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Preliminary report on the
summary of 1971 tax reform
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THE SENATE

CANADA

Thursday, November 4, 1971.

# STANDING SENATE COMMITTEE ON

# BANKING, TRADE AND COMMERCE

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## PRELIMINARY REPORT

## ON

## THE SUMMARY OF 1971 TAX REFORM LEGISLATION

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The Honourable Salter A. Hayden, Q.C., Chairman

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MEMBERSHIP OF THE COMMITTEE

THE STANDING SENATE COMMITTEE ON BANKING
TRADE AND COMMERCE

The Honourable Salter A. Hayden, Chairman,

and

The Honourable Senators

| | |
|---|---|
| Aird | Grosart |
| Beaubien | Haig |
| Benidickson | Hays |
| Blois | Isnor |
| Burchill | Lang |
| Carter | Macnaughton |
| Choquette | Molson |
| Connolly (Ottawa West) | Smith |
| Cook | Sullivan |
| Croll | Walker |
| Desruisseaux | Welch |
| Everett | White |
| Gelinas | Willis |
| Giguere | |

Ex officio members: Flynn and Martin

(Quorum 7)

ORDER OF REFERENCE

Extract from the Minutes of the Proceedings of the Senate, September 14, 1971:

"With leave of the Senate,

The Honourable Senator Hayden moved, seconded by the Honourable Senator Denis, P.C.:

That the Standing Senate Committee on Banking, Trade and Commerce be authorized to examine and consider the Summary of 1971 Tax Reform Legislation, tabled this day, and any bills based on the Budget Resolutions in advance of the said bills coming before the Senate, and any other matters relating thereto; and

That the Committee have power to engage the services of such counsel, staff and technical advisers as may be necessary for the purpose of the said examination.

After debate, and -

The question being put on the motion, it was -

Resolved in the affirmative."

Robert Fortier,
Clerk of the Senate.

...DUCTION

On September 14, 1971 there was tabled in the House a document entitled "Summary of 1971 Tax Reform Legislation" and on the same date, by resolution of the Senate, consideration of same was referred to the Standing Senate Committee on Banking, Trade and Commerce.

For the purposes of brevity and identification, the "Summary of 1971 Tax Reform Legislation" will be referred to in this report as the "proposed legislation" and the Standing Senate Committee on Banking, Trade and Commerce will be referred to as "your Committee" or "the Committee".

The Committee would like to take the opportunity at this time to commend the Government in respect of many of its proposals pertaining to individuals, in particular for the reduction in taxes, the increased personal exemptions for both single and married taxpayers and for taxpayers aged 65 and over, the allowance of a deduction for child care expenses, the deduction for moving expenses occasioned by a job change and the increased deductions for pensions and charitable contributions. Your Committee also notes with approval the allowance of a deduction by corporations of interest paid on money borrowed to acquire shares of other corporations. We would further commend the Government for modifying many of the proposals put forward in the "White Paper Proposals for Tax Reform" in response to the many representations made in respect of same.

Pursuant to the order of reference dated September 14, 1971, your Committee has heard a number of representations and has received a number of written submissions on the proposed legislation. Having studied the various representations which have been heard or received up to and including the 27th day of October 1971, your Committee has concluded

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received up to and including the 27th day of October 1971, your Committee has concluded

that it is desirable to submit to the Minister of Finance, as expeditiously as possible, a number of recommendations in respect of the proposed legislation which is presently being considered by Committee of the Whole in the other House. It is the hope that, upon the receipt by the Minister of Finance of these recommendations, the same will be accepted by him as being pertinent and relevant, and to the extent so regarded, that appropriate amendments will be submitted by him to the other House while the said proposed legislation is being considered in the Committee stage.

Having regard to the urgency of the matter and the problem of time, your Committee is submitting for your approval at this time a limited number of recommendations but it is hoped that the Committee will still be in the position to make further recommendations before the proposed legislation reaches this House. Alternatively, the Committee will submit these further recommendations when the said proposed legislation reaches this House after having passed the other House.

The proposed recommendations are hereinafter submitted in seriatim form.

IMPACT ON THE CONTINUING VIABILITY OF CANADIAN MULTINATIONAL CORPORATIONS - THEIR DOMESTIC AND FOREIGN OPERATIONS THROUGH FOREIGN AFFILIATES, THEIR NEED FOR SUCH FOREIGN OUTLETS TO MAINTAIN HIGHER LEVELS OF EMPLOYMENT IN CANADA, THEIR CAPITAL NEEDS IN CANADA AND ABROAD AND THEIR COMPETITIVE POSITION IN WORLD MARKETS

Your Committee is deeply concerned with the possible effect of the proposed legislation on the competitive position of Canada's international corporations in world markets. To the extent that Canada's world trading position is adversely affected, it follows that our economic growth as a whole must likewise suffer.

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Your Committee is deeply concerned with the possible effect of the proposed

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A. Passive Income

One of the areas which gives rise to this concern is that relating to the treatment of income earned abroad by Canadian residents and their foreign affiliates. The principal purpose of these provisions is to prevent Canadian residents from avoiding or unduly deferring Canadian income tax on passive income such as dividends, interest, rents, royalties and certain types of capital gains by diverting such income to a non-resident corporation or trust and allowing the non-resident corporation or trust to accumulate such income abroad instead of repatriating it to Canada.

To prevent any possible abuse in this regard, it is proposed that Canadian residents (both corporate and individual) will be obliged to include in income their "participating percentage" of any diverted income earned by a non-resident corporation or trust which is "affiliated" (as defined) with the Canadian taxpayer. This income must be taken into account each year by the Canadian resident whether or not received in the year from the foreign affiliate.

Most certainly, the objective of attempting to thwart tax avoidance is a valid one. However, the anti-avoidance rules relating to diverted income are extended in such an indiscriminate manner as to encompass not only diverted income but also all passive income of foreign affiliates even though the affiliates were established for bona fide business purposes and were not established or used for the purpose of diverting passive income abroad in order to avoid or unduly defer Canadian income tax.

This is particularly unfortunate in the light of the fact that the proposed legislation does not define what income is to be excluded from the diverted income rules as being "active business income". Because of this, there is a serious danger that income

such as interest received by a foreign affiliate on short term deposits or on trade receivables and royalties received by such an affiliate in respect of patents or know-how developed by it abroad in the course of its active business operations (to name but a few) may be taxed currently in the hands of the Canadian shareholder as diverted income even though such income is in fact directly attributable to the foreign affiliate's active business. Such income is not diverted income.

Further, it has been noted that international corporations are not infrequently obliged by the laws of a foreign country to carry on their business operations in that country through a foreign affiliate which is controlled by residents of that country. In circumstances such as these, the fact that the foreign affiliate earns passive income is often a matter which is beyond the control of the Canadian international corporation and is therefore not motivated by tax avoidance considerations. Nevertheless, in the absence of adequate de minimis relieving provisions in the proposed legislation, the Canadian international corporation will be subject to Canadian income tax on its "participating percentage" ~~of~~ such passive income.

This indiscriminate extension of the diverted income rules to include all passive income of foreign affiliates is further aggravated by the following:

1. Because of the manner in which the term "participating percentage" is defined, the amount taxable in a Canadian shareholder's hands under the passive income rules may, in some instances, be greater than the portion of the foreign affiliate's passive income that actually accrues to his benefit; this could occur where the foreign affiliate is not wholly-owned by one Canadian taxpayer and there is more than one class of shares of capital stock outstanding (treating certain income debentures as capital stock for this purpose).

2. No provision has been made in the proposed legislation to allow a taxpayer to apply losses sustained in one year in respect of a passive income source against passive income "earned" in other years under a loss carry-over provision.

Even if the assimilation of passive income with diverted income could be justified, the above-described defects should be rectified.

B. Dividends received from foreign affiliates

Your Committee is also concerned with one other matter that is inherent in the proposals relating to international income. It is intended that the treatment to be accorded to dividends received from foreign affiliates will differ according to whether the foreign affiliate is, or is not, located in a country with which Canada has a tax treaty.

Your Committee has difficulty in appreciating the reason for this difference in treatment. Until such treaties are negotiated, uncertainty will prevail. This can only have an unsettling effect on our trading and business operations abroad. Quite apart from this, it offends your Committee that business decisions should be influenced by the government's success, or lack of success, in negotiating tax treaties. Our international trading position should not be either jeopardized or used as a means of bargaining between governments.

In this connection, while the Committee is aware of the Government's intention to provide tax-sparing relief with respect to operations established in developing countries pursuant to commitments entered into prior to 1976, nevertheless, we cannot agree with the taxing of dividends from affiliates operating in non-treaty countries. Many of these countries are developing nations which offer tax incentives to foreign corporations. Canada should not tax away these incentives and reduce their value to Canadian corporations.

C. Other considerations

As a result of the foregoing proposals, the after-tax return to Canadian international corporations from foreign business operations will be reduced and their competitive standing in world markets will be prejudiced. If this occurs, the effect may be to discourage foreign business operations and, having regard to Canada's dependency on world trade, the curtailment of these operations can only have an adverse effect on our own

economic growth. Further, any such restriction on foreign business will reduce the support for marketing and research facilities in Canada, which again will worsen our competitive position abroad. Needless to say, the demand for technical skills and other employment opportunities will be reduced, compounding our present unemployment position.

In voicing its concern about the impact of these proposals on employment opportunities in Canada, your Committee is not unmindful of the fact that two of Canada's largest international corporations who appeared before the Committee and who stated that they would be adversely affected by those proposals are understood to employ approximately 25,000 Canadians. As is well known, any loss of employment in a particular sector of the economy such as this has a ripple effect on the economy as a whole and must inevitably lead to further unemployment. Copies of the briefs submitted to your Committee by the two above-mentioned corporations were forwarded to the Department of Finance at its request.

It is imperative that we, as a nation, do not lose sight of the fact that Canada is one of the major trading countries of the world and that the encouragement of Canada's international corporations in their efforts to expand world markets is of the greatest national importance and the highest priority. Any measures such as those contained in the proposed legislation which inhibit these efforts are to be deplored, particularly in view of the fact that these proposals run counter to the patterns being set by other developed nations. For example, the effect of the proposals recently put forward by the United States government with respect to domestic international sales organizations (commonly referred to as the DISC proposals) would be to defer payment of U.S. income tax until dividends are distributed.

Indeed, the Government in its original approach to the taxation of foreign source income, as outlined in its White Paper Proposals for Tax Reform (1969), conceded that Canadian international corporations should not be placed at a competitive tax disadvantage. At page 72 (paragraph 6.9) of the White Paper it is stated:

> "On the other hand, Canadian business is often required to go abroad to seek foreign sources of supply and to develop foreign markets. Going international is frequently necessary to enable Canadian companies to achieve the economies of scale which are otherwise denied to them by the relatively small size of the Canadian domestic market. Such companies would find it hard to compete on the international scene if they were subject to more onerous taxes than those which apply to their competitors."

In addition to all of the foregoing, recent comments of the Minister of Finance indicate that the Government is also aware of difficulties that may be encountered when he stated as follows:

> "We have already received a number of representations relating to the passive income provisions and it seems clear that some changes to the law as necessary should be made before the provisions take effect. However, we have concluded that it would be premature to introduce changes at this time before all representations have been received and given the study they require."

YOUR COMMITTEE RECOMMENDS the following:

I A. Foreign accrual property income (passive income)

That the Government give renewed consideration to the "foreign accrual property income" (FAPI) rules with a view to making at least the following changes:

(a) That the definition of the term "foreign accrual property income" by amended to exclude from the category of income which is subject to the foreign affiliate rules any income or capital gains from property that may reasonably be regarded

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(a) (continued)

as having been used for the purpose of gaining or producing income from an active business; or, that the term be redefined in such other manner as to ensure that the overall thrust of the foreign accrual property income provisions will be restricted so that the income subject to these rules will include only diverted income; in the result, that income such as interest on short-term deposits, interest on trade receivables, gains on the disposition of capital property used in a bona fide business operation and other like items will not be classed as foreign accrual property income.

(b) That the de minimis rule contained in the proposed legislation be broadened to the effect that the passive income rules will not apply to any foreign affiliate whose passive income does not exceed a specified percentage of its total gross revenue (such as the 30% rule in the United States); alternatively, the de minimis rule may be expressed as a percentage of the foreign affiliate's gross assets.

(c) That the term "foreign affiliate" be re-defined for purposes of the foreign accrual property income rules to include with respect to foreign corporations only those corporations which are controlled directly or indirectly in Canada.

