fire, etc.
   (unless the proceeds were reinvested in a similar property within a reasonable time).
5. Exemption would be provided in respect to special transactions between corporations and their shareholders and between corporations having common control. A transfer of property (other than securities) to a corporation in return for common shares would not usually be considered a disposition. An exchange of shares as a result of a recapitalization of a company would not be considered a disposition.
6. Gains from dispositions not at arm's length or through gift or bequest or arising on death or loss of residence would be computed by reference to the fair market value at the time of disposition.
7. The cost of publicly traded securities on hand at the effective date would be taken as the greater of actual costs or value at that date provided the property were disposed of within a period of 3 to 5 years. Otherwise the value at the effective date would be treated as cost for purposes of computing any gain realized.
8. In the case of property, other than publicly traded securities, a taxpayer would be given two years from the time of the effective date to request Departmental approval to a valuation of the property at that date. If such a request were made the taxpayer would be restricted to using the approved valuation and could not revert to the optional basis discussed below.
9. In the case of property for which a valuation was not requested (and excluding publicly traded securities) the value as of the effective date would be determined by apportioning any gain over

the holding period (up to a maximum of 10 years prior to the effective date). The net gain attributable to the period subsequent to the effective date would be reduced by a further percentage of say 25%.

10. Provision would be included for the optional revaluation from year to year of property held by taxpayers in order to recognize losses or anticipate gains. It is also suggested that consideration be given to the requirement of a periodic mandatory revaluation of assets such as publicly traded securities.
11. Losses other than those arising on property of a personal nature would be fully deductible and eligible for a 2-year carryback and an indefinite carryforward to be applied against all other income.
12. Losses on disposition of residential real property would not be deductible. Gains on such property would be subject to a lifetime exclusion of $25,000 per taxpayer unit. The cost of improvements can be added to the original cost basis of the property by reference to actual costs or by the addition of 1% of the cost of the buildings for each year the property was held.
13. Losses incurred on the disposition of a farm property would be allowed as a deduction from any income. Since farm property (operated as such for not less than 2 years) is eligible for a $25,000 lifetime exemption for gains to a tax-paying unit any deducted losses would be subsequently recaptured against excludable gains.
14. While losses on personal items would not be deductible, losses on such items as art or jewellery could be offset against gains realized on the disposition of similar items in the same year, in the preceding two years or in any subsequent year.
15. Annual tax returns would include a detailed investment schedule indicating all income including gains or losses.

(d) Gifts and bequests

1. The comprehensive tax base would include all gifts and bequests received from one tax unit by another tax unit or non-resident except when the transfer occurs between members of the same tax unit.
2. The "donor" tax unit would obtain no deduction for gifts or bequests.
3. Gifts would include all successions whether by will or otherwise, forgiveness or cancellation of debt, sales for inadequate or artificial consideration, benefits derived from use of property without consideration, the powers of appointment which can be used by the taxpayer to obtain property during his lifetime.
4. If the recipient renounced a gift within 90 days of becoming aware of the gift or within 90 days of being able to exercise a power of appointment to his own benefit, which ever was later, the amount would not be included in the comprehensive tax base.
5. Gifts to corporations would be subject to tax in the corporation except in certain limited cases such as incorporation and certain reorganizations.

6. Gifts to a trust would be subject to initial tax in the trust (except in certain limited cases) and the ultimate beneficiaries would obtain credit for this tax on receipt of the "grossed-up" trust property.
7. Provision should be made for reducing the amount included in the comprehensive tax base of the donee in the case of quick successions.
8. Annuities received by a donee would be valued at present value.
9. Gifts arising on death would be included in the comprehensive tax base at the time of actual or constructive receipt by the donee or, if received by a trust, at the earlier of 24 months after death or trust obtaining probate. The trust would include the gift in income if the donee could not be identified within 24 months after death.
10. Gifts would be valued at fair market value without statutory rules.
11. Inter vivos gifts would be valued and included in income at the time of receipt by the donees.
12. Gifts arising on death would be valued at the date of death but could be revalued within 2 years from the date it was included in income, and any loss taken as a deduction at that time.
13. Tax on gifts of property other than cash or marketable securities could be paid over a 5 to 10 year period.
14. Credit (up to the Canadian tax imposed) would be given for all foreign estate or gift taxes imposed on gifts received from nonresidents except where the property is situated in Canada.
15. Each individual would have a $5,000 lifetime exemption for gifts received. In addition there would be an annual exemption of $250 per individual, $250 for each spouse in a family unit and $100 for each dependent of a family unit. A family unit could aggregate its annual exemption.
16. Gifts to tax-exempt bodies would, as under present legislation, be free of tax.
17. The Report recommends the repeal of estate and gift taxes and provincial succession duties.

(e) Miscellaneous

1. Tax-free allowances currently received by Members of Parliament, Members of a Legislative Assembly and elected municipal officers should be included in income.
2. Income earned from the operation of a ship or aircraft by a nonresident person, service pensions or allowances, RCMP pensions should be taxed.
3. Income earned from the office of Governor General, service pensions from other countries during the next 5 to 10 years, income of an officer or servant of a country other than Canada whose duties require him to reside in Canada, Halifax Disaster pensions certain German compensation should continue to be excluded from income.

