REPORT

OF THE

ROYAL COMMISSION

ON

CO-OPERATIVES

OTTAWA
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1945

ORDER-IN-COUNCIL

P.C. 8725

Certified to be a true copy of a Minute of a Meeting of the Committee of the Privy Council, approved by His Excellency the Governor General on the 16th November 1944.

The Committee of the Privy Council have had before them a report dated 10th November, 1944, from the Minister of Finance, representing that doubt has arisen as to the effect of the Income War Tax Act and The Excess Profits Tax Act, 1940, in the case of co-operative corporations, associations and societies both as regards the general principles intended by Parliament to be applied and the effect, in many matters of detail, of the said taxation statutes upon these co-operative organizations and their members;

That this doubt, both as to the general principles, intended to be applied and the effect of the aforesaid statutes, has created serious problems in connection with the administration of these taxation statutes and a considerable measure of uncertainty in the business operations of some of the co-operative organizations themselves; and

That a full public inquiry into the application of income and profits tax measures to organizations organized and operated on a co-operative or mutual basis and organizations claiming so to be organized (hereinafter referred to as co-operatives) and into the comparative position in relation to taxation under such measures of persons engaged in business in direct competition with co-operatives should be undertaken without delay.

The Committee, therefore, on the recommendation of the Minister of Finance, advise,

1. That the Honourable Errol M. W. McDougall, a Judge of the Court of King's Bench, Quebec; Mr. B. N. Arnason, Regina, Sask., Mr. G. A. Elliott, Edmonton, Alta., Mr. J. M. Nadeau, Montreal, P.Q.; and Mr. J. J. Vaughan, Toronto, Ont., be appointed commissioners under Part I of the Inquiries Act to inquire into—
   - (*a*) the present position of co-operatives in the matter of the application thereto of the Income War Tax Act and the Excess Profits Tax Act, 1940, and
   - (*b*) the organization and business methods and operations of the said co-operatives as well as any other matters relevant to the question of the application of income and profits tax measures thereto, and
   - (*c*) the comparative position in relation to taxation under the said Acts of persons engaged in any line of business in direct competition with co-operatives,

and report, in so far as the same can conveniently be done, all facts which appear to them to be pertinent for determining what would, in the public interest, constitute a just, fair and equitable basis for the application of the Income War Tax Act and The Excess Profits Tax Act, 1940 to co-operatives and to persons other than co-operatives in respect of methods of doing business analogous to co-operative methods, such as the making of payments commonly called patronage dividends and to make such recommendations for the amendment of existing laws as they consider to be justified in the public interest;

2. That the Honourable Mr. Justice McDougall, Court of King's Bench, Quebec, be chairman of the said commissioners;

3. That the commissioners be authorized to engage services of such technical advisers or other experts, clerks, reporters and assistants as they deem necessary or advisable and also the services of counsel to aid and assist the commissioners in the inquiry;

4. That the commissioners be authorized to determine the places where the inquiry shall be conducted and the manner of conducting the proceedings in respect of the inquiry;

5. That the commissioners be directed to report to the Governor in Council.

A. D. P. HEENEY,
Clerk of the Privy Council.

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THE PRESIDENT OF THE PRIVY COUNCIL

Sir:—

Pursuant to the terms of Order-in-Council No. 8725, approved under date of November 16th, 1944, we, the Commissioners therein appointed under Part I of the Inquiries Act have the honour to submit herewith, our Report.

In order to secure the information considered necessary to the accomplishment of our task, upon organization it was decided to hold a number of sessions of the Commission throughout Canada, at which interested persons would be afforded the opportunity of presenting their views. With this end in view public notices were issued calling upon all such persons to present written briefs of their submissions with indication of the place at which they would desire to appear personally in support thereof. A schedule of hearings was prepared and publicised, announcing sessions of the Commission for the cities of Vancouver, Calgary, Edmonton, Regina, Winnipeg, Toronto, Ottawa, Montreal, Quebec, Moncton and Halifax, indicating the dates of such hearings and outlining the subject matter of the enquiry by citation from the Order-in-Council in question.

In response to such advance notices, briefs to the number of about 175 were filed with the Commission by co-operative associations, Boards of Trade, Canadian trade associations, corporations, firms, individuals and public bodies, containing the submissions which it was desired to bring to our attention. Beginning in Vancouver on January 15th, 1945, the Commission proceeded to conduct the enquiries in open court, by hearing such evidence in support of the factual issues involved as the various appearers desired to submit. The Commission was assisted by counsel and the interested persons were afforded the opportunity of appearing in person or by counsel. With the object of giving to each and every citizen ample facility freely to put forward his views, the proceedings were conducted as informally as possible, compatible, however, with the importance and gravity of the matter in issue. So great was the interest aroused, as evidenced by the number of briefs received, that the Commission was unable to deal with all the submissions presented in the estimated and allotted time for each center. It was, accordingly, found necessary to postpone to a date beyond the determined schedule, such of the submissions as could more advantageously be heard in Ottawa. It was, thus, not until May 3rd, 1945, that the formal hearings were concluded in Ottawa, with an understanding that those persons or bodies who notified an intention of presenting a written or oral argument would be accorded an opportunity so to do.

The enquiry was not confined to the information elicited at these hearings but was extended to other sources such as interviews with Government officials, the very considerable literature upon the subject, public and private records and the answers to a general questionnaire sent out to a great number of co-operative organizations which had not submitted briefs, the response to which was most gratifying.

During the course of our hearings, reference was constantly made to the manner in which this subject had been dealt with in Great Britain and many of the submissions urged the adoption or adaptation of the British system of taxing co-operative associations to our Canadian conditions. The information available to us, upon this aspect of the subject, since the date of the amendment made in 1933 to the British Income Tax statutes, was inadequate to permit of reaching definite conclusions. We, accordingly, decided that three members of the Commission should proceed to Great Britain for the purpose of pursuing our enquiries into that phase of the question. Leaving Canada on May 19th,

these members of the Commission spent some six weeks in Great Britain, visiting the principal centers of co-operative activity at London, Manchester, Glasgow and Edinburgh. Informal meetings were held with officials of the Board of Inland Revenue, the principal co-operative organizations, representatives of various non-cooperative groups, economists, and writers, upon the subject of the nature and growth of co-operatives in Britain, their organization, methods of operation, the situation as to the taxation of such enterprises at the present time and the attitude of the interested parties thereto. During this period the two remaining members of the Commission, accompanied by our Counsel, paid a visit to the United States and there made a similar study as to the extent and form of organization of the co-operative movement in that country, and enquired into the manner in which the taxation laws were applied thereto. Annexed to the Report, as appendices, will be found summary reports of these special enquiries.

The record, which is transmitted herewith, comprises copies of the briefs submitted, together with a complete transcript of the evidence adduced and such supporting exhibits as may have been filed. In some instances, where separately put forward, the arguments of counsel are also included.

May we be permitted to express our indebtedness to our Counsel, Mr. E. T. Parker, K.C., whose valuable assistance has been unstintingly furnished. To the Registrars of the Commission, Major H. D. Woods and Mr. J. A. Chapdelaine and our Executive Assistant, Colonel G. W. Ross, we are extremely grateful for their assiduous and efficient labours. In like manner we express appreciation of the signal assistance afforded by Mr. J. G. Glassco, F.C.A., of the firm of Clarkson, Gordon, Dilworth and Nash, and his assistants upon the intricate accounting problems encountered, and to Professor V. C. Fowke of the University of Saskatchewan for his assistance in preparing Appendix A. We are also indebted to the members of the staffs of the various Government Departments, both Provincial and Dominion, to whom we applied for information, for their willing co-operation. The following were particularly helpful: Mr. W. F. Chown of the Economics Division, Department of Agriculture; Mr. I. S. McArthur, Acting Chief of the Agricultural Branch, Dominion Bureau of Statistics; Mr. A. C. Steedman, Chief, Merchandising and Services Branch, Dominion Bureau of Statistics; Dr. Maurice Ollivier, and officials of the Department of National Revenue and of the Department of Insurance.

Nor must we fail to acknowledge as well the assistance of the Librarians of the Bank of Canada, of the Department of Agriculture, and of Parliament.

Finally, to the faithful and essential services of the members of our staff we desire to record our appreciation.

SCOPE OF ENQUIRY

To avoid misconception as to the precise scope of the present enquiry and to define the limits of the task entrusted to the Commission, it may be well, at the outset, to emphasize the directive terms of Order-in-Council (No. 8725). The Commission is authorized "to enquire into:—

(*a*) the present position of co-operatives in the matter of the application thereto of the Income War Tax Act and The Excess Profits Tax Act, 1940, and

(*b*) the organization and business methods and operations of the said co-operatives as well as any other matters relevant to the question of the application of income and profits tax measures thereto, and

(*c*) the comparative position in relation to taxation under the said Acts of persons engaged in any line of business in direct competition with co-operatives,

and directed to

> report, in so far as the same can conveniently be done, all facts which appear to them to be pertinent for determining what would, in the public interest, constitute a just, fair and equitable basis for the application of the Income War Tax Act and The Excess Profits Tax Act, 1940 to co-operatives and to persons other than co-operatives in respect of methods of doing business analogous to co-operative methods, such as the making of payments commonly called patronage dividends and to make such recommendations for the amendment of existing laws as they consider to be justified in the public interest;

It will thus be appreciated that the Commission has no mandate to recommend changes in the general principle of income tax legislation as presently in force in Canada, nor is its advice sought in regard to the general policy animating the present Income War Tax structure. The mission with which we are entrusted is confined to recommending, if we consider it desirable, amendments to the existing legislation only in relation to the comparative position of certain organizations and their direct competitors. In the following pages, it will be sought scrupulously to remain within the ambit of the task so assigned.

The law with which we are presently concerned is contained in the Income War Tax Act (1917 c. 28, as amended) and The Excess Profits Tax Act, 1940 (1940, ch. 32 as amended).

The general provisions of the Income War Tax Act relevant to the present discussion are the following:

Section 2, subsection 1, paragraph (*h*) which is as follows:

> "person" includes any body corporate and politic and any association or other body, and the heirs, executors, administrators and curators or other legal representatives of such person, according to the law of that part of Canada to which the context extends".

Section 3, which is as follows:

> "For the purposes of this Act, 'income' means the annual net profit or gain or gratuity, whether ascertained and capable of computation as being wages, salary, or other fixed amount, or unascertained as being fees or emoluments, or as being profits from a trade or commercial or financial or other business or calling, directly or indirectly received by a person from any office or employment, or from any profession or calling, or from any trade, manufacture or business, as the case may be whether derived from sources within Canada or else-

where; and shall include the interest, dividends or profits directly or indirectly received from money at interest upon any security or without security, or from stocks, or from any other investment, and, whether such gains or profits are divided or distributed or not, and also the annual profit or gain from any other source....."

The relevant sections of The Excess Profits Tax Act, 1940, are Section 2, subsection 1, clauses (*e*), (*f*), and (*g*), which are as follows:

(*e*) 'person' includes any body corporate and politic and any partnership, association or other body, and the heirs, executors, administrators and curators or other legal representatives of such person, according to the law of that part of Canada to which the context extends.

(*f*) 'profits' in the case of a corporation or joint stock company for any taxation period means the amount of net taxable income of the said corporation or joint stock company as determined under the provisions of the Income War Tax Act in respect of the same taxation period...

(*g*) 'profits' in the case of a taxpayer other than a corporation or joint stock company, for any taxation period, means the income of the said tax payer derived from carrying on one or more businesses, as defined by section three of the Income War Tax Act, and before any deductions are made therefrom under any other provisions of the said Income War Tax Act."

and Section 2, subsection 2 which is as follows:

"Unless it is otherwise provided or the context otherwise requires expressions contained in this Act shall have the same meaning as in the Income War Tax Act, and definitions contained in the said Income War Tax Act shall apply in this act."

and Section 7, paragraph (*a*), which is as follows:

"The following profits shall not be liable to taxation under this Act:—

(*a*) The profits of taxpayers referred to in paragraphs (*d*), (*e*), (*f*), (*g*), (*h*), (*i*), (*k*), (*m*), (*p*), and (*q*) of section four of the Income War Tax Act."

The sections specially applicable to Co-operative Associations, Credit Unions and Mutual Fire Insurance Companies are quoted in those sections of the Report which relate to these various organizations.

STATEMENT OF PROBLEM

The question submitted for our consideration is not whether individual co-operators should be subjected to Income Tax. They are taxable at the present time. The question is:— Are the associations or incorporated bodies into which co-operators have banded themselves together for the purpose of carrying on their joint enterprise, in the particular circumstances applying to them, to be assessed to Income Tax and Excess Profits Tax, under the appropriate statutes, as such distinct entities in the same manner as other corporate bodies are taxed thereunder, independently of their constituent membership, and, if so, to what extent? Is there justification, in the public interest, for the present treatment of the co-operative form of enterprise in a manner different from that accorded to its non-cooperative competitor?

The answers to these questions will involve analysis of the nature of the income earned by co-operative associations and a conclusion as to what part

thereof, if any, constitutes taxable income of the association as distinct from its membership under the statutes in question, excluding from consideration for the moment section 4 (*p*) of the Income War Tax Act or similar exceptive clauses.

As above indicated, we are directed:

(*a*) To report all facts which appear to be pertinent for determining what would, in the public interest, constitute a just, fair and equitable basis for the application of the Income War Tax Act and The Excess Profits Tax Act, 1940, to co-operatives and to persons using similar business methods; and

(*b*) To make such recommendations for the amendment of existing laws as we consider would be justified in the public interest.

In view of the lengthy enquiries made and the mass of material collected it will, we fear, be necessary to report in some detail the facts elicited in order to establish the basis upon which recommendations may be founded. In reporting these facts and making these recommendations, it is convenient to classify the organizations which come within the scope of our enquiry into the following groups:

1. Co-operative associations and their direct competitors.
2. Credit unions and their direct competitors.
3. Mutual fire and casualty insurance organizations and their direct competitors.

Co-operative associations are treated in Part I of this Report, credit unions in Part II and mutual insurance organizations in Part III. In order to facilitate reading, the relevant factual conclusions are stated in the main body of the Report. More detailed studies supporting these conclusions are to be found in the appendices.

Though it is convenient to treat these three groups separately, nevertheless the problems involved have certain elements in common. These problems have been studied from the point of view outlined in the following paragraphs.

THE NATURE OF THE INCOME TAX

Even though it be obvious, we believe it will be well to point out at the outset that the Income War Tax and Excess Profits Tax are taxes on incomes of persons, whether individual or corporate. The amount of the tax in each case is calculated with reference to the income of the taxpayer.

In the second place, the taxes in question relate to the money value of net income produced. We consider that the tax should apply to any part of such net income as can readily be brought into relationship with the measuring rod of money unless there are strong special reasons for exempting it. Moreover, as far as practicable, the net income produced should be counted as income of each taxpayer in the period in which it is received directly or indirectly by him. Otherwise, some taxpayers will have an advantage over others in that they will be able to re-invest their income without first paying income tax thereon. Those who pay the tax when they receive the income will be able to put to profitable use only what is left after paying the tax. Those who do not pay the tax when the income is received will be able to put the whole of that income to profitable use.

In the third place, the income tax is fundamentally based upon the taxpayer's actual income and not upon the income which he conceivably might have received if he had not acted as he did. The chief exceptions to this principle at present contained in the Acts are the provisions which relate to transactions, the main purpose of which is deemed to be the evasion of the tax.

These points are of special importance in dealing with the set of problems involved in our enquiry. In each of the three classes of organizations considered, difficult problems arise—first, as to whether in the operation of each class, income is produced at all and second, if so, whose income it is.

INCIDENCE AND JUSTICE

What constitutes a "just, fair and equitable" application of the corporate income and excess profits taxes to the organizations we are considering and their direct competitors can be decided only after determining who really bears the burden of the taxes in question. Some taxes are readily shifted or passed on so that, once the shifting is accomplished, the actual taxpayer does not bear the burden of the tax. Other taxes cannot readily be passed on. We take the position that the corporate Income Tax and the Excess Profits Tax are not readily shifted but are borne initially and for the most part by the taxpaying companies and their shareholders.

We are not called upon to express an opinion as to whether the existing taxes on corporate incomes are unjustly high or unjustly low relatively to the general income tax structure, nor do we desire to do so. Accordingly, in discussing the justice of the present or proposed application of the tax to co-operative associations and their direct corporate competitors we are not to be understood as referring to this more general question.

Problems relating to justice in applying any tax on corporate income must be considered from one or other of two points of view or from both. In the first place, the tax may be regarded as a special tax imposed on the company as such in return for the advantages conferred on the company itself by incorporation. If this point of view be taken, it is important to compare the advantages conferred by incorporation on the types of organization which fall specially within our terms of reference with the advantages conferred by incorporation on their direct competitors. It is important, also, to compare the relative taxpaying abilities or faculties of the various organizations involved.

Alternatively, it has been argued that the corporate income tax is really a tax upon the shareholders of companies and not upon the company itself. From this point of view the tax on corporate incomes is regarded as an integral part of the general tax structure and it becomes important to consider whether the corporate income tax and the personal income tax taken together as a whole fall justly as between those individuals who receive their incomes through corporations, co-operative associations, mutual insurance companies or credit unions. We have not adopted either of these standards of justice to the exclusion of the other.

In any event, no solution can be fair and just unless it can be effectively administered. Unless a solution is reasonably free from uncertainty and ambiguity in its application to all taxpayers affected, that solution will inevitably give rise to unfairness and dissatisfaction.

PART
I

PART I

Co-operative Associations

SECTION I

DEVELOPMENT OF CO-OPERATIVE BUSINESS IN CANADA

Agricultural Societies with certain co-operative features have been in existence in Canada since the earliest days of agricultural settlement. Records indicate that some of these were active towards the end of the eighteenth century, but these were unincorporated, informal and mainly interested in improving the production methods rather than in undertaking buying or selling functions for their members. Organized co-operation in Canada for purchasing or marketing goes back to the sixties of the last century. About this time, creameries and cheese factories put in their appearance. Most co-operatives organized before 1900 were loosely formed organizations, without definite provisions for such features as are now considered to be the characteristics of a co-operative society. These features were not provided in company legislation, and for that reason most of the co-operatives organized before 1890 were unincorporated. As farmers acquired more knowledge of the problems involved in the marketing of their products and the purchasing of their supplies, interest in extension of activities became apparent, especially in Western Canada. The Grain Growers Grain Company was organized in 1906, the Saskatchewan Co-operative Elevator Company in 1910, and a similar organization in Alberta in 1913. Associations for the marketing of fruit were organized in Nova Scotia in 1912 and in British Columbia in 1913. The desirability of co-ordinating the activities of local marketing and purchasing groups—sometimes unincorporated—led to the organization of the United Farmers Co-operative Company, of Ontario, in 1914, and the Co-opérative Fédérée de Québec in 1922. During this period there was considerable organization of local farmers' purchasing and marketing associations, some of which provided rural store services. The organization of consumers co-operatives has not been rapid. One of the most important of these organizations, the British Canadian Co-operative at Sydney Mines, Nova Scotia, was organized in 1906.