B. Dividends received from foreign affiliates

That the proposed differentiation in treatment of dividends, received from foreign affiliates, depending on whether the foreign affiliate is located in a treaty country or non-treaty country, be ~~withdrawn~~ eliminated and that all dividends received by resident corporations from foreign affiliates be exempt from tax. In any event, your Committee can find no valid reason for the failure to provide a ~~foreign~~ tax credit in respect of foreign withholding taxes on dividends from non-treaty countries.

(a) (continued)

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II That the Government announce any changes in these provisions at the earliest opportunity and, pending same, that the effective date of the passive income rules which are to commence with respect to passive income earned in taxation years commencing after December 31, 1972 be deferred in their implementation for a period of at least one further year to December 31, 1973.

In conclusion, your Committee feels constrained to reiterate the views expressed by it in its Report on The White Paper Proposals for Tax Reform condemning the implication inherent in the Government's proposals that vast tax avoidance schemes exist through the use of foreign entities. As stated in its Report, the Committee believes that tax avoidance of this kind can be effectively blocked under existing legislation and failure to block such abuses (if they exist) is due more to lack of enforcement of existing law than to lack of legislation.

FARMERS

A Basic herds

At the time, farmers who maintain a permanent herd of animals for the purpose of producing livestock or livestock products for sale are construed as having a capital asset in the form of a "basic herd". This treatment has been sanctioned by the Department of National Revenue in its "Farmer's & Fisherman's Tax Guide" which sets out rules for establishing and enlarging basic herds. In other words, the brood animals forming part of the basic herd are analagous to other capital assets of the farmer such as land and orchards and to the fixed capital assets of any other business.

Under the proposed legislation, it is intended to abolish the concept of the basic herd and to treat such herds as inventory or stock-in-trade. Under the transitional rules, basic herds which have already been established will continue to be treated as

ii) That the Government announce any changes in these provisions at the earliest opportunity and, pending same, that the effective date of the passive income rules which were now to commence with respect to passive income earned in taxation years commencing after December 31, 1972 be deferred in their implementation for a period of at least one further year to December 31, 1973.

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capital assets to the extent that gains accrued at the commencement of the new system will not be subject to tax. However, gains accruing thereafter will be treated in the same manner as profits on the sale of inventory.

Your Committee is not aware of any reason for not continuing to recognize a permanent herd for what it is, namely, a capital asset.

YOUR COMMITTEE RECOMMENDS that provision be made in the proposed legislation for the continued recognition of a farmer's permanent herd as a "basic herd" and, therefore, as a capital asset.

B Capital gains and farm land

Your Committee is of the view that farmers occupy a special position in the economic structure of this country. Over the years, this sector of the economy has become increasingly subjected to pressures which have led to a profound change in the nature and use of farm lands. Your Committee is concerned by this trend and believes that measures should be taken to reverse it.

YOUR COMMITTEE RECOMMENDS that consideration be given to extending the rollover provisions to permit land together with any other capital property which is used by an individual in a farming activity to be transferred, either during lifetime or on death, to lineal ascendants or descendants without being subject to capital gains treatment under the deemed realization provisions. This exemption should only be available in those circumstances where the transferee or transferees continue to carry on the farming activities.

EMPLOYEES PROFIT SHARING PLANS

Under present law, an employee who is a beneficiary under an employees profit sharing plan is taxed in the same manner as an employee who receives a profit sharing bonus directly from his employer and invests the money received. In summary, the employee's position is as follows:

1. the employee is taxed annually on an amount which his employer contributes to the plan on his behalf in the same manner as he would have been if he had received a bonus of an equivalent amount directly;
2. the employee is not allowed a deduction in respect of any contributions which he himself may pay into the plan;
3. the employee's share of the income earned each year by the plan is taxed annually in his hands; and
4. amounts received by the employee out of the plan (whether on retirement or otherwise) are, in general, non-taxable since these amounts will normally have been taxed previously.

Under the proposed legislation, the same general rules will apply. However, with the taxation of capital gains, the employee will also be taxed annually on his proportionate share of one-half of the net capital gains realized by the trust in each year (excluding any portion accrued prior to January 1, 1972 ~~accrued up to Valuation Day~~) as well as on his share of the income earned by the trust in the year. In addition, provision is made in the proposed legislation with respect to the taxation of any unrealized gain on capital property distributed in specie to an employee on his withdrawal from the plan. Under these provisions, the employee is subject to tax in the year of his withdrawal on any accrued gain in respect of the property received from the trust (excluding any portion

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accrued prior to January 1, 1972) but it would appear from the proposed legislation that such accrued gains will be treated as ordinary income rather than as capital gain.

Quite evidently, these accrued gains should at least receive capital gain treatment and this should be clearly stated in the proposed legislation. However, even this treatment is unsatisfactory inasmuch as it places a member employee at a severe disadvantage vis-a-vis an employee who invests after-tax earnings directly. In the opinion of your Committee, capital property which is in substance the employee's property should not be considered as having been realized at fair market value on distribution to the employee. The deferral of gain would be consistent with the treatment to be accorded to a capital beneficiary of an ordinary trust.

YOUR COMMITTEE RECOMMENDS the following:

1. That where property is distributed in specie to an employee by the trustee of an employees profit sharing plan, the trustee should be deemed to have disposed of the property for proceeds equal to its cost amount (as defined) to the trust;

2. That the employee should be deemed to have acquired the property at the cost amount to the trust; and

3. That the employee should not be taxed until he ultimately disposes of property, at which time any gain should be subject to capital gains treatment.

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2. That the employee should be deemed to have acquired the property at the cost amount to the trust; and
3. That the employee should not be taxed until he ultimately disposes of property, at which time any gain should be subject to the capital gains treatment.

DEFERRED PROFIT SHARING PLANS

The tax treatment of deferred profit sharing plans differs from the treatment accorded employees profit sharing plans. The provisions of the present law relating to deferred plans are, in summary, as follows:

1. the employee is not taxed currently on any amounts which his employer may contribute to the plan on his behalf nor on the income earned in the year by the plan; and
2. instead, the employee is subject to tax on the full amount received on his withdrawal from the plan minus any portion representing a refund of contributions paid by the employee into the plan; the exclusion of the employee's contributions follows from the fact that the employee is not allowed a deduction for contributions but is obliged to make these payments out of tax-paid dollars.

It is significant to note that the amount taxable as income in the employee's hands represents not only his share of (a) the employer's contributions, and (b) the income earned by the plan, but also (c) his share of any net capital gains of the trust. This treatment has been acceptable to member employees partly because of the tax deferral feature inherent in these plans but also in large measure because the employee has the right to avail himself of the special tax averaging provisions of Section 36 of the present Income Tax Act in respect of a lump sum payment received on his withdrawal from the plan.

Under the proposed legislation, the lump sum distribution from the plan will continue to be treated as ordinary income whether the distribution is made from employer contributions, income accumulated by the trust, capital gains realized by the trust or unrealized gains in respect of property distributed in specie to the employee.

However, the tax averaging provisions of Section 36 of the present Act are not carried forward into the proposed legislation in respect of amounts accumulated by the trust after 1971. Instead, these provisions are to be replaced by averaging provisions which, for purposes of members of deferred profit sharing plans, appear to be quite inadequate. In this regard transitional provisions are to be introduced to permit employees to take advantage of an averaging provision equivalent to Section 36 of the present Act in respect of amounts accumulated in the trust up to December 31, 1971. However, if such an election ~~is~~ be made by an employee, he cannot avail himself of either of the proposed averaging provisions (general or forward) in respect of that portion of the amount accumulated in the trust after December 31, 1971. Also, in future years, the transitional rule will be of diminishing benefit.

The general and forward averaging provisions available under the proposed legislation are not only much less generous than the elective provision under section 36 of the present Act, but the requirement to purchase an income averaging annuity in order to obtain forward averaging in effect removes the basic purpose of a deferred profit sharing plan, i.e. the accumulation of a lump sum on retirement.

In the opinion of your Committee, the effect of the proposed legislation will be to legislate these plans out of existence. ~~In the opinion of your Committee~~ ~~some~~ Relief should be granted ~~in respect of deferred profit sharing plans~~; the ~~best~~ most appropriate means of achieving this relief is ~~in~~ by the application of capital gain rules to the property of the trust.

YOUR COMMITTEE RECOMMENDS the following:

1. that any amount distributed by the trustee of a deferred profit sharing trust out of capital gains realized by the trust should qualify for capital gains treatment in the employee's hands;

However, the tax averaging provisions of Section 36 of the present Act are not carried forward into the proposed legislation in respect of amounts accumulated by the trust after 1971. Instead, these provisions are to be replaced by averaging provisions which, for purposes of members of deferred profit sharing plans, appear to be quite inadequate. In this regard transitional provisions are to be introduced to permit employees to take advantage of an averaging provision equivalent to Section 36 of the present Act in respect of amounts accumulated in the trust up to December 31, 1971. However, if such an election be made by an employee, he cannot avail himself of either of the proposed averaging provisions (general or forward) in respect of that portion of the amount accumulated in the trust after December 31, 1971. Also, in future years, the transitional rule will be of diminishing benefit.

The general and forward averaging provisions available under the proposed legislation are not only much less generous than the elective provision under section 36 of the present Act, but the requirement to purchase an income averaging annuity in order to obtain forward averaging in effect removes the basic purpose of a deferred profit sharing plan, i.e. the accumulation of a lump sum on retirement.

In the opinion of your Committee, the effect of the proposed legislation will be to legislate these plans out of existence. ~~In the opinion of your Committee some~~ relief should be granted ~~in respect of deferred profit sharing plans; the~~ most means of achieving this relief is by ~~in~~ the application of capital gain rules to the property of the trust.

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1. that any amount distributed by the trustee of a deferred profit sharing trust out of capital gains realized by the trust should qualify for capital gains treatment in the employee's hands;

2. that where property is distributed in specie to an employee by the trustee, the trustee should be deemed to have disposed of the property for proceeds equal to its "cost amount" (as defined) to the trust,

3. that the employee should be deemed to have acquired the property at the "cost amount" to the trust, and

4. that the employee should not be taxed until he ultimately disposes of the property, at which time the ~~proceeds~~ any gain should be accorded capital gain treatment.

## DEEMED DISPOSITION ON CEASING TO BE A RESIDENT IN CANADA

One of the provisions of the proposed legislation which has occasioned widespread concern is the Government's proposal that taxpayers who emigrate from Canada will be deemed for capital gains purposes to have disposed of all of their capital assets (other than "taxable Canadian property") for an amount equal to the fair market value of the property at the date of their departure. Any taxable capital gain (or allowable capital loss) determined by reference to such fair market value must then be taken into account in computing the emigrant's income for tax purposes for the year in which he ceases to be a resident.

One of the effects of these provisions is that a taxpayer who leaves Canada to take up residence abroad will often be subject to double taxation - first in Canada in the year in which he ceases to be a resident and secondly in his new country of residence in the year in which he ultimately disposes of the property. This will occur if the foreign country imposes tax on capital gains (but does not have a provision similar to that contained in the proposed legislation to the effect that there is a deemed acquisition on becoming a resident) and if the tax payable in one country is not available as a credit against the tax payable in the other. The only possible relief in such ~~a~~ situation would be by way of tax treaty and, in your Committee's opinion, this type of relief is unlikely as we know of no other country which uses an accrual basis of accounting for capital gains upon entering or leaving the country. Failure to provide adequate relief runs counter to the principle in our law that double taxation is to be avoided.

The proposed legislation does provide an alternative to the foregoing. Instead of paying tax on his deemed gains ~~(on property disposed of other than "Taxable Canadian Property") at the date of his departure~~, the taxpayer may elect to defer taxation until the year in which the gains are actually realized. However, if such an election is made, the taxpayer will be subject to Canadian income tax in the year of realization on his world income for that year (and not simply on the capital gain) to the same extent as if he were still a resident in Canada. This alternative will often prove unduly

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harsh insofar as it applies to persons who are not in fact resident in Canada when the gain is realized. For example, a taxpayer who has ceased to be a resident of Canada may find himself in the position of having to pay a substantial amount of Canadian income tax under these provisions in the year in which such a gain is realized even though the amount of the gain be nominal.

