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Finance Minister E.J. Benson today released a technical paper explaining mechanisms to give shareholders credit for corporate tax paid under the proposed system of tax integration.

The document, sent to the Commons and Senate committees studying tax reform, enlarges on the White Paper in five areas:

1. Closely-held corporations

The two steps are outlined under which these corporations would, effectively, be taxed at personal rates by giving shareholders full credit on dividends for tax collected from the corporations. Distributions in the form of stock dividends would permit corporations to retain funds for internal use.

2. Widely-held corporations

Shareholders of these corporations would receive credit on their dividends for half the corporate tax paid. The paper explains here and in the section on closely-held corporations how a typical company might organize a "creditable tax account" on its instalments of tax and payment of dividends.

3. Intercorporate Holdings

Where one corporation owns shares in another, shareholders of the first corporation would receive credit for taxes paid by the second corporation in several ways discussed in this section.

4. Overpayments, Refunds and Assessments

"Creditable" tax arises when tax is paid. It remains creditable until it lapses, normally 2½ years from the end of the corporation's taxation year (staledating); until it is passed to shareholders to cover dividends; or until a refund is claimed in the event of an overpayment. The circumstances in cases of refunds and assessment disputes are explained.

5. Commencement of the system

This section discusses methods by which tax would become creditable in the year in which the system starts. It deals with the tax still to be paid on surpluses existing

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under the present system. It also sets out some special rules concerning closely-held corporations which are necessary to ensure that taxes are in fact paid on income defined to be taxable under both the present and proposed system. In part these rules relate to goodwill sold in the first few years of the new system. Since the cost of goodwill purchased could be written-off for tax purposes under the new system, purchasers would be willing to pay more for it than under the existing system. In recognition of this increase in value part of the proceeds of the sale of goodwill would be taxable.

GIVING SHAREHOLDERS CREDIT FOR CORPORATE TAX PAID

The purpose of this paper is to provide further details concerning the proposal in the White Paper that credit be given to Canadian shareholders for part or all of the Canadian corporate tax paid by their corporations.

There are five sections to the paper, dealing with the following aspects of the proposals.

1. Closely-held corporation.
2. Widely-held corporation.
3. Inter-corporate holdings.
4. Overpayments, refunds and assessments.
5. Commencement of proposed system.

1. CLOSELY-HELD CORPORATION

For a closely-held corporation which did not use the partnership option, taxation at personal rates would involve two steps: tax would be collected from the corporation at 50%, and credit for this tax would be given to the shareholder with a dividend distribution. Under this system it is expected that there would be a high level of distribution, since there would be no further personal tax on the dividends (once the top personal rate had been gradually reduced to 50%), and resident shareholders would want to claim the credit during the period in which it was available. To the extent funds were needed in the corporation, the dividend could be in the form of a stock dividend.

The operation of this system for a closely-held corporation with resident individual shareholders is illustrated below. It will be noted that a substantial portion of

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the net profit for the year is shown as being retained and capitalized by issuing stock dividends. The amount so capitalized would be added to the cost basis of the shares, and would reduce the taxable capital gain should a shareholder dispose of his shares.

ABC Company Limited
(a closely-held corporation)

	Years Ending December 31			
	1975	1976	1977	Total
Income Account:				
Profit before tax	$ 120,000	150,000	160,000	430,000
Corporation tax				
Federal	(48,000)	(60,000)	(64,000)	(172,000)
Provincial	(12,000)	(15,000)	(16,000)	(43,000)
Net profit	$ 60,000	75,000	80,000	215,000
Surplus Account:				
Opening balance	$ 500,000	515,000	520,000	500,000
Net profit	60,000	75,000	80,000	215,000
Cash dividends	(20,000)	(30,000)	(35,000)	(85,000)
Stock dividends	(25,000)	(40,000)	(40,000)	(105,000)
Closing balance	$ 515,000	520,000	525,000	525,000
Capital Account:				
Opening balance	$ 100,000	125,000	165,000	100,000
Stock dividends	25,000	40,000	40,000	105,000
Closing balance	$ 125,000	165,000	205,000	205,000

Net Proceeds to Resident Individual Shareholders

	1975	1976	1977	Total
Cash dividends	$ 20,000	30,000	35,000	85,000
Stock dividends	25,000	40,000	40,000	105,000
Corporate tax credit	45,000	70,000	75,000	190,000
	$ 90,000	140,000	150,000	380,000
Personal tax, e.g.40%	(36,000)	(56,000)	(60,000)	(152,000)
	$ 54,000	84,000	90,000	228,000

The effective tax burden on the income of this closely-held corporation would be the same as if it had been unincorporated. In the three years the owners of an unincorporated business would have netted:

Income	$430,000
Less personal tax @ 40%	172,000
	$258,000

For the same three years, the shareholders of the closely-held corporation would net:

From dividend distributions to date, as above		$228,000
From future dividend distributions-		
Increase in surplus	$25,000	
Creditable tax	25,000	
	50,000	
Less personal tax @ 40%	20,000	
		30,000
		$258,000

Accounts to control the flow of creditable tax would be maintained by the corporation. These would show the additions to creditable tax arising from payments of corporate tax, the amounts passed out with dividend distributions, and the balance on hand. The basic features can be demonstrated in the following illustration for the ABC Company Limited for the year ended December 31, 1976:

ABC Company Limited
Creditable Tax Account

Date	Details	Creditable Until June 30 1978	1979	1980	Balance
1976					
Jan. 1	Opening balance re: tax for 1975	--			--
Jan. 31	1st instalment for 1976*		5,000		5,000
Feb. 29	2nd instalment for 1976		5,000		10,000
Mar. 31	3rd instalment for 1976		5,000		15,000
	Final balance for 1975	15,000			30,000
Apr. 30	4th instalment for 1976		5,000		35,000
May 31	5th instalment for 1976		5,000		40,000
June 15	Cash dividend	(12,500)			27,500
June 30) to) Dec. 30)	6th to 12th instalments for 1976		35,000		62,500
Dec. 31	Cash dividend	(2,500)	(15,000)		45,000
	Stock dividend		(40,000)		5,000
1977					
Jan. 31	1st instalment for 1977			5,000	10,000
Feb. 28	2nd instalment for 1977			5,000	15,000
Mar. 31	3rd instalment for 1977			6,500	21,500
	Final balance for 1976		15,000		36,500
		--	20,000	16,500	

* In the amount of $5,000, representing 1/12 of the tax liability for the previous year, if the national tax rate of 50% were applied to the taxable income of $120,000 for that year. Since the national tax rate of 50% is assumed to be made up of 40% federal and 10% provincial, any payments of provincial corporate tax at a rate higher than 10% would not create creditable tax.