After 1900, the provinces began to enact co-operative statutes. The province of Quebec placed on its statute books the first co-operative Act in 1906 to provide for the organization of credit unions and other co-operatives. Nova Scotia adopted a co-operative Act in 1908; British Columbia in 1911; and Saskatchewan in 1913. By 1938, every province had enacted co-operative legislation relating to the organization of co-operatives, and most provinces provided special departmental services for the administration of such legislation. There is as yet no Dominion Co-operative Act.

By the end of 1943, according to the Economics Division, Dominion Department of Agriculture, there were 1675 agricultural marketing and merchandising co-operatives in Canada, with a membership of 585,826. These included co-operatives handling dairy products, fruits and vegetables, grain and seed, livestock, poultry, honey, maple products, tobacco, wool, fur, lumber and wood, food products, clothing and home furnishings, petroleum products and auto accessories, feed, fertilizer and spray material, machinery and equipment, coal, wood and building material, as well as miscellaneous marketing and miscellaneous merchandising, not specified.

In addition, there were 67 fishermen's co-operatives; 1780 credit unions; 400 farmers' mutual insurance co-operatives, besides a group rendering mis-

cellaneous services such as hospital care, community recreation and entertainment, bus transportation, home building, trucking agricultural products, seed cleaning, rural electrification, telephone services, and agricultural production, including the co-operative ownership and operation of farm machinery.

Co-operative business in Canada can be divided into three general classes. In the first place, the associations assemble, sometimes process, and market the products of the farm and fisheries. This operation we will call *co-operative marketing.* In the second place they acquire and sell farm supplies and general merchandise. This type of activity we will refer to as the *purchase and supply* business of co-operative associations. Finally, some associations provide a variety of miscellaneous services ranging from the local distribution of electric power to the conducting of funeral homes. In carrying on these activities, different co-operative associations specialize in varying degrees. In the prairie provinces, for example, separate associations have developed for the marketing of each of the main farm products. Other associations are concerned with distributing farm supplies and general merchandise. Still others operate co-operative general stores. In Quebec, in contrast, an association typically markets a variety of farm products and, at the same time, distributes farm supplies and general merchandise.

The extent and growth of co-operative business in Canada is analyzed in Appendix A to this Report. This appendix, however, relates primarily to the business of agricultural co-operative associations and, since 1942, to the business of non-agricultural co-operative retail stores as well.

In all provinces of the Dominion some business is conducted by co-operative associations but it is unevenly distributed both as to amount and type. In 1943, for example, 29 per cent of the total co-operative business was carried on in Saskatchewan, and 15 per cent in Ontario, and 15 per cent in Alberta, while only 4 per cent was carried on in the Maritimes. (Appendix A, Table VI and Figure 2).

In terms of dollar volume of business transacted, the marketing operations of Canadian agricultural co-operatives are much larger than the merchandising operations. In 1943, marketing operations accounted for 85 per cent of the dollar volume of commercial business of Canadian co-operatives (excluding fisheries). However, the relative importance of marketing varied as between provinces from 49 per cent of the total co-operative business in Nova Scotia to 93 per cent in Manitoba. (Appendix A, Table I). The extent to which co-operatives have been developed in the marketing of agricultural or other primary products appears to be related to the degree to which the large and rigid freight, handling and other costs are interposed between the primary producer and the market for his products. When these costs are high, fluctuations in prices in the final market cause larger percentage fluctuations in the prices received by the primary producers. This is true of such commodities as grain, fish, fruits, butter, livestock, eggs and poultry. On the other hand, the difficulty of relating production to the requirements of local consumers markets has led to extensive co-operative organization in the assembling and processing of fluid milk. Furthermore, those producers of primary products whose income is most subject to fluctuation have shown the most interest in the buying of farm and other industrial supplies on a co-operative basis.

MARKETING OPERATIONS

This business extends beyond the narrow functions of assembly, purchase, sale, storage, transportation and finance and includes processing and manufacturing operations as well. Some of these latter operations are a necessary part of marketing under existing laws and industrial structures; others, while not

necessary, can be carried on conveniently or efficiently in conjunction with marketing functions in the more limited sense. These operations include pasteurizing milk, making of butter, cheese, ice cream and powdered milk; canning and preserving fruit, fish and vegetables; storing, cleaning, drying and milling grains, and even slaughtering and packing livestock. Some marketing associations have their own subsidiary printing and insurance companies. In performing these marketing and manufacturing operations the co-operative associations, like their competitors, make use of the ordinary agents of production: land, labour, capital equipment and managerial ability in much the same way as do their competitors. They also undertake risks which may result successfully or unsuccessfully for themselves or their members.

The direct competitors of the marketing associations are as diverse as the associations themselves. In the field of grain and seed, the competitors include incorporated elevator and milling companies and a variety of incorporated and unincorporated seed houses and local flour and feed mills. In the field of dairy products some of the direct competitors of co-operative associations are incorporated companies, some are partnerships and some are sole proprietorship businesses. At least one competing business is for the time being operated by a provincial government board. In the field of livestock marketing a great variety of incorporated and unincorporated businesses compete in some or all of the functions performed by co-operative associations. The direct competitors of co-operatives include also some joint stock companies whose practices resemble to a greater or lesser extent the practices of co-operative associations but who are held not to fall within the scope of section 4 (p) of the Income War Tax Act.

In 1943-44, 35% of the co-operative marketing of farm products in Canada was done in Saskatchewan, 17% in Alberta, 14% in Manitoba, 11% in Ontario, 7% in Quebec, 6% in the Maritimes and British Columbia taken together, and 10% consisted of interprovincial marketing. (Appendix A, Figure 3).

Grain and seed alone accounted for 45.5% of the agricultural products marketed through co-operatives in 1943. The six items: grain and seed, livestock, dairy products, fruits and vegetables, tobacco and poultry products, accounted for more than 98 per cent of the value of agricultural products marketed by co-operative associations in that year. Wool, maple sugar, fur, honey, alfalfa seed and other items were also handled in small amounts. In addition, co-operatives handled fishery products.

The dollar volume of the business in farm products both of co-operative associations and their direct competitors has increased considerably since 1933. A comparison of changes in the value of agricultural products marketed through co-operative associations in Canada with changes in the total cash income derived from the sale of farm products is to be found in Appendix A (Table VIII, Figure 7). It will be seen that the value of agricultural products marketed through co-operative associations in different years formed from 20% to 27% of the total cash income from the sale of farm products. (Appendix A, Table XXIII). While this proportion has varied from year to year, no marked trend is apparent. Accordingly, we conclude that neither the associations nor their direct competitors have substantially increased their proportion of the total farm products marketed during this period.

In some commodities and areas the business of the associations has expanded much more rapidly than that of their competitors. In other commodities and areas, it has lagged behind. If we exclude from consideration co-operative marketings of grain and seed and also farm income derived from the sale of grain and seed, it appears that the co-operative associations have increased somewhat their proportion of the remaining marketing business.

(Appendix A, Table XI, Figure 8). In Manitoba, and to a lesser degree in Ontario, Quebec and the Maritimes, the associations appear to have increased their proportion of total farm marketing; in British Columbia, there is no noticeable change in the proportion of total products marketed through the associations, while in Saskatchewan and Alberta, the expansion in total co-operative marketing has lagged behind the expansion in cash farm income. (Appendix A, Tables VIII, XI and XIII). During the war period, there are striking contrasts between different products when the rate of growth of co-operative marketing is compared with the rate of increase in the corresponding cash farm income. (Appendix A, Table XIV).

By and large it appears that co-operative associations have been able to increase their relative share of the marketing business in more commodities and in more areas than have their competitors. In some fields and in some areas, however, this increase in co-operative business has been quite striking.

PURCHASING AND FARM SUPPLY OPERATIONS

Part of the business of co-operative associations in Canada consists of acquiring and selling to their members (and sometimes to non-members) farm and other industrial supplies as well as food and general merchandise. Sometimes these sales are made at the retail, sometimes at the wholesale, level. The associations purchase the larger part of these commodities through ordinary business channels either directly or by means of their wholesale federations. A smaller part is manufactured by the wholesale federations or their susidiaries or purchased from co-operative associations in other countries.

These operations are performed by a number of types of association. Retail co-operative stores handle food and general merchandise and some farm supplies. Some associations are engaged in the purchase and sale of farm supplies in bulk and at retail as their principal business. Others, whose principal business is marketing, sell supplies as well.

In 1943, feeds, fertilizers, and spray material, accounted for 39 per cent of the merchandise and supplies distributed by these associations; food products for 23 per cent ; petroleum and auto accessories for 17 per cent; coal, wood, and building materials for 7 per cent; clothing, home furnishings, machinery and other miscellaneous items 14 per cent. (Appendix A, Figure 6).

The merchandising and supply business of co-operatives is distributed unevenly among different provinces and regions. In 1943, 22 per cent of this business was done in Saskatchewan, 21 per cent in Quebec; 18 per cent in Ontario; 13 per cent in the Maritime Provinces, and the remainder in other parts of Canada. (Appendix A, Figure 5).

Between 1933 and 1943, during the period of recovery from depression and during the war years, the dollar volume of merchandise purchased by co-operatives in Canada increased about eightfold but this increase was not distributed evenly among areas. The data by provinces are not completely reliable but the increase appears to have been greatest in Quebec and least in Ontario and British Columbia.

There are no exactly comparable data concerning the increase in similar sales for Canadian business as a whole. The evidence available suggests that co-operative merchandising as a whole has increased much more rapidly than either general retail sales or sales of country general stores; whether it has increased more rapidly than the sale of farm supplies as a whole is less clear from the evidence available. (Appendix A, Tables XXXIII, XXXIV, XXXV). In Saskatchewan, between 1930 and 1943, the value of the sales of co-operative associations increased from two per cent to six per cent of the sales value of all

similar products and services sold in Saskatchewan. (Appendix A, Table XXXVI). For Canada as a whole the sales of co-operative retail stores taken alone was 0.6 per cent of total retail sales both in 1931 and in 1941.

The membership of the supply associations usually consists of farmers, fishermen or other primary producers. The membership of the co-operative stores is more varied. Typically when they are situated in small towns and villages, their membership consists generally of persons resident in the surrounding rural areas but includes inhabitants of the towns and villages as well. In some cases the members for the most part are miners and, in rare cases, the membership is almost entirely urban.

The direct competitors of these associations include oil companies, both retail and wholesale, elevator companies and coal and lumber dealers who are usually incorporated, the agents of farm machinery companies, and retail stores of various sorts. Some of these retail stores are incorporated, some are not. In 1941, for example, 46 per cent of the retail store business in Canada was done by individual proprietors, 41 per cent by corporations, nine per cent by partnerships, and the remaining four per cent by liquor and other stores. (Appendix A, Table XXXII).

FISHERIES

We have not attempted to conduct a thorough survey of the comparative development of co-operative associations handling fish and fishermen's supplies. It is possible, nevertheless, to give an indication of recent trends in co-operative activity in this field. As a result of special inquiries into the depressed condition of the fishing industry government assistance, both Dominion and Provincial, has been granted for the purpose of assisting co-operative development among fishermen. The organization of co-operative associations in the fishing industry began in Prince Edward Island in 1924; there was no further development until 1930, when other similar groups were set up in the other Maritime Provinces. In 1933, the Prince Rupert Co-operative Fishermen's Association was established in British Columbia. In 1939, two other major organizations came into existence, the United Maritime Fishermen and the United Fishermen of Quebec. In 1945, this latter association had 29 affiliated locals representing 80 per cent of Gaspé fishermen. Finally, mention should be made of a co-operative fresh water fishery set up recently in Alberta.

In 1941, the 77 associations in operation did a total business of $2,646,000. Their estimated membership was 4500. In 1942, there were 65 associations consisting of 4,826 members doing a business of $2,628,000. In 1943, there was a considerable increase in business. Sixty-eight associations with 7193 members reported a total business of $5,055,000. It may be noted that while the business of the 66 fishery associations reporting in 1942 was $2,628,000., the total value of fishery products in Canada in that year was $75,117,000.

No statistics as to the numbers of co-operative associations incorporated annually or dissolved annually are available for Canada as a whole. However, a study of this subject in the province of Saskatchewan for the twenty-five year period 1914 to 1938 indicates that of 1091 co-operative associations incorporated in the province during this period, 531 had been dissolved by the end of 1938. Of those dissolved, 23 per cent were never active commercially to any considerable extent. Of the remaining 408 active associations dissolved, 188 had a membership of less than 30 and an average existence of 4.4 years; 121 with a membership of 30 to 59 had an average existence of 5.7 years, and 99 associations with a membership of 60 or over had an average period of survival of 6.8 years.

SECTION II

ORGANIZATION AND OPERATION OF CANADIAN CO-OPERATIVE ASSOCIATIONS

The structural organization of co-operative associations is very varied. In the first place, there are many small unincorporated associations consisting usually of a small group of individuals in one locality. Many incorporated associations also have only a small local membership; others, with a large or scattered membership, divide their members into geographical districts each with its own local unincorporated unit. These small "locals" elect delegates to attend the annual or special meeting of the association. In other cases, the association divides its membership according to the product shipped. Sometimes a number of incorporated local associations establish a federation. In this case, both the federation and the local associations are incorporated bodies. The locals own the federation and elect delegates to the meeting which appoints the Board of Directors of the federation. In rare instances, however, the federation itself is not an incorporated body, although its members are incorporated associations. In some cases too, the federation includes in its membership not only local incorporated associations but also individuals. Such federations may act as central marketing, processing, or manufacturing organizations, or as wholesale purchasing and manufacturing bodies for their members. In addition, some federations perform other services for the member associations advising them with respect to accounts and financial practices, or actually keeping their accounts. Some federations even make payments to the individual members of the "locals" on behalf of the local organization. In some cases, an association, whether a federation or comprised of individual members, owns and controls one or more incorporated subsidiaries which, at times, carry on the main business of the parent body. Federations have likewise been known to engage in activities more or less supplementary to the main business of the association. While we have found no subsidiary whose sole activity is the financing of the parent organization, it is nevertheless true that some of these subsidiaries do obtain bank loans which assist in carrying on the combined operations of the parent and of the subsidiary and some federations sell on credit to their member associations. Both the federated type and the individual-membership type may, in turn, form provincial or dominion-wide federations. Associations, or federations of associations, may also become members of international co-operative federations or of co-operative federations with head office in some other country.

Many of these associations and federations are members of some provincial co-operative union or of the Co-operative Union of Canada. The Provincial and Dominion co-operative unions, whether incorporated or not, engage primarily in research and propaganda activities. They are not commercial or trading organizations and, typically, have no taxable income.

VARIETY AND UNIFORMITY

The development of the co-operative movement has been characterized by a great deal of experimentation. As a result, co-operative associations do not conform to any uniform standard either in their methods of operation or in their forms of organization. Their diversity in these respects has been increased by a number of other important factors. Different fields of business and different geographic areas have presented different problems. Methods of financing vary from area to area and from industry to industry. Contracts with members and membership qualifications are by no means uniform. Some of the associations are incorporated under the various co-operative statutes,

and some under special Acts, either of the provinces or of the Dominion. Others have been granted their charters under the Dominion Companies Act or one of the corresponding provincial Acts. A few have not sought incorporation.

From 1906 to 1911, attempts were made to bring about the enactment of Dominion co-operative legislation but these efforts were defeated. Two Acts were passed by Parliament in 1939 to assist in the co-operative marketing of wheat and other agricultural products but, up to this time, there is no special Dominion statute under which co-operative associations may be incorporated. Many witnesses contended that the lack of uniformity in co-operative organization and practice was attributable in part to the absence of Dominion legislation on this subject. While we feel that suggestions of this nature do not call for recommendation on our part, we are yet constrained to report that there is a widespread desire that a co-operative Act be placed on the statute books of the Dominion.

Every province in Canada has on its statute books legislation providing for the formation of co-operative associations; Alberta and Saskatchewan each have two general Acts; Quebec has three. Although some general principles are common to all these provincial statutes, their provisions vary greatly in detail, and have been subjected to amendments from time to time. In addition to the general co-operative statutes, special private Acts have been enacted relating to the organization of such of the larger associations as found that existing legislation was not adequate. Since these statutes cannot be adequately summarized, they should be consulted when accurate and detailed information is required.

Not only do co-operative forms of organization and operation vary but there is no generally accepted terminology to describe the details of their organization and their practices. Some co-operative terms have been suggested by the general philosophy of the movement; others have been borrowed appropriately, or inappropriately, from ordinary company and business usage. Accordingly, things called by the same name in two different associations may in fact and in law be different. Conversely, things called by different names may be the same. Even the provincial statutes frequently use different terms for the same thing and impose their dissimilar terminologies on the associations within their respective jurisdictions. Moreover, co-operative practice and terminology are both changing continually. Much of the confusion of thought apparent in the discussion of the subject may be traced to this unfortunate looseness of terminology.

Such uniformity as exists in the midst of this great variety of detail arises from the fact that co-operators have attempted to apply to a variety of problems a few general principles. While these principles are neither precise nor rigorous, they are sufficiently definite to have left their mark on co-operative practice and statutes. Each member or each delegate is given only one vote no matter how many shares he may own. In order to insure customer control, the association typically attempts to assure that investors by way of shares or reserves are also customers. A variety of methods have been adopted in an attempt to make the member's interest as investor correspond at least roughly with his interest as customer. The associations accordingly have the power to purchase their own shares and to control the transfer of these shares. The rate of "dividend" or "interest" is limited by statute. Products are bought and sold, or accepted on consignment, at prices subject to a final adjustment at the end of the accounting period. Capital is ordinarily raised by small instalments either in cash or by deductions from the selling price of products or by the application of price adjustments to the capital account of the individual member. These similarities make it possible to describe in a general way, subject to

qualifications as to detail, how Canadian co-operative associations are organized. Sometimes the typical provisions occur in the statutes, sometimes in the charter, and sometimes in the bylaws of the association. Many of the co-operative statutes prescribe a set of standard bylaws but these bylaws may be changed subject to the approval of the official charged with administering the co-operative Act. Supplementary bylaws are adopted by the various associations.