Your Committee notes that the problem alluded to in the preceding paragraph only arises in respect of property other than "taxable Canadian property". It is important to realize that a taxpayer who leaves Canada and who has assets consisting of "taxable Canadian property" is not subject to the aforementioned rule. When he subsequently becomes a non-resident, he may dispose of his "taxable Canadian property" and, although subject to tax, the tax is calculated on the basis that he has no income other than his gain on the disposition of his "taxable Canadian property". Unless the taxpayer is otherwise deemed to be a resident of Canada, it is obvious that this rule has quite different tax effects from those which would apply if the same taxpayer also had property other than "taxable Canadian property". In the latter situation, the taxpayer will be subject to Canadian income tax in the year of realization on his world income. Your Committee does not appreciate the necessity for such a difference in tax treatment.

There are other anomolies such as the lack of carry-forward provisions in the event of capital losses.

Your Committee also considers it unfortunate that no allowance has been made in these provisions for the many exceptional circumstances which are bound to occur; for example, where the taxpayer is forced to leave Canada for health reasons or by reason of a transfer abroad at the request of his employer.

YOUR COMMITTEE RECOMMENDS;

1. that provision should be made to enable the Minister of National Revenue to grant relief if, in his opinion, hardship will result and the departure is occasioned
   a) by reason of illness;
   b) by reason of the transfer of an employee at the direction of the employer; or
   c) by any other reason which the Minister considers deserving of relief.

2. that when a taxpayer ceases to be a resident of Canada he should be deemed to have disposed of all his capital assets, wherever situate, for an amount equal to fair market value and that a fixed rate of tax, say of 20%, be levied on any gains at that time; and
3. that if the taxpayer elects to defer payment of tax as provided for in the proposed legislation, he should not be obliged to pay Canadian income tax on his world income if he is not in fact resident in Canada in the year of realization; instead, all of the capital property owned by the taxpayer at the date of his departure should be deemed to be "taxable Canadian property" and the taxpayer should be subject to tax on any taxable capital gains realized in respect thereof in the same manner as other non-residents.

GIFTS, BEQUESTS AND DEVISES TO
CHARITIES - DEEMED REALIZATION

The proposed legislation provides that all capital property (other than depreciable assets) owned by a taxpayer at the date of his death will be deemed to have been realized at its then fair market value and any capital gain or loss shall be included in income for that taxation year. In the case of depreciable property, there will be a deemed realization at midway between fair market value and undepreciated capital cost. A similar rule is proposed in respect of gifts inter vivos. There is an exception to the general rule where assets are transferred on death or by way of inter vivos gift to a spouse or to certain trusts in favour of a spouse. In the latter circumstances, the transferee is considered to have acquired the property at an amount equal to the "cost amount" of the property to the transferor.

Your Committee is concerned that no exception has been made in respect of gifts, bequests or devises to registered charitable organizations or to other similar tax-exempt organizations. By way of contrast, gifts, bequests and devises to such organizations are not subject to tax under the present Estate Tax Act nor under the provincial succession duty Acts. Your Committee therefore considers it unreasonable that a taxpayer should be subject to an income tax on a deemed realization when making a gift, bequest or devise to a charitable organization or to other similar tax-exempt organizations.

Your Committee appreciates that, in some circumstances, it may be more beneficial from an income tax point of view to accept a deemed realization of an amount equal to the fair market value of the subject matter of a gift and claim a deduction for the full market value thereof. On balance, however, your Committee believes that the legislation should be neutral in respect of any tax benefits

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~~(except that otherwise provided for)~~ resulting from the making of a charitable ~~the~~ gift (except as otherwise provided).

YOUR COMMITTEE RECOMMENDS that the proposed legislation be amended to provide that, where capital property ~~(other than cash)~~ is transferred to a charitable organization or other similar tax-exempt organization by way of gift, bequest or devise, the taxpayer will be considered to have disposed of the property for an amount equal to the ~~adjusted~~ "cost ~~base~~ amount" thereof to him.

MINING AND PETROLEUM

Since the majority of provisions of the proposed legislation affecting the resource industries are to be implemented by amendments to the Income Tax Regulations, most of the comments which follow refer to the news release of the Department of Finance dated July 6, 1971. That document outlines the regulations proposed to apply to the mining and petroleum industries.

A. Earned Depletion

The proposed legislation will remove the automatic 33 1/3% depletion presently permitted under the Income Tax Act; it is to be phased out gradually over the next 5 years. Automatic depletion will be replaced by the concept that depletion must be earned by incurring exploration and development expenditures. The formula adopted will be that for every $3 of eligible expenditures made after November 7, 1969 a taxpayer would earn the right to deduct $1 of depletion in computing his taxable income after 1976, subject to a maximum of 33 1/3% of net production profits.

The proposed regulations define expenditures which will be eligible to earn depletion as including the following:

a) Canadian exploration and developments expenses, except for:

i) the acquisition cost of Canadian resource properties,

ii) costs in respect of such community and transportation facilities as houses, schools, hospitals, sidewalks, roads, sewers, sewage disposal plants, airports, docks and similar property (other than a railroad not situated on the mine property) acquired to establish community and transportation facilities necessary for the operation of the mine,

iii) Canadian exploration and development expenses in the vicinity of the mine after it came into production, and

iv) interest on funds required to finance exploration, prospecting and development.

b) New depreciable mine assets (ie. a building except an office building that is not situated on the mine property; mining machinery and equipment; and electrical plant set forth in Class 10 of Schedule B by virtue of subsection 1102 (9) of the Income Tax Regulations in connection with a new mine or a major expansion of an existing mine), and

c) Expenditures on new buildings and machinery, to the extent that they are to be used to process ore from Canadian mineral resources beyond the stage to which they were previously processed in Canada, up to but not beyond the prime metal stage or its equivalent.

Expenditures for the acquisition of Canadian resource properties should, in ~~the~~ opinion on your Committee, qualify to earn depletion. The acquisition of such properties is an integral part of exploration and development expenditures: indeed it is the first step in any exploration or development program. Your Committee recognizes, however, that the inclusion of the cost of Canadian resource properties as expenditures which would be eligible to earn depletion would require that safeguards be inserted into the proposed legislation to prevent the buying and selling of such properties between related taxpayers to artificially earn depletion. One suggestion would be to deduct $1 of the transferor's earned depletion for each $3 of proceeds of ~~provide that only Canadian resource properties acquired at arm's length could~~ disposition. If the transferor had no earned depletion capable of the ~~qualify for earned depletion.~~ reduction, it could be subject to recapture of depletion previously allowed.

iii) Canadian exploration and development expenses in the vicinity of the mine after it came into production, and

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Following the publication of the White Paper on Tax Reform, the Department of Finance issued a news release dated August 26, 1970 which contained a letter from the Minister of Finance to the provincial ministers of finance and treasurers. That document stated that the government was "prepared to propose three further important changes affecting the taxation of the mining industry".

The first two changes were to widen the definition of expenditures which would qualify for "earned depletion" to include

(1) "the costs of new facilities located in Canada to process mineral ores to the prime metal stage or its equivalent"; and

(2) expenditures "for mine buildings, and machinery and equipment acquired in connection with a major expansion of an existing Canadian mine. This extension would put the major expansion of an existing mine on a roughly comparable tax footing with the opening of a new mine."

Your Committee heard evidence of expenditures of the type set forth in that letter which were incurred by reason of the acceptance by mining companies of the above-proposed changes. In your Committee's view, the mining industry was entitled to accept the government's proposals at their face value, namely as being "further important changes affecting taxation of the mining industry". In effect the government represented that the changes proposed in its news release of August 26, 1970 would be implemented in legislation and Regulations so that the mining industry might more immediately undertake the opening of new mines and the major expansion of existing mines in the interest of expanding employment and the national economy. One witness stated that his company had incurred expenditures of $120 million in expanding its production facilities,

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$30 million of which were spent on major smelter and refinery expansions. The Company made public its reliance on the August 1970 changes to the White Paper when it announced that expansion. The government did not at that time contradict what was apparently the clear intention of its news release.

However in the proposed regulations released on July 6, 1971 there appears the statement that "expenditures on new buildings and machinery, to the extent they are to be used to process ore from Canadian mineral resources beyond the prime metal stage or its equivalent" would be eligible to earn depletion. The restriction to "new" buildings and machinery appears to contradict directly the government's August 26, 1970 proposal to permit expenditures for "mine buildings and machinery and equipment acquired in connection with a major expansion of an existing Canadian mine" to earn depletion.

Your Committee heard evidence that officials in the Department of Finance have stated that their interpretation of the proposed regulations would render ineligible for earning depletion, expenditures on a major expansion of existing facilities. Their alleged interpretation will require eligible buildings to be new from the ground up. However since your Committee has not yet heard any witnesses from the Department of Finance, it has set out the facts in connection with

(1) the news release by the Minister of Finance on August 26, 1970 proposing additional changes to widen the definition of expenditures that can qualify for earned depletion;

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(3) the interpretation allegedly put upon the language of the Minister's proposal of August 26th, 1970 substantially limiting its scope; and

(4) evidence submitted that it was only following the Minister's widening of the proposed scope of the definition of earned depletion that projects involving substantial expenditures became feasible.

YOUR COMMITTEE RECOMMENDS that serious consideration be given to the situation presented by this set of facts.

In any event, your Committee believes that if the government's intention be to encourage additional processing in Canada, all expenditures on structures and machinery incurred to increase Canadian processing facilities should qualify to earn depletion. Companies which cannot afford to construct elaborate smelting and refining facilities as part of their initial investment should not be penalized if subsequently they expand their existing processing facilities. Nor should the construction of custom smelters and refineries be denied this incentive to the extent that they process foreign ores.

In the White Paper on Tax Reform, at page 67, the Department of Finance proposed that expenditures "on exploration for or development of mineral deposits in Canada" be eligible to earn depletion. The August 26, 1970 News Release reiterated the White Paper proposals in this regard. However the proposed regulations issued July 6, 1971 exclude the four above-noted categories of Canadian exploration and development expenses which will be eligible to earn depletion. Your Committee heard numerous submissions urging that these exclusions be eliminated.

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The company engaged in the $120 million expansion programme referred to above incurred $40 million of expenditures on development of an existing

open pit mine by stripping waste rock, only to discover that expenditures eligible to earn depletion are now to exclude "Canadian exploration and development expenses in the vicinity of a mine after it came into production".

Other witnesses stated that such an exclusion would penalize small mines that have insufficient capital to enable them to complete their total exploration before bringing a property into production. Your Committee feels that this particular exclusion is not warranted. The government may be concerned with the difficulty of determining whether an open pit or underground operation is exploration or actual mining. YOUR COMMITTEE CONSIDERS that to be a question of fact to be decided in each case, and does not consider that problem to be sufficiently burdensome to warrant excluding any bona fide exploration from being eligible to earn depletion.

Your Committee is of the opinion that the risks of the oil and gas industries are of sufficient magnitude to require that depreciable property such as production equipment and natural gas plants be eligible to earn depletion in the same manner as mining machinery and equipment are treated in the case of new mines and major expansions of existing mines. At a time when the cost of production equipment (such as drilling and production platforms) required for the development of off-shore and far-north petroleum and gas properties will be enormous (likely double and triple present costs), YOUR COMMITTEE RECOMMENDS that those and similar expenditures qualify to earn depletion.

In order to encourage the development of remote areas of Canada, YOUR COMMITTEE RECOMMENDS that the cost of social capital and transportation facilities be eligible to earn depletion. Those expenditures, when incurred in remote

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regions, can form a major portion of total exploration and development costs and are essential to the operation of a mine. Without such expenditures there could be no development of the property.

The exclusion from eligibility to earn depletion of interest on funds required to finance exploration projects can only penalize smaller companies with limited capital. YOUR COMMITTEE THEREFORE RECOMMENDS that the cost of borrowing money to be used to finance exploration qualify to earn depletion.

In summary YOUR COMMITTEE RECOMMENDS that all "Canadian exploration and development expenses" as defined in the proposed legislation should earn depletion, as should depreciable mine assets (whether new or used), depreciable production equipment and natural gas plants in the petroleum and natural gas industries, and expenditures on new buildings and machinery as well as on expanded buildings and machinery, to the extent that they are to be used to process ore from any mineral resources beyond the stage to which they were previously processed in Canada, up to but not beyond the prime metal stage or its equivalent. Therefore any expenditure which is required to reduct the profit from which depletion may be deducted should qualify as an eligible expenditure.

In the event that your Committee's recommendation in this regard be not adopted, an alternative (but less satisfactory) treatment would be to permit the expenditures enumerated above to be deducted from income by resource companies for purposes of computing their taxable income, but to stipulate that such expenditures would not reduce their production profits from which earned depletion is deductible. In other words if the expenditures in question are not to be permitted to earn depletion, they ought not to reduce the base on which depletion is calculated; however they should remain deductible in computing taxable income.

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YOUR COMMITTEE RECOMMENDS that the transitional period required to convert from automatic depletion to earned depletion be extended to 1980. Alternatively, companies should be permitted to "bank" eligible expenditures whenever incurred (that is, including expenditures incurred prior to November 7, 1969) after deducting from such "bank" all depletion previously allowed. Expenditures made prior to November 7, 1969, (which is the date prescribed by the proposed regulations as being the date after which companies can accumulate expenditures which will qualify to earn depletion) were incurred on the basis that automatic depletion would be available. Accordingly those expenditures should at least be included in the computation of earned depletion.

B. Accelerated Capital Cost Allowance

The three-year exemption from tax of profits derived from the operation of a new mine is to be withdrawn on December 31, 1973. It will be replaced by an accelerated write-off of specified capital equipment and facilities. The proposed regulations provide that the following types of new depreciable assets acquired before a new mine comes into production and for the purpose of gaining or producing income from the mine (including income from the processing of mineral ores up to the prime metal stage or its equivalent) will qualify for accelerated capital cost allowance:

1. a building (except an office building that is not situated on the mine property),
2. mining machinery and equipment,
3. electrical plant that would otherwise be included in Class 10 of Schedule B by virtue of sub-section 1102 (9) of the Income Tax Regulations, and
4. houses, schools, hospitals, sidewalks, roads, sewers, sewage disposal

plants, airports, docks and similar property (other than a railroad not situated on the mine property) acquired to establish community transportation facilities necessary for the operation of the mine.

Depreciable property of the type listed in clauses (1), (2), and (3), will also qualify for the accelerated capital cost allowance where it is acquired in the course of the major expansion of an existing mine and before the commencement of production at the higher level of capacity. For this purpose a major expansion will be considered to have taken place if the productive capacity of the mine mill is increased by at least 25%.

The proposed regulations will enable both new mines and existing mines engaged in major expansion programmes to claim accelerated capital cost allowance on specified types of "new depreciable assets", provided they be acquired before the mine came into production (or, in the case of major expansions, before production at the increased capacity commences). The purpose of this incentive appears to be to promote increased development of new and expanded mines, rather than to encourage the purchase of new assets instead of used assets. YOUR COMMITTEE CONSIDERS that if a company decides that it should, for economic and business reasons, purchase used assets rather than new ones, the cost thereof should be eligible for the accelerated capital cost allowance.

In addition your Committee sees no reason to limit this incentive to assets acquired before production begins. That restriction places at a severe disadvantage those mines with insufficient financing to defer the commencement of production until after all of the qualifying assets have been acquired.

Similarly many "new" mines cannot afford to build a smelter or a refinery immediately. If a smelter or refinery were added after a mine had

established itself, the addition would not appear to qualify as a "major expansion", since that term is defined in the proposed regulations to mean an increase by 25% in the productive capacity of the "mine mill". Your Committee is of the opinion that new or used smelting and refining assets, whenever acquired, should be eligible for accelerated capital cost allowance. This will help to promote increased processing of minerals in Canada.

Your Committee also wishes to draw attention to the following items which, although technical, do merit serious consideration:

(a) an expenditure which the proposed regulations describe as a "building (except an office building that is not situated on the the mine property)" should be amended to include other "structures" to make it clear that dams, conveyor trussels, tanks and sub-structures will qualify for accelerated capital cost allowance;

(b) the phrase "mining machinery and equipment" should be amended to read "mining and processing machinery and equipment" to accord with the preamble to the proposed regulations. The preamble states that various assets acquired for the purpose of producing income from the mine, "including income from the processing of mineral ores up to the prime metal stage or its equivalent" would be eligible for fast write-off;

(c) the definition of the social capital and transportation costs which will qualify for accelerated capital cost allowance should be re-phrased by stating the general categories of expenditures which are to qualify. That general principle should be followed by an enumeration of particular items which would not restrict the generality of the

established itself, the addition would not appear to qualify as a "major expansion", since that term is defined in the proposed regulations to mean an increase by 25% in the productive capacity of the "mine mill". Your Committee is of the opinion that new smelting and refining assets, whenever acquired, should be eligible for accelerated capital cost allowance. This will help to promote increased processing of minerals in Canada.

Your Committee also wishes to draw attention to the following items which, although technical, do merit serious consideration:

(a) an expenditure which the proposed regulations describe as a "building (except an office building that is not situated on the the mine property)" should be amended to include other "structures" to make it clear that dams, conveyor trussels, tanks and sub-structures will qualify for accelerated capital cost allowance;

(b) the phrase "mining machinery and equipment" should be amended to read "mining and processing machinery and equipment" to accord with the preamble to the proposed regulations. The preamble states that various assets acquired for the purpose of producing income from the mine, "including income from the processing of mineral ores up to the prime metal stage or its equivalent" would be eligible for fast write-off;

(c) the definition of the social capital and transportation costs which will qualify for accelerated capital cost allowance should be re-phrased by stating the general categories of expenditures which are to qualify. That general principle should be followed by an enumeration of particular items which would not restrict the generality of the

guiding principle. As presently worded, the proposed regulations would appear to exclude dams, lighting installations and water lines, for example;

(d) social capital and transportation costs incurred on a major expansion of an existing mine logically should qualify for fast write-off to the same extent as buildings, machinery and equipment; and

(e) the definition of "major expansion of an existing mine" should be revised to include a 25% increase in the productive capacity of a mine or mill. On occasion the output of a mine could increase by 25% without a corresponding increase in mill capacity (for example, where ore is custom milled). It is seldom that ore is custom milled outside Canada.

C. Transfers of Resource Properties

Under present law, mining properties and royalty interests are treated as capital assets. That is, their acquisition cost is not deductible and proceeds on their sale are not taxable. However, since 1962 the acquisition cost of oil and natural gas rights have been deductible as exploration and development expenses, and proceeds on their disposal have been fully taxable.

The proposed legislation will, following an eight-year transitional period, require the inclusion in income of the entire proceeds of sale of all Canadian resource properties. Correspondingly, the cost of acquiring such properties will be deductible from income.

YOUR COMMITTEE RECOMMENDS that the transfer of Canadian resource properties between related companies should be permitted to occur without incidence of tax, but that only arm's length transfers be eligible to earn depletion.

DEFERRED RECOGNITION OF
CAPITAL GAINS (ROLLOVERS)

With the introduction of taxation of capital gains in Canada, provisions must be made for the deferring of tax in appropriate circumstances such as where there is no change in economic interest. The proposed legislation duly recognizes this and contains a number of provisions to defer the tax on gains. The principal ones are:

1. Involuntary dispositions where property has been destroyed or expropriated and the compensation received is used before the end of the following taxation year to replace the property.
2. The conversion of convertible bonds, debentures and notes for shares of the same corporation or bonds for bonds from the same debtor.
3. The transfer of assets to a corporation if the transferor (which may include a partnership) owned at least 80% of each class of the corporation's capital stock immediately following the transfer. This deferral is subject to a number of limitations and restrictions.
4. The transfer of capital property to a spouse or to specified classes of trusts for the benefit of a spouse.
5. The transfer of property by a partner of a Canadian partnership to the partnership. This deferral is also subject to certain restrictions and limitations.
6. The transfer of partnership property to a member of the partnership provided that the transferee subsequently carries on the business formerly carried on by the partnership.
7. The liquidation of a wholly-owned Canadian subsidiary into its Canadian parent corporation.

8. The disposition of shares on the reorganization of a corporation's share capital to the extent that any money or property (other than shares of the corporation) received by the shareholder does not exceed the adjusted cost base of the shares disposed of in the course of the reorganization.

9. The disposition of shares upon the amalgamation of two or more corporations provided that

   (a) where preferred shares are disposed of, the shares of the successor corporation which the shareholder receives in exchange therefor have substantially similar rights and conditions as the preferred shares which were exchanged, and

   (b) where common shares are disposed of, the shareholders of the predecessor corporation receive in total at least 25% of the issued common shares of the successor corporation.

Your Committee is of the opinion that the aforementioned rules which provide for foregoing deferred recognition of capital gains (rollovers) are of assistance but are not adequate. A tax system should not impede transfers of properties in bona fide legitimate business transactions. Sound management decisions often dictate that transfers of capital property be made between related groups of corporations for example, transfers of unused equipment from one subsidiary to another which could employ it more efficiently. Unfortunately the proposed legislation imposes a barrier to such transactions unless the corporation is willing to pay the tax on a deemed gain or is willing to assume a non-allowable capital loss. ~~This amounts to a penalty for which~~ There is no valid reason for imposing penalties in circumstances such as this especially when

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Appropriate safeguards have been incorporated in the proposed legislation to disallow superficial losses and to block artificial transactions and tax avoidance.

Your Committee fails to understand why the Government has departed from the ground rules it laid down in its own White Paper on Tax Reform, which read on page 42, paragraph 3.43:

> "The government believes that there are some situations in which it would be unfair to collect a capital gains tax even though the taxpayer has sold or otherwise disposed of an asset at a profit. These situations fall into two broad classifications - those where there is a forced realization and those where there has been no change of underlying ownership even though there has been a sale."

Provided that there is no change in economic interest, no deemed realization should occur in any circumstances where, for example,

a) there is a forced transfer,

b) corporate reorganizations occur,

c) property is transferred to a corporation by its "incorporators" - the proposed legislation restricts deferral to those situations where the transferor (which may include a partnership) transfers property to an 80% controlled corporation,

d) there is a transfer of assets to a business trust.

The Committee believes that there are other transactions which are as equally entitled to a deferral as those specified in the proposed legislation and suggested above. It is not possible for your Committee to envisage all of the transactions which should be accorded deferred gain treatment, therefore:

YOUR COMMITTEE RECOMMENDS that the tax-free deferral provisions be broadened to the greatest extent possible to include all situations where underlying ownership remains the same. Because It is recognized ~~that~~ it is impossible to, foresee all of the situations in which deferrals should be permitted, ~~and, for this reason~~, it may be appropriate to authorize the Minister of National Revenue to expand the deferral provisions by way of Regulation as the need for such provisions becomes apparent, perhaps requiring prior approval as a condition of obtaining the benefit of a tax-free deferral.

DESIGNATED SURPLUS

Your Committee has noted that the concept of "designated surplus" is to be retained in the proposed legislation. This concept was originally introduced into the present Act in 1950 to prevent taxpayers from being able to distribute their corporate surplus free of tax. Prior to the enactment of these provisions, it was possible to arrange to receive a corporation's undistributed income in the form of a non-taxable capital gain through the relatively simple expedient of selling the shares of a surplus-laden corporation to another corporation which could then distribute the surplus of the first corporation free from income tax.

In order to offset any advantage to this kind of transaction, provisions were enacted to the effect that, where a corporation acquired control of another, the surplus or retained earnings on hand at the end of the taxation year immediately before control was acquired was designated and any dividends paid out of such surplus is taxable to the receiving corporation.

As events have shown the designation of corporate surplus was not entirely satisfactory and in 1963 a further provisions was enacted known as Section 138A, whereby the receipt of amounts by a vendor of shares should be construed as a dividend and could be taxable as such in his hands. With the introduction of Section 138A it might have appeared that the designation of corporate surplus was no longer necessary, but it was nevertheless retained.

In considering the need for retaining the designated surplus provisions, your Committee notes that the tax savings that might be achieved under present law in the absence of designated surplus provisions could be as great as 60% of the surplus involved (i.e., tax at the 80% maximum rate of personal income tax less the 20% dividend tax credit). The proposed inclusion of one-half of capital gains in ordinary income

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combined with the proposed reduction in the maximum rate of personal income tax and the change in the dividend tax credit system will substantially reduce the amount of tax saving which could be achieved by converting corporate surplus into a capital gain. Therefore, there is not the same need for the designated surplus provisions under the proposed legislation as there is under the present Act.

Despite this, various amendments have been made to these provisions which will effectively deter many valid corporate reorganizations. An example of this tightening of the designated surplus provisions is the deeming of a dividend to have been paid out of designated surplus in the event of a vertical amalgamation, e.g. the amalgamation of a parent and its subsidiary.

Having regard to the reduced need for the designated surplus provisions and the obstacles which these provisions place in the way of bona fide corporate reorganizations, these provisions should be eliminated; particularly in view of the fact that Sections 137(2) and 138A(1) of the present Income Tax Act, with which the Department of National Revenue has successfully attacked dividend stripping arrangements, are to be carried forward into the proposed legislation. It would also appear desirable for the purpose of simplification that your Committee give consideration to the abandonment of designated surplus, particularly when the proposed legislation is introducing so many new types of surpluses.

It might also be relevant to note that since the deemed dividend provisions of the proposed legislation do not apply to foreign corporations, Canadians who control such corporations will be able to convert corporate surplus into a taxable gain. There is therefore some precedent in the proposed legislation for eliminating the designated surplus concept. However their counterpart Canadian

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corporations will be refused such a treatment.

YOUR COMMITTEE RECOMMENDS that the special taxes which are to be levied on dividends paid or received out of a corporation's designated surplus be withdrawn.

It is recognized that the elimination of tax on dividends paid out of designated surplus will presumably require amendments to the proposed legislation to provide that these dividends will reduce the cost base of shares for eventual capital gains purposes. It may also be necessary to provide that a corporation which wishes to make a distribution of pre-1972 designated surplus will be required to "tax pay" amounts distributed from such surplus by paying the special 15% tax relating to 1971 undistributed income.

Recent ~~Recently~~, amendments to the proposed legislation were tabled pertaining to the definition of designated surplus. One of the effects of these amendments would be to designate the undistributed income on hand of a corporation the control of which changed prior to the end of its 1972 taxation year. This would appear to mean that an amalgamation which was effected before 1972 would result in the designation of the entire surplus of each of the amalgamating corporations. Such designation of surplus would carry over into the amalgamated corporation.

Your Committee considers that such a result could not have been intended, and it desires to voice its disapproval of designated surplus in general and this amendment in particular.

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CONSOLIDATED RETURNS OF INCOME

The question of consolidated returns of income by related corporations is not a new one, having been raised many times in the past. In point of fact this concept was part of our taxation law for some 20 years, between the periods of 1932 and 1952. The apparent reason for its introduction into the law during that period, was the absence of business loss carry forward provisions and as a result, qualified corporate groups were permitted to consolidate their incomes and thus absorb their losses on a current basis. In effect, these corporations were prepared to be associated for income tax purposes as if they were a single entity.

In 1952, with the introduction of provisions allowing taxpayers to a business loss carry-over, it was believed that there was a reduced need for consolidated returns of income by corporate groups and the concept was therefore abandoned. There is also some suggestion that the decision was dictated by administrative convenience.

In appreciating this matter it is noted that for some period of time we have also had in our law the concept known as associated corporations. In order to assist small business corporations, provision was made in the income tax law for a dual rate of corporate tax. That is, the corporation was subject to tax at one rate on a defined amount of taxable income and at a higher rate on any taxable income in excess of this amount. However, it was decided that corproations which formed part of a related group (as defined) should be considered to be associated and that one corporation in the group should be entitled to the lower rate of tax or, alternatively, that the amount eligible for the lower rate should be allocated amongst the group. These associated corporation rules were for the purpose of determining the applicable tax rate and did not permit the application of current losses from one corporation to another within the group.

Throughout the years, extensive rules have been enacted for the purpose of deeming corporations to be associated. Under the present provisions, the Minister of National Revenue is also entitled, in his discretion, to treat corporations as associated. The effect of these provisions is to associate corporations who would not otherwise wish to be associated.

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In the opinion of your Committee it appears somewhat incongruous that there exist situations wherein some related corporations wish to be associated, and other related corporations do not. To this end, the concept of the consolidated return of income provided a vehicle for the former while the concept of the associated corporation provided the vehicle for the Minister of National Revenue in respect of the latter. The difficulty is that upon the abandonment consolidated return of income provisions, the former group continue to be associated corporations without the ability to apply current losses from one corporation to another.

Your Committee recognizes the fact that separate corporations must often be created for various commercial purposes. In some cases, provincial or federal laws will require separate corporations to be established. These corporations are nevertheless in substance part of the same corporate family and their financial consolidation should therefore be duly recognized.

While the loss carry-over provisions permit application by each corporation of current losses to other taxation years, nevertheless, the immediate application of such losses to other corporate members of the group ~~and their income~~ is a more realistic view of the situation. Your Committee recognizes the basic principle that profits of one member of a group should be used to reduce the losses of another member of the group. This principle has been duly recognized in the United States.

Because of the restricted number of rollover provisions in the proposed legislation and the resulting difficulty which will be encountered in merging the operations of a related corporate group, your Committee believes that it is essential that corporations should be permitted to file consolidated returns of income, if they so elect.

The Committee has made this suggestion on previous occasions. This view has been reinforced by other notable committees, commissions and professional bodies, including the House of Commons Committee on Finance, Trade and Economic Affairs, the Royal Commission on Taxation (Carter), the Canadian Bar Association and the Canadian Institute of Chartered Accountants.

YOUR COMMITTEE RECOMMENDS that provision be made in the proposed legislation to permit corporations which are members of a qualifying group to elect to file on a consolidated return of income basis. If it is found that such a provision is impractical; YOUR COMMITTEE RECOMMENDS that consideration be given to the introduction of a scheme of subvention payments similar to that formerly used in the United Kingdom.

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CONSTRUCTION INDUSTRY

Your Committee has studied the representations made by this industry and has come to the conclusion that two major points should be modified in the proposed legislation.

The first one relates to the reporting of income and arises from the fact that it is extremely difficult to determine the annual income from contracts such as stipulated sum contracts of more than one year's duration. For this reason, the construction industry has historically reported income on the completed contract method ~~for lump sum contract~~ of under two years' duration. This method has been approved by the Minister of National Revenue as a matter of administrative practice. However, there is no statutory authority for this method of reporting income and the taxpayer has accordingly no right of appeal if the Minister refuses in any given situation to accept this method of reporting.

The second problem raised relates to the fact that the description of assets falling within class 12(h) and class 22 of Schedule B to the present income tax regulations is unduly restricted in respect of the conditions referred to therein. It is the view of your Committee that the conditions set forth in these classes do not reflect present-day prices for the purpose of class 12(h) and that a more extended definition should be provided for the equipment to be included in class 22.

YOUR COMMITTEE RECOMMENDS

1. That the completed contract method on fixed sum contracts of under two years' duration should be incorporated in the proposed legislation as an accepted method to determine a construction business' taxable income for a year.
2. That special attention be given in regulations to be issued concerning capital cost allowance related to the construction industry in order to remove unnecessary restrictions and to expand its application.

CAISSES POPULAIRES AND CREDIT UNIONS

Under the proposed legislation, caisses populaires and credit unions will no longer be exempt from tax. Instead, it is proposed that these organizations will be taxed in substantially the same manner as other private corporations. As such, they will be entitled to take advantage of the small business deduction to the extent allowable to other private corporations.

One of the defects of the proposals originally put forward by the Government was that the provisions relating to the small business deduction failed to give recognition to the constraints that are placed upon caisses populaires and credit unions by their governing legislation. These organizations are required by law to set aside an annual mandatory reserve, no part of which may at any time be distributed amongst the organization's members. In addition, they may set aside such additional reserve as they consider necessary to assure their financial stability. Like the mandatory statutory reserves, these voluntary reserves cannot be distributed to members.

In considering the effect of the original tax proposals on these organizations it should be recognized that amounts set aside as reserves annually pursuant to the relevant governing legislation are not allowed as a deduction in computing income for tax purposes. These reserves should not be confused with the allowances which caisses populaires and credit unions will be allowed to claim as a deduction under the proposed legislation in respect of their outstanding loans and investments.

In view of such statutory restrictions, these organizations are unable to distribute all of their after-tax income by way of dividend and are therefore unable to perpetuate the small business deduction in the same manner as other private corporations. Having duly considered the representations submitted by these organizations, your

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In view of such statutory restrictions, these organizations are unable to distribute all of their after-tax income by way of dividend and are therefore unable to perpetuate the small business deduction in the same manner as other private corporations. Having duly considered the representations submitted by these organizations, your

Committee concluded that the following recommendation should be put forward:

> That caisses populaires and credit unions should not be required to include in their "cumulative deduction account" (for purposes of determining the available balance of their total business limit of $400,000) such portion of their taxable income as is set aside in the year as a reserve to the extent that such reserve is not available for distribution to members. This should be subject to the further limitation that no recognition be given to any such reserve to the extent that the total amount set aside does not exceed, say, 5% of the organization's total deposits and share capital at the ~~end~~ commencement of the year.

The effect of the amendments which the Government recently tabled in this regard is to alleviate, at least in part, some of the problems which confronted these organizations under the original proposals. We commend the Government for introducing these amendments. However, as the effect of these amendments differs somewhat from the afore-mentioned recommendation, YOUR COMMITTEE RECOMMENDS that this matter be given further consideration by the Government.

ADMINISTRATION AND ENFORCEMENT

Your Committee has had referred to it several provisions of the proposed legislation relating to enforcement. Your Committee concurs with attempts to protect the rights of taxpayers whose affairs are under investigation. The Committee is concerned however, that these attempts have not gone far enough, and furthermore, that other existing defects have not been dealt with.

Under the proposed legislation the power of holding an inquiry pursuant to the Inquiries Act is continued. Nevertheless, the changes proposed permit:

a) the hearing officer to be appointed by the Tax Review Board upon the application of the Minister of National Revenue,

b) the person whose affairs are being investigated is entitled to be present, and to be represented by counsel, and

c) the hearing officer may, upon application by the Minister, ~~to the~~ hearing officer, exclude the person whose affairs are being investigated, and his counsel, ~~may be excluded~~ if their presence would prejudice the conduct of the inquiry.

Your Committee has also noted that in matters of evasion, if the Minister of National Revenue has elected to proceed by way of a criminal prosecution, no liability for any ministerial penalty may be levied unless such penalty was assessed prior to the laying of the information or complaint.

Finally, the saving provision relating to the prevention of double ministerial penalties as found in Section 56, ss 3 of the present legislation, is omitted from the proposed legislation.

YOUR COMMITTEE RECOMMENDS the following:

1. that in respect of inquiries into the affairs of a taxpayer under the proposed legislation:

1. a) the appointed hearing officer should not be an official of the Department of National Revenue,

   b) the taxpayer whose affairs are being investigated should be entitled either personally or through counsel, to cross-examine all witnesses and as well, to a copy of the transcript of all evidence taken at such inquiry, and

   c) any order excluding from an inquiry the taxpayer whose affairs are being investigated, or his counsel, should be subject to immediate review by a judge of the Federal Court of Canada.

2. that the double jeopardy provision should be expanded so that if the Minister of National Revenue elects to proceed against a taxpayer by way of information or complaint, the Minister cannot as well levy a ministerial penalty; or conversely, if the Minister elects to proceed against a taxpayer by way of ministerial penalty, the Minister cannot as well commence criminal proceedings by way of information or complaint.

3. that the saving provision contained in Section 56, ss 3 of the present Act be introduced into the proposed legislation.

VALUATION DAY

With the introduction of a capital gains tax in Canada, it is essential that such a tax should not apply to any portion of ultimate proceeds of disposition which represent simply a recovery of original cost. This was the error of the White Paper when it originally proposed that capital property should generally be valued at fair market value at Valuation Day.

To some extent the foregoing error has been corrected by the introduction of the concept popularly referred to as the "tax-free zone". Gains will be included for taxation purposes only to the extent that the proceeds exceed the higher of actual cost and Valuation Day value, and losses will be deductible only to the extent that the proceeds are less than the lower of actual cost and Valuation Day value.

Your Committee commends the Government for introducing this concept in the proposed legislation. However, the Committee regrets that the Government did not see fit to provide that property acquired by a taxpayer prior to June 18, 1971 by way of gift, bequest or devise should be deemed to have been acquired at a cost equal to the fair market value of the property at date of acquisition. Such a provision would be inconsistent with the proposed treatment of property so acquired after December 31, 1971.

YOUR COMMITTEE RECOMMENDS that provision be made in the new law to the effect that property acquired by way of gift, bequest or devise prior to June 18, 1971 be deemed to have been acquired at an amount equal to its fair market value at date of acquisition, for the purpose of calculating any taxable gain but not for the purpose of calculating any allowable loss.

EPILOGUE

The foregoing sets forth the observations, opinions and recommendations of your Committee on the briefs presented and witnesses heard up to and including the 27th day of October, 1971. It is therefore of a preliminary nature only.

Your Committee intends to present a second report after the termination of its hearings covering submissions made subsequent to October 27, 1971.

Some of the topics with which your Committee intends to deal in its second report are:

1. professional income on an accrual basis,
2. new rules applicable to partnerships and to trusts and their beneficiaries,
3. the treatment of mutual funds, investment corporations and clubs,
4. investment income of private corporations,
5. Canadian income of non-residents such as withholding tax, branch tax, non-resident owned investment corporations, capital gains of non-residents,
6. corporate distributions,
7. natural resources (other than those already dealt with) for example the pulp and paper industry,
8. mutual funds (registered retirement savings plan),
9. treatment of income of insurance companies
10. the ability of recipients of all forms of lump sum payments to avail themselves of general and forward averaging even though they elect the equivalent of section 36 averaging in respect of the pre-1972 portion of such payments.
11. Tax incentives for fixed income securities.

EPILOGUE

The foregoing puts forth the observations, opinions and recommendations of your Committee on the briefs presented and witnesses heard up to and including the 27th day of October, 1971. It is therefore of a preliminary nature only.

Your Committee intends to present a second report after the termination of its hearings covering submissions made subsequent to October 27, 1971.

Some of the topics which your Committee intends to deal in its second report are:

1. professional income on an accrual basis,
2. new rules applicable to partnerships and to trusts and beneficiaries,
3. the treatment of mutual funds, investment corporations and clubs,
4. investment income of private corporations,
5. Canadian income of non-residents such as withholding tax, branch tax, non-resident owned investment corporations, capital gains of non-residents,
6. corporate distributions,
7. natural resources (other than those already dealt with) for example the pulp and paper industry,
8. mutual funds (registered retirement savings plan),
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10. the ability of recipients of all forms of lump sum payments to avail themselves of general and forward averaging even though they elect the equivalent of section 36 averaging in respect of the pre-1972 portion of such payments.
11. Tax incentives for fixed income securities.

Your Committee finally notes with approval that the proposed legislation has been the subject of discussion at the recent conference between the Minister of Finance and his counterparts in each of the provincial governments. It is to be hoped that these will be continuing discussions. The Committee's views as to the need for these consultations in order to develop a unified tax system are adequately expressed in its Report on The White Paper Proposals for Tax Reform where it was stated:

> "Your Committee, however, wishes to again express its appreciation of the Government's desire to work closely with the provinces in an attempt to evolve with the passage of time a symmetrical taxation system, and it urges the Government to continue its quest for the attainment of this highly desirable goal."

Respectfully submitted,

Salter A. Hayden,
Chairman.

THE SENATE

CANADA

Standing Senate Committee on Banking, Trade and Commerce

# PRELIMINARY REPORT NO. 2

ON

THE SUMMARY OF 1971

TAX REFORM LEGISLATION

The Honourable Salter A. Hayden, Q.C., Chairman

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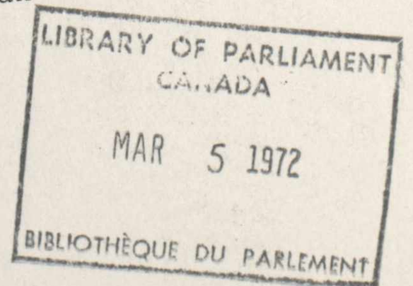
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MEMBERSHIP OF THE COMMITTEE

THE STANDING SENATE COMMITTEE ON
BANKING, TRADE AND COMMERCE

The Honourable Salter A. Hayden, Chairman, and

The Honourable Senators:

| | |
|---|---|
| Aird | Grosart |
| Beaubien | Haig |
| Benidickson | Hays |
| Blois | Isnor |
| Burchill | Lang |
| Carter | Macnaughton |
| Choquette | * Martin |
| Connolly (Ottawa West) | Molson |
| Cook | Smith |
| Croll | Sullivan |
| Desruisseaux | Walker |
| Everett | Welch |
| * Flynn | White |
| Gelinas | Willis |
| Giguère | |

* Ex officio members

(Quorum 7)

## ORDER OF REFERENCE

Extract from the Minutes of the Proceedings of the Senate, September 14, 1971:

"With leave of the Senate,

The Honourable Senator Hayden moved, seconded by the Honourable Senator Denis, P.C.:

That the Standing Senate Committee on Banking, Trade and Commerce be authorized to examine and consider the Summary of 1971 Tax Reform Legislation, tabled this day, and any bills based on the Budget Resolutions in advance of the said bills coming before the Senate, and any other matters relating thereto; and

That the Committee have power to engage the services of such counsel, staff and technical advisers as may be necessary for the purpose of the said examination.

After debate, and--

The question being put on the motion, it was--

Resolved in the affirmative."

Robert Fortier,
Clerk of the Senate.

Wednesday, November 24, 1971.

INTRODUCTION

On September 14th, 1971, there was tabled in the House a document entitled "SUMMARY OF 1971 TAX REFORM LEGISLATION" and, by resolution of the Senate on the same date, consideration of same was referred to the Standing Senate Committee on Banking, Trade and Commerce.

For the purposes of brevity and identification, the "SUMMARY OF 1971 TAX REFORM LEGISLATION" will be referred to in this report as the "proposed legislation" and the Standing Senate Committee on Banking, Trade and Commerce will be referred to as "your Committee" or "the Committee".

On Thursday, November 4th, 1971, The Honourable Salter A. Hayden, Chairman of your Committee, submitted a preliminary report on the proposed legislation and, in such report, a number of recommendations were submitted with respect thereto.

In the report of November 4th, 1971, hereinbefore referred to, the following statement was made:

> "Having regard to the urgency of the matter and the problem of time, your Committee is submitting for your approval at this time a limited number of recommendations but it is hoped that the Committee will still be in the position to make further recommendations before the proposed legislation reaches this House. Alternatively, the Committee will submit these further recommendations when the said proposed legislation reaches this House after having passed the other House."

Since the submission of the preliminary report, your Committee has heard a further number of representations and has received further written submissions on the proposed legislation. Having studied these further submissions and representations which were received in the period following the 27th day of October, 1971, to the 10th day of November, 1971, when the last hearing took place, your Committee has concluded that it is desirable to submit to the Minister of Finance, as expeditiously as possible, a number of further recommendations in respect to the

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proposed legislation which is presently being considered by Committee of the Whole of the other House. It is the hope that, upon receipt by the Minister of Finance of these further recommendations, the same will be accepted by him as again being pertinent and relevant, and to the extent so regarded, that appropriate amendments will be submitted by him to the other House while the said proposed legislation is still being considered in the Committee stage.

In your Committee's report of November 4th, 1971, and in the section captioned "EPILOGUE", your Committee recorded its intention to present a second report after the termination of its hearings covering submissions made subsequent to October 27th, 1971. Your Committee referred in such captioned "EPILOGUE" to some of the topics which it intended to cover in its second report. Having regard to the exigencies of time, your Committee has been able to deal with only some of the topics referred to in the "EPILOGUE". The proposed recommendations with respect to these topics are hereinafter submitted.

PULP AND PAPER INDUSTRY

1. General considerations

The pulp and paper industry plays a vital role in the economy of this country. It is because of this predominant role that your Committee has given special attention to the representations made by the Canadian Pulp and Paper Association.

Corporations in the natural resource industries are characterized by the following common factors:

(a) development and processing of natural resources,

(b) investment of large amounts of capital,

(c) creation of substantial employment, and

(d) sales on a world-wide basis.

Corporations in the natural resource industry are also characterized by a large degree of risk. Part of such risk is represented by the huge capital investment in machinery and equipment required in the pulp and paper industry.

From the information provided to your Committee, the following resume is submitted:

For the year 1970 the industry exported 12.54% of the total Canadian domestic exports and ranks as one of the largest exporters in Canada. In 1970 the industry employed 156,400 persons including permanent and seasonal woodland operators. In addition, a substantial number of persons are employed in related fields. The statistics submitted by the representatives of the industry indicate that the five major suppliers of wood pulp and newsprint in the world are Canada, United States, Scandinavia, Japan and Russia. United States and Scandinavia are Canada's main competitors in this industry.

The following table illustrates the change and the continuous deterioration in Canada's position in this field in relation to its major competitors over the last 20 years.

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From the information provided to your Committee, the following resume is submitted:

For the year 1970 the industry exported 12.54% of the total Canadian domestic exports and ranks as one of the largest exporters in Canada. In 1970 the industry employed 136,600 persons including permanent and seasonal woodland operators. In addition, a substantial number of persons are employed in related fields. The statistics submitted by the representatives of the industry indicate that the five major suppliers of wood pulp and newsprint in the world are Canada, United States, Scandinavia, Japan and Russia. United States and Scandinavia are Canada's main competitors in this industry.

The following table illustrates the change and the continuous deterioration in Canada's position in this field in relation to its major competitors over the last 20 years.

| | Relative Percentage Share of Production | | | |
|---|---|---|---|---|
| | Wood Pulp | | Newsprint | |
| | 1950 | 1970 | 1950 | 1970 |
| Canada | 28 | 23 | 72 | 58 |
| United States | 49 | 53 | 14 | 22 |
| Scandinavia | 23 | 24 | 14 | 20 |
| | 100% | 100% | 100% | 100% |

Representatives from this industry have expressed the view that this decline is caused by, among other factors, tax disadvantages suffered by Canadian corporations in relation to their major foreign competitors. These representatives prepared an analysis of comparative income tax payable by United States corporations and Canadian corporations for the 5 years ended in 1969. This analysis indicates that these United States corporations incurred average taxes of 34% of income (taking into account both capital and income) whereas Canadian corporations incurred comparable average taxes of 49%.

As to Sweden's tax treatment, the current annual rate of corporate income tax payable is approximately 40% as compared with 51% to 54% in Canada. To this tax advantage Swedish corporations obtain more generous capital cost allowance (depreciation and depletion) and also investment reserves. In Finland, the currency devaluation of 31% which occurred in 1967, coupled with that country's fiscal policy has further placed its pulp and paper industry in a relatively advantageous competitive position as a world supplier.

It is therefore apparent that the Canadian pulp and paper industry is at a great disadvantage vis-a-vis its international competitors. It is therefore essential that special consideration be given to assist the industry to maintain and improve its international position.

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This industry's reliance on world markets also has an important direct effect on employment in Canada.

It is generally acknowledged that Canadian corporations which sell their products in international markets are in a difficult competitive position if their tax burden is much greater than that applicable to their competitors. It is apparent that the incidence of tax on the pulp and paper industry in Canada deserves to be examined carefully and that some attempt should be made, if at all possible, to place this industry in a reasonably fair position vis-a-vis its foreign competitors if Canada wishes to promote its export trade and employment in this industry.

At the risk of repeating itself, your Committee would again quote part of a statement made by the Government in the White Paper Proposals for Tax Reform.

> "6.9-----. Going international is frequently necessary to enable Canadian companies to achieve the economies of scale which are otherwise denied them by the relatively small size of the Canadian domestic market. Such companies would find it hard to compete on the international scene if they were subject to more onerous taxes than those which apply to their competitors.-----."

Your Committee concurs with this statement but deplores the fact that no recognition has been given to this very problem in respect of the pulp and paper industry under the proposed legislation.

The pulp and paper industry is subject to high capital requirements. As a consequence, carrying charges and amortization costs have a very great effect on the cost of production. For this reason, your Committee is of the opinion that any alleviating measures should be related to this factor, and that a concept of "earned depreciation" should therefore be given consideration in the proposed tax legislation.

The concept of "earned depreciation" could be formulated in the following manner: a corporation would earn the right to claim a special deduction based upon amounts incurred in respect of any qualified expenditures made after the commencement

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of the new system.

Earned depreciation would be in addition to the normal capital cost allowances. It would not reduce undepreciated capital cost and would not be subject to recapture of capital cost allowance. The corporation would have the right to claim all, or part, of this earned depreciation in the year in which its capital expenditures are made or to defer all, or any part, until some subsequent year. Appropriate safeguards could be introduced to prevent abuses.

In order not to discriminate against corporations which embarked upon a modernization or expansion program prior to the commencement of the new system, it would be necessary to establish a deemed earned depreciation. The amount of this deemed earned depreciation could be calculated as a certain percentage of the undepreciated capital cost of qualified expenditures on hand at the commencement of the system. If necessary, a limit could be placed on the maximum amount deductible in any year.

2. Pollution abatement and control

Apart from the tax disadvantages mentioned above, a new factor has recently been added to the industry's operating costs. This is the requirement to install and improve equipment and measures for the abatement and control of pollution.

Pollution abatement and control is not merely a local problem: it is primarily a national problem. The need for anti-pollution measures cannot be over-emphasized, however. At the same time as Canada is endeavouring to improve the general environment for all Canadians, it would be short-sighted to overload the costs of some of our exporting industries which are competing in world markets.

Without debating the relative effectiveness or fairness of the use of tax incentives for the purpose of abatement or control of pollution generally, the nature of the pulp and paper industry is such that it must be located near large bodies of water for both production purposes and for direct, inexpensive transportation. Apart from the requirement of adequate hydro-electric power, such locations are usually somewhat remote from centres of population except where the

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concentration of people and ancillary businesses have developed in that particular area. The importance of the contribution to the national wealth produced by this industry clearly appears to warrant some spreading of the cost to include more than local communities and the pulp and paper industry.

With a view to correlating the national and local objectives of pollution abatement and control and to obtain a fair sharing of the cost burden, it appears advisable to supplement existing grant programs and tax incentive programs by developing a special loan program for the pulp and paper industry. This could consist of long-term federal loans without interest or federally guaranteed loans to pulp and paper corporations.

Alternatively, if interest be charged, part or all of such interest might be rebated from year to year. This could be achieved by allowing an annual additional capital cost allowance whereby the original capital cost could be increased by a percentage factor sufficient to accomplish the desired after-tax effect equivalent to a rebate of interest.

Your Committee considers that the foregoing would prevent an undue loading of additional costs on production by distributing some of the burden on a national basis.

While loan programs, forgiveness of loans and rebate of interest cannot be expected to fall directly within the scope of fiscal policy, your Committee is of the opinion that equivalent results could be produced by translating the after-tax effect into special capital cost allowance (depreciation) measures and rates in the proposed legislation.

Such measures are now available under the present legislation. As a matter of fact, in the government's budget tabled on December 3, 1970, additional capital cost allowances were created whereby manufacturing and processing enterprises are permitted to value new investments in machinery, equipment and structures at 115% of their actual cost as a base for calculating capital cost allowances. This is applicable to new capital investments acquired during the period commencing

December 4, 1970, and ending March 31, 1972.

Having regard to the foregoing factors and special disabilities affecting this industry YOUR COMMITTEE RECOMMENDS:

1. that a concept of "earned depreciation" be introduced in the proposed legislation or, alternatively, that additional capital cost allowances be granted by one of the following methods:
   (a) increasing the present rate of capital cost allowances,
   (b) introducing additional yearly capital cost allowance through permitting the original capital cost or the undepreciated capital cost as at the commencement of the new system to be valued at more than 100%, and
   (c) granting accelerated capital cost allowance.
2. that expenditures by corporations in the pulp and paper industry for the control and abatement of pollution be financed and assisted by one of the following methods:
   (a) government grants or long-term interest-free loans, or
   (b) special capital cost allowances such as those referred to above.
3. Logging tax credit

It was submitted to your Committee that there exists an element of double taxation for some corporations because the abatement for the provincial logging tax is not 100%. This is caused by the fact that the credit for federal abatement is not calculated on the same basis as that calculated for the logging tax itself. This present anomaly, far from being cured by the proposed legislation, has been compounded by a further limitation in calculating the logging tax credit, namely the required inclusion of taxable capital gains in the tax base, which gains are to be excluded from the taxable income available for the logging tax credit (although such gains could be included in the calculation of the logging tax itself). This double taxation becomes very severe in a loss year or when the non-logging operations suffer a loss.

Furthermore, there are provinces which do not levy a logging tax as such, but instead levy other taxes corresponding to the logging taxes of other provinces. It is suggested that the government should examine the various taxes levied on the pulp and paper industry in provinces which do not have a formal logging tax, and determine if some provinces or municipalities are levying taxes which are in substance similar to logging taxes but which are nevertheless not deductible from income tax payable.

YOUR COMMITTEE RECOMMENDS:

1. that the amount of provincial logging tax paid be credited against federal income tax payable within specified limits and with the following additions:

   (a) that the base upon which the logging tax credit is calculated for federal purposes should be the same as that upon which the provincial logging tax was imposed, and

   (b) that any creditable logging tax not deductible in a taxation year be carried forward and be deductible against future federal income tax payable.

2. that the government consider the possibility of granting similar relief to those corporations that are paying provincial or municipal taxes on their logging operations not levied as logging taxes but which are in substance similar to a logging tax (and are not subject to the federal abatement).

TAX-EXEMPT NON-RESIDENT INVESTORS

Under the present Income Tax Act the Minister of National Revenue is authorized to issue a "certificate of exemption" to any non-resident person who establishes that he resides in a country which imposes an income tax and that he is exempt from such tax under the laws of that country. The effect of obtaining a certificate of this kind is that the non-resident person is exempt from Canadian non-resident withholding tax in respect of interest payable on any bond, debenture or other similar debt obligation that was issued to him after June 13, 1963.

The obvious purpose of this provision (as hereinafter noted) was to encourage the sale of Canadian debt obligations to tax exempt non-residents by removing the tax disadvantage which such persons otherwise would suffer if they reinvest in Canada rather than in their country of residence. Unlike the non-resident person who is subject to tax in his country of residence and who is generally able to recover part, if not all, of the Canadian income tax payable on Canadian source income by way of credit against the income tax otherwise payable by him, the tax-exempt non-resident is unable to recover any part of the Canadian income tax which he may be required to pay. Therefore, but for the "certificate of exemption" provisions, a tax-exempt non-resident would suffer a tax disadvantage by investing in Canadian debt obligations rather than in securities issued by persons resident in his country of residence (the income from which would be exempt from tax).

In order to qualify for a certificate of exemption under the proposed legislation, a non-resident must not only be exempt from income tax in the country in which he resides but must also be

1. a person who would be exempt from Canadian income tax under the relevant exempting provisions of the proposed legislation if he were resident in Canada, or

2. a trust or corporation established solely in connection with an employee's superannuation or pension fund or plan.

## X-EXEMPT NON-RESIDENT INVESTORS

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1. a person who would be exempt from Canadian income tax under the relevant exempting provisions of the proposed legislation if he were resident in Canada, or
2. a trust or corporation established solely in connection with an employee's superannuation or pension fund or plan.

Any non-resident person failing to qualify under these new requirements who holds a certificate of exemption which was issued under the provisions of the present Income Tax Act and which is still in force on December 31, 1971, will continue to be exempt from Canadian non-resident withholding tax in respect of interest payable to him on or before December 31, 1974 - provided that he continues to be exempt from tax in his country of residence. Interest received by him thereafter will be subject to the normal withholding tax provisions unless he is able to meet the new requirements of the proposed legislation.

In considering the effect of these new provisions, your Committee heard evidence presented on behalf of a major non-resident investor who now holds a certificate of exemption but who will fail to qualify for a similar certificate under the proposed legislation. This organization has invested substantial amounts in long-term Canadian debt obligations and has entered into commitments to purchase additional Canadian bonds, in each case on the assumption that its exemption from Canadian non-resident withholding tax would remain in force as long as it continued to qualify as a tax-exempt person in its country of residence. Having regard to the amount invested in Canada and having regard also to the fact that many of the debt obligations were purchased privately (consisting of securities in respect of which no prospectus has been filed), this particular organization appears to have valid reasons to believe that it will encounter considerable difficulty in selling its Canadian securities and thereby avoid the tax disadvantage which it would suffer if it continued to own such investments after December 31, 1974.

This particular situation is presumably by no means unique and your Committee considers it inequitable that the exemption should be withdrawn with respect to investments or commitments which have already been made - and on such short notice. In fact, your Committee believes that the sale of Canadian debt obligations (as distinct from Canadian equities) to non-residents should be encouraged by extending the present exemption from withholding tax provisions instead of restricting it.

When the exemption presently accorded to tax exempt non-residents was first introduced, the Honourable Mr. W. Gordon, the then Minister of Finance, stated as follows:

"The purpose of this resolution is, of course, to make it easier or make it more desirable for pension funds in other countries to invest in Canadian bonds. As we all know, we are primarily interested in and thinking about the inflow of capital. Certainly, in totals and magnitudes, we are primarily interested in the sale of Canadian bonds abroad rather than Canadian equities."

In the opinion of your Committee the circumstances above described have not changed and indeed are perhaps more necessary than ever.

YOUR COMMITTEE RECOMMENDS that the exemption accorded to tax-exempt non-resident persons under the present Income Tax Act should be continued in the proposed legislation.

MINING AND PETROLEUM (NON-OPERATORS)

Your Committee stated in its preliminary report of November 4, 1971, that the 33 1/3% automatic depletion which is allowed under present law to an operator of a resource property will be abolished under the proposed legislation at the end of a five year transitional period (i.e. after 1976) and will thereafter be replaced by an earned depletion allowance equal to $1 for every $3 of eligible expenditures incurred on exploration and development after November 7, 1969. The Committee recommended in this connection that the transitional period be extended to the end of 1980 or, alternatively, that taxpayers be allowed to "bank" for earned depletion purposes an amount equal to all eligible expenditures incurred, whether incurred before or after November 7, 1969, but that all depletion previously allowed be deducted in determining the balance of the "bank" available for earned depletion allowance.

As a result of its continuing study of the tax reform measures, your Committee has noted that the proposed legislation would also remove, as of the end of 1976, the 25% automatic depletion that is now allowed to non-operators in respect of income such as royalties which they may derive from resource properties. Royalty income received after 1976 is to be treated in the same manner as productions profits and therefore, will be eligible for the proposed 33 1/3% earned depletion.

Your Committee is of the view that it is equally important that the five year transitional period relating to the withdrawal of the automatic depletion allowance should also be extended to non-operators, at least in respect of income derived from a royalty or other similar interest in a resource property which the taxpayer acquired prior to June 18, 1971, or which he was obligated at that date to acquire. The alternative recommendation which the Committee put forward in its preliminary report with respect to the basis of computing earned depletion for operators of a resource is unlikely to afford much relief to non-operators in respect of interests acquired prior to June 18, 1971, as these taxpayers will not have incurred

MINING AND PETROLEUM (NON-OPERATORS)

Your Committee stated in its preliminary report of November 4, 1971, that the 33 1/3% automatic depletion which is allowed under present law to an operator of a resource property will be abolished under the proposed legislation at the end of a five year transitional period (i.e. after 1975) and will thereafter be replaced by an earned depletion allowance equal to $1 for every $3 of eligible expenditures incurred on exploration and development after November 7, 1969. The Committee recommended in this connection that the transitional period be extended to the end of 1980 or, alternatively, that taxpayers be allowed to "bank" for earned depletion purposes an amount equal to all eligible expenditures incurred, whether incurred before or after November 7, 1969, but that all depletion previously allowed be deducted in determining the balance of the "bank" available for earned depletion allowance.

As a result of its continuing study of the tax reform measures, your Committee has noted that the proposed legislation would also remove, as of the end of 1976, the 25% automatic depletion that is now allowed to non-operators in respect of income such as royalties which they may derive from resource properties. Royalty income received after 1976 is to be treated in the same manner as productions profits and therefore, will be eligible for the proposed 33 1/3% earned depletion.

Your Committee is of the view that it is equally important that the five year transitional period relating to the withdrawal of the automatic depletion allowance should also be extended to non-operators, at least in respect of income derived from a royalty or other similar interest in a resource property which the taxpayer acquired prior to June 18, 1971, or which he was obligated at that date to acquire. The alternative recommendation which the Committee put forward in its preliminary report with respect to the basis of computing earned depletion for operators of a resource is unlikely to afford much relief to non-operators in respect of interests acquired prior to June 18, 1971, as these taxpayers will not have incurred

as extensive exploration and development expenditures as operators. They will therefore not be entitled to a comparable amount of earned depletion if the Committee's alternative recommendation is implemented.

YOUR COMMITTEE RECOMMENDS that the 25% automatic depletion now allowed to non-operators in respect of income derived from a royalty or other similar interest in a resource property be continued for royalties received prior to 1981 in respect of interests which the taxpayer owned at June 18, 1971, or which he was obligated at that date to acquire.

TRANSITIONAL AVERAGING PROVISIONS CONCERNING LUMP SUM PAYMENTS OUT OF PENSION PLANS AND DEFERRED PROFIT SHARING PLANS.

Single payments out of a pension plan or deferred profit sharing plan which are received in a taxation year ending after 1973 will be eligible for relatively generous averaging provisions presently afforded by section 36 of the Income Tax Act to the extent of amounts vested up to January 1, 1972. The proposed legislation would restrict the right to such averaging by providing that once a taxpayer has elected to utilize section 36 averaging in respect of amounts vested up to January 1, 1972, he is precluded from invoking the general and forward averaging provisions of the proposed legislation in the same year in respect of amounts vested after 1971. The amount available for section 36 averaging is thus limited to that portion of the lump sum payment which accrued up to January 1, 1972.

It is apparent that as the benefits under pension and deferred profit sharing plans which vest after 1971 increase in relation to those which vested prior to 1972, the benefit afforded by section 36 averaging will decline in respect of lump sum payments received after 1973, until the point is reached when section 36 averaging will become unattractive.

YOUR COMMITTEE RECOMMENDS that

(a) section 36 averaging should be available in respect of the portion of a lump sum payment received in a taxation year ending after 1973 out of a pension plan or deferred profit sharing plan which the taxpayer would have received pursuant to such a plan if he had withdrawn therefrom on January 1, 1972, and also

(b) the general and forward averaging provisions of the proposed legislation should be available in respect of the portion of such payments which have vested after 1971.

Single payments received out of a pension plan or a deferred profit sharing plan made in a taxation year ending after 1971 and before 1974 are to be entitled to section 36 averaging in their entirety. Your Committee considers such treatment to be equitable.

NON-RESIDENT-OWNED INVESTMENT CORPORATIONS (N.R.O.'s)

The effect of the provisions of Section 70 of the present Income Tax Act (which relates to non-resident-owned investment corporations) is, in general, to treat non-residents who hold Canadian investments indirectly through the medium of a Canadian holding company in substantially the same manner as they would have been taxed if they had owned such investments directly - provided, of course, that the Canadian holding company qualifies as a non-resident-owned investment corporation (referred to hereinafter as an N.R.O.).

Certain exceptions to this general rule do exist in the present Income Tax Act. For example:

1. A non-resident who owns shares of a corporation which has a degree of Canadian ownership (as defined in Section 139A of the Act) is subject to a 10% Canadian non-resident withholding tax on dividends received from that corporation whereas all dividend income flowing through an N.R.O. attracts a 15% tax under Section 70.
2. Interest payable to non-residents on certain types of Canadian debt obligations (e.g. certain federal and provincial bonds) is now exempt from Canadian non-resident withholding tax but is subject to the 15% N.R.O. tax if paid to an N.R.O.
3. Any investment income which an N.R.O. may derive from non-Canadian sources is subject to Canadian tax under the N.R.O. provisions whereas such income would not be subject to Canadian income tax if paid to the non-resident directly.

However, these and the various other exceptions which exist under the present Income Tax Act have generally been considered relatively insignificant and have not discouraged non-residents from investing in Canada through the medium of an N.R.O.

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It is implied on page 58 of the "Summary of 1971 Tax Reform Legislation" that this neutrality in the taxation of non-resident investors, whether they invest

directly in Canada or indirectly through an N.R.O., would be continued under the new system; and, in particular, that non-resident shareholders of an N.R.O. would not be subject to Canadian income tax in respect of any capital gains which would not be taxable in Canada if realized personally by a non-resident investor. However, contrary to the statements contained in the Summary, the tax position of a non-resident shareholder of an N.R.O. is not equated with the treatment accorded to non-residents who invest directly. For example:

1. Capital gains realized by an N.R.O. on the disposition of capital property other than "Canadian property" will be subject to Canadian non-resident withholding tax when ultimately distributed by way of dividend to the N.R.O.'s non-resident shareholders. This treatment is clearly anomalous and the proposed legislation should be amended to provide that any net gains realized on the disposition of non-Canadian property should form part of an N.R.O.'s "capital gains dividend account" which may ultimately be distributed to shareholders free from Canadian non-resident withholding tax.
2. Any capital gain realized by a non-resident on the disposition of shares of an N.R.O. (including a gain arising on death) will be subject to Canadian income tax under the proposed legislation. This treatment is inequitable as it could result in double taxation or in the taxation of amounts which should not attract Canadian income tax. For example, part or all of the gain realized by non-resident shareholders could be attributable to gains realized by the N.R.O. on the disposition of taxable Canadian property which had not been distributed to shareholders at the date on which the particular shareholder disposed of his shares of the N.R.O. These gains would have been taxed in the N.R.O.'s hands and would accordingly be available for distribution as a tax-exempt dividend out of the N.R.O.'s "capital gains dividend account". Therefore, the non-resident

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shareholder should not be subject to Canadian income tax on any portion of the gain realized on the disposition of his shares of the N.R.O. that is attributable to gains previously realized by the N.R.O. on the disposition of taxable Canadian property.

Similar problems exist where the gain realized by the non-resident shareholder is attributable to:

(a) undistributed capital gains which the N.R.O. previously realized on the disposition of any other type of capital property,

(b) any unrealized appreciation in the value of the N.R.O.'s capital property, and

(c) any accumulated income already taxed in the N.R.O.'s hands.

It follows that, unless appropriate amendments are made to the proposed legislation so as to ensure that N.R.O.'s and their shareholders are treated in a manner consistent with the treatment accorded to non-resident persons who invest directly in Canada, non-resident investors will no longer look upon N.R.O.'s as a suitable investment vehicle and many of these corporations will be wound up. In the result, a considerable amount of the capital now invested in Canada through the medium of N.R.O.'s may be lost. Such a consequence would be most unfortunate having regard to the importance of the role played by N.R.O.'s as a source of capital in Canada and to the contribution which such corporations otherwise make to the Canadian economy.

YOUR COMMITTEE RECOMMENDS that further consideration be given to the provisions of the proposed legislation relating to non-resident-owned investment corporations and appropriate amendments be made to ensure that there is neutrality (similarity) of tax treatment as between non-residents who invest directly in Canada and those who choose to invest through the medium of a non-resident-owned investment corporation, particularly with respect to the treatment of capital gains.

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INSURANCE CORPORATIONS

A. Life insurance corporations

There was referred to your Committee a matter which does not arise directly out of the proposed legislation but, rather, represents a problem which exists under the present Income Tax Act and which will continue to exist under the proposed legislation. In view of the fact that this matter will continue to represent a problem under the new legislation, the Committee considers it appropriate and proper to raise this issue at this time.

The problem which has been raised relates to the income tax treatment of dividends received by life insurance corporations in respect of investments in shares of other taxable Canadian corporations and which are acquired out of non-segregated funds. These funds (which, for the sake of simplicity, are hereinafter referred to as the "General Funds" of a life insurance corporation) are invested and held for the benefit of the following groups of persons:

1. tax exempt policyholders, e.g., any person who owns a policy which is registered with the Department of National Revenue as a registered retirement savings plan or which is issued pursuant to a registered pension plan;
2. other policyholders (excluding those persons owning policies, the reserves for which are invested in "segregated funds"), and
3. the corporation itself or, in the case of corporations other than mutual life insurance corporations, the corporation's shareholders.

In order to determine the amount of the corporation's liability for income tax, it is necessary to allocate the corporation's total investment income amongst

these groups in accordance with a formula set out in the Income Tax Act and the Income Tax Regulations.

In examining this matter, your Committee was advised that the total amount of investment income allocable to each group under the provisions of the present law is reasonable in the circumstances and that no objection is taken to the use of a statutory formula for this purpose. The problem lies in the fact that each group is deemed under the allocation formula to share proportionately in each type of investment income earned by the General Funds (including dividends received from taxable Canadian corporations even if such corporations are subsidiaries of the life insurance corporation in question). As a result, part of such dividends are allocated to tax exempt policyholders, thereby reducing the amount of the deduction allowable in computing the corporation's taxable income in respect of dividends received from other taxable Canadian corporations. This also holds true under the proposed legislation.

As is often the case, the assumptions made in devising statutory formulas such as this can be in error. In the case of life insurance corporations, the policyholders' funds must be invested in such a manner as to ensure that policy guarantees can be made and that such obligations can be met when the policies mature. Therefore, policyholders' funds are generally invested in fixed-interest type securities rather than in shares of other corporations. Most, if not all, of the investments in corporate shares are acquired out of the corporation's (or shareholders') funds and it follows that any allocation of dividend income contrary to this fact will result in the life insurer being effectively denied all of the dividend deductions to which it should properly be entitled. Most certainly, such a problem does not exist with respect to other corporations such as banks, trust companies and other similar financial institutions

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YOUR COMMITTEE RECOMMENDS that corporate dividend income received and arising from investments made by a life insurance corporation out of its non-segregated funds in shares of capital stock of corporations be excluded from the allocation of investment income formula set forth in the proposed legislation.

PRIVATE GENERAL INSURANCE CORPORATIONS

Under the proposed legislation there exists in at least two respects, a distinction between a private and public corporation. That is to say, depending on whether a corporate taxpayer is public or private, the income tax treatment of transactions may differ. These two differences may be summarized as follows:

1. A public corporation may receive dividends from other corporations without payment of tax, while a private corporation receiving a dividend from a non-controlled corporation, is subject to a tax of 33 1/3%. This tax however is refundable to the corporation upon the payment of a further dividend to its shareholders.
2. A public corporation will not be entitled to any preferential tax treatment in respect of its taxable business income, however, a small private business corporation will be entitled to preferential tax treatment on its first $50,000 of taxable business income. This preferential treatment is subject to a number of restrictions. One of these restrictions is that the after-tax profits of such a corporation must not be applied towards defined "ineligible investments" otherwise the corporation will be subject to a tax for so doing.

At the outset, your Committee wishes to commend the Government for retaining the concept of a preferential tax treatment for the small business corporation. However, as will be noted, your Committee believes that, first, the requirements are unusually restrictive and may defeat the purpose of the relieving provision; and secondly, little account appears to have been taken of other statutory provisions, both Federal as well as Provincial, relating to the business conduct of corporations, which provisions may be in conflict with the restrictions as set forth in the relieving provisions. Private general insurance corporations are but one example of this latter category.

Moreover, the private general insurance corporation may not only be at odds with the proposed legislation in respect of "ineligible investments", because of other legislation that is imposed upon it, but such a corporation may also be

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Moreover, the private general insurance corporation may not only be at odds with the proposed legislation in respect of "ineligible investments", because of other legislation that is imposed upon it, but such a corporation may also be

unable to comply with the proposed "33 1/3% refundable tax" rule, for the same reason. Both of these matters are hereinafter dealt with.

Your Committee would turn first to the question of the "33 1/3% refund tax" rule and its application to a private corporation. In the case of private general insurance corporations, your Committee has ascertained that the Canadian and British Insurance Companies Act (R.S.C., 1970, Chap. I-15) will severely limit such a corporation from applying this rule in its favour. There are two reasons:

1. Pursuant to Section 105 of this Act, a federal Canadian insurance company is prohibited from declaring and paying dividends in excess of 75% of its average profits for the three preceding years.
2. Further, pursuant to Section 103 of this Act, a federal Canadian insurance company must maintain at all times, assets of 115% in relation to 100% of its liabilities as a solvency test, this test conditioning as well, the payment of dividends. Unfortunately, "refundable tax" would not be treated as an admitted asset for the purpose of the solvency test under this Act.

The only comment which your Committee can make with regard to this question is that it represents an almost classic example of income tax theory being contrary to the required practice of the everyday business world.

Similarly, and as already noted, there is danger that an analagous result may also occur in respect of the private general insurance corporation and the tax to be levied where a corporation has made an "ineligible investment". Pursuant to Section 63 of the Canadian and British Insurance Companies Act (R.S.C., 1970, Chap. I-15) an insurance company is obliged to invest in securities that would otherwise be considered as "ineligible" for the purpose of the proposed legislation. In this respect the proposed legislation is therefore possibly in conflict with and inconsistent with, another federal statute known as the Canadian and British Insurance Companies Act (R.S.C., 1970, Chap. I-15). A similar result will also prevail in respect of the various Provincial acts.

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YOUR COMMITTEE RECOMMENDS that special provisions be introduced to alleviate the position of those private corporations which cannot take advantage of "refundable tax" by reason of any conflicting or inconsistent statutory law governing their conduct.

Similarly, that special provisions be introduced to provide that in the case of a private general insurance corporation, compliance with the investment requirements of governing federal or provincial legislation shall not constitute "ineligible investments".

Respectfully submitted,

Salter A. Hayden,
Chairman.

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