It will be noted that the corporate tax becomes creditable immediately upon payment. As proposed in paragraph 4.27 of the White Paper, the tax would remain creditable until 2½ years from the end of the taxation year in respect of which it arose (for special circumstances in which the tax would remain creditable longer, see section 4 of this report). As shown in the illustration, the creditable tax assumed to go out with dividends first would be that which "staledated" first.

The corporation would make an annual reporting of its creditable tax account to the tax authorities at the same time as filing its income tax return. At the time of each dividend distribution, the onus would be on the corporation to see that there was creditable tax on hand to cover the amount reported to the shareholders. The dividend slip would look something like this -

We are enclosing a dividend cheque for	$100
In addition you may claim credit for tax paid by the corporation:	
federal tax of	80
provincial tax of	20
You should report taxable income of	$200

In the case of a stock dividend the last two items on the slip would be the same as above but the first item might read

We are enclosing a stock dividend of (for tax purposes the stock will be treated as having cost you $100)	$100

2. <u>WIDELY-HELD CORPORATION</u>

For this type of corporation, one-half of the national corporate tax rate of 50% would be creditable to resident shareholders. Technically, it is proposed that this be achieved by having a creditable tax of 25% and a non-creditable tax of 25%.

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The effect of this method of taxation in relation to individual resident shareholders is illustrated below. The level of cash dividend shown has been typical of most public Canadian corporations other than those in the resource industries in recent years, and would not be expected to increase under the proposed system.

XYZ Company Limited
(a widely-held corporation)

	Years Ending June 30		
	1975	1976	1977
Taxable income	$2,400,000	2,800,000	3,100,000
Corporation taxes			
Integrated (1)	(600,000)	(700,000)	(775,000)
Unintegrated (1)	(600,000)	(700,000)	(775,000)
	1,200,000	1,400,000	1,550,000
Untaxed financial profit (2)	200,000	250,000	275,000
Net profit for year	$1,400,000	1,650,000	1,825,000
Surplus account:			
Opening balance	3,000,000	3,700,000	4,550,000
Net profit	1,400,000	1,650,000	1,825,000
Cash dividends (3)	(700,000)	(800,000)	(900,000)
Closing balance	$3,700,000	4,550,000	5,475,000
Individual shareholders:			
Cash dividends	700,000	800,000	900,000
Corporate tax credit	350,000	400,000	450,000
Taxable income	1,050,000	1,200,000	1,350,000
Personal tax, e.g. 40%	420,000	480,000	540,000
Net proceeds	630,000	720,000	810,000

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(1) Each including 20% federal and 5% provincial rates.

(2) Arising, for example, from claiming capital cost allowances in excess of depreciation booked.

(3) Assuming that the ratio of payout to retained after-tax taxable income is about 3:2. This was the average ratio for the years 1955 to 1964 for non-resource companies, according to Table 9 of study number 27 published by The Royal Commission on Taxation, entitled, "Rates of Return on Canadian Common Stocks: Dividends, Retentions and Goodwill Gains".

The accounting for creditable tax would be similar to that followed in the case of a closely-held corporation. The illustration set out below assumes a quarterly dividend in cash.

XYZ Company Limited
Creditable Tax Account
($000's)

Date	Details	Creditable Until Dec. 31 1975	1976	1977	1978	Balance
1975						
Jul. 1	Opening balance	225	500	525		1,250
Jul. 31	1st instalment for 1976[1]				50	1,300
Aug. 31	2nd instalment for 1976				50	1,350
Sept 15	Cash dividend of $180	(90)				1,260
Sept 30	3rd instalment for 1976				50	1,310
	Final balance for 1975			75		1,385
Oct. 31	4th instalment for 1976				50	1,435
Nov. 30	5th instalment for 1976				50	1,485
Dec. 15	Cash dividend of $180	(90)				1,395
Dec. 31	6th instalment for 1976				50	1,445
1976						
Jan. 1	Staledated credit	(45)				1,400
Jan. 31	7th instalment for 1976				50	1,450
Feb. 29	8th instalment for 1976				50	1,500
Mar. 15	Cash dividend of $180		(90)			1,410
Mar. 31	9th instalment for 1976				50	1,460
Apr. 30	10th instalment for 1976				50	1,510
May 31	11th instalment for 1976				50	1,560
June 15	Cash dividend of $260		(130)			1,430
June 30	12th instalment for 1976				50	1,480
	etc.		280	600	600	

NOTE: (1) Assumed to be 1/12th of $1,200,000, one-half of which is creditable.

It will be noted in the illustration that on January 1, 1976, a portion of the creditable tax became staledated because it had not been passed out with distributions within the time limit of 2½ years. In some cases the directors might consider it to be in the best interest of shareholders to periodically declare stock dividends in order to pass out all the creditable tax, while still retaining funds for expansion.

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There will be cases in which there will be insufficient creditable tax to cover the cash dividends; for example, due to accelerated capital cost allowances. In that event the creditable tax would accompany the dividend in the usual ratio of \$1 of creditable tax to \$2 of dividend until the creditable tax is exhausted. In this case the dividend slip might read -

We are enclosing a dividend cheque for	\$100
In addition you may claim credit for tax paid by the corporation:	
federal	36
provincial	9
You should report taxable income of	\$145

3. INTERCORPORATE HOLDINGS

For inter-corporate holdings, it would be essential that the amount of creditable tax be known at the time the particular dividend is paid, for otherwise dividends with their accompanying tax credits could not pass freely and quickly through corporations. As already noted above, the creditability would be based primarily on the payment of tax rather than on the tax as finally assessed, and accordingly the position could be ascertained at the time a dividend was paid.

For purposes of creditable tax accounting, creditable tax received with a dividend would be treated as a payment on account of the corporation tax of the receiving corporation. As such, it would in turn create creditable tax which could be passed on to shareholders of the receiving corporation within the usual period - that is, up until the end of 2½ years from the end of the taxation year.

Since the proposed system treats inter-corporate dividends as taxable income, expenses related to inter-corporate dividend income would be deductible. This would result in a refund of tax, or a reduction of tax liability, to the receiving corporation. For example, if in the illustration in paragraph 4.56 of the White Paper there had been expenses of $30 related to the dividend income, the treatment of the closely-held corporation receiving the dividends would have been as follows:-

	From CHC	From WHC
Dividend received	$100	100
Creditable tax with dividend	100	50
	200	150
Less expenses	30	30
Taxable income	170	120
Corporate tax	85	60
Less creditable tax	100	50
Balance payable or (refundable)	(15)	10
Amount available for distribution to its shareholders (dividend less expenses plus or minus tax)	85	60
Creditable tax	85	60

Gains or losses realized by a closely-held corporation from shareholdings in Canadian or foreign corporations would have no special implications for the creditable tax accounting. Gains on shares in Canadian widely-held corporations would of course only be one-half included in arriving at income of the corporation.

In the case of a widely-held corporation, dividends from closely-held Canadian corporations would not need any further rules, since this source of income would be taxed in the usual manner, and the creditable tax with dividends would be handled as outlined above.