ORGANIZATION OF CO-OPERATIVE ASSOCIATIONS

Incorporation is granted either by Letters Patent or registration. Generally, Articles of Incorporation must be filed with the Registrar of joint stock companies, the Inspector of Co-operatives, the Provincial Secretary, or some other Provincial Government official. The use of the word "co-operative" as part of the registered name of an association or company is restricted in six of the provinces to associations which qualify under their Acts. In three provinces, it is not restricted.

In their enabling documents of incorporation, the co-operative associations are usually granted wide powers of marketing, processing, and manufacturing the products in which they deal. In addition, many are empowered to carry on other activities more or less closely associated with their main business. In many cases, these powers are very wide, though in Quebec they appear to be more narrowly restricted to the marketing of products and the purchase of supplies. With very few exceptions, however, the objectives of the association are quite similar to those of any other kind of enterprise. Some co-operatives, especially wholesale federations, are permitted to carry on operations as manufacturers, miners, lumbermen, refiners, stonemasons, transporters, importers and exporters in goods, wares and products of any kind and description. With few restrictions they are authorized to borrow money, to mortgage their property, to invest funds, to acquire shares in other companies and, in general, to exercise any ancillary powers necessary to attain their objectives. They are also empowered to create central agencies, federations and subsidiary companies. Usually it is provided either in the statutes, charters, or bylaws, as the case may be, that the business is to be carried on by the association at cost and without profit to itself, or for the sole benefit of the members.

CAPITAL STRUCTURE

The enabling statutes provide for the formation of co-operative associations with share capital or financed by "loan units" or membership fees. All provinces provide for the formation of associations with share capital. Quebec authorizes the issue of both preferred and common shares. In most provinces, a limit is set to the number of shares that may be held by one individual, either by statute as in Quebec under the Co-operative Agricultural Associations Act, or by the bylaws or letters patent of the individual association. In some provinces, this limit is imposed by the provision that not more than 10% of the shares issued may be held by one member. An applicant for membership in a share capital association is required to apply for a minimum number of shares, sometimes one and sometimes more than one, in accordance with the bylaws of the association. In most cases the transfer of shares is restricted by statute or bylaws and is subject to the approval of the directors of the association. In most provinces, the amount of stock authorized is not limited by the charter of the association. The associations are permitted to repurchase their own shares, usually at par if the capital of the association has not been impaired, otherwise at some appropriate fraction of the par value. In all provinces, the rate of "interest" or dividend on capital stock is limited. Although payments in

proportion to share capital are usually referred to as "interest", such "interest" is usually payable, up to the limit imposed by the statute or bylaws, only at such rates as the association may decide. The statutes of some provinces permit payment of rates up to 8%, but the usual rate does not exceed 6%.

The limitation of the shareholdings of the individual member, the control of transfer of shares, the authority to issue an unlimited amount of share capital and to repurchase the shares of the association enable the co-operative associations to correlate, to some degree at least, the amount of investment by the individual member with his importance as a customer. If a member dies or leaves a community or withdraws from the occupation from which the association obtains its members, provision is usually made to purchase his shares. Shares are issued to new members who are actual or potential customers of the association. If this process were discontinued, then, in the course of time, a situation would arise in which many members of the association would cease to be customers. Older farmers' companies that were unable to secure the right of unlimited issue and repurchase of shares, under the legislation available when they were organized, now frequently find themselves in this situation.

In Ontario, Manitoba, Saskatchewan and Alberta, marketing and purchasing associations may be formed without share capital. Such associations usually require the prospective member to pay a small membership fee. In such cases, the statutes or the charter or bylaws of the association usually provide that the members shall have equal rights in the association. While it is convenient to distinguish between a membership fee and subscription for one share of capital stock with very small par value, the difference between these two methods of financing, for many purposes, is not considerable. In Ontario the capital of co-operative companies without share capital may be either or both in the form of loan units or promissory notes of the members payable on demand. In those provinces which permit it, the current trend seems to be toward the formation of associations without share capital.

MEMBERSHIP QUALIFICATIONS

From what we have said so far, it will be apparent that new members are admitted to membership in co-operative associations by a number of different methods. In the share capital type of association, the member is usually required to subscribe for one or more shares and may be required to make a cash payment. The remainder of the par value of his qualifying shares may be obtained from "patronage dividends" allotted to him by the association or from deductions of the proceeds of the sale of his products. When an association has no share capital, it usually exacts a small membership fee. This fee may be paid in cash or may be credited to the customer from "patronage dividends" declared by the association or deducted from the proceeds of the sale of his produce. This type of association sometimes provides for "associate members" or "patrons" as well as full members. "Patronage dividends" are typically allotted to the associate members or patrons but these are not entitled to vote at meetings of the association. When "patronage dividends" or deductions to a specified minimum amount have been credited to the patron or associate member, he may become a full member sometimes by signing an application form, sometimes simply by accepting notification that he is entitled to become a member. Some associations distinguish between shippers who have signed a contract to market the whole of their product through the association and others who have not so signed.

CONTROL

Generally, (as already pointed out), each member of the association has only one vote at the meetings of the association. In seven of the nine provinces voting by proxy is not permitted. In some cases, the association divides its membership into smaller unincorporated local groups arranged upon a regional basis. Each of the groups then elects one or more delegates to attend and vote at the meetings of the association. Similarly, delegates are elected by member associations to attend the meetings of federations. The number of delegates from each local association may depend on the relative size of its membership or the relative volume of business transacted by the local with the federation.

The directors of the association, elected at the general meeting, are given wide powers of direction and supervision over management. None the less, their decision as to the distribution of the annual surplus of the association is subject to the terms of the statutes and bylaws and where these leave some discretion, the actions of the directors are subject to the approval of the general meeting. The general meeting also enacts the bylaws, elects officers and appoints auditors.

Marketing associations carry on their business operations in a variety of different ways and, for our purposes, we may distinguish between those associations which purport to act as agents for their members—the so-called "agency type" of association—and other associations which purchase the products from the members and do not purport to act strictly as their agent. Usually, though not always, the "agency type" associations receive the products of their members on consignment.

MARKETING ASSOCIATIONS THAT RECEIVE PRODUCTS ON CONSIGNMENT

Some associations receive products as agents or on consignment from their members and sometimes from non-members as well. The terms on which they receive the product may be expressly stated in a written contract with the individual member, or set forth more or less explicitly in the bylaws of the association. In some cases these contracts require the shipper to deliver the whole or some substantial part of his product to the association; in other cases, the shipper is not so bound. Usually, the association agrees to act as agent, or agent and factor of the member, to handle, store and sometimes process the commodity; to dispose of it to the best advantage according to the judgment of the officers of the association and to account to the member for the proceeds on the basis of quantity and quality. Many members, in other words, deliver their products of varying quantity and quality to a common agent, each under a like but separate contract express or implied. Often one of the terms of each contract is that other members will deliver their products under a like contract. The association is usually empowered to pool the products of the shippers thereby reducing handling costs. In some cases, non-members receive the same financial returns as members. In other cases, they receive smaller returns. The products of members and non-members being pooled are often processed or manufactured. The raw, processed, or manufactured product is then sold. This marketing and processing requires the use of equipment, labour and management, and the marketing and processing tends to add value to the finished product.

Different associations follow varying methods in paying their shippers. Some make no cash payment at all when the shipments are received. Others make a payment which is considerably less than the market price, and still others make a payment which is as nearly as practicable the full price that the

product is expected to bring, less cost of handling and processing. In some cases, the initial payment, if any, is followed by a final payment, or one or more interim payments as well as a final payment.

In some cases the association is empowered to make deductions up to a stipulated percentage of gross sales, or up to a specified number of cents per unit of product handled, for the purchase of land, buildings and equipment, and is required to issue to the member, in return, evidence of equity in, or claims against the association equal in face value to the amount so deducted. Sometimes, also, it is permitted to make similar deductions for working capital. It is also given the right to deduct specified amounts to cover operating costs, expenses and losses reduced by revenue from sundry sources. It is required to account to the members for the excess of the amounts so deducted over the costs actually incurred. This it may do by apportioning this excess among the members and either paying the amounts allotted in cash or deferring payment and crediting the members with the amounts in question, or paying some part of the allotments and deferring the remainder. In some cases, part of the excess deductions, subject to approval of the general meeting of the association, is retained by the association without being apportioned to the members. In still other cases, it is simply carried forward to the next accounting period and forms part of the proceeds to be distributed to members in that period.

The payments and allotments made by the association to its shippers accordingly may be summarized as follows:—

(*a*) Initial payment, if any, made when the product is received by the association.

(*b*) Interim payments, if any.

(*c*) Amounts paid to members after the product has been sold and the operating expenses of the period determined.

(*d*) Similar amounts apportioned to members but withheld. A part of difference between deductions for operating costs and losses may be withheld and not apportioned to the members.

(*e*) Deductions for permanent investment in return for which the member receives share certificates or certificates of indebtedness where shares are not used.

OTHER MARKETING ASSOCIATIONS

Instead of accepting products on consignment, other marketing associations purchase products from members and often non-members and resell them sometimes after, sometimes without, substantial processing. Often these non-agency associations do not enter into written contracts with each member but the bylaws of the associations, the statutes under which they come into existence and perhaps their customary practices serve to prescribe, at least within rough limits, their methods of doing business and their obligations to members. When the association buys the product of a member, it may make an initial payment to him in cash corresponding closely to the current price of the product. At the end of its fiscal period, the association computes the amount realized from the sale of the product. The total so arrived at is the gross income of the association. From this gross income the association then deducts amounts already paid to members and its operating expenses, reduced by sundry income. What remains constitutes the annual surplus. The directors of the association, subject to the provisions of the relevant statutes and bylaws, make certain deductions from this surplus and apportion the remainder.

In some provinces the marketing associations are organized under the same Act and are required to deal with the surplus in the same way as do the purchasing associations. In other provinces, marketing associations are organized under separate legislation. In the latter provinces, the associations retain, unallocated, a portion of the surplus stipulated by contract or bylaw, or decided upon by the directors subject to the approval of the general meeting of the association.

From the remaining surplus, those associations, which are empowered to pay interest on share capital or other amount standing at the credit of the members, deduct the amount permitted or required for this purpose by the contracts or bylaws of the association.

The bylaws may permit the association to deduct also an "educational" reserve. The remainder is apportioned among the members in proportion to patronage. The amounts thus apportioned may be paid to the patrons in cash but the bylaws may provide for the deferment of a portion of these patronage allotments. In the case of share capital, marketing associations' patronage payments may be applied against the balance owing by the member on share subscriptions.

OPERATIONS — PURCHASE AND SUPPLY ASSOCIATIONS

The purchase and supply associations purchase supplies for resale to their customers and collect from them therefor certain sums. From the proceeds of sale they deduct their ordinary expenses, reduced by sundry income. The difference constitutes the surplus for the year's operations.

Co-operative legislation which provides for the organization of purchasing associations, or of both purchasing and marketing associations, usually requires or permits the associations to make certain deductions from the annual surplus before arriving at the amount available for allocation to members: (*a*) statutory reserves; (*b*) educational reserves; (*c*) interest on share capital or on allocated reserves.

(*a*) *Statutory Reserves*

The statutes of most of the provinces require the associations to set aside as a statutory reserve at least 5% or 10% of the surplus. In these provinces the associations may, and usually do, provide for reserves larger than the statute requires. In Ontario, however, the statute imposes an upper limit of 20% of the annual surplus. The members have no right to participate in or exact payment of these reserves unless the association is wound up.

(*b*) *Educational Reserves*

In many of the provinces, the associations are permitted to set aside each year a certain percentage, usually not in excess of 5%, to be used for membership activities or to attract new members.

(*c*) *Interest on Share Capital or Allocated Reserves*

In some cases the contracts or bylaws stipulate that interest shall be paid at a fixed rate whether earned or not. More frequently, however, the bylaws provide that interest shall be paid at the stipulated rate only if earned. In still other cases they provide that it may be paid, if earned, up to the maximum rate permitted by the bylaws or the statute.

When these deductions have been made from the annual surplus of the association the statutes usually provide that the remainder shall be apportioned to members or customers in proportion to the volume of business they have done with the association. Some associations allot "patronage dividends" to

members and non-members alike; others pay or allot smaller "patronage dividends" to non-members; still others do not allot "patronage dividends" to non-members at all. Powers granted to the associations in this respect differ as between different provinces. Associations are usually empowered to pass a bylaw deferring payment of a portion of the amounts so allotted to be used for the purposes of the association.

In most cases the bylaws of the associations stipulate that patronage dividends payable to the shareholder shall be applied to the unpaid balance of the shares for which any member has subscribed as a condition of membership. An individual member may, of course, subscribe for additional shares and direct the association to apply patronage dividends payable to him to the unpaid balance of his share subscription. Some associations which undertake marketing and purchasing activities are empowered to make systematic deductions to pay up his share subscriptions in a specified number of years. In such cases patronage dividends need not be applied to unpaid share subscriptions.

CO-OPERATIVE FINANCING

In summary, different types of associations secure funds for investment in a great variety of different ways.

The contracts or bylaws of a marketing association which receives products on consignment may provide for deductions for capital purposes and operating expenses. In return for the deductions for capital purposes the association may issue share certificates, where shares are used, or certificates of indebtedness where shares are not used. On the basis of the authority to make these deductions, the directors may borrow from the banks or the public. Part of the difference between the deductions for operating expenses and the expenses actually incurred may also be retained and used for the purposes of the association.

In the case of a marketing association which purchases products from the producers, the bylaws may provide that each member must subscribe for a minimum amount of share capital, payable in cash or by instalments. Where no share capital is issued, membership fees may be paid in cash or by instalments. Payment for the products is made, usually at current market prices, and when the produce is resold, part of the surplus, after paying operating expenses, may be retained being apportioned among the members; part may be apportioned and retained; part may be returned to the members or applied against share or membership subscriptions.

In a share-capital purchasing association, each member is required to subscribe for a minimum number of shares payable in cash, or partly in cash and partly on call, or if not sooner paid, out of "patronage dividends" declared by the association. Some associations require their members to deposit "loan units" for the duration of their membership. These may also be paid from patronage returns if not sooner paid in cash. Associations which finance without share capital, or which require only a small qualifying subscription for shares, may finance largely by means of deferring payment of patronage allotments. Any of these types of association may be financed partly by withholding a part of the surplus without allocating it to members. Any type may borrow from its members or from the public on individual loan contracts. These loans may be advanced in cash, or the association may be empowered to withhold patronage payments as a loan from the member.

The relative importance of share capital contributions, capital deductions, deferred dividends and unallocated surplus varies greatly from one association to another. In a sample of 40 purchasing associations in Saskatchewan during the eight years 1936 to 1943, thirty per cent of the increase in members' equity

was accounted for by share capital subscriptions and allocated reserves representing withheld patronage dividends. The remainder was represented by earnings withheld and not allocated. In a sample of 50 associations in the province of Quebec during the same period, 46% of the increase in members' equity was represented by share capital and allocated reserves, and 54% by unallocated surplus and reserves (Appendix C).

In all cases, associations are faced with the problem of keeping the investments of their individual members at least roughly proportional to their patronage. Accordingly, provision must be made from the resources of the association to purchase the shares of retiring members or to pay to members the "patronage dividends" or deductions held back in former years. As far as their financial position permits, and in order to maintain an active membership, associations attempt to purchase the shares and other claims of members who die, or wish to withdraw from the association. Usually, in Canada, however, so long as an individual remains a member of the association, he is not encouraged to withdraw his capital from the association. Some associations, however, have adopted a systematic method of retiring shares, deductions or withheld "patronage dividends". In these cases, funds secured from current deductions, or retained "patronage dividends", or current payments on shares, or other sources, are used to retire deductions made or dividends withheld in former years. The earliest contributions are usually retired first. This system of retention and payment is repeated as the years go by and the deductions or retained "patronage dividends" are termed a "revolving fund". The deductions and retained "patronage dividends" may be held for varying periods. During this period they form part of the invested capital of the association. In addition to financing its day to day operations, these funds may be invested in plant and facilities or in Government bonds or other securities, income from which goes to increase the revenues of the association. Sometimes the amounts credited to members in the revolving fund bear interest and sometimes not. Sometimes the length of the period of retention is stipulated in the bylaws, sometimes it is left to the discretion of the directors of the association. The members' rights to these revolving funds are sometimes evidenced simply by entries on the books of the association, sometimes by entries in pass books, and sometimes by shares or certificates of various descriptions.

EXPULSION

The statutes, bylaws or contracts usually provide that a member may be expelled from an association for conduct detrimental to the welfare of the association. If such expulsion is decided upon by the Board of Directors, commonly, it must be confirmed by the general meeting of the association. On expulsion, the directors may pay the member the par value of his shares and the amount allocated to him on the books of the association, either in cash or in instalment. No case has been called to our attention in which a member, on withdrawing from the association, was denied the payment of his equity therein.

GOVERNMENT ASSISTANCE TO CO-OPERATIVE ASSOCIATIONS

From time to time co-operative associations have received assistance from the Dominion Government and the governments of some of the provinces. All provinces have enacted co-operative legislation and many of them provide special services for administering this legislation and advising, organizing, and regulating co-operative associations. Other assistance has taken the form of loans and grants for organization and operating purposes. Financial assistance of this kind has been particularly common in the Western provinces and in Quebec but other provinces have likewise, from time to time, afforded finan-

cial assistance to co-operative associations. In addition, some provincial departments actually undertake marketing activities exhibiting some co-operative features. This work is discontinued as soon as the farmers organize to take over the marketing of the products in question. On a number of occasions, the Dominion Government has encouraged or assisted co-operative organizations. In the past, six of the nine provinces exempted co-operative associations from the payment of income tax. Another province, which levied no income tax, exempted them from its tax on corporations.

PRESENT TAX POSITION OF CO-OPERATIVE ASSOCIATIONS AND THEIR DIRECT COMPETITORS

At present co-operative associations regarded as falling within the purview of section 4 (p) of the Income War Tax Act are not liable to corporate income or Excess Profits tax. As we have seen, their competitors consist of public and closely held companies, partnerships, sole proprietorship businesses, non-exempt co-operative companies and even Government enterprises. The incorporated competitors are subject under the Income War Tax and Excess Profits Tax Acts to a tax of 40% (30% in the case of small companies) on income up to 116⅔% of their standard profits and a tax of 100% (less a 20% post war refund) on income in excess thereof. Unincorporated business competitors of the co-operative associations are not subject to tax as business entities under the Income War Tax Act but their owners are subject to income tax on their business and personal incomes. Under the Excess Profits Tax Act unincorporated businesses are subject to a tax of 15 per cent of their total profits or, alternatively, the whole of their excess profits, whichever tax is the larger. Some of the direct competitors of the co-operative associations are non-exempt companies which carry on trade in ways which are, in many respects, analogous to the business methods of the exempt companies. These companies would be entitled to deduct payments in proportion to patronage where the terms on which they have sold or obtained a product involve a contractual obligation to make the payment, and it is not purely voluntary. These contractual payments are deductible whether paid in cash or credited to the accounts of the producers or customers as an irrevocable obligation.