4. Gambling gains in excess of a small annual exemption should be taxable. Losses should be deductible to the extent that they can be applied against gains (carryback 2 years and indefinite carry-forward).
5. Cancellation or forgiveness of debt should be treated as income of the debtor, except in those instances when the debt arose in a transaction at arm's length and was not deductible in computing income.

3. *Retirement Plans*

New rules for retirement income plans are proposed as follows:

(a) Registered plans

1. Retirement income plans would have to be registered to qualify for tax deferment.
2. Registration restrictions would be similar to provisions presently found in the Income Tax Act and the Ontario and Quebec pension benefits acts.
3. Deferment would not be permitted beyond the amount necessary to purchase an annuity of $12,000 per annum:
   (a) in the case of a single individual, guaranteed for 10 years at age 65.
   (b) in the case of a married individual, on a joint life basis (no guarantee period) with the annuity commencing at. the time the older of the joint lives attained age 65.
4. The $12,000 limitation would apply to the aggregate of pension benefits under all plans for any one individual or family unit.
5. New plans providing larger benefits would not be registered.
6. The effect of the Canada Pension Plan and the Quebec Pension Plan would be ignored.
7. Registered plans would be exempt from tax on income and gains and could recover the corporate tax paid with respect to dividends.
8. All amounts paid to beneficiaries would be included in the comprehensive tax base.
9. A special penalty tax of 15% would be imposed on withdrawals prior to age 60 to the extent that the funds were not reinvested in another registered plan and the withdrawal increased the comprehensive tax base to an amount in excess of $7,000 for the year.
10. Where sufficient funds had been accumulated in the plan to provide the $12,000 benefit noted above, income and gains and employer contributions to the plan would be included in the employee's comprehensive tax base.
11. In the case of existing plans, where the funds already on hand would provide a pension of more than $12,000, income, gains and employer contributions would be taxed in the hands of the annuitant but there would not be a deemed distribution of the excess funds already on hand.
12. The deregistration of a plan for any reason would result in the full balance at the credit of each annuitant being taxable immediately (subject to averaging).

(b) Non-registered retirement income plans

1. Such plans should be regarded as a conduit to beneficiaries.
2. Employers would be allowed to deduct contributions if reasonable. No employee deductions would be allowed.
3. Income of unregistered plans would be taxed when credited to beneficiaries. The corporate tax applicable to Canadian dividends would flow through to the beneficiaries.
4. Provision would be made for deduction of loss if the ultimate benefits were less than the cost basis of the taxpayer's tax-paid interest in the plan.

(c) Foreign source pensions and Canadian
pensions paid to non-residents of Canada

1. Foreign source pensions would be treated as receipts from a non-registered plan. Employer contributions and investment income accumulated prior to an individual becoming a resident of Canada would be deemed to be contributions by the individual.
2. A Canadian resident who became a non-resident should be subject to a 30% to 40% withholding tax on the income portion.
3. Pensions paid to non-residents should be subjected to a 30% withholding tax.
4. In the case of withdrawals by a non-resident prior to age 60, a withholding tax of 50% should be required.

4. *Tax-Paying Units*

It is proposed that the family be recognized as a tax-paying unit as has been done in other countries. Thus, there would be family tax-paying units and single tax-paying units.

Two suggested rate schedules are set out, one for family tax-paying units and one for single tax-paying units. The rate schedules are set out in Appendix A to this memorandum. The rate schedules rise to a maximum 50% rate which is reached when income amounts to $100,000 per year or more. Preference is indicated for a net worth tax (of say 2%) levied on net assets over $1 million every few years rather than raising the top marginal personal rate to much above 50%. The detailed proposals are set out below:

(a) The tax-paying unit

1. All income flowing into the unit and between units would be taxable. Transfers within the family unit would not affect income. The tax free transfer of property between spouses would be limited to one-half of the income after tax reported by the family unit until the marriage had lasted for five years or until the couple had a natural-born child, whichever was the earlier.
2. It is recommended that the following resident persons be treated as a family unit:
   (a) husband and wife,
   (b) husband, wife and one or more dependent children,
   (c) a surviving spouse,

(d) a surviving spouse and one or more dependent children,

(e) a divorced or separated parent and one or more dependent children,

(f) one or more dependent children separated from both parents,

(g) a single individual and one or more dependent children.

3. Dependent children would include unmarried children resident in Canada, natural born or adopted, 21 years of age or under, or over 21 years of age and mentally or physically infirm. No income test is provided.
4. The family unit would commence at the beginning of the taxation year in which a resident couple were married. Property brought into the marriage by either spouse would not be included in the inçome of the family unit. Any portion of the unused lifetime gift exemptions would carry into the family unit.
5. The family unit would not terminate on the death of one of the spouses. There would be no tax consequences resulting from a transfer of property from the decedent spouse to the surviving spouse. A one-person family unit would, however, compute tax by reference to the individual rate schedule rather than the family unit rate schedule.
6. If the surviving spouse did not remarry and there were no dependent children, the family unit would terminate on the death of the surviving spouse. There would be a deemed disposition of property for purposes of computing income. The value of any property flowing to other tax units would be included in income of the receiving unit.
7. If a surviving spouse remarried, the former family unit would terminate and a new unit would be formed. There would ,however, be no recognition of gain in the former unit, nor income to the new unit.
8. On the divorce or separation of the spouses the family unit would terminate, but again, there would be no tax consequences. Alimony or maintenance payments (periodic or otherwise) would be income to the recipient and deductible to the payor. If either of the parties retain the custody of one or more dependent children a new family unit(s) would be formed. Otherwise, new single units would be formed.
9. If all members of a family unit ceased to be resident, the family unit would terminate with a realization of property gains. If a spouse or a dependent child remained resident, the unit would not terminate but there would be a deemed realization of gain in respect of the property of the persons leaving the country.
10. Where a child became self-sufficient at an early age, earned income on a full-time basis and did not live with his parents, an option would be provided to permit him to withdraw from the family unit and file as an individual tax unit.
11. A child over 21 but not over 25 taking post-secondary education on a full-time basis could elect to remain a member of the family unit.