Dividends from other widely-held Canadian corporations would require special treatment. In paragraph 4.59 of the White Paper it is proposed that such income be effectively taxed at a 33-1/3% rate fully creditable, in order that no further unintegrated corporate tax be collected merely because of the intercorporate movement of dividends. In effect, this amounts to grossing up the actual dividend to its amount before both creditable and non-creditable corporate tax, and charging only the creditable rate thereon. This may be illustrated as follows where a widely-held corporation receives dividends:

	From CHC	From WHC	
Dividend received	$100	100	
Creditable tax	100	50	
Taxable income	200	150	
Corporate tax:			
Creditable - 25%	50	50	(on $200)
Non-creditable - 25%	50	N/A	
	100	50	
Less creditable tax	100	50	
Balance	Nil	Nil	
Amount available for distribution	100	100	
Creditable tax	50	50	

If the receiving corporation had expenses of $30 related to the dividend, the effect would be as follows:

	From CHC	From WHC
Dividend received	$ 100	100
Creditable tax with dividend	100	50
	200	150
Less expenses	30	30
Taxable income	170	120
Corporate tax		
Creditable	42.5	40
Non-creditable	42.5	N/A
	85	40
Less creditable tax	100	50
Balance (refundable)	(15)	(10)
Amount available for distribution to its shareholders (dividend less expenses plus balance of tax refundable)	85	80
Creditable tax	42.5	40

Gains on shares in other widely-held corporations would be taxed in the same way as dividends - at a fully creditable rate of 33-1/3% - in order to keep a balance between the treatment of dividends and share gains. If there was a net loss on shares in other widely-held corporations, 4/3rds thereof could be aggregated with income from other sources for purposes of the creditable tax, but not the non-creditable (in other words, a refund of 33-1/3% of the loss would be made, provided the corporation had enough creditable tax).

4. OVERPAYMENTS, REFUNDS AND ASSESSMENTS

Corporation income tax, or half of it, will become creditable when it is paid. It will remain creditable until it is passed through to the shareholders or has become staledated, or until the corporation files a tax return claiming a refund of the tax. If a corporation files a tax return claiming a refund because its instalments exceed its liability for the year, that excess will immediately be removed from the creditable tax account. Similarly, if a corporation filed a return reducing its tax for a year as a result of a loss carried back from the following year, the amount of the refund claimed would be removed from the creditable tax account.

Where the taxpayer wanted a refund of such an overpayment, the refund would be limited to the creditable tax still on hand, since a refund could not be given for creditable tax already passed out to shareholders. Any portion of the overpayment which was not refunded because of this limitation could still be applied on account of subsequent tax liability. Since the limitation only affects creditable tax, in the case of a widely-held corporation it would only apply to the creditable rate of 25%. Overpayments of the non-creditable tax of 25% could be refunded in the usual fashion.

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A comparable problem arises when a corporation disputes an assessment or a re-assessment. Consequently, when a taxpayer objects to an assessment or re-assessment, the additional tax demanded by the assessment (that is, additional to the amount declared by the corporation in its return) would be transferred to suspense and either be refunded to the corporation on the success of its objection and/or appeal, or become creditable on the day on which it was clearly no longer subject to appeal. Because this latter day might be later than the day on which the tax would normally staledate, such tax would remain creditable until 18 months after the end of the taxation year in which it was no longer subject to appeal.

If an assessment or re-assessment is not the subject of a notice of objection, the additional tax demanded by the assessment would not staledate until 18 months after the end of the taxation year in which the assessment was issued. This would mean that in a great majority of cases additional tax levied on an original assessment would be creditable in the year in which it was paid and remain creditable until the same day as the instalments of tax for that year. At the same time, where additional tax was unsettled for a period of time, or where a re-assessment was issued three or four years after a return was filed, there would still be a period of 18 to 30 months in which any additional tax would be creditable even though the usual period for creditability had passed.

5. COMMENCEMENT OF THE PROPOSED SYSTEM

The proposed credit for corporation tax would apply to all dividends paid from commencement of the new system.

Since the corporate tax is creditable immediately upon payment, and corporate tax instalments are paid currently on a monthly basis, the dividends of most corporations would carry creditable tax immediately under the new system. Where a corporation's current tax instalments were insufficient to cover current dividends, or where a corporation wanted to build up a backlog of creditable tax, it might prefer to elect to pay the 15% tax on opening surplus and distribute some tax-paid dividends to shareholders (see later paragraphs in this section).

Where a corporation's fiscal year did not coincide with the commencement of the new system, special rules would be needed to determine the creditable portion of tax instalments paid on account of that year. It is proposed that as the date for each instalment due in the first year of the new system arrives, a fraction of the total instalments paid to that date on account of the liability for the year in progress would become creditable. For example, consider the case of a corporation with a June 30th fiscal year end in the event that tax reform is effective January 1, 1971. When the seventh instalment of tax for the year to end June 30, 1971 falls due on January 31, 1971, one-seventh of all of the instalments paid on account of the year to that date would become creditable. A month later when the eighth instalment was due, an additional fraction would become creditable - enough to bring the cumulative amount made creditable to two-eighths. On March 31st the cumulative fraction would be brought to three-ninths; on April 30th, to four-tenths; on May 31st to five-elevenths; and on June 30th to six-twelths. A precise adjustment to the precise tax rates would take place when the return was filed (since under the White Paper proposals the amount of income subject to the low rate would be reduced in the first calendar year of the new system, an additional amount of tax would become creditable for many corporations when this precise computation was made).

The creditable tax received with dividends from other Canadian corporations would be creditable immediately and would not be reduced by the fractions mentioned in the preceding paragraph.

The general rule for corporate dividend distributions would be that they would be included in income and would carry creditable tax in the appropriate ratio, to the extent there was creditable tax on hand at the time of the dividend. Where there was insufficient creditable tax on hand, the balance on the dividends would carry no creditable tax.

In the absence of any further rules, the subsequent distribution of the surplus that a corporation had at the beginning of the new system would be taxed at full rates of the shareholder (although he would get a deduction for a capital loss if and when he sold his shares which would partially recover this tax in the case of shares of widely-held corporations and fully recover it in the case of those of closely-held corporations). Under the present tax system there are provisions for withdrawing such surplus at flat rates of about 15%. It is therefore proposed that an option be made available to all corporations to make tax-paid

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distributions out of opening surplus by paying a special withholding tax of 15%. For a resident shareholder this tax would be in final settlement of his tax liability, and the amount of the dividends before the withholding tax would be deducted from his share base. For a non-resident shareholder, the tax would apply against any ordinary liability for non-resident withholding tax.

Technically, such a tax-paid dividend would be treated in much the same way as "tax-paid undistributed income" is under the present legislation and could pass through corporate shareholders. However, the form of the tax-paid distribution would not be restricted as it is in the present legislation: it could be a cash dividend.

As explained in paragraphs 4.74 to 4.78 in the White Paper it might still be possible for a closely-held corporation to wind up without paying any tax on its opening surplus, due to the fact that the opening surplus would be capitalized in the share base and this share base would be fully deductible. It is therefore proposed that for a closely-held corporation, distributions that did not carry creditable tax would be deemed to come out of the opening surplus and be subject to the special 15% tax referred to above. In most cases this would be preferable to being subject to ordinary rates of tax on a non-creditable dividend, and it would clear up the tax liability on the opening surplus.

Also explained in paragraphs 4.74 to 4.77 of the White Paper, the immediate introduction of full credit for taxes paid by closely-held corporations, when combined with the full deductibility of their opening share values, creates the possibility that tax could be eliminated on income which would otherwise be taxable under the present system and which should be taxable under the proposed system.

The illustration given in the White Paper relates to a depreciable asset. Land which was held for sale in the ordinary course of business would be another example which would demonstrate the potential for eliminating taxable income.

For example, assume a group of individual taxpayers had purchased a parcel of land for $100,000 and on valuation day it was worth $280,000. If the land was sold shortly after the commencement of the new system and the marginal rate of the taxpayers was 50%, there would be a tax liability of $90,000 and they would have net proceeds of $190,000.

If instead the land was held in a closely-held corporation, it is quite possible that in the absence of a special rule the shares would be worth $280,000 on valuation day and that the shareholders could net the entire proceeds of $280,000 if the corporation sold the land shortly after the commencement of the new system and was then wound up. The series of transactions would be as follows:

Proceeds of sale	$280,000
Less corporate tax	90,000
Distribution by corporation	190,000
Add creditable tax	90,000
	$280,000

There would be no personal tax payable on the $280,000, since it would be offset by a deduction of the opening share value of $280,000. In this way, the excess of the fair market value of the land over its cost would have entirely escaped tax, even though the transaction would have been taxable under the present system.

The position with respect to goodwill is somewhat different, although the results would be the same. Because the purchase of goodwill would become a depreciable expenditure under the White Paper proposals, the government believes that purchasers would be willing to pay more for goodwill under the proposed system than under the present system. In fact, the government expects that taxpayers would be willing to pay at least 125 tax-deductible dollars under the proposed system for every 100 after-tax dollars under the present system. For this reason, it has proposed that if goodwill is sold in the first year of the proposed system, 40 per cent of the proceeds would be taxable (paragraph 5.8 of the White Paper). If the vendors tax rate were 50 per cent or less, he would still net at least the $100 that we would receive under the present system.

In a way similar to that described with respect to land and depreciable property, the value of the goodwill in a corporation would - in the absence of a special rule - be capitalized in the value of the shares, and no part of the proceeds of sale of the goodwill would, effectively, bear tax.

Assume a business operation in which the tangible assets have a tax value of $1,000,000 and there is goodwill in the amount of $480,000 which, under the new system, would have a value of about $600,000. If the business was unincorporated and the owners had a marginal tax rate of 50%, the sale of business in the first year of the proposed system would net $1,480,000:

Proceeds from sale of business	$1,600,000
Less 50% tax on 40% of $600,000	120,000
	$1,480,000

On the other hand, if this business had been in a closely-held corporation, the net proceeds could be $1,600,000. As in the case of the land, the distribution of corporate surplus ($1,480,000) and the credit for corporate tax ($120,000) could be received free of tax since they would be offset by a deduction for an opening share value (which would be $1,600,000 in the absence of a special rule). The purchaser of the business would have a cost which could be written off against future income even though there had been no tax cost to the vendor.

In view of this, it is proposed in paragraph 4.79 of the White Paper that some of the tax of closely-held corporations be non-creditable, to ensure that taxes are collected on income otherwise taxable under the present system, and on income which would be taxable under the proposed system if received by unincorporated business. Specifically, in the ordinary course of operations 1/5th of the profits of a closely-held corporation would give rise to non-creditable tax, so that over a period of time tax would gradually be collected on the amount by which the opening share value exceeded the tax values of the underlying assets. (For this purpose, the tax values of securities and shares would be the opening value for purposes of the proposed tax on capital gains.) Where corporation tax arose from specified types of transactions - such as recaptured depreciation, sale of oil and mining properties, or sale of goodwill - all of the tax would be non-creditable.

If some of the taxable income of the closely-held corporation was taxed at the rate of 21%, the tax on the excess of the opening share values over the underlying tax values would be satisfied at that rate. Furthermore, since the shareholders of some closely-held corporations might not want to take advantage of creditable tax until the top personal rates had been lowered to 50%, the closely-held corporation would be given the option of treating more of its corporate tax as non-creditable; the requirement would then be met in a shorter period of time, and at a lower tax cost.

The opening share value for purposes of the computation of the difference would be declared by the board of directors of the corporation at the time of filing the corporation's first tax return under the new system. This declaration would set out the board's opinion of the fair market value of all of the shares of the corporation if they were sold in a block to one buyer. Even though this valuation were agreed with the Department of National Revenue, it would not be binding on individual shareholders in their determination of the Valuation Day value of their holdings. It would be open to them to argue that their particular holding was worth more than average (e.g. since it carried with it control of the corporation) or less than average (e.g. since it did not have voting rights) or indeed that the "average" was itself incorrect. In this latter connection, the "average" value as agreed with the board of directors would be the beginning point for the Department's valuations of individual holdings, and might be expected to have some influence on the courts as evidence of the value of the corporation.

If the corporation realized a tax-free capital gain on an asset other than securities or shares, the amount of the tax-free capital gain would also reduce the total amount to which non-creditable tax would apply. For example, if a corporation sold to its business in the fourth year of the new system and received as part of the proceeds $100,000 in respect of its goodwill, the corporate tax on the taxable amount of $55,000 would be non-creditable, but both the $55,000 and the tax-free proceeds of $45,000 would reduce the opening difference.

Since the proposal requires that the tax on one-fifth of the corporation's taxable income be treated as non-creditable each year, there could be cases in which the opening difference would have been dealt with before the tax-free capital gain arose. In those cases, part of the tax previously declared non-creditable would become creditable and be available to be passed through to the corporation's shareholders. The staledating rules would apply to this creditable tax as though the tax had been levied on the tax-free gain.

As indicated in paragraph 4.79 of the White Paper, if a corporation elected to adopt the partnership option from the commencement of a new system, the share values would be based on the tax values of the underlying assets and the income of the corporation would be taxed in the hands of the shareholders in the same way as the owners of an unincorporated business. If for some reason the corporation did not elect the partnership option until after the introduction of the new system, the share values at the time of election would then be reduced by remaining portion of the opening excess of the share values over the tax values of the underlying assets in respect of which non-creditable corporate tax had not already been collected.

Department of Finance.

IMMEDIATE

Ottawa, March 19, 1970
70-34

Finance Minister E.J. Benson today released a technical paper explaining mechanisms to give shareholders credit for corporate tax paid under the proposed system of tax integration.

The document, sent to the Commons and Senate committees studying tax reform, enlarges on the White Paper in five areas:

1. <u>Closely-held corporations</u>

   The two steps are outlined under which these corporations would, effectively, be taxed at personal rates by giving shareholders full credit on dividends for tax collected from the corporations. Distributions in the form of stock dividends would permit corporations to retain funds for internal use.

2. <u>Widely-held corporations</u>

   Shareholders of these corporations would receive credit on their dividends for half the corporate tax paid. The paper explains here and in the section on closely-held corporations how a typical company might organize a "creditable tax account" on its instalments of tax and payment of dividends.

3. <u>Intercorporate Holdings</u>

   Where one corporation owns shares in another, shareholders of the first corporation would receive credit for taxes paid by the second corporation in several ways discussed in this section.

4. <u>Overpayments, Refunds and Assessments</u>

   "Creditable" tax arises when tax is paid. It remains creditable until it lapses, normally 2½ years from the end of the corporation's taxation year (staledating); until it is passed to shareholders to cover dividends; or until a refund is claimed in the event of an overpayment. The circumstances in cases of refunds and assessment disputes are explained.

5. <u>Commencement of the system</u>

   This section discusses methods by which tax would become creditable in the year in which the system starts. It deals with the tax still to be paid on surpluses existing under the present system. It also sets out some special rules concerning closely-held corporations which are necessary to ensure that taxes are in fact paid on income defined to be taxable under both the present and proposed system. In part these rules relate to goodwill sold in the first few years of the new system. Since the cost of goodwill purchased could be written-off for tax purposes under the new system, purchasers would be willing to pay more for it than under the existing system. In recognition of this increase in value part of the proceeds of the sale of goodwill would be taxable.

TITLES

GIVING SHAREHOLDERS CREDIT FOR CORPORATE TAX PAID

The purpose of this paper is to provide further details concerning the proposal in the White Paper that credit be given to Canadian shareholders for part or all of the Canadian corporate tax paid by their corporations.

There are five sections to the paper, dealing with the following aspects of the proposals.

1. Closely-held corporation.
2. Widely-held corporation.
3. Inter-corporate holdings.
4. Overpayments, refunds and assessments.
5. Commencement of proposed system.

1. CLOSELY-HELD CORPORATION

For a closely-held corporation which did not use the partnership option, taxation at personal rates would involve two steps: tax would be collected from the corporation at 50%, and credit for this tax would be given to the shareholder with a dividend distribution. Under this system it is expected that there would be a high level of distribution, since there would be no further personal tax on the dividends (once the top personal rate had been gradually reduced to 50%), and resident shareholders would want to claim the credit during the period in which it was available. To the extent funds were needed in the corporation, the dividend could be in the form of a stock dividend.

The operation of this system for a closely-held corporation with resident individual shareholders is illustrated below. It will be noted that a substantial portion of the net profit for the year is shown as being retained and capitalized by issuing stock dividends. The amount so capitalized would be added to the cost basis of the shares, and would reduce the taxable capital gain should a shareholder dispose of his shares.

ABC Company Limited
(a closely-held corporation)

	Years Ending December 31 1975	1976	1977	Total
Income Account:				
Profit before tax	$ 120,000	150,000	160,000	430,000
Corporation tax				
Federal	(48,000)	(60,000)	(64,000)	(172,000)
Provincial	(12,000)	(15,000)	(16,000)	(43,000)
Net profit	$ 60,000	75,000	80,000	215,000
Surplus Account:				
Opening balance	$ 500,000	515,000	520,000	500,000
Net profit	60,000	75,000	80,000	215,000
Cash dividends	(20,000)	(30,000)	(35,000)	(85,000)
Stock dividends	(25,000)	(40,000)	(40,000)	(105,000)
Closing balance	$ 515,000	520,000	525,000	525,000
Capital Account:				
Opening balance	$ 100,000	125,000	165,000	100,000
Stock dividends	25,000	40,000	40,000	105,000
Closing balance	$ 125,000	165,000	205,000	205,000

Net Proceeds to Resident Individual Shareholders

	1975	1976	1977	Total
Cash dividends	$ 20,000	30,000	35,000	85,000
Stock dividends	25,000	40,000	40,000	105,000
Corporate tax credit	45,000	70,000	75,000	190,000
	$ 90,000	140,000	150,000	380,000
Personal tax, e.g.40%	(36,000)	(56,000)	(60,000)	(152,000)
	$ 54,000	84,000	90,000	228,000

The effective tax burden on the income of this closely-held corporation would be the same as if it had been unincorporated. In the three years the owners of an unincorporated business would have netted:

Income	$430,000
Less personal tax @ 40%	172,000
	$258,000

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For the same three years, the shareholders of the closely-held corporation would net:

From dividend distributions to date, as above		$228,000
From future dividend distributions-		
Increase in surplus	$25,000	
Creditable tax	25,000	
	50,000	
Less personal tax @ 40%	20,000	
		30,000
		$258,000

Accounts to control the flow of creditable tax would be maintained by the corporation. These would show the additions to creditable tax arising from payments of corporate tax, the amounts passed out with dividend distributions, and the balance on hand. The basic features can be demonstrated in the following illustration for the ABC Company Limited for the year ended December 31, 1976:

ABC Company Limited
Creditable Tax Account

Date	Details	Creditable Until June 30 1978	1979	1980	Balance
1976					
Jan. 1	Opening balance re: tax for 1975	--			--
Jan. 31	1st instalment for 1976*		5,000		5,000
Feb. 29	2nd instalment for 1976		5,000		10,000
Mar. 31	3rd instalment for 1976		5,000		15,000
	Final balance for 1975	15,000			30,000
Apr. 30	4th instalment for 1976		5,000		35,000
May 31	5th instalment for 1976		5,000		40,000
June 15	Cash dividend	(12,500)			27,500
June 30 to Dec. 30	6th to 12th instalments for 1976		35,000		62,500
Dec. 31	Cash dividend	(2,500)	(15,000)		45,000
	Stock dividend		(40,000)		5,000
1977					
Jan. 31	1st instalment for 1977			5,000	10,000
Feb. 28	2nd instalment for 1977			5,000	15,000
Mar. 31	3rd instalment for 1977			6,500	21,500
	Final balance for 1976		15,000		36,500
		--	20,000	16,500	

* In the amount of $5,000, representing 1/12 of the tax liability for the previous year, if the national tax rate of 50% were applied to the taxable income of $120,000 for that year. Since the national tax rate of 50% is assumed to be made up of 40% federal and 10% provincial, any payments of provincial corporate tax at a rate higher than 10% would not create creditable tax.

It will be noted that the corporate tax becomes creditable immediately upon payment. As proposed in paragraph 4.27 of the White Paper, the tax would remain creditable until 2½ years from the end of the taxation year in respect of which it arose (for special circumstances in which the tax would remain creditable longer, see section 4 of this report). As shown in the illustration, the creditable tax assumed to go out with dividends first would be that which "staledated" first.

The corporation would make an annual reporting of its creditable tax account to the tax authorities at the same time as filing its income tax return. At the time of each dividend distribution, the onus would be on the corporation to see that there was creditable tax on hand to cover the amount reported to the shareholders. The dividend slip would look something like this -

We are enclosing a dividend cheque for	$100
In addition you may claim credit for tax paid by the corporation:	
federal tax of	80
provincial tax of	20
You should report taxable income of	$200

In the case of a stock dividend the last two items on the slip would be the same as above but the first item might read

We are enclosing a stock dividend of (for tax purposes the stock will be treated as having cost you $100)	$100

2. <u>WIDELY-HELD CORPORATION</u>

For this type of corporation, one-half of the national corporate tax rate of 50% would be creditable to resident shareholders. Technically, it is proposed that this be achieved by having a creditable tax of 25% and a non-creditable tax of 25%.

The effect of this method of taxation in relation to individual resident shareholders is illustrated below. The level of cash dividend shown has been typical of most public Canadian corporations other than those in the resource industries in recent years, and would not be expected to increase under the proposed system.

XYZ Company Limited
(a widely-held corporation)

	Years Ending June 30 1975	1976	1977
Taxable income	$2,400,000	2,800,000	3,100,000
Corporation taxes			
Integrated (1)	(600,000)	(700,000)	(775,000)
Unintegrated (1)	(600,000)	(700,000)	(775,000)
	1,200,000	1,400,000	1,550,000
Untaxed financial profit (2)	200,000	250,000	275,000
Net profit for year	$1,400,000	1,650,000	1,825,000
Surplus account:			
Opening balance	3,000,000	3,700,000	4,550,000
Net profit	1,400,000	1,650,000	1,825,000
Cash dividends (3)	(700,000)	(800,000)	(900,000)
Closing balance	$3,700,000	4,550,000	5,475,000
Individual shareholders:			
Cash dividends	700,000	800,000	900,000
Corporate tax credit	350,000	400,000	450,000
Taxable income	1,050,000	1,200,000	1,350,000
Personal tax, e.g. 40%	420,000	480,000	540,000
Net proceeds	630,000	720,000	810,000

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(1) Each including 20% federal and 5% provincial rates.

(2) Arising, for example, from claiming capital cost allowances in excess of depreciation booked.

(3) Assuming that the ratio of payout to retained after-tax taxable income is about 3:2. This was the average ratio for the years 1955 to 1964 for non-resource companies, according to Table 9 of study number 27 published by The Royal Commission on Taxation, entitled, "Rates of Return on Canadian Common Stocks: Dividends, Retentions and Goodwill Gains".

The accounting for creditable tax would be similar to that followed in the case of a closely-held corporation. The illustration set out below assumes a quarterly dividend in cash.

XYZ Company Limited
Creditable Tax Account
($000's)

Date	Details	Creditable Until Dec. 31 1975	1976	1977	1978	Balance
1975						
Jul. 1	Opening balance	225	500	525		1,250
Jul. 31	1st instalment for 1976(1)				50	1,300
Aug. 31	2nd instalment for 1976				50	1,350
Sept 15	Cash dividend of $180	(90)				1,260
Sept 30	3rd instalment for 1976				50	1,310
	Final balance for 1975			75		1,385
Oct. 31	4th instalment for 1976				50	1,435
Nov. 30	5th instalment for 1976				50	1,485
Dec. 15	Cash dividend of $180	(90)				1,395
Dec. 31	6th instalment for 1976				50	1,445
1976						
Jan. 1	Staledated credit	(45)				1,400
Jan. 31	7th instalment for 1976				50	1,450
Feb. 29	8th instalment for 1976				50	1,500
Mar. 15	Cash dividend of $180		(90)			1,410
Mar. 31	9th instalment for 1976				50	1,460
Apr. 30	10th instalment for 1976				50	1,510
May 31	11th instalment for 1976				50	1,560
June 15	Cash dividend of $260		(130)			1,430
June 30	12th instalment for 1976				50	1,480
	etc.		280	600	600	

NOTE: (1) Assumed to be 1/12th of $1,200,000, one-half of which is creditable.

It will be noted in the illustration that on January 1, 1976, a portion of the creditable tax became staledated because it had not been passed out with distributions within the time limit of 2½ years. In some cases the directors might consider it to be in the best interest of shareholders to periodically declare stock dividends in order to pass out all the creditable tax, while still retaining funds for expansion.

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There will be cases in which there will be insufficient creditable tax to cover the cash dividends; for example, due to accelerated capital cost allowances. In that event the creditable tax would accompany the dividend in the usual ratio of \$1 of creditable tax to \$2 of dividend until the creditable tax is exhausted. In this case the dividend slip might read -

We are enclosing a dividend cheque for	\$100
In addition you may claim credit for tax paid by the corporation:	
federal	36
provincial	9
You should report taxable income of	\$145

3. INTERCORPORATE HOLDINGS

For inter-corporate holdings, it would be essential that the amount of creditable tax be known at the time the particular dividend is paid, for otherwise dividends with their accompanying tax credits could not pass freely and quickly through corporations. As already noted above, the creditability would be based primarily on the payment of tax rather than on the tax as finally assessed, and accordingly the position could be ascertained at the time a dividend was paid.

For purposes of creditable tax accounting, creditable tax received with a dividend would be treated as a payment on account of the corporation tax of the receiving corporation. As such, it would in turn create creditable tax which could be passed on to shareholders of the receiving corporation within the usual period - that is, up until the end of $2\frac{1}{2}$ years from the end of the taxation year.

Since the proposed system treats inter-corporate dividends as taxable income, expenses related to inter-corporate dividend income would be deductible. This would result in a refund of tax, or a reduction of tax liability, to the receiving corporation. For example, if in the illustration in paragraph 4.56 of the White Paper there had been expenses of $30 related to the dividend income, the treatment of the closely-held corporation receiving the dividends would have been as follows:-

	From CHC	From WHC
Dividend received	$100	100
Creditable tax with dividend	100	50
	200	150
Less expenses	30	30
Taxable income	170	120
Corporate tax	85	60
Less creditable tax	100	50
Balance payable or (refundable)	(15)	10
Amount available for distribution to its shareholders (dividend less expenses plus or minus tax)	85	60
Creditable tax	85	60

Gains or losses realized by a closely-held corporation from shareholdings in Canadian or foreign corporations would have no special implications for the creditable tax accounting. Gains on shares in Canadian widely-held corporations would of course only be one-half included in arriving at income of the corporation.

In the case of a widely-held corporation, dividends from closely-held Canadian corporations would not need any further rules, since this source of income would be taxed in the usual manner, and the creditable tax with dividends would be handled as outlined above.

Dividends from other widely-held Canadian corporations would require special treatment. In paragraph 4.59 of the White Paper it is proposed that such income be effectively taxed at a 33-1/3% rate fully creditable, in order that no further unintegrated corporate tax be collected merely because of the intercorporate movement of dividends. In effect, this amounts to grossing up the actual dividend to its amount before both creditable and non-creditable corporate tax, and charging only the creditable rate thereon. This may be illustrated as follows where a widely-held corporation receives dividends:

	From CHC	From WHC
Dividend received	$100	100
Creditable tax	100	50
Taxable income	200	150
Corporate tax:		
Creditable - 25%	50	50 (on $200)
Non-creditable - 25%	50	N/A
	100	50
Less creditable tax	100	50
Balance	Nil	Nil
Amount available for distribution	100	100
Creditable tax	50	50

If the receiving corporation had expenses of $30 related to the dividend, the effect would be as follows:

	From CHC	From WHC
Dividend received	$ 100	100
Creditable tax with dividend	100	50
	200	150
Less expenses	30	30
Taxable income	170	120
Corporate tax		
Creditable	42.5	40
Non-creditable	42.5	N/A
	85	40
Less creditable tax	100	50
Balance (refundable)	(15)	(10)
Amount available for distribution to its shareholders (dividend less expenses plus balance of tax refundable)	85	80
Creditable tax	42.5	40

Gains on shares in other widely-held corporations would be taxed in the same way as dividends - at a fully creditable rate of 33-1/3% - in order to keep a balance between the treatment of dividends and share gains. If there was a net loss on shares in other widely-held corporations, 4/3rds thereof could be aggregated with income from other sources for purposes of the creditable tax, but not the non-creditable (in other words, a refund of 33-1/3% of the loss would be made, provided the corporation had enough creditable tax).

4. OVERPAYMENTS, REFUNDS AND ASSESSMENTS

Corporation income tax, or half of it, will become creditable when it is paid. It will remain creditable until it is passed through to the shareholders or has become staledated, or until the corporation files a tax return claiming a refund of the tax. If a corporation files a tax return claiming a refund because its instalments exceed its liability for the year, that excess will immediately be removed from the creditable tax account. Similarly, if a corporation filed a return reducing its tax for a year as a result of a loss carried back from the following year, the amount of the refund claimed would be removed from the creditable tax account.

Where the taxpayer wanted a refund of such an overpayment, the refund would be limited to the creditable tax still on hand, since a refund could not be given for creditable tax already passed out to shareholders. Any portion of the overpayment which was not refunded because of this limitation could still be applied on account of subsequent tax liability. Since the limitation only affects creditable tax, in the case of a widely-held corporation it would only apply to the creditable rate of 25%. Overpayments of the non-creditable tax of 25% could be refunded in the usual fashion.

A comparable problem arises when a corporation disputes an assessment or a re-assessment. Consequently, when a taxpayer objects to an assessment or re-assessment, the additional tax demanded by the assessment (that is, additional to the amount declared by the corporation in its return) would be transferred to suspense and either be refunded to the corporation on the success of its objection and/or appeal, or become creditable on the day on which it was clearly no longer subject to appeal. Because this latter day might be later than the day on which the tax would normally staledate, such tax would remain creditable until 18 months after the end of the taxation year in which it was no longer subject to appeal.

If an assessment or re-assessment is not the subject of a notice of objection, the additional tax demanded by the assessment would not staledate until 18 months after the end of the taxation year in which the assessment was issued. This would mean that in a great majority of cases additional tax levied on an original assessment would be creditable in the year in which it was paid and remain creditable until the same day as the instalments of tax for that year. At the same time, where additional tax was unsettled for a period of time, or where a re-assessment was issued three or four years after a return was filed, there would still be a period of 18 to 30 months in which any additional tax would be creditable even though the usual period for creditability had passed.

5. COMMENCEMENT OF THE PROPOSED SYSTEM

The proposed credit for corporation tax would apply to all dividends paid from commencement of the new system.

Since the corporate tax is creditable immediately upon payment, and corporate tax instalments are paid currently on a monthly basis, the dividends of most corporations would carry creditable tax immediately under the new system. Where a corporation's current tax instalments were insufficient to cover current dividends, or where a corporation wanted to build up a backlog of creditable tax, it might prefer to elect to pay the 15% tax on opening surplus and distribute some tax-paid dividends to shareholders (see later paragraphs in this section).

Where a corporation's fiscal year did not coincide with the commencement of the new system, special rules would be needed to determine the creditable portion of tax instalments paid on account of that year. It is proposed that as the date for each instalment due in the first year of the new system arrives, a fraction of the total instalments paid to that date on account of the liability for the year in progress would become creditable. For example, consider the case of a corporation with a June 30th fiscal year end in the event that tax reform is effective January 1, 1971. When the seventh instalment of tax for the year to end June 30, 1971 falls due on January 31, 1971, one-seventh of all of the instalments paid on account of the year to that date would become creditable. A month later when the eighth instalment was due, an additional fraction would become creditable - enough to bring the cumulative amount made creditable to two-eighths. On March 31st the cumulative fraction would be brought to three-ninths; on April 30th, to four-tenths; on May 31st to five-elevenths; and on June 30th to six-twelfths. A precise adjustment to the precise tax rates would take place when the return was filed (since under the White Paper proposals the amount of income subject to the low rate would be reduced in the first calendar year of the new system, an additional amount of tax would become creditable for many corporations when this precise computation was made).

The creditable tax received with dividends from other Canadian corporations would be creditable immediately and would not be reduced by the fractions mentioned in the preceding paragraph.

The general rule for corporate dividend distributions would be that they would be included in income and would carry creditable tax in the appropriate ratio, to the extent there was creditable tax on hand at the time of the dividend. Where there was insufficient creditable tax on hand, the balance on the dividends would carry no creditable tax.

In the absence of any further rules, the subsequent distribution of the surplus that a corporation had at the beginning of the new system would be taxed at full rates of the shareholder (although he would get a deduction for a capital loss if and when he sold his shares which would partially recover this tax in the case of shares of widely-held corporations and fully recover it in the case of those of closely-held corporations). Under the present tax system there are provisions for withdrawing such surplus at flat rates of about 15%. It is therefore proposed that an option be made available to all corporations to make tax-paid

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distributions out of opening surplus by paying a special withholding tax of 15%. For a resident shareholder this tax would be in final settlement of his tax liability, and the amount of the dividends before the withholding tax would be deducted from his share base. For a non-resident shareholder, the tax would apply against any ordinary liability for non-resident withholding tax.

Technically, such a tax-paid dividend would be treated in much the same way as "tax-paid undistributed income" is under the present legislation and could pass through corporate shareholders. However, the form of the tax-paid distribution would not be restricted as it is in the present legislation: it could be a cash dividend.

As explained in paragraphs 4.74 to 4.78 in the White Paper it might still be possible for a closely-held corporation to wind up without paying any tax on its opening surplus, due to the fact that the opening surplus would be capitalized in the share base and this share base would be fully deductible. It is therefore proposed that for a closely-held corporation, distributions that did not carry creditable tax would be deemed to come out of the opening surplus and be subject to the special 15% tax referred to above. In most cases this would be preferable to being subject to ordinary rates of tax on a non-creditable dividend, and it would clear up the tax liability on the opening surplus.

Also explained in paragraphs 4.74 to 4.77 of the White Paper, the immediate introduction of full credit for taxes paid by closely-held corporations, when combined with the full deductibility of their opening share values, creates the possibility that tax could be eliminated on income which would otherwise be taxable under the present system and which should be taxable under the proposed system.

The illustration given in the White Paper relates to a depreciable asset. Land which was held for sale in the ordinary course of business would be another example which would demonstrate the potential for eliminating taxable income.

For example, assume a group of individual taxpayers had purchased a parcel of land for $100,000 and on valuation day it was worth $280,000. If the land was sold shortly after the commencement of the new system and the marginal rate of the taxpayers was 50%, there would be a tax liability of $90,000 and they would have net proceeds of $190,000.

If instead the land was held in a closely-held corporation, it is quite possible that in the absence of a special rule the shares would be worth $280,000 on valuation day and that the shareholders could net the entire proceeds of $280,000 if the corporation sold the land shortly after the commencement of the new system and was then wound up. The series of transactions would be as follows:

Proceeds of sale	$280,000
Less corporate tax	90,000
Distribution by corporation	190,000
Add creditable tax	90,000
	$280,000

There would be no personal tax payable on the $280,000, since it would be offset by a deduction of the opening share value of $280,000. In this way, the excess of the fair market value of the land over its cost would have entirely escaped tax, even though the transaction would have been taxable under the present system.

The position with respect to goodwill is somewhat different, although the results would be the same. Because the purchase of goodwill would become a depreciable expenditure under the White Paper proposals, the government believes that purchasers would be willing to pay more for goodwill under the proposed system than under the present system. In fact, the government expects that taxpayers would be willing to pay at least 125 tax-deductible dollars under the proposed system for every 100 after-tax dollars under the present system. For this reason, it has proposed that if goodwill is sold in the first year of the proposed system, 40 per cent of the proceeds would be taxable (paragraph 5.8 of the White Paper). If the vendors tax rate were 50 per cent or less, he would still net at least the $100 that we would receive under the present system.

In a way similar to that described with respect to land and depreciable property, the value of the goodwill in a corporation would - in the absence of a special rule - be capitalized in the value of the shares, and no part of the proceeds of sale of the goodwill would, effectively, bear tax.

Assume a business operation in which the tangible assets have a tax value of $1,000,000 and there is goodwill in the amount of $480,000 which, under the new system, would have a value of about $600,000. If the business was unincorporated and the owners had a marginal tax rate of 50%, the sale of business in the first year of the proposed system would net $1,480,000:

Proceeds from sale of business	$1,600,000
Less 50% tax on 40% of $600,000	120,000
	$1,480,000

On the other hand, if this business had been in a closely-held corporation, the net proceeds could be \$1,600,000. As in the case of the land, the distribution of corporate surplus (\$1,480,000) and the credit for corporate tax (\$120,000) could be received free of tax since they would be offset by a deduction for an opening share value (which would be \$1,600,000 in the absence of a special rule). The purchaser of the business would have a cost which could be written off against future income even though there had been no tax cost to the vendor.

In view of this, it is proposed in paragraph 4.79 of the White Paper that some of the tax of closely-held corporations be non-creditable, to ensure that taxes are collected on income otherwise taxable under the present system, and on income which would be taxable under the proposed system if received by unincorporated business. Specifically, in the ordinary course of operations 1/5th of the profits of a closely-held corporation would give rise to non-creditable tax, so that over a period of time tax would gradually be collected on the amount by which the opening share value exceeded the tax values of the underlying assets. (For this purpose, the tax values of securities and shares would be the opening value for purposes of the proposed tax on capital gains.) Where corporation tax arose from specified types of transactions - such as recaptured depreciation, sale of oil and mining properties, or sale of goodwill - all of the tax would be non-creditable.

If some of the taxable income of the closely-held corporation was taxed at the rate of 21%, the tax on the excess of the opening share values over the underlying tax values would be satisfied at that rate. Furthermore,

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since the shareholders of some closely-held corporations might not want to take advantage of creditable tax until the top personal rates had been lowered to 50%, the closely-held corporation would be given the option of treating more of its corporate tax as non-creditable; the requirement would then be met in a shorter period of time, and at a lower tax cost.

The opening share value for purposes of the computation of the difference would be declared by the board of directors of the corporation at the time of filing the corporation's first tax return under the new system. This declaration would set out the board's opinion of the fair market value of all of the shares of the corporation if they were sold in a block to one buyer. Even though this valuation were agreed with the Department of National Revenue, it would not be binding on individual shareholders in their determination of the Valuation Day value of their holdings. It would be open to them to argue that their particular holding was worth more than average (e.g. since it carried with it control of the corporation) or less than average (e.g. since it did not have voting rights) or indeed that the "average" was itself incorrect. In this latter connection, the "average" value as agreed with the board of directors would be the beginning point for the Department's valuations of individual holdings, and might be expected to have some influence on the courts as evidence of the value of the corporation.

If the corporation realized a tax-free capital gain on an asset other than securities or shares, the amount of the tax-free capital gain would also reduce the total amount to which non-creditable tax would apply. For example, if a corporation sold to its business in the fourth year of the new system and received as part of the proceeds \$100,000 in respect of its goodwill, the corporate tax on the taxable amount of \$55,000 would be non-creditable, but both the \$55,000 and the tax-free proceeds of \$45,000 would reduce the opening difference.

Since the proposal requires that the tax on one-fifth of the corporation's taxable income be treated as non-creditable each year, there could be cases in which the opening difference would have been dealt with before the tax-free capital gain arose. In those cases, part of the tax previously declared non-creditable would become creditable and be available to be passed through to the corporation's shareholders. The staledating rules would apply to this creditable tax as though the tax had been levied on the tax-free gain.

As indicated in paragraph 4.79 of the White Paper, if a corporation elected to adopt the partnership option from the commencement of a new system, the share values would be based on the tax values of the underlying assets and the income of the corporation would be taxed in the hands of the shareholders in the same way as the owners of an unincorporated business. If for some reason the corporation did not elect the partnership option until after the introduction of the new system, the share values at the time of election would then be reduced by remaining portion of the opening excess of the share values over the tax values of the underlying assets in respect of which non-creditable corporate tax had not already been collected.

Department of Finance.