SECTION III

ARGUMENTS RELATING TO THE TAXATION OF CO-OPERATIVE ASSOCIATIONS

In the course of our hearings a great many arguments and considerations were urged upon us. It is fitting that these should be now discussed.

PUBLIC INTEREST

The representatives of co-operative associations advanced two main grounds upon which they sought to be freed from tax. They urged, in the first place, that their associations performed certain public services for people in receipt of low incomes which ordinary companies did not attempt, or at least not to the same extent, from which premise flows the plea that, in the public interest they should be specially favoured. Secondly, it was alleged that they were not profit making institutions by intention or practice; that their object was to perform services for their members at cost, giving rise to the argument that, in fact, they did not derive profits from their members. Many recognized, however, that some profits might arise and accrue to the members through the association from non-member business or deriving from investments.

The Commission is in no doubt that the co-operative associations can and do perform services which are valuable not only to their members but redound to the advantage of the community in general. In many fields their methods of organization and operation enable them to meet special economic needs more effectively than these can be met by ordinary trading companies. On the other hand, the forms of organization and operation of the latter enable them to perform other public services and other functions more efficaciously than can the co-operative associations.

In particular, the co-operative form of organization, especially in rural areas, affords an opportunity to individual members of outstanding capacity to obtain an experience in management, administration and leadership which, in the ordinary course of events, they could not obtain in any other way. The development of these men through training is not only valuable to the associations themselves but is of advantage to the country as a whole. Similarly, however, the ordinary companies and businesses provide a like opportunity for their employees of promising ability to become proficient in business by assuming and discharging the responsibilities of important administrative positions.

This point is very closely akin to another. In the modern world of large enterprises, especially when times are difficult, some individuals with low incomes are likely to feel that they are being taken advantage of and are powerless to resist such exploitation. The establishment of a co-operative association may assist in meeting the needs of such members and in bringing relief to this feeling of frustration by providing an outlet to normal creative activity. The value of such an objective for individual ambition, not only to the member himself but to the community generally, need hardly be stressed. Although the associations render important social services by providing a vehicle whereby individuals in low income groups may help themselves, it is none the less true that they themselves are dependent on Government services and facilities financed by taxes levied upon those who possess the ability to pay.

In the special field of marketing the products of the farm and fisheries, the members are perhaps better placed to judge the tastes of the market and adjust their products accordingly if they have their own representative in the market and are assured that the tastes of the consumers will be reflected back to them directly in appropriate price differentials according to grade and quality. In the same way, of course, non-cooperative companies handling manufactures or primary products are usually in a better position if they have their own representatives in their more important markets.

Again co-operative associations appear to have developed most rapidly in fields where there are wide and rather rigid price margins associated with government control or custom, or where a multiplicity of outlets make for high costs of distribution and marketing as, for example, in Western Canada where the whole organization of marketing and distribution was originally planned to serve a larger population than has actually developed. If co-operative associations can help to prevent the development of unreasonably wide margins and unnecessary duplication of facilities, they will be performing a public service which governments can accomplish only with difficulty. However, alert and efficient non-cooperative trading enterprises perform similar services not only in areas where the associations are now engaged, but in many other commercial and industrial fields.

Some representatives of the co-operative associations argued, and it was repeated on may occasions, that the methods of co-operation resting, as they say, upon the self help motif, appealed to and developed a higher set of principles than the individual and purely selfish pursuit of gain. If it be necessary for us to express an opinion in this somewhat abstract and idealistic field, it is

this: in their actions human beings are actuated by a wide variety of motives and in varying proportions. The more varied the forms of organization open to them in earning their livings, the more probable it is that each will be able to find a satisfying and useful niche within the general economic framework. Trial and error alone can determine in what fields ordinary companies and in what fields co-operative associations can most usefully make their own peculiar contributions to our economy.

It was pointed out that the members of most co-operative associations are farmers, fishermen and other primary producers. Producers of primary products and business ventures engaged in marketing their goods are subject to extreme fluctuations in income. The Income and Excess Profits Taxes in the past may have burdened them unduly when applied in years of high income without due allowance for years in which losses occurred. It is true, also, that both the co-operative associations and their private competitors in these fields are subject to the same wide fluctuations in income. Recent amendments to the legislation afford a considerable measure of relief.

On this first head of argument, therefore, considerations of public interest do not lead us to the conclusion that co-operative associations should be given a blanket exemption from income tax while their competitors are subjected to the full burden of the current heavy rates. The considerations referred to do suggest, however, that where there is doubt as to what the income of an organization really is, the relative strength of co-operative associations and their competitors should be carefully considered to make certain that the solution finally adopted will not ruin one or the other, or unduly constrict their relative growth and development.

The granting of fiscal advantages is not usually a good method of giving special encouragement or assistance in the field of economic venture. Exemptions granted to one segment of the commercial community can scarcely benefit the public as a whole. Welcome though they may be to those who receive them, the burden from which some are relieved falls with proportionately increased weight on the rest of the economy. The cost of granting the exemption is usually not known. Accordingly, it is difficult to know whether or not the results are worth the cost. The advantages of any general exemption accrue to those who need it and to those who do not. In this particular case the advantages are likely to accrue in larger proportion to those associations whose income is large and whose need is less, while those associations who have no net income are receiving no advantage from the exemption.

THE ASSOCIATIONS AND THEIR MEMBERS RECEIVE INCOME

The position of co-operative associations in relation to income tax arises in two ways: (1) from the statutory exemption which at present applies to some of them and (2) from the alleged statement of fact and law that they earn no income. The second main contention of co-operative witnesses and counsel, accordingly, is that co-operative associations are non-profit organizations. This statement connotes a number of different but related meanings. Sometimes it means that the associations do not distribute the net surplus arising from the co-operative business in proportion to investment, except for a limited rate of "interest". At other times it means that the associations try to arrange their affairs to insure that there will be no conflict of interest between the members as customers and the association as buyer or seller. Again, it may mean that the association is financed in such a way that the interest of each member as owner and investor is at least roughly proportional to his interest as a customer. Finally, it may give the idea that the associations try to "operate at cost", that is to say, they endeavour to return to their member customers the

whole of their receipts except for necessary expenses. Compendiously it means that co-operators try to do all these things. The mere statement of this non-profit purpose in their charters or bylaws is not conclusive to a finding that co-operative associations do not in fact and practice earn an income which might, in all fairness, be assessed to income tax. The circumstance that they may order their affairs in such a way as to avoid friction between buyer and seller, or so that the investments of the members are roughly proportional to their patronage, is not relevant in determining whether they earn a taxable income.

It was urged upon us that co-operative associations, even though they possess the advantages of limited liability, were nevertheless not legal entities, separate and apart from their members. We do not subscribe to this view nor does it, in our opinion, correctly state the facts or the law. Most co-operative associations are incorporated bodies. They are, in our opinion, "bodies" corporate and, therefore, "persons" within the meaning of that word as used in the Income War Tax Act. We regard the individual members and the corporate bodies with which they are associated as "persons" separate and distinct the one from the other. Each is a potential taxpayer with respect to that income which may properly be considered to be his.

In opposition to the foregoing contentions advanced by the co-operative movement, some of their competitors assert:

(1) That the associations perform precisely the same productive functions as ordinary companies, using the same sort of buildings and equipment, employing the same sort of labour, using the same technical methods, obtaining the goods they handle and process from the same sources, and selling them in the same markets as do their non-cooperative competitors;

(2) That they are organized as limited liability companies and do business under the same sort of contracts and with the same powers and obligations as ordinary traders;

(3) That they are organized and operated *for the purpose* of making a profit, and

(4) That consequently they should be assessed to taxes upon the same basis as an ordinary company.

We have already indicated that, in our view, the purpose or alleged purpose of the associations is irrelevant. We are convinced that they do not do business under precisely the same sort of contracts as ordinary traders. The first contention, however, is both true and important and leads to a fundamental conclusion. If we consider a marketing or supply association and its members as one group of individuals, then the whole of the incomings of this group from the sale of produce is the gross income of the association and its members taken together. If from this gross income are deducted the expenses incurred to outsiders and ordinary allowances for bad debts due by outsiders and depreciation of buildings and equipment, whether in the hands of the members or the association, then the whole of what remains is net income produced by the association and its members. This net income, moreover, is calculable in terms of dollars. It is identical with the income which is ordinarily subjected to income tax. All of it should be assessed as income either of the members, or of the association, or of both, unless there are very clear special reasons for exempting any part of it. This point is not really in dispute since, without exception, witnesses on behalf of co-operative associations were of the opinion that the association conferred a financial benefit on the members.

A co-operative store which sells consumers goods is perhaps in a slightly different position. In this case, the expenses of the association and its members incurred to outsiders is clear and determinate. However, the goods are not resold by the members; they are used or consumed by them. Conse-

quently, the gross money income of the association and its members taken together cannot be computed. In this case, it is necessary to decide at the outset what part of the receipts of the association from its members are really prices paid by the members. This difficulty may have been at the foundation of the compromise solution recommended by the British Commission of 1933 that rebates or patronage dividends ("divis") returned to members of a consumer store were not to be regarded as being the profits of anyone, while the amount retained by the society, less ordinary expenses was to be regarded as the taxable income of someone, notably the society.

In the early stages of the tax controversy in England, an attempt was made to apply the doctrine of mutuality to this situation. This argument, originally developed in connection with mutual insurance, was advanced in support of the contention that neither the society nor the members make any profits from their joint venture. But, in the view which we take of the Canadian tax situation, this argument is of little assistance. Co-operative associations are organized for buying or selling or both. Even in the case of a co-operative consumers' store, the amount saved by the consumer is influenced not only by what the consumer originally pays the association but also by the amount the association has to pay its suppliers and its employees, by the amounts received from outside investment, and by the amount of its business with non-members. It is our unhesitating opinion that the association and its members, as a result of the trading venture which they undertake, do make a profit. The difficulty arises in determining to which of the two, the members or the association as such, this profit inures. In the hands of one or the other, it is assessable to tax. Thus, while originally "mutuality" may have had great potency in support of an argument that in fact, no profits were made from the venture, it has lost much of its former vigour in those aspects of co-operative business which now confront us.

As we have already seen, co-operative associations do not do business by virtue of the same sort of contracts as the ordinary company, or with precisely the same obligations. In particular, the methods of organization of co-operative associations make it unnecessary for them to distinguish as clearly as does an ordinary company between amounts which in source and function are at least roughly analogous to the profits of an ordinary company and other amounts which are similarly analogous to capital contributions of the shareholders, or to the expenses of an ordinary company. For example, in a marketing association, part of the deductions from the proceeds of sale of the members' products resemble charges made by the association for handling the members' products. Other parts more closely resemble capital subscriptions of the members to finance the association. In the case of an ordinary company, it is perfectly clear what part of the shareholders' equity has come from subscriptions by shareholders and what part has been retained from the profits of the company. Obviously, if an ordinary company was authorized by the customer to keep as a loan part of the proceeds of sale of products consigned to it, this loan would not be considered part of the income of the company. Again, the association is, to some extent, obligated to make return to the members in proportion to patronage. These returns resemble in part an ordinary price rebate or discount. However, their amount is affected by the efficiency of management of the association and a variety of unpredictable circumstances beyond its control. It may be affected also by revenue from the investments of the association in bonds or other securities. It may be influenced as well by the policy the association follows with respect to engaging in business with non-members and granting patronage returns to the latter. On the other hand, if satisfactory returns of this kind are not made, it is probable that the membership and the business of the association will decrease.

Functionally, then, the so-called patronage dividends may partake of the nature of a return of profits to the members, or a return of excess charges, or a return of investments, or an expense of the association. These practices, be it noted, are not to be regarded as devices adopted by the co-operatives to avoid payment of taxes. Rather they are characteristic of the ordinary co-operative way of doing business.

The contracts between the association and its members differ at least in phrasing and detail as between different associations. The terms of the relevant statutes, memoranda, articles of association, bylaws and specific and implied contracts, differ from the corresponding documents and contracts between an ordinary company and its customers; or between an ordinary company and its shareholders. The precise effect of the various clauses of the contracts and the general implications to be drawn therefrom, taken as a whole, have not been clarified, in Canada, by judicial interpretation, and it is far from clear in principle what effect may or should be given thereto. There are very few Canadian decisions touching the question. Each case must depend and turn upon its own facts. It is thus impossible to lay down, as a general rule, definitely how much of their surplus the associations are actually obligated to return to their members, or at what date, or on what terms. Here lies the difficulty in deciding what amounts may reasonably be considered, for income tax purposes, to be income received directly by the member and taxable only in his hands, and what amounts can reasonably be considered to be the distinct income of the association and taxable in its hands, even if later distributed to the member. We were referred to two decisions of the Supreme Court of Canada. The first of these decisions was rendered in the case of *Fraser Valley Milk Producers Association vs Minister of National Revenue 1929 S.C.R. 435*. It was rendered on the 30th day of April, 1929, and unanimously affirmed the decision of Audette J. in the Exchequer Court, rendered on the 8th day of October, 1928. The other decision was that rendered in the case of *Saskatchewan Co-operative Wheat Producers Association vs The Minister of National Revenue 1930 S.C.R. p. 402*. It was delivered on the 10th day of April, 1930, and affirmed the decision of Audette J. in the Exchequer Court rendered on the 29th day of May, 1929. We are advised that these decisions turned upon the particular facts therein involved and do not for that reason furnish any guiding principle applicable to our general enquiry.

The competitors of the associations contended that the co-operative surplus is strictly analogous to the profits of an ordinary corporation; that the co-operative form of organization enables the association to secure a large volume of business and to effect economies in marketing; also that this surplus is attributable to the use of capital and the employment of labour and to the successful outcome of business risks. These are the factors, they argued, that enable ordinary companies to make profits. The conclusion followed, accordingly, that the whole of the surplus of co-operative associations should be taxed as the profits of the association. In our opinion these various factors do assist in effecting economies. In a competitive situation, however, most of the economies which ordinary companies secure tend to be passed on to their customers in the form of lower prices. The taxable income of the companies, however, depends on the prices actually charged. Similarly, if a co-operative association effects economies and passes these on to its customers, we are of the opinion that it should not be taxed as though it did not adopt this practice.

COMPETITION AND TAX EXEMPTION

The present income taxes impose a heavy burden on ordinary companies and their shareholders. It is important to consider whether the immunity of the co-operative associations from tax imposes an *additional* burden on their

corporate competitors by giving the associations an unfair competitive advantage.

In the foreground of the apprehension expressed by the competitors of the associations was the suggestion that the latter might use their reserves, now being built up without payment of taxes, to drive such competitors out of business by precipitating a price war, or to finance the improvement of facilities and premises, or to buy up ordinary businesses, or to initiate new ones. However improbable it may be that an association would make use of accumulated funds to finance unreasonable price reductions and precipitate a price war, yet some associations temporarily might make the mistake of adopting such a policy. The associations at present do retain earnings without paying income tax. (Appendix C). These retained earnings may be used to expand premises, improve services and thus secure new members. This expansion tends to diminish the business volume and the incomes of ordinary enterprises— enterprises already in existence or enterprises that might have been established if the association had not expanded. Moreover, the tax free reserves which an association may accumulate will assist it in surviving periods of falling prices and business depression.

When a new co-operative association is formed, the funds initially paid to the seller of the purchased business do not come from tax free reserves, but from actual collections in cash from the members of the new association. The remainder may come wholly or partly from income which has not been subjected to tax. When an established association purchases a business, all or part of the funds required may be obtained from capital newly subscribed in cash; part or all may come from income which has not been taxed. The evidence presented tends to suggest that some part of the prospective advantages of freedom from taxation, in some cases, may have been capitalized and paid to the former owner as part of the purchase price. The seller of the business, in this situation, sustained no injury, but other prospective purchasers may have been handicapped.

We find no basis for the view that the freedom of co-operative associations from income taxes has, in the past, induced the associations to engage in unreasonable direct price competition, or enabled them to damage their competitors by attracting funds which otherwise would have been available for investment in ordinary business. Whether the ability to pay patronage dividends gives an association a competitive price advantage is debatable. It would appear, therefore, that the chief *competitive* advantage which the co-operative associations as entities enjoy, by reason of their tax exempt position, lies in their present capacity to set aside larger reserves than they could if they were taxed on the same basis as are their competitors.

This conclusion finds support in the fact that co-operative marketing associations do not appear to have been able to obtain a larger proportion of the business of marketing farm produce. It is probably significant too that no direct competitor of a co-operative association appeared before the Commission to testify that, up to the present, he had been severely prejudiced by co-operative competition, though many did complain of the heavy weight of taxes that the companies have had to bear. Rather were the fears limited to the competitive advantages the associations might obtain in the future from their large reserves. In our opinion, it is desirable that a solution be found which will go at least some distance toward removing these fears in so far as they arise from tax exemption.

EQUITY IN TAXATION

We turn now to consider whether the advantages received by co-operative associations by incorporation are substantially the same in kind and amount as those conferred on ordinary companies. Certain provisions of the Income War Tax Act already recognize that different kinds of ordinary companies may reasonably be given somewhat varying tax treatment. Recommendations have recently been made concerning the special treatment of private and closely held companies. The advantages conferred by incorporation include, among others, the power to issue transferable shares with limited liability, perpetual succession and the use of a common seal. Incorporation, moreover, establishes a legal entity from which shareholders may exact their dues by means of legal process. The power to issue transferable shares with limited liability has proved to be a great advantage in securing large accumulations of funds from individuals who would be unwilling to risk their entire fortunes in the venture, and who wish to be able to realize their investments without undue delay.

Both co-operative associations and ordinary companies enjoy these advantages except that the shares of co-operative associations and closely held companies are often not readily transferable and both draw their funds from restricted sources of investment. An additional self-imposed restriction of the associations arises from the fact that they repurchase the shares of persons who have ceased to be customers. These considerations lead to the conclusion that associations like companies derive advantages from incorporation and may reasonably be taxed on whatever income they do receive. However, the advantages derived by the associations are probably, on the whole, less than those enjoyed by ordinary companies. We do not undertake to decide whether the advantages of incorporation are commensurate with the present high rates of corporate taxation.