12. Income of dependent children would be included in the family income only to the extent that it exceeded $500 in any year.
13. A child would cease to be a member of a family unit on marriage, death, ceasing to qualify because of age, ceasing to be resident, "opting out" as discussed above, or if adopted by another family.
14. Unrealized gains on property taken by the child from the original family unit would be recognized as income to the family unit in the year in which he withdraws.
15. Except in the case of adoption, children would be required to include in their income the value of any property taken from the original family unit (over and above the annual gift exemption and the lifetime exemption of $5,000). This would include withdrawal of the child's own earnings already taxed in the family unit.
16. A child becoming a non-resident could elect to be taxed as a resident and remain a member of the family unit. Failure to do this would result in recognition of gain on property withdrawn and income to the child, and subsequent gifts of property would result in gain to the family unit and income to the child (subject to a withholding tax).
17. A family unit of dependent children would cease when the last dependent child ceased to be a dependent (as defined). At that point there would be a deemed realization of gain. Property taken by each child would be included in his income.
18. Common law relationships would be regarded as family units provided the two parties had lived together for at least one year and filed a joint declaration to be treated as man and wife for tax purposes.

(b) Computation of tax

1. Personal exemptions for single and married persons are replaced by zero brackets at the bottom of each rate schedule. Thus the first $1,000 of income to a single taxpayer and the first $2,100 of income to a family unit are exempt from tax.
2. Exemptions for dependent children are to be replaced by tax credits of $100 for the first child and $60 for each additional dependent child in the family unit. Where one child is effectively the "second parent" in a family unit, no credit would be allowed for that child.
3. Provided both husband and wife were engaged in employment or business for more than 120 days per year an additional credit of $80 would be allowed to a family unit having one or more children receiving family allowances. If the family unit contained a child under the age of 7 a further tax credit of $120 would be permitted.
4. The treatment of medical expenses would be revised to permit the deduction of out-of-pocket medical expenses including medical insurance premiums or medical service plan contributions. Medical expenses paid by such plans would not be deductible. The 3% floor on the deduction of medical expenses would be retained with no optional standard deduction.

5. The Report suggests that there should be a greater measure of control over the issuing of charitable donation receipts. Once this was accomplished the limit for the deductibility of donations should be increased from 10% to 15% of income. (In the case of corporations the 10% limit should be retained). The standard deduction for charitable donations should be set at no more than $50.
6. Gifts in kind should be deductible to the extent that they exceed $500 in any one year. Since this would be a disposition of property, any excess of the fair market value over the cost basis would be included in income.
7. Deductions for donations to Canadian provinces, municipalities and to the Canadian government should be continued.
8. Political donations *might* be deductible through a 25% tax credit up to $50 per individual tax unit and $100 per family tax unit.
9. Tax credits are recommended for gifts to close relatives outside the donor's tax unit. The credit would be 10% of the gift up to a maximum credit of $100 for each close relative.
10. Where close relatives share the same domicile or family tax unit there would be a deemed gift of $1,000 (less any amount contributed by the relative for clothing and shelter). The 10% credit would be available to the donor and the donee would be required to bring the benefit into his income (subject to annual and lifetime gift exemptions).
11. A 25% tax credit is proposed in respect to fees paid by or on behalf of a student for post-secondary education. A further credit of up to $300 in recognition of living costs should be provided for a full-time student taking post-secondary education when the student is not a dependent child. Unclaimed credits would be available for carryover.
12. Husbands and wives as members of a family unit could elect, if they so chose, to file separate returns. In such a case all standard deductions and limitations on itemized deductions claimed by each taxpayer would be reduced by one-half. Each spouse would then calculate his or her tax liability by doubling taxable income, apply to that figure the rate schedule for family units, and then reduce the resultant tax by one-half.

(c) Income averaging and deferment

The Commission recognizes that provision for income averaging and deferment is a necessity when it is proposed to tax in full property gains (including realizations on death) and gifts and inheritances. The Commission proposals in this area are as follows:

1. It is proposed that the present income tax sections providing for averaging or special rates of tax on particular types of income should be repealed.
2. All Canadian taxpayers should be permitted to average their income over any number of years they choose up to a maximum of five. Only consecutive years should be averaged and there should be no overlapping (except upon death or ceasing to be resident).

Averaging should not encompass years when the taxpayer was a member of more than one tax paying unit.

