CANADA

S T U D I E S

of the

ROYAL COMMISSION ON TAXATION

Number 15

Stripping of Corporate Surplus

by

Research Staff

November 28, 1963

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Price subject to change without notice

ROGER DUHAMEL, F.R.S.C.
Queen's Printer and Controller of Stationery
Ottawa, Canada
1967

This is one of a series of studies that have been prepared for the Royal Commission on Taxation. Although these studies are published under the auspices of the Commission, this does not necessarily imply that the Commission agrees with the views expressed.

PREFACE

The taxation of corporate distributions involves consideration of the burden of taxation that should be imposed on:

(a) income relative to other bases of taxation;

(b) corporate income relative to other kinds of income;

(c) corporate income in the hands of corporations relative to corporate income in the hands of shareholders.

Having examined all of the foregoing questions, it would then be necessary to consider the particular tax structure and rate structure that would achieve the desired distribution of the burden. There are a very large number of alternatives among which to choose.

It is obvious from the foregoing that the taxation of corporate distributions cannot be considered in isolation from decisions about other parts of the tax system. Because many of these basic matters can only be considered in the light of information which is not yet available,* the staff is unable to comment on the broad question of the taxation of corporate distributions. However, it has considered in some detail that aspect of this question about which the Minister of Finance and tax practitioners have expressed grave concern—the problem of surplus stripping. Rather than attempting to discuss how corporate distribution might be taxed in order to achieve <u>all</u> of the goals of the tax system, this

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*This staff study was completed in November 1963, prior to the time that other related research by the Commission was concluded.

working paper seeks to analyze only the ways in which corporate distributions might be taxed in order to approach more closely the goal of equity through the reduction or elimination of surplus stripping. However, an attempt has been made to indicate the implications of various "solutions" to the surplus-stripping problem both for the realization of the goal of equity and for the realization of other goals.

This study attempts to answer the following questions:

1. What is surplus stripping and what effects does it have?
2. What has been done in Canada to meet this problem?
3. How have other countries handled surplus stripping?
4. Could the problem be met in a more acceptable or more effective manner without making basic changes in the tax structure?
5. Could the problem be met in a more acceptable or more effective manner by making basic changes in the tax structure?

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PART I

THE BACKGROUND

CHAPTER 1—THE PROBLEM OF SURPLUS STRIPPING

THE NATURE OF THE PROBLEM

Except under special circumstances, the Canadian tax system seeks to tax corporate income in the hands of the corporation as earned and in the hands of the shareholders after distribution. By controlling the distribution policy of a corporation or by purchasing on the open market the shares of a corporation with a given distribution policy an individual can, in effect, reinvest a specific fraction of his share of the current earnings of the corporation without bringing those earnings into his income for that year. Because the value of a corporation's shares tends to rise as a result of the retention of earnings and because the gain in the value of the shares resulting from retentions is not subject to tax, some part of a gain realized on the sale of the shares of a corporation that has retained earnings gives to the individual the same kind of result as the tax-free distribution of surplus. 1/

This type of non-taxable capital gain is easily enough achieved when, as in the case of a widely held corporation, the shares are traded on the open market. The situation with respect to the shares of closely held corporations is quite different because of their restricted marketability. Generally speaking, only the shares representing control of a closely held corporation can be sold at a price consistent with the value of the underlying assets and the earnings of the corporation. The minority shareholder therefore cannot realize his investment except under special circumstances. Moreover, under normal market transactions, it is difficult for the majority shareholder to realize part of his investment. He is either forced to sell control or keep control. These factors explain why surplus-stripping schemes have ordinarily related to controlling interests in closely held corporations.

Under normal conditions, when the shares of a corporation with retained earnings are sold and the assets representing the surplus remain in the corporation, the purchaser assumes from the seller the potential tax liability that would result if the corporation were to distribute its surplus. This liability is simply postponed and, even though the postponement may be indefinite and the liability may therefore seem somewhat academic, there is as the law now stands no objection to the postponement. The surplus remains and may continue to grow. There is no surplus stripping.

If, however, the purchaser proceeds to extract from the corporation all or part of the surplus without incurring any or all of the tax liability which the seller would have incurred had the surplus been distributed to him, surplus stripping has taken place. Under a surplus-stripping scheme the seller realizes some portion of the value of the surplus in the form of a non-taxable gain; the purchaser is able to utilize all or part of the surplus of the corporation in payment or recovery of part of the cost of the shares purchased; and the revenue does not receive the amount of tax which it might have expected to receive on the distribution of the surplus. 2/ To this loss, as opposed to a postponement, of the potential tax liability on the distribution of the surplus, the revenue not unnaturally objects.

The following simplified example illustrates one of the techniques that was available to strip surplus prior to the introduction of legislation to prevent it. Consider the example of a corporation, A, controlled by an individual, B. Corporation A was in a liquid position and had a substantial surplus that individual B wished to withdraw. Individual B established another corporation, C, that he also controlled. Individual B then sold his shares of corporation A to corporation C. Corporation C could then cause corporation A to declare a dividend equal to the amount of the surplus, and this dividend passed tax free from corporation A to corporation C. Corporation C could then remit these funds to individual B in part payment for the shares of A, and as a capital receipt they would not be subject to tax in his hands. In this series of transactions the potential personal tax liability attached to part of the surplus in the original corporation was eliminated and the individual controlling this corporation obtained a tax-free gain on the sale of his shares that was, in effect, a distribution of surplus. 3/ Control of the original corporation was maintained.

There are, of course, many variants of the surplus-stripping theme. As illustrated above, some schemes are applicable when control is to be maintained. Similar schemes might be utilized when the corporation is to be wound up or when control is being sold to another individual who intends to operate the business. 4/ A few of the basic methods are discussed briefly later in this study. However, most schemes have two features in common. First, the surplus is realized as a non-taxable capital gain through the sale of shares to a person 5/ who, after gaining control, can withdraw it in such a way that it will be non-taxable in his hands or taxed at a lower than normal rate, or that the resulting income can be offset against an equivalent loss. Because the surplus is not directly distributed to them the potential tax liability of the original shareholders is eliminated. Secondly, virtually all surplus-stripping schemes involve the participation of the persons who control a closely held corporation. These schemes are unmanageable, and probably unnecessary, for widely held corporations. As argued above, shareholders in widely held corporations can achieve the same kind of result in a much more prosaic manner.

It perhaps should be pointed out that the initiative to undertake a surplus-stripping scheme might come from a prospective purchaser of the shares as well as from the individual who holds the shares. A person, whose tax liability on distribution of the surplus is less than that of the individual who holds the shares, can offer a price for the shares that will give the prospective vendor more than he would get through a taxable distribution, and the purchaser can make a profit in the process.

It might appear that surplus stripping is motivated by the desire to escape a second tax at high personal rates on what is left of earnings after payment of a substantial corporate tax. Although this may aggravate the problem, high personal tax rates are not the real cause of surplus stripping. That this avoidance would occur even if the tax to be avoided were a low flat-rate tax rather than a high progressive tax is borne out by the fact that surplus stripping has been prevalent since it became possible to withdraw surplus within the framework of the Act on paying a 15% tax on undistributed income. The attitude is: "Why pay a 15% tax if it is possible to avoid tax completely?"

From what has been said above it can be seen that surplus stripping arises because corporations retain earnings and because, under the present tax system, an attempt is made to tax these earnings on distribution. This usually presents no problem for the widely held corporation. However, for the closely held corporation this system creates a strong motive to find methods of avoidance.

Many amendments to the legislation have been made over the years in an attempt to prevent dividend stripping of one kind or another. As discussed later, at least until 1963, these amendments were not completely effective.

THE IMPLICATIONS OF SURPLUS STRIPPING FOR EQUITY

Surplus stripping is a means of avoiding personal income tax that is not open to all individuals or to all kinds of income; it is ordinarily effectively open only to those who control closely held corporations. The effect of surplus stripping is to transfer some of the tax burden from this relatively small group to other taxpayers. 6/

As discussed above, shareholders can avoid or reduce the application of personal income tax on their portions of retained corporate earnings through the postponement or elimination of the potential tax liability on the distribution of such earnings. The elimination of the liability is usually available only to those who control closely held corporations, while the postponement of tax liability is more readily available to shareholders in widely held corporations. When surplus stripping can be practised it is not certain which group has the greater tax advantage. However, if the surplus-stripping loopholes were stopped, and no other changes were made, those who control closely held corporations would almost certainly be at a disadvantage relative to shareholders in widely held corporations.

THE ECONOMIC EFFECTS OF SURPLUS STRIPPING

If those with a controlling interest in closely held corporations can remove surplus virtually free of personal income tax the following effects are produced.

1. The prospective after-tax rate of return to those who hold a controlling interest in profitable, closely held corporations is raised. The higher the personal tax bracket of the individual relative to the corporate tax rate, the more attractive is the after-tax rate of return from such enterprises.

2. This may offset in whole or in part the imperfections of the capital market which are alleged to result in a shortage of capital for such companies.

3. Those who control such corporations are induced to retain temporarily more earnings than otherwise would be the case. However, the slightly larger volume of saving is probably invested less productively than if this tax consideration were absent, for they will be willing to accept a lower before-tax rate of return than investors who cannot avail themselves of surplus stripping.

4. The ability to strip surplus results in the incorporation of

more businesses than otherwise would be the case.

5. Resources are devoted to carrying out and attempting to prevent surplus stripping.

6. The few investors who, in the absence of surplus stripping, would have sought investments in foreign tax havens keep their funds in Canada. This effect is limited because these corporations tend to combine ownership and management—and management is less mobile than capital.

7. To recoup the revenues lost through surplus stripping other taxes will tend to be higher. This effect is probably insignificant.

If surplus stripping were prevented we would therefore find:

(a) somewhat less saving; but a more efficient allocation of saving;

(b) a larger proportion of closely held corporations sold to widely held corporations and fewer to individuals in the upper income brackets;

(c) less capital available for small, closely held companies;

(d) upper income individuals possibly seeking tax-haven investments outside Canada, with perhaps a slight increase in capital exports;

(e) a reduction in the time spent on such schemes by tax practitioners.

Because we do not know the extent of surplus stripping it is impossible to assess the importance of these economic effects.

OTHER EFFECTS OF SURPLUS STRIPPING

While surplus stripping is inequitable, it is not the only inequity in the system and may not be the greatest one. The problem has, however, received a great deal of attention from tax practitioners in recent years and has been treated by at least some of them as a matter of grave public concern.

The surplus-stripping loophole created special problems for tax practitioners. Should a client be advised to avail himself of the loophole or not? Cautious practitioners emphasized the dangers that were involved in surplus stripping because they expected that the government would act promptly to close the loophole—and perhaps penalize those who had stripped surplus. Others advised their clients to take the gamble. In the event, the government did not act for a long period and there were numerous instances of blatant tax avoidance. The existence of this loophole therefore greatly increased the uncertainty surrounding an important part of the tax system. Uncertainty creates contempt for the system and results in more tax avoidance and attempted evasion. This may be more important than the inequity itself.

THE PROBLEM IN PERSPECTIVE

Surplus stripping is probably not important for the Canadian economy. Furthermore, it has been argued that, if surplus stripping alone were prevented, one inequity would be eliminated but another would be created Thus, the elimination of surplus stripping as such would not <u>necessarily</u>

constitute an improvement. This in turn means that changes in the tax system that would simultaneously avoid both kinds of inequities have to be considered. If it is impossible to make such changes on technical grounds or if it is judged that such changes would be undesirable on other grounds, it would then be necessary to try and evaluate the extent to which surplus stripping (or its equivalent) should be permitted in order to achieve the greatest equity between those who control closely held corporations and shareholders in widely held corporations. This is to be preferred to the contempt for the whole tax system that can develop through some taxpayers engaging in avoidance, and others in evasion, under conditions where the intention is uncertain.

Before discussing the surplus-stripping problem as such it is desirable to indicate the kinds of changes in the tax structure that would eliminate both inequities simultaneously. There are at least the following possibilities.

1. Provide that shareholders include in their personal incomes each year their portion of <u>all</u> of the current incomes of the corporations in which they hold shares. This would eliminate the problem of surplus stripping. It would also put the shareholders in widely held and in closely held corporations on the same tax basis. This kind of scheme would impose the same tax burden on corporate income as on income from other sources if it were accompanied by the elimination of the corporate income tax as such. However, whether or not it would impose the appropriate burden of tax on the capital invested in corporations relative to other capital and other

sources of income depends upon one's views about the shifting of income taxes. This kind of scheme is discussed in Chapter 5 and in Appendix A to this study.

2. Allow individual shareholders to exclude all corporate distributions from their taxable incomes. This would, in a sense, put all shareholders on the same footing, but it would mean the weakening and possibly the abandonment of the progressive personal income tax rate structure. Whether the tax burden on corporate income in the hands of the corporation would be of the appropriate weight, relative to taxes on other kinds of income, would depend upon the tax applied on corporate income in the hands of the corporation and on one's views about tax shifting. Surplus stripping would be unnecessary. A scheme of this type is discussed in Chapter 5 and in Appendix C to this study.

3. Devise a tax structure that would be a compromise between approaches (1) and (2). This compromise solution could eliminate surplus stripping, put the shareholders in widely held and closely held corporations on the same basis, and take current corporate distributions into personal income to some extent. Such a scheme is discussed in Chapter 5 and in Appendix B to this study.

4. Define personal income to include all the realized gains in the values of corporate shares and tax them at full personal rates. By extending the concept of personal income in this way all shareholders would be on the same footing and surplus stripping would be pointless. However, this approach goes far beyond the

point at issue in this study, for it would impose taxes on gains that were completely unrelated to corporate income. This approach is not discussed in this study.

CHAPTER 2—HISTORY AND ASSESSMENT OF CANADIAN LEGISLATION DESIGNED TO PREVENT SURPLUS STRIPPING

HISTORY, 1917 TO 1949 7/

When introduced in 1917, the Income War Tax Act 8/ required shareholders to include in their personal income their share of retained corporate earnings unless the Minister was of the opinion that the accumulation of retained earnings was not for the purpose of evading tax, and was not in excess of reasonable business requirements. In 1919 this position was reversed so that retained earnings were not included in personal income unless the Minister decided that the retention was to avoid tax, or was in excess of reasonable requirements. 9/ By making the taxation of retained earnings the exception rather than the rule, the opportunity to avoid tax was furnished.

Prior to 1924, it appears that by retaining corporate income, personal tax thereon could be postponed; by winding up or reorganizing the business retained earnings could be withdrawn tax free. In 1924, following the United Kingdom court decision in Inland Revenue Commissioners v. Burrell, 10/ which held that such receipts were capital in nature and not dividends, the government made its first attempt to close a surplus-stripping loophole. Section 3(9) was added to the Act to provide that the distribution of property in any form on discontinuance, winding-up, or reorganization would be deemed to be a dividend to the extent of the undistributed income then on hand. 11/ It seems that the struggle by taxpayers to withdraw retained earnings without incurring tax and by the taxing authorities to prevent such avoidance of tax dates back at least to 1924. 12/

In 1926, to avoid multiple taxation of corporate income, section 3(12) was enacted to exempt intercorporate dividends. This provided a loophole whereby shares could be sold to a new corporation (in effect owned by the same shareholders) and the surplus passed through the new corporation as a tax-exempt intercorporate dividend and thence out to the original shareholders in payment for the shares sold to the new corporation. To counter this, section 4(11) was introduced in 1926 to provide that shareholders selling shares in these circumstances would be taxable on the dividend passing to the new company as if they had received the dividend themselves.

Other legislation introduced in 1926 to prevent surplus stripping was as follows.

Section 4(8) deemed the withdrawal of retained earnings by appropriation of property or by an advance or loan to shareholders to be a dividend.

Section 4(9) prevented the distribution of capital without first distributing or at least paying tax on undistributed income.

Section 4(10) deemed a premium on redemption of shares that was paid out of undistributed income to be a dividend.

Section 4(12) deemed the conversion of undistributed income into capital through a stock dividend to be a dividend.

From the above it can be seen that surplus stripping is not a recent innovation and that many of the schemes for avoiding any further tax on corporate earnings when they reach the shareholders' hands were thought of, and some of them tried, within a few years after income tax was introduced.

The measures for preventing the stripping of surplus as shown above would appear to have been fairly effective because, by 1930, the accumulation of retained earnings caused such a serious problem that it was decided to ease the situation. In that year an amendment to section 19(1) permitted tax-free distributions of retained earnings accumulated prior to 1930 on winding-up, discontinuance or reorganization. 13/ This right continued until 1934 when it was withdrawn.

In 1934 the legislation that had been added in 1926 to make premiums on share redemptions taxable was tightened to make such premiums taxable whether or not there was undistributed income on hand.

Prior to 1936 section 19 deemed a dividend to have been paid on the distribution of any property by a company with undistributed income on hand to the extent thereof on its winding-up, discontinuance or reorganization. By the addition in 1936 of section 19(2) it was provided that, notwithstanding the normal immunity accorded to intercorporate dividends, such a deemed dividend would be taxable in the hands of companies incorporated or carrying on business in Canada. There was no requirement under section 19 (as there was under section 4(11) above, which later became section 14) that the receiving corporation be controlled by the same persons who controlled the distributing corporation.

In 1938 several important additions were made to the Act. These were contained in sections 32A and 32B. One of these additions remains in the Act today as section 138. The others were dropped in 1948. All the new provisions vested in the Treasury Board the power to direct the tax consequences of transactions motivated by the desire to reduce or avoid taxes. Although two of the new provisions were couched in the most general of terms, either of which was sufficiently wide to cover almost any sale of shares of a corporation with undistributed profits on hand, one section dealt with a specific loophole not covered by either section 14 or section 19. Thus it was provided in section 32A(3) that if substantially all the shares of a company having undistributed income on hand were purchased by any other company the Treasury Board could find that the main purpose of the sale by the vendor was to reduce or avoid the tax which would have been paid by him on the distribution of the undistributed income of the corporation. On such a finding being made and notwithstanding the normal immunity granted to intercorporate dividends, 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 were to be taxed in its hands. Special appeal procedures were established for the purpose of determining whether the main purpose of a transaction was tax avoidance.

In 1943 section 16, which applied to reductions and redemptions of share capital, was broadened to include conversions. This closed another small loophole. 14/

In 1944, the accumulation of retained corporate earnings had once again become a serious problem and the Ives Committee was appointed to investigate it. As a result of the report made by this Committee, Part XVIII of the Act was introduced in 1945. This permitted specified corporations to make distributions in cash after paying a special tax ranging from 15% to 33% on undistributed income accumulated to the end of their 1939 taxation years.

These were the main attempts to prevent surplus stripping before the introduction of the Income Tax Act 15/ in 1948. At that time major changes in tax legislation took place, including the elimination of most ministerial discretion.

HISTORY, 1949 TO 1962

The problem was by no means solved, and the tax sophisticates were able to find many loopholes in the new Act. Some of the earlier preventive provisions were carried through to the new Act, and other provisions were enacted.

Discretion on Unreasonable Accumulations

Ministerial discretion to prevent the accumulation of undistributed income in excess of the reasonable requirements of the business or for the purpose of avoiding tax was contained in section 13 of the Income War Tax Act. 16/ This discretion was carried into the 1948 Act as section 9(6). Section 9 as a whole dealt with distribution on winding-up; in 1950 it was repealed and replaced by section 71 (now section 81 of the present Income Tax Act). 17/ In the process ministerial discretion to deem excess undistributed income to be distributed was dropped.

Indirect Distribution of Surplus

When the 1948 Income Tax Act was passed by Parliament some of the sections dealing with surplus stripping that had appeared in previous legislation were withdrawn. Included among them were section 14 (dealing with intercorporate dividends between companies under common control), section 19(2) (dealing with intercorporate transmissions of undistributed income on hand on winding-up, discontinuance or reorganization) and section 32A(3) (granting the Treasury Board power, in certain circumstances, to direct the tax consequences of transactions in securities when substantially all the shares of a company having undistributed income on hand are purchased by another company).

The introduction of designated surplus legislation in 1950 was an attempt to prevent abuse of the tax-free passage of dividends between corporations. Briefly stated, this legislation provides that where one Canadian corporation acquires control of another at a time when the other corporation has undistributed income on hand, such undistributed income will become "designated surplus" and a dividend will not pass tax free between the corporations to the extent that it is paid out of the designated surplus.

In 1955, the designated surplus provisions were extended to cover the situation where control of the surplus corporation is sold to a non-resident corporation, an exempt person other than a personal corporation, or a trader or dealer in securities. A 15% or 20% tax is payable by the surplus corporation upon payment of a dividend out of designated surplus in these circumstances. 18/

There are two vulnerable points in the designated surplus provisions that are exploited in several surplus-stripping schemes. One is caused by the definition of designated surplus, and the other by the definition of control. Designated surplus is defined as undistributed income of the controlled corporation at the end of its last taxation year before control was acquired. A controlled corporation is defined as one where more than

50% of its issued share capital (having full voting rights under all circumstances) belongs to another corporation, or to another corporation and persons with whom that other corporation does not deal at arm's length. It follows, therefore, that there will not be any designated surplus so long as:

(i) the controlled corporation did not have any undistributed income on hand at the end of the last taxation year before control was acquired, or

(ii) control as defined in the Act can be avoided.

Such control can be avoided by arranging that the shares sold to another corporation do not have full voting rights under all circumstances. This can be achieved by splitting shares into voting and non-voting shares. Shares sold to the other corporation may represent practically all the dividend rights so that the undistributed income of the original corporation may be paid out as a dividend of which only an insignificant amount will attract tax. Control may also be avoided by selling the shares to two or more persons who are at arm's length and arranging that no one person holds control.

Another means of avoiding designated surplus is to have the shares in the operating company held by a holding company from the outset of the business venture, or from a time when the operating company had no undistributed income on hand.

Unlike certain provisions of the Income War Tax Act, which had deemed the dividend passing between the corporation to be income of the former owners of the shares, the new designated surplus provisions attempted to earmark the undistributed income and to prevent it from passing free of corporation income tax. This indirect approach left several loopholes to be exploited. The only deterrent was that the purchasing corporation would not be entitled to deduct intercorporate dividends in computing its income to the extent that they were paid out of designated surplus.

Sales to Persons Other than Taxable Canadian Corporations

Since the designated surplus provisions were aimed at the tax-free passage of intercorporate dividends, the deterrent could be avoided by selling shares of the surplus company to:

(i) a non-resident corporation that would pay less than 15% tax, or

(ii) a tax-exempt person, or

(iii) a trader or dealer in securities who could offset the dividend income with a loss on disposal of the shares after stripping the surplus.

To close these loopholes, Part IIB(section 105B) was enacted in 1955. It provided that, where the surplus company paid a dividend that would have been regarded as having been paid out of designated surplus had section 28 been applicable, a 15% tax on the dividend would be payable by the surplus company in circumstances (i) or (ii) and a 20% tax in circumstances (iii). 19/

In 1959 provisions covering statutory amalgamations were introduced in Part IIC (section 105C). The result of this legislation is that, where a corporation had designated surplus prior to amalgamation, such designation is removed on amalgamation.

Permission to Distribute at Other than Personal Rates

Legislation enacted in 1950 20/ permitted the creation of tax-paid undistributed income by payment of a special 15% tax on undistributed income accumulated by corporations to the end of 1949 taxation year. Furthermore, for 1950 and subsequent years, tax-paid undistributed income could be created by payment of a 15% tax on an amount equal to dividends paid in 1950 and subsequent years. There were important restrictions on this privilege however. By employing this procedure a corporation can avoid embarrassing accumulations of potentially taxable surplus by paying out half of current earnings as a dividend and by the payment of a special 15% tax on the other half. Tax-paid undistributed income cannot be withdrawn tax free in the form of a cash dividend. It is possible, however, to effect a withdrawal by issuing a preferred stock dividend and subsequently having it redeemed.

ASSESSMENT OF THE POSITION PRIOR TO THE 1963 BUDGET PROPOSALS

Prior to the 1963 budget proposals and despite the numerous attempts to prevent it, "surplus stripping" was still being practised. The main methods by which it was being achieved were as follows:

(a) the sale of shares to other Canadian corporations, non-resident corporations, exempt entities and dealers in securities, by taking advantage of the weaknesses in the designated surplus provisions.

(b) Conversion to non-resident corporation status. Under this scheme shares are sold to non-residents who transfer the site of management to a place outside of Canada and then remove the surplus free of tax as a payment from one non-resident to another non-resident.

(c) The deficit company method whereby the shares are sold to a company having losses which can be carried forward to offset the dividend passing between the companies.

(d) The amalgamated personal corporation method where, through amalgamation, it may be claimed that the new company emerging was always a personal corporation and that dividends paid out are exempt from tax.

(e) The circular shareholding method whereby a subsidiary or sub-subsidiary acquires the shares of its ultimate parents and leaves the group of companies with no assets other than the shareholdings in each other.

(f) The revaluation method which involves one or more operating corporations owned by a holding corporation. The incomes of the operating corporations can be retained for a period and, at a suitable time, the holding corporation's assets (including the investment in shares of the operating corporations) written up to fair market value and a stock dividend paid out of resultant capital surplus. This stock dividend, which is in the form of redeemable preferred shares, is not taxable in the shareholders' hands if the holding corporation has no undistributed income on hand at the end of its taxation year in which it declared the stock dividend. Cash dividends may then be paid by the operating corporations to the holding corporation and the funds used to redeem the redeemable preferred shares.

In addition to the above, even where surplus had become designated, there was some uncertainty about the effectiveness of the designated surplus provisions in the Act. Because of the definition of "earnings in the control period" contained in section 28(5) of the Act, it appears that the designated surplus was subject to erosion by subsequent corporate losses and by payment of provincial income taxes where it had taxable income.

BUDGET PROPOSALS, 1963

In his Budget Speech of June 13, 1963, the Minister of Finance proposed the introduction of new legislation aimed at the practice of surplus stripping. The budget proposal became section 138A of the Income Tax Act. The relevant parts of section 138A read as follows:

> (1) Where a taxpayer has received an amount in a taxation year,
>
> (a) as consideration for the sale or other disposition of any shares of a corporation or of any interest in such shares,
>
> (b) in consequence of a corporation having
>
> (i) redeemed or acquired any of its shares or reduced its capital stock, or
>
> (ii) converted any of its shares into shares of another class or into an obligation of the corporation, or
>
> (c) otherwise, as a payment that would, but for this section, be exempt income,
>
> which amount was received by the taxpayer as part of a transaction effected or to be effected after June 13, 1963 or as part of a series of transactions each of which was or is to be effected after that day, one of the purposes of which, in the opinion of the Minister, was or is to effect a substantial reduction of, or disappearance of, the assets of a corporation in such a manner that the whole or any part of any tax that might otherwise have been or become payable under this Act in consequence of any distribution of income of a corporation has been or will be avoided, the amount so received by the taxpayer or such part thereof as may be specified

by the Minister shall, if the Minister so directs,

(d) be included in computing the income of the taxpayer for that taxation year, and

(e) in the case of a taxpayer who is an individual, be deemed to have been received by him as a dividend described in paragraph (a) of subsection (1) of section 38.

....

(3) On an appeal from an assessment made pursuant to a direction under this section, the Tax Appeal Board or the Exchequer Court may

(a) confirm the direction;

(b) vacate the direction if

(i) in the case of a direction under subsection (1), it determines that none of the purposes of the transaction or series of transactions referred to in subsection (1) was or is to effect a substantial reduction of, or disappearance of, the assets of a corporation in such a manner that the whole or any part of any tax that might otherwise have been or become payable under this Act in consequence of any distribution of income of a corporation has been or will be avoided; or

(ii) ...

(c) vary the direction and refer the matter back to the Minister for reassessment.

It will be observed that this legislation has

(a) returned to the direct approach, which attempts to tax the vendor of the shares,

(b) reintroduced a measure of ministerial discretion to deal with surplus stripping.

In the debates that followed the introduction of the budget proposal the Minister indicated that he had reluctantly introduced this legislation pending a better solution.

Pending judicial interpretation of section 138A, the following is a summary of its probable effects:

(i) It is only if the conditions set out as a prerequisite to the exercise of the discretion include all possible means of surplus stripping that this practice will be eliminated.

(ii) The existence of this legislation aimed at surplus stripping will reduce the number of attempts to carry out this practice.

(iii) Normal business transactions will be inhibited because of taxpayer uncertainty as to the applicability of this section to the contemplated transactions.

(iv) The courts will have the power to vacate the direction on the grounds stated in subsection (3)(b)(i) or they may vary it, apparently leaving no important discretionary power vested in the Minister. (See Chapter 4 for further discussion of this point.)

PART II

THE FOREIGN EXPERIENCE

CHAPTER 3—FOREIGN EXPERIENCE WITH THE DIVIDEND-STRIPPING PROBLEM

INTRODUCTION

In the preceding chapter a history of the dividend-stripping problem in Canada and the legislative response thereto at various times were discussed. In this chapter it is intended to deal with the present response to that problem in certain foreign countries that employ a system of taxing corporations and shareholders similar to that currently employed in Canada. Attention will be focused on major countries with a background of Anglo-American legal traditions (i.e., the United Kingdom, the United States and Australia), but South Africa and to a lesser extent Germany have been included for comparative purposes. Finally, an attempt will be made to summarize the foreign legislation under common headings.

A distinction will be made between legislation that attempts to prevent undue accumulations and legislation that seeks to prevent tax avoidance on accumulations that have taken place.

UNITED KINGDOM

Legislation Designed to Prevent Undue Accumulations

Under section 245 of the United Kingdom Income Tax Act of 1952 it is provided that, where it appears to the Special Commissioners that any company to which that section applies has not, within a reasonable time after the end of its fiscal year, distributed to its shareholders, in such manner as to render the amount distributed liable to be included in the shareholders' income for surtax purposes, a reasonable part of the company's actual income, then the Commissioners may, by notice to the company, direct that for purposes of assessment to surtax, the said income of the company shall be deemed to be the income of the members. It is specifically provided that the companies to which section 245 applies are, among others, those under the control of not more than five persons or that are deemed to be under the control of not more than five persons. Special exemption from the impact of this section applies to subsidiary companies and companies in which the public are substantially interested even though they might be under the control of not more than five persons. In order to qualify as a company in which the public is substantially interested, there are three requirements. First, shares (other than preferred shares) to the extent of not less than 25% of the voting power must have been allotted to, or acquired by, the public unconditionally. Secondly, such shares must be beneficially held by the public at the end of the relevant period. Thirdly, such shares must have been dealt in and quoted on a stock exchange in the United Kingdom during the period. In connection with the above requirements it appears that the "public" means anyone else other than the controllers.

Legislation Designed to Prevent Avoidance of Tax

In addition to the anti-accumulation legislation described above, the United Kingdom has attempted at various times to prevent surplus stripping by enacting legislation describing specific circumstances in which what otherwise would be a capital gain would be treated as income. This legislation was directed at sales to security dealers and exempt persons among others, but discussion of it is not necessary for the purpose of this study.

Despite this detailed legislation, it became apparent that opportunities for tax avoidance still existed in connection with transactions in securities. Consequently, in 1960, legislation was introduced aimed at securities transactions specifically. It was couched in reasonably general terms and did not attempt to spell out the specific situations in which it would apply. This legislation gave discretionary power to the Revenue and was strongly criticized on the grounds that it authorized the levy of a tax on transactions not expressly made taxable by Parliament. However, subject to certain safeguards, Parliament apparently accepted the view that only a provision like this could effectively deal with tax avoidance in the form of surplus stripping.

Because the tax structure in the United Kingdom is different from that in Canada, there appears to be no purpose to discussing the detailed provisions of the United Kingdom legislation. In general, however, it may be said that the legislation is aimed at a transaction or a series of transactions in securities 21/ followed by the payment of an abnormal dividend 22/ whereby a taxpayer or taxpayers are able to obtain a tax advantage. 23/ In certain circumstances there is the additional condition that the vendor of the shares receives a consideration that represents the value of assets available for distribution by way of dividend. If these conditions exist the Revenue may, at its discretion, initiate a tax advantage cancellation procedure.

The legislation does not apply if the taxpayer can show that the transactions were carried out either for bona fide commercial reasons or in the ordinary course of making or managing investments and that none of the objects was to obtain a tax advantage.

Where the Revenue believes that this legislation applies the procedure is as follows:

1. The Revenue issues a preliminary notice to the person concerned that it believes the transaction falls within the terms of the legislation.
2. The person has the right, within thirty days, to submit a statutory declaration disputing the revenue's belief and stating the facts and circumstances which refute that belief.
3. This ends the matter unless the Revenue wishes to take further action in which case a certificate to that effect is sent to the Tribunal 24/ together with the taxpayer's statutory declaration and the Revenue's counter-statement.
4. The Tribunal determines whether or not there is a prima facie case. If the Tribunal's determination is negative, this ends the matter. No appeal is provided from a determination at this point.
5. If the taxpayer does not exercise his right in 2 above or if the Tribunal decides there is a prima facie case, the Revenue may issue a second notice that specifies the basis for the adjustments the Revenue considers requisite.
6. Within 30 days of this second notice, the taxpayer may appeal to the Special Commissioners on the grounds either that the legislation does not apply to him or that the adjustments are not appropriate.
7. If either the taxpayer or the Revenue is dissatisfied with the finding of the Special Commissioners they may require the appeal

to be reheard by the Tribunal. An appeal from the Special Commissioners or the Tribunal to the courts is available on a point of law.

The taxpayer has the right to a clearance in respect of transactions or proposed transactions. This procedure is as follows:

1. The taxpayer submits to the Revenue details of the transactions or proposed transactions and asks for a ruling.
2. Within 30 days the Revenue may ask for further information. If this information is not supplied within 30 days the Revenue need take no further action.
3. Within 30 days of receiving the further information the Revenue must notify the taxpayer whether or not it is satisfied that the transactions or proposed transactions fall outside the legislation.
4. If the Revenue indicates it is satisfied, it is precluded from further action unless full and accurate disclosure of all material facts has not been made by the taxpayer.

UNITED STATES

Legislation Designed to Prevent Undue Accumulations

Contrary to the legislation in the United Kingdom which imputes amounts of income unreasonably withheld by a corporation to its shareholders, the counterpart legislation in the United States imposes a so-called penalty tax on such income at the corporate level. The rates of penalty tax are 27.5% on the first $100,000 of accumulated taxable income and 38.5% on any amount in excess of $100,000. Prior to 1921, however, the

United States legislation was more closely akin to that in the United Kingdom and unreasonable retentions were imputed to shareholders. The change to the present system in the United States was directly related to the constitutional requirement of realization.

In its present form the penalty tax applies to every corporation, other than personal holding companies and tax-exempt companies, formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed. The ultimate issue involved in the application of the penalty tax is whether the corporation "was formed or availed of for the purpose of avoiding the income tax with respect to its shareholders". The various tax circumstances of the stockholders of a corporation, the securities of which are widely held, may well run the gamut. It would be administratively difficult for such a corporation to try to cater to the tax needs of its stockholders. This is another way of saying that, where such a corporation does accumulate substantial earnings, the prohibited purpose is not likely to be present. For all practical purposes, the penalty tax is applicable only in the case of closely held corporations.

The standard of proof necessary to satisfy a court that a corporation has been formed or availed of for the prohibited purposes is that, if the earnings and profits of a corporation are permitted to accumulate beyond "the reasonable needs of a business", that fact shall be determinative of a purpose to avoid income tax with respect to shareholders, unless the corporation by the preponderance of evidence shall prove to the contrary. As opposed to the ultimate issue of whether a corporation was formed for the prohibited purpose there is, then, this preliminary issue respecting the factual determination of whether earnings and profits have been accumulated beyond the reasonable needs of the business.

To soften the burden placed on the taxpayer by virtue of the factual determination previously described, the legislature has enacted certain provisions that, under prescribed conditions, have the effect of shifting to the revenue the onus of proof with respect to what constitutes the reasonable needs of the business. In the absence of such legislation the burden would be on the taxpayer.

In considering the possible applicability of the penalty tax to closely held enterprises and in response to an analysis of the effect of such a tax liability on the internal financing requirements of small businesses, legislation enacted in 1954 provided a credit of $30,000 (now $100,000) as a deduction in arriving at "accumulated taxable income". Accumulated taxable income is the tax base on which the penalty tax is levied and is derived from certain adjustments that must be made to "taxable income". Included among the adjustments to taxable income are deductions for taxes and dividends. Other elements that must be taken into account in establishing the penalty tax base include the deduction for amounts of profits retained for the reasonable needs of the business, the deduction for dividends paid after the close of any taxable year and on or before the 15th day of the third month following the close of such taxable year, and consent dividends. Consent dividends are amounts that the shareholders consent to report as dividends even though not actually distributed.

Legislation Designed to Prevent Avoidance of Tax

Due partially to the absence of a complete prohibition on the accumulation of corporate income and partially to the unwieldy nature of the legislation that does attempt to prevent excessive corporate accumulations of income, it is still possible to retain income within the framework of corporations. The ability to postpone distribution is all the more important when it is realized that amounts distributed on liquidation of a corporation are treated as distributions of capital. Consequently, other sections of the United States taxing legislation attempt to deal with the problems arising when shareholders of corporations with accumulated earnings seek to realize those earnings at capital gains rates without a complete sale of their stock which would end the relationship with the corporation and without liquidating the business of the corporation.

These other sections of the United States taxing legislation provide that, under certain circumstances, the proceeds of a contrived capital distribution will be converted into ordinary income in the hands of the taxpayer-shareholders. Included in the vast network of contrived arrangements that the legislation attempts to foil are the following:

(1) the distribution of preferred stock dividends, the dividend stock being then sold and redeemed by the corporation, leaving the shareholders with their stock interest plus cash representing in effect part of the former corporate surplus;

(2) the corporate division under which some corporate assets are placed in a new corporation, whose stock is

then distributed through spin-off, split-off or split-up to the shareholders to be sold by them;

(3) the corporate share redemption and partial liquidation under which the corporation distributes some of its assets for some of the shareholders' stock with their control unhampered;

(4) the complete liquidation followed by reincorporation of part of the assets, leaving the shareholders with control of those assets and with the remaining assets in their hands;

(5) the mergers and reorganizations involving in more complex form the types of transactions described above.

There is some opinion to the effect that the previously described legislation would not be effective in the absence of a sympathetic judicial response to the tax avoidance problem. 25/ This response can be gathered from the emergence of various doctrines that supplement the intention of the legislature and, in some ways, accomplish the purpose intended by anti-avoidance legislation in other countries. Among these doctrines, the so-called "business purpose" test is the most important. Judicial action founded on the application of the business purpose test is considered proper to protect technical rules from distortion through tax-motivated transactions lacking a business purpose or other substantial economic reality.

AUSTRALIA

Legislation Designed to Prevent Undue Accumulations

Under Division 7 of Part III of the Income Tax and Social Services Contribution Assessment Act of the Commonwealth of Australia (1936-1960) a separation between closely held and widely held companies is made for the purpose of defining the type of company that will bear the additional tax on undistributed profits. That tax is calculated at the rate of 50% and applies only to "private companies". Prior to 1952, undistributed profits were notionally imputed to the company's shareholders for inclusion in their incomes. The present form of Division 7 embodies that portion of the recommendations of the Commonwealth Committee on Taxation (1952) that dealt with the tax avoidance problem associated with corporate accumulation of profits. The underlying principle was that the additional tax would be levied at so severe a rate that all private companies would distribute their profits after deducting corporate income tax and any permitted retentions. It was felt that very few companies would in fact pay the penalty tax. It is reported that the desired result has been largely achieved. 26/

It will be recalled that the practical effect of similar legislation to that described in the preceding paragraph in both the United Kingdom and the United States is that such legislation applies only to closely held companies. The same is true of the Australian legislation which applies only to "private companies". For purposes of the Australian tax a private company is one in which the public are not "substantially interested" (i.e., a company the shares of which have not been quoted in the official list of a stock exchange) and which possesses one or more of the following characteristics. That is to say, in addition to being a company in which the public are not substantially interested, that company, in order to attract the accumulated earnings tax, must have one or more of the following attributes:

1. all the issued shares must be held by not more than twenty persons, or
2. more than half of the voting power is capable of being exercised by not more than seven persons; or
3. shares representing more than half the paid-up capital (other than preferred) are held by not more than seven persons; or
4. not less than three quarters of the voting power is capable of being exercised by not more than seven persons; or
5. shares representing not less than three quarters of the paid-up capital (other than preferred) are held by not more than seven persons; or
6. the company must be capable of being controlled by any means whatever by not more than seven persons.

It appears that the overlapping of subsections (2), (4), (3) and (5) in the preceding paragraph are designed to allow a broader exemption to companies that are controlled by a person and his relatives than to companies that are controlled by persons alone. Thus, in applying subsections (2) and (3) it is provided that a person and his nominees count as "a person" but in applying subsections (4) and (5) a person and his relatives and his or their nominees count as "a person".

The penalty tax on corporate accumulations is in no way discretionary. Any company which has not made a sufficient distribution "is liable to pay additional tax" in accordance with the legislation. There is no special appeal procedure from the levying of a penalty tax. Subject to review of the assessment at the departmental or administrative level the taxpayer may refer the assessment to a Board of Review or treat his objection as an appeal and forward it to an appropriate court. (A Board of Review is not a court.) On every such reference or appeal the burden of proving the assessment excessive is on the taxpayer. Appeals from a decision of a Board of Review are limited to questions of law as are appeals from a court of first instance under the alternative procedure.

The procedure under Division 7 is put in motion when the revenue issues to the taxpayer a special form showing the calculation of the amounts required to be paid in order to avoid the undistributed profits tax. Although it appears that this procedure is not based on a statutory requirement, it is consistent with the objective of Division 7, the encouragement of distributions.

In the determination of the penalty tax the company's taxable income for the relevant year is taken as the starting point. In most cases the only deduction will be the corporate tax payable on taxable income. The reduced amount is called "distributable income". The next step in the procedure is to calculate the "retention allowance". For this latter calculation any income derived from property is deducted from distributable income, and the taxpayer then computes the "retention allowance" by taking certain percentages of the remainder and 10% of the income from such property. As a retention allowance the taxpayer is allowed to claim 50% of the first £1,000 of distributable income less income from property, 40% of the second £1,000, and 35% of the remainder. It is assumed that the reason for permitting a retention allowance is substantially the same as that of the United Kingdom and the United States, where corporate accumulation is associated with "reasonable distribution" and "the reasonable needs of the business"—that reason being, among other things, to take care of internal financing requirements. Amounts of "distributable income" in excess of the retention allowance must be distributed within a prescribed period in order to avoid the penalty tax. It is understood that the declaration of a stock dividend on the capitalization of retained profits would qualify as a distribution of "distributable income".

Legislation Designed to Prevent Avoidance of Tax

It is in the setting of a penalty tax on accumulated earning or, more properly, of an attempt to avoid that tax and the personal tax on shareholders by circuitous means, that the Australian "annihilating provision" has become well known in Canada. This section, or one analogous to it, has been contained in Australian income tax legislation since the first legislation was enacted in 1915. As applicable in the corporation-shareholder setting only certain parts of that provision appear to be relevant. It should be noted, however, that the whole section is of wide application and the discussion here will deal with its effect in only a fairly narrow area.

Section 260 of the Australian Act provides, <u>inter alia</u>:

> Every contract, agreement, or arrangement made or entered into, orally or in writing, whether before or after the commencement of this Act, shall so far as it has or purports to have the purpose or effect of in any way, directly or indirectly—
> (c) defeating, evading, or avoiding any duty or liability imposed on any person by this Act, be absolutely void, as against the Commissioner, or in regard to any proceeding under this Act, but without prejudice to such validity as it may have in any other respect or for any other purpose.

Without substantially varying opinions delivered in the trial and appeal courts in Australia, the Judicial Committee of the Privy Council has held that this section requires that the proceeds derived from the sale of shares by those in control of companies with undistributed earnings in a dividend-stripping transaction, are properly to be included in the income of the shareholders for tax purposes. 27/ In other words, the Judicial Committee has held that in such cases there is an "arrangement" which had or purported to have "the purpose or effect" of "avoiding" a "liability imposed" on any person by the Act. In a noteworthy portion of the same judgment the Judicial Committee expressed the opinion that it was only by virtue of section 260 that the amounts concerned could attract tax. In the absence of that section the transaction in question and the amounts received would have been of no consequence for tax purposes. It stated that if a transaction could be explained by reference to normal business or family dealings, section 260 would have no application.

SOUTH AFRICA

Legislation Designed to Prevent Undue Accumulations

Like the United States and Australian treatment of undistributed income in the hands of companies the shares of which are closely held, the South African approach to this problem also results in the imposition of an additional tax at the corporate level. In South Africa the tax is payable at the rate of 25% of the amount by which the "distributable income" of the company for the year of assessment exceeds the "dividends distributed" by such company during the specified period.

The South African tax applies only to private companies registered or carrying on business in the Republic. A private company is one that, on a specified date, is not a public company. Included among the categories of public companies are, first, companies all classes of whose equity shares are publicly quoted by a stock exchange; and secondly, any other companies in respect of which the revenue is satisfied that the general public was throughout the year interested as shareholders in more than 50% of every class of equity share issued by the company, and that the business of the company was conducted and its profits distributed in such a manner that no person enjoyed any advantage which would not be enjoyed if the company had been under the control of a board of directors acting in the best interests of all its shareholders and had been one which could have its shares quoted by a stock exchange. Contrary to the general law respecting appeals from the decision of the revenue in the exercise of its discretion, it is specifically provided that in the matters referred to above the discretion, even if properly exercised, is subject to objection to appeal.

Although the penalty tax applies to every private company, special exemptions exist with respect to even those companies in certain circumstances. Thus, a private company is exempt from undistributed profits tax if it can satisfy the Commissioner that the sum of its reserves and balance of undistributed profits does not exceed R100,000 or 40% of its paid-up capital, whichever is greater. Here again, the Commissioner's decision is made subject to appeal. Further, any company whose total net profits for the year of assessment do not exceed 5% of its paid-up capital is exempt from undistributed profits tax.

Aside from the determination of status and special exemption qualification referred to in the preceding paragraph, the penalty tax is in no way discretionary. The tax is payable by every private company. The point of departure for determining the "distributable income" of a private company is "total net profits". This latter concept contemplates something that is broader than "taxable income" since all receipts and accruals of the company from all sources (including some that are otherwise exempt) are specifically brought within the charge to tax. Since, as it will be seen later, a company is allowed a deduction from "total net profits" for certain costs associated with the acquisition of plant and machinery, any amounts recovered or recouped on the sale or disposition of such plant and machinery in respect of which a deduction has previously been taken, must be included in the distributable income in the year of recovery or recoupment. This inclusion is added to "total net profits". From the total of the two preceding calculations a company is entitled to deduct the following items: (1) any income taxes payable by the company; (2) 40% of the total of "total net profits" and the recoveries and recoupments previously described, excluding therefrom any dividends included in those amounts; (3) costs incurred during the year for any new plant or machinery which will be or has been brought into use for the purpose of trade and used directly in a process of manufacture. The final deduction in calculating "distributable income" relates only to farming companies and will not be elaborated in this study.

As previously indicated, the distribution of appropriate dividends to shareholders will avoid liability for the undistributed profits tax. It is understood that a distribution of "bonus shares" on the capitalization of a company's undistributed profits would rank as a distribution of a dividend.

Legislation Designed to Prevent Avoidance of Tax

In addition to a number of sections in the South African Income Tax Act that are designed to prevent specific and known schemes of tax avoidance, there is a general provision designed to counter any transactions and schemes entered into in which the sole or one of the main purposes is tax avoidance. To this extent it resembles the Australian Law. The present version of the general anti-avoidance section closely resembles that recommended by the South African Committee of Enquiry into the Income Tax Act. 28/

The discretionary power vested in the taxing authorities under the anti-avoidance provision is subject to objection and appeal, but whenever tax avoidance is proved in any proceeding there is a rebuttable presumption that the sole or one of the main purposes of the transaction was tax avoidance.

GERMANY

Legislation Designed to Prevent Undue Accumulations

In Germany, where retained profits are taxed to the corporation at 51% and distributed profits are taxed at only 15%, it might be expected that the pay-out ratio would be so high that there would be no corporate surplus problem. However, available commentary indicates that in Germany corporations do retain a substantial part of their profits. The reason for this anomalous situation rests in the fact that the German shareholder is fully taxed on dividends received without any relief for double taxation and at sharply graduated tax rates.

The capital gains treatment should be noted. In the case of securities the general rule is that capital gains are taxed only where the security has been held for less than six months; these taxable gains are taxed at regular income rates. An exception to this rule deals with some transactions in securities of closely held corporations by shareholders controlling more than 25% of the capital; here a gain is taxable regardless of the length of the ownership period but the tax is levied at special rates ranging from 10% to 30%. It would appear that in Germany, as in Canada, it is the shareholders of closely held corporations who are interested in dividend stripping. However, in Germany the shareholder tries to convert dividend income that attracts a maximum rate of 53% into capital gains where the maximum rate is 30%.

Legislation Designed to Prevent Avoidance of Tax

The German tax law contains elaborate provisions designed to prevent tax minimization at the shareholder level through the vehicle of a redemption of shares or other reduction of its capital. "Transactions which are designed to prevent the receipt of a dividend for tax avoidance purposes are disregarded, and the tax is imposed as if the dividend had been received. This rule has been applied in cases of fictitious reductions of capital made for the purpose of a tax-free distribution of accumulated profits." 29/

SUMMARY

In the following paragraphs an attempt is made to isolate and group together the common features that have emerged from the country-by-country analysis carried out in the preceding paragraphs. As has been shown, the tax laws of all the foreign countries considered contain special provisions that in various ways deal with the problem associated with the accumulation of corporate earnings.

Attempts to Prevent Undue Accumulations of Corporate Earnings

In the United States, Australia, and South Africa the relevant legislation subjects some portion of retained earnings to an additional tax upon the corporation. In Australia and the United States the tax has been described as a penalty tax and is set at a confiscatory level. In the United Kingdom the special legislation provides for the imputation of a portion of corporate retentions to the shareholders. In Germany the corporation pays a higher rate of tax on retained earnings than on distributed earnings.

The Application of the Special Legislation to Closely Held Companies

In the United Kingdom, Australia, and South Africa the legislation designed to prevent undue accumulations is limited by statute to only those corporations with a maximum number of shareholders. In the United States the legislation has been drafted so that it can apply only to closely controlled corporations even though it is said to apply to "all" corporations. In Germany, even though the previously described legislation applies to all companies, the supplementary legislation, which transforms a capital gain into ordinary income on the sale of shares representing a "substantial interest", is a major threat to the shareholders of closely held companies.

The Means of Accommodating the Requirements of Business Under the Special Legislation

In the United Kingdom and, in a modified way, in the United States the relevant provisions dealing with corporate accumulations apply only to amounts that are "unreasonably" withheld. In the United States, in addition to the test related to reasonableness, the calculation of the base against which to apply the penalty tax also takes into account a statutory amount that can be accumulated without fear of incurring the tax. In Australia and South Africa the amount of surplus that can be accumulated in any year without incurring the additional tax is determined by means of a calculation prescribed by statute.

The Presence of Administrative Discretion Under the Special Legislation

In the United States, Germany and Australia, no elements of administrative discretion are granted in deciding matters related to corporate accumulations. In England the discretion takes the form of a determination of whether the annual distribution is reasonable. In South Africa the discretion takes the form of a determination of the type of company to which the additional tax is to be applied.

The Existence of Appeal Procedure Under the Special Legislation

Notwithstanding common law rules to the contrary, taxpayers in South Africa are given a right of appeal from discretionary determinations. Under the appeal procedure in the United Kingdom and the United States the onus is on the Revenue to establish the unreasonableness of an annual corporate distribution and retention. In Australia, where the special legislation is wholly embodied in the taxing statute, the burden of proof, as in all appeals, is on the taxpayer.

The Existence of Anti-Avoidance Provisions

In Australia and South Africa the taxing statutes contain generally worded anti-avoidance sections that are not specifically directed at surplus stripping. In the United Kingdom and in Germany the generality of the relevant anti-avoidance legislation is circumscribed by the requirement that certain conditions must exist before the sections can be employed. Among the most important conditions is the existence of transactions in securities. In the United States specific or general anti-avoidance provisions do not seem to be necessary because of the role played by the courts in frustrating attempts to avoid taxes.

Conclusions From the Consideration of Foreign Experience

It appears that official concern with tax avoidance in the corporation-shareholder setting in foreign countries is divided between at least two separate types of avoidance problems. The first of these problems flows from the ability to postpone taxes at the shareholder level by retaining profits within the corporate shell. The foreign legislation that is responsive to this problem attempts in various ways to encourage, if not compel, distribution.

While the avoidance problem described in the preceding paragraph would not be regarded as surplus stripping, it is likely that the legislative instruments used to combat that problem have lead to a greater degree of surplus stripping than would have occurred had such legislation not been enacted. Consequently, it seems to have become necessary to shore up the previously mentioned anti-accumulation legislation with other legislation which seeks to combat this second problem, that is, the surplus-stripping problem.

In furtherance of this objective it appears that the United States and the United Kingdom have pursued a course that differs very considerably from that taken by other foreign countries. Thus, in the United States and the United Kingdom the approach has been to spell out in detail the tax consequences that will follow from transactions in securities or property of corporations with accumulated profits. These detailed provisions might be described as pieces of specific anti-avoidance legislation. Based on the experience of these two foreign countries, there is reason to doubt that such legislation is the final answer to the surplus-stripping problem. Thus, in the United Kingdom the legislature has recently adopted a type of generally worded anti-avoidance provision dealing with transaction in securities. In the United States the taxing authorities have long argued, and with marked success, that there is a separate and distinct body of legal principles that may be invoked to carry out more fully the unwritten intention of the legislature.

In Australia and South Africa there do not seem to have been any attempts made to isolate surplus stripping from other forms of tax avoidance. As a result, any assessments made to counteract a surplus-stripping transaction would probably be carried out within the framework of the general anti-avoidance provisions which are found in the taxing statutes of both those countries.

PART III

ALTERNATIVES

CHAPTER 4—ALTERNATIVES THAT DO NOT INVOLVE MAJOR CHANGES IN THE BASIC TAX STRUCTURE

INTRODUCTION

As stated earlier in this study, the then Minister of Finance indicated that he had reluctantly introduced ministerial discretion to deal with surplus stripping, and that he would be prepared to accept a better solution if one could be found. Subsequent to the introduction of the budget, the degree of ministerial discretion originally proposed was reduced by the insertion of appeal procedures, but some elements of discretion may still remain. (Ministerial discretion already exists in limited areas of the Income Tax Act.) This chapter of the study will discuss alternatives to section 138A that do not involve major changes in the present tax structure.

The range of alternatives includes:

(a) amend the present legislation to close the "loopholes";

(b) introduce legislation to prevent accumulations of surplus not required for the purpose of the business;

(c) introduce some special form of taxation on the profit on realization of shares in closely held corporations to compensate for the tax revenue postponed by the accumulation of surplus;

(d) introduce general or specific anti-avoidance legislation which does not require ministerial discretion; or

(e) introduce certain safeguards to overcome those effects of ministerial discretion that are considered objectionable.

A general discussion of these alternatives follows.

AMENDMENT OF LEGISLATION TO ELIMINATE "LOOPHOLES"

If the Act could be drafted so as to close all the "loopholes" that are used in surplus stripping, ministerial discretion could be withdrawn.

Chapter 2 of this study illustrates that there have been continuous efforts to design such legislation but that these efforts have been defeated because, under our legal system, the words of a taxing statute may be interpreted without regard to its spirit or the real intention of Parliament. This indicates that when drafting new and apparently unrelated legislation great care must be exercised to ensure that new loopholes are not inadvertently opened. In general, past experience does not provide much encouragement that this line of endeavour will meet with success.

LEGISLATION TO PREVENT UNREASONABLE ACCUMULATIONS OF SURPLUS

The financing of corporate expansion by the retention of earnings has been accepted in the tax structures of many countries, including Canada. However, some retentions are motivated more by the desire to avoid personal tax on distribution than by the requirements of the corporation's business. It is often the former type of retention that leads to surplus stripping.

The retention of corporate surplus, motivated by the desire to avoid personal income tax, implies two prerequisites:

(a) that the shareholders' interests are similar as far as their personal tax positions are concerned, and

(b) that these shareholders control the corporation's distribution policy.

The combination of these two conditions leads to the conclusion that in general this procedure is available only in the case of corporations controlled by shareholders whose personal tax circumstances are similar and whose numbers are sufficiently small that they are aware of their similarity of interest. It appears to be this conclusion which has resulted in the special legislation concerning closely held corporations in certain foreign countries.

Any attempt to combat this type of accumulation necessarily involves three decisions:

(a) Which corporations are to be subject to special legislation?

(b) What part of the accumulation was tax-motivated and what part was retained for business purposes?

(c) In what manner is the unreasonable retention to be dealt with?

Item (c) does not pose a serious problem but it may be difficult to design legislation for items (a) and (b) in such a way as to avoid inequities and anomalies unless there is a degree of ministerial discretion or other flexibility in the law.

From a review of Chapter 3 of this study it is apparent that the degree of rigidity in the comparable foreign legislation varies from country to country. Australia and the United Kingdom both define the type of corporation subject to the special legislation but, whereas Australia sets out a formula for computing the permissible amount of retention, the United Kingdom does not. In the United States all corporations are, in theory at least, subject to the special legislation although, in practice, it applies to closely controlled corporations; the computation of the amount of unreasonable retention is not defined, though there is a statutory maximum permissible retention, which is not subject to challenge by the taxing authorities.

This type of legislation merely prevents the indefinite postponement of the final tax on that portion of the accumulation that is considered to be unreasonable and that might provide additional impetus to surplus stripping.

It should be noted that both the United Kingdom and Australia have found that anti-avoidance legislation is necessary to prevent loss of the tax revenue contemplated by the legislation directed at closely held corporations.

TAX ON PROFIT FROM SALE OF SHARES OF CLOSELY HELD CORPORATIONS

This procedure has been adopted by Germany, but it can at best result in only rough justice. The tax will apply on the increase in value of the shares arising from reasonable and unreasonable accumulations alike, and on any increase in value unconnected with accumulations of surplus. Because it applies only to closely held corporations, it places the shareholders of such corporations at a disadvantage relative to shareholders of widely held corporations.

GENERAL OR SPECIFIC ANTI-AVOIDANCE LEGISLATION

As indicated in the preceding chapter, both the United Kingdom and Australia have found that anti-avoidance legislation is necessary in addition to the legislation directed at closely held corporations. Germany also appears to have an anti-avoidance provision.

The relevant anti-avoidance legislation in the United Kingdom is directed specifically to the problem of surplus stripping and involves a degree of ministerial discretion. The Australian anti-avoidance legislation, on the other hand, is general in that it is directed at all schemes the aim of which is the avoidance of tax, whether in the field of surplus stripping or elsewhere, and it does not contain any degree of ministerial discretion.

It appears to be possible, therefore, to design either specific or general anti-avoidance legislation in such a way that ministerial discretion is not necessary. Because of the inherent vagueness of general anti-avoidance legislation, it is desirable to provide some means of enabling taxpayers contemplating a transaction to determine in advance the position of the Department with respect to the applicability of the provision.

ADVANCE RULINGS

The preceding discussion raised the possibility of introducing a system of advance rulings in conjunction with the introduction of a general anti-avoidance provision. In addition to that possibility or as an alternative thereto, it is believed that a system of advance rulings would reduce some of the more objectionable features inherent in legislation that contains elements of ministerial discretion. In both settings an obvious advantage of making such procedure available would be to cut down on taxpayer uncertainty. Present legislation in both the United States and, to a lesser extent, in the United Kingdom provides that under certain circumstances a taxpayer contemplating a transaction may obtain the binding opinion of the taxing authorities with respect to its tax consequences. In the United States such opinions are published and as a result tend to ensure that all taxpayers will receive equal treatment.

MINISTERIAL DISCRETION

It is advisable to examine the effects of ministerial discretion in general, and consider the probable effects of the restricted discretion set out in the new section 138A.

It is well established that Parliament has the right within its legislative sphere to vest in public officials the power to make discretionary decisions. In addition, it has been recognized that all such discretionary powers are not of the same nature. In general, these powers have been judicially distinguished from one another according to the function vested in the public official. Thus, some public officials are said to be vested with a judicial function, others with a quasi-judicial function and, finally, others with an administrative function. Furthermore, there have been instances where two of these functions were created by the same legislative instrument and vested thereby in the same person. The degree of discretion and the grounds for appeal from the exercise thereof will vary depending on the judicial characterization of a particular discretionary power.

Setting aside for a moment detailed consideration of what is meant by an administrative function, certain general tests have evolved that assist in determining whether the power granted to an official is judicial or quasi-judicial. The basic difference between these two discretionary functions if that no question of public policy arises in respect of the exercise of a judicial function; the judicial authority must apply the law to the facts as ascertained by him and give his decision accordingly. It appears that section 138A does not contemplate that the minister's discretionary decision should be arrived at exclusively by the process just described.

It seems more likely that the type of function vested in the Minister by section 138A is of a quasi-judicial nature. A quasi-judicial function differs from a judicial function in that it is to be exercised, not according to a statutory direction to apply the law of the land to the facts and act accordingly, but according to a statutory direction or permission to use his <u>administrative</u> discretion and be guided by considerations of public policy after he has ascertained the facts and the bearing of the law on the facts so ascertained. There are, then, two elements inherent in a quasi-judicial discretionary power. The first is to determine the facts and apply the law of the land thereto. The second is to exercise the discretion. The former element contains duties of a judicial nature. The second is purely administrative. It will be seen, therefore, that the elements of a judicial nature must be discharged in the manner prescribed by law but that most such elements relate to matters antecedent, ancillary or incidental to the exercise of the administrative discretion. When the Minister actually makes his determination, he passes from the position of judge (or quasi-judge) to that of administrator, and his determination is an administrative act based on considerations of public policy with no judicial or quasi-judicial aspects. It is with respect to the former of the two elements (i.e., the quasi-judicial element) that the courts have assumed a duty of supervision with a view to determining as far as possible whether they have been properly carried out. But this is the limit of the supervision. It is well established that no court should review the actual exercise of the administrative element in the absence of specific statutory authority enabling it to do so.

Inasmuch as section 138A contains each of the two previously described elements it would appear to vest in the Minister of National Revenue a quasi-judicial power. In that and another respect, which will be considered in the following paragraph, section 138A has some resemblance to section 6(2) of the Income War Tax Act. Under that section the Minister was given the duty to "determine" and the power to decide what amounts were "reasonable or normal" for depreciation purposes. In Wrights' Canadian Ropes v. M.N.R. 30/ it was held that the Minister had not had sufficient information to enable him to arrive at a proper determination. Since the determination preceded the exercise of the discretion the taxpayer's appeal was allowed.

The other feature that section 138A has in common with section 6(2) of the Income War Tax Act relates to the matter of appeals. In the Wrights' Canadian Ropes case the Privy Council held that a right of appeal to the Exchequer Court was given with respect to assessments based on section 6(2). However, the limits within which the Court could interfere in the discretionary decision were held to be strictly circumscribed. Under section 6(2) it was held that because the section made the Minister the sole judge of the fact of reasonableness or normalcy, the Court was not entitled to substitute its opinion for his. It is in this respect that sections 138A and 6(2) differ most materially, because under section 138A the Court is specifically permitted on its own finding of fact to vacate the discretionary determination of the Minister. As a result of this statutory provision relating to appeals it would appear that the main elements of administrative power in section 138A are nullified. Not only can a court of appeal interfere in the Minister's decision with respect to the judicial or quasi-judicial power vested in the Minister, as held in the Wrights' Canadian Ropes case, but it can also substitute its opinion with respect to the administrative and normally unappealable power vested in the Minister. In these circumstances it would appear that the net result of section 138A is that no important discretionary power is vested in the Minister.

CONCLUSIONS

As pointed out above it may be possible to eliminate ministerial discretion from section 138A without diminishing its effectiveness. If this were done it would become a piece of specific anti-avoidance legislation. Because of the objection of the Minister to the use of discretion, this possibility might be explored. Whether or not it is found feasible to eliminate ministerial discretion, the advisability of introducing a system of advance rulings in this area should be considered. The Commission has not yet studied the problem of advance rulings and therefore can make no decision on this subject at this time. However, the procedures developed in the United Kingdom appear to work satisfactorily, and should be carefully considered.

However, as pointed out in Chapter 1, if surplus stripping as such is eliminated, shareholders in widely held corporations would have an advantage over those who control closely held corporations. For this reason we have considered changes in the tax structure that would put shareholders of both kinds of corporations on an equal footing. Several such methods are discussed in the next chapter.

CHAPTER 5—ALTERNATIVES INVOLVING MAJOR CHANGES IN THE BASIC TAX STRUCTURE

INTRODUCTION

Alternatives considered in this chapter range from methods which eliminate the problem to methods which inhibit surplus stripping. Under the heading "Schemes That Would Eliminate Surplus Stripping", methods are discussed that would tax corporate income either in the hands of the shareholder and/or the corporation on an annual basis once and for all. Under the heading, "Other Methods", methods are discussed that would tax corporate income in the hands of the corporation annually, and tax the shareholders on distribution. All of the methods require changes in the present tax structure and several would require anti-avoidance measures as well.

The first three methods have been researched in detail (see appendices), while the other methods have not, although they are similar in many respects to one or another of the first three proposals. Methods that would inhibit surplus stripping represent partial solutions and have not received the same extensive review and comment.

Of the schemes that would eliminate surplus stripping, those that would levy a flat rate of tax on the corporation and no tax on the shareholders undoubtedly have the advantage of simplicity and ease of administration over schemes that would integrate the corporation tax with the personal tax rate structure. But if the implication of surplus stripping is that those who engage in it escape their fair burden of taxation as measured by the personal tax rate structure, acceptance of flat-rate schemes that are not integrated with the personal tax rate structure tends to eliminate the surplus-stripping problem by default.

It should be noted that certain of the proposals reviewed were not necessarily specifically addressed to the surplus-stripping problem, but had other considerations in mind. However, in so far as they are relevant to the problem of surplus stripping they are considered below.

SCHEMES THAT WOULD ELIMINATE SURPLUS STRIPPING

The Induced Distribution Method

This method presupposes a top personal progressive rate of 65%, and levies a tax at an effective rate of 65% on undistributed corporate profits. This is achieved by levying in the first instance a flat-rate tax of 45% on corporate income and a further 20% tax on the grossed-up equivalent of income not distributed. After payment of this additional tax, the net corporate income remaining would be tax-paid undistributed income not subject to any further tax on subsequent distribution to shareholders. On distributions from current income, Canadian corporate and individual shareholders (with certain exceptions) would include in their incomes the grossed-up equivalent of the distribution, and would take credit for the tax paid by the corporation in respect of this distribution. This scheme would continue the present withholding tax on dividends to non-residents, and the special tax on non-resident-owned investment corporations, as well as the present taxation of foreign source dividend income.

It is believed that this method will eliminate the surplus-stripping problem, since there will no longer be any tax advantage in corporate retention of earnings. Because retention would be of some distinct disadvantage to shareholders, it is assumed that all income would be distributed. This method will also eliminate the dual-rate and designated surplus legislation, and the introduction of a flat rate of tax will eliminate the associated corporation problem. Some problems of tax avoidance would remain. Also, some inequities might arise where reassessments are made several years after the event and there had been an intervening change in shareholders. The need to renegotiate the federal-provincial tax arrangements would also be a disadvantage of this method.

The transitional problem that would arise from the introduction of this proposal, and the problems of the elimination of the split corporate rate are discussed in Appendices D and E respectively.

The economic effects of this proposal can be summarized briefly as follows. There would be an increase in the demand for equities by Canadians, and a shift away from bonds, with low income Canadians preferring the shares of large corporations. There would be some shift by high income Canadians to foreign equities. There would not be much effect on foreign direct investment but foreign investment portfolios would tend to shift away from Canadian equities and toward Canadian bonds. Some fall in total domestic saving could be expected as a result of higher pay-outs by corporations, and a shift in the tax burden from low to high income groups.

Further detailed analysis of this scheme is contained in Appendix A.

Additional Tax on Retained Earnings

This method presupposes a top personal progressive rate of 65%, and levies an effective rate of tax of 61.5% on corporate earnings where no distribution is made. This is achieved by a flat-rate tax of 45% on corporate income, together with a surtax of 30% on that portion of the corporate income not distributed. After payment of the surtax, the net corporate income remaining would be tax-paid undistributed income and would be tax free in the hands of shareholders when distributed. Where distribution is made out of current earnings, such distributions would be taxed in the shareholders' hands on the same basis as at present, and would be eligible for the 20% dividend tax credit. Dividends received by one tax-paying Canadian corporation from another would be included in income for purposes of computing the "corporate surtax" only. There would be no change in the present withholding tax, the present treatment of non-resident-owned investment corporations, or the treatment of foreign source dividend income.

The surplus-stripping problem would be effectively eliminated. Also eliminated would be problems of designated surplus and associated corporations, although this method does not necessarily require a flat rate as opposed to a dual rate of corporate tax. Some problems of tax avoidance would remain. There would also be a problem in that shareholders would have to find cash from their own resources to pay the tax eligible on stock dividends, the issuance of which would be encouraged by this penalty method.

The transitional problems that would arise from the introduction of this proposal and the elimination of the split corporate rate are discussed in Appendices D and E respectively.

The economic effects of this proposal can be briefly summarized. This proposal would reduce the attractiveness of shares relative to other earning assets, and particularly the shares of small corporations and corporations with low pay-out ratios. Some repatriation of foreign capital and outflow of Canadian capital would occur. The total volume of domestic saving would probably decline through a reduction in corporate retentions. As a result, corporations would have to use more external finance, putting pressure on the capital market.

Further detailed analysis of this scheme is contained in Appendix B.

Tax-Free Distribution

This method presupposes a top personal progressive rate of 65%, and levies a tax at the flat rate of 50% on corporate income. It then excludes from taxable income dividends received from taxable Canadian corporations, except at the taxpayer's option, exercise of which permits him to claim the 20% dividend tax credit. There would be no change in the present withholding tax or the present treatment of non-resident-owned investment corporations or foreign source dividend income.

This method eliminates the surplus-stripping problem by not permitting it to exist, in that there is no personal tax rate in respect of corporate distributions. It also eliminates the designated surplus and associated corporations problems, although this method does not necessarily require a flat rate as opposed to a dual rate of corporate tax. This method has advantages from the standpoint of certainty and simplicity.

The transitional problems that would arise from the introduction of this proposal, and the problems of the elimination of the split corporate rate are discussed in Appendices D and E respectively.

The economic effects of this proposal can be summarized briefly as follows. There would be an increased demand for Canadian shares by high income groups, and a shift from shares to bonds by low income groups. Foreigners would tend to shift out of Canadian shares, and there would be a repatriation of capital from abroad by Canadians. Canadian corporations would make more use of external financing with some tendency toward favouring share rather than debt financing.

Further detailed analysis of this scheme is contained in Appendix C.

OTHER METHODS

Proposal of F. S. Capon 31/

This method involves the elimination of the corporate income tax and the dividend tax credit, and the imposition of a 50% to 75% tax on annual corporate earnings not distributed. Distributions to individuals would be taxed at personal rates, and dividends paid to other Canadian corporations, certain Canadian institutions and non-residents would be subject to a 50% tax collectible by the paying corporation.

This method would appear to solve the surplus-stripping problem since the heavy tax on undistributed earnings would force full distribution, and in this respect is similar to the induced distribution method described above. It does however raise problems concerning the determination of beneficial ownership of shares, as well as those arising out of the requirement that distributions be in cash.

Proposal of D. R. Huggett 32/

This method's main proposal is the elimination of the dual rate of corporate tax and the introduction of a flat-rate corporate tax, to be equated with the top personal rate which would be reduced to approximately 50%. Dividends received from taxable Canadian corporations would not be included in taxable income.

This proposal is virtually identical to the proposal for tax-free distributions discussed above, and would eliminate in like manner the surplus-stripping problem. However, Mr. Huggett suggests as an alternative that the "grossed-up equivalent" of the dividend be included in income, and full credit given for the corporate tax paid. This would introduce full progressiveness in respect of distributions, but because of the time lag which could occur before all tax considerations are finally dealt with, would not eliminate the surplus-stripping problem.

Proposal of J. E. Sands 33/

This proposal advocates, among other things, widespread changes in the present concept of income, including the treatment of capital gains as income. In the area of corporate taxation, the proposal recommends that the income from investment in corporate shares be determined in the final analysis by deducting the cost of the investment from the aggregate of dividends received and proceeds of disposition. Pending final or deemed realization, the annual corporate income—distributed or not—would be attributed pro rata to shareholders, and each shareholder would be taxed at personal rates on his attribution. Corporate taxes as such would be eliminated, and dividends received from Canadian corporations would be excluded from income. On final or deemed realization, the necessary adjustment would be made to the shareholder's income in order to equate income attributed and the finally determined income, namely, aggregate of dividends and proceeds of disposition less costs.

This method of fully attributing annual corporate income to the shareholders would, if practicable, solve the problem of surplus stripping, as well as the problems associated with the dual rate of corporate tax and designated surplus. However, the difficulties attendant upon such a proposal tend to make its adoption impractical. For instance, taxation of non-resident shareholders on an attribution basis would cause serious difficulties. Intercorporate shareholdings would necessitate complex computations of income and produce timing problems, and the time element in computing corporate income might necessitate such income being taxed one year in arrears, which opens up evasion possibilities. In the area of equity considerations there are other serious drawbacks. Shareholders could be taxed on income which they might never realize by dividend or gain on realization. Also, because the contractual rights of various types of shares are related to dividends rather than corporate income, either radical changes would have to be made in these rights or one shareholder might receive dividends on which another has paid tax. Corporate reassessments could also create equity problems.

SCHEMES THAT WOULD INHIBIT SURPLUS STRIPPING

Proposal of Special Committee on Corporate Taxation 34/

Basically, this proposal would continue the present rates of corporate tax, but would impose, in lieu of the present method of taxing dividends, a flat tax of 15% to be withheld by the corporation on any distribution or deemed distribution. In the case of corporate shareholders, this tax would be payable only on the first distribution. In recognition of the present favourable tax treatment accorded Canadian resident individual shareholders with taxable incomes up to $10,000, a refund of the 15% shareholder's tax would be granted to such individuals. To encourage distribution, a rebate of tax (approximately 10%) would be allowed certain Canadian corporations in respect of dividends paid to Canadian shareholders. Although not recommended, it was suggested that a degree of progression ranging up to 40% could be introduced, if considered desirable. The present provisions in respect of designated surplus and personal corporations would be repealed and the right to elect under section 105 would remain pro tem. Amendments to the present legislation would be made to prevent "disappearance" of any surplus that may remain.

This proposal appears to be to a large extent a substitution for the present section 105 distributions, which are cumbersome and frequently impractical. The proposal would substantially inhibit surplus stripping by reducing the tax advantage and thereby the incentive. However, it leaves some problems unsolved and creates new ones. The continuation of the dual rate of corporate tax leaves the associated corporation problem unchanged. The rebate of tax to resident individuals with taxable income under $10,000 would appear to be open to abuse. The rebate of tax to be given to the corporation in respect of dividends paid to Canadian shareholders would be shared by all shareholders, but this distribution incentive may have been intended as an inducement to make shares available to Canadian residents rather than giving preferential treatment to Canadian shareholders. This provision might raise problems in that, before the rebate could be claimed, the corporation would be required to know the beneficial ownership of all its share capital. The proposed 15% shareholder tax would levy an additional tax on the payment of dividends by a subsidiary to its parent in the normal course of business.

Preliminary Proposal of the Canadian Institute of Chartered Accountants 35/

This proposal recommends that the dual rate of corporate tax be eliminated and a flat rate of 45% substituted. A 15% withholding tax is proposed on all dividend payments and deemed distributions, which would be the maximum personal tax on such income. There would be an election to include all such income in taxable income at the grossed-up amount, which would be eligible for the 20% dividend tax credit. Intercorporate Canadian dividends would be subject to the 15% withholding tax, with the net dividend becoming tax-paid undistributed income. Mergers and amalgamations would be allowed, subject to the payment of the 15% withholding tax. Certain small corporations would be allowed the option of being taxed as partnerships as a partial compensation for the withdrawal of the dual rate of corporate tax. Amending legislation to close all loopholes currently existing is also recommended.

As with the recommendation of the Special Committee on Corporate Taxation, this proposal would diminish the problem of surplus stripping by reducing the incentive to strip, in that the maximum tax that could be avoided would be 15% of the after-tax corporate income. However, should this be sufficient incentive to cause a continuation of surplus stripping, the practice could in theory be stopped by the anti-avoidance legislation suggested in the proposal. It should be pointed out that if such legislation could be made effective, it should be possible to continue the present tax structure with similar type amendments. The proposed 15% shareholder tax would levy an additional tax on the payment of dividends by a subsidiary to its parent in the normal course of business. This proposal would also eliminate the problems inherent in associated corporations and designated surplus, but would require amending legislation to prevent stripping through the non-resident method.

Proposal Received Through C. W. Leach 36/

This proposal would eliminate the dual rate of corporate tax and substitute a flat-rate tax of 40%, which would be treated as a modified withholding tax. Dividends to individuals would be included in personal income on a "grossed-up" basis, with recipients receiving credit for the 40% corporate tax, but only to the extent of personal income tax otherwise payable on dividends received. Intercorporate dividends would be exempt to the extent of 85%. The balance would be taxable income which, assuming a 40% corporate rate of tax, would impose a 6% tax on intercorporate dividends; non-resident withholding tax provisions would be continued. The present provisions in respect of dividends paid out of designated surplus would be repealed and replaced by a 5% to 7.5% tax on dividends going to exempt institutions.

This proposal would impose a 6% tax burden on one of the favourite methods of surplus stripping, but due to the time lag which could occur before all tax considerations are finally dealt with, the general problem of surplus stripping would not be solved. The proposal would presumably allow a tax credit of up to 40% on distributions even though the corporate income could have been taxed in prior years at only 21%. The proposed inclusion of 15% of intercorporate dividends in taxable income would result in an additional tax on the payment of dividends by a subsidiary to its parent in the normal course of business. The problems of associated corporations and designated surplus would be eliminated under this proposal.

Proposal of Morris Neaman 37/

This proposal recommends the imposition of a 40% flat-rate corporate tax in lieu of the present dual rate, and a tax of 10% on corporate distributions, to be withheld at the source, but to be refundable to Canadian corporate recipients of dividends from other Canadian taxpaying corporations. There would be no further tax on dividends received by resident individuals. Corporations would be obliged to distribute annually at least 5% of their undistributed income on hand at the end of the previous year.

This proposal would legalize surplus distributions at a fairly low cost to shareholders (10% of after-tax corporate income) and would thus reduce the incentive for and therefore the extent of surplus stripping, but would not necessarily end it. The imposition of the flat-rate tax would eliminate the designated surplus and associated corporations problems.

CONCLUSIONS

Eleven proposals have been considered, the first three of which were developed by the staff of the Commission, and are attached in Appendices A, B, and C. The staff of the Commission have not considered the other proposals in depth, because they seem to have no clear advantage for the purpose of eliminating the surplus-stripping problem over the range of possibilities within the first three proposals.

The first three proposals would eliminate surplus stripping, and put widely held and closely held corporations on the same basis. However, all three of these proposals have much wider effects, and no final decision should be made to adopt any one of them in the narrow context of surplus stripping.

For simplicity, the split rate of corporate tax is eliminated in all three of the proposals. This is a necessary feature of the first proposal; but the other proposals could be modified in such a way as to maintain the split rate. See Appendix E which deals with some alternatives to the split rate.

INTERIM FINDINGS

1. Section 138A will probably reduce surplus stripping substantially.
2. This new section in so far as it is an anti-avoidance section, seems to be a logical extention of the present tax structure.
3. However, it involves a degree of ministerial discretion that is repugnant to the minister and to others. This element of ministerial discretion may be unnecessary. The section might be made more acceptable and remain equally effective by removing the discretionary element and thereby transforming the section into a specific anti-avoidance provision with a right of appeal.
4. Whether or not the discretionary element is eliminated, consideration could be given to the practicability of introducing a system of advance rulings related to this specific provision in order to reduce uncertainty.
5. An examination of legislation in other countries suggests that no marked improvement over the present Canadian treatment of the problem, as supplemented by section 138A, is likely to be achieved without substantial changes in the tax structure.
6. However, because such substantial changes in the tax structure have wider implications, the decision to adopt any one of them should not be made in the narrow context of surplus stripping.

REFERENCES

1/ It would be technically impossible to tax the gain resulting from the retention of earnings separately from the total gain (or loss) in the value of the shares.

2/ There were at least two surplus-stripping schemes that dit not depend upon the realization of surplus in the form of a non-taxable gain on the sale of shares. These were the amalgamated personal corporation method and the revaluation method. These are described briefly on page 22. The gain on the sale-of-shares method was however the most common.

3/ The surplus in corporation A was transferred to corporation C and theoretically the potential personal tax liability continued, but the surplus was no longer represented in the value of corporation C's assets.

4/ When a closely held corporation with surplus is acquired by a widely held corporation as an operating entity, surplus stripping is not important because the personal tax liability acquired with the closely held company can be postponed in perpetuity. However, designated-surplus provisions may be a source of inconvenience.

5/ "Person" includes either a corporation or an individual. Among persons who have at one time or another been able to withdraw surplus free of tax or at low rates of tax are: (a) non-residents; (b) persons or organizations exempt from tax under Part I of the Income Tax Act; (c) traders or dealers in securities; and (d) Canadian corporations (because under ordinary circumstances dividends could be passed between corporations tax free).

6/ There are no data currently available to provide a reliable estimate of the extent of surplus stripping. It is, therefore, not possible to estimate the extent to which surplus stripping has redistributed the burden of taxation.

7/ See the Report of the Royal Commission on the Taxation of Annuities and Family Corporations, 1945, Ottawa: King's Printer, pp. 52-60.

8/ S.C. 1917, chapter 28.

9/ J. Richards Petrie, The Taxation of Corporate Income in Canada, Toronto: University of Toronto Press, 1952, p. 53.

10/ [1924] 2 K. B. 52.

11/ Petrie, The Taxation of Corporate Income in Canada, op. cit., p. 54.

12/ Ibid, p. 54.

13/ Section 3(9) of the 1917 Act became section 19(1) of chapter 97 in the 1927 revision of the statutes.

14/ Section 16 was section 4(9) before the 1927 revision of the statutes.

15/ S.C. 1948, chapter 52.

16/ Section 13 was numbered section 3(4) before the 1927 revision of the statutes.

17/ R.S.C. 1952, chapter 148.

18/ Income Tax Act, section 105B.

19/ Section 28 pertains to the tax-free passage of intercorporate dividends and the restrictions in respect of designated surplus.

20/ S.C. 1950, chapter 40, section 95A. This became section 105 of chapter 148, R.S.C. 1952.

21/ A transaction in securities includes transactions of whatever description involving securities. It includes a purchase, sale, exchange, issue, application and subscription for securities, and alteration of rights attaching to securities.

22/ An abnormal amount of dividend is one which substantially exceeds a normal return on the price paid for the securities. This statement is much simplified.

23/ A tax advantage means a relief or increased relief from income tax, or the avoidance or reduction of an assessment or a possible assessment to income tax, whether the avoidance or reduction is effected by non-taxable receipts or by a deduction in computing profits.

24/ The Tribunal consists of the Chairman of the Board of Referees and two or more persons appointed by the Lord Chancellor as having special knowledge of and experience in financial and commercial matters.

25/ See generally: B.I. Bittker, Federal Income Taxation of Corporations and Shareholders, Hamden: Federal Tax Press, 1959, at pp. 344-346; Sec. 11.09; J. Stanley and R. Kilcullen, The Federal Income Tax, Tucson: The Tax Club Press, 1961, pp. 182-187; and S.S. Surrey and W.C. Warren, Federal Income Taxation, Cases and Materials, Brooklyn: The Foundation Press, Inc., 1960 ed., p. 733.

26/ N.E. Challoner and J.M. Greenwood, Income Tax Law and Practice (Commonwealth), Sydney: The Law Book Co. of Australasia, Pty Ltd., 1962, p. 774, para. 942.

27/ Newton and Others v. Commissioner of Taxation of the Commonwealth of Australia, [1958] A.C. 450 (P.C., per Denning, L.J.).

28/ Union of South Africa, Second and Final Report of the Committee of Enquiry into the Income Tax Act, Pretoria: The Government Printer, 1952, pp. 28-32, paras. 1-27; at p. 31, para. 19; and at p. 32, para. 26.

29/ Harvard Law School, World Tax Series, Taxation in the Federal Republic of Germany, Chicago: Commerce Clearing House Inc., 1963, p. 426.

30/ [1947] A.C. 109.

31/ Submission to the Royal Commission on Taxation.

32/ Submission to the Royal Commission on Taxation.

33/ Submission to the Royal Commission on Taxation.

34/ Report to the Minister of Finance by the Special Committee on Corporate Taxation, March 21, 1961, reproduced in Royal Commission on Taxation: Summary of Public Hearings, 1963-64, Toronto: CCH Canadian Limited, 1964, pp. 40-55.

35/ Submission to the Royal Commission on Taxation.

36/ Of the accounting firm of McDonald, Currie and Co., Montreal, Quebec.

37/ Submission to the Royal Commission on Taxation.

APPENDIX A

THE INDUCED DISTRIBUTION METHOD

Description

1. The top personal progressive rate would be 65% which would be achieved by eliminating the 70%, 75%, and 80% brackets from the present structure.
2. Corporation income would be subject in the first instance to a flat rate of tax of 45%.
3. On taxable distributions in any form, Canadian corporate or individual shareholders, with the exceptions indicated in (e) below, would include in their income the grossed-up equivalent of the distribution, that is, $\frac{100}{55}$ of the distribution. A dividend declared in shares or in notes would be considered a distribution for this purpose.
4. Canadian shareholders who are required under (c) above to include in their income the grossed-up equivalent of the distribution would take credit for tax paid by the corporation in respect of the grossed-up distribution.
5. Exempt Canadian institutions, certain Canadian institutions to which special tax provisions apply, non-resident shareholders and non-resident-owned investment corporations would not be eligible for the treatment described in (c) and (d) above.
6. On that portion of the corporate income which is not currently distributed, the corporation would pay an additional tax of 20% on the grossed-up equivalent of the

income not so distributed with the result that corporate income not distributed currently is subject to a total tax of 65%. After payment of this additional tax, the net corporate income remaining would be tax-paid undistributed income, and on a subsequent distribution to the shareholders would not be taxable in their hands; it would not qualify for the treatment described in (c) and (d) above.

7. Dividends paid within six months after the end of the paying corporation's fiscal year and declared to be payable out of the preceding year's income would qualify as current distributions.

8. The withholding tax on dividends in any form paid to non-residents would be continued, as would the special tax on non-resident-owned investment corporations.

9. As previously indicated, most Canadian tax-paying corporations would be subject to the treatment under (c) and (d) above. This would result in refunds where the receiving corporation had sustained a loss in the year.

10. Taxation of foreign source dividend income would continue as at present.

11. Corporate losses would be carried forward within the corporation and no carry-back would be permitted.

Revenue Computations

Based on 1962 Taxation Statistics (for 1960) but applying 1962 tax rates, the revenue effects would be of the following order:

	Present Revenue 1/	Proposed Revenue 1/	Increase (Decrease)
	(millions of dollars)		
Corporation income tax	1,470	1,495	25
Non-resident withholding tax at an average rate of 15%	70	130	60
Individual income tax on Canadian dividends received	70	-20	-90
	1,610	1,605	-5

1/ Present revenue is based on 1960 dividend pay-out ratio of approximately 50%, whereas proposed revenue is based on 100% pay-out.

Basic Considerations

SIMPLICITY AND CERTAINTY OF THE LAW

Greater simplicity in the law would be achieved by the elimination of the dual rate on corporate income and the designated surplus legislation. Apart from those provisions dealing with income diversion, the legislation in respect of personal corporations could be repealed. Legislation would be required to deal with the possibilities of tax avoidance, mentioned under the caption "Administrative Ease and Economy", and to deal with the foreign tax credit problem, discussed under the caption "Simplicity of Reporting and Compliance".

ADMINISTRATIVE EASE AND ECONOMY

Greater ease and economy would result from the simplification of the law referred to above. The full corporate tax credit and the tax on undistributed earnings should induce the distribution of corporate income, but possibilities for tax avoidance would still exist by which individual taxpayers in high tax brackets could delay indefinitely or eliminate entirely the personal tax on distributions without incurring the tax on undistributed corporate income. One way would be to move dividends up through a chain of holding corporations with year-ends manipulated to facilitate delay. This would pave the way for a winding-up scheme similar to those currently used in surplus stripping.

The introduction of full credit for corporate tax would make the sale of shares to a dealer in securities even more attractive than under the present system; it would also increase the inducement for transactions in shares between high and low bracket taxpayers around the dividend record date.

Because more refunds would have to be processed, there would probably be an increase in administrative costs, but this would not be significant.

SIMPLICITY OF REPORTING AND COMPLIANCE

To avoid the additional tax on undistributed income while conserving funds, some corporations would distribute by way of stock dividends or notes. This could result in considerable work and expense in issuing stock dividends in small fractions and notes in small amounts.

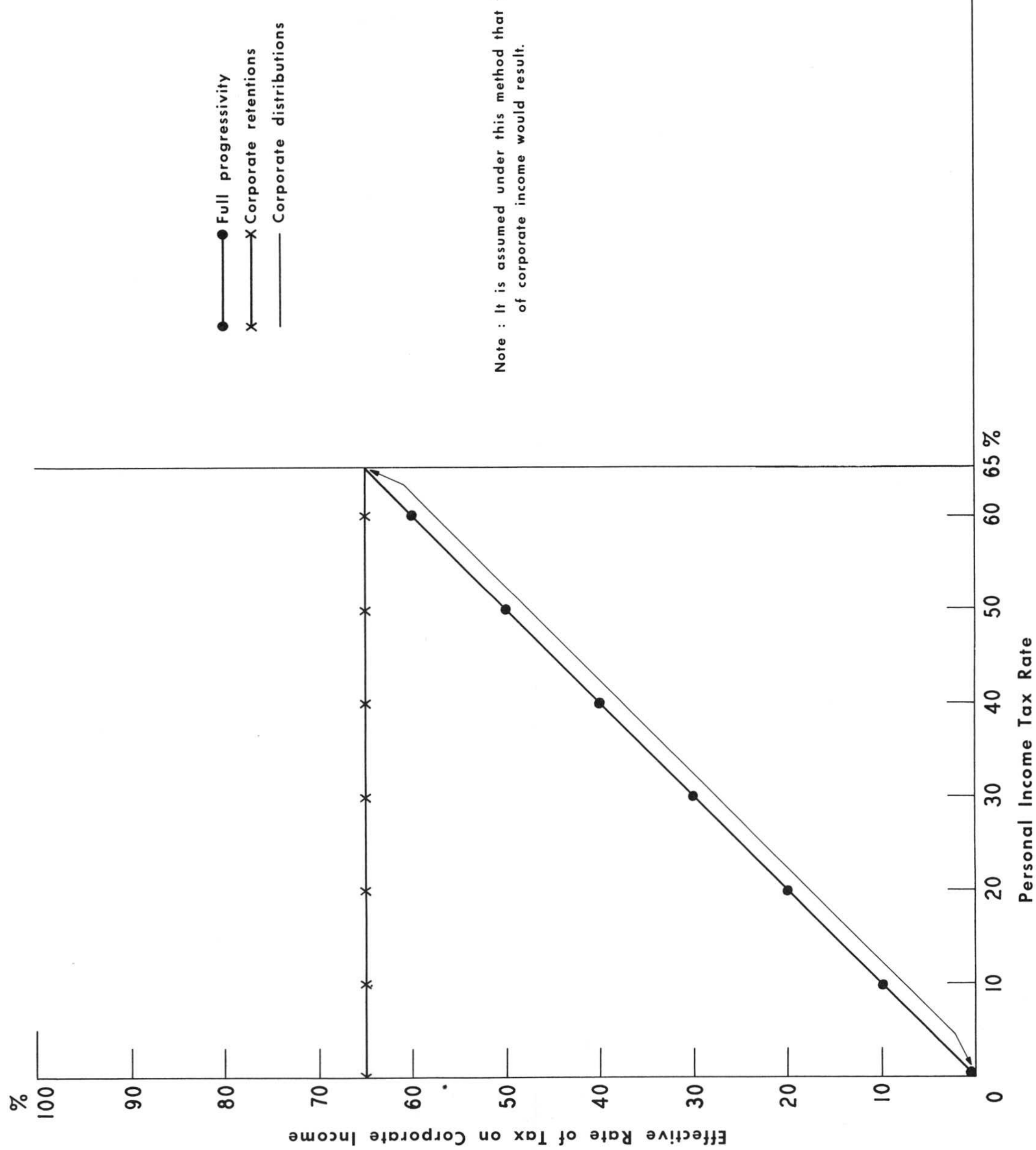
This transformation of earnings into capital or debt has, of course, legal consequences. If a corporation having cumulative preferred shares in its capital structure were to distribute all earnings currently in order to avoid the additional tax on undistributed income, in a subsequent loss year its directors would be precluded from declaring a preferred dividend. Provisions against the eventuality here described could be made by permitting corporations to retain income without application of the additional tax in a restricted form up to some percentage of preferred share capital. If it were thought desirable to provide against more varied eventualities that could arise from transformation of income into capital, the maximum restricted surplus could be related to the total paid-up capital in all forms. In the absence of effective preventive legislation, such a provision creates further opportunities for surplus stripping. Under the present law, a foreign tax credit applies against Canadian corporate tax payable in respect of foreign source income. The credit allowed is either the foreign tax actually paid or the equivalent Canadian tax on the foreign source income, whichever is the smaller amount. By the application of this feature of the law to the present proposal, Canadian shareholders could receive substantial tax credits for corporate tax that had not been paid to Canada if the dividend-paying corporation had a significant amount of foreign source income. If it is found necessary to restrict the corporate tax credit that could be claimed, information slips would be required for each shareholder indicating the amount of corporate tax credit that could be claimed.

Unless adjustments arising from reassessments in subsequent years were made in the year of discovery rather than in the year to which they are applicable, some problems could arise.

EQUITY BETWEEN TAXPAYERS

As shown by Chart 1, if full distribution of corporate profits were made a high degree of both horizontal and vertical equity would be achieved. The required payment of a 20% tax on income not distributed produces neither horizontal nor vertical equity, because it taxes

CHART 1: IMPLICATIONS FOR VERTICAL EQUITY OF THE INDUCED DISTRIBUTION METHOD



Note : It is assumed under this method that full distribution of corporate income would result.

low and high income individual shareholders at a flat rate of 65% on corporate income not distributed. However, because there is no tax advantage in retention, it is assumed that all income would be distributed.

CORPORATE AND NON-CORPORATE FORMS OF BUSINESS

Income derived through corporate and non-corporate forms would be similarly taxed if the total income of the corporation was distributed. This would not be so in respect of income not distributed, but as stated above it has been assumed that all income would be distributed.

FEDERAL-PROVINCIAL TAX ARRANGEMENTS

Because the basis on which tax revenues are shared with the provinces has been changed, renegotiation would be necessary.

INTERNATIONAL TAX CONVENTIONS

It appears that there would be no serious problem in this area.

Economic Considerations

The main impact effects of a change from the present system to the system outlined in this appendix can be summarized as follows:

1. There would be a slight increase in total corporation income tax, brought about by a sharp increase in tax payable by small corporations and a decrease in tax payable by corporations with an income in excess of about $200,000 per year (amounting to almost 10% for the large corporation).
2. There would be a moderate absolute increase (but a big percentage increase) in withholding taxes brought about by a substantial increase in tax payable on foreign holdings in Canadian corporations,

which now pay out a low portion of their income in dividends, and a small increase in tax payable on foreign holdings in high pay-out Canadian corporations.

3. There would be a moderate decrease in personal income taxes, brought about by a substantial fall in taxes on low income Canadian shareholders of Canadian corporations and some increase in taxes on most high income Canadian shareholders of Canadian corporations.
4. For most corporations, there would be a tax incentive to distribute earnings.
5. As a corollary of (4), there would no longer be a tax incentive for the foreign parent of a Canadian subsidiary to retain the profits of the subsidiary in Canada; in fact, there would be a positive incentive to remit profits to the parent company.

The further effects of these changes will now be considered.

EFFECTS ON THE CAPITAL MARKET—DOMESTIC

Aggregate personal income tax on dividends from Canadian companies would fall (total refunds on corporate tax paid to low income shareholders would be greater than the extra tax paid by high income shareholders). There is a presumption, therefore, that the demand for shares would increase. Two relatively minor factors, however, might work in the opposite direction. First, shareholders with marginal rates of tax in excess of 60% would bear a higher tax burden. If their decisions about types of assets to hold were highly sensitive to tax changes, they might respond by trying to sell their Canadian equities. Secondly, excluding exempt institutions from the right to claim refunds of tax paid at the corporate level might reduce the demand for equities by such institutions.

Changes in the distribution of tax at the corporate level would tend to lower sharply the effective yield per share obtainable on the shares of small corporations, and to increase that obtainable on the shares of large corporations. Shares of small corporations are not close substitutes for other capital market assets, but the value of such shares would probably fall, raising the pre-tax rate of return that small corporations would have to offer in prospect in order to attract new equity capital. The reduction in the tax on large corporations would tend to increase the price of shares in such companies.

It seems likely that those investors who are induced to buy Canadian equities would be, in the main, sellers of bonds. Thus, the secondary effects of the shifts in individual investment portfolios could not be expected to cancel out, and a fall in bond prices relative to share prices would take place.

EFFECTS ON THE CAPITAL MARKET—INTERNATIONAL

Three aspects of the proposal would affect foreign demand for Canadian shares: first, the tax changes as such; second, the consequent changes in the prices of Canadian shares; third, the consequent change in the willingness of Canadian corporations to pay out current profits in cash to shareholders.

The effects of the tax changes as such would make Canadian shares less attractive than at present to most foreign shareholders, because neither the United States nor the United Kingdom permit foreign tax credits against stock dividends. This would not be a substantial factor as far as wholly owned subsidiaries were concerned, because their financial arrangements could be directed by their parents in such a way as to avoid attracting tax against which no credit could be obtained.

In the case of direct investment, the change in the corporate tax on large companies reduces the tax burden on earnings distributed to the United States from 57.5% to 53.25%. For some United States parents, this would be an incentive to increase direct investment.

The effects of changes in share prices would be felt directly by individual and corporate portfolio investors but only very indirectly by companies with wholly owned subsidiaries. Increases in share prices and decreases in bond prices that would result from the improvement in the tax position of the Canadian shareholder, would reduce foreign demand for Canadian shares and increase foreign demand for Canadian bonds. However, increases in the prices of shares of large corporations that reflected the lower effective tax on the earnings of such corporations would not reduce foreign demand.

The effects of higher pay-out ratios would be important mainly for foreign individuals and for those foreign corporations unable to claim credit from their tax authorities for the underlying corporate tax. For most such taxpayers higher pay-outs would be unwelcome because their taxable income would be increased at the cost of reducing the prospects of tax-free or tax-favoured capital gains.

In general, the proposal would not have much effect on foreign direct investment, but would tend to discourage the holding of Canadian shares in the investment portfolios of foreign persons and companies and, by depressing bond prices, encourage foreign buying of Canadian bonds.

EFFECTS ON DOMESTIC SAVING

The foregoing paragraphs have been concerned with the adjustments that the introduction of the proposal would induce in the patterns of asset holding. This section deals with the effects on the total flow of domestic saving.

One type of effect would be associated with the possibility that business saving would fall if increased cash dividends exceeded the increase in corporate profits. Some part of any additional distribution would be saved by the persons who received it. However, it is not likely that the rise in personal saving would fully offset the fall in business saving and a fall in aggregate saving could be expected.

There would also be effects on domestic saving resulting from the distributional effects of the plan. Low and middle income shareholders in large corporations would gain at the expense of the highest income shareholders in large corