

REPORT  
OF  
THE ROYAL COMMISSION  
ON  
The Taxation of Annuities  
and Family Corporations

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1945

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OTTAWA  
EDMOND CLOUTIER  
PRINTER TO THE KING'S MOST EXCELLENT MAJESTY  
1945

Ottawa, Ontario

March 29th, 1945.

The Honourable J. L. Hsley, K.C., P.C.,  
Minister of Finance,  
Ottawa, Ontario.

Dear Sir:—

I have the honour to hand you herewith the report of the Royal Commission on Taxation of Annuities and Family Corporations, pursuant to the Order in Council of 13th November, 1944, P.C. 8679, a copy of which appears on pages 7 and 8 of said report.

Yours faithfully,

J. A. MICHON,  
Secretary to the Commission.

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## ORDER IN COUNCIL P.C. 8679

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 13th 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 there are various types of payment received by individuals regarding which there may be reasonable doubt as to whether they are payments of income or capital or a combination of income and capital; and that the present level of income tax rates greatly accentuates the necessity of determining whether such payments are income or capital or a combination of both and, if the latter, of clearly demarcating the income portion from the capital portion of the payments in order to avoid inequitable tax treatment as between various types of income and as between various forms of savings and capital accumulation;

That under the various tax laws in force in Canada, the combined effect of the taxes imposed on income which has been accumulated as earned surplus by a private corporation or a closely held corporation and on the assets of such corporation when they pass by succession or devise to the heirs or beneficiaries of a person owning a substantial proportion of the shares of such a corporation, may in certain cases constitute so heavy a burden as to offend against all reasonable standards of equity, and that such tax burdens, if long continued, may have an adverse effect upon the national welfare by discouraging the initiation and expansion of new enterprises of a size appropriate to the resources of single individuals or of family groups.

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

1. That Mr. William C. Ives, retired Chief Justice, Trial Division of the Supreme Court of Alberta, Dr. D. A. MacGibbon, of the City of Winnipeg, Man., and Mr. M. W. Mackenzie, of the City of Montreal, P.Q., be appointed Commissioners under Part I of the Inquiries Act, —
  - (a) to investigate and report upon the present treatment under the Income War Tax Act of payments to individuals in the form of annuities or other annual or periodic payments received under the provisions of any contract, will or trust; payments to individuals in the form of pensions, superannuation or other periodic payments or single payments received following retirement from or cessation of employment with an employer; payments by individuals under an annuity, insurance, endowment or other savings contract; and other payments of such a character that it is not obvious whether they are solely income or solely capital or partly the one and partly the other;—

and to consider whether any modification of that treatment is desirable and, if so, what alterations of the law are required for the purpose;

- (b) to investigate and report upon the taxes imposed under laws in force in Canada, on income and successions or inheritances arising upon the death of a person owning a substantial proportion of the shares of a private corporation or a closely held corporation which has accumulated an earned surplus, and to consider whether under any circumstances there should be an abatement of the tax liability, and, if so, under what circumstances and to what extent there should be such abatement;
2. That Mr. William C. Ives, retired Chief Justice, Trial Division of the Supreme Court of Alberta, be Chairman of the said Commissioners;
  3. That the commissioners be authorized to engage the services of such technical advisers or other experts, clerks, reporters and assistants as they deem necessary and 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; and
  5. That the commissioners be directed to report to the Minister of Finance.

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

## REPORT TO THE HONOURABLE THE MINISTER OF FINANCE

We, the Commissioners appointed under Part I of the Inquiries Act, —

- (a) to investigate and report upon the present treatment under the Income War Tax Act of payments to individuals in the form of annuities or other annual or periodic payments received under the provisions of any contract, will or trust; payments to individuals in the form of pensions, superannuation or other periodic payments or single payments received following retirement from or cessation of employment with an employer; payments by individuals under an annuity, insurance, endowment or other savings contract; and other payments of such a character that it is not obvious whether they are solely income or solely capital or partly the one and partly the other; and to consider whether any modification of that treatment is desirable and, if so, what alterations of the law are required for the purpose;
- (b) to investigate and report upon the taxes imposed under laws in force in Canada, on income and successions or inheritances arising upon the death of a person owning a substantial proportion of the shares of a private corporation or a closely held corporation which has accumulated an earned surplus, and to consider whether under any circumstances there should be an abatement of the tax liability, and, if so, under what circumstances and to what extent there should be such abatement;

now beg leave to report as follows:—

We have held 32 public sittings; we have examined 73 witnesses, and we have considered a total of 305 submissions addressed to us on the subject of our inquiry. Many of the witnesses represented important bodies covering the entire Canadian field of social and economic activity. A large number of submissions were made in writing by organizations throughout Canada, without oral representations. These briefs are incorporated in the record.

The evidence we have heard and the information given us we think to be fairly exhaustive as we believe that we have been in touch with most of the important sources of knowledge and of informed criticism on the subjects with which we were called upon to deal.

We are grateful for the assistance afforded us by the witnesses who gave evidence on behalf of the public and of associations and corporate bodies, as well as those who appeared in a purely private capacity.

Officials of the Department of Finance and the Department of National Revenue have been most painstaking and willing in meeting our numerous requests for information and their assistance has been invaluable.

We thank the Board of Transport Commissioners for Canada for putting at our disposal office space and their Board Room in the Union Station at Ottawa for the purpose of conducting our hearings.

We should like to add an expression of our appreciation of the services of our Counsel, Mr. Geo. W. Auxier, of our Secretary, Mr. J. A. Michon and of Mrs. Louise Gratton, who has acted as Assistant to the Secretary throughout. We also express our appreciation to Mr. R. A. Whitman, C.S.R., and his staff for the excellent reporting service given during the public hearings of the Commission.

We have thought it expedient to divide our Report into two parts in the order suggested by our Terms of Reference, numbering the sections under each part to facilitate reference.

## PART

### I

#### ANNUITIES AND OTHER ANNUAL OR PERIODIC PAYMENTS

The almost unanimous opinion expressed to the Commission by witnesses heard; by briefs submitted and by letters from present annuitants and those in receipt of pensions is that contractual annuities and pensions comprise a substantial element of capital which has been once taxed and that it should not be taxed a second time.

We have found almost no support for the Judicial Decisions in England that capital used in the purchase of an annuity loses its character as such and has been exchanged for income when applied in a different economic structure as in Canada.

Nor can we find any sufficient reason for the taxation of annuities or annual payments received under the provisions of any will or trust except to the extent that the same are paid out of the income of the estate or trust.

The general opinion expressed to the Commission by witnesses is that the taxation of the capital element in annuities and pensions will discourage thrift in the field where it is most desirable.

A further argument was made that this taxation policy would in the near future charge the public revenue with a burden of Old Age Pensions very much greater than the immediate loss resulting from a policy that would encourage thrift and self provision.

Representations were made urging the allowance of premiums paid on insurance and deferred annuity contracts as a deduction from income in order that individuals having no access to any pension plan might be placed in relatively the same position as the employee who has such access.

We were urged that it is inequitable to impose succession duty on the commuted value of an annuity or pension when such annuity or pension is to be taxed as income when received. It was also argued that husband and wife should be recognized as an economic unit, and that such unit accumulated the savings which purchased the annuity or pension; that in fact there is no transmission of the survivor's share.

A number of organizations containing a large membership of employees in industry and the teaching profession submitted that the basic statutory exemption of \$660. was too low, particularly so when the taxpayer being a man had reached the age of 65 and a woman the age of 60. It was urged that the exemption be increased at this age because of the loss of earning power and the cost of living attendant upon the frailties of old age.

The complaints and criticism of a considerable number who had purchased Government annuity contracts prior to 25th June, 1940, when the present section 5(k) of the Act came into force, and who had contractual rights therein to increase their annuities as their savings permitted, were strong and severe. They contend that they had no knowledge of the proposed change in time to protect themselves, but a much greater number complain that they purchased their annuities from the Crown on the assurance of the department and its salesmen, and upon the statements in literature distributed by the Government, that the annuities they were invited to purchase would be exempt from all federal taxation. They feel that they have been betrayed by their Government.



## ANNUITIES

1. *Evolution of Taxation of Annuities under Income War Tax Act.*

Inasmuch as the taxation of contractual Annuities has a somewhat different history from the taxation of Annuities under Wills and Trusts, it will be more convenient to deal with each separately.

(a) *Contractual Annuities*

The original Income War Tax Act (1917 Cap 28) contained as part of the section defining "income" the following words: — "including the income from but not the proceeds of life insurance policies paid upon the death of the person insured, or payments made or credited to the insured on life insurance endowment or annuity contracts upon the maturity of the term mentioned in the contract or upon the surrender of the contract".

These words, originally contained in the body of the section of the Act defining "income", later, on the revision of the Statutes in 1927, became section (3)(1)(b) of the Act as one of the particular classifications included in the term "income" for tax purposes.

These words continued in the Act without change from 1917 until 1940.

Until 1929, it was apparently never considered that payments made under a contractual annuity were taxable by virtue of this sub-section, or by the general definition of "income" as contained in the Act. At any rate, they were never taxed — either in whole or in part.

In 1929, the case of *Kennedy vs the Minister* (1929 Ex. C.R. 36) came before the Exchequer Court. The question raised in that appeal was not the taxability of the annuity payments, but whether Mr. Kennedy was entitled to a married man's status in connection with the taxation of his own income when his wife had a Dominion Government Annuity paying her \$1500 per year. Mr. Justice Audette, who heard the appeal, found not only that the wife's annuity payments were income for the purpose of depriving her husband of his right to exemption as a married man, but found, on a review of the English case law on the subject, that the annuity payments constituted taxable income to the wife.

The judgment in the Kennedy case threatened to seriously affect, if not put an end to, the sale of Government annuities, so at the next session of Parliament, Section 5(1)(k) was introduced into the Income War Tax Act in order to specifically exempt from taxation Government annuities, and, in order to avoid any charge that the Government was in unfair competition with private concerns, any "like" annuities up to the maximum of \$5,000.

This section (1930 c. 24 s. 3) read as follows:—

(k) the income to the extent of five thousand dollars only derived from annuity contracts with the dominion or provincial governments or any company incorporated or licensed to do business in Canada effecting like annuity contracts, provided, however, that any annuity in excess of the said five thousand dollars purchased by a husband for his wife or vice versa shall be taxed as income to the purchaser.

In the case of a husband and wife each having an annuity the exemption herein provided for shall not exceed five thousand dollars between them in respect of such annuity income. The exemption may be taken by either the husband or the wife or apportioned between them.

Annuity income shall not be excluded for purposes of determining the exemptions provided for in subsection two of section five of the said Act.

The decision of the Minister in respect of any question arising under paragraphs (1), (i) and (k) hereof shall be final and conclusive.

Two years later, the maximum limit placed on any annuity purchasable from the Government having been reduced from \$5,000. to \$1200., section 5(1)(k) was struck out and re-enacted in the following form by 1932 c. 43 s. 6, assented to and effective May 26, 1932.

"(k) twelve hundred dollars only, being income derived from annuity contracts with the Dominion Government or like annuity contracts issued by any Provincial Government or any company incorporated or licensed to do business in Canada;

Provided that, in the case of a husband and wife each having annuity income, the exemption herein provided shall not exceed twelve hundred dollars between them in respect of such annuity income and the exemption may be taken by either the husband or the wife or apportioned between them by agreement or by the Minister;

And provided further that the income arising out of annuity contracts entered into prior to the coming into force of this paragraph (k) shall continue to be exempt as heretofore provided by section three of chapter twenty-four of the statutes of 1930;

And provided further that where a husband purchases an annuity for his wife or a wife for her husband, the income therefrom shall be taxed as income of the purchaser;

And provided further that annuity income shall not be excluded for purposes of determining the exemptions provided for in subsection two of section five of the Act."

No amendment was made to the section defining income following the decision in the Kennedy case and we have been unable to determine with certainty the practice that was followed during the next ten years by the Income Tax Division. It appears, however, that apart from annuities covered by the exemption, only some annuities were subjected to tax and in those cases, no distinction was made between "annuities certain" and "life annuities" with or without a guaranteed term. "Annuities certain", sometimes referred to as "term annuities", are payments for a fixed term of years without regard to whether or not the annuitant lives.

The matter was not of great general importance however during those years. Government annuities and "like" annuities were specifically exempt to fairly generous limits except for the comparatively few cases where husband and wife each had a large annuity; and the settlement of claims under insurance policies at maturity, either on death or otherwise, by the annuity method, could be effected by the issue of a supplementary contract "like" a Government annuity. Then in 1939, the case of *Shaw vs the Minister* came before the courts. Mrs. Shaw had insured her husband's life. The policy provided that on the death of the assured the Company would pay Mrs. Shaw, the beneficiary, the sum of \$700. per month for life and with a guarantee of such payments for 120 months, and it gave the beneficiary the right to commute all instalments into a single cash payment of \$71,400. On the assured's death, Mrs. Shaw did not elect to take the single cash payment and received instead the monthly payments, no supplementary contract having issued. She was assessed for tax thereon and appealed. In the Exchequer Court, 1939 Ex. C.R. 35, President Maclean held the payments taxable in full, and held the contract was not "like" a Government Annuity

and was therefore not entitled to partial exemption under sec. 5(1)(k). On appeal to the Supreme Court of Canada (1939 4 D.L.R. 81) the Court held that the annuity payments were the "proceeds of a policy of insurance" and not the "income from the proceeds" and were consequently exempt under Sec. 3(1)(b) apart entirely from any general theories as to whether annuity payments are income or capital.

Following the decision of the Supreme Court of Canada in the Shaw case, Parliament repealed Section 3(1)(b) of the Income War Tax Act and substituted for the previous words the following (1940 cap 34 s. 8) including as "income"

"annuities or other annual payments received under the provisions of any contract, except as in this Act otherwise provided."

these words being copied largely from the English Income Tax Acts and schedules for the obvious purpose of bringing into play in Canada the English case law on the question of the taxation of annuities.

At the same session the exemption of Government and "like" annuities under Section 5(1)(k) was abolished except as to pre-existing contracts. That section was struck out and re-enacted as follows by 1940 c. 34 s. 13.

"(k) The income arising from any annuity contract entered into prior to the twenty-fifth day of June, 1940, to the extent provided by section three of chapter twenty-four of the statutes of 1930 and section six of chapter forty-three of the statutes of 1932: provided that such exemption shall not extend to that portion of the income which exceeds the amount of the annuity actually specified in the contract before the twenty-fifth day of June 1940, where such excess amount arises by reason of any option or contractual right to enlarge the annuity income by the payment of additional sums or premiums, unless such additional sums or premiums have actually been paid before the said date:"

In the meantime certain inroads had been made on the taxation of contractual annuities in England. In 1930 the English Court of Appeal decided the case of *Perrin vs Dickson: 14 T.C. 608*. Bishop Perrin had contracted with an Insurance Society for an annuity for his son. In consideration of premiums payable for the six years 1912 to 1917, the Society undertook to pay an "annuity" for the seven years from 1920 to 1926 if the appellant's son should so long live. In the event of the son's death, the total of the premiums paid, without interest, less any amount received by way of annuity payments, was repayable to the appellant. The son lived the period in question, but the appellant was assessed on the annuity payments. It was established that the sums payable under the policy were calculated so as to return to the appellant if the son lived the amounts paid as premiums with interest thereon. The Court reviewed all the English case law on the subject and decided that the transaction was simply the repayment of the premiums with interest by regular annual payments, each of which contained elements of income and capital.

On the basis of this decision, following the 1940 amendment to the Income War Tax Act, the Income Tax Division abandoned the practice of taxing in full payments arising under "annuities certain" or "term annuities" and taxed instead only the interest element, using for the purpose of separating the "interest element" a method whereby the present value of the annuity payments, at the date the annuity matured, was divided by the number of payments provided in the annuity contract, and the amount so calculated was considered to be the capital element in each annuity payment, the balance representing interest. In other words, the interest element in the annuity contract was spread evenly

over the whole term of the annuity, for the sake of convenience to both the Department and the annuitant.

It is interesting to note that shortly after the practice of taxing annuities certain in full was abandoned in Canada, the English Court of Appeal in *Sothorn Smith vs Clancy: 1941 1 All E.R. 111* in a case similar to *Perrin vs Dickson*, criticised that decision, but distinguishing it under the particular circumstances of that case, held virtually that payments under an annuity certain were wholly income and taxable as such.

Notwithstanding this decision the Canadian Income Tax Division has continued to follow the practice in the case of annuities certain of taxing only the "interest element", though continuing to tax the full proceeds of life annuities, with or without a guaranteed term. This practice applies whether the case is that of the straight annuity contract, or is the payment of the proceeds of a life insurance policy by the annuity method, through selection by the insured or the beneficiary of one of the optional methods of payment contained in the policy.

The only reported decision on contractual annuities in Canada following the amendment of Section 3(1)(b) in 1940 is the case of *Lumbers vs Minister*. In that case a life insurance contract, entered into in 1918 and maturing in 1939, provided, at the option of the assured, a lump sum payment or monthly payments for life with a guaranteed period of 20 years. The appellant in his tax return showed the payments as income but claimed exemption of \$1200 under 5(1)(k) on the ground that the contract was "like" a Government annuity.

In the Exchequer Court (1943 4 D.L.R. 216) the appeal was dismissed. On appeal to the Supreme Court of Canada (1944 2 D.L.R. 545) the Exchequer Court judgment was affirmed. Before the Supreme Court it was argued for the first time that the payments in question were not income but return of capital, but the majority of the Court held that the amendment of Section 3(1)(b) in 1940 settled this point adversely to the appellant.

At the present time, therefore, the tax practice with respect to contractual annuities is as follows:—

1. In the case of annuities taken out prior to May 26, 1932, if they are Government annuities, or "like" Government annuities, they are exempt to the extent of \$5000. per year, provided that where husband and wife each have an annuity only one exemption is allowed, and provided further that where the face amount of the annuity as stated in the contract is an amount less than \$5000., the face amount governs the extent of the exemption, notwithstanding any option or contractual right to enlarge the annuity income by the payment of additional sums unless the additional sums were paid before June 25, 1940.
2. In the case of Government or "like" annuities taken out between May 26, 1932, and June 25, 1940, they are exempt to the extent of \$1200. per year subject to the same limitations as set out above.
3. The above two paragraphs apply also to settlements of insurance policies maturing prior to May 26, 1932, or June 25, 1940, where settlement was made, on an option exercised by either the assured or by the beneficiary, by means of a supplementary annuity contract.
4. In the case of annuities purchased (or insurance policies maturing) subsequent to June 25, 1940,
  - (a) Annuities certain are taxed only as to the "interest element" as outlined above.

(b) Payments under life annuities or annuities for life with a guaranteed term are, in their entirety, considered taxable income, except in the latter case, where two separate contracts issue:

- (i) an annuity certain taxable only as to the interest element as outlined above and
- (ii) a deferred life annuity taxable in full.

5. These same principles apply to annuities arising out of the sale of property. If property is sold for an annuity for a term certain, no life contingency being involved, the interest element only is taxed, the consideration for the annuity being the value of the property as set forth in the contract, or ascertained by the Minister under Section 3(2) of the Act. If the property is conveyed in consideration of a life annuity, the annuity payments are considered to be wholly taxable income.

6. Where an annuity certain or a life annuity with a guaranteed term passes on the annuitant's death to the estate or to a beneficiary, they are both treated alike — as an annuity certain for the balance of the term. The present worth is taken as the capital value for Succession Duty purposes, and the interest element in the remaining payments, calculated as already outlined, is taxed as income to the estate or beneficiary.

(b) *Annuities under Wills and Trusts*

An amendment to the Income War Tax in 1919 (Cap 55 Sec 2) added Section 3(6) as follows:

"Income of a beneficiary of an estate shall be deemed to include the amount accruing during each taxation year to which he, his heirs or assigns are entitled from the income of the estate whether distributed or not."

A further amendment (1920 C. 49 S. 4) provided that income accumulating in trust for unascertained persons should be taxable in the hands of the trustee as if it were the income of an unmarried person.

These two amendments, on the revision of the Income Tax Act in 1927, became, with some minor changes, Section 11(1) and (2) of the Act.

These two subsections have been enlarged upon to some extent since the revision in 1927, the nature of which amendments is not of particular importance here. It might be pointed out however that Section 11(4) was added in 1934 which, as amended and added to, now provides:

4. (a) Income received by an estate or trust and capitalized shall be taxable in the hands of the executors or trustees, or other like persons acting in a fiduciary capacity.
- (b) Income earned during the life of any person shall, when received after the death of such person by his executors, trustees or other like persons acting in a fiduciary capacity, be taxable in the hands of such fiduciary.
- (c) Income taxable under the provisions of this subsection shall be taxed as if such income were the income of a person other than a corporation, provided that no deduction may be made under Rule five of section one and Rules one, three, four and five of section two of paragraph A of the First Schedule to this Act.

The Act also, from its inception, provided in what is now Section 3(1) (a) that the term income should include "the income from but not the value of property acquired by a gift, bequest, devise or descent".

The tax position therefore prior to 1930 of a person taking an annuity under a will or trust, was that insofar as the annuity was payable out of income of the estate or trust, it was considered taxable income in his hands. Insofar as it was payable out of capital it was not taxed.

After the judgment of Audette J. in the Kennedy case in 1929, the Department adopted the practice of taxing annuities under wills and trusts in full, regardless whether paid out of income or capital or both.

In 1936 the Exchequer Court decided *Toronto General Trusts vs the Minister* (1936 Ex C.R. 172). In that case, usually referred to as the "Whitney" case, the will directed that an annuity of \$25,000 per annum be paid to the wife of the testator. The Court, on the basis of two decisions of the Supreme Court of the United States, held that as the annuity was charged generally on the estate and might be paid out of income or capital of the estate, or both, it was completely exempt under the provisions of Section 3(1) (a) and therefore the assessments of the beneficiary Sarah Whitney for the years 1931 et seq were set aside.

As a result of this decision, the Income War Tax was amended in 1938 (C. 48 S. 3) by adding to section 3 subsection (1)(g) as follows:

"(g) Annuities or other annual payments received under the provisions of any will or trust, irrespective of the date on which such will or trust became effective, and notwithstanding that the annuity or annual payments are in whole or in part paid out of capital funds of the estate or trust and whether the same is received in periods longer or shorter than one year."

the effect of which amendment was to change the law from one extreme to the other.

In 1943, as a result of protests against the hardships caused by this amendment, the following proviso was added (1943-44 Cap 14 s. 1)

"Provided, however, that annuity payments or other annual payments received under the provisions of any will or trust which became effective prior to the first day of January, 1944, shall be exempt to the extent of the amount paid out of the corpus of the estate or trust but not exceeding fifteen hundred dollars in any year."

which gave an opportunity for testators to change their wills to provide lump sum legacies rather than annuities should they desire to avoid taxation of their beneficiaries, and afforded some relief to the beneficiaries of testators who died prior to January 1st, 1944, without having changed their wills.

Later in the year 1943, the Exchequer Court dealt with the appeal of *O'Connor vs the Minister* (1943 Ex C.R. 168). Senator O'Connor had provided by his will that his beneficiary should have the sum of \$1,000. each March 24th and December 4th until she had received the sum of \$40,000. or until her death whichever should first occur, with the remainder to his residuary legatees in the event of her death before having received the full sum, said payments to be made out of the capital of his estate. Mr. Justice Thorson held, after reviewing the history of the statute and all the English cases on "annuities" that this was not a true annuity, but was only the payment of a legacy by instalments. He allowed the beneficiary's appeal, basing his judgment on the fact that the payments were to be made out of capital and referring to the fact that the will provided a definite total sum, though it might be reduced by early death of the beneficiary.

As a result, the tax position is at present somewhat uncertain. Generally speaking, all "annual payments" made under a will or trust are taxable as income,

and whether they are made out of capital, income or both, makes no difference. On the other hand, if a maximum sum is stipulated, and the payments are provided to be made out of capital, they may be considered to be payment of a legacy by instalments and exempt under the principle established in the O'Connor case.

It might be noted that the probable effect of the 1938 amendment is to bring in the English jurisprudence, including the cases of *Brodie vs. Commissioners* 17 T.C. 432 and *Lindus & Hortin vs Commissioners* 17 T.C. 442. In the first of these the trustees were directed to pay the income of the estate to the widow, and to pay out of capital sufficient to make up a total of £4000 per year. She was assessed for income tax on the entire sum of £4000 although a part of it was derived from capital of the estate. The assessment was affirmed on the ground that as the payments were received by her as "income" the fact that the source of the payments was in part the capital of the estate was immaterial. In the *Lindus and Hortin* case the trustees were directed to pay to the testator's daughter the income from half the residuary estate. A family arrangement was made under which the trustees were given a general discretion to supplement the income by payments out of capital, no specific sum being stated. The daughter was held taxable on all sums received by her, whether paid from the income or the corpus of the estate.

(c) *Payments received under sickness, accident or disability contracts.*

While there has been no published Canadian ruling defining status for income tax purposes of payments received under the terms of sickness and accident or disability contracts, we are informed that it has always been the practice to treat such receipts as exempt in the hands of the recipient.

In 1942, by the enactment of Section 4(1), paragraph (u), amounts received as compensation under any Provincial Workmen's Compensation Act or the Dominion Government Employee's Compensation Act are specifically excluded as taxable income thereby raising a question as to whether or not other sickness, accident or disability payments are by inference to be considered as taxable income. The practice of the Department, however, remains the same and it would seem an improvement to confirm this practice by suitable amendment of the law.

## 2. *Should Annuities be Fully Taxable*

The Income War Tax was first levied in 1917 as part of a system of war revenues to meet the financial necessities of the Federal Government arising out of the first world war. Continued in the intervening years as an important source of ordinary revenue for the Dominion, the income tax in the present struggle has become the backbone of the nation's financial system. In 1919, the income tax yielded \$9,350,000 and the business profits tax \$33,000,000 out of total Government revenues of \$313,000,000. In 1944 preliminary figures show that the income tax yield amounted to \$1,036,700,000. To this should be added \$428,700,000 from the excess profits tax re-instituted in 1940 or a total of \$1,465,400,000 out of \$2,659,000,000 of total revenues. While part of this stupendous expansion is accounted for by an enlargement in the national income the scope of the tax itself has been extended and the rates of levy sharply increased. The vast payments made by the Canadian taxpayers for war revenue purposes are the monetary correlary to the prosecution of the war.

Such a heavy tax burden makes it of the highest importance that it should be distributed fairly between individuals and between various types of income. As the income tax level has become higher and more inclusive the nature of income itself has

come under more critical scrutiny by taxpayers and the necessity has been shown of clearly demarcating between various forms of savings and capital accumulation. As the history of taxation shows, disputes between the collecting agency and the taxpayer have led from time to time to an appeal to the courts and in certain instances to amendments to the Income Tax Act to make its provisions more explicit.

While everyone has a general notion of what constitutes income, this notion is very often not precise and economists have long recognized the difficulty of framing a definition that would cover all the senses in which the term "income" is currently used. The basic distinction between capital and income is that between a fund at a distinct point of time and a flow which comes in during a definite period. National income within such a period may be viewed under four different aspects: "as the net total of commodities and services (economic goods) produced by the people comprising a nation; as the total of such goods received by the nation's individual members in return for their assistance in producing commodities and services; as the total of goods consumed by these individuals out of the receipts thus earned; or finally, as the net total of desirable events enjoyed by the same individuals in their double capacity as producers and consumers". (Kuznets Encyclopedia of Social Services, Vol. 11, p. 205.) While these concepts of income are all valid for economic analysis for given purposes it is obvious that they are not all equally suitable for the purpose of collecting an income tax. Moreover, in a modern economy the levy necessarily falls on the money value of income rather than upon income in real terms.

The first technical problem in drafting an income tax measure is to define income for fiscal purposes in sufficiently inclusive terms to cover all classes and kinds of income desired to be taxed and to maintain consistently this definition throughout the statute. Anomalies are liable to occur involving unfair taxation by shifting from one concept of income to another. The difficulty of defining income is increased by the complexity of the circumstances under which various forms of payment accrue to the individual taxpayers in any modern commercial and industrial community. To amplify the definition or in case of doubt whether they fall within its ambit, it is customary, without limiting the generality of the definition, to specify that certain forms of payment received by individuals are to be deemed income under the statute.

However carefully drafted the definition of income may be, differences arise about whether certain payments are to be considered income under the Act, and, if specifically named, whether their inclusion in the Act is consistent with the basic intention underlying the statute. While there appears to be general agreement about the main categories of income, namely reward for services, interest and profits, considerable variations occur in taxing income from one country to another in the treatment of more casual forms of income and in what might be termed borderline cases. These to some degree arise from differences in the organization of the economic resources of the country and in the importance as a source of revenue of certain types of payment received by individuals. This is especially true with respect to the role of annuities and annuity forms of payments in the economy of the United Kingdom. For this reason in examining the fiscal concept of income in Canada the inclusion of any item within it must be considered strictly within the Canadian national setting.

Income is defined in the Canadian Income War Tax Act 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 elsewhere; 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 including . . . . ."

Appended to this definition are eight paragraphs naming certain forms of payment received by individuals that are included as income. Among such named are (1) payments out of any superannuation or pension fund or plan; (2) annuities or other annual payments received under the provisions of any contract, and (3) annuities or other annual payments received under the provisions of any will or trust. With respect to the latter the Act states that they are to be considered income "notwithstanding that the annuity or annual payments are in whole or in part paid out of the capital funds of the estate or trust."

Section 2 of the Act provides that "where under any existing or future contract or arrangement for the payment of money, the Minister is of the opinion that (a) payments of principal money and interest are blended, or (b) payment is made pursuant to a plan which involves an allowance of interest, whether or not there is any provision for payment of interest at a nominal rate or at all, the Minister shall have the power to determine what part of any such payment is interest and the part so determined to be interest shall be deemed to be income for the purposes of this Act."

Present administrative practice treats the payments received under a life annuity as income and the whole amount is taxable. Purchased annuities with a fixed term to run are taxed upon the interest element in the payments only. With respect to pension or superannuation payments to an employee from a pension fund or plan these may be taxed or tax free, depending upon whether the employees' contributions to the fund have or have not been exempted from income tax under Section 5, paragraph (1)(h) of the Act.

The Commissioners are directed to investigate and report upon the present treatment of such payments for income tax purposes and to consider whether any modification of that treatment is desirable with a view to "avoiding inequitable tax treatment as between various types of income and as between various forms of savings and capital accumulation." Such a task involves (a) a clear notion of the concept of income embodied in the Income War Tax Act; (b) an examination of the forms of payment to which attention is directed with a view to establishing whether they fall logically within this concept of income or constitute an anomaly; (c) whether, in any event, there are valid social reasons why the treatment accorded to the beneficiaries of these payments under the present Act should be changed, and (d) what alterations, if any, of the law required to give effect to the Commissioners' findings.

- (a) The general definition of income contained in the Act states that the income to which it refers is the "annual net profit or gain or gratuity" received from "any profession or calling" or from "any trade, manufacture or business". It includes "interest, dividends or profits" received from money at interest or from stocks, or from any other investment. In ordinary usage "net profit" denotes the profit remaining after the deductions of all charges, expenses, losses, etc., incurred in securing it. Similarly interest is a premium paid for the use of money and leaves the principal sum intact. It would appear clear that in computing income for tax purposes the Act contemplates that the income levied upon shall

not constitute an impairment of capital. Additional evidence of this intention is contained in Sections 5 and 6 where provision is made in determining income for allowances to be granted with respect to such wasting assets as mines, oil and gas wells and timber limits. The same principle is applied with respect to depreciation. The clear implications of the terms of the definition and these provisions are that the basic concept of income employed in the Act is that of "income produced". This is in accord with the ordinary accountancy use of the term and the business man's view of income.

- (b) The inclusion of payments from a life annuity as income to the full amount is an anomaly in the statute and is based upon a concept of income clearly different to that employed in the principal definition under which payments received by individuals are taxed. Annuities are yearly or other periodic payments of a certain sum of money receivable by an individual either for a term certain of years or for life. They may be acquired by purchase or may be received under the provisions of a will or trust. In the case of an annuity with a term certain it is possible to compute exactly what part of the annual payment is interest upon the capital invested and what part represents a return of capital itself. Under present income tax administrative practice that part only which is interest is treated as income for taxation purposes.

With a life annuity the whole amount received by the annuitant is taxable as income. It is generally agreed that people who purchase life annuities or provide for them under a will or a trust do so in order to ensure that a modest amount of capital may provide as large a fixed annual sum as possible for living expenses. It is not customary for the annuitant to lay aside a portion of the payment received to ensure the replacement of the capital invested in the annuity since this would defeat the purpose of the annuitant. The whole annual payments received are used to provide a living. Quite obviously, in one sense of the term, these payments must be considered income but equally obviously they cannot in their entirety be considered income under the general concept of income contained in the principal definition of income in the Income War Tax Act. In fact the meaning of the term "income" when applied to payments received from a life annuity is not that of "income produced" but that of "income consumed". "Income consumed" is a valid concept of income for certain purposes but if used as the basic concept in an income tax act would transform the measure into a tax on expenditure. It follows logically that since the Income War Tax Act adopts for fiscal purposes basically the concept of "income produced" this concept should be applied consistently in fairness throughout the Act. With respect to the taxation of life annuities, whether acquired by purchase or received under bequest, this would mean that that part of the annuity payments which represents interest accruing on the capital invested would be taxable as income but that part which represents return of capital would be exempt.

Due to the element of uncertainty with respect to the length of life of the annuitant it is not possible to determine exactly in each individual instance what part of the payments made under a contractual annuity represents interest or profits upon the investment and what part represents return of capital but this fact is not a serious objection to an exemption being granted on approximately the amount of capital involved. This amount can be ascertained with reasonable accuracy by the use of an expectancy table for annuitants in any given age group. The method is exemplified at the present time in the procedure employed under the Dominion Succession Duty Act where the capital element represented in a life annuity is valued for taxation under the Dominion Succession Duty Act.

- (c) The chief objection adduced against limiting the taxation of life annuities to that part which consists of interest accruing on the capital investment apparently rests upon a prejudice that there is something peculiarly heinous in an individual converting his capital into a life annuity in order to obtain as large an annual sum of consumable income as possible during his lifetime or to take this means of providing for his wife or other dependants. He is represented as "deliberately turning his capital into income" as if this were a discreditable action. Undoubtedly the basis of this attitude is a deep-seated belief in the importance of saving and capital accumulation as an essential factor in the economic progress of the community. Without in the least denying the value of capital accumulation it must be pointed out and should be recognized that with the great mass of people in the lower and moderate income brackets the self-denial incurred in saving is accepted and borne solely with the purpose of ensuring that the individual and those dependent upon him, when his earning capacity has ceased, should have enough to live on without becoming a public charge. The capital accumulated as a result of such saving was achieved in contemplation of the necessity of its expenditure later as a means of subsistence. Evidence submitted shows that the number of people who are able to support the expenditures necessary in their declining years and to provide for their wives or other dependents without trenching upon their accumulated savings are very limited: Where capital encroachments are found to be necessary, and the individual has recourse to a life annuity as the surest method of guaranteeing independence, it appears to be inequitable to treat that part of the annuity which represents an outlay of his capital as taxable income.

From the standpoint of the state it is manifestly desirable that as large a number of citizens as are capable of doing so should save and accumulate capital resources sufficient to maintain themselves when their capacity to earn income no longer exists. In this connection the effect upon the individual's sense of self-respect in remaining financially independent and in not being compelled to solicit aid from the state should not be ignored. Direct consumption of an individual's capital, which would not be taxable under the Income Tax Act, without the protection of a life annuity in many cases can lead to indigency through the premature exhaustion of resources before death occurs. Incidentally, it may be noted that it is an ordinary condition of receiving state aid that the applicant's capital resources, if any, must be reduced almost to exhaustion.

With regard to the alleged danger of the wealthy converting their capital into annuities for increased consumption purposes and thereby reducing the yield of revenue from estates under the Succession Duty Act if that portion of the payments from a life annuity that represents interest accruing on the capital invested is taxed as income, the incentive to follow such a course would be largely removed. As a matter of fact it is a strong argument for a change in the law that the wealthy man is not under the same compulsion to purchase an annuity to protect his old age. Not infrequently, the ability of an individual upon retirement from active work to convert part of his capital into a life annuity may prove to be the surest method by which the balance can be conserved to form an estate that would come under the Succession Duty Act. It should also be pointed out that when the Income War Tax Act was amended in 1940 to tax annuities there was no Dominion Succession Duty. The Dominion Government is now imposing a succession duty on annuities capitalized on life expectancy where there is a survivorship.

There appears to be no sound basis why a prejudice should exist against life annuities on the ground that payments received under them represent the turning of capital into current resources and thus leads to increased consumptive expenditures. This is especially true at the present time when great emphasis is being placed upon the importance of maintaining domestic expenditures at a high level after the war as a factor in national prosperity and when fears are being expressed over the possibility that over-saving may act in this respect as a deterrent.

Finally, it should be observed that under present administrative practice there is a method by which the individual, who contemplates purchasing a life annuity, can, at a somewhat higher cost, avoid largely the tax imposed on that part of the payments received under it that represents a return of capital. This can be accomplished by the purchase of two annuities instead of one. The first annuity would be for an annuity term certain covering the years of his life expectancy. The capital element in an annuity for a term certain is not taxable as income under the Income War Tax Act. On the date of the termination of this annuity the second annuity, a pure deferred life annuity, would then become effective if the annuitant is still living. With this annuity the total payments received under it would be taxable as income. It is an anomalous situation that two individuals each in substance with life annuities should be subject to differential taxation treatment under the Income War Tax Act.

In view of these considerations the Commissioners are of the opinion that the Income War Tax Act should be amended to exempt from taxation the capital element represented in annuities, but that that portion of annuities which represent interest accruing should be taxable as income.

### 3. *Government Annuities*

The Government Annuity Act, providing for the sale of Government annuities, became law in 1908. By this measure, annuities were to be made available to any person domiciled in Canada. Provision was also made for the purchase of annuities by societies or corporations on behalf of their members or employees. Annuities were not to exceed \$600 per year and were to become payable at the minimum age of 55. They were not to be assignable nor attachable and amounts paid in on deferred annuities were not recoverable except in the case of death when repayment would be made with interest on a 3% basis. The amount of interest allowable on the fund was to be fixed by Order in Council. This was subsequently set at 4%. In 1913, the maximum amount of \$600 a year for an annuity was increased to \$1,000.

The object of this legislation was stated to be the promotion of habits of thrift and to afford an opportunity for people to provide for their old age at the lowest possible cost and with the greatest possible security. The measure was not designed to furnish annuities for wealthy people but was intended only as an incentive to the person of small means. While no direct contribution was proposed from the Federal Treasury, it was intimated that some advantage might be allowed on the rate of interest and that the costs of administration might be carried by the Government. The measure met with practically no objection in going through Parliament and it was said at the time that the insurance companies were not interested in this class of business.

In 1920, a new principle was introduced into the Annuities Act when the maximum annuity purchasable was increased from \$1,000 to \$5,000 per year. The right to purchase an annuity was also made available to people "resident" in Canada. The limitation that annuities should not be paid until the age of 55 was eliminated and the rate of interest on sums repayable on account of

death before the annuity became due was increased to 4%. In explanation of these changes, the then Minister of Finance stated that there was a demand for larger annuities, that the sale of annuities was one method by which the Government could raise money (in 1920 the Dominion Government was borrowing money at slightly over 6%, whereas the rate on annuities was 4%) and that the wider appeal that annuities would make would popularize their sale.

In 1930, however, the Government reverted to the original idea of annuities being provided as the means to enable people in moderate circumstances to make provision for a relatively small income in their old age. An amendment to the Act reduced the maximum annuity available to \$1200 per year. The reasons given for this change were the fact that annuities were exempt under the Income Tax Act, that better health conditions had lengthened the age of annuitants, and that a decline had occurred in the earning power of money. It was stated that the Government had considered lowering the rate of interest on annuities from 4% but as an alternative had decided upon these other changes instead. In 1937, after an actuarial report the rates were revised upwards about 15%.

In 1940, Government annuities were made fully taxable as income under the Income War Tax Act with an exemption for annuity contracts issued prior to June 25th, 1940.

The sale of annuities began at the inception of the Annuities Branch on September 1st, 1908, but for a lengthy period the number of individual certificates and contracts issued was small. From March 31, 1909, to March 31, 1927, the average number issued per year was under 500. The average for the next eight years was 2,000 per year but the number issued had increased by 1935 to 3,930. Since 1935, the increase in number issued has been rapid, the average per year between 1935 and 1944 being approximately 8,500. For the fiscal year ending March 31st, 1944, individual contracts and certificates issued totalled 19,354. It should be understood that these figures cover both annuities issued resulting from individual purchases and those arising from the purchase of annuities by societies or corporations for their members or employees.

On March 31st, 1944, the balance at the credit of the Government Annuity Fund amounted to \$213,561,537. The receipts for the fiscal year ending on that date amounted to \$34,511,546. This includes an item for interest on the Fund at 4% amounting to \$7,802,408 or leaving \$26,709,137 receipts from the sale of annuities. The amount paid out for the fiscal year 1943-44 on vested annuities was \$10,812,872. The receipts of the Fund for the year 1944 include the sum of \$32,180 transferred to it by the Dominion Government presumably to maintain it in an actuarially sound condition. Transfers of this nature vary from year to year but in the aggregate amount to approximately \$10,000,000. The cost of the administration of the Fund, which is borne by the Government, is approximately \$275,000 annually.

The analysis of 24,662 vested contracts, that is where the annuitant is receiving payments under the contract, reveals that 75.1% were for amounts of less than \$600 per year and that 86.8% were under \$900 per year. The number of vested contracts with annuities of over \$1200 per year (issued prior to August, 1931) were 131 or only 0.5% of the total. About 85% of the annuitants were between the ages of 50 and 79 years inclusive, the largest single group being in the 60-69 age group which contained 38.5%. The proportion of male annuitants to female annuitants was approximately 1 to 2.

The Bill passed in 1908, brought within its scope the sale of annuities as mentioned above to societies, associations and corporations who might wish to purchase them on behalf of their members or employees. That is, Dominion

annuities were made available to employers who were setting up pension plans for their employees. This provision of the Act was not taken advantage of until 1938 but since that date, the Government Annuities Branch has developed business of this nature. For the year 1943-44, of the 19,354 contracts and certificates issued in that year, 13,568 related to annuities under a pension plan and the remainder to individual contracts. Of the total number of plans and certificates issued since the inception of the Annuities Branch, in round numbers 35,000 relate to those issued under pension plans and 70,000 to individual contracts. This would indicate that a good bit of the growth made in recent years in the sale of annuities was due to employers using the Annuities Branch in connection with their retirement plans. While the number of individual contracts issued has not been as large as might reasonably have been expected, it is apparent that the sale of Government annuities has met the needs of a substantial number of people who have desired protection of this nature for their old age.

The Dominion Government, in carrying the expenses of the Annuities Branch as a charge on National Revenue and in allowing a 4% rate of interest on the Annuity Fund, is contributing a subsidy to the holders of Government annuities that is not available to other annuitants. With respect to individual contracts, the person who acquires a Government annuity is usually not in a position to take advantage of a pension scheme and therefore, in laying aside savings to purchase an annuity, does not enjoy a deduction from his income under the Income War Tax Act that a contributor under an approved pension plan receives. Moreover, from the outset of this legislation, with a view to encouraging this form of thrift, the Government indicated that a measure of support would be given by the Dominion Treasury. In 1908, when the Annuities Branch was instituted, the current rate of interest on Dominion Government Bonds was approximately 3 $\frac{3}{4}$ %. In 1920, the rate rose on the average to slightly over 6%. In 1931, the rate was approximately 4.6% and at the present time the rate is around 3%. Throughout this period, the 4% rate on Government Annuities has stood without change. Maintaining an interest rate of 4% with respect to annuities arising out of pension plans arranged with the Annuities Branch by employers on behalf of their employees raises the question of the propriety of the Annuities Branch entering into competition for this business with private concerns which offer similar facilities. The Annuities Branch in making arrangements with employers for handling retirement funds has the advantage of being able to offer a higher rate of interest on the funds to be accumulated than the basis upon which the insurance companies must work. It was stated in evidence that the rates effective with the insurance companies for pension funds are about 35 or 40% higher than the Government annuity rates. Despite this difference under certain circumstances employers go to the insurance companies in setting up pension plans. One advantage in having an annuity with an insurance company is that if an employee withdraws from service he can get his money back. This is not possible under pension plans arranged with the Government Annuities Branch. This is the main difference. One employer writes "The first large group of employees which was not satisfied with the Government Annuity plan was the female group, who contemplating or hoping some day to be married, did not wish to enter a plan upon which they could not draw at least the contributions they themselves had made into it should they not stay until normal retirement date." A second reason for going to an insurance company for a pension plan based on annuities is that with employees in the higher income bracket the annuities desired may be larger than \$1200. per year, the amount of annuity to which the Annuities Branch is limited. While due recognition should be given to the difference in terms which exists between annuities issued by the Annuities Branch and those issued by an insurance company, there does not

appear to be any good reason why employers who are able to take advantage of the pension plans available with the Annuities Branch should receive Government assistance in having the funds contributed by them accumulated at a higher rate of interest than that currently available to other employers.

In any event the fact that the interest rate on contractual annuities issued by the Government Annuities Branch is higher than the current power of money does not disturb the conclusion that these annuities should be taxable under the Income War Tax Act only on the interest element in the payments received by the annuitant.

#### 4. Contractual Annuities issued by Insurance Companies.

Contractual annuities issued by insurance companies are the result of direct sales of annuities by the companies or of settlements made under insurance policies. At the end of December, 1943, the record for Canadian insurance companies shows that there were in force at that date 48,010 ordinary deferred annuities providing for annual payments \$18,900,000.; 8,391 vested annuities for \$3,310,000. and 9,246 contracts arising out of settlement of life insurance policies for \$4,193,775. Of the latter, a substantial portion were for annuities with a term certain. Ordinary annuities purchased from an insurance company are of the same nature as those issued by the Government Annuities Branch except that they may be larger in amount.

After 1929, when annuities were by the Courts held taxable as income and the Income War Tax Act was amended to exempt annuities issued by the Government Annuities Branch and *like* annuities, the practice of the insurance companies, when an insurance policy with an annuity option became a death claim, was to terminate the contract and to give to the beneficiary in its place a new or supplementary contract for the annuity. The reason for issuing this new contract was to give the beneficiary an annuity which would qualify without question as being *like* a Government annuity and, therefore, would entitle the holder to the exemption provided under Section 5(1)(k) of the Act.

Following the withdrawal of exemption on life annuities issued after June 25th, 1940 under Section 5(1)(k), a new practice was adopted by the insurance companies, that of issuing two contracts: (1) an annuity with a term certain on which income tax would apply only on the interest element in the payments made and (2) a pure deferred annuity which would commence after the term certain annuity had run out. The payments from this second annuity would be fully subject to income tax but in this way, part of the burden of income tax on what was in effect a life annuity, would be avoided. This course, however, was not possible where the insured had stipulated for payments to the beneficiary in the form of a straight life annuity.

If the interest element represented in the payments made under a life annuity contract alone were taxable as income, the issuing of two contracts by the insurance companies in settlement of death claims where annual payments are specified would probably cease. Discrimination in tax treatment exists at present as between two beneficiaries where in one instance the insured has stipulated a straight life annuity and in the other instance where it is possible for the insurance companies to issue two contracts.

The accumulation of earnings to provide for old age and for dependents through the medium of life and endowment insurance policies has become almost universal. When the insured considers that he can best protect his widow or dependents by investing such an accumulation of capital in a life annuity, the annuitant is clearly entitled to receive the same taxation treatment as that which is applicable to the purchaser of an ordinary contractual life annuity.

In both instances a sum of money is laid out in the purchase of a life annuity; in both instances the payments made to the annuitant as the result of the annuity contract represents a return of the capital that has been invested in the annuity together with such interest as has accrued upon it. The interest element alone should be taxable as income.

5. *Technique of taxing the income element in annuity payments.*

The purchase of a life annuity means that the annuitant pools his capital with other life annuitants, and in effect agrees to a common distribution of capital out of the pool. In exchange for the certainty that he will receive payments if he lives beyond the years of his life expectancy, he surrenders to the pool that portion of his capital remaining at the time of his death.

In taxing that part of the payments received which represents the individual annuitant's share of the income of the pool or fund, the state must necessarily have regard to the nature of the investment. Different countries, in conformity with their tax structure, apply different methods of taxation in dealing with the income portion of an annuity. The problem is to select that method which is most appropriate to the national tax structure. For Canada the method recommended is that suggested by Mr. A. D. Watson, Chief Actuary of the Insurance Department of the Dominion Government, in a personal submission. The adoption of this method would represent an extension to the taxation of life annuities or other periodic payments of the practice that is now employed by the Income Tax Department in taxing the income portion of annuities certain.

By this method the purchase price or commuted value of the annuity is subtracted from the sum total of the annual payments expected to be received under the annuity computed on the basis of the life expectancy tables. The result gives the total amount of income taxable for that period. This sum is then divided by the number of years the payments are expected to run. The quotient is the average amount of income derived each year from the investment and taxable as such. With this method, when the annuity is purchased, the contract should either bear on its face a statement showing the average portion of the annuity payments to be received from it each year, which represent income, or a statement should be supplied to the annuitant by the vendor containing this information for income tax purposes.

The advantages of this method are its simplicity and certainty. The annuitant knows from the outset the amount of income upon which he will be subject to tax each year. If the annuitant dies before the age limit of expectancy is reached, the taxable income ceases. If he lives beyond the age limit of expectancy, he receives an enhanced rate on his investment and the income portion received will continue to be taxable throughout the duration of the payments. In this way, in the aggregate, the Income Tax Department will bring under tax all the income payments received by the individual annuitants under their contracts.

Of the various forms of annuities currently issued, the most important are: annuities for a term of years; annuities for life; annuities payable for a term of years certain and thereafter during the lifetime of the annuitant, and annuities with a joint survivorship. The "Watson" method of taxing the income portion of annuities is equally applicable to each form and its general extension to the whole annuities field appears to be quite feasible. When an annuity is purchased by instalment payments, the commuted value of the annuity purchased should be the tax base.

Recognition of the principle that only that portion of annual or periodic payments that represent income is taxable and the adoption of the "Watson"



method of giving effect to this principle would introduce into the Income War Tax Act a large measure of simplification in the administration of the field of taxation of periodic payments whether received under a contractual annuity or an insurance policy.

#### 6. *Annual or Periodic Payments received under the Provisions of a Will or Trust*

At the outset it is desirable to set forth briefly the conditions under which annual or periodic payments are made under the provisions of a will or trust.

The situation is that at no time do the capital funds contained in a trust lose their identity. The transaction is not one of purchase and sale. The trustee does not guarantee annual payments of fixed amounts during the whole of the lifetime of the settlor or of his beneficiaries, nor is there any certainty that the funds placed with the trustee will continue to be sufficient for such a period. Similarly, with respect to annual or periodic payments received under wills, no purchase of an income occurs and no guarantee is given or certainty exists that payments will be made for life or for any definite period. When the assets of an estate are under the management of a trustee, payments from it continue only so long as the capital and its earnings last.

Where a trust is set up during lifetime, the main purpose usually is to afford protection against the vicissitudes of business, failing health and judgment. These trusts are ordinarily established to relieve elderly persons and others from the problems incidental to the management of property. They are also established to provide for invalid or improvident children or dependents. Placing the funds in the hands of a trustee insures that the beneficiary will be maintained, not become a public charge and that the funds will not be unwisely dissipated. With these trusts the demarcation between payments made from capital and from earnings is as distinct as with similar payments made under the provisions of a will.

If the annual payments required to be made under a will or trust entail encroachments upon the capital assets, these encroachments will necessitate the sale of certain specific assets in the trustee's account. Indeed, the Income War Tax Act in its present form does not contemplate that these payments will be made purely out of the earnings of the capital involved. The Act categorically states that annual payments "that are in whole or in part paid out of capital funds of the estate or trust" are to be treated as income.

It is obvious that all of the considerations that make it illogical to tax as income under the Income War Tax Act that part of a purchased annuity that represents a return of capital to the annuitant apply with additional strength when, in a case of a trust or will, the payments made represent not the return of the proceeds of the capital invested but are only made possible by the sale or disposal of the actual capital assets placed with the trustee. There can be no possible doubt or ambiguity about the fact that income tax is here being levied directly upon capital. Such a procedure violates all the conceptions that ordinarily govern in the framing of an income tax statute.

The appropriate instrument to tax such capital, if it is to be taxed, in the fiscal economy of the Dominion is, we think, the Succession Duty Act or in certain instances the gift tax. When, in 1936, the Exchequer Court held in the Whitney case that annual payments out of an estate could not be taxed as income, there was no Dominion Succession Duty Act and therefore a man under his will could provide that a certain person should receive annual payments for life payable out of the capital or partly out of the capital of his estate and the Dominion of Canada would receive no revenue. The amendment to the Income War Tax Act of 1940, bringing annual payments out of capital or partly

out of capital under the income tax, was a method of meeting this situation. However, with the enactment of the Dominion Succession Duty Act in 1941, any reason why capital should be taxed as income under the Income War Tax Act disappeared.

The present situation is really indefensible. Under the law as it stands, income tax is levied upon a man's income including that portion laid aside for capital accumulation. When he dies this capital, as part of his estate, is taxed under the Dominion Succession Duty Act. If, in an endeavour to protect his widow or dependents so far as he is able, he directs that annual payments are to be made to them out of his estate, these payments are again taxed as income. Thus the capital accumulated by his savings is taxed twice under the Income War Tax Act as income and once under the Dominion Succession Duty Act as capital. If the testator were to place no safeguards around the handling of his estate and it were allowable for the beneficiaries to withdraw capital sums from it at any time and to any degree, no income tax would be imposed under the Income War Tax Act on these withdrawals. Annual payments provided by a prudent testator are taxed on a basis which is unjust and discriminatory. Moreover, ample evidence was furnished the Commissioners from actual cases that the impact of payments due under succession duty combined with those due from the full taxation of annual payments by the Income War Tax Act often inflict crushing burdens for a number of years on the beneficiaries of an estate.

In addition to considerations of logic and equity, it is clearly in the public interest that small estates, which do not afford sufficient income from revenue to maintain a widow or dependents, should be carefully managed in order that the total resources be not unwisely and prematurely dissipated. These small estates are by far the most numerous. The trust companies of Canada report that over 50% of the estates that have gone through their companies during the last five years were under \$25,000. in amount. A more general example is supplied by figures submitted from the Province of Manitoba. During the period October 1st, 1932, to October 1st, 1942, succession duty papers were filed with respect to approximately 10,006 estates of residents of that Province. Of these, 7,264 were for a gross value of less than \$10,000.; 2,080 were between \$10,000. and \$25,000. In 1943, there were approximately 1190 estates of Manitoba residents which filed succession duty papers of which all but 64 were less than \$25,000. in amount.

The problem that constantly arises with these small estates is how to insure sufficient means to maintain a widow and dependent children until the latter are old enough to support themselves. In the case of a widow without dependents, the purchase of a life annuity may solve the problem but with dependent children, the wisest solution in many instances is to provide for annual payments out of the estate and its earnings under a trustee. The levying of income tax upon the portion of these payments which is paid out of capital often means that the beneficiary becomes liable to income tax when the revenue yield from the estate alone would not warrant such an imposition.

With a view to avoiding the severity of a tax of this nature, the testator is tempted to leave his estate in the form of a lump sum settlement. The objections to such a disposition of his resources are briefly, the inexperience of the widow in handling property, the danger of loss through unwise loans or other investments made in an attempt to expand the income from the estate and the tendency to exhaust the estate prematurely by greater withdrawals from it than are really necessary to live upon. With lump sum settlements, the possibility is increased and always present that the widow, through the unwise

handling of limited resources, may have to rely ultimately on an old age pension for support and thus become a public charge. It is in the general interests of Canada that every reasonable inducement should exist for persons to provide for themselves and their dependents and that in making the most provident use of limited resources to this end they should not automatically become subject to the penalty of heavier taxation.

An incidental result of importing the alien principle of taxing capital into the Income War Tax Act under Section 3(g) is that it creates uncertainty with regard to what periodic payments under a will or trust will be deemed "annual payments" under the Act and as such become taxable in full. This uncertainty leads to difficulty in drawing wills that will give effect to the testator's intentions without incurring taxation penalties. It widens the field of administrative discretion, already very extensive in the Income War Tax Act, and seems bound to increase litigation with the Crown. It contravenes Adam Smith's famous maxim that "The tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid are all to be clear and plain to the contributor and to every other person."

The remedy lies in strict adherence to the basic principle embodied in the Income War Tax Act, namely, the taxation of the annual income arising from the use of capital but the exemption of capital itself. Section 3(g) should be amended to provide that to the extent only that such payments are made from the income of the estate or trust should they be taxable.

## B

### PENSION, SUPERANNUATION, AND OTHER SIMILAR PAYMENTS

#### 1. *Law Relating to Pensions under Income War Tax Act.*

The first mention of pensions is in the 1919 amendments to the Income War Tax Act (1919 Cap 55). By that statute, subsection 7 was added to section 3 of the Act allowing the deduction from income of contributions to a pension fund or plan retained by an employer from the remuneration of an employee and paid into such a fund or plan, the same amendment providing that the pension should constitute taxable income to the taxpayer.

After the revision of the Act in 1927, this was broken down into two parts:

Section 3(c) in the 1927 statute included as taxable income

"any payment to any employee out of any employees' superannuation or pension fund or plan"

In 1941 (C. 18 S. 5) section 3(c) was amended to read

"any payment out of any superannuation or pension fund or plan"

so as to include payments made after retirement of an employee, or to a widow after the death of an employee.

In 1942 (1942-43 C. 28 S. 3) due to the heavy taxation of lump sum payments made to retiring employees or on their death in a year when tax rates are high, it was again amended and now reads:

(c) any payment out of any superannuation or pension fund or plan: provided, however, that in the case of a lump sum payment out of any

such fund or plan which is paid upon the death, withdrawal or retirement from employment of any employee or former employee in full satisfaction of all his rights in any such fund or plan, one-third only of such lump sum payment shall be deemed to be income; and

The other part of the original section 3(7) was on the revision of 1927 enacted as subsection (g) of Section 5(1), dealing with exemptions and deductions from income. It then provided that income should be subject to deduction of

"any part of the remuneration of a taxpayer retained by his employer in connection with an employee's superannuation or pension fund or plan".

In 1936, (C. 38 s. 5) this was limited to \$300 in any one year, and in 1942 (1942-43 C. 28 s. 5) it was further limited to plans approved by the Minister.

In 1944, (1944-45 C. 43 s. 4) the section was further amended to extend the deduction to amounts paid by a taxpayer as part of his union dues into a superannuation fund or plan having the Minister's approval, and a further deduction up to \$300 per year was allowed to a taxpayer for payments made in respect of past services into an approved pension fund or plan. The present section reads as follows:

"(g) in respect of amounts for superannuation or pension funds or plans approved by the Minister for the purposes of this paragraph

- (i) an amount not exceeding three hundred dollars in the taxation year, actually retained by the employer from the remuneration of the taxpayer for an employees' superannuation or pension fund or plan in respect of services rendered in the taxation year or paid by a taxpayer who is a member of a trade union as part of his union dues, and
- (ii) an amount not exceeding three hundred dollars in the taxation year, paid to an employees' superannuation or pension fund or plan by the taxpayer in respect of services rendered by him previous to the taxation year while he was not a contributor."

It might be noted here that contributions made by employees of the Dominion Government under the Civil Service Superannuation Act are by Section 13 of that Act (R.S.C. 1927 C. 24) wholly deductible.

In 1928, to relieve the hardship of having the income of a pension trust subject to income taxes, a new sub-section (h) was added to section 5(1) giving the trustees of a pension fund the right to elect to have the income of the fund freed from taxation in the trustees' hands. If such election was exercised, then the employee forfeited his right to deduct from income his contributions into the fund, but on the other hand, the payments out of the fund to the employee in the form of a pension or a lump sum payment were exempt from tax in the proportion that the amounts paid by the employee into the fund after the effective date of the election bear to the total amount paid in by him. The section as enacted by 1928 C. 12 s. 6 and still in effect is as follows:—

"(h) In case of a trust established in connection with, or a corporation incorporated for the administration of an employees' superannuation or pension fund or plan, the income from the investment of the superannuation or pension funds shall be exempt if the trustee or corporation so elects. In such event the exemption provided for by the next preceding paragraph shall not be allowed but any payment to an employee out of the fund shall, notwithstanding anything contained in this Act, be exempt according to the proportion that the sum of the amounts

paid by the employee into the fund after the effective date of the election bears to the total amount paid by him into the fund.

Election shall be effected by writing, addressed to the Minister, signed by the trustee or corporation in control of the fund.

Notwithstanding the date of election, the Minister shall have full power to determine from what date the election shall take effect."

It should be noted that this election applies only where there is a separate pension fund administered by trustees. The more common pension plan, handled through group annuities issued either by the Government Annuities Branch or by an insurance company provides no right to elect since there is no distinct fund.

Employers' contributions into a pension scheme or plan were for a long time considered deductible by the employer as a general expense of his business, but as there was some doubt as to this, due to deductions being limited to expenses "wholly, exclusively and necessarily" expended in the earning of the income, Section 5(1)(ff) was enacted in 1941 (1940-41 C. 18 s. 6) providing generally that an employer might deduct an amount not exceeding \$300 for each employee actually paid into a pension or superannuation fund, provided that the total did not exceed 5% of the payroll calculated on the basis provided. This section was amended by 1942-43 C. 28 s. 5 and now reads as follows:—

- (ff) The amount actually paid by an employer to an employees' superannuation or pension fund or plan, approved by the Minister for the purposes of this paragraph, in respect of the services rendered to the employer by his employees, officers or directors, within the taxation year; provided, however, that such amount shall not exceed five per centum of the aggregate compensation paid within the taxation year to such employees, officers and directors covered by the said fund or plan after deducting from such aggregate compensation the excess above six thousand dollars paid to any such employee, officer or director, and provided further that in computing the amount actually paid by such employer the excess above three hundred dollars paid in any year in respect to the services of any such employee, officer or director shall not be allowed for the purposes of this paragraph.

In the meantime it was found that many funds were actuarially unsound due in part to falling interest rates and decreased mortality, and on this account and in order to take care of older employees on establishment of a pension fund or plan provision was made by adding Section 5(1)(m) (1938 C. 48 s. 5) enabling the employer to obtain tax deduction on lump sum payments into a fund or plan. This Section was amended in 1942 (1942-43 C. 28 s. 5) to provide that the payment must be approved by the Minister on the advice of the Superintendent of Insurance and it was further amended by 1944-45 C. 43 s. 4 and now reads as follows:

- (m) In respect of a special payment or payments made in Canada by an employer on account of an employees' superannuation or pension fund or plan in respect of past services of employees pursuant to a recommendation by a qualified actuary in whose opinion the resources of such fund or plan require to be augmented by an amount equal to the special payment or payments to ensure that all obligations of the fund or plan to the employees concerned may be discharged in full, approved by the Minister on the advice of the Superintendent of Insurance and made so that an amount paid is irrevocably charged for the benefit of the fund or plan,

- (i) if the whole amount so recommended to be paid is paid in one year, one-tenth of the payment in each of ten successive taxation years commencing with the year in which the payment is made; and
- (ii) if one-tenth of the amount so recommended to be paid, or less, is paid pursuant to a plan whereby the whole amount is to be paid over a period of years, the amount of the payment made in the taxation year:

Provided that where a payment described in subparagraph (i) of this paragraph has been made before the nineteen hundred and forty-four taxation year and is approved by the Minister, one-tenth thereof may be deducted in the nineteen hundred and forty-four taxation year and in each taxation year thereafter until ten successive years, beginning with the year of payment, have elapsed.

The tax situation therefore is now as follows:

In the case of a pension fund where the trustees have elected under 5(1)(h), and for all practical purposes the trustees of all separate funds have elected

- (a) The employee's contributions are not deductible.
- (b) The income of the fund is exempt from tax.
- (c) The employer's contributions are deductible within the limits prescribed.
- (d) The pension to either employee or his dependents is exempt from tax (in the proportion the employee's contributions after election bear to his total contributions). This applies also to lump sum payments to *employees* but
- (e) A lump sum payment out of the fund to dependents on the death of an employee, is considered taxable income to the extent of one-third in the year of receipt.

In the case of a pension plan with no separate fund where there is no election

- (a) The employee's contributions are deductible within the prescribed limits.
- (b) The income earned by the contributions, there being no separate fund, is not taxed.
- (c) The employer's contributions are deductible to the same extent as in the case of funded plans where the trustees have elected.
- (d) The pension to either employee or his dependents is wholly taxable.
- (e) Lump sum payments to an employee or his dependents are considered taxable income to the extent of one-third in the year of receipt.

The position, therefore, leaving aside the matter of lump sum payments on retirement or death, is that where there is a fund and the trustees have elected, the only part of the money available to provide the pension that has ever been brought into charge for income tax, is the total of the employee's contributions. The employer's contributions (within the allowable limits of section 5(1)(f) and the income of the fund have never attracted tax. On the other hand, where there is no separate fund, all money going to provide the pension is taxable income in the hands of the employee or his dependents when received as a pension.

It might also be pointed out that both types of pension, where extended to the employee's dependents on his death, are treated alike for Succession Duty purposes. The present value of the pension is determined by the value of a

comparable life annuity, and the question whether or not the pension will be liable to income tax is not taken into account in arriving at its value.

Payments made by an employer to a retiring employee, apart from any pension plan, have always constituted a troublesome problem for the Income Tax authorities. The general principle is that if such a payment is expressed as a straight gift and no tax deduction is claimed by the employer, the payment will not be taxable in the hands of the employee, nor will a retiring employee be liable to tax if the payment is made to him as compensation for the loss of his office. If, however, the payment is made in recognition of past services, he will be taxable on the full amount of the payment, and the employer, if subject to tax, may generally claim the payment as a deduction.

To relieve against the hardship of having the entire amount brought into charge in one year, Parliament in 1944 (1944-45 C. 43 s. 2) added Section 3(6) to the Act as follows:—

6. Where the Minister is satisfied that a single payment by an employer to an employee upon retirement, other than a payment out of or pursuant to a superannuation or pension fund or plan approved by the Minister, is in recognition of long service, one-fifth only of the payment shall be deemed, for the purposes of this Act, to be income of the taxpayer in the year it is received and one-fifth thereof shall be so deemed to be income of the taxpayer in each of the four succeeding years in which he is living.

## *2. Principle of Equality of Treatment.*

In considering the taxation of annual, periodic or lump sum payments made under pension plans or in the form of superannuation allowances, it is important to recognize the essential difference between such payments and those arising from ordinary insurance or annuity contracts or from wills and trust instruments.

In discussing the taxation of annuities and payments made from estates and trusts in the previous sections, it has been assumed that the capital value of the payments in question was accumulated or acquired by the owner out of receipts which, if in the nature of taxable income, had been taxed. The payments which are dealt with in this section are those which in whole or in part derive from contributions of an employer, which contributions at least until they emerge as pensions, are not treated as taxable income in the hands of the employee.

As a result of this fact, it is necessary to revert for a moment to the concept of income which was discussed in Section A. It was there suggested that, while the word income has different meanings, for the purposes of levying income tax, income is essentially considered as having two principal components — rewards for services and earnings of capital. There can be little doubt that the contributions made by an employer to employees pensions, irrespective of how such contributions are made, are essentially a reward for services. It may be that the employer regards his contributions in a somewhat different light from the annual outlay for wages and salaries, but this does not alter the fact that the aggregate which the employee or his dependents receive from the employer is in the nature of a reward for services rendered, and as such should be considered as taxable income in the hands of the employee.

In order that the burden of taxation may be spread with the greatest possible degree of equity, and accepting the concept that taxable income should include rewards for services, it follows that the law should strive to give equivalent treatment to all individuals irrespective of the way in which they are rewarded for their services. There are a great many ways in which such rewards are paid,

but for the purposes which we are here considering, all persons may be divided into two broad categories:

- (1) Those individuals who render their services in consideration of a reward payable partly during the period in which the services are being rendered, and partly after the termination of such services; examples of this class are employees of Governments, institutions and corporations which provide pensions or superannuation allowances;
- (2) those individuals who render their services in consideration of remuneration which will be received wholly during the period in which the services are rendered; this category includes employees of concerns which do not provide pensions or superannuation allowances, persons engaged in the professions, individual merchants, traders, farmers, craftsmen and the like.

In order to obtain some idea of the relative importance of these two groups the Commission engaged the services of the Department of Industrial Relations of Queen's University to make a study and report on the pension plans and funds now in force in Canada, and the extent of their coverage.

The results of this study are given in Appendix "A" to this report, and while a number of interesting conclusions can be drawn therefrom, there are two facts of the utmost importance which are brought out. The first is that the percentage of persons gainfully employed in Canada who have access to a pension plan or fund is relatively small; it is the minority only who enjoy the advantages of such a plan. The great majority of gainfully employed must make provision for their old age and for their dependents out of the earnings received in their working years, which earnings in their entirety are treated as taxable income.

The comparative position of persons in these two groups can best be illustrated by considering the position of two individuals, one an artisan who provides for his old age by the purchase of a deferred life annuity, and pays the whole cost thereof out of his current earnings; the other an employee of an institution, who after retirement receives a pension for life from his former employer without the employee having made any cash contribution to such pension.

It has already been demonstrated that in the first case the artisan should not again be subject to income tax to the extent that he draws down his capital accumulation by the annuity method. He has already paid his full share of taxes on the income as it was being earned, and in drawing his annuity payments to support himself in the latter years of life to the extent that it represents his savings, he is simply enjoying a benefit which he has postponed. The second individual, however, is in a different position; he is in no sense receiving back his own capital, but rather is in receipt of a deferred reward for services, the whole of which can and should properly be considered as taxable income. Between these two extremes, the man who must make his own provision for old age, and the man who receives what is generally called a "non-contributory pension", there are numerous types and kinds of pension or superannuation arrangements. Before proceeding to discuss the taxation of such pensions it is necessary to consider the basis on which the funds are accumulated.

### 3. *Essential Components in Pensions and Superannuations*

No two pension plans appear to be exactly the same, but they all rest on two or more of the following three components:—

- (1) Employees' contributions



- (2) Employers' contributions
- (3) Interest received by the trustees on accumulated contributions.

At the present time the Income War Tax Act provides that the trustees of a funded pension plan may elect as to whether or not the interest earnings on the fund shall be subject to income tax in the hands of the trustees. If an election is made that such interest shall not be taxable, the employees receive no deduction from their personal income in respect of their contributions to the fund, but on the other hand the pensions paid from the fund may be received by the retired employee on a tax free basis. In the alternative, the interest on the fund is taxable as income in the hands of the trustee, but employee's contributions into the fund, within a certain prescribed maximum, may be claimed as a deduction by the employee in computing his personal income tax. This alternative arrangement results in the payments made from the fund to the retired employee being treated as taxable income in his hands.

The majority of pension plans in force in Canada utilize the facilities of the Dominion Annuities Branch or of life insurance companies. In these cases there is no distinguishable fund, and, therefore, no annual interest or earnings on the fund subject to tax. Under these circumstances an election to have the income tax-free in the hands of the trustee would be meaningless, and there is, therefore, no provision in the law for the trustees of the plan to elect as provided for funded plans under Section 5(1)(h) of the Income War Tax Act.

The other class of pension plans are those which maintain a separate fund. In these cases the trustees of the fund have a technical right to elect under Section 5(1)(h) but, in fact, they have no real choice as to their course of action because under to-day's tax rates a failure to elect would create an intolerable situation for the fund. These funds are based on actuarial calculations of life expectancy and the current level of interest rates to be received on the accumulated funds is, of course, taken into account in determining the scale of contributions to be made, and of pensions to be paid. A fund producing an income of any size would, under current tax rates, lose such an important element of its revenues that it must perforce elect to have its income tax-free. It follows, therefore, that there is in fact no real choice available to the trustee of a pension plan or fund, and that for all practical purposes the provisions for election in the Act are meaningless.

The Commissioners are of the opinion that under no circumstances should the earnings of an approved pension fund be subject to tax in the hands of its trustees. There seems to be a clear analogy between the operation of these funds or plans and the operation of life insurance companies, which issue annuity contracts or endowment insurance contracts. In fact, a pension plan would seem to come within the spirit, if not the letter, of the exemption provided by Section 4(1)(g) of the Income War Tax Act.

#### 4. *The Employee's Contribution*

As the law now stands one class of individual in Canada is required to pay tax on his savings in their entirety during the period when his services are being rendered. The other class, through the medium of a pension fund or plan, is permitted to postpone the taxation of some part of the reward for his services until after he has retired from active employment.

If theoretical equality were to be achieved between these two groups one of two courses would have to be adopted; either the employee, who in due course will receive a pension from his employer, should be taxed in his working years on something more than he actually receives, namely, on the contributions of his employer or, alternatively, those in the other class should be allowed

postponement from taxation of some part of their actual earnings to the extent that such earnings were put aside for use after retirement.