3. Averaging should be permitted only when the income of the lowest year in the averaging period is less than 75% of the income of the highest year. Any benefit obtained from averaging would be reduced by a fixed sum of $50 to eliminate small claims.
4. Averaging would be permitted whether income was rising or falling. Averaging would continue to be permitted following retirement and by the family unit following the death of the income-earning spouse.
5. An extended period of time for filing amended returns should be available provided the only change is to make an election to average and claim a refund based on that election. No interest would be payable on such a refund.
6. Losses incurred before and following the averaging period could be carried forward and back into the averaging period. Unused losses would be available for carry forward out of the averaging period.
7. The maintenance of "income adjustment accounts" by the government is recommended to provide a method of income deferment. Deposits into an income adjustment account would be deductible from income if made during the calendar year or within 60 days after the end of the year. No limit would be placed on the amount of deposits, no interest would be paid and they would be non-assignable.
8. Provision should be made that the balance of any taxpayer's account could not be less than the sum of deposits made within the previous twelve-month period to his income adjustment account.
9. Withdrawals from the income adjustment accounts would be taxable and it is suggested that 30% be withheld on account of the beneficiaries' tax.
10. Taxpayers ceasing to be resident in Canada would be required to bring any amount in their adjustment account into income in the year of emigration.
11. Individual tax units would be required to withdraw deposits on or before reaching the age of 60. Family tax units should withdraw all deposits on or before the date on which the youngest member of the unit reaches the age of 60.
12. The use of income adjustment accounts is also proposed for funds received by dependent members of a family unit. Deposits so made would be deductible from the income of the family unit. It is suggested that in this case a modest rate of interest be paid on withdrawal. Deposits withdrawn by the dependent (or former dependent) would be brought into income of the tax unit of which he was a member at the time of withdrawal.
13. Relief from the tax burden caused by fluctuating incomes would also be available to some extent through the use of the following provisions:

    (a) contributions to registered retirement income plans,

(b) unlimited carry over of losses,

(c) proposal to permit property revaluation from cost to market,

(d) provision of a 5-year term over which taxes could be paid (with interest) in the event that gifts or other income were received in non-liquid form.

(e) provision that specific types of lump sum payments (such as damage awards related to the loss of future income) could be excluded from income if used by the taxpayer to acquire a Registered Government Annuity. Payments of such an annuity would commence immediately and would be included in income as received.

5. *Special Industries*

(a) Mining and petroleum

The Report recommends the withdrawal of the principal tax concessions presently provided for the mining and petroleum industries. The specific recommendations are as follows:

1. Immediate withdrawal of all depletion allowances, including depletion for operators, non-operators and shareholders.
2. Complete withdrawal of the three-year tax exemption for new mines, except for an exemption limited to $1,000,000 for a mine brought into production during a five-year transitional period.
3. Exploration costs (including depreciable assets usable only for a specific exploration project) to be fully deductible.
4. Costs of exploration for minerals outside Canada would be deductible.
5. Development costs (including certain depreciable assets) incurred during a transitional period to be eligible for immediate write-off. Thereafter, development costs would be depreciable at 20% or 30% on a diminishing balance basis.
6. Depreciable assets used in smelting and refining would be subject to capital cost allowance at regular rates for buildings and equipment.
7. The cost of purchased mining and petroleum properties would be amortized at prescribed rates (as high as 50% in the transitional period; later dropping to 10% or 20%) applied to operating revenues derived from the property. During a transitional period, the cost of property rights acquired from a government would be allowed as an immediate write-off.
8. All other payments to the provinces for natural resources (e.g. lease payments, royalties or taxes on income) would be fully deductible. Provincial mining taxes would be deductible rather than allowed as a tax credit.
9. Companies qualifying as new and small businesses would be allowed to deduct mining and petroleum property acquisition costs as well as exploration and development costs as incurred to a maximum of $250,000.
10. Taxpayers in mining and petroleum industries would be permitted to amortize over three to five years the excess of certain non-

deductible costs incurred since, say, 1958 over.depletion claimed since that time. Exploration and development costs presently available and not claimed at the effective date of legislation to be eligible for immediate write-off.

11. All profits made on disposition of mining and petroleum properties would be included in income *including* gains accruing prior to the effective date of the legislation.
12. Gains realized by non-residents on disposition of mining and petroleum properties would be subject to Canadian tax.
13. The prospector and grubstaker exemption in respect of the proceeds of sale of an interest in mining properties, or shares of a company received in consideration for mining properties, would be withdrawn in stages.
14. The provisions relating to mining and petroleum would apply to all taxpayers and would not be restricted by a "principal business" test.
15. Companies could pass to purchasers of new shares the right to the immediate deduction of exploration and development costs to be financed out of the proceeds of the share issue. Controls would be established to ensure that the proceeds of the share issue were ultimatly used on direct exploration and development (not including financing and administration costs).
16. The following additional measures might be considered if the above-mentioned proposed tax treatment is inadequate:
    (a) The government loan program for exploration in the North could be expanded.
    (b) Increased subsidies might be made for transportation, communication and geological surveys.
    (c) A subsidy equal to a fraction of additional exploration expenses might be provided.