It is reasonable now to deal with the relative faculties or capacity of co-operative associations and companies to pay taxes. It has repeatedly been pointed out that co-operative associations are unusually difficult to initiate and the Saskatchewan study suggests that in their early years, their financial difficulties may be greater, on the average, than those of similar ordinary companies. It is true also, since each member has one vote only, that the stability of the association depends upon the discretion of its more needy members. This cannot usually be said of an ordinary company. In its more mature stages, however, the "share-capital" type of association, with its large unallocated reserves, appears to be quite a stable organization. The financial strength of an "agency-type" association, financed largely by means of allocated reserves, is less clear. In practice, however, in Canada, the members have not in the past been able to obtain repayments of allocated reserves except with the approval of the directors of the association. We are thus led to the view that associations financed in this way, once they have reached their mature development, are also fairly stable institutions and capable of bearing the burden of taxes. We conclude that there is no justification for the complete exemption of either of these types of co-operative associations on the grounds that, as companies, they have no ability to pay taxes.

Viewed from another angle the corporate income tax may be regarded as a tax paid by the company on behalf of its shareholders. From this point of view that portion of the tax which is assessed upon the undistributed profits of the corporation is an average payment on behalf of the owners of the company on funds accruing to their benefit but on which they are not currently taxed. If that part of the tax which is imposed on dividends is to be defended, it must be on the grounds that companies have the power, which unin-

corporated businesses have not, of determining the year in which the profits of the company will be received by the shareholders and be assessed to personal income tax. When personal income tax rates are rather steeply progressive, and the earnings of a business fluctuate from year to year, the power to maintain stable dividends diminishes the total tax payable by the shareholders.

The co-operative association, like the trading company, has the power to maintain stable dividend rates. Moreover, the co-operative associations qualifying under section 4 (p) of the Income War Tax Act may set aside reserves, some of which are not at present taxed in the period when earned either as income of the member, or as income of the association. True, the member cannot realize on these tax free accumulations by selling his shares at a higher price, but he does obtain an advantage by the faculty, as it were, of re-investing earnings in the association without first paying tax on them. This is an advantage to such members of the association as are in receipt of taxable incomes. Be this as it may, the majority of the members of co-operative associations, in normal times, receive incomes which are below the exemption limit. Accordingly, the ability to re-invest without first paying personal income tax, is of lesser advantage to the members of a co-operative association than it is on the average to the shareholders of a company. Considerations of this nature are not sufficient, in our view, to justify the plea for complete exemption of co-operative associations from income tax.

EXPERIENCE IN BRITAIN AND THE UNITED STATES

The task of applying income tax to co-operative organizations has always been before the tax authorities in Canada in respect of associations which have not qualified under section 4 (p) of the Income War Tax Act. Our terms of reference and the evidence before us suggests that no final and completely satisfactory policy has evolved. With a view to further enlightenment, we deemed it advisable to investigate the application of income tax to co-operative societies in Great Britain and to non-exempt associations in the United States. These studies are included in Appendix D and may be referred to for greater detail.

In England the tax is applied to all amounts that the co-operative associations put to reserves. Under the conditions and practices prevailing in that country, this policy has not presented serious administrative difficulties. It is well to bear in mind, however, that in Britain, no associations purport to act as agents for their members, nor do they obtain capital by withholding purchase dividends or bonuses credited to their members.

In the United States non-exempt associations are allowed to deduct patronage allotments whether paid or withheld. This method seems to be administratively feasible under the conditions prevailing in that country.

SECTION IV

PROPOSALS MADE TO THE COMMISSION

Many and various have been the proposals submitted to the Commission. Some of these merit fuller consideration and comment:

(1) *That section 4 (p) be broadened beyond its present limits* to enlarge the exemptive features thereof. We have already indicated our reasons for opposing the general exemption of co-operative associations.

(2) *That co-operative associations be taxed only on their investment income and such part of their trading surplus as arises from non-member business.* This proposal rests on the "mutuality" argument. As we have already pointed out, we take the position that the whole of the income of the members and the association is taxable income either of the members, or of the association, or both. Consumer associations represent, in Canada, only a relatively unimportant exception to this general principle.

(3) *That the associations be taxed just as an ordinary company.* We accept the general principle involved, but since the associations do not conduct their affairs in just the same way as an ordinary company, this proposal must be excluded. It falls far short of solving our problems.

(4) *That in difficult cases the Minister be given power to determine the income of the association.* While in tax matters the administration must be given certain discretionary powers, we regard this proposal as tending to impose an unduly heavy burden on administrative officials.

(5) *That a special tax be imposed on co-operative associations on some basis other than income.* Our mission, however, is confined to income and excess profits taxes. A majority of the commissioners takes the view that these suggested imposts would not be such.

(6) *That interest at a reasonable rate on non-interest bearing investments of members be imputed as part of the income of the association.* We have taken the view that such imputation is to be avoided if at all possible.

(7) *That the British system of taxing co-operative associations be applied, patronage dividends being allowed as a deduction.* We are to some extent in sympathy with this suggestion but the practices of Canadian co-operative associations differ considerably from those prevalent in Britain.

(8) *That co-operative associations be allowed to deduct distributions made in proportion to patronage and that their direct competitors be allowed to deduct dividends paid to their shareholders.* We consider that the last part of this proposal would give rise to greater inequalities as between different companies than any it would correct. If it were adopted, competitors of the direct competitors of the association might, with some reason, demand that the same privilege be extended to them. We can see no definite and equitable end to this process.

(9) One of the proposals made to us was that section 4 (p) of the Income war Tax Act be repealed. If this were done, all co-operative associations would be taxed on whatever taxable income they might have and the responsibility of determining if they had taxable income and the amount thereof would rest upon those whose duty it was to administer the Act. The difficulty in determining the amount of such taxable income in cases not coming within the purview of section 4 (p), and the further difficulty of construing the section in order to ascertain whether any particular co-operative association came within its provisions or not, has given rise, as we understand it, to much of the uncertainties in administration referred to in Order-in-Council No. 8725. We venture, therefore, to discuss this proposal in greater detail, in the light of advice furnished the Commission.

We are advised that section 4 (p) was inserted in the Income War Tax Act in its present form by section 2 of chapter 24 of the Statutes of 1930 (assented to on May 30, 1930), and has remained unamended since that time. During the two years immediately preceding the enactment of this section, the two decisions above referred to had been rendered by the Supreme Court of Canada, each dealing with the question as to whether certain monies received by co-operative associations was chargeable to income tax in the hands of the associations concerned. The contention was advanced before us that the section in question was enacted as a result of one or both of these decisions.

Section 4, enacts that "the following income shall not be liable to taxation". Incomes specified in paragraphs (*a*) to (*y*) are then listed. Subsection (*p*) thereof is as follows:

"(*p*) The income of farmers', dairymen's, livestockmen's, fruit growers', poultrymen's, fishermen's and other like co-operative companies and associations, whether with or without share capital, organized and operated on a co-operative basis, which organizations

(*a*) market the products of the members or shareholders of such co-operative organizations under an obligation to pay to them the proceeds from the sales on the basis of quantity and quality, less necessary expenses and reserves;

(*b*) purchase supplies and equipment for the use of such members under an obligation to turn such supplies and equipment over to them at cost, plus necessary expenses and reserves.

Such companies and associations may market the produce of, or purchase supplies and equipment for non-members of the company or association provided the value thereof does not exceed twenty per centum of the value of produce, supplies or equipment marketed or purchased for the members or shareholders.

This exemption shall extend to companies and associations owned or controlled by such co-operative companies and associations and *organized for the purpose of financing* their operations."

It is to be noted that section 4 is not properly an "exempting" section, as it is frequently called; it is what may be called a "non-liability" or exceptive section, declaring that certain incomes and the entire income of certain persons "shall not be liable to taxation". The "exemption" provisions of the Act are contained in section 5.

Who are the "persons" then, whose income is declared by section 4 (*p*) not liable to taxation? First, they are certain "companies and associations", but not all companies and associations. Those only can qualify for the benefits conferred by the section which have the following characteristics:

(*a*) they must be *co-operative* companies or associations;

(*b*) they must be *organized and operated* on a *co-operative* basis;

(*c*) they must be either a *farmers'* or a *dairymen's*, or a *livestockmen's*, or a *fruit growers'*, or a *poultrymen's*, or a *fishermen's* co-operative association, or *other like* co-operative associations.

(*d*) they must be engaged in the business and on the terms mentioned in clause (*a*) or (*b*) under an *obligation* to make certain returns to their members;

(*e*) they may market the produce of and purchase supplies for non-members provided the value thereof does not exceed 20% of the value of produce and supplies marketed and purchased for members.

The first difficulty encountered in construing this section is to understand to what the word "like" refers. It was suggested to us that it was used as an adverb and modified the words "organized and operated", i.e., to companies and associations organized on a like basis, that is, the co-operative basis. Contra, it was urged that it was used as an adjective and qualified "co-operative companies and associations" and limited those whose income was declared "shall not be liable to taxation", to such whose business and/or members was like that of farmers, dairymen, livestockmen, fruit growers, poultrymen, or fishermen. In the light of this doubt, the section can scarcely stand as it is.

Difficulty arises also as to the meaning to be ascribed to the words "co-operative" and "organized and operated on a co-operative basis". There is no definition of these terms in the Act. No unanimity was evident among the many persons who appeared before us as to what these terms mean.

Differences of opinion arose as to the meaning of the phrase "market the products". Competitors of co-operators contended that the phrase was restrictive and that a company or association which engaged in processing or manufacturing their members' products and selling the processed or manufactured article were not engaged when so doing in marketing their members' products, and that those whose main business or a substantial part thereof consisted in processing and marketing the processed article could not be said to be within the section. On the other hand, it was argued that the point was of no importance.

Doubt was also expressed concerning the meaning of the term "obligation". Some contended that the term must be interpreted to mean a legal contract, definite as to time and amount, and strictly enforceable. Others contended that the term should be considered to refer to the sort of obligation typically imposed on the associations by the statutes under which they operate the agreements made with their members whether written or implied by usage.

Another uncertainty in applying the section as it stands, centers around the words "members" and "non-members", particularly as they relate to the "20%" clause so-called. We found that some associations treated and recognized every patron or customer as a member, with no qualification for membership required other than that he be a patron or customer.

The last clause of the section, viz. "This exemption shall extend to companies and associations owned or controlled by such co-operative associations and organized for the purpose of financing their operations" is difficult to construe and apply for two reasons. First, what does "this exemption" mean? As already stated section 4 subsection (p) is not an "exempting" section. It is a section declaring that the incomes of certain specified persons and certain income are not to be liable to taxation. Second, what is the meaning of the words "organized for the purpose of financing their operations"? We found in a considerable number of cases, that companies and associations had caused to be organized subsidiary corporations, wholly owned and managed by them. It was difficult to understand how they were financing the operations of the co-operative associations.

As a result of the ambiguities of language and the difficulty of administering the section, and because we are of the opinion there is no general class or group of co-operative [illegible]ations in Canada today whose income should be declared not to be liable to taxation, we are of the opinion that the section in its present form cannot survive the attacks made upon it.

In suggesting the repeal of section 4 (p) of the Income War Tax Act, we do so in the consciousness that enterprises which are truly co-operative in organization and operation have no need of the exceptive provisions thereof. If they make no profit they are not taxable. Those associations which do not so qualify, for reasons which we have detailed, should not be accorded a blanket exemption to which they are not otherwise entitled. It may be said that the term "co-operative" is nowhere defined in the statute. That is quite true and, indeed, it would be an almost insuperable task to devise a definition which, having regard to original principles on the one hand, and present day practices on the other, would do justice to the subject. In our view, it is sufficient to say that associations which have been constituted under provincial laws and are there recognized as co-operatives, have thus been accorded a status and designation which is quite sufficient for tax purposes.

(10) In many of their submissions, representatives of ordinary companies argued that the taxation of the whole corporate income, taken together with the taxation of dividends when received by shareholders constituted unjust double taxation, and urged that the Commission recommend a change in general tax policy to bring about some alleviation of this alleged hardship. The majority of the Commission take the position that our recommendation in this respect must be confined to the suggestion that when a general revision of the Canadian tax structure is under consideration, the contention in question be thoroughly investigated.

(11) One proposal made to us was that any recommendations for taxing co-operative associations should apply retroactively. Were it not that this point was pressed upon us with some insistence, we would pass it in silence. We do not regard it as any part of our function to make any recommendations which, if enacted into law, would affect the rights or obligations of taxpayers under the existing law. It is the duty of those charged with the responsibility of administering the Act to apply its provisions as they understand them. If doubt or uncertainty arises, the Courts are always available both to the taxpayer and to the Crown to establish their respective rights and obligations. Having regard, however, to the ambiguities contained in section 4 (p) of the Income War Tax Act and the resulting, (though understandable) hesitant administrative practice in applying it, we are of the opinion that co-operative associations have so conducted their affairs that great hardship would result should our recommendations be made to apply retroactively. We also feel that many of them would be prejudicially affected if the existing law should be interpreted so as to make them liable for payment of taxes for the period subsequent to the enactment of section 4 (p). Believing as they did, and not discouraged in that belief by the administrative attitude, we venture the hope that those co-operative associations which have, in good faith, conducted their affairs in the light of a possible, even plausible, construction of the section in question will be accorded relief from payment of taxes on patronage dividends actually or constructively paid to their members or customers, since the enactment of section 4 (p).

SECTION V

CONCLUSIONS AND RECOMMENDATIONS

In the light of the observations advanced in the last two sections, we have scrutinized the various items in the accounts of the co-operative associations with a view to determining which items may reasonably be considered the income of the association; which items should be taxed only as income of the members; and which should be taxed as income of the association and also of the members when distributed to them. The position of some of these amounts is clear; the position as to others has been called into question.

Interest on a loan to or other investment in, the association with a fixed date of maturity, should be deductible as an expense of the association, provided that it can be exacted annually at the rate fixed when the loan or investment was made. It should be treated as income of the member when he receives it. Loans or investments in the association which the member is entitled to withdraw on reasonable notice resemble notice deposits. Interest on such loans, investments or deposits should be treated as a deductible expense of the association if paid at a rate specified in advance, even though the association may from time to time change such rate. These payments should be treated as part of the income of the member when he receives them.

However, "interest" or dividends which are declared by the association after the close of its fiscal period at varying rates, or only if earned, should not be treated as a deductible expense of the association. Such payments resemble closely a distribution of the profits of the association. Even though the rate be fixed in advance, we consider that such payments should not be treated as a deductible expense of the association if the principal amount has no definite maturity date and is not withdrawable by the member on reasonable notice. Such amounts should be taxed also as income of the member when he receives them.

Payments made in cash by the members in the purchase of shares, loan units, membership fees, or other similar equities are manifestly not part of the income of the association. Similarly deductions from the gross proceeds of the sale of a member's products which the association is authorized to retain as a loan or apply to the payments of share capital or other equity in the association, for which the member has subscribed, or is obligated to subscribe, are not part of the income of the association. However, the latter should be included as part of the taxable income of the member when they are deducted and applied.

Where the contract or the bylaws provide that in addition to deducting these capital contributions, if any, deductions shall be made from the gross proceeds of sale of the members' products to cover operating expenses or handling costs, the actual expenses incurred by the association in this connection are, of course, deductible for income tax purposes; but any difference between the deduction thus made and the expenses actually incurred should be treated in the same way and subject to the same deductions as the ordinary surplus of an association.

There remain for consideration the great variety of payments and allotments made from the gross revenue of the association and its members in proportion to patronage. We take the general position that such of these amounts as are made readily available to the members or customers should be considered income of the members or customers and not of the association.

However, the meaning of "readily available" requires clarification. It is intended to include patronage payments in cash before or shortly after the end of the fiscal period; applications of such patronage allotments to payments for share capital or investments for which the member has subscribed, or which he is under an obligation to make. In addition, it is intended to include allotments credited to the member in such a way that he can withdraw them on giving reasonable notice of his intention so to do. Such payments or credits in proportion to patronage, when made by marketing or farm supply associations, clearly add to the member's or customer's income and should be taxable in his hands, when paid or credited to him. However, patronage payments or credits for consumers goods should not be reported by the member or customer as a part of his income for tax purposes, unless they enter into his trading account.

On the other hand, the remainder of the surplus of the association, or the remainder of the excess of deductions made to cover operating costs over the costs actually incurred, should be subject to tax as income of the association. This remainder, retained by the association, may remain on its books as undistributed surplus or be carried to unallocated reserves (not including valuation reserves), or it may be credited to the accounts of the members, but in such a way that they cannot, as individuals, withdraw the amounts in question on giving reasonable notice, even when shown on the balance sheet as "accounts payable" or "allocated reserves" or "deferred dividends".

These patronage allotments which the members cannot withdraw on giving reasonable notice, then, should not be allowed as a deductible expense of the association when earned. However, if they are later paid or rendered

available to the members, they should be deducted from the income of the association in the year when they are paid or made available and should be treated as taxable income of the member when made available to him.

It will be observed that we make a distinction between patronage credits and other sums which are not made available to the member and those which he can withdraw on giving reasonable notice. With respect to the latter amounts, the directors, of course, may be given reasonable powers to protect the association in case of a general run on withdrawable funds. The exercise of such powers will not prevent withdrawal, except to the extent necessary to protect the members' equities. Attention is called to the regulations governing British Co-operative Societies as set forth in Appendix D. In that country, the bylaws of the societies provide for reasonable notice of large withdrawals. Except with the consent of the directors not more than 10% of the shares outstanding may be purchased or withdrawn in any one year. Moreover, the directors are permitted, temporarily, to suspend redemption of shares in periods of crisis. In practice, however, both share and loan capital are readily withdrawable.

We are also of the opinion that where ordinary companies, partnerships or individual business enterprises hold forth, to their customers, that they will distribute among them on a patronage basis a portion of the surplus earnings, they should be allowed to deduct such payments before arriving at taxable income.

To avoid discrimination, the patronage payment made by a co-operative association or ordinary business should be made at the same rate to all customers, whether members or not, for the same class or type of goods or services. This would not prevent variation in the rates for different classes or types of goods or services, provided all customers are treated equally for the same class or type.

It has been pointed out to us on numerous occasions that co-operative associations are difficult to organize and that their rate of mortality is high, especially in their earlier years. They are not in a position to attract capital for investment purposes, except in small amounts. Moreover, they are apt to find it difficult to finance the employment of the necessary managerial personnel. In addition, there is a pronounced tendency to organize co-operatives in times of economic stress. We are, therefore, of the opinion that in the public interest, co-operative associations, upon consent of the Minister, should be exempt entirely from income tax during the first few years of their operation.

The foregoing recommendations apply to all types of co-operative associations and businesses, whether their members or customers are individuals or associations, and without respect to the kind of business in which they are engaged. However, a few types require special treatment.

Some local community halls are incorporated as co-operative associations. Typically they are forbidden to make any payments to their members in cash and any proceeds of their operation on winding up must be spent for community or charitable purposes. These associations, it appears to us, fall clearly within section 4 (h) of the Income War Tax Act.

Co-operative telephone associations and co-operative associations engaged in the local distribution of electrical power or in operating local telephone systems usually have no direct competitors and, in many parts of the Dominion, obviously are alternative to municipal or provincial institutions. If these services were provided by governments, no taxes would be paid. We recommend that they should remain exempt.

Some associations have been formed to provide economical housing facilities for their members. These projects, we believe, are sufficiently similar in pur-

pose and operation to the organizations whose income is excepted by section 4 paragraph (y) of the Income War Tax Act that they should be included in the scope of this paragraph.

The income of co-operative associations formed exclusively to finance or provide medical and hospital services should also be excepted.

We are of the opinion that the amounts which an association or other business are permitted to deduct in computing their taxable income (except patronage dividends on consumer goods) should be included in the income of the recipient for the period during which they are paid or credited to him. To facilitate administration, we recommend that the Minister be given the power to require such annual returns as may be considered desirable.

Though our recommendations have been concerned primarily with the position of co-operative associations and their competitors under the Income War Tax Act, we are aware that the associations, when made subject to tax under that Act, will automatically be assessable to tax under the Excess Profits Tax as well.

SECTION VI

SUMMARY OF RECOMMENDATIONS

(In this section the word "customer" shall be deemed to include shippers and suppliers as well as purchasers where the context requires.)

(1) That section 4, paragraph (p), of the Income War Tax Act be repealed.

(2) That the Income War Tax Act and The Excess Profits Tax Act be amended to provide for the taxation of co-operative associations and organizations on the same basis as other persons in accordance with the recommendations which follow.

(3) That co-operative associations and organizations, joint stock companies, partnerships, and other bodies and persons shall be allowed to deduct, in computing taxable income, such amounts as patronage bonuses, patronage dividends, refunds of excess handling charges, discounts, rebates and other similar amounts which are paid or credited to their customers, in proportion to the quantity, quality or value of goods acquired, marketed, or sold or services rendered; provided that:

- (*a*) such amounts are paid in cash or its equivalent within six months after the annual meeting of the relevant fiscal period of the association, organization or company and within six months after the end of the relevant fiscal period of other businesses; or alternatively, that they are credited within the same period to each customer and exigible by him on giving such notice as may be deemed reasonable. (Appendix D).
- (*b*) the statute or statutes under which any such co-operative association or organization is incorporated or registered, or its bylaws, or a contract with its customers, hold forth the prospect that payments will be made in proportion to patronage.
- (*c*) the company or other person holds forth the prospect to customers that payments will be made in proportion to patronage.
- (*d*) payments in proportion to patronage shall be at the same rate to all customers with respect to the same type or class of commodities, goods or services, with allowance for differentiation in class, grade or quality where appropriate.

(4) That deductions from the gross proceeds of a customer's products be excluded from the income of the association, organization or other business, if applied against an obligation incurred by such customer to purchase shares, or to make other investment in the association; or if credited to the customer, and exigible by him on giving such notice as may be deemed reasonable. (Appendix D).

(5) That amounts credited in proportion to patronage and deductions from the gross proceeds of sale of the customer's products, which were not deductible for tax purposes when credited or deducted shall, nevertheless, be allowed as a deduction in the period during which they are paid to the customers.

(6) (*a*) That interest, on any form of investment in, or loan to, the association or other taxpayer having a fixed date of maturity, be allowed as a deduction, provided such interest is exigible annually by the claimant or creditor at the rate fixed at the time such investment or loan was made.

(*b*) That interest, on any form of investment or loan which is withdrawable on giving such notice as may be deemed reasonable (Appendix D), be allowed as a deduction if exigible by the claimant or creditor at a rate fixed in advance.

(7) That a newly formed association which obtains incorporation or registration under provincial co-operative legislation, or is incorporated as a co-operative under Dominion authority, for the purpose of producing and/or marketing natural products of its members or customers and/or of purchasing supplies, equipment, household necessities or services, for its members or customers and which is not owned or controlled, directly or indirectly, by an existing association, or a group of existing associations, shall, with the consent of the Minister, be exempt from income tax for its first three fiscal periods following the commencement of operations. An association claiming such relief should, nevertheless, be required to file annual returns in accordance with Part V of the Income War Tax Act in such form as may be determined by the Minister.

(8) That section 4, paragraph (y) of the Income War Tax Act be amended, if necessary, to include associations incorporated or registered under provincial co-operative legislation for providing co-operative housing service.

(9) That associations incorporated or registered under provincial co-operative legislation, or incorporated as a co-operative under Dominion authority, for the purpose of providing telephone services, distribution of electric power, or medical and hospital services, be exempt from income and excess profits taxes.

(10) That the Minister be given power to require all persons to make such annual returns of "patronage dividends" declared, or "deductions" made, as may be deemed desirable.

PART
II

PART II

Credit Unions

Information furnished to the Commission makes it clear that co-operative societies organized for the purpose of accepting the savings of their members in the form of shares and deposits and for providing a source of credit for their members form an important and a rapidly expanding part of Canadian co-operative development. In Quebec such societies are called 'Caisses Populaires', and in other provinces they are known as 'Credit Unions'. There are also regional and provincial federations of these societies organized either for the purpose of serving as a medium for deposit of surplus funds by member units and as a source of credit for them or to provide inspection or educational services.

An account of the development of credit unions and the more detailed information concerning them is found in Appendix E.

The operating practices of credit unions and the statutes relating to them are fairly uniform. This uniformity is in contrast to the considerable variety in practices and legislation respecting purchasing and marketing co-operative associations. It is attributable, in the first place, to the fact that credit unions are engaged in furnishing one type of service only, namely, the receipt of money and the providing of credit, while other co-operative bodies are organized to sell or to buy a large variety of goods and services. In the second place, the enactment of credit union legislation did not become general, and credit unions did not develop extensively in provinces outside of Quebec, until after thirty years of experience in that province. This experience had demonstrated the need for careful supervision and inspection of credit unions and this was subsequently provided for in credit union legislation in every province.

TYPES OF CREDIT UNION

The membership of a credit union is limited by its bylaws to persons having some well defined bond of occupation or association or residence. Co-operative credit societies accordingly may be classified as follows:

(*a*) Rural Credit Unions. Of the credit unions operating in Canada in 1943, 57% were rural credit unions, organized for the most part within the boundaries of a well defined local rural district. Their members may include residents of a village and farmers in the surrounding trading area. In Quebec particularly, the rural parish is the basis of membership.

(*b*) Urban Credit Unions. These made up the remaining 43 per cent of the total number of credit unions in 1943. Their membership is composed exclusively of village residents or of well defined occupational, associational or parish groups in towns or cities.

(*c*) Federations of Credit Unions. The object of these federations is to accept surplus funds of member credit unions and to make loans to credit unions which are members. They function thus to some extent as central credit unions or banks for their members. The Caisses Centrales of Quebec are examples of this type of organization. There are also federations comprised not only of credit unions but also of other incorporated co-operatives. These federations perform the functions of central credit unions for their membership, as for example the Saskatchewan Co-operative Credit Society. There are, in addition, federations organized exclusively for educational, accounting, inspection and other services for credit unions not related to money transactions. La Fédération des Caisses Populaires Desjardins in Quebec and the Credit Union Federation of Saskatchewan are organizations of this type.

ORGANIZATION AND OPERATION

Credit Union legislation requires that from 7 to 20 people sign an application for incorporation, the minimum number of incorporators varying in accordance with statutes of the different provinces. Shares are valued at $5.00 or $10.00 each and the capital is usually unlimited in amount. An entrance fee may be charged, this being usually stated by bylaw, but is seldom more than 25 cents. The field of membership prescribing the tie of association, occupation or residence of the prospective members must be stated in the bylaws. The legislation usually states that the objects and powers of a credit union should be "The provision of thrift among its members and the creation of a source of credit for its members, at legitimate rates of interest, exclusively for provident and productive purposes". The statutory powers typically granted a credit union are set forth in Appendix E. In all Credit Union Acts, it is provided that other credit unions and sometimes other co-operatives or corporations may be members. A credit union is a limited liability company and in most provinces the legislation provides that the word "limited" shall form a part of the registered name.

Certain operating principles are also specified in all credit union legislation. Each member has only one vote. The rate of interest on loans must not exceed one per cent per month on the unpaid balance. In practice, the rate may be varied below this maximum, depending on whether the loans are made to farmers or on mortgage, etc. While a credit union may own land for its purpose the maximum value of such land is usually limited to $5,000. A credit union has the usual powers to take security in connection with all loans, and the amount which may be loaned with or without security is usually limited by legislation. The amount which may be borrowed by the credit union is related to the amount of the capital in such proportion as is usually specified by legislation. A characteristic feature of all credit union legislation is that loans can be made to members only. The right of directors or other officers to borrow from the credit union is subject to certain statutory restrictions. The payment of interest on deposits, at such rates and at such times as may be specified in the bylaws, is provided for. No director or other official except the secretary-treasurer or manager and asistants, if any, are permitted to receive any remuneration for their services. It follows from this that much of the administrative work in connection with a credit union is done free of charge.

Shares and deposits in a credit union may be withdrawn at such notice as shall be prescribed in the bylaws, or such additional notice as may be approved by the registrar or other government official entrusted with the administration of credit union legislation. Usually a longer notice of withdrawal may be required with respect to shares. In practice, however, a member who has funds with his credit union in the form of shares or deposits, can withdraw these at any time.

The revenue of a typical credit union will include the following:

(*a*) Interest on loans to members.
(*b*) Entrance fees—transferred to reserve.
(*c*) Fines levied, if any—transferred to reserve.
(*d*) Interest on government or other securities.
(*e*) Interest and/or dividends from investments or deposits with other credit unions or federations thereof, etc.

The expenses of a typical credit union include the following:

(*a*) Officers' salaries, which are limited to the manager or secretary-treasurer and assistants, if any;

(*b*) Ordinary operating expenses, including rent, light, heat, postage and excise, stationery and supplies, advertising, etc.
(*c*) Bond premiums—fidelity.
(*d*) Loan insurance.
(*e*) Annual dues for membership in federation, if any.
(*f*) Depreciation of fixed assets. The amount which can be invested in land is limited by most provincial legislation.
(*g*) Taxes. Some provinces exempt, by legislation, the property of credit unions from assessment for municipal taxation.
(*h*) Interest paid on borrowed money.
(*i*) Interest paid on deposits.
(*j*) Organization expenses.

The surplus earnings of a credit union are divided as follows:

(*a*) An amount usually of not less than 20 per cent, is set aside as a reserve against bad loans or losses and may not be used for other purposes except on liquidation.
(*b*) An amount, usually not exceeding 5 per cent, may be reserved for educational or community purposes.
(*c*) Subject to the approval of the annual meeting, dividends on shares of not more than 5 or 6 per cent at the most, may be declared.
(*d*) A borrower refund or patronage dividend may be returned to the borrower in proportion to the amount of the interest paid by him on his loan. Not all credit unions make a refund to borrowers, but the practice is becoming more common.

Interest is paid by credit unions on deposits at rates varying from 1 to 2½ per cent, while share dividends range from 1 to 5 per cent, 3 per cent being a common rate. With regard to interest charged on loans, the practice appears to be to charge the maximum to start with, and gradually lower the rate as the capital funds and volume of business increases. Credit unions, amongst occupational groups, may charge 1 per cent per month on the unpaid balance, while rural groups may charge from 6 to 8 per cent per annum. The rate on mortgage loans may be 4 or 5 per cent. As the earnings of credit unions increase, the policy seems to be to lower rates on loans and in many instances to make patronage refunds to borrowers, as well as to pay only a moderate dividend on shares and a reasonable rate of interest on deposits.

In each credit union there are three committees whose functions are described in Appendix E. Credit Unions in the past have had very low loss ratios. Witnesses attributed this circumstance in part, at least, to the fact that credit unions are organized on a community or group basis. It is relatively easy to select the members carefully, and each borrower is influenced by his desire to keep faith with his friends and neighbours, who comprise the membership, to repay the loan if at all possible.

PRESENT TAX POSITION OF CREDIT UNIONS

There are two sections in the Income War Tax Act which affect credit unions, namely :

(*a*) Section 4 (q), which excepts from taxation "The income of any banking institution organized under co-operative provincial legislation which derives its revenue from loans made primarily to members residing within the territorial limits within the province to which the institution is restricted for carrying on its business";

(*b*) Section 92 (1), which provides that any person shal. deduct at the source an amount equal to seven per cent from

"(*i*) any amount as interest pursuant to the provisions of a fully registered bond, debenture or other similar obligation, or

(*ii*) any amount by way of dividend in respect of any share or stock."

At the time section 4 (*q*) was enacted, credit union development was chiefly in Quebec, where credit unions were known as "peoples banks", and this probably explains the use of the term "banking institution". In practice, credit unions and federations comprised of credit unions and co-operatives have been regarded as coming within the provisions of paragraph (q).

CONSIDERATIONS AND ARGUMENTS

A great deal of evidence was submitted regarding the rather specialized services which credit unions can and do render to their members. It was contended that the credit union form of activity was of special assistance to the members for the following reasons:

(*a*) It provides a method whereby people in poor circumstances are encouraged to develop a habit of thrift, since by pooling their savings they can provide a source of credit for themselves in times of need;

(*b*) The bond of association, occupation or other community interest on which the membership of credit unions is based tends to minimize the element of risk which has to be considered by another type of lending institution when considering an application for a loan from an individual with little or no collateral security;

(*c*) Accordingly, it provides a service for those who are either not provided with credit services from other lending institutions at all, or only at much higher rates because of the risks involved.

(*d*) The tangible material and other benefits which can be derived through the credit union form of activity enable and encourage the members to solve their problems through self help rather than by relying on Government aid in times of emergency or depressed conditions.

No submissions were made to the Commission from business interests expressing opposition to credit unions or claiming that credit unions should be taxed on the ground that they are competing with other types of business enterprise. The contention was advanced, however, that no business enterprise should be entitled to exemption and that no exception should be made in the case of credit unions or federations thereof.

We are satisfied that credit unions perform a highly useful function in assisting people who are unable to take effective advantage of savings and loan facilities provided by other lending institutions. We are also satisfied that credit unions are not displacing any other type of business enterprise, except to provide an alternative source of loans in a field where individual money lenders or lending institutions do not provide similar credit facilities at comparable net rates. It is clear, therefore, that unions provide a useful supplement to other lending institutions and that the continued development of credit unions is desirable from the standpoint of the public interest.

Credit unions return to their members a very high proportion of their surplus earnings. In some cases, however, they are retaining amounts which appear to be larger than are required for reserves against bad loans and losses on the basis of past experience. If they were to be taxed by the methods we have recommended for co-operative associations, additions to these excess reserves would be made subject to tax. However, the individual amounts to be assessed would, in many cases, be very small. Moreover, we consider that

it is not desirable to discourage the accumulation of reserves to protect the savings of members who, for the most part, receive small or very moderate incomes.

It will be observed that in order to come within the provisions of section 4 (q), an institution must derive its revenues from loans made primarily to members. We are of the opinion that a reasonable interpretation of the terms "primarily from loans made to members" does not debar a credit union from investing a portion of its funds in Government or other securities rather than to have them lie idle. One of the main objectives of a credit union is the encouragement of thrift. To achieve this purpose the credit union must be able to *attract* funds by paying a rate which will encourage its members to accumulate savings.

It was pointed out to us that during the war, the proportion of credit union funds invested in government securities was larger and the proportion used to make loans to members smaller, than normal. This circumstance was attributed to the current shortages of durable equipment and consumer goods, and to the members' response to the government's requests to curtail spending. We are satisfied that as conditions return to normal, a larger portion of the funds of credit unions will be loaned to members. The present abnormal situation should not be considered as affecting the position of credit unions where exemption is claimed on the ground that it is a banking institution which derives its revenues from loans made primarily to members.

With regard to section 92, evidence was presented to the Commission that deduction of the tax of 7 per cent from share dividends at the source have been required in at least one province, but that in other provinces the policy has been to relieve credit union officers of this duty. It was argued, and with some justice, that dividends paid on withdrawable shares were similar to interest payments on bank deposits and should therefore not be subject to deduction at the source. We are inclined to the opinion that, in view of the administrative work involved, it would be better to exclude credit union share dividends from deduction at the source, under section 92, and to require the unions to report to the Department of National Revenue all payments of dividends or interest in excess of such minimum amout as may be desirable from the standpoint of administration.

SUMMARY OF RECOMMENDATIONS REGARDING CREDIT UNIONS

1. That the income of credit unions or Caisses Populaires continue to be excepted from taxation under section 4, paragraph (q) of the Income War Tax Act.

2. That section 4 (q) of the Income War Tax Act be amended to make it clear:

(*a*) that it includes federations whose membership may comprise other credit unions, co-operative associations, parishes, school districts and other similar bodies.

(*b*) that organizations excepted thereunder must derive their revenues primarily from loans made to members.

PART
III

PART III

Mutual Insurance Organizations

We were also directed to enquire into the application of income and profits tax measures to organizations formed and operated on a "mutual basis"—and into the comparative position in relation to taxation of persons engaged in business in direct competition with mutuals. Accordingly, a number of briefs were filed and witnesses representing mutual fire insurance companies of different types, as well as representatives of joint stock insurance companies engaged in fire, automobile and casualty insurance, appeared before the Commission. Representatives of agents of fire insurance companies were also heard. We were not directed to make any enquiry respecting life or marine insurance companies, mutual or otherwise, and hence representations were not made by these organizations.

Reference has already been made in Part I of this Report to certain sections of the Income War Tax Act and Excess Profits Tax Act, 1940, which are relevant to the discussion of co-operatives. The following sections of various legislation are of special significance in the discussion of mutual insurance activities and organizations. Section 4 of the Income War Tax Act provides that the following shall not be liable to taxation:

"Mutual Corporations"

(*g*) "the income of mutual corporations not having a capital represented by shares, no part of the income of which inures to the profit of any member thereof, and of life insurance companies except such amount as is credited to the shareholder's account"

"Farmers' Associations"

(*i*) "the income of such insurance mortgage and loan associations operated entirely for the benefit of farmers as are approved by the Minister"

Section 4 (p) of the Income War Tax Act, (discussed in Part I) which applies to co-operatives engaged in marketing or purchasing activities is also of significance in relation to certain co-operative organizations which carry on an insurance business.

Section 7, paragraph (a), of The Excess Profits Tax Act, 1940, provides that the income of organizations exempt under section 4 (*g*) and 4 (*i*) of the Income War Tax Act as quoted above, shall not be liable to taxation.

While the Special War Revenue Act is outside our terms of reference, numerous representations were made with respect to the tax levied on the net premiums of fire insurance companies in accordance with the provisions of this legislation. For convenience of reference , we reproduce the relevant sections of this Act as amended in 1942, chapter 32.

(2) Paragraph (*b*) of section thirteen of the said Act, as enacted by section one of chapter fifty-four of the statutes of 1932 and amended by section two of chapter fifty of the statutes of 1932-33, is repealed and the following substituted therefor:—

"(*b*) "Company" includes any corporation or any society or association, incorporated or unincorporated, or any partnership, or any exchange, or any underwriter, carrying on the business of insurance, other than a fraternal benefit society, a corporation transacting marine insurance, or a purely mutual corporation in respect of any year in which the net premium income in Canada of such

mutual corporation is to the extent of not less than fifty per centum thereof derived from the insurance of farm property or wholly derived from the insurance of churches, schools or other religious, educational or charitable institutions;"

4. Paragraph (*f*) of the said section thirteen is repealed and the following substituted therefor:—

"(*f*) "net premiums" means, in the case of a company transacting life insurance, the gross premiums received by the company other than the consideration received for annuities, less premiums returned and less the cash value of dividends paid or credited to policyholders; and, in the case of any other company, the gross premiums received or receivable by the company or paid or payable by the insured less the rebates and return premiums paid on the cancellation of policies: Provided that in the case of a mutual company which carries on business on the premium deposit plan and in the case of an exchange "net premiums" means the actual net cost of the insurance to the insured during the taxation period together with interest on the excess of the premium deposit over such net cost at the average rate earned by the company on its funds during the said period;"

5. Section fourteen of the said Act, as enacted by section one of chapter fifty-four of the statutes of 1932, is repealed and the following substituted therefor:

"14. (1) Every company authorized under the laws of the Dominion of Canada or of any province thereof, to transact the business of insurance, other than an association of persons formed on the plan known as Lloyds, a mutual company not carrying on the business of life insurance, and an exchange, shall pay to the Minister a tax of two per centum upon the net premiums received by it in Canada less net premiums paid for reinsurance to companies or associations to which this section applies, during the year 1941 and each calendar year thereafter.

(2) Every association of persons formed on the plan known as Lloyds, and every mutual company not carrying on the business of life insurance and not carrying on business on the premium deposit plan, authorized under the laws of the Dominion of Canada or of any province thereof, to transact the business of insurance, shall pay to the Minister a tax of three per centum upon the net premiums received by it in Canada, less net premiums paid for reinsurance to companies or associations to which this section applies, during the year 1941 and each calendar year thereafter.

(3) Every mutual company authorized under the laws of the Dominion of Canada or of any province thereof, to transact the business of insurance and which carries on business on the premium deposit plan and every exchange so authorized shall pay to the Minister a tax of four per centum upon the net premiums received by it in Canada during the calendar year 1941 and each calendar year thereafter.

In discussing mutual insurance, it may be useful to study the following definition found in the Ontario Insurance Act: "Mutual Insurance" means a contract of insurance in which the consideration is not fixed or certain at the time the contract is made and is to be determined at the termination of the

contract according to the experience of the insurers in respect of all similar contracts, whether or not the maximum amount of such consideration is predetermined".

Mutual Organizations of Different Types

A number of different groups of mutual insurers, including farmers mutuals, submitted briefs to the Commission, explaining their methods of operation. A brief description of the main groups follows.

Farmers mutual insurance companies are of special importance in Ontario and Quebec. It is interesting to note that legislation to provide for the organization of mutual insurers was provided in Quebec as early as 1818. Farmers mutuals in all provinces operate on the basis of premium notes, subject to cash payment and/or assessment. In the Ontario Act, for example, the "surplus" of a farmers mutual is defined as "the assets of the insurer other than the premiums note residue after deducting therefrom all liabilities of the insurer (other than contingent liabilities or unmatured contracts) and the proportion of cash payments and instalments thereof paid in advance, applicable to unexpired policy contracts calculated as required by subsection 5 of section 73". In the main, the methods of organization and operation of the farmers mutuals in Ontario are the same as those of the other provinces. Some indication of their importance is found in the fact that 65 Ontario farm mutuals serve 140,000 rural policyholders, and their total business is about 90 per cent rural. In Quebec, according to the evidence presented to the Commission, there are 320 mutual farmers insurance companies, including county, municipal and parish groups, with total insurance written amounting to about $180,000,000.

Before dealing with other classes of mutual insurers, certain other features which tend to distinguish farmers mutuals should be borne in mind. They specialize in farm risks, a field in which joint stock companies are not active to any great extent. Furthermore, these groups, as shown by provincial statistics, are economical in operation. Their local character gives the officials a special opportunity of appraising farm risks, as they know the properties they are insuring and the people they are dealing with. Further, from the evidence submitted, it appears that statutory safeguards with respect to minimum rates and maximum risks are being carefully followed. In short, the farmers mutual appears to meet a need which is not met to the same extent by other types of insurers.

Other mutual fire insurance groups also specializing to a considerable extent in farm risks have a large membership, in contrast with the local farm mutuals. These include the "Cash Mutuals", which commenced operations on the premium note basis, but are now operating on the cash premium basis as well. Mutuals operating on both the cash premium and the premium note plan are of special importance in Ontario, and in Western Canada, insuring a large number of farmers. It was also submitted that in addition to farm risks, a large number of village and other risks have been insured by these and other farm mutuals, where municipal or other fire fighting facilities are not available. In some cases, these mutuals have entered the casualty insurance field, as well as the urban insurance field in connection with both residential and commercial property. Four farm cash mutuals in Ontario made submissions to the Commission. These bodies are incorporated under the Ontario Insurance Act.

The four cash mutuals in question contended that departure from the premium note system was made necessary to counteract the criticism by joint stock companies that the liability of the policyholder in a mutual company was never fixed, but was undetermined and unlimited, and that in consequence,

a mutual policy gave little security. For this reason it was considered desirable to give the insurer a choice between the cash premium and the premium note mode of insurance, with the result that a considerable proportion of the business of Canadian mutual fire insurance companies, apart from the regular farmers mutuals, has been developed on the cash premium basis. Another contention advanced by the cash mutuals was that while they tended to give their policyholders the benefit of lower rates rather than cash dividends, it was of special importance for them to build up reserves in view of the predominance of farm and village risks written.

The following quotation from the Ontario Insurance Act, Section 275, deals with the reserve fund to be accumulated by a mutual fire insurance company:

"(1) Subject to the provisions of sub-section 5, a Mutual or Cash-Mutual insurance corporation may form a permanent reserve fund, to consist of such part of the net profits as may from time to time be set aside by the directors for that purpose; or to be made up by annual assessments for that purpose not exceeding, for any single assessment, 10% on the premium notes held by the corporation, until the total fund reaches two per centum of the corporation insurance in force.

(2) Such funds shall be held for the security of the insured and shall be subject to the provisions of this Act relating to the investment of the funds of insurance companies.

(3) The net income from the fund shall be included in the general receipts of the company, and shall constitute a part of the 'net profits', if any, as defined in this section.

(4) The fund so accumulated shall be used for the payment of losses and expenses when the cash funds of the company in excess of an amount equal to its liabilities (including guarantee capital, if any) are exhausted, and when the said fund is drawn upon the allocation of profits or assessments as aforesaid may be retained or continued until reached.

(5) The said fund may not be reduced by the payment of dividends to shareholders or members, or by a reduction of current premiums below the limit of 2% of the insurance in force hereinbefore mentioned, but it may be increased beyond."

Another group of mutuals, the American Mutual Alliance, which made representations to the Commission, are organizations with a membership consisting of business enterprises, either incorporated or unincorporated. These mutuals have their headquarters in the United States, but are licensed to do business in Canada. While these mutuals are comprised of business enterprises, their basis of organization and methods of operation are somewhat similar to those of mutuals comprised of individual persons. They are organized without share capital, with membership confined to policyholders, each member company or enterprise has one vote at meetings of the mutual, a cash premium is paid and the unabsorbed portion returned to the member. The companies comprising this group maintained that their object was to transact business for their members at cost, and that in this connection 98 per cent of the premiums paid by members from 1929 to 1943 had been used, first, to pay losses, second— to pay expenses, and third— as dividends or refunds to policyholders.

Another group of mutuals which made representations to the Commission is also comprised of incorporated companies. These are sometimes known as the New England Factory Mutuals. One feature which distinguishes this group from mutuals of other types is the so-called premium deposit.

Each policyholder is required to deposit an amount at the time the policy is issued, which may be considerably in excess of the net cost of insurance for one year. Each member company is charged with its pro-rata share of losses and expenses, as well as contributions to reserves. When the policy is cancelled or expires, the charges are totalled and the balance of the deposit is returned to the member.

In connection with the deposits required from members of factory mutuals, it was stated that on the average the absorbed portion of the premium deposit may be approximately 10 per cent. On the other hand, it was contended that the high value of the individual risks insured, even though carefully selected from the standpoint of fire protection, rendered large premium deposits necessary. The risks insured are carefully selected, consisting almost exclusively of manufacturing and commercial properties of high grade construction, fully equipped with sprinkler protection, according to the specifications of the insurer. According to the submissions made to the Commission, the amount of insurance written by Factory Mutuals in the United States and Canada during 1943 was $16,700,000,000, comprised of about 10,500 individual risks. Of this amount the Canadian business was about 7 per cent.

Another group of mutuals which is quite different from the standpoint of organization are known as Inter-insurers or Reciprocal Exchanges. This group, which was represented before the Commission by the American Reciprocal Association, includes amongst its membership twenty exchanges with headquarters in the United States. Ten of these exchanges do substantial business in Canada. The exchange, as such, is not incorporated, thus differing from all other mutual insurance groups. Nearly all the members (subscribers) at each exchange are corporate bodies. It is stated that the object of the subscribers is to insure one another. To accomplish this it is necessary to appoint a common agent or attorney to transact the business of the exchange. Each subscriber, therefore, gives a power of attorney to the common attorney or agent to transact business on his behalf. This attorney is known as "Attorney-in-Fact". The attorney collects the monies from each subscriber, which are placed to the credit of the subscriber and remain his property, so that each subscriber has an individual account. The attorney deducts from this, such sum as is necessary to pay losses and expenses and to provide necessary reserves and surplus for contingencies. The part not needed is returned to the subscribers annually. In the event of withdrawal of a subscriber from the exchange, the subscriber receives from the attorney all the money to his credit, including his share of any reserves or surplus. In practice, while the risks insured through reciprocal exchanges are carefully selected, it is found expedient to have the amount deposited by the subscriber sufficient to meet contingencies, including unexpectedly high losses. This reserve for contingencies is provided for in the subscribers agreement. The reserve is, of course, invested, and as such, produces some income which is credited to subscribers. The Attorney-in-Fact is subject to supervision by an advisory committee of subscribers. Each exchange is licensed under a firm name. Unlike other mutuals, proxy voting is permitted at meetings of the exchange. Another distinction is that the equity of each subscriber in the reserve fund is retained by the exchange from time to time, but subject to withdrawal.

Reference should also be made to the stock mutuals, although no witnesses were heard in behalf of this group. There are only a few companies of this type. They were organized originally as purely mutual companies on the premium note system. Later they were given authority to issue capital stock and to sell cash premium policies, but policyholders on the cash premium plan are excluded from membership. Dividends are paid on capital and premium notes in force are subject to assessment.

Another insurance organization carrying on business on a co-operative basis is known as the Pool Insurance Company. This company was organized in 1939 by the three Western Wheat Pools under the Manitoba Companies Act. The object was to enable the three Pools to insure their own elevators and distribute any savings accruing from the business of the company on a patronage basis. In 1940, a charter was secured from the Parliament of Canada to enable the company to comply with the ruling of the Board of Grain Commissioners, that insurance on grain in licensed elevators must be carried with an insurance company under a Dominion license. The company is organized with share capital and may pay a dividend thereon of not more than 5 per cent. The balance has been distributed in the form of an excess charges refund, in proportion to earned premiums paid to the company by the policyholders.

The competitors of mutuals in the field of fire, casualty and automobile insurance are joint stock companies, which conduct their insurance business exclusively on the cash plan. These include British joint stock companies, foreign joint stock companies, including mostly United States firms, and joint stock companies with head offices in Canada.

The Competitive Position.

Some indication of the competitive situation as between the mutual insurance companies and the joint stock companies is provided by statistics furnished by the Dominion Superintendent of Insurance regarding the business transacted by fire and casualty companies operating under a Dominion license. In 1943, the premium income of 267 fire and casualty insurance companies reported was $99,897,515. Of this amount, 11 reciprocals received 0.6% of the total premium income, 11 deposit premium mutuals received 1.1%, 30 other mutuals including the American Alliance group, and Canadian Mutual Companies received 11.8%, three stock mutuals received 1.9%, while 212 joint stock companies received 84.6% of the premium income.

The so-called "underwriting profit" or "gain from underwriting" of these companies amounted to $5,498,546 in 1943. Of this amount the reciprocals had 4.3%; the deposit premium mutuals, 6.8%; other mutuals, 19.9%; the stock mutuals reporting 4%; and the joint stock companies, 65%. In this connection reference has already been made to the method of calculating the "Net Premiums" of the reciprocals and the premium deposit mutuals as set forth in the Special War Revenue Act. This has a bearing on the proportion which the underwriting profit of these companies bears to the premium income, as compared with mutuals of other types and of joint stock companies.

While many of the principles adopted and conclusions reached in Part I of the Report are applicable to mutual insurers, still, certain differences in methods of operation between co-operative associations and insurers merit special consideration.

SOME COMPARISONS BETWEEN MUTUALS AND JOINT STOCK COMPANIES

Representatives of joint stock companies pointed out that there were certain similarities between their type of organization and that of the mutuals. This is true. With the exception of the reciprocal exchanges, both groups enjoy corporate status, and the advantages deriving from limited liability. Both are required by legislation to maintain certain reserves for the protection of policyholders. The same insurance company terminology is used with respect to both groups.

There are, however, certain obvious differences between the two types of organization. In a joint stock company the persons who own and control the enterprise are, by and large, a different group from those who make use

of its insurance services. In a mutual company, on the other hand, there is identity of interest between owners and users. This distinction is less clear, however, where a part of the surplus of a stock mutual is distributed on the basis of shares held. The difference is also less well defined where a mutual writes cash policies, some of which are subject to the payment of dividends on the basis of premiums paid by policyholders, and some of which are not. A further distinguishing feature between the two types of insurers rests in the fact that in mutual insurance the application for and payment of a policy is, in practice, synonomous with membership. Viewing the two types as a whole, it is evident that the control of a mutual and participation in its surplus, if any, is vested in those who use its services as policyholders, whereas the control of and the participation in the surplus of a joint stock company is vested in those who use it for investment as shareholders.

Some Contentions advanced by Joint Stock Companies

The first of the contentions of the joint stock companies was that the "dividend" paid on premiums to policyholders in a mutual was akin to a distribution of profits and, therefore, taxable. Admitting the joint stock companies' contention that fire insurance risks are more difficult to estimate in advance than life insurance risks, where the use of statistics and actuarial formulae makes a close estimate possible, this does not detract from the similarity between a dividend paid by a fire insurance mutual and a similar payment by a life insurance mutual. As stated in Part I of this Report, we are of the opinion that a dividend paid in proportion to patronage is a characteristic feature of the co-operative or mutual way of doing business. The members of a mutual pay premiums for two purposes, to insure one another and to maintain the organization necessary to conduct this service. If they find that they have paid more than is required to meet losses, expenses and to provide for necessary reserves, they can secure a refund in proportion to the premium paid. It is impossible to regard such a payment to the insured as a profit taxable in the hands of the insurer. If, however, a portion goes not to the insured, but to the shareholder, as a return on his investment, such a payment is not a rebate on an overpayment for insurance, but a reward for investment and risk undertaken by the shareholder who provides the service for policyholders. We are of the opinion that a return of a dividend on a premium is not essentially different from the unassessed portion of a premium note. Both are necessary to the mutual way of doing business.

A further contention advanced by the joint stock companies was that mutuals should be assessed for income tax on precisely the same basis as joint stock companies. Here again the difference between the methods of operation of the two groups would render the incidence of such a tax inequitable as far as the mutuals are concerned. It would not only involve taxing the "dividend" to which reference has already been made, but other funds in the hands of the mutual, exigible by the policyholder. A premium payment in a mutual serves to pay losses and expenses and also to provide operating capital. A refund in the form of a dividend on premiums is not profit of the mutual. Any amount retained by the mutual but exigible by the policyholder is not income of the mutual but a fund contributed partly for operating capital and partly to pay unexpected or future losses.

Mutuals may have Income

In Part I of this Report we have endeavoured to distinguish what the co-operative retains permanently and what is actually paid by the co-operative to its members or is exigible by them. The question, therefore, arises whether mutuals in which there is no proprietary interest other than that of policy-

holders, earn or receive any revenue which is liable to tax. If they receive a net income, to whom does it inure—to the mutual or to the members? We are of the opinion that mutuals can and do, under certain conditions, have income which may be made liable to tax. This income may arise partly from investments and partly from other operating gains. What the mutual receives and retains in the form of investment income, plus other additions to surplus which are free from claims of policyholders, may be regarded as income, which should be liable to tax.

Mutuals Specialize in Certain Fields

It was clearly established during the course of our hearings that some mutual organizations specialize in insuring farm risks and render a much needed service in that field, which is not provided to any appreciable extent by other insurance organizations. In addition, village and town property, unprotected by municipal or other fire-fighting organizations, are insured almost entirely by mutuals. The reasons why mutuals are able to insure risks of this kind have already been indicated. In view of the great need for expansion of insurance services with respect to rural areas, we consider it undesirable from the point of view of public interest to impose any tax which would make it more difficult for mutuals or other insurers to develop still further this much needed insurance service in all rural districts. As a matter of fact, no case was brought to our attention in which a joint stock company suffered loss of business or was otherwise prejudiced by the operations of a farm mutual. The general contention rather was that all mutuals should be taxed on the same basis as joint stock companies. It would appear that mutuals are making progress in certain highly specialized fields, but that the overall picture shows little change. Both types of insurers appear to be giving an efficient service. There is no evidence to suggest that the progress of the mutuals is due to tax exemption. This does not mean, however, that they may not have some taxable income.

Some Contentions advanced by Mutuals

The main contention of the mutuals is that they endeavour to operate at cost, and further, that their operation thereby tends to reduce insurance rates generally. On the other hand, this does not dispose of the argument that mutuals can and do, in some instances, have taxable income. There were, however, other arguments advanced by the mutuals to indicate the inequity of their position. These merit careful attention. They include:

(*a*) That the difference in the rates imposed with respect to the premium tax under the Special War Revenue Act is unwarranted. Spokesmen for the mutuals took the view that a tax at a uniform rate should be paid by all companies, and that they were ready to continue paying such a tax. While the Special War Revenue Act is outside the scope of our terms of reference, we have to report that very considerable dissatisfaction exists with respect to the existing rate structure, and we are of the opinion that this matter should be reviewed by the Government before any income tax is imposed on mutuals.

(*b*) Canadian mutuals referred to the fact that investment income is excluded from taxable income in Canada in connection with the operations of British and foreign insurance companies. This appears to be a departmental arrangement with these companies which has been in effect for some years. While Canadian joint stock insurance compa-

nies made no complaint regarding this arrangement, some Canadian mutuals contended that it involved discrimination against Canadian stock companies.

(c) Critical reference was also made to the exemption from income tax of marine insurance companies and the exemption granted to such companies under the Special War Revenue Act. No representative of marine insurance companies made submissions to the Commission, and we are not requested to investigate their tax position. We simply report the criticism expressed.

CONCLUSIONS

We are of the opinion that mutuals can and do have income which is subject to tax. This income results from investments and operating gains which are free from claims of policyholders. At the same time we consider that mutuals in certain specialized fields are rendering a service which is not provided by other organizations, notably, in insuring farm and other unprotected rural risks. These mutuals tend to keep their rates as low as is consistent with the risk involved. We consider that it would not be in the public interest to impose income tax upon those insurers whose activities are primarily in these fields.

Considering the situation as a whole, we are of the opinion that the income tax should not be imposed on mutuals without a review of the varying rates of existing premium tax under the Special War Revenue Act, the taxation of investment income of British and foreign insurance companies and the position of marine insurance companies.

Summary of Recommendations

We therefore recommend as follows:

1. That the Income War Tax Act and The Excess Profits Tax Act (1940) be amended to provide for the taxation of mutual organizations carrying on the business in Canada, of fire, casualty and automobile insurance, in accordance with the recommendations which follow.

2. That dividends on, or refunds of premiums to policyholders, whether paid in cash or applied against renewal premiums, together with any unabsorbed premiums or premium deposits returned to or payable to policyholders, and any other amount credited to a policyholder or subscriber in such a way that it is exigible by him on giving such notice as may be deemed reasonable, be allowed as a deduction in computing taxable income.

3 That joint stock companies and other insurers writing fire, automobile and casualty insurance, which pay dividends or make refunds of premiums to policyholders be allowed to deduct such dividends or refunds in computing taxable income.

4. That before giving effect to the foregoing recommendations the incidence of the tax on net premiums of mutual insurance organizations under the Special War Revenue Act, the exemption from taxation granted to marine insurance companies, and the treatment for income tax purposes of investment income in Canada accruing to British and foreign insurance companies, should be reviewed by the Government;

(5) That the income of any insurer, mutual or otherwise, shall not be liable to taxation when in any year the net premium income in Canada is derived, to the extent of not less than 50% thereof, from the insurance of farm

property and other property not protected by municipal or other fire fighting organizations, or is derived wholly from the insurance of churches, schools or other religious educational and charitable institutions.

The present Report is signed by all the members of the Commission subject, however, to such reservations and comments as are appended hereto.

The whole respectfully submitted,

ERROL M. McDOUGALL,
Chairman.

B. N. ARNASON,
G. A. ELLIOTT,
JEAN-MARIE NADEAU,
J. J. VAUGHAN.

Ottawa, September 25th, 1945.

Memorandum of Comments and Reservations

by B. N. Arnason

In Part I, section IV, of the Report reference is made to the ambiguities contained in section 4, paragraph (p) of the Income War Tax Act. The opinion is there expressed that great hardship would result should the recommendations in the Report be made to apply retroactively. The opinion is also expressed that many co-operative associations would be prejudicially affected if the existing law were to be interpreted so as to make them liable for the payment of taxes subsequent to the enactment of section 4 (p). The hope is also expressed that co-operative associations which have conducted their affairs in the light of a possible, even plausible, construction of the paragraph in question, will be afforded relief from the payment of taxes on patronage dividends actually or constructively paid since the enactment of 4 (p).

Although I do not intend this as a dissent to the Report, I desire to emphasize particularly the serious consequences which would follow, for co-operative organizations and their members, if co-operatives were to be required to pay taxes on patronage dividends paid or allocated since the enactment of section 4 (*p*). While paragraph (*p*) appears ambiguous, members and officials of co-operatives have undoubtedly endeavoured to conduct the affairs of their organizations in the belief that at least patronage dividends, paid or allocated, would be exempt. If these dividends were to be taxed the results might well be disastrous for the co-operatives concerned, as well as a hardship for their members.

It is also to be remembered that many co-operative associations have set aside unallocated reserves to preserve the equity of their members. These reserves have in many instances been set aside as a result of either statutory requirements in provincial co-operative legislation, or in accordance with special Acts of Incorporation, and also by reason of the belief that they had authority to set aside "necessary reserves" under section 4 (*p*).

For the reasons stated, I submit that it would not be in the public interest to assess such co-operatives for income taxes for the period subsequent to the enactment of section 4 (*p*).

In Part I, section VI 3 (*a*) of the Report, it is recommended that amounts paid by co-operative associations and other businesses in proportion to patronage be allowed as a deduction, if credited to the member or customer, provided the payment so credited may be withdrawn on giving reasonable notice. The same principle is embodied in recommendation number (4) regarding deductions from the gross proceeds of a customer's product. Reference is made to Appendix D as a guide as to what may be a reasonable notice. This refers to the practices followed by co-operative societies in Great Britain respecting the withdrawal of share capital.

It is desirable that the rights of the member of a co-operative to withdraw the funds which he has invested therein be clearly established, both from the viewpoint of sound co-operative practice and to distinguish clearly what belongs to the member, as compared with what is retained permanently by the co-operative. While British practice is a useful guide in this respect, it is necessary to consider the conditions under which Canadian co-operatives operate. In Great Britain, co-operative societies deal mostly in consumer goods the demand for which is quite steady, notwithstanding fluctuations in employment amongst the membership. The societies are well established financially, have large reserves and as a result are in an excellent position to meet promptly any demands for withdrawals of share capital by their members. In Canada, on

the other hand, co-operatives are engaged mostly in marketing agricultural or other primary products, the volume of which may fluctuate sharply from year to year and decline decidedly over a period of years. As for farm supply co-operatives, their business is not only seasonal, but the volume of trade is directly related to variations in the income of the members derived from the production of primary products. In addition to that, the majority of co-operatives in Canada do not have reserves comparable to those of British co-operatives.

While I concur with the recommendation that the member should be allowed to withdraw patronage dividends or other amounts credited to him on giving reasonable notice, consideration of what constitutes such reasonable notice must have reference to conditions that prevail in Canada. The main point, I suggest, is the member's right of withdrawal on giving such notice as will enable him to realize on his equity without endangering the equity of other members. This can be done without insisting that the practice, from the point of view of the time element involved, be precisely the same as is general under British conditions.

This consideration leads to another. The Report seeks to distinguish between what the co-operative association keeps for itself and what the member can effectively claim as his own—that is, what is "exigible" by him. The latter includes patronage payments paid in cash or applied against obligations incurred by the member to the association with respect to investment, or amounts credited to him but withdrawable on reasonable notice. This again is in accordance with British practice. Canadian co-operatives have, however, found it necessary to defer the payment of patronage dividends or deductions from gross proceeds of members' products for varying periods. This method of financing has been found necessary under conditions that prevail amongst agricultural co-operatives, where the volume of business may fluctuate sharply from year to year, and where large capital expenditures are needed in contrast to the requirements of consumers societies. The Commission takes the view that where amounts are deferred for an indefinite period at the sole discretion of the directors, such amounts should only be deductible for tax purposes when actually paid to the members.

There is, however, another method which is not dealt with in the recommendations, and that is, where the bylaws of an association or contract with the members, provide that deductions from gross proceeds or patronage dividends shall be deferred for a definite period only. Where the date of payment is set at a definite date in the future in such a way that there is an irrevocable undertaking to pay, which cannot be altered at the will of the association, such deferred payments cannot be considered as "income" of the association and taxable in its hands. Such deferment is not inconsistent with practices followed by British co-operatives when adapted to conditions under which Canadian co-operatives have to operate. It represents an intermediate method as between capital which can be withdrawn at any time and capital which can only be withdrawn with the consent of the association. It establishes clearly the obligation to the member. It is a method which has been found essential to the requirements of many agricultural co-operatives. To allow patronage payments, deferred for a definite period under a definite obligation to pay, as a deduction in computing taxable income, will avoid the result that Canadian co-operatives are more restricted in financing with funds payable to their members than are those co-operatives in the United States which are not exempt from Federal income tax, but are nevertheless allowed to deduct allocated dividends in computing taxable income.

I, therefore, recommend that deductions from the gross proceeds of a member's product, or patronage dividends, which are retained by a co-oper-

ative association for a definite period with an irrevocable obligation to pay at the time stipulated, be allowed as a deduction in computing the taxable income of such association.

With the exception of new associations and co-operatives of certain types designated in recommendation number (9)—see section VI, Part I of this Report, the recommendations involve the taxation of co-operative purchasing and marketing associations on their unallocated reserves. The evidence submitted to the Commission, however, makes it clear that co-operatives are a more unstable type of organization than other businesses. In addition, they are unable to attract capital for investment purposes to the same extent as a joint stock company and are forced to rely on contributions from people of limited means who desire to use their services. Furthermore, most co-operatives in Canada are engaged in serving agriculturists and other primary producers which means considerable fluctuation in the volume of business done. This state of affairs is recognized in provincial co-operative legislation across Canada by statutory provisions regarding reserves to safeguard the equity of the members.

In view of certain weaknesses inherent in the co-operative type of organization as dealt with elsewhere in the Report, and also in view of the fact that by and large members of co-operatives are people with low incomes who are in a difficult position to make special contributions to offset heavy losses sustained by their organizations, I suggest that in the public interest co-operatives should be allowed to set aside limited reserves for protecting the equity of their members, before computing taxable income. For tax exemption purposes, such reserves might be limited to the minimum provisions for similar reserves as set forth in provincial co-operative legislation. An alternative basis for a reserve to guard against impairment of the members' equity in a co-operative might be a yearly appropriation equivalent to 2% of the net assets until the amount in such reserve is equivalent to a maximum of 20% of such net assets. These might be defined as total assets, reduced by valuation reserves, less liabilities to the public and less current liabilities to members.

It was also contended at the hearings of the Commission that certain other businesses, especially those engaged in handling agricultural products, are subject to considerable variation in income and find it difficult to set aside sufficient reserves for unforeseen contingencies. Although these businesses are at present in liquid position, this might easily be reversed with changing economic conditions. It would, therefore, appear that consideration should be given to allowing other types of businesses to set aside limited reserves to guard against the impairment of capital before computing taxable income, provided the necessary application in this regard is made to the Minister and he is satisfied that such reserves are warranted. In so far as co-operatives and other businesses are confronted with comparable problems, after taking into consideration the weaknesses inherent in the co-operative type of organization, such a policy would assist in achieving a measure of equality between the two types of business activity.

I, therefore, recommend that from the point of view of the public interest co-operative purchasing and marketing organizations be allowed to set aside limited reserves to guard against the impairment of capital and unexpected losses, before arriving at taxable income.

I also recommend that consideration be given to allowing other types of businesses to set aside similar reserves, before arriving at taxable income, where the Minister is satisfied that these are warranted.

Respectfully submitted,

B. N. Arnason.

Comments

by J. M. Nadeau

I do not intend to make this a reservation to the Report and recommendations with which I am in entire agreement. I do feel, however, that particular emphasis should be laid on the uncertainty of the position of co-operatives in the matter of the application of section 4 (*p*) of the Income War Tax Act. Therefore, I respectfully suggest that any action which might be taken to enforce the collection of past due taxes by the Government should be motivated by the idea of not imposing, in the public interest, any undue hardship on farmers' and fishermen's co-operatives which conducted their affairs in good faith, believing, as they did, that patronage dividends paid or allocated were not liable to taxation under existing acts.

Unallocated reserves in many instances are equivalent to "necessary reserves" as authorized in section 4 (*p*) in order to protect the member's equity. I believe it is also in the public interest that such unallocated reserves should be given the same tax exemption from taxation as suggested for allocated patronage dividends in the foregoing paragraph.

Respectfully submitted,

Jean-Marie Nadeau.

Memorandum of Comments and Reservations

by J. J. Vaughan

I regret that I cannot join my colleagues in making this Report unanimous in all respects. Although I do not subscribe to all the arguments contained therein, I am in agreement with the taxing of co-operatives to the extent set out in the recommendations. As the adoption of this measure of taxation only, would fall far short of removing the present inequality of taxation as between Co-operatives and Companies, it is necessary in my opinion that some further remedial action should be taken.

I should like to make it clear that I am not opposed to co-operatives. On the contrary, I believe they have been and are serving a very useful purpose, particularly in the remote parts of the country, in providing a means whereby groups may be formed to improve their economic position. That co-operatives have a place in our national economy is unquestioned. But it must be said that Companies also have a very important place in that economy. Indeed much of the development of Canada up to the present time may be attributed to the initiative of Companies, made possible by their employment of capital, largely subscribed by private investors. This capital has enabled Companies to embark on new forms of enterprise, to expand businesses already established, to provide employment, to increase the wealth of the country, and to raise the standard of living. Companies also have afforded a channel for investment which has enabled many people to earn a better return on their savings and surplus funds than otherwise would have been possible. Therefore, it is highly desirable that companies should be permitted to proceed as in the past and that they should be able to produce a return that will encourage the investment of capital, much of which will be needed in the reconstruction period of the future.

At many points throughout Canada the competition is keen between co-operatives and companies, but companies, as has been so forcibly pointed out at our hearings, are competitively in an unfair position; they are required to pay a heavy income tax and in many cases an excess profits tax while co-operatives are exempt from these taxes, thus leaving the latter in the advantageous position of being better able to build up reserves and expand their activities. Having regard to the fact that Canada is a fertile field for co-operatives and that they are now well established under able direction, and that they are sponsored and aided by provincial governments, there is every reason to expect a substantial expansion in their business. This expansion as it takes place will result in increased competition and render the tax inequality more pronounced. unless some remedial action is taken.

As the measure of taxation to be imposed by the Commission on co-operatives, as recommended by the Report, will not, as already stated, remove the inequality that exists, and inasmuch as further action, in my opinion, is necessary, there seem to be two courses to consider. One is to impose a further amount of taxation on co-operatives, and the other is to remove a part of the taxation now imposed on companies. The methods employed by co-operatives in operating and accounting are entirely different from those employed in ordinary business. Included in their surplus are operating profits, income from investments and balances owing to members on products and commodities handled, all blended in a way that the exact profit is not determinable. As a result it is very difficult, if not impossible, to further apply an income tax to co-operatives. That co-operatives do make profits is stated in the Report, and with that statement I agree, and that they are efficiently managed on the whole is unquestioned, so it logically follows that such profits should be comparable with those made by similar competing businesses. But as these profits do not appear separately in the books of co-operatives and as the income tax cannot readily be applied to their entire profits, some other form of tax would appear to me to be more appropriate if the first course mentioned should be followed. However, the recommendation of any form of tax other than the income tax would be beyond the scope of the terms of reference in P.C. 8725.

The second course mentioned is to remove a part of the taxation now imposed on companies. The other members of the Commission have expressed their opinion that to recommend such action would be beyond the scope of the terms of reference contained in P.C. 8725. I do not, however, concur in this, and quote what I regard as the relevant parts of the order which in my opinion grant the Commission such power viz., that the Commissioners named be appointed—

"to inquire into"—

" (*b*) the organization and business methods and operations of the said co-operatives as well as any other matters relevant to the question of the application of income and profits tax measures thereto, and

(*c*) the comparative position in relation to taxation under the said Acts of persons engaged in any line of business in direct competition with co-operatives,

and report, in so far as the same can conveniently be done, all facts which appear to them to be pertinent for determining what would, in the public interest, constitute a just, fair and equitable basis for the application of the Income War Tax Act and The Excess Profits Tax Act, 1940 to co-operatives and to persons other than co-operatives in respect of methods of doing business

analogous to co-operative methods, such as the making of payments commonly called patronage dividends *and to make such recommendations for the amendment of existing laws as they consider to be justified in the public interest;*"

Accordingly, I believe it is in order and appropriate that the comparative position of Companies with Co-operatives in relation to taxation should receive consideration.

In our hearings from Vancouver to Halifax, various Boards of Trade, the Canadian Chamber of Commerce, the Canadian Manufacturers Association and other bodies and companies emphasized the unfairness of the so-called double taxation in Canada, i.e., the taxing of the entire profits in the hands of the Company and the taxing again in the hands of the shareholders of that part of the profits which is received by them in dividends. Also it was advocated by those appearing, that as a measure towards remedying the unfairness of the present taxation of companies as compared with the tax exemption granted co-operatives that this double taxation be removed. It should be noted that such double taxation is not in effect in England, Australia or New Zealand.

As the imposition of any further measure of income tax on co-operatives than that recommended by the Commission is regarded as impracticable, and as the recommendation of any other form of tax would be outside the jurisdiction of the Commission, my opinion is that the second course should be followed. In respect to this, the extent of the loss to the National Treasury also must be considered.

Having due regard to the foregoing, my recommendation is that the corporation income tax be reduced from 40% to 30% and that shareholders paying income tax in Canada be allowed a credit of 50% of the tax paid by the company, in respect to their dividends.

The adoption of this recommendation would serve a twofold purpose. It would be a further step in removing the inequality in taxation as between Co-operatives and Companies, and it would remove in some measure, the double taxation which is so much complained of at the present time.

J. J. VAUGHAN.