There are these two different forms of treatment, but it is not at all certain that one is necessarily more advantageous than the other. A true comparison could only be made if it were possible to forecast, with accuracy, the level of income tax rates and the level of statutory exemptions under the Act.

In Part "D" of the report consideration will be given to the possibility of an extension to the general taxpayer of the principle of postponement of taxation of a part of the reward for services. The paragraphs which follow deal only with the problem as it relates to pensions.

The Commissioners have had it brought to their attention that the present provisions of the Income War Tax Act cause serious hardship to those persons who are looking forward to a pension which will not be in excess of the statutory exemptions. Such an employee participating in a pension plan which operates a fund, the trustees of which have had perforce to elect that the income of the fund should be free of tax in their hands, is held to have a less advantageous tax position than the employee who, under similar circumstances, participates in a pension plan operated through an insurance company or the Dominion Government Annuities Branch. The latter employee gets credit in his personal income tax for his contribution to the pension, and will escape tax on the pension when received, because the aggregate pension would be less than the statutory exemption. On the other hand, and considering a man in a higher income bracket, it has been argued before the Commission that it is socially desirable to encourage individuals to pay as much tax as possible during their working years, with a view to minimizing obligations in the latter years of life when income is reduced and earning power gone.

The Commissioners have considered the desirability of maintaining alternative courses in this respect. It is probably the case that if the right of election referred solely to the time at which an employee's contribution was taxed, rather than to the taxation or non-taxation of the income of the fund and of the employer's contribution, few pension funds would elect to have the employees' contributions taxable as made into the fund. It must be the case that the great majority of employees look forward to a pension that would be less than what might reasonably be expected to be the statutory income tax exemptions in more normal times, that is a figure somewhat in excess of the present level of exemptions. Under these circumstances, it would be in the interests of the majority of contributors to pension plans to obtain the benefit of an exemption as their contributions are made into the fund, since in all probability their pensions when received would not be subject to income tax. The exception might occur where the average employee was in the middle or higher income brackets. But even in such instances the employees in the lower income brackets, and there would be some even though in the minority, would be penalized. An important factor is that the choice cannot be left to the individual concerned, but must be made by the trustees of the Pension Plan.

Another important factor is that the majority of pension plans now in force do provide for a deduction in respect of the employee's contribution at the time the contribution is made, and, therefore, for a pension which in its entirety is taxable income. This alternative makes for simplicity and appears to the Commissioners as logical and practical. There is, after all, little difference between the position of an employee of, say, the Dominion Civil Service, who must contribute 5 per cent. of his salary to a Pension Fund, and the position of an employee of another organization, who received a salary of 95 per cent. of the Civil Servant's salary and, in addition, a "non-contributory pension" equal

to the Civil Servant's Pension. In the latter case the employee, in effect, postpones the taxation of part of his earnings until the latter years of life.

There does not appear to be any logical justification for the present provisions of the Law, which, under certain circumstances, provide that the pension shall be tax-free in the hands of the pensioner, simply because the contributions by the employee were subject to taxation in his hands at the time they were made. This provision of the law seems to be an arbitrary course, which was taken because at the time there appeared to be no logical basis on which to divide the resultant pension into taxable and tax-free parts.

A theoretical basis for separating such a pension into taxable and tax-free parts, would be to treat as tax-free the return of capital in that portion of the pension which derived from the recipient's own contributions, and to consider the balance as taxable, being the part which would, in fact, have derived from the employer's contributions. Such a division, however, would be almost impossible of computation unless the trustees maintained two separate and distinct funds — the one composed of employees' contributions, and the other of employer's contributions.

The Commissioners are of the opinion that to impose a requirement that two funds be maintained would be unduly burdensome, and also doubt whether many pension plans would take advantage of such a provision even if the opportunity were available to them. Accordingly, the Commissioners are of the opinion that the relatively few pension funds which have made the election provided for in Section 5(1)(h) of the Income War Tax Act should, in respect of the future, be brought into line with the alternative course, namely, that employees' contributions be allowed as a deduction by them in computing their personal income tax, and that the pension payments be taxable income in the hands of the recipient.

While the Commission is satisfied that this general principle should be adopted in respect of the future, it is of great importance that any change which is now made in the Law should not work a hardship on those individuals who are at the present time members of pension plans which have elected under Section 5(1)(h). We are impressed with the fact that alternative courses of action have been open to the management of pension funds in the past, and that the decisions taken by the trustees of such funds were made by them in good faith under what was then the Law. It is probably impossible to devise any simple rule which would do complete justice to all individuals concerned and it is, therefore, the view of the Commission that whatever arrangement is made should err in favour of the members of these funds.

The present law has provided for a right of election by pension trustees only since the year 1928. In order to adjust for the different tax treatment accorded to members of funds before and after the date of an election under Section 5(1)(h) the present tax law provides that the resulting pension out of such a fund shall be divided into a taxable and a tax free part, the exempt part being that proportion which the contributions made by an employee since the date of election bear to the total contributions which he has made to the fund. At best, this is an arbitrary decision and we are not satisfied that it is necessarily fair to all employees. In many cases, the pensions which are payable out of these funds are determined by relating the years of service to the salary at retiring age and bear no exact relation to the actual contributions made by the employee. However, it would probably cause the least interference with the pension position of employees now contributing to pension plans affected to extend the principle for division of pensions under Section 5(1)(h) to cover any changes made as a result of our recommendation.

The law at present provides an upper limit on the amount of an employee's contribution which may be claimed as a credit in calculating the employee's personal tax liability. This provision does not limit contributions which an employee may make, but simply limits the extent of the deductions he can claim for income tax purposes. It is noted that this limitation does not apply in the case of the Dominion Civil Service Superannuation Plan. The question arises as to whether or not it is necessary for the law to provide an upper limit in respect of employees' contributions.

In this connection it has been brought forcibly to the attention of the Commissioners that the present limit of \$300 is in the case of some employees quite inadequate, in view of current interest levels. We have been told that if the general objective is to provide a pension of approximately one-half of the salary at retirement then the contributions from the employer and employee must total approximately 18 per cent, rather than the aggregate now permitted, which in the case of higher paid employees cannot exceed 10 per cent. In the case of the employee contribution the present limitation of \$300 a year, may have served a purpose when considered in relation to the other provisions of the Tax Act dealing with pensions and pension funds; however, if our recommendations are accepted, so that all pension plans will be treated on the same basis and the employee's contribution allowed as a deduction from his income when made, and the total resultant pension taxable, it would seem unnecessary to provide for any upper limit on the employee's contribution. To provide such a limit would mean that if an employee's contribution to the fund exceeded the prescribed maximum, a part of the resulting pension would derive from contributions which had once been treated as taxable income in the hands of the pensioner. Applying the general principles which we have recommended, it would follow that some part of the pension should be received tax-free, but, as has already been pointed out, this presents serious difficulties in the determination of the part of the pension that should be so exempt from further income tax. The only purpose that the upper limit on the employee's contribution can serve is to prevent the possibility of a few persons taking undue advantage of the principle of postponement of taxation. It has been argued before us that a number of provisions in the Income Tax Law have been introduced to prevent a few unscrupulous persons from taking advantage of a particular situation, notwithstanding that such provisions act to the detriment of many other taxpayers; it has been urged upon us that the many should not be prejudiced in order to catch the few. The alternative course, however, may result in an extension of the principle of administrative discretion, and many of the witnesses appearing before us have urged the adoption of arbitrary provisions of the law in order to avoid the necessity for reliance on administrative discretion. In general, it is our view that specific provisions in the tax law, notwithstanding that such provisions may be somewhat arbitrary, are none the less more desirable than provision for administrative discretion. However, in the present case the Commissioners are of the view that it is unnecessary to provide an upper limit on employees' contributions to pension funds, and that the situation will be controlled adequately by reason of the fact that the plans, in any event, must have the approval of the Minister before they can take advantage of any of the special provisions in the law relating to such plans. If, however, it is deemed necessary to provide an upper limit, we urge strongly that the present limit be raised and that such limit be reviewed from time to time in the light of current interest levels and other economic conditions. Maxima which are provided in the tax law must, to achieve their purpose and to give equity, be reviewed periodically in the light of current circumstances, which may represent a complete change from the circumstances which governed the original decision.

### 5. *The Employer's Contribution*

The Commission is not directly concerned with the taxation treatment accorded the employer in respect of contributions which he may make to pension funds. Our concern is with the position of the retired employee. Furthermore, it does not appear that the taxation treatment of employees' pensions should vary as a result of the employer's tax status. There can be no logic in treating the pensioner of a university differently from a pensioner of a commercial enterprise, merely because the pensioner happened to have a different type of employer.

At the same time, some aspects of the employer's position have been drawn to our attention, and appear worthy of consideration.

The first is the limit placed by the present law on the amount of contributions to a pension plan which may be taken as a deductible expense in determining the taxable income of a commercial undertaking. Today we think in terms of price and wage ceilings and there is no doubt that such regulatory devices should not be exposed to defeat by permitting unlimited increases in employer contributions to pension funds. However, the present limits on employer's contributions to approved superannuation plans prescribed in the Act lose a good deal of the force they may have had by reason of those provisions recently introduced into the Act, whereby an employer may make, in addition to the permitted maximum contribution, lump sum payments in respect of an actuarial deficit in a fund. If the scale of pensions provided by the plan be approved, there seems little logic in refusing to allow the employer to provide adequately for such pensions. In our opinion the maximum should be removed.

It is a provision of the law that a pension plan must be approved by the Minister before advantage can be taken of any of the special provisions of the Act relating to such funds. This is clearly necessary, but we are of the opinion that the principle of continuing supervision should be added to the requirement of initial approval of the terms of the plan. The insurance companies, the banks, and other depositories of the people's savings are subject to rigorous supervision and rightly so. Pension funds are not greatly different — they are, after all, the depositories of the life savings of a large number of people. Direct and continuing government supervision, had it been in force heretofore, might well have anticipated from the government point of view the actuarial deficit position in which practically all pension funds now find themselves. This situation necessitated recent important amendments to the Income War Tax Act, which could probably have been dealt with more satisfactorily had government action been taken earlier.

### 6. *Interest accumulations on employee contributions*

Earnings on accumulated savings accrue to an individual in a variety of ways. Some are easily recognized as earnings, such as the interest on money invested at interest, and the net rentals on real property. These are considered as taxable income. Other forms of earnings cannot be readily identified, and under the tax law are not considered as income, in part as an administrative convenience and probably in part as an inducement to certain courses of action on the part of the taxpayer. For example, an individual is not taxed in respect of the net rental value of a house which he owns and in which he lives. Another form of earnings on accumulated savings which is not taxed as income to the individual is the interest which accumulates through the operation of endowment insurance policies. In theory it would be possible to make a mathematical calculation of all the various forms of earnings on accumulated savings that escape taxation, but the fact remains that any attempt along these lines, while

it would make for greater theoretical equity would make the calculation of income tax not less but more complicated. Already our tax law requires an income tax declaration so complex that its efficiency is threatened.

If our recommendation be adopted the interest which accumulates will be considered as taxable income when received by the pensioner. While this is a variation from the treatment now accorded interest accumulating through the medium of an endowment insurance contract, or that recommended in respect of the interest accumulating in a deferred life annuity contract, it would tend to balance the interest saving that accrues from the postponement of taxation.

### *7. Continuing Pensions to Dependents*

It is frequently a provision of pension plans that in the event of the death of a pensioner a reduced pension shall be continued to his widow or dependent children. This raises the question of how the pension should be treated for taxation purposes when received by the widow or dependents. If we consider first the continuation of a pension which was taxable income in its entirety to the pensioner, we are faced with a payment which in its nature is a reward for services but which is received by a person other than the employee. It seems reasonable that such a pension should be considered taxable income to the widower or dependent. It is in fact a deferred reward for services and notwithstanding that the services were rendered by one person and the pension received by a second, it seems more logical to accept the principle of transferring the income to the widow rather than any attempt to consider the deceased employee as having received a lump sum payment at the moment of death, equivalent to the commuted value of the pension.

While the terms of reference of the Commission probably preclude any official recommendation having to do with duties payable under the Dominion Succession Duty Act, we feel that we should draw to the Government's attention certain aspects of the effect of that Act which have a direct bearing on the income taxation of pensions. It has already been noted that no distinction is made at present under the Dominion Succession Duty Act between pensions which are taxable as income and those which are not so taxable. It has also been pointed out that no account is taken of any contingencies upon which the payment of a pension to a widow may be dependent. Some plans, for example, provide that the pension shall cease in the event of the widow's remarriage. We suggest that if our recommendation be accepted, that continuing pensions to a widow or dependent be considered as taxable income in their hands, that it is inconsistent to consider the commuted value of such pensions as an asset of the deceased at the time of his death; such pension was never received by the deceased and frequently he has no power of disposition over it. The approach which we suggest will recognize that the pension payable to a widow is not asset that is transferred from her husband at the time of his death but it is simply the receipt by her of a deferred reward for services in the rendering of which she has played a substantial and important part. We believe that the widow should be considered as receiving something that is her own as of right rather than a voluntary bequest from her husband.

This recommendation would be in harmony with our general recommendation that for the future, all pensions should be considered as taxable income as received with appropriate exemptions from taxation when the employee is making his contribution. If this be adopted as the general principle it will, of course, be necessary to reconcile those cases where contributions have been made in the past without benefit of tax concession. It should not, however, be difficult to work out satisfactory solutions in harmony with the general principle advocated.

## THE TREATMENT OF LUMP SUM PAYMENTS ON CESSATION OF EMPLOYMENT

There are a variety of circumstances under which individuals may receive a lump sum payment on the cessation of employment. Some of these are non-contractual and are simply a payment by an employer in recognition of faithful services. Others arise from a contractual right of withdrawal by an employee of contributions which he has made into a pension fund or plan.

### 1. *Non-Contractual Payments*

Applying the general principles which are advocated earlier in this report any lump sum payment made by an employer to an employee on cessation of employment, other than contractual right of withdrawal of the employee's own contributions to a pension fund, must be considered in the nature of a reward for services and, therefore, should be treated as taxable income. At the present time the law provides that a lump sum payment of this nature made by an employer to a retiring employee may be spread by the employee for taxation purposes as income over the succeeding five years. In the event of the employee's death before he has reported as taxable income the whole of the lump sum payment received, the remaining balance of the lump sum is considered as accruing to the deceased on a tax-free basis.

There does not appear to be any particular reasoning behind the choice of five years over which the payment may be spread; rather it appears to be an arbitrary decision which recognizes the inequity which would result if the total payment was considered as income in one year.

The Commission is of the view there is no completely logical basis that can be adopted for the taxation of such lump sum payments. Perhaps the most logical solution would be to relate such a payment to the level of remuneration that the employee was receiving at the time of retirement, having in mind that in many cases the payment is made in lieu of pension. It is frequently the objective of pension plans and funds to provide pensions of approximately one-half of salary at retirement age, and it might, therefore, be argued that such payments be taxed as income to the individual concerned as if received in equal monthly instalments equivalent to one-half the monthly salary being earned at the time of retirement. Such provision, however, would add a new complication to the calculation of income for tax purposes and would still be arbitrary. Under the circumstances, there seems to be no particular reason to change the existing law.

It has been brought to our attention that the present tax law has been interpreted by the Courts as recognizing a distinction between payments made by an employer in recognition of past services and payments made in the nature of compensation or indemnity for loss of office. This distinction, we feel, is somewhat artificial and unless the law is changed there may be an inducement, by the simple expedient of wording of agreements, to arrange for such payments as are to be made to come within the definition of compensation for loss of office. Compensation to an individual for loss of office is essentially an indemnity for loss of prospective earnings—and where the payment is made by an employer to an employee there is no justification for placing the recipient in a more advantageous position than he would have been had the indemnity not been necessary. We would, therefore, recommend that all lump sum payments made by an employer to an employee on cessation of employment be given the same treatment.

## 2. Contractual Payments

The withdrawal by an employee of contributions which he has made to a pension plan and upon which he has received a deduction for income tax purposes is a somewhat different matter, but still it is difficult to see how any provision can be made that is not simply an arbitrary rule. The present law provides that one-third only of the amount so withdrawn should be taxed as income in the year in which the withdrawal is made. Here again, it would be possible to tax the withdrawal on a basis of spreading the lump sum over a period of years equal to the period in which the sum had been accumulated. This, however, would in many cases extend the collection of tax over an unreasonably long period of time. Another alternative would be to levy a tax at a flat rate based on the average rate of tax paid by the individual concerned during the period in which the accumulations had been made. This is perhaps the most theoretically correct method, but it presents administrative complications. Under all the circumstances the Commission is of the view that the continuation of the present practice of taxing one-third of the total lump sum payment probably gives a fair measure of justice and, because of its simplicity, should be retained.

There is, however, one proviso to this general rule, which might usefully be added. It does not have to do with any case that is as yet common, but one that may well arise more frequently in the future. The substantial increase in recent years in the number of employers providing pension plans suggests that in the future there will probably be many cases where an employee of one concern resigns to take employment with another organization, both of which concerns operate pension plans. If the plan of the second employer should permit contributions to be made by the new employee in excess of the regular annual contributions, and the employee can withdraw his contributions from the plan of his previous employer, then, to the extent that contributions are simply transferred from one approved plan to a second, the withdrawal should not be subject to tax.

## 3. Payments to Dependents

A special situation arises when lump sum payments are made to a dependent of the employee rather than to the employee during his lifetime. If the payment be non-contractual but is made to the dependent by the employer of the deceased employee, we believe that the amount of the payment should be considered as taxable income received by the dependent who should have the same privilege of spreading the payment over the succeeding five years as the deceased employee would have had, had he received the payment. The arguments advanced earlier to justify acceptance of the principle of transferring to the dependent what might ordinarily be considered income of the deceased employee apply with equal force to lump sum payments made by an employer to a deceased employee's dependents. Similarly, a contractual return of the deceased employee's contributions to a pension fund made to his dependents might well continue to be taxed in the dependents' hands on the same basis as if the payments had been made to the deceased employee, namely, one-third of the amount received considered as taxable income in the year the payment is made.

Contractual payments of any type other than a return of the employee's contributions, such as lump sum death benefits, have some analogy with payments arising under a policy of life insurance. Following this line of reasoning, it could be argued that death benefits paid out of a pension fund should be received tax free by the beneficiary. Such a course, however, must be considered in the light of our general recommendation that the employee be allowed an exemption from income in respect of his contributions to the pension fund and our recommenda-



tion that there be no extension of this principle to other taxpayers in respect of life insurance premiums. Under the circumstances, we believe that death benefits paid out of a pension fund should not be treated as analogous to payments under life insurance policies but should in strict logic be treated in the manner recommended for non-contractual payments made by an employer to the dependents of a deceased employee. However, as the amounts involved will be small, and in order to simplify administration, we recommend that all such payments be treated on the same basis as a return of contributions, namely, one-third only considered as taxable income in the year of receipt.

#### D.

### THE POSTPONEMENT OF TAXATION OF A PART OF THE REWARD FOR SERVICES

It was urged upon the Commission by some witnesses that under the existing level of taxation it is extremely difficult for an individual, who does not have access to a pension plan, to make reasonable provision for his old age and for his dependents. These witnesses recommended a general exemption for savings within certain limits.

A number of serious difficulties would be met if an attempt were made to extend to the ordinary individual a right of deduction for savings comparable to that now available to a member of a pension plan. In the first place, there would have to be some reasonable assurance that the money set aside would in fact be retained as savings and used for the purpose of maintenance after retirement. A satisfactory assurance in this regard does exist in the case of Dominion Government annuities which are not subject to cash surrender and which cannot be drawn down in any way other than a life annuity. However, if the privilege was extended to Dominion Government annuities it would seem necessary that it should also be available in the case of annuity contracts issued by life insurance companies which are not subject to such rigid conditions. Of more importance, the privilege would have to be extended to endowment and life insurance contracts. The majority of wage earners in the country cannot afford to provide adequate insurance protection and in addition make contributions towards a life annuity. They must, within the limited resources available to them, provide insurance protection first and then when the need for protection is past trust that they will be able to exchange the cash surrender value of the policy for a straight life or joint survivorship annuity. A tax concession to the purchaser of an annuity which did not extend to the purchaser of life insurance would be to discourage the socially desirable course of wage earners providing for their dependents through the medium of life insurance.

It follows then if any exemption from income was to be given in respect of the savings that an individual might make from year to year, it would have to extend to payments on annuity contracts and premiums for life and endowment insurance. It is difficult to see how it could be extended to cover forms of savings notwithstanding that such other forms may be a completely satisfactory method of providing for old age from the individual's point of view. This means that while an extension of the principle would make the privilege available to a larger number of persons, it still would not be a privilege that would be available to all taxpayers.

Another objection to an extension of the principle suggested would be the difficulty of a fair assessment of taxes against the man who built up his life savings under such an exemption and then for one reason or another drew on his

savings in a lump sum. Equitable taxation of the lump sum payment would be difficult and yet to allow the payment to be received on a tax free basis would be to provide an obvious loop hole for the avoidance of taxes properly payable.

The Commission is of the opinion that while the recommendation has much to commend it, its introduction would result in serious administrative difficulties. The present situation of which the witnesses before the Commission have complained is probably more a reflection of the high wartime tax rates than a strong desire for the principle of accumulating savings on a tax free basis as a permanent feature of the income tax law.

### E.

#### SUMMARY OF RECOMMENDATIONS

1. That the capital element represented in contractual annuities should be exempt from taxation under the Income War Tax Act but that that portion which represents interest accruing should be taxable as income.
2. That the method now employed in determining and taxing the income portion of a term certain annuity should be extended to life annuities by using life expectancy as the term.
3. That annual or periodic payments received under the provisions of a will or trust should be considered taxable income to the extent only that they are paid out of the income of the estate or trust.
4. That the earnings of all approved pension funds be exempt from income tax in the hands of the trustees.
5. That the right of the trustees of a pension fund to elect under Section 5 (1)(h) of the Income War Tax Act should be withdrawn and the special arrangements arising out of elections already made be discontinued for the future.
6. That where an employee has been entitled to a deduction from income in each year in respect of his contributions to an approved pension fund or plan for income tax purposes, the pension should be fully taxable when received.
7. That where an employee has not been entitled to a deduction from income in each year in respect of his contributions by reason of an election under Section 5(1)(h), only a proportionate part of the pension should be taxable.
8. That a pension continuing to dependents should be taxable as income in their hands in the proportion that the original pension was taxable.
9. That Succession Duties should not be imposed on the value of a survivor's pension receivable as taxable income.
10. That the present limits placed upon deductions from income with respect to employers' and employees' contributions to an approved pension fund or plan should be removed.
11. That pension funds should be subject to official supervision.
12. That the present practice of taxing lump sum payments made by an employer to a retiring employee or on the cessation of employment should be continued and extended to any payment made by an employer to an employee in respect of loss of office.
13. That the present practice of taxing one-third of lump sum payments from a pension fund or plan should be continued.
14. That there should be no deduction allowed from taxable income in respect of the premiums paid for life insurance or deferred annuities.

## PART II.

## TAXATION OF EARNED SURPLUSES OF PRIVATE OR CLOSELY HELD CORPORATIONS

Your Commissioners believe it is necessary to define as concisely as possible the type of corporation with which we are dealing in this part of our Report. The words used in the Reference are "a Private Corporation or a closely held Corporation".

The definition cannot well be related solely to either control of the Corporation or to a definite number of shareholders.

It is our opinion that the definition of "Private Company" used in the Dominion Companies Act should be accepted as the type of Corporation whose problems now exist under the combined impact of Income tax and Succession Duty tax. We believe the definition is not too wide but is amply comprehensive.

We have received a large number of letters from Private Companies across Canada, concisely setting out the relevant details of organization, the amount of share capital and the accumulated surplus of undistributed earnings. A substantial number of briefs have been presented to the Commission at public hearings by representatives, whose evidence we have heard and considered.

In every case the problem is the same, varying only in degree. Wherever the value of the estate of a deceased shareholder is substantial, it is impossible to meet the Succession Duty out of a distribution of earned surplus after payment of the income tax on the amount of the distribution. The tax can only be paid by an advantageous sale of the Company as a going concern which is difficult and precarious.

It must be understood, of course, that this impasse is stated as applicable to the shareholder who is not possessed of substantial liquid assets outside the Private Company.

We are strongly impressed by the evidence with the value and necessity of these Private Companies in the Canadian economy, not only as an important factor in the welfare and national progress up to the present time but their potential value in post-war years. The accumulated surpluses will provide the means of vitally necessary expansion with a result of greatly enlarging the field of employment.

Their importance is not only in the matter of employment but the situs of their activity is found chiefly in more or less widely scattered urban communities across Canada and so serves to decentralize employment.

A very great percentage of the population of Canada depend directly or indirectly upon the healthy condition of Private Companies.

Your Commissioners have a lively appreciation of their responsibilities to the necessities of the public revenue and to the effect of their recommendations upon the welfare of these many Private Companies, and those directly or indirectly dependent upon them. Our recommendations cannot effect exact equity or exact justice. Our objective has been to provide a method that will not only leave the Private Company in a healthy condition but enable it to pay to the Government as nearly as possible the aggregate amount of income tax that would have been paid if the Company had made an annual distribution to its shareholders, and also bearing in mind the value of encouraging the establishment of new companies.

We are mindful also that the large Private Company with assets exceeding a million may solve their problems by a measure of reorganization and a distribution of shares for public subscription. We find that the number of such companies are comparatively few.

We think we should state that many witnesses before us urged the administrative benefits that would accrue by having the assessment and collection of the Succession Duty tax solely in Federal hands. This opinion will also be found in many of the submissions.

It was further urged with equal strength that the shareholder in a company receive credit on his income tax for the amount of the corporate income tax paid by the company proportioned to his shareholding in the company.

The witnesses further expressed the opinion that in the assessment of Succession Duty the value of the estate passing should be reduced by the contingent liability to income tax of any distribution of accumulated earnings to be made to the estate.

#### A.

##### *History of Law and Present Practice of Taxing Income of Corporations on distribution.*

The original Income War Tax Act was apparently based on English income tax legislation at least insofar as the tax treatment of corporations was concerned.

Under our Act (1917 C.28) corporation income was subject to a tax of 4%. Individual incomes were also subject to a normal tax of 4%, and in addition, a supertax on a graduated scale commencing at \$6,000. Dividends from corporations were considered to be income, but Section 3(1)(d) provided:—

- (d) for the purposes of the normal tax, the income embraced in a personal return shall be credited with the amount received as dividends upon the stock or from the net earnings of any company or other person which is taxable upon its income under this Act: Provided, however, that in determining the income the personal and living expenses shall not be taken into consideration.

Consequently, there was at that time no such thing as the so called "double taxation" of corporate profits in effect today.

By 1918 C.25 the corporation income tax rate was increased to 6%, the individual rate for normal tax remaining at 4%. Supertax continued to be levied, but at an increased rate and with a surtax added on income over \$6,000.

By 1919 C.55 the corporation rate was increased to 10% and the normal individual rate to 8% on income over \$6,000. The surtax was repealed, and the supertax (renamed "surtax") made applicable to all individual income over \$5,000.

These rates, with some minor changes, remained in effect until 1925.

During all this period the exemption from normal tax of dividends received by shareholders continued but from the variation in the rates applicable to corporations and individuals, there appears to have commenced in 1918 a gradual departure from the principle of having all income, of corporation or individual, bear a single uniform normal tax, with dividends received by an individual from a corporation subject to a further tax only if that individual had sufficient income to bring him within the surtax or supertax brackets.

By 1926 C.10 effective as to all income for the year 1925 and thereafter, the corporate income tax rate was reduced to 9%, and individual rates were overhauled, the normal tax and surtax being abolished and a single schedule of graduated rates substituted, applying to all income in excess of certain minimum exemptions.

By the same Act, section 3(1)(d) which had exempted corporation dividends from the normal tax, was declared not to apply to dividend income of a taxpayer for the year 1925 and thereafter.

Since January 1st, 1925, therefore, the principle of taxing corporate income in the hands of the company and again on distribution in the form of a dividend to shareholders has been an established principle of Canadian tax law.

The development of another section of the Income War Tax Act also shows the gradual departure from the idea that the corporation, while a separate entity, was in substance only a conduit pipe for the transmission to the shareholder of the income earned by the company.

Section 3(4) of the 1917 Act, while recognizing the necessity of some part of the earnings being used in the development of the business, was obviously included to prevent the avoidance or postponement of surtax on corporate earnings by the simple expedient of failing to declare dividends. That section, the forerunner of the present sections 12 and 13, provided as follows:

3(4) For the purpose of the supertax only, the income of a taxpayer shall include the share to which he would be entitled of the undivided or undistributed gains and profits made by any syndicate, trust, association, corporation or other body, or any partnership, if such gains and profits were divided or distributed, unless the Minister is of opinion that the accumulation of such undivided and undistributed gains and profits is not made for the purpose of evading the tax, and is not in excess of what is reasonably required for the purposes of the business.

In 1919 (1919 C.55) this section was repealed, and the substituted section, while expressing somewhat the same idea in a negative way, demonstrates a changing attitude towards corporation income, the corporation being thought of more and more as a separate entity—as something apart from its shareholders.

Section 3(4) as re-enacted in 1919 read as follows:

“The share of a taxpayer in the undivided or undistributed gains and profits of a corporation shall not be deemed to be taxable income of the taxpayer, unless the Minister is of opinion that the accumulation of such undivided and undistributed gains and profits is made for the purpose of evading the tax, and is in excess of what is reasonably required for the purposes of the business.”

While the original section considered as income to the shareholder his proportionate share of the earnings of the company, unless distribution was withheld for some good reason, the section substituted in 1919 provided that the income of the corporation should NOT be considered income of the shareholders unless distribution was withheld for the purpose of evading tax.

Although it was recognized from the start that some part of the earnings of the corporation must be used in the business, the development of the idea that a corporation's earnings were not income to the shareholder until distributed may have led in some cases to unnecessary withholding of distribution, particularly in cases where the controlling shareholders were men with substantial incomes—well into the supertax or surtax brackets.

Until 1924 no thought was given apparently to the tax position when on winding up or discontinuance of a company this accumulated income was eventually distributed to the shareholders.

In that year the English Court of Appeal, in *Inland Revenue Commissioners vs Burrell*: 1924 2 K B 52, held that in liquidation the distribution of a corporation's property, though including accumulated income, was not the payment of a dividend but was simply the distribution of the company's capital, and any profit to the shareholder was a capital gain and not liable to supertax.

While the English Parliament has apparently made no change in the law as a result of this decision, except perhaps to introduce more stringent provisions to compel distribution by way of dividends while a company is operating, the Canadian Parliament in the same year, by 1924 C.46 added section 3(9) reading exactly as does the present section 19(1). It became effective July 19, 1924 and provided:

"On the winding-up, discontinuance or re-organization of the business of any incorporated company, the distribution in any form of the property of the company shall be deemed to be the payment of a dividend to the extent that the company has on hand undistributed income."

During the next two years it became apparent that there were several methods open by which corporations could circumvent the operation of section 3(9). With the abolition in 1926 of the exemption from normal tax of dividends from corporations, it became even more important to prevent resort to these methods so in that year (1926 C.10) a number of new sections were introduced for this purpose.

At the same time, in order to avoid triple tax on earnings of a subsidiary corporation distributed through the parent company it became necessary to exempt from corporate tax the dividends received by one corporation from another. This was done by section 3(12) added by 1926 C.10 (now section 4(1)(n)), and it added still further avenues of escape from individual tax which were required to be closed.

The effect of the sections added for this purpose in 1926, with what appears to be the reason behind their adoption is as follows. As the sections with minor amendments have remained in the Act since 1926, their present sequence and numbering is given with reference in each case to the original section number.

Section 14 of the present Act was introduced as Section 4(11) by 1926 C.10 and reads as follows:

14. "Where a person owning shares of a corporation transfers such shares or a portion thereof to a second corporation acting as his agent, trustee or attorney or promoted at his instance or controlled by him, which second corporation subsequently receives a dividend from the first mentioned corporation and applies the income thus received, in whole or in part, directly or indirectly

"(a) in payment of the shares purchased by the second corporation from such person;

"(b) in the discharge of any liability incurred to such person by reason of and in connection with the purchase of such shares; or,

"(c) in the discharge of a loan obtained by the second corporation for the purpose of paying for such shares, then such person shall be taxable in respect of such dividend as if he had received it in the year that the first mentioned corporation declared the dividend."

Were it not for this section, a person owning shares in Company A could cause to be incorporated Company B, and sell the shares to Company B at a price calculated by including the entire undistributed income of Company A. Company A could then declare a dividend equal to its entire undistributed income which would be tax free to Company B under section 4(1)(n); Company B could use the money in part payment of the purchase price of the shares; and the original owner of the shares would thereby obtain free of tax, his proportion of the undistributed income of the company.

*Section 15* was introduced in 1926 as section 4(12) of the Act. It reads as follows:

15. When, as a result of the reorganization of a corporation or the readjustment of its capital stock, the whole or any part of its undistributed income is capitalized, the amount capitalized shall be deemed to be distributed as a dividend during the year in which the reorganization or readjustment takes place and the shareholders of the said corporation shall be deemed to receive such dividend in proportion to their interest in the capital stock of the corporation or in the class of capital stock affected.

Section 19(1) added as 3(9) by 1924 C.46 applied only where the "property of the company" was distributed. Section 15 was required to prevent the transfer of an income surplus to capital account by the issue of new shares.

*Section 16* was introduced in a slightly different form in 1926 as section 4(9). It provides:

16. (1) Where a corporation having undistributed income on hand reduces or redeems any class of capital stock or shares thereof, or converts any class of the capital stock or shares thereof into any other class of capital stock, shares or other security thereof, the amount or the value of any consideration or right received by any shareholder by virtue of the reduction, redemption or conversion shall, to the extent to which such shareholder would be entitled to participate in such undistributed income on a total distribution thereof at the time of such reduction, redemption or conversion, be deemed to be a dividend and to be income received by such shareholder.

(2) The provisions of this section shall not apply to any class of stock which, by the instrument authorizing the issue of such class, is not entitled on being reduced or redeemed to participate in the assets of the corporation beyond the amount paid up thereon plus any fixed premium and a defined rate of dividend nor to a reduction of capital effected before the sixteenth day of April, one thousand nine hundred and twenty-six.

This section was designed to prevent, amongst other things, the distribution of capital, by means of a reduction of share capital, or the distribution of a capital surplus, without first distributing, or at least paying tax on, accumulated income.

Subsection (2) excludes from the operation of the section, legitimate cases where preference shares were issued, redeemable at a specified premium.

Until (by 1943-44 C.14 S.15) it was re-enacted in its present form, section 16 applied only to reduction and redemption and not to conversion of shares.

*Section 17*: As originally enacted in 1926 (C.10 S.8) as 4(10) this section provided

"where a corporation, having undistributed income on hand redeems its shares at a premium paid out of such income, the premium shall be deemed to be a dividend and to be income received by the shareholder."

Under this Section the case *National Trust vs Minister of National Revenue* (1935 Ex.C.R.167) arose. Sir Lyman Melvin Jones held 2900 7% preferred shares of the capital stock of Massey Harris Company Ltd. After the issue of the shares, supplementary letters patent gave the company the right to redeem the preference shares at 110 or at the option of the holder, to exchange them for 5% preference shares. His shares were redeemed at 110. The premium was assessed as income. The assessment was disputed on the ground that the company had transferred undistributed income to "surplus account" and that the funds of the Company on this account were not "undistributed income on hand".

It was held by Angers J. that the transfer to "surplus account" did not affect the situation. It was still "undistributed income on hand". He also held that 16(2) had no application, as it only reduces the taxable portion (which might otherwise be the entire amount paid on redemption) to the amount of the "premium". The premium was held taxable.

Before this case came to trial the section was amended by 1934 C.55 to provide that the premium should be deemed a taxable dividend, whether or not the company has undistributed income on hand, and whether or not the premium is paid out of such income

As amended it reads:

17. Where a corporation redeems its shares at a premium, the premium shall be deemed to be a dividend and to be income received by the shareholder.

In 1939 the same question came before the Court in *Executors of Massey vs Minister of National Revenue*: (1939 Ex.C.R.41) affirmed on appeal to the Supreme Court (1940 S.C.R. 191). It involved a redemption of the same class of shares of Massey Harris prior to the change in the Act by 1934 C.55 but it was argued that they were redeemed out of the proceeds of the sale of new shares, the "undistributed income" having gone into bricks and mortar, etc. The bank records showed the source of the actual money used in redeeming the shares to have been money derived from the issue of the new securities.

The Court held (Davis J. dissenting) that the source of the actual money made no difference. The company having cash on hand was entitled to treat the cash as the embodiment of the surplus, and that it did so was shown by a hypothetical balance sheet distributed with a notice to the shareholders of the new issue. Therefore this premium was taxable.

Section 18 was passed in substantially its present form by 1926 C.10 as section 4(8) of the Act. It provides:

18. For the purposes of this Act, any loan or advance by a corporation, or appropriation of its funds to a shareholder thereof, other than a loan or advance incidental to the business of the corporation shall be deemed to be a dividend to the extent that such corporation has on hand undistributed income and such dividend shall be deemed to be income received by such shareholder in the year in which made.

2. This section shall not apply to a loan or advance made by a corporation in the ordinary course of its business where the lending of money is part of the ordinary business of the company.

This section is designed to prevent the funds of a company being distributed to and used by a shareholder virtually as his own without payment of tax. Tax could otherwise be avoided if the company did not enforce repayment.



In 1930 (by 1930 C.24 S.4) section 19(1) was amended to make the distribution on winding up, discontinuance or re-organization taxable only to the extent that the company "has on hand undistributed income earned in the taxation period 1930 and subsequent periods".

This right to re-organize and distribute or capitalize free of tax income accumulated prior to the commencement of the 1930 taxation period continued until 1934 when (by 1934 C.55 S.10 applicable July 3, 1934) the section was restored to its original (and present) form.

Since July 3, 1934 section 19(1) has applied to tax on winding up, discontinuance or re-organization all of the undistributed income of the company whether earned before or after that date, and whether before or after the end of the 1929 taxation period. Any doubts on this score were settled by the judgment of the Supreme Court of Canada in *Merrill vs Minister of National Revenue* (1942 S.C.R. 269). However, in practice at least, as will be seen later, any income accumulated prior to the effective date of the original Income Tax Act is not made subject to tax in such cases.

We have been unable to ascertain to what extent advantage was taken of the opportunity afforded to capitalize or distribute, tax free, pre 1930 surplus income. From the evidence presented to the Commission it is quite clear that many companies did not do so.

Section 19(2) was the next section added to the Act to prevent the circumvention of Section 19. Added by 1936 C.38 S 11, and re-enacted by 1942-43 C.28 S.17 this section now provides:

19 (2) Where, pursuant to subsection one of this section a dividend is deemed to be paid to a company incorporated or carrying on business in Canada, such company shall, notwithstanding section four of this Act, be taxable on the amount thereof; and where, pursuant to subsection one of this section a dividend is deemed to be paid to a company incorporated outside of Canada which does not carry on business in Canada, the company making the payment unless it is one of the companies described in paragraph (p) of section two or paragraph (k) of section four of this Act, shall deduct from such payment the amount of income tax payable thereon under subsection two of section nine of this Act at the rate applicable thereto at the time when such payment is deemed to be made and shall pay the same to the Receiver General of Canada.

Leaving aside the reference to companies described in sections 2 (p) and 4(k) of the Act, which are not important for our purposes, this section was thought necessary to prevent shareholders of a company about to be wound up from incorporating another company, and selling to it their share holdings. A distribution might then be made tax free under 4(1)(n) by the first company to the second, and the second, having no "undistributed income on hand", could on liquidation distribute such receipts amongst its shareholders, also free of tax.

The result of Section 19(2) is that the distribution is taxable in the hands of the second company as a dividend, and, being income, is taxable again in the hands of the shareholders of the second company when distributed to them.

Section 14 is designed to prevent the same result in the case of an ordinary dividend, but not a distribution on winding up.

The effect of Section 19(2), resulting in a second corporation tax can be avoided in legitimate cases of dissolution of subsidiaries, by having the subsidiary declare a dividend of all surplus income before winding up.

The final steps in the series of amendments designed to prevent tax free distribution of the accumulated income of corporations came with the adoption and subsequent amendment of sections 32A and 32B.

*Section 32A* was first added by 1938 C.48 S.7, then applying only to transactions between residents and non-residents. It was amended in 1940 and again by 1943-44 C.14 and now provides as follows:—

32A. (1) Notwithstanding any of the provisions of this Act, where the Treasury Board is of the opinion that the main purpose for which any transaction or transactions was or were effected (whether before or after the passing of this Act) was the avoidance or reduction of liability to tax under this Act, it may, if it thinks fit, direct that such adjustment shall be made as respects liability to tax under this Act as it considers appropriate, so as to counteract the avoidance or reduction of liability to tax under this Act, which would otherwise be effected by such transaction or transactions, and tax shall be assessed and levied accordingly and shall be payable as in this Act provided.

(2) Notwithstanding anything in this Act contained, if upon examination of any transaction or transactions made directly or through the medium of third parties, or by the creation of new or intermediary companies, it appears to the Treasury Board that any payment or benefit in cash or otherwise, received by any person subsequent to the year 1939 as a result of such transaction or transactions has been received directly or indirectly from a company having undistributed income on hand, then the Treasury Board may find that the main purpose of such transaction or transactions was to reduce or avoid taxation, and it shall thereupon be deemed for the purposes of this Act that such person, whether he received any such payment or benefit in the form of capital or otherwise, has received income subject to tax in such year or years since 1939 and in such amount or amounts the Treasury Board may determine, and tax shall be assessed and levied upon such person and shall be payable as in this Act provided.

Any such finding by the Treasury Board may be made notwithstanding that such transaction or transactions may have been entered into either within or without Canada or prior or subsequent to the coming into force of this section.

(3) Notwithstanding anything in this Act contained, if substantially all of the shares of a company having undistributed income on hand have been purchased since the coming into force of this Act, by any other company or companies, the Treasury Board may find that the main purpose of the sale by the vendor was to reduce or avoid the tax which would have been paid by the shareholders of such company having undistributed income on hand on the distribution to them of the said undistributed income, and in such case, notwithstanding paragraph (n) of section four of this Act, the dividends paid or deemed to be paid by the company having undistributed income on hand and received or deemed to be received by any such other company or companies shall upon being so received or deemed to be received be taxed against such company or companies and the tax shall be assessed, levied and paid as in this Act provided.

(4) In any appeal from an assessment made pursuant to any finding, direction or determination of the Treasury Board under this section, the Exchequer Court of Canada shall have jurisdiction to determine whether

the main purpose of the transaction or transactions or sale was the avoidance or reduction of liability to tax or whether any finding, direction, determination or adjustment ought to have been made or given, or was appropriate.

Subsection (1) is very general in terms and may cover almost any transaction. Subsection (2) sets out one set of circumstances where the Treasury Board is entitled to find that the main purpose of a transaction was to reduce or avoid taxation. It is sufficiently wide to cover almost any sale of shares of a company with undistributed income on hand. Subsection (3) was apparently designed to cover a case missed by Sections 14 and 19(2). Were this section not in the Act, the shareholders of Company A which has an undistributed surplus, could sell shares to Company B at a price based on capital plus surplus, Company B might then have a dividend declared by Company A out of undistributed income, and thereby recover the part of the purchase price represented by the surplus of Company A. Section 14 would not cover this, for it applies only in specific cases where the dividend is used by Company B in payment for the shares or in the discharge of liability incurred in paying for the shares. Section 19(2) only covers "winding up, discontinuance or re-organization", and not the case of an ordinary declaration of dividend.

Subsection 4 gives a right of appeal to the Exchequer Court on the question whether tax avoidance was the "main purpose".

*Section 32B* was added in its present form by 1938 C.48. This section provides:

32B. Where on winding up or otherwise a company distributes any assets to its shareholders without sale or at a sale price substantially below the fair market price, which assets if sold at the market price would create income of the corporation within the meaning of this Act, the Minister shall have power to determine the fair market price of such assets and the company shall be deemed to have sold such assets at the price so determined and thereby to have received income subject to tax and the distributable portion received by a shareholder or member shall be deemed to be a dividend.

Were it not for this section, a company could for example, distribute its inventory in kind to its shareholders at a price under market.

It will be appreciated that the possibility of any scheme to distribute in any form the property of a corporation without paying personal tax on that part representing undistributed income is apparently blocked by the series of sections just outlined.

Mr. T. W. Bullock, C.P.A., Assistant Deputy Minister (Assessing) of the Taxation Division of the Department of National Revenue gave evidence as to the method followed by the Division in calculating the amount of "undistributed income on hand" for the purpose of taxation under section 19 and related sections of the Act. From his evidence it appears that the assessed income of the corporation for all years from 1917 to the date of distribution is totalled. To this is added exempt income (dividends from other corporations or tax-free bond interest). From this total is deducted operating losses, sustained during these years, capital losses to the extent that they exceed capital profits which have not been distributed; dividends paid during the period, Income, Business and Excess Profits Tax paid during the period, and expenses which have been incurred but not allowed for income tax purposes. The remainder is the "undistributed income on hand". It is apparent therefore that income earned prior to the commencement of the fiscal year of the corporation ending in 1917—income earned before the

effective date of the original Income Tax Act—is not brought into charge on a distribution under Section 19 nor is any capital surplus on hand.

It should be kept in mind however that this applies only to a distribution on winding up, discontinuance or re-organization. It is well established that apart from such cases, and apart from a distribution of capital as a step in an authorized reduction of capital (subject to the limitations of Section 16 of The Income War Tax Act), any payment made by a company to its shareholders, whether a distribution of what is capital in the hands of the company, a distribution of income accumulated prior to 1917, or a distribution of income earned after 1917, is considered a dividend and is taxable income in the hands of the shareholders. (*McConkey vs Minister of National Revenue*: 1937 Ex C.R. 209).

A history of the taxation of corporate profits would not be complete without some reference to certain classes of companies entitled to special tax treatment under the Income War Tax Act. Two of these, the "Non-Resident Owned Investment Corporation" defined by Section 2(1)(p), and those companies referred to in Section 4(1)(k) whose business is carried on entirely outside of Canada, are not important to our enquiry. Two other types only one of which still survives, deserve some brief mention. These are the "personal" and "family" corporations which were brought into existence by 1926 C 10, presumably in order that some relief might be given from the abolition, by that Act, of the exemption from normal tax which corporation dividends had theretofore enjoyed.

*Personal Corporation* is defined by Section 2(1)(i) as a company, wherever incorporated or carrying on business, controlled by one person residing in Canada or one such person and his wife or family, and the revenue of which to the extent of one-quarter or more is derived from ownership of or trading or dealing in securities, money lending, or from any estate or trust. Such companies are incorporated chiefly to localize the situs, for succession duty purposes, of the investments of an individual, and to eliminate difficulties in handling investments that would otherwise be encountered on his death.

By Section 21 the personal corporation is ignored for tax purposes. It pays no tax but its income is deemed to be distributed in full and the shareholders are taxed each year on their respective shares. Actual distributions are not again taxed when made.

The *Family Corporation* is no longer treated separately for tax purposes, although the definition of such a company is still contained in section 2(1)(d). It is defined as a company, 75% of the stock of which is owned by the members of one family, at least one of whom takes an active part in the business, or a corporation 80% of the stock of which is owned by persons actively employed in the business, or by them and their families.

Section 22 until its repeal by 1932 C.43 gave such companies the right to elect annually whether to be treated for tax purposes as an ordinary corporation, or to be treated as a partnership in which latter event the income for the year would be taxed in the hands of the resident shareholders as if distributed, and the corporation itself would pay no tax except with respect to the interest of non-resident shareholders.

In order to dispose finally of such companies from the standpoint of administration, a new section 22 was enacted by 1940 C.34 giving family corporations the right until December 31st, 1942 only, to distribute without further tax income accumulated during the years they were treated as partnerships. After that date dividends of such companies were considered taxable income to the shareholders, even though paid from income on which they had already been taxed.

## 1. Nature of the Problem

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The problem with which we have to deal relates to the combined effect of income taxes and succession duties arising on the death of any of the principal shareholders of closely-held corporations with accumulated surpluses. In many instances the principal asset of the deceased is represented by his equity in the company and, in order to pay succession duties, it is found necessary to distribute a substantial part, if not all, of the accumulated surplus as a dividend. The impact of the income taxes at the prevailing rates on such a distribution is extremely serious and when combined with Federal and Provincial Succession Duties may result in the confiscation of almost the entire estate.

Many of these companies are owned by one individual or by a few individuals or by a family. Often they have begun with a small amount of capital, but by turning back into the undertaking most of the profits they have earned they have gradually accumulated large undistributed surpluses. In many cases a substantial part of the surplus is represented by fixed assets or current resources needed for the conduct of the business, so that a large distribution would place a severe strain on the finances of the company, even without the impact of personal income tax on the shareholder. The current levels of income tax create for many companies an impossible situation. The Income War Tax Act provides that the distribution in any form of the assets of a corporation to its shareholders, while it is a going concern, shall be taxable as income to the shareholders in the year in which the distribution is made. On winding up of a company distributions to the shareholders are considered as taxable income to the extent of the undistributed income of the corporation then on hand. The Act also states that a loan by a company which has distributed income on hand to one of its shareholders shall be deemed to be income to him in the year it is made.

From one aspect the principle of graduated rates of tax applicable to personal income may be said to be the cause of the difficulty. When a lump sum distribution of earnings occurs, under the progressive rates of taxation, a large part of the amount distributed must be utilized to pay tax, much larger than would be the case had the income been distributed regularly over the years. Under prevailing rates the tax payable on \$50,000.00 is approximately \$35,000.00; on \$250,000.00 the tax payable is around \$227,000.00; and on \$500,000.00 the tax is approximately \$472,000.00. After the \$100,000 figure is reached income received in excess of that amount by an individual is taxable at the rate of 98%.

Increases have also occurred from time to time in the taxes levied under Provincial Succession Duty Acts on estates. In 1941 the enactment of the Dominion Succession Duty Act imposed an additional burden. As a result, the estate of a testator domiciled in Ontario, for example, who left in 1925 \$250,000.00 to be divided equally between two adult children, would be liable for succession duties amounting to \$21,250. In 1944 combined Ontario and Dominion Succession Duties on \$250,000.00 would be \$53,625.00. If the testator's estate consisted of a family corporation with a large portion of its value in undistributed surplus, it would be impossible for the corporation, if it sought to make this surplus available to pay taxes, to declare a sufficiently large dividend to liquidate, after the payment of income tax, the amount of the succession duties.

It is manifest that under present tax laws the heirs of such an estate, unless owning other substantial assets, could not possibly hope to retain the business. Their only recourse would be to sell it as the only way open to pay the succession duties without losing almost their entire capital. The sale of such a business in itself often becomes a difficult problem. It requires a particularly favourable conjuncture to sell a relatively small or moderately sized business located in a small town or village. The most likely buyer would be a competitor or a large

corporation desirous of extending its control over an industry. On most occasions the sale would have to be negotiated under circumstances disadvantageous to the seller, with the probability that the enterprise would change hands at a price considerably below its real value as a going concern. Thus, under present tax laws, the death of the principal owner of a closely-held corporation not only tends to break the continuity of the business but may prove to be in the nature of a disaster to his dependents and the community as well.

In instances where there are two or three principal owners of a closely-held corporation, additional complicating circumstances exist. In the event of the death of one of these shareholders the distribution of a large dividend from undistributed income means that the other owners of the corporation must also receive a dividend and be subject to the high income tax rates applicable to their share of the surplus. Moreover, if the sale of such a business involves grave difficulties, these are relatively greatly increased if what is on offer is merely a minority share in the business. A minority share in an enterprise is frequently not an attractive proposition to the average businessman. For this reason, if the estate endeavours to raise money to pay succession duties by negotiating a loan on the security of the deceased's shares in the corporation, it may well find it impossible to do so. It is frequently not within the scope of commercial banking and the facilities available for procuring middle or long term loans of this kind are decidedly limited.

It is apparent that the problem under the existing framework of tax legislation is one which bristles with difficulties. It has been frequently suggested to us that the only real solution lies in the abolition of the tax on corporate income, and the adoption of a single tax base. A recommendation in this regard we believe to be beyond the scope of our reference—certainly the considerations involved would require a much broader study of the tax structure than we have been required to make. It has also been suggested that the Dominion Succession Duty Act should be repealed, but this we regard also as beyond the scope of our reference.

## *2. Number of Companies Affected*

While statistics are not available to determine exactly the number of private or closely-held corporations which would be in difficulties if the death of a principal shareholder made a distribution of accumulated surplus necessary, it is possible to make a fairly close estimate. Approximately 28,000 corporations file income tax returns annually. An analysis of these returns (see Appendix B) reveals that 10,000 of these companies are closely held corporations with surpluses of varying amounts. Of these, however, 8,000 have surpluses of less than \$25,000, and it is estimated that the average surplus for this group would be very close to \$10,000 each. It is probable that no serious problem exists with regard to the distribution of surpluses of these companies. There remain 2,000 closely-held companies having surpluses in excess of \$25,000. The distribution of the surpluses of these companies if found to be necessary constitutes the problem which we have to consider. Four hundred and ninety-five companies in this category have been surveyed and they show an aggregate of capital stock issued amounting to \$60,320,000, with accumulated surpluses totalling \$80,243,000. On the assumption that these 495 companies constitute a representative sample, the aggregate total capital for all the 2,000 closely-held corporations with surpluses in excess of \$25,000 would be approximately \$242,000,000. The accumulated surpluses involved would be \$322,000,000. It must be noted, however, that while the immediate problem may be limited to some 2,000 companies, there is a similar potential problem for all closely-held companies, as well as for any individuals or small groups who may contemplate the incorporation of a company.

### 3. *The National Interest*

A large number of submissions have warned us that a continuance of the present taxation treatment of family or closely-held companies is bound to be injurious to the development and expansion of industry in Canada. They emphasize the importance, from a national point of view, of initiative and enterprise as factors in building up industry from small beginnings to concerns of substantial or large size. Many of the owners of these companies point out that they started with very little capital but by living carefully and putting back into the business the bulk of their profits, they have gradually expanded them until they now give employment to some 200 to 500 people compared with less than a score when they began. In the opinion of these men the effect of the present tax laws upon the accumulation of capital will destroy the incentive to launch out in the future upon independent business ventures and they maintain that unless there is a change in the present situation the small enterprise will cease to develop.

It is well known that many of the largest business enterprises in Canada had their start in small family concerns. Many of these have since become large business companies but the process of growth from small companies to large ones continues. Much of the history of industrial expansion in Canada could be written around their development. To weight the balance of taxation against the smaller industrial concern would seem to be unwise. Characteristically such companies are organized as closely held corporations and the men who own them in many instances represent fresh blood and new ideas in business. They supply much of the dynamics of enterprise.

From a slightly different angle of approach, it is pointed out that present tax laws are affecting the structure of industries in Canada and resulting in the "gradual disappearance of small private businesses and the concentration of economic enterprise in large scale units". This point of view is clearly stated in the following submission:—

"it seems to me an unwise policy to force small private businesses which have been built up by initiative and hard work to be sold on the death of the chief proprietor in order to pay Succession Duties. I believe that the individually owned, small businesses are a great source of strength to the Canadian economy and have done much to provide employment. If more and more of these small businesses are put up for forced sale, a greater concentration of economic and other power is placed in the hands of large, province-wide and Dominion-wide corporations, which are usually about the only purchasers for the small businesses."

Undoubtedly there has existed for some time a strong tendency to concentrate the control of separate plants in the same industry under unified management. The result has been to facilitate the formation of trusts and cartels, the growth of which, has given wide concern and led to what is known as the "trust problem". The effects of taxation policy in its more remote consequences cannot be estimated precisely but it seems certain that insofar as our taxation system bears with a special severity upon the family owned corporation, it threatens their ability to survive. Independent moderately sized businesses provide a strong competitive element in Canadian economy which would be lost with their disappearance. Apart from this consideration a country with a business structure composed of strongly based moderately sized units appears to offer greater possibilities of growth than one where concentration of control is the rule.

The importance of moderately sized family corporations to the towns and villages of the country where they are often located has also been stressed. An industry of this type is usually the backbone of the economic life of its community.

The owners, not infrequently, take an active interest in the welfare of the locality. If the business has to be sold on the death of the founder or principal owner, and passes under centralized control, there is the possibility that the plant may be closed and its operations transferred to some other unit of the organization located elsewhere. When this occurs, the life of the community suffers severely. In any event, a change from local to absentee ownership often results in the loss of many secondary advantages to the community.

Throughout the presentations runs the theme that with the close of the war and the necessity of finding employment for men returning from overseas, every effort should be made in Canada to set the stage for a big expansion of industry. The present situation is not considered favourable to such a development. It was said in evidence that "individuals will be discouraged or prevented from starting new businesses, which will be necessary, if we want a high level of employment after the war, first because of their inability to save the initial capital required for the purpose, and secondly, because of the limitations placed upon the rewards for success. The serious effects which this situation would have upon business activity generally and upon the level of employment after the war", it is said "cannot be exaggerated". It is felt that private enterprise will face its severest test in the post-war years in carrying out its post-war plans and putting forth the necessary effort to uphold and broaden its pre-war records. The importance of this phase of the problem means that it must be given the most serious consideration. Accumulated surpluses are one of the strongest factors in ensuring this expansion.

### C.

## SUGGESTED METHODS OF TAXATION

### *Guiding Principles*

A great variety of suggested solutions have been made to the Commission, but before dealing with the merits or limitations of particular proposals it will be advisable to outline the general criteria which the Commissioners have had in mind in sifting the evidence before them.

1. Perhaps the most important consideration is that the Commissioners believe that a substantial measure of relief must be granted to the companies with which we are directly concerned. In making this statement the Commissioners are impressed with the fact that in the great majority of cases—in fact in almost all the cases—the present situation has come about as a result of the failure of the tax law to recognize a developing situation, rather than any attempt on the part of the management of the companies to withhold profits in the business to the end that personal income taxes might be minimized. There are, of course, exceptional cases where profits have been retained in a business and a substantial surplus accumulated, which is far in excess of the reasonable requirements of the business as such. In these cases it may be that the motivating factor in the retention of earnings was avoidance of personal income tax to the shareholders. These cases, however, are the exception and in the great majority the present situation results from nothing more than the normal, prudent and well-established practice of retaining each year in a company some part of the profits for that year. This principle of plowing back earnings is much older than the income tax. It is not a practice developed as a result of tax considerations, but has become a tenet of finance. For these reasons we believe that a real measure of relief must be granted and that the solution should not include any form of



penalty for failure to distribute all the earnings of the business in prior years. It is undoubtedly true that the development of the Canadian economy would not have achieved its present state without the facility of conducting business under a corporate structure, separate and distinct from the shareholders of the corporation. Furthermore, had it been impossible under the tax law for corporations to retain some part of their earnings for contingencies and natural growth and expansion there could not have been the development of business in this country which has taken place in the past twenty-five years. The great majority of companies with which we are concerned find themselves in their present situation as a result of the failure on the part of the tax law to recognize the principles on which the business life of the country has been and continues to be developed.

2. The second criterion that the Commissioners have had in mind is that there must be some reasonable measure of equality as between individual taxpayers and also as between the shareholders of the companies which have followed different policies in making distribution of their earnings in past years. This principle of equality of treatment to taxpayers of necessity includes the protection of the interests of the public treasury. A solution which met in full the immediate problem of the most exaggerated case would not only adversely affect the public revenue, but would be unfair to other taxpayers who had followed a normal course in the distribution of profits and, therefore, had made their contribution to the tax revenues of the Dominion.

3. The Commissioners are convinced that the uncertainty which has existed in prior years as to the taxation of these surpluses on distribution should not be allowed to continue in respect of future accumulations. While the present situation is aggravated by the current levels of taxation, it is worthy of note that the income tax was introduced in the year 1917 and fourteen years later, in 1930, relief on the distribution of surpluses accumulated up to that point was given. Now, after another period of fifteen years, the situation is again a pressing problem. It would, we believe, be wholly unsatisfactory and, in fact, it would have adverse effects, if business in this country had to look forward to another period of fourteen or fifteen years during which a similar situation would again develop, and then trust that some relief would be granted. The Commissioners, however, are of the opinion that it is not possible to find one solution that will be suitable for the future and, at the same time, give adequate relief in respect of the past. A greater degree of relief is necessary in respect of the past. It is, therefore, recommended that the problem be divided into two separate and distinct parts—the one dealing with surpluses accumulated in prior years and the other dealing with the future. The date that the Commissioners choose as the dividing line is the end of the 1939 fiscal year. The solution in respect of the past must have regard to the tax rates in force in the various periods of surplus accumulation. The sharp increase in the tax rates during the war would distort any average figures determined in respect of the years prior to 1939.

4. The terms of reference state a problem which arises on the death of a principal shareholder of a family or closely-held corporation.

Great difficulties would be encountered in attempting to make any solution applicable only to the share of the deceased shareholder in any distribution of accumulated income; these difficulties appear to condemn such a limitation. This being the case, there would appear to be no point in limiting relief to cases where a principal shareholder dies, as there is no sound reason why a surviving shareholder should be treated in one manner where a fellow shareholder dies, and in another manner where no death occurs.

In considering the problem before us we have come to the conclusion that relief should not be limited to those cases occasioned by the death of a shareholder. It is equally, if not more, important that the principal shareholder of this type of corporation as he approaches the later years of life should be enabled to put his affairs in order, and should not be required to leave the settlement of difficult tax problems to his widow or his executors. We believe that whatever solution is found for the situation resulting from the death of a shareholder should be equally available to the man who wishes to settle the problem in contemplation of his death and the resultant succession duty liability, both of which will inevitably occur.

5. In approaching the problem the question immediately arises as to the type or class of company to which relief is to be granted. The terms of reference refer to "closely-held or family corporations" and we have assumed that the Commission is charged with determining in more precise terms the meaning of the words "closely-held or family corporations". In considering this problem in its broader aspects we think that generally speaking it is a sound principle of taxation to avoid special arrangements for special classes or types of company. The desirable goal is a standard basis of taxation of all corporate enterprise, irrespective of the number or relationship of the shareholders. It is inevitable that there be some departure from this principle, but exceptions should be few and every one must be fully justified. When a definite class of corporation is provided for in the law there are immediately raised a number of borderline cases, and without any real justification in equity one corporation will be entitled to the special arrangements established for the class and another will be excluded. The objections to setting up a special class of company, however, are greater in considering the problem in the future than they are in respect of the problem as it affects the past.

We are impressed with the fact that at the present time there is no difference in the theoretical taxation treatment accorded the shareholder of the closely-held corporation and the shareholder of a public company. There is, however, a very real practical difference, in that in the case of the closely-held corporation a day usually comes when personal income tax is levied on all the earnings of the corporation which have been put back into the business and not distributed as dividends. In theory a similar situation might arise for the publicly-held corporation, but in practice it seldom, if ever, occurs. Liquidation or winding up of publicly-held companies usually only takes place in the event of financial difficulties, which probably mean that the company has lost any earnings which have been accumulated in earlier years. The small company, however, finds itself in the position of having to meet this problem of an actual or theoretical distribution of accumulated earnings when the ownership changes, either by reason of the death of a shareholder or by a voluntary act of the principal shareholder in attempting a perfectly natural transaction, namely, the disposal of his business when he wishes to retire from active work. Change of ownership of the shares of a publicly-owned company through sales thereof on recognized markets raises no such issue.

In the case of the public company that part of the earnings which are retained in the business eventually accrue to the benefit of the shareholder, in fact even if not in theory, as a capital gain and not as income. A shareholder can dispose of his interest in the company at any time, and the price that he will receive, which is a capital receipt, will be affected by the amount of earnings which the company has retained. If the reinvestment in the enterprise of some part of the earnings of a corporation is a sound principle, it should be available on the same basis to the small and to the large corporation, and the objective in taxation

should be to place no undue burdens on the shareholders of a prudently administered business.

### *1. Withdrawal of a Dividend Free of Income Tax Sufficient to Pay Succession Duties*

A number of briefs presented to the Commissioners urged that a solution of the problem lay in permission being granted to family or closely-held corporations to declare and pay a dividend free of income tax, provided that the amount of the dividend was limited to an amount sufficient to meet the succession duty liability arising from the ownership of the shares of the Company, and provided further that the dividend was, in fact, used for the payment of succession duties. This proposal in slightly different forms was recommended by a number of persons appearing before the Commission and the general approach was supported in many letters that were received.

In the Commissioners' view it is unnecessary to consider at any length the variations of this main proposal, since there appear to be at least two fundamental objections to any solution based on this principle. The first objection is that the rate of succession duty that is applicable to any individual's estate is based, first, on the overall size of his estate and, secondly, on the relationship to the individual of the beneficiaries. It follows that if the relief granted were to be based on the succession duty liability there could be no equality of treatment as between taxpayers. In fact, such a proposal would give the greatest relief to the wealthy individual, who left his estate to persons other than blood relations.

A second objection to this proposal is that it would be impossible to give equality of treatment to the several shareholders of a closely-held Company. The provision of a special dividend which was made necessary to provide for the succession duty liability of the principal shareholder would, of necessity, result in a proportionate distribution to all other shareholders. If such a dividend had to be earmarked in some way for the payment of succession duties that might eventually be due in respect of such shareholders' estate a number of serious and apparently insurmountable difficulties arise—e.g., the minority shareholder might never have any succession duty liability.

The Commission is of the opinion that a solution of the problem cannot lie in relating the relief to be granted to the amount of the succession duty liability of the principal or of all shareholders.

### *2. Recognition of the Income Tax Liability in Arriving at the Succession Duty Valuation*

One of the most common suggestions made in the submissions to the Commission was that in valuing the shares of a family or closely-held corporation account should be taken of the fact that the surplus of the company could not be distributed to the shareholders without incurring a substantial tax liability.

The evidence of Mr. Frank Beer of the Succession Duty Branch of the Department of National Revenue, upon whom devolves the duty of valuing shares of private companies for succession duty purposes, shows that the contingent income tax liability which would accrue on distribution of the surplus, is not taken into account in any degree in arriving at a valuation. Whether the assets of the company are entirely represented by share capital or whether they are in the form of undistributed income on hand, is considered irrelevant.

It was urged upon the Commission that in valuing shares of such a company a calculation should be made of the income tax liability that would result from a distribution of the whole of the surplus in one year. The amount of this tax liability should then be deducted from the value of the company in calculating the value of the individual shares of the company.

As in the case of a solution related to the amount of the succession duty liability, a solution which would recognize the potential income tax liability of the individuals concerned fails to meet the criterion of equality of treatment to all taxpayers. The income tax liability of each shareholder would vary with the amount of his personal income and the greater the wealth of the individual the greater the degree of relief. Perhaps the most important objection and one that is apparently insurmountable to a solution along these lines would be that the succession duty authority would be required to take into account a contingent liability, which might never become payable. In fact, under present tax rates and in the case of large corporations, this proposal would result in ridiculously low valuations for the companies as going concerns. While such values might represent all that would be left if the company were wound up, the fact remains that the company would obviously be worth considerably more as a going concern, and some solution short of a winding up would be found. It is unlikely that many of the companies concerned would be prepared to sell their undertakings at the price which would result from such a basis of valuation.

Still another difficulty with this suggestion is that to be effective and to achieve an adequate measure of relief the solution would have to be adopted by the nine provincial taxing jurisdictions, as well as by the federal authorities.

While the Commissioners are of the opinion that a solution of the problem does not lie in attempting to provide for a precise calculation of this tax liability in valuations made for succession duty purposes, there is, none-the-less great force in the argument that in valuing the undertaking of a family or privately-held corporation under existing law some recognition should be given to the fact that the Dominion Government through the operation of the income tax law has a claim on the assets of the company, represented by its surplus, and that it is unrealistic to disregard such liability. While we do not believe that it is possible to recognize this liability by any precise formula, we suggest that the administrative officers of the Succession Duty Department in forming judgment on the valuation of shares of a closely-held or family corporation should give weight to the measure of contingent liability that does exist in connection with undistributed income on hand in the company.

### *3. Taxation of Surplus as though it had been Distributed in the Years in which it was Earned.*

A number of witnesses before the Commission suggested that the undistributed income now on hand in family or closely-held corporations should be deemed to be distributed in one year, with a tax payable equal to the amount of tax that would have been paid had the income been distributed year by year as earned. This view would appear to present an equitable approach but there are serious objections to any attempted solution which rests on a precise calculation of the tax which would have been paid had such distributions been made. In the first place, it involves a very complicated calculation because it calls for a re-assessment of the personal income tax returns of all shareholders of the company for each of the years during which the surplus has been accumulated. Further difficulties arise in cases where there have been transfers of ownership of shares during the period in which the surplus has been accumulated. Still more difficulties arise in dealing with the not uncommon situation where there have been years of loss as well as years of surplus accumulation. The Commissioners however are of the view that a solution of the problem insofar as surpluses which have accumulated in prior years are concerned rests on some formula which will approximate the results suggested by those who advocate a re-assessment of the personal income tax returns of the shareholders during the years in which the surplus was accumulated. The Commissioners feel that a detailed calculation

would be unduly burdensome and would not necessarily do justice in all cases; it would still be an artificial basis, since the surplus was not and in the great majority of cases could not have been distributed as earned.

A variation of this proposal which was advocated by a number of witnesses before the Commission is that family and closely-held corporations be given the opportunity of making a distribution of the surplus accumulated up to a specified date, either by an actual distribution of assets to the shareholders or by a capitalization of such surplus upon payment of a tax calculated by applying a flat rate to the aggregate of undistributed income on hand at the specified date. It was suggested that the rate to be used should be based on the average rates of personal tax that have been in force up to the date specified, assuming a level of personal income appropriate to the average case. A further modification that was suggested was that there should be an additional tax payable in respect of large sums accruing to an individual shareholder under such a plan, in order that those in the high income brackets would not benefit unduly from the determination of the basic rate on the levels of tax applicable to those of more modest incomes.

A further refinement of this general approach was suggested by those who urged that one flat rate of tax be applicable to surpluses accumulated during the years 1920 to 1929 and another rate applicable to surpluses accumulated in the years 1930 to 1939, recognizing that the personal rates of tax in the 1930's were substantially higher than those applicable in the 1920's. Some witnesses advocated that the permission which was granted in the years 1930-34 to distribute surplus accumulated up to 1929 on a tax free basis should be re-introduced into the Income War Tax Act. These witnesses argued that many family or closely-held corporations had not taken advantage of the legislation existing in 1930-34, either because of ignorance of the law or because they were unable to do so through circumstances beyond their control.

As has been stated already, the Commissioners are of the view that the only feasible solution in respect of the surplus accumulated in past years by the corporations with which we are concerned is to permit a distribution or capitalization of such surplus upon payment of a flat rate of tax, modified to give effect to some of the suggestions outlined in the previous paragraphs.

#### *4. Taxation of Private or Closely-held Corporations as a Partnership.*

A suggestion put forward by a number of witnesses before the Commission was that there be re-introduced into the Income War Tax Act the provisions which were rescinded in 1932, relating to family corporations. In brief, those provisions permitted a defined class of closely-held corporation to elect to be treated as a partnership for the purposes of taxation; that is, that the entire taxable income of the corporation each year be deemed to be distributed to and taxed in the hands of the shareholders and that the corporation as such be exempt from income tax. This proposal, no doubt, arises from the view, which appears to be widely held, that it is desirable to get away from the "double taxation" of corporate profits; the provisions relating to family corporations previously in the law did remove the double taxation feature insofar as the companies affected were concerned. However, as such a large proportion of Canadian corporations are family or closely-held corporations (approximately 10,000 out of a total of 28,000 companies in Canada appear to come within this classification), it would seem an unwarranted departure from the principle of double taxation of corporate profits to grant a single tax basis to them unless it was a part of a basic change in the whole field of taxation of corporate profits. Presumably this factor was of importance in the decision to rescind the provisions previously applicable to "family corporations".

While the foregoing arguments apply in times of low or moderate personal and corporate income tax rates, a different situation would result under the present personal and corporate tax levels. The adoption of the old "family corporation" principle would, in many cases, prevent a company from retaining a reasonable proportion of its earnings for unforeseen contingencies and for the normal growth and expansion of the business. The situation may be illustrated by the hypothetical case of a corporation, owned by one man, which earns \$50,000 in a given year, after payment of all expenses except a salary to the owner of \$15,000. Such a corporation would have \$35,000 of taxable income which, after payment of a minimum corporation tax rate of 40 per cent, would leave \$21,000 which could be put back into the business, without incurring any further immediate tax liability. As a family corporation the entire \$50,000 would be subject to personal rates of tax, which at present would amount to some \$33,000, assuming the shareholder to be a married man without dependents. If the shareholder retained for living expenses the same net amount which he would have retained from a \$15,000 salary, the only amount available for re-investment in the business would be approximately \$9,000, as against the \$21,000 which would be available if the business were treated as an ordinary corporation.

It may be that under particular circumstances some family or closely-held corporations would take advantage of such a solution if it were available under the law. If they were able to do so on a continuing basis the problem presented when a succession duty liability had to be paid would be met. While some companies might well follow such a course, there would undoubtedly be many that would not choose or perhaps would not be able to pay tax on such a basis under existing tax levels, and for these companies the problem to which we are seeking a solution would still exist. The Commissioners believe that a solution along these lines would not adequately meet the situation, and under high levels of corporate and personal tax might well act as a serious limitation on the development of Canadian business.

##### *5. Recognition of the Accumulation of Earnings as Natural Growth.\**

A number of witnesses before the Commission urged that the tax law should recognize the requirement of sound management that some portion of the income earned by a corporation be not distributed to shareholders, but be retained in the corporation to meet unforeseen contingencies and to provide for the natural growth and expansion of the company. This suggestion is predicated on the fact that the corporation is a legal entity, separate and distinct from its shareholders, and that its income, which is taxed as such, is not necessarily all "income", within the meaning of the word for tax purposes, in the hands of the shareholders. The law at present recognizes that a corporation need not, and in many cases, cannot, distribute its total earnings in each year, and that only such part of the earnings as is distributed in any year should be treated as taxable income to the shareholders in that year. It is worthy of note that Section 13 of the Income War Tax Act reserves to the Minister the right to take certain action in cases where he is of the opinion that an undue accumulation of earnings is taking place in the hands of any corporation. While we have been told that the authority granted by this Section has not been exercised to any extent, the existence of the Section in the Act recognizes the need for some accumulation of earnings from year to year.

It is also, we believe, of consequence that the tax law does not say that the total income earned by a corporation must eventually be considered as income to the shareholders. The law recognizes that a corporation will have disbursements

\* For a different viewpoint see Commissioner MacGibbon's reservations.

and losses which will, in fact, be met out of income, even though they are not taken into account in determining the taxable income of the corporation. Accordingly, the tax law provides that on the winding up of a corporation it is only the undistributed income that is actually on hand which is considered as a distribution of income to the shareholders. This approach to the problem suggests that a solution for the future lies in a recognition in the tax law that, within some permitted maximum, earnings which are in fact retained in the corporation should be considered, on eventual winding up or discontinuance of business, as a capital accretion of the original investment, rather than as income to the shareholders, the receipt of which has been deferred.

In considering this suggestion we have examined a number of statistical summaries designed to show the percentage of earnings which successful businesses have retained. Our study has shown that it is not possible to state with certainty any general figure which would represent the percentage of earnings that should be retained in a well administered private company. The percentage retained varies with the type of activity in which the company is engaged, with the size of the company, and with the general economic conditions of the period concerned. On the other hand, there is a substantial body of evidence to support the contention that very few companies can, over any extended period, distribute more than 80 per cent of their net earnings. In other words, while it is impossible to say what percentage of earnings should be retained, it seems to be possible to state a minimum amount that should be retained by almost any successful enterprise.

A detailed statistical analysis could be undertaken to establish the average percentage of earnings which has been retained by these businesses in Canada which have remained in business over some stated period. We question, however, whether a figure produced in this way would in fact give any greater degree of equity than the choice of an arbitrary figure. The adoption of such a principle would require either the setting of an arbitrary limit, the development of a scale of limits which would attempt to differentiate between industries and size groups, or, a third alternative, an extension of the principle of administrative discretion. In this connection it is interesting to note that the system of income tax in force in the United Kingdom, which is frequently referred to as the "single tax basis", rests, in part, insofar as it applies to private companies, on an annual review by the authorities of the amount of earnings retained in the company for the purposes of the business. We are informed that once approval has been given to the amount of earnings so retained in the business such amount is thereafter considered as part of the capital of the enterprise, and may be distributed to the shareholders on winding up without any further tax liability being incurred. This principle, we believe to be sound, but we do not advocate the reliance on administrative discretion in determining the amount of earnings which can properly be considered as capitalized. Rather, we would prefer an arbitrary limit expressed in the law, even though such limit did not meet fully the requirements of all companies.

Some witnesses in urging this proposal as a solution for the future argued that the amount of earnings which should be permitted to be capitalized should be determined as a percentage of the capital and accumulated surplus in the corporation. Others urged that the amount be determined as a percentage of earnings after taxes. Arguments can be advanced in support of both these courses, but we believe the latter to be the most desirable particularly having regard to its administrative simplicity. Determination of income for tax purposes presents many problems, but machinery for the purpose has been established and, in general terms, earnings can be determined with a greater degree of certainty than can capital values.

## RECOMMENDATIONS

In considering the proposals that have been made, the Commissioners are impressed with the fact that, under the general tax structure in force, it does not appear that any completely satisfactory solution can be found. Furthermore, there is no one of the many proposals made which is advocated by a majority of the witnesses. The situation is quite different from that pertaining to the first branch of the reference on the subject of taxation of annuities, where there was an almost unanimous view that contractual annuities comprised a substantial element of capital that should not be exposed to income tax for a second time. The numerous suggested solutions to the problems of the closely-held or family corporations which were put forward of necessity had regard to the present income tax structure, and the only real similarity that can be found in them is the opinion that no real solution can be developed until there is a recasting of the whole income tax structure as it applies to corporate profits. The Commissioners subscribe to this view, but believe that it is possible to make a recommendation which, while recognizing the limitations of the double tax structure, will make possible the granting of relief to those companies which now face the problem, and which will remove the element of uncertainty that now exists in the situation until such time as a complete review of the tax structure may be possible. We recognize that our proposal will not do justice in all cases.

Our proposal rests on two fundamental bases. The first is that the solution in respect of past years must be such that it will render to the public treasury an amount of tax approximating that which would have been received had the surplus accumulations been distributed year by year as earned. In dealing with the past we are limited by the tax structure that has been in force, and by the fact that the problem now confronting the companies with which we are concerned varies in degree according to the policies that they have followed in respect of profit distribution. We are satisfied, therefore, that the only equitable solution in respect of the past is one which will, as nearly as may be practical, place all corporations in substantially the same position. With respect to the future, with which we include the war years, we believe that the solution must rest on a recognition in the tax law of the principle that some part of the earnings of a business must be retained for contingencies and for the natural growth and expansion, and that it is, therefore, impractical, under a system of personal taxation based on graduated rates, to consider that all the earnings of the corporation eventually accrue to the shareholders as income. Some part of such earnings, we believe, should upon dissolution be considered as capital accretion, following the principle established under the British tax system.

The Commissioners do not believe that this principle established in the law would necessarily give a more advantageous tax basis to corporate enterprise than that available to an individual conducting his business as a sole trader or as a partnership. The taxation treatment of a business carried on under corporate form is quite different from that given to the sole proprietor or partnership. One is a single tax basis and the other a double tax basis. The aggregate tax paid by the shareholders of a corporate enterprise includes the tax paid by the corporation as well as that paid by the shareholders. The income which is paid to the shareholders, and which is thereby subject to personal rates of tax, may be averaged by the payment of a standard rate of dividend, notwithstanding a fluctuating rate of corporate profit. The sole proprietor does not have this same facility, but, as against this, the sole proprietor is not called upon to pay the corporate tax on profits of his business. We believe that if there is need to adjust



the net tax contribution by either the corporate enterprise or the sole trader the adjustment can well be made by means of alterations in the corporation tax rates. The introduction of a new principle which would recognize the plowing back of earnings into an enterprise that takes place need not upset the balance between the tax contributions from the two forms of business enterprise.

1. The Commissioners are of the opinion that the companies to which the special provisions herein proposed should be made available are those Canadian companies, irrespective of the jurisdiction in which they were incorporated, which come within the definition of a private company as set out in the Dominion Companies Act. The difficulty with which we have to deal is one which may arise in any company which is not listed on any recognized stock exchange and the shares of which, as a result have no ready market. The distinction between public and private companies in the Dominion Companies Act and the Companies Acts of most of the Provinces is based largely on whether or not a company offers its shares to the public. While most of the suggestions made to the Commission, no two of which are alike, contemplate a greater restriction we feel that to limit unduly the companies to which relief is afforded would be a mistake. The classification should be wide enough to cover most companies requiring relief and yet narrow enough to rule out companies for the shares of which a ready market is available. Further it follows a manner of division already well known and well established.

We recognize that there will be a number of companies that were incorporated before the introduction of the private companies' provisions in the Dominion Companies Act, as well as companies incorporated under provincial authority, which may not meet the full technical requirements of the definition in the Dominion Companies Act. It is not our view that such companies should be excluded, but rather that the definition, when incorporated into the income tax law, should in general terms include any company whose shareholders, exclusive of employees, number less than fifty and whose shares have not been offered for public subscription. Throughout the balance of these recommendations we shall refer to private companies by which we mean companies coming within the class that we suggest be established.

Our terms of reference instruct us to consider the position of private companies and, therefore, our inquiry has had regard to this type of company. Accordingly, our recommendation, both in respect of past accumulations of surpluses and accumulations in the future, is made in relation to this class of company only. As stated earlier, however, we believe that it is desirable to avoid setting up special categories of taxpayers and we have, therefore, given some consideration to the possibility of our suggested solution for the future being one which could be applied to all corporate taxpayers. Our study of the situation has not been sufficiently extensive for us to make a definite recommendation in this regard, but we believe that consideration should be given to the adoption of the principle we recommend for private companies as a general principle applicable to the taxation of corporate enterprise.

2. We recommend that any private company having accumulated undistributed income on hand may, to the extent that such income was earned prior to the end of its 1939 fiscal year, apply for permission to settle the income tax liability that would arise on the distribution of such income to its shareholders. In determining undistributed income we recommend the continuation of the practice now being followed by the Income Tax Division, which was described in Section B of this part of the report.

3. We are of the opinion that it is necessary to specify a period during which the special arrangements for the settlement of this tax liability will be available

and accordingly recommend a period of not less than two years from the date on which the terms of the plan are made public by statute. The rates of tax which we propose have been established with regard to the rates of personal income tax that were in effect during the period up to the end of 1939, and also with regard to the period over which these surpluses have been accumulated. In seeking a solution which will do rough justice it is necessary to consider the interest element and, while we do not suggest that any precise calculation be made, we have recommended rates of tax somewhat in excess of what might be shown to be the marginal rates of tax applicable on the next \$1.00 of income of the average shareholder assuming distribution of the surplus over a period of years between 1917 and 1939. It is, therefore, necessary that the proposals we make be available only for a limited period, but we believe it essential that the companies concerned be given an adequate opportunity to make the necessary arrangements for the settlement of their problems. This may well involve a major re-arrangement in the finances of the company. We believe that any plan adopted should be given the widest possible publicity in order that all companies, particularly those located outside the bigger centres, may know of the courses open to them.

4. We believe that the special proposal which we make for the settlement of the tax liability in respect of undistributed income accumulated up to the end of the 1939 fiscal year should be available only on condition that the company deal with the tax liability calculated on the entire undistributed income accumulated up to that point. Any proposal which permitted the companies to avail themselves of the special rates of tax which we suggest in respect of only a part of the accumulated surplus would, we believe, give an opportunity to the companies to take undue advantage of the proposals.

5. The plan we recommend for the settlement of the problem as it relates to surpluses accumulated up to the end of 1939 is that, upon payment of a tax by the company calculated as set out in the next paragraph, the company be permitted to capitalize such surplus, less the amount of tax applicable thereto, or to distribute such net amount to the shareholders in any manner that may be permissible by law,—the whole transaction being made without the imposition of any further income tax liability on the shareholders in respect of such income. We believe that in the majority of cases the companies will be able to finance the necessary tax payment, but we do not anticipate that such provisions would, in the ordinary case, result in any large distribution of cash dividends to shareholders, since in the majority of cases surpluses are represented by capital assets or current resources needed for the conduct of the business.

6. The tax payable by the company should be the aggregate of a tax calculated in respect of the distribution to each shareholder determined from the following table:—

- On the first \$25,000, or any portion thereof, 15%
- \$3,750 on a distribution of \$25,000 and 18% on the amount by which the distribution exceeds \$25,000 and does not exceed \$50,000.
- \$8,250 on a distribution of \$50,000 and 21% on the amount by which the distribution exceeds \$50,000 and does not exceed \$100,000.
- \$18,750 on a distribution of \$100,000 and 24% on the amount by which the distribution exceeds \$100,000 and does not exceed \$200,000.
- \$42,750 on a distribution of \$200,000 and 27% on the amount by which the distribution exceeds \$200,000 and does not exceed \$300,000.
- \$69,750 on a distribution of \$300,000 and 30% on the amount by which the distribution exceeds \$300,000 and does not exceed \$400,000.
- \$99,750 on a distribution of \$400,000 and 33% on the amount by which the income exceeds \$400,000.

An alternative method would be to tax a distribution of accumulated income to the individual as a lump sum withdrawal of savings that had not paid income tax at the time it was earned on the basis of taxing one-third of the total amount at 1944 income tax rates applicable to a single person without other income. The method would employ the scale of graduation now incorporated in the Income War Tax Act as a measure of ability to pay. The principle of taxing one-third of the total amount of a lump sum withdrawal of savings that had not borne income tax is exemplified in the Act under Section 3(c) in the case of a lump sum return of savings to an employee out of a pension fund or plan upon his withdrawal or retirement from employment. In this case the taxation of one-third of the total has been considered to approximate broadly the amount of income tax that would have been paid if the income had been taxed when earned.

7 Some concern has been expressed that the settlement of this tax liability might adversely affect the ability of private companies to meet their post-war financial requirements. With a view to minimizing this objection we recommend that the companies concerned should be permitted to use in part settlement of this tax liability the refundable portion of any excess profits taxes which may have been assessed and paid.

8. In respect of surplus accumulations made in the 1940 and subsequent fiscal years we recommend that the tax law recognize that a part of the earnings of the corporation, after payment of full corporation taxes, must be retained in the business and should be considered, on eventual distribution to the shareholder, as a capital accretion and not as taxable income. As this proposal rests on the premise that it is necessary to withhold earnings from distribution to the shareholders it follows that the special provision which we recommend would only be available to the extent that earnings were, in fact, retained in the business. Accordingly, the special arrangements which we suggest would only operate in the case of a re-organization of a company, which involved a beneficial change of ownership, or on the winding up or discontinuance of the business of the corporation. We recommend that 20% of the aggregate taxable income after payment of corporation tax and after deduction of operating losses in years in which a loss was suffered be the maximum permitted as a capital accretion on the winding up, discontinuance or change of ownership of a private company. We recognize that in many cases it will be necessary for the companies concerned to retain considerably more than 20% of earnings for the purposes of the business, but until such time as this principle has been in force for a reasonable period, and the results of its operation observed, we do not believe that a greater percentage could be justified. The only alternative to a relatively low fixed percentage would be to follow the British practice of an annual review of the position of each closely held corporation for the purpose of determining the needs of that particular corporation. We think it undesirable that the administrative officers of the Government should be placed in the position where they have to pit their judgment as to the financial needs of a business against the judgment of the management of that business. Accordingly, we urge that the principle of a fixed percentage be established. This provision which we recommend of a recognition of capital accretion need not prevent a company from making distributions in excess of 80% of its earnings while it is a going concern. The company would be completely free to make its own decision as to the amount of earnings which it could prudently distribute, and we suggest no change in the present law that any dividends or shareholders' bonuses paid or distributed while the company is a going concern should be taxable income in the hands of the taxpayer. Distributions of a company in excess of 80% of its earnings would simply mean that on the eventual winding up or sale of the business the full benefit of the capital accretion principle would not be available to the shareholders.

To introduce the principle which we suggest we recommend that the law be amended to provide that on the reorganization of a private company, which involves a change in the beneficial ownership, or on the winding up or discontinuance of business of such a company, the undistributed income of such company, which is deemed to be the payment of a dividend under the present law, be reduced by an amount equal to 20% of the company's aggregate taxable income, less income and excess profits taxes thereon earned in the 1940 and subsequent taxation years, after deducting any operating losses suffered in 1940 or any subsequent taxation year.

#### SUMMARY OF RECOMMENDATIONS

1. That the companies to which these recommendations apply be those which, in general, come within the definition of a private company as provided in the Dominion Companies Act.
2. That capitalization or distribution of surpluses earned prior to the end of the 1939 fiscal year be permitted on payment of a special tax by the company, which will approximate the tax that would have been paid by the shareholders had the surplus been distributed year by year as earned.
3. That to accomplish this objective a graduated rate of tax be applied to the amount of the distribution or capitalization made or accruing to each shareholder—the minimum rate being 15% on amounts up to \$25,000, and the maximum being 33% on amounts in excess of \$400,000 to any one shareholder.
4. That permission to capitalize or distribute such surpluses be available for a period of two years from the date that the plan is made law.
5. That the refundable portion of excess profits tax be made available to apply in part payment of the special tax.
6. That on the reorganization of a private company which involves a change in beneficial ownership, or on the winding up or discontinuance of business of any such company, the undistributed income which is deemed to be the payment of a dividend under the present law be reduced by an amount equal to 20% of the income after tax earned in the 1940 and subsequent taxation years.

Respectfully submitted,

W. C. IVES, *Chairman*

D. A. MACGIBBON\*

J. A. MICHON, *Secretary*

M. W. MACKENZIE

Ottawa, March 29th, 1945.

\* Subject to reservations on certain matters as set out in his memorandum attached.

## MEMORANDUM OF RESERVATIONS

*By Dr. D. A. MacGIBBON*

I concur with my fellow commissioners in all the recommendations contained in this report except the final one. I do not concur in the recommendation that in future private companies be permitted to set aside 20% of earnings after payment of corporation tax as a surplus free of personal income tax to the recipients on the winding up, discontinuance or change of ownership of a private company. Nor do I concur in the final sections of the report advocating this measure. Despite the skill and adroitness with which the assembled arguments are presented, I am not convinced that it would be in the public interest to introduce into the Income War Tax Act, on the basis of a so-called capital accretion principle, a special privilege to private companies. The proposed legislation "predicated on the fact that the corporation is a legal entity separate and distinct from its shareholders" lends support logically, I consider, to the unfair practice of the double taxation of income earned and distributed through the medium of corporate bodies.

Conceding the privilege to private corporations of setting aside 20% of net earnings to be free of income tax on withdrawal in the event of a winding up, discontinuance or change of ownership would offend, I believe, in a considerable number of cases against the principle that individual taxpayers, who are shareholders of closely held corporations, should pay substantially the same amount of income tax on the distribution of accumulated income that they would have paid if the income had been distributed at the time it was earned. The inclusion of such a provision in the Income War Tax Act would place the shareholders of such closely held corporations, despite payment of corporations taxes, in a preferential position compared with ordinary taxpayers in accumulating savings during their lifetime.

Because of the nature of the business, the owners of some closely held companies would find it necessary to set aside annually a percentage of earnings greater than 20% and to this extent a part of their accumulated income when distributed would be subject to income tax. Under these circumstances the tax free concession would be discriminatory in its effects as between the shareholders of different companies. On the whole, however, I think that if the recommendation of allowing 20% of earnings to be set aside as a surplus free of personal income tax on subsequent distribution were given effect to a large number of closely held companies in the future would plan their dividend policy so as to be able to distribute all or a major portion of their accumulated surpluses free of income tax.

Generally speaking, I do not consider the granting of special tax free privileges to be a desirable method of revising the Income War Tax Act. The granting of this particular concession would make it likely, I think, that with the immediate point of pressure removed by such a measure, action upon the present generally unsatisfactory condition of corporate taxation methods in Canada would be indefinitely postponed; the necessity for a general revision would not receive the attention that the situation really demands. I am strongly of the opinion that a fundamental solution of the larger problem of eliminating the double taxation feature involved in the taxation of corporate income in Canada will alone permanently and satisfactorily remove the difficulties attending the taxation of undistributed surplus in closely held corporations upon distribution.

For all these reasons, I regret that I cannot see my way clear to concur with my colleagues in their recommendation.

Until the whole field of the taxation of corporate income in Canada is adequately surveyed and re-organized, I suggest that the method which may be selected for taxing accumulated surpluses for the period up to the end of 1939 be continued and applied to surplus accumulated after that date with an appropriate increase in rates having regard to the sharp advance in personal income tax rates that has occurred since 1940.

Respectfully submitted,

D. A. MACGIBBON.

Ottawa, March 29, 1945.

**APPENDIX "A"**

**PENSION PLANS**

**A STUDY OF PENSION PLANS AND ANNUITIES FOR THE ROYAL  
COMMISSION ON TAXATION OF ANNUITIES AND  
FAMILY CORPORATIONS**

**C. H. Curtis  
Kingston, Ontario  
March 2, 1945**

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## APPENDIX "A"

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## PENSION PLANS

This study is an analysis of information which the Department of Industrial Relations, Queen's University, collected from those administering pension and annuity plans approved by the Department of National Revenue. The Department of Industrial Relations secured a list of these approved plans and, at the request of the Commission, circulated a questionnaire among the corporations and associations listed. It was hoped in this way to secure reports on a sufficient number of pension and annuity plans to make it possible to estimate the importance of such plans in terms of the total number of persons participating and in terms of the total sums of money set aside for the provision of pensions.

### THE NUMBER OF PLANS COVERED

The Department of Industrial Relations sent out 927 questionnaires. By February 27, 1945, it received 502 replies. A number of these replies cover more than one of the approved plans on the list, for companies frequently found it convenient to combine the reports of their subsidies with the report of their own pensions. Some replies covered plans which are not listed but which are reported as being on the same basis as those listed. Thus the 502 replies provide information on 578 of the plans on the list and on 47 plans that were not listed, a total of 625 plans. Of these 625 plans 38 are reported as inoperative. Some, it appears, were never set up, some were discontinued before 1944 and some have been put in operation since December 31, 1944. This study deals, then, with the 587 operative plans which are covered by 464 of the 502 replies received.

Each of the 464 replies dealing with operative plans will be considered here as a single plan. This procedure is dictated by the fact that, in most cases, it is impossible to separate the plans which are combined in one report. It does not interfere with the accuracy of the analysis provided it is borne in mind that the 464 plans and combined plans cover 587 approved plans out of a total of some 927 listed plus 47 unlisted plans.

### THE NUMBER OF PERSONS COVERED

The replies to the questionnaire show that 406,899 persons are eligible for participation in the 464 plans under review. Of these persons, 343,326 are covered by pensions plans.

If the pension plans on which no reports have been received are of the same order as those reported, it seems reasonable to assume, taking due account of some very large plans already reported, that about 450,000 persons are covered by pension and annuity plans approved by the Department of National Revenue and some 534,000 are eligible to participate in operative plans. These persons are in the following broad occupational groups: mining, manufacturing, electric light and power, building and construction, transportation and communications, warehousing and storage, trade, finance and insurance, service and clerical work. The latest information available on employment of persons in occupational groups is a sheet released on February 9, 1945, by the Research and Statistics Branch, Department of Labour, entitled *Estimated Manpower Distribution in Canada*. This sheet shows that on October 1, 1944, there were 2,860,000 gainfully employed persons over 14 years of age in non-agricultural industry, excluding employers, own accounts and no pays. Before this estimate can be placed against the estimated number of those covered by pensions, it should be reduced to take account of the fact that many gainfully employed persons are classed as temporary employees by their employers and, as such, are not eligible to participate in pension plans. Others included in the estimate are engaged in logging and fishing—

occupational groups from which no pension plans are listed. If these deductions should reduce the estimate of 2,860,000 by 660,000 to give 2,200,000 employed persons the nature of whose employment would make them eligible for pensions, then some twenty per cent of these persons are covered by approved pension plans as of December 31, 1944 and some twenty-five percent have pension plans open to them.

It is interesting to note that of the 406,899 persons reported as eligible for participation in pension plans only some 105,000 might be put in that somewhat vague category "industrial workers". These are taken here to be persons employed in mining and manufacturing establishments. Of these 105,000 persons, some 48,000 are covered by pension plans.

Before considering further the size of this group of industrial workers eligible for participation in pension plans, it should be pointed out that employers in industry were asked in the questionnaire for the total number on their payrolls, wage earners and salaried employees, male and female and for their payrolls for December 1944 for each of these groups. They were not asked to classify their employees as eligible and not eligible for participation in pension plans. It was decided that this latter information was not readily available to most employers and that the securing of it would delay replies to our questions. Furthermore it was thought that the number of persons on the payroll and the number eligible for pensions would be about equal. Some few replies show an estimate of the number reported on the payroll who are *not* eligible for participation. These comments lead to the conclusion that possibly between one third and one quarter of those on payrolls are classed as temporary employees who do not come under the pension schemes.

The number of *industrial* workers classified as eligible for participation in pensions, must therefore be reduced from 105,000 to 80,000 or even 70,000. This adjustment is not necessary in the case of other employees for other administrators were asked directly for the number of eligible persons.

Even with this adjustment in the estimate of industrial workers eligible it appears that industrial workers do not take advantage of pension plans as do non-industrial workers. Some 48,000 out of an eligible 70,000 or 80,000 are covered while out of the total of 406,899 employees in all groups eligible some 343,326 are covered. A few typical replies chosen at random from those submitted by industrial concerns is presented in Table 1 to show the extent to which industrial workers are covered in individual firms. It will be noted, too, that those classified as salaried employees participate in pensions in relatively larger numbers than those classified as wage earners.

TABLE 1

Company	Number of Persons on Payroll		Number of Persons Covered by Pension Plan	
	Salaried	Wage Earners	Salaried	Wage Earners
I.....	17	110	8	19
II.....	711	2054	179	205
III.....	15	35	5	3
IV.....	25	329	18	256
V.....	445	692	247	251
VI.....	68	236	43	91
VII.....	8	143	5	17
VIII.....	50	255	23	25

This lack of participation by industrial workers may be partly the result of the fact that participation in a pension plan is not, ordinarily, a condition of employment in industry, while it is a condition of employment in many cases for those in the other occupational groups covered by this survey. Furthermore, by far the larger number of pension plans in industry are new plans, set up in the period 1939-1944. It may be that the industrial worker is not yet convinced of the desirability of the innovation.

Most of the industrial pension plans included in this survey are small. The 48,000 industrial workers reported covered by pensions are in some 250 plans—over fifty per cent of the 464 plans included in this study. Yet these 48,000 employees constitute only some fourteen percent of the total number of employed persons covered by the 464 plans. It seems, therefore, that many small industrial concerns have introduced pension plans since 1939 and that these plans are more general throughout "industry" than the number of persons covered by them would lead one to believe.

Unfortunately the questionnaires did not ask for full information on female employees eligible for and covered by pension plans. For that reason the replies give a very incomplete picture of the extent to which these employees are affected by pension plans. The 275 plans that do report female employees covered by plans show that 7,515 of the 40,443 persons covered are female employees. It is interesting to note that most of these female employees were classified as salaried employees.

Most of these 275 plans are small—as the total number of participants suggests—and most of them are in industrial establishments.

#### THE DATE OF ESTABLISHMENT OF PLANS

Table 2 shows the number of plans, now operative, that were established in each year since 1928. Table 3 shows the number of plans, now operative, that were in existence at each year end from 1929 to 1944 inclusive.

It should be noted that Tables 2 and 3 take no account of plans which were set up before 1944 and discontinued before 1944. There is no information available regarding such plans. These Tables show only the net increase in the number of plans—the total number of plans established less the number that survived until December 31, 1944.

The Tables suggest that pension plans are usually introduced in periods of business prosperity. Unfortunately, for the reason just given above, it is impossible to show how many were introduced in the prosperity of the late 1920's only to collapse in the depression of the early 1930's. Certainly few of the plans now operative have their origin in this latter depression period. At the same time it is true, as Table 3 shows, that the number of pension plans surviving until 1944 almost doubled between the years 1929 and 1936 inclusive.

The most conspicuous thing that appears in the Table is the large number of operative plans reported as established during the years 1939 to 1944 inclusive. In this period 298 of the 464 operative plans—some sixty-four percent—were established. These plans cover 52,472 employees about fifteen percent of the total number of employees covered. Thus the recently established plans, although numerous, are small. Most of them, as pointed out above are in small industrial establishments.

TABLE 2

NUMBER OF OPERATIVE PENSION PLANS ESTABLISHED EACH YEAR, 1929-1944

1929.....	15
1930.....	15
1931.....	6
1932.....	3
1933.....	2
1934.....	13
1935.....	6
1936.....	13
1937.....	18
1938.....	25
1939.....	31
1940.....	38
1941.....	32
1942.....	23
1943.....	84
1944.....	90

TABLE 3

NUMBER OF OPERATIVE PLANS IN EFFECT AT EACH YEAR END 1929-1944

1929.....	65
1930.....	80
1931.....	86
1932.....	89
1933.....	91
1934.....	104
1935.....	110
1936.....	123
1937.....	141
1938.....	166
1939.....	197
1940.....	235
1941.....	267
1942.....	290
1943.....	374
1944.....	464

## ESTIMATED INCOME OF PERSONS COVERED BY PENSION PLANS

The incomes of persons covered by pension plans are estimated here in two ways. The administrators of some plans were asked to give the rate of their employees' contributions expressed as a percentage of earnings and to give the amount of employees' contributions for the month of December 1944. These two figures serve as the basis for the calculation of the incomes of the employees concerned, for that month. The annual income is then taken to be twelve times the income for the month.

Other administrators—chiefly those in industrial establishments—were asked to give their payrolls for the month of December, showing the number of salaried employees, the number of wage earners and the total pay of each group for the month. These figures permit the calculation of the average monthly earnings of each group. It is assumed that employees under pension plans are remunerated at the average rate earned by their group and their earnings are calculated on that basis.

In a few cases actual earnings of employees were available. When these are used to check the estimates it appears that the incomes calculated by the first procedure may be over-estimated. This error may arise from the fact that some employees contribute amounts in excess of those prescribed by the rates in effect. The estimation of income on the basis of these contributions and the prescribed rates would lead to an over-estimate.

On the other hand, it appears that there may be an under-estimate of the incomes calculated by the second method. It is probably true in many cases that it is the higher salaried employees and the better paid wage earners who participate in pension plans. The use of an average of the earnings of all salaried persons and an average of the earnings of all wage earners will then lead to the under-estimation of the incomes of those covered by the plans.

The incomes arrived at by these two procedures are added to secure a total. It is hoped that the errors in estimation will be cancelled out to some extent in this process.

These estimates show that the 343,326 persons reported as covered by pension plans earned \$52,169,925 in December 1944 and \$626,039,091 in the year 1944.

It was estimated above that all approved pension plans probably cover 450,000 persons. Their earnings, estimated on the basis of the earnings of those reported would be about \$68,333,000 in December 1944 and \$820,000,000 for the year 1944.

The Business Statistics Branch, Dominion Bureau of Statistics, on February 27, 1944 provided what it terms a rough estimate of the payrolls of a majority of industrial and service groups in Canada. This estimate shows a total of \$5,684,582,000. It does not include the payrolls of agriculture, logging, fishing and trapping.

If this total payroll is reduced by about twenty-five per cent. to eliminate the earnings of temporary employees whose employment is such that they would not come under pension plans, then \$4,263,437,000 would be the estimated earnings of persons the nature of whose employment would make them eligible for coverage by pension plans. This reduction of total estimated earnings is parallel to the reduction in total number of employed persons made above.

The estimated earnings of the estimated 450,000 persons covered by all approved pension plans, that is, \$820,000,000 is almost twenty per cent. of the adjusted estimate of the payrolls of industrial and service groups.

The estimated earnings of the 343,326 persons reported as actually covered by pension plans, that is, \$626,039,091, is about fourteen per cent. of the adjusted estimate of the payrolls of industrial and service groups.

It should be borne in mind that all these estimates regarding income are rough and that a study of more complete data than is now available might lead to somewhat different conclusions.

#### CONTRIBUTORY AND NON-CONTRIBUTORY PLANS

Most of the pension plans under consideration are classed as contributory—445 of the total of 464 fall into this category.

Employees covered by these plans contribute on various bases. Sometimes all contribute the same percentage of salaries or wages—three percent., four per cent. or as much as seven per cent. The rate of individual contributions sometimes

varies depending on the age of the participant or on his salary or wage range. Sometimes employees are allowed to contribute sums in excess of the regularly assessed contributions.

### CONTRIBUTIONS TO PENSION PLANS

#### 1. *Monthly Contributions.*

In the month of December 1944, employees covered by pension plan contributed a total of \$1,435,271 towards pensions. In the same month employers contributed, on behalf of employees \$2,470,747. Thus total contributions for the month were \$3,906,018. Total contributions are 7.6 per cent. of the estimated earnings in December 1944 of those reported as covered by pension plans.

#### 2. *Annual Contributions.*

In the year 1944 employees covered by pensions contributed \$19,058,141 towards the plans. Employers, in the same period contributed \$25,572,608. The total of these contributions, \$44,630,749, is 7.1 per cent. of the estimated earnings in 1944 of those reported as covered by pension plans.

#### 3. *Contributions over the Past Ten Years.*

In the past ten years employees have contributed \$121,630,619 to pension plans now operative and employers have contributed \$178,061,852 making a total of \$299,692,471 that went into such plans from both sources.

It will be noted that the contributions made by employers are, in each period, in excess of those made by employees. Quite a number of those replying to the questionnaires showed as separate items the portion of their annual contribution to pensions that was the usual amount and the portion that was in payment of past services. These payments on account of past services are made both by employers with new plans and those with plans of some years' standing. They probably account for most of the excess of employers' contributions over employees' contributions.

### PLANS WITH DEDUCTIBLE CONTRIBUTIONS AND PLANS WITH NON-DEDUCTIBLE CONTRIBUTIONS

Employees' contributions to most of the pension plans under review are reported to be deductible by them in calculating their taxable income. This is true in 421 of the 464 plans. Since 20 of the remaining plans are non-contributory, it follows that employees' contributions to 23 plans are not deductible in calculating taxable income.

### THE ADMINISTRATION OF PLANS

Most of the plans reported provide pensions through insurance companies or through the Annuities Branch, Department of Labour. Some plans provide part of the annuity through the Annuities Branch, part through an insurance company. By either or both of these methods pensions are provided under 385 of the plans. The remaining 79 plans provide pensions out of special funds set aside and managed by the administrators of the plans themselves.

### PLANS PROVIDING PENSIONS OUT OF SPECIAL FUNDS

The pension plans reported as providing pensions out of special funds deserve separate consideration. These plans are not numerous. Only seventy-nine of the 464 reported plans are of this sort. But they cover 283,143 of the 343,326 persons reported as covered by pension plans. Furthermore, they receive the bulk of all contributions to pensions as Table 4 shows.

**TABLE 4**  
**TOTAL CONTRIBUTIONS TO ALL PENSION PLANS AND**  
**TO PLANS WITH SPECIAL FUNDS**

Period	Contributions to all Plans	Contributions to Plans with Special Funds
Month of December 1944.....	3,906,018	3,225,857
Year 1944.....	44,630,749	33,453,123
Past ten years.....	299,692,471	252,741,690

Most of the pension plans established before 1929 were of this type—37 of the 50 plans reported. In the period 1929-1938 inclusive 14 plans with special funds were established. Since the latter date, 27 more of these plans have been set up.

The bulk of the estimated income of those reported covered by pension plans goes to persons in this group. Their December 1944 income is estimated at \$44,530,335 out of the estimated total income for December of all persons covered by pensions of \$52,169,925. Their income for the year 1944 is estimated at \$534,364,021 out of the estimated total for the year of \$626,039,091.

Most of the plans with special funds are contributory—70 of the 79 fall into this category. Contributions to 45 of these 70 are reported as deductible by contributors in calculating their taxable income.

The total book value of special funds at the last fiscal year end is reported to be \$339,578,562. No corresponding figure is available for plans administered through insurance companies or through the Annuities Branch. Yet people in these other plans have equities too in funds analogous to these special funds.

This brief survey of pension plans with special funds draws attention to the fact that the largest number of persons on pension plans and the largest sums of money devoted to the purpose of providing pensions are involved in plans administered in this one particular way.

#### NON-CONTRIBUTORY PLANS

The second group of plans that deserves special consideration is the non-contributory group. The sums of money involved in these plans add to the incomes of employed persons but they add much less ostensibly than do the joint contributions characteristic of contributory plans. It seems desirable therefore to examine these plans separately to determine the number of persons which they cover and the equity of these persons in the undertakings.

There are not many pension plans reported to be non-contributory. The twenty plans so reported cover 30,532 persons. One plan partly contributory and partly non-contributory is omitted because of the impossibility of separating the two elements in it. These plans cover 30,532 of the 33,504 persons reported eligible for participation.

Most of these plans have been set up recently. Only four were established before 1929 and only two in the years 1929-1938 inclusive. Thus fourteen plans came into existence in the years 1939-1944 inclusive.

It is estimated that the 30,534 persons covered by these plans earned \$4,607,344 in the month of December 1944 and \$55,288,188 in the year 1944. The average estimated monthly earnings of these 30,534 persons is \$181.00 as

compared with the average estimated monthly earnings of all persons reported covered by pension plans of \$182.00.

The contributions to these plans for the month of December 1944 are \$269,726. This sum is about 5.9 per cent of the estimated monthly earnings of the persons covered. Thus the monthly contributions to these plans are a smaller percentage of estimated monthly earnings than the monthly contributions of all persons covered by pension plans. In the latter case monthly contributions were 7.6 per cent of estimated monthly earnings.

The contributions to these plans during the year 1944 amounted to \$3,808,922 and during the past ten years to \$23,338,907. This sum of \$3,808,922 is 6.9 per cent of the estimated income of persons covered by these non-contributory plans. This percentage compares favourably with the 7.1 per cent of estimated income of all persons covered by pension plans for the year 1944 which goes as contributions into all plans reported.

The conclusion from this information on the incomes of those on non-contributory plans and on the contributions to non-contributory plans seems to be this: employed persons on non-contributory plans receive from their employers monthly salaries and wages about equal to those paid to persons on contributory plans. In addition, these persons covered by non-contributory pensions have the cost of such pensions borne for them by their employers. The size of the employers' contributions in 1944 relative to the size of the employees' incomes in 1944 is about the same as the size of all contributions to all pension plans in 1944 relative to the size of the incomes in 1944 of all persons covered by pension plans. This approximate equality in the relative size of contributions suggests that the pensions paid under non-contributory plans may compare favourably in size with those paid under contributory plans.

Half of the non-contributory plans provide pensions through insurance companies or the Annuities Branch, the other half out of special funds. The book value of the special funds is \$36,648,365.

## APPENDIX I

### *Summary of Returns from Questionnaires on Pension and Annuity Plans*

1. Number of questionnaires sent out.....	927
2. Number of questionnaires completed.....	502
3. Number of pension plans covered: <sup>1</sup>	
(a) Number of listed plans:	
(1) Operative.....	540
(2) Inoperative.....	38
Total.....	578
(b) Number of unlisted plans.....	47
Total.....	625

<sup>1</sup> Several companies found it convenient to submit a combined report on their own pension plan and those of their subsidiaries. Thus the 502 completed questionnaires cover more than 502 pension plans.



## APPENDIX II

*Statistical Summary of All Operative Plans Reported*

1. Number of plans studied . . . . .	464 <sup>1</sup>
2. Number of persons reported:	
(a) Eligible for participation in plans . . . . .	406,899
(b) Covered by plans . . . . .	343,326
3. Estimated number of persons:	
(a) Eligible for participation in all approved plans, reported and not reported . . . . .	534,000
(b) Covered by all approved plans, reported and not reported . . . . .	450,000
4. Number of plans established each year:	
(Total prior to 1929: 50)	
1929 . . . . .	15
1930 . . . . .	15
1931 . . . . .	6
1932 . . . . .	3
1933 . . . . .	2
1934 . . . . .	13
1935 . . . . .	6
1936 . . . . .	13
1937 . . . . .	18
1938 . . . . .	25
1939 . . . . .	31
1940 . . . . .	38
1941 . . . . .	32
1942 . . . . .	23
1943 . . . . .	84
1944 . . . . .	90
5. Estimated Income of persons reported as covered by plans:	
(a) Month of December, 1944 . . . . .	\$ 52,169,925
(b) The year 1944 . . . . .	\$626,039,091
6. Estimated Income of all persons covered by all approved plans (based on the estimate of persons covered given in Section 3 above and on estimated income of those reported covered, shown in Section 5 above)	
(a) Month of December, 1944 . . . . .	\$ 68,333,000
(b) The year 1944 . . . . .	\$820,000,000
7. (a) Number of plans reported to be contributory . . . . .	444
(b) Number of plans reported to be non-contributory . . . . .	20

<sup>1</sup> Of the 502 completed questionnaires 464 are reports on plans in operation on December 31st, 1944, 38 merely state that the plans in question were inoperative during 1944.

These 464 completed questionnaires on operative plans are reports covering 540 operative plans found in the list provided by the Commission and 47 operative plans not on that list. Thus one completed questionnaire may cover more than one plan. Each is treated here as if it were a single plan, for it is impossible to separate plans combined in one report.

## 8. Contributions to pension plans:

## (a) Contributions for the month of December 1944

(1) by employees.....	\$1,435,271	
(2) by employers on behalf of employees.....	\$2,470,747	
(3) Total.....		<u>\$3,906,018</u>
(4) Contributions for the month of December, 1944 as a percentage of the estimated income for the month of persons reported covered by pension plans.....		7.6

## (b) Contributions for the year 1944

(1) by employees.....	\$19,058,141	
(2) by employers on behalf of employees.....	\$25,572,608	
(3) Total.....		<u>\$44,630,749</u>
(4) Contributions for the year 1944 as a percentage of the estimated income for the year of persons reported covered by pension plans.....		7.1

## (c) Contributions for the past ten years

(1) by employees.....	\$121,630,619	
(2) by employers on behalf of employees.....	\$178,061,852	
(3) Total.....		<u>\$299,692,471</u>

9. Number of plans contributions to which are reported to be deductible by contributors in calculating their taxable incomes..... 421

## 10. Administration of plans:

(a) Through insurance companies and/or the Annuities Branch....	385
(b) Special funds.....	79

## APPENDIX III

*Statistical Summary of Pension Plans With Special Funds*

1. Number of plans studied.....	79
2. Number of persons reported:	
(a) Eligible for participation in plans....	296,900
(b) Covered by plans.....	283,143
3. Number of plans established;	
(a) Before 1929.....	37
(b) Between 1929 and 1938 inclusive	14
(c) Between 1939 and 1944 inclusive	28

4.	Estimated income of persons covered by plans with special funds:		
	(a) Month of December 1944.....	\$ 44,530,335	
	(b) The year 1944.....	\$534,364,021	
5.	Number of plans reported to be contributory.....		70
6.	Contributions to plans with special funds:		
	(a) Contributions for the month of December, 1944		
	(1) by employees.....	\$1,241,176	
	(2) by employers on behalf of employees.....		\$1,984,681
	(3) Total.....		<u>\$3,225,857</u>
	(4) contributions for the month of December, 1944 as a percentage of estimated income for the month of persons reported covered by pension plans with special funds.....		7.2
	(b) Contributions for the year 1944		
	(1) by employees.....	\$14,786,905	
	(2) by employers on behalf of employees.....	\$18,666,218	
	(3) Total.....		<u>\$33,453,123</u>
	(4) contributions for the year 1944 as a percentage of estimated income for the year of persons reported covered by pension plans with special funds.....		6.3
	(c) Contributions for the past ten years:		
	(1) by employees.....	\$102,703,866	
	(2) by employers.....	\$150,037,824	
	(3) Total.....		<u>\$252,741,690</u>
6.	Number of plans contributions to which are reported to be deductible by contributors in calculating their taxable incomes.....		45
7.	Book value of special funds at their last year end.....	\$339,578,562	

#### APPENDIX IV

##### *Statistical Summary of Non-Contributory Pension Plans*

1.	Number of plans studied.....		20
2.	Number of persons reported:		
	(a) Eligible for participation in plans..	33,504	
	(b) Covered by plans.....	30,532	
3.	Number of plans established:		
	(a) Before 1929.....	4	
	(b) Between 1929 and 1938 inclusive	2	
	(c) Between 1939 and 1944 inclusive	14	

4. Estimated income of persons covered by non-contributory plans:
- (a) Month of December 1944..... \$ 4,607,344
  - (b) The year 1944..... \$55,288,188
5. Contributions by employers to non-contributory plans:
- (a) For the month of December 1944... \$269,726
    - (1) Contributions for the month of December 1944 as a percentage of estimated income of persons reported covered by non-contributory plans..... 5.9
  - (b) For the year 1944..... \$3,808,922
    - (1) Contributions for the year 1944 as a percentage of estimated income for the year of persons reported covered by non-contributory plans..... 6.9
  - (c) For the past ten years..... \$23,338,907
6. Administration of non-contributory plans:
- (a) Through insurance companies and/or the Annuities Branch.... 10
  - (b) Special funds..... 10

**APPENDIX "B"**

**STATISTICAL REPORT ON NUMBER OF PRIVATE OR CLOSELY  
HELD CORPORATIONS IN CANADA, WITH TABULATION  
OF REPRESENTATIVE INFORMATION ON A  
PORTION OF SUCH COMPANIES**

Prepared by  
DEPARTMENT OF NATIONAL REVENUE—TAXATION DIVISION,  
OTTAWA  
March, 1945

## APPENDIX "B"

The number of corporations filing T.2 income tax returns with the Department of National Revenue varies each year but may be accepted as numbering approximately 28,000. It is understood that the Commissioners are interested in ascertaining the number of such companies that may be described as privately or closely held.

The Department in its administration of the Act has not differentiated between corporations which are considered to be publicly held and those deemed to be privately held. Therefore no categorical division between these two groups is available. For the purposes of this inquiry, however, an estimated distribution of the 28,000 corporate taxpayers has been made which divides the companies into the following categories:

- A—Public Companies. . . . . Including companies whose shares are listed on a stock exchange or whose annual accounts are published in financial journals.
- B—Private Companies. . . . . Including Canadian subsidiaries of external companies and other private companies which are not controlled by one individual or a very small number of shareholders.
- C—Closely Held Companies. . . . . Including private companies which are closely held by one individual or a very small number of shareholders.
- D—Inactive or Non-Taxable Companies. . . . . Including companies not actively engaged in business or which are non-taxable under the provisions of the Income War Tax Act.

In the table below all corporations filing with the Taxation Division, Department of National Revenue, are divided as closely as possible into the above categories. And in the case of private or closely held companies there is a further subdivision into those having no surplus, a surplus of less than \$25,000 and those with a surplus in excess of \$25,000. It is felt that the latter subdivision would be of interest to the Commission.

Inactive or non-taxable companies. . . . .	3,000
Public Companies. . . . .	2,800
Private and Closely Held companies having no surplus. . . . .	7,300
Private companies having a surplus up to \$25,000. . . . .	2,000
Private companies having a surplus in excess of \$25,000. . . . .	2,900
Closely Held companies having a surplus up to \$25,000. . . . .	8,000
Closely Held companies having a surplus in excess of \$25,000. . . . .	2,000
Grand Total. . . . .	28,000

The distribution by size of surplus is based on a sample study of 6,449 companies. Results based on such a sample cannot be considered as conclusive but are believed to be a sufficiently reliable indication.

The number of closely held companies having a surplus in excess of \$25,000 was derived from reports furnished by the various Income Tax district offices. In respect of 495 companies in this category details were obtained as to the

issued capital, accumulated surplus, total shares issued and number of shares held by the main shareholder. A condensation of these figures in four sample groups is given below:

Number of Companies	Issued Capital	Accumulated Surplus	% Surplus to Capital
296	\$36,687,000	\$47,068,000	128%
52	6,575,000	8,663,000	132%
64	5,499,000	9,456,000	172%
83	11,559,000	15,056,000	130%
<u>495</u>	<u>\$60,320,000</u>	<u>\$80,243,000</u>	133%

On the assumption that the above 495 companies constitute a representative sample of the 2,000 estimated total of such companies the aggregate issued capital for the 2,000 closely held companies may be computed at approximately \$242,000,000 and the accumulated surplus involved at approximately \$322,000,000.

No tabulations have been made of the accumulated surplus of the 8,000 closely held corporations having a surplus of less than \$25,000. It may be estimated, however, that the average surplus for the group as a whole would be very close to \$10,000 in which case the aggregate accumulated surplus could be estimated at \$80,000,000.

## APPENDIX C

*Extract from The Companies Act, 1934 (1934 C.33) defining private company*

3(j) "private company" means a company as to which by letters patent or supplementary letters patent

(i) the right to transfer its shares is restricted;

(ii) the number of its shareholders is limited to fifty, not including persons who are in the employment of the company and persons, who, having been formerly in the employment of the company, were, while in that employment, and have continued after the termination of that employment to be shareholders of the company, two or more persons holding one or more shares jointly being counted as a single shareholder; and

(iii) any invitation to the public to subscribe for any shares or debentures of the company is prohibited.