(b) Life Insurance Companies

The Commission recommended sweeping changes to the taxation of life insurance companies as follows:

1. The present distinctions between stock and mutual companies and fraternal benefit societies should be dropped.
2. Business income of resident and non-resident life insurance companies should be determined and taxed in the same way as business income of other companies.
3. Non-resident companies should be subject to an additional 15% branch tax.
4. Policy dividends should be taxable in the hands of policyholders with an exemption for dividends paid out of surplus existing at the time of implementation. Life insurance companies should withhold tax at 15% from taxable policy dividends.
5. For tax purposes, actuarial liabilities should be computed using an arbitrary investment return rate in excess of 4%. If the initial surplus resulting from the revaluation of the actuarial liability

was credited to shareholders, it should be subjected to the 50% corporation tax.

6. Provision should be made to permit allocation of profits to policy holders and shareholders in the same way as other companies allocate income to shareholders.

(c) General Insurance

1. Business income for general insurance companies, including Canadian branches of foreign general insurance companies, should be computed in the normal way with deductions for unearned premium reserves, provisions for claims which have been incurred but not settled, and dividends paid to policyholders. No deduction would be permitted for other policy reserves or contingency reserves. The dividends paid to policyholders would be taxed as income in their hands.
2. The business income of the Canadian branches of foreign general insurance companies would be subject to the 15% special tax on branch profits Investment income earned by such companies in excess of that reasonably related to the Canadian business would be subject to a special withholding tax similar to that presently imposed.

(d) Banks

1. Banks should be permitted to continue to use arbitrary allowances but these should be greatly reduced. The Commission recommended reserves along the following lines:

Amount of loan	*Suggested rate*
Up to $100,000	Something less than 2%
$100,00 - $500,000	½%

Allowances on loans over $500,000 should be established by specific review. Alternatively, a standard allowance of up to 7 times the average loss experience for the previous five years could be allowed.

2. There should be a transitional period of 10 years to allow banks to convert their present reserves to the proposed limits.
3. Write-offs should be accepted without dispute so long as recoveries did not exceed 10% of write-offs. Any excess of recoveries over 10% should be carried back to the applicable year and tax and interest imposed.

(e) Mortgage Lenders

1. The present mortgage reserves provided by section 85G should be extended to include all taxpayers except banks.
2. Arbitrary allowances should be continued but the rate should be reduced from the present 3% to something along the following lines:

Percentage of loan to fair market value of property	*Suggested rate*
Less than 75%	Close to 1%
More than 75%	Something less than 2%

3. A size limitation of $500,000 for arbitrary allowances should be applied since loans over that figure are capable of regular review and assessment.
4. All insured mortgages should be excluded from the arbitrary allowances.
5. There should be a transitional period of five years to allow taxpayers to adjust their existing reserves to the proposed limits.

(f) Co-operatives, Credit Unions and Caisses Populaires

The Commission's proposals for these organizations would result in their being taxed much like ordinary corporations.

1. Such organizations would be taxable at a 50% rate on all income after deducting patronage dividends, interest, etc., payable to members.
2. Dividends, interest, etc., would be deductible only to the extent that at least 50% was paid in cash to members. Members would be taxable, on the whole dividend.
3. Amounts paid to members out of taxed earnings would be taxable in the hands of the members and credit would be given for the tax paid by the organization.
4. A 15% withholding tax would be required on all dividends, interest, etc., that was payable to members and deductible by the organization.
5. There would be special rules to prevent income from activities with non-members being used to offset losses on activities with members.
6. The Commission stated that it may be necessary to include in income an imputed income on assets used to provide service to members although the immediate introduction of this measure was not recommended.
7. The present 3-year tax exemption for co-ops would be withdrawn. New co-ops would be eligible for the same incentives as other new small businesses.

(g) Farming and Fishing

1. Income from farming and fishing should be computed on the accrual basis rather than on a cash basis unless gross farming revenue is less than $10,000.
2. The practice of establishing basic herds should be discontinued except for those farmers who will be continuing to file on a cash basis.
3. The treatment of farm house expenses should be reviewed to eliminate the deductibility of the personal element.
4. The present restriction on the deduction of hobby farm losses would be repealed and covered by the general rule for the deductibility of business losses.
5. Specific averaging for farmers would be replaced by the general averaging provisions.

6. Farmers would compute capital cost allowances on the normal method and the use of the straight line method should be denied.
7. The adjustment required to convert the farm accounts from a cash to an accrual basis should be applied to reduce the basis of the farm property at the effective date.

(h) Charitable Organizations

1. Income of charitable organizations, whether carrying on activities inside or outside Canada, should continue to be exempt.
2. Income from portfolio investments received by charities should be exempt from taxation and the charity would be entitled to a refund of any taxes paid in respect of such income.
3. Certain types of business income would be subject to tax at corporate rates. No recovery of the corporate tax paid by 10% or more owned companies would be permitted.

(i) Miscellaneous

1. Contractors should account for profits on the percentage of completion method for income tax purposes. No profits or losses are to be recognized with respect to a contract until the contract costs exceed 35% of the contract price. The entire anticipated losses would then be deductible.
2. In the forestry industry, it was recommended that a deduction rather than a tax credit be provided for provincial logging taxes.
3. Non-resident-owned investment company legislation would be withdrawn. These companies would be "phased out" over a 10-year period.
4. The foreign business corporation provisions would cease to apply to any corporation after, say, five years except that they would cease to apply immediately to any corporation which is not a public company listed on a recognized Canadian stock exchange.

6. *Sales Tax*

The Commission studied the existing sales tax and various possible alternatives including a wholesale tax, and added value taxes and turnover taxes. Because of the lack of neutrality of the present manufacturers tax and similar difficulties with wholesale taxes, the Commission recommended that the manufacturers tax be eliminated and a retail tax (including a tax on some services) be introduced. The Commission noted that provincial co-operation would be essential for such a tax to be administratively feasible.

The principal recommendations are set out below:

1. Excise taxes would be removed except on tobacco and liquor.
2. The sales tax base would be broadened to include some consumer services as well as goods.
3. The recommended exemptions include:
   (a) food and drink (other than alcoholic beverages and restaurant meals over a minimum price)

(b) fuel and electricity
(c) drugs and medicines sold on prescription and applicances for the handicapped
(d) magazines, newspapers and books
(e) producers' goods (presumably including goods used to provide taxable services) except where there is a danger of diversion of goods to consumer use (e.g. automobiles).

4. Eventually exemption should be extended to building materials and distributors' goods.
5. In the long run, many exemptions for goods such as food should be removed and replaced by a system of allowances, transfer payments or tax credits.
6. Services should be taxed at the same rate as goods and initially should include: 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 telegraphy services might be taxed with or without exemption when rendered to a business.
7. Services taxable to consumers but not to businesses should include the storage of goods, custom fabrication of goods, and the rental, repair and installation of goods.
8. Certain services should be exempt to consumers, including: medical, dental, nursing, hospital, legal, educational and undertaking services. Persons providing such services should be exempt from tax on all purchases.
9. Used goods would be subject to tax. When used goods were traded in on new goods, tax would apply only to the net price for the new goods.
10. Casual sales on which tax cannot be collected would be exempt.
11. Sales to governments would be taxable.
12. Only services rendered by businesses and institutions on a regular basis would be taxed and persons with an annual turn-over below a stated minimum would not be taxed.
13. The exemption for children's clothing found in most provincial acts would not be granted.
14. Vendors should not be paid any remuneration.
15. Added value taxes should only be applied if the combined federal and provincial rate exceeds 14% and collection problems could not be administered easily.

7. *Administration*

The traditional secrecy in formulating tax law by the budgetary process should not be eliminated or changed. However, in order to allow for more public discussion of changes in tax law, the Commission recommended that the following steps be taken:

1. Formation of an informal advisory committee composed of representatives from business, professional and academic fields to advise the Department of Finance on taxation and fiscal policy.
2. Formation of a joint committee of the House of Commons and the Senate which would hold public hearings on proposed changes to the tax law and would report its findings to the House for its consideration.

The Commission made the following recommendations and comments concerning the form, content and review of tax law:

1. Legislation should be written in general language, and more detailed provisions governing the application of the broad principles of the Act should be set out in regulations.
2. Proposed regulations should be subject to public hearings prior to adoption and subject to review by a parliamentary committee after adoption.
3. While ministerial discretion is unavoidable, it should be kept to a minimum. Where ministerial discretion is involved, the taxpayer should be granted an advance ruling and a parliamentary committee should review the use of discretionary powers and the continuing need for the discretion.

The Commission made the following recommendations with respect to the administration of taxes:

1. The present Department of National Revenue should be replaced by an independent, non-political agency which would report to Parliament through the Minister of Finance.
2. The income tax administration should be decentralized, with most functions being performed in District Offices and five new Regional Offices.
3. To provide a more even flow of income tax returns, T1 Short Forms should be filed by March 31 which would necessitate advancing the filing date for T4 slips to January 31.
4. Taxpayers should be allowed the right to file an amended income tax return within four years from the due date of the return.

The Commission observed a need for a substantial increase in the quantity of information available to the public and made the following recommendations:

1. More general information should be made available to taxpayers to assist them in determining their tax liabilities.
2. The information contained in the Assessors' Guide concerning the Department's interpretation of the law should be made public knowledge.
3. A system of advance rulings is necessary where ministerial discretion is involved. In addition, this system should be expanded gradually and the rulings should be published if they do not reveal confidential or secret information.

The Commission recommended the following changes in the present appeal system:

1. Three levels of informal appeals should be available to the taxpayer prior to the Notice of Objection stage: a pre-assessment conference, a district conference and a regional conference, all at the option of the taxpayer.
2. The Tax Appeal Board and the judicial functions of the Tariff Board should be merged to create a Tax Court with three divisions: Income Tax, Transactions Tax and Customs Tariff.
3. The Tax Court would be a court of original jurisdiction which could, at the option of the taxpayer, hold hearings in camera.
4. Decisions of the Tax Court could be appealed to the Exchequer Court on matters of law. Under this recommendation an appeal to the Exchequer Court would no longer represent a new trial as is the present case.

The Commission indicated concern about a taxpayer evading tax by leaving Canada and becoming a resident of another country. The Commission considered it advisable to provide for reciprocal enforcement of tax judgments within defined limits with foreign countries to deal with the evasion problem.

IV. POSSIBLE EFFECTS OF RECOMMENDATIONS

Finally, in an effort to point up the possible effects of the recommendations there are three tables in the Report on pages 33, 35, and 38 of Vol. I which are reproduced below. A reading of these tables will give one an arithmetic idea of what the changes would be if the Report is implemented.

TABLE I
TAX CALCULATION FOR A MARRIED TAXPAYER WITH TWO DEPENDENT CHILDREN WITH WAGE AND SALARY INCOME ONLY

	Salary Income of $5,000		Salary Income of $35,000	
	Under Current System	Under Our Proposals	Under Current System	Under Our Proposals
Comprehensive Base Income				
Wages and salaries	$ 5,000	$ 5,000	$35,000	$35,000
Less: Employment expenses and unemployment insurance premium	......	199	......	549
Net employment income for tax purposes	$ 5,000	$ 4,801	$35,000	$34,451
Family allowances	......	144	......	144
Total Assessable Income	$ 5,000	$ 4,945	$35,000	$34,595
Deductions:				
Standard deduction and family exemptions	2,700	50	2,700	50
Taxable Income	$ 2,300	$ 4,895	$32,300	$34,545
Gross Tax	$ 281	$ 438	$12,200	$ 9,004
Tax credits:				
Credit for dependants	......	160	......	160
Personal Income Tax	$ 281	$ 278	$12,200	$ 8,844
Old age security tax	92	......	120	......
Total Income Taxes	$ 373	$ 278	$12,320	$ 8,844

Note: Personal income taxes are before abatements to the provinces and are calculated under the current tax system using 1966 rates. Standard deductions of

$100 under the current system and $50 under our proposals are used in calculating taxable income. The recommended minimum allowance of 3 per cent of employment income up to a $500 maximum is used for employment expenses. It is assumed that both dependent children receive family allowance of $6 per month, and that only one member of the family receives income, all in the form of wages and salary.

TABLE 2

TAX CALCULATION FOR A MARRIED TAXPAYER WITH TWO DEPENDENT CHILDREN WITH CORPORATE SOURCE INCOME ONLY

	Corporate Source Income of $25,000		Corporate Source Income of $175,000	
	Under Current System	Under Our Proposals	Under Current System	Under Our Proposals
Comprehensive Base Income				
Dividends	$ 5,000	$ 5,000	$ 35,000	$ 35,000
Corporation tax paid	10,000	10,000	70,000	70,000
Capital gain due to retained earnings	5,000	5,000	35,000	35,000
"Goodwill" capital gains	5,000	5,000	35,000	35,000
Corporate source income	25,000	25,000	175,000	175,000
Family allowances	144	144	144	144
Total Income	$ 25,144	$ 25,144	$175,144	$175,144
Total Assessable Income	$ 5,000	$ 25,144	$ 35,000	$175,144
Deductions:				
Standard deduction and family exemptions	2,700	50	2,700	50
Taxable Income	$ 2,300	$ 25,094	$ 32,300	$175,094
Gross Tax	$ 281	$ 5,560	$ 12,200	$ 76,224
Non-refundable tax credits:				
Credit for dependants	......	160	......	160
Dividend tax credit	1,000	......	7,000	......
	......	$ 5,400	$ 5,200	$ 76,064
Refundable tax credit:				
Corporation taxes attributed	......	10,000	......	70,000
Personal Income Tax	......	($4,600)	$ 5,200	$ 6,064
Old age security tax	92	......	120	......
Corporation income tax	$ 10,000	$ 10,000	70,000	70,000
Total Direct Taxes	$ 10,092	$ 5,400	$ 75,320	$ 76,064

Note: As in Table 1. Corporation income tax under the current system is calculated assuming that all corporate income is taxed at a rate of 50 per cent. The assessable income under the current system is limited to the dividends received. It is also assumed that dividends are equal to retentions, that total corporate income is unchanged by our proposals and that "goodwill" capital gains, which reflect the premium that a prospective shareholder is willing to pay for the anticipated earnings of the corporation, are equal to dividends. Direct taxes include personal and corporation income taxes and gift and estate taxes.

TABLE 3

TAX CALCULATION FOR A MARRIED TAXPAYER WITH TWO DEPENDENT CHILDREN RECEIVING NON-CORPORATE SOURCE INVESTMENT INCOME OF $25,000 AND $10,000 IN GIFTS

	Under Current System	Under Our Proposals
Comprehensive Base Income		
Investment income currently taxable	$20,000	$20,000
Capital gains	5,000	5,000
Total investment income	$25,000	$25,000
Gifts	10,000	10,000
Family allowances	144	144
Total Income	$35,144	$35,144
Total Assessable Income	$20,000	$35,144
Deductions:		
Standard deduction and family exemptions	2,700	50
Taxable Income	$17,300	$35,094
Gross Tax	$ 5,085	$ 9,212
Tax credits:		
Credit for dependants	......	160
Personal Income Tax	$ 5,085	$ 9,052
Old age security tax	120	......
Gift tax attributable	1,100	......
Total Direct Taxes	$ 6,305	$ 9,052

Note: As in Table 1. It is assumed in calculating gift taxes paid on the gift of $10,000 that the donor has used up his gift tax exemption for the year and that the gift is fully taxable but subject only to the 11 per cent rate. Because so many gifts are now exempt, this assumption results in a higher than average rate of tax being applied to the gift in this example. Direct taxes are defined to include personal income taxes, corporation income taxes and gift and death taxes.

Because estate tax and gift tax is eliminated under the proposals of the Commission and inheritances and gifts are taxed as income it might be useful to show an example with respect to total taxation under our present system and under the recommendations, if implemented, of the Carter Report.

For the purposes of the illustration the positions of two definitely imaginary gentlemen—a Mr. Pearson and a Mr. Diefenbaker—will be compared. Both of them are happily married and have one child, an adult son. In other ways too, their situations are very similar. They are both 60 and about to die. During their lifetimes each of them founded a family business which is incorporated and has flourished. They own all the shares in their respective corporations and wish to leave them to their sons. Given all these similarities, there is one major difference—Mr. Pearson lived in the pre-Carter era and Mr. Diefenbaker lived post-Carter.

1. *Assumptions*

Obviously we have to make a number of assumptions.

1. Each made an initial investment of $50,000 in the corporation and the corporation is now valued at $1,000,000 made up as follows:

(a) Intial Investment	$ 50,000
(b) Retained Earnings	750,000
(c) "Good Will"	200,000
	$1,000,000

2. Each had drawn $27,000 per annum in salary and left the remaining profits in the corporation (under the existing tax structure $27,000 would being a married taxpayer up to the 50% bracket).
3. Each has another $100,000 in assets which are to go to their wives.
4. The funds to meet taxes arising on death are to be obtained from the company.
5. The sons have taxable income of $50,000.

2. *Taxes Payable on death of Mr. Pearson*

1. *Estate Taxes*

Net Aggregate Value	$1,100,000
Less—exemption	60,000
Net	$1,040,000
Approximate estate taxes	$ 349,000

2. *Income Taxes*

We have assumed that the money to meet the estate taxes must come from the company and this results in income taxes being paid. The cheapest method appears to be to draw $250,000 by way of dividend and an equivalent amount by way of sec. 105. This total distribution of $500,000 will net the estate approximately $356,000 for a tax cost of $144,000.

3. *Total Taxes Payable*

Estate Taxes	$ 349,000
Income Taxes	144,000
	$ 493,000

3. *Taxes payable on death of Mr. Diefenbaker*

1. *Income Taxes Payable by Mr. Diefenbaker's Estate*

Good Will Gain now deemed realized	$ 200,000

(Note: The retained earnings have increased Mr. Diefenbaker's cost basis for share gain purposes.)

Tax thereon	$ 96,000

This amount can be withdrawn from the company without tax consequences.

2. *Taxes Payable by Heirs*

Widow:—$100,000 not subject to tax	nil
Son:—$904,000 (taking advantage of the block averaging provision)	$ 444,000

(Again this amount can be withdrawn from the company without tax consequences.)

3. *Total Taxes Payable*

By the Estate	$ 96,000
By the Heirs	444,000
Total	$ 540,000

4. *Comparison of taxes payable*

The total taxes payable in respect of Mr. Pearson are $493,000.

The total taxes payable in respect of Mr. Diefenbaker are $540,000.

On the face of it the pre-Carter position is better than that of the post-Carter period by some $47,000. However, at this point we should examine our original assumption in the light of the inter-relationship of the structures that has been discussed. When we do we find that the comparison we have made is not particularly valid because the perfect equality of financial status that was assumed at death could not (or certainly should not) happen.

5. *Effects of integration proposal adjusted tax rate structure*

One of the assumptions made was that Mr. Pearson drew a salary sufficient to bring him up to the 50% tax bracket. Giving him the allowance for marital status only, he would draw $27,000 per annum on which he would pay $8,570 exclusive of old-age security tax.

If Mr. Diefenbaker drew $27,000 per annum under the post-Carter rate structure he would pay only $6,227 for an annual tax saving of about $2,350 which, for comparison purposes we must assume he has not spent. However, further analysis reveals that Mr. Diefenbaker could (under the new tax structure) have drawn by way of salary, or by way of dividend, or could have allocated to him a further $73,000 annually before he reached the 50% tax bracket. The difference in tax on $73,000 at the assumed corporate rate of 50% and the proposed new progressive tax rate structure recommends a further annual saving of $4,050 which we again assume he has not spent.

In total then, Mr. Pearson would have an annual tax saving of approximately $6,400 per annum which would go to increase his assets. Over a period of ten years prior to his death this would aggregate to $64,000 plus income on that amount. It is apparent that, on the assumptions made, Mr. Diefenbaker's estate would be greater than Mr. Pearson's at death.

6. *Second Comparison*

Going back to the original calculations, the extra tax on Mr. Diefenbaker's death was approximately $47,000 but, over the last ten years of his life his income taxes would have been $64,000 less than Mr. Pearson's. At death he should be at least $64,000 wealthier than Mr. Pearson.

Unfortunately this is not yet the end because it is necessary to consider what he does with the extra $64,000. If it is left to his widow, who manages to spend it before her death, there will be no further tax to pay so the post-Carter situation appears to be better—despite Mr. Diefenbaker being assessed to tax on a "capital gain" of $200,000. However, if he leaves his extra $64,000 plus to his son there will be another $32,000 in tax to be paid and at that point the average swings to the pre-Carter situation.

7. *Conclusion*

It is apparent that this illustration based on one set of assumptions does not illustrate whether post or pre-Carter legislation is less onerous. Making a different set of assumptions, the results would be dramatically different. But it is hoped that it does demonstrate that many of the specific recommendations of the Carter Report cannot be examined in isolation and compared with what appears to be the comparative legislation presently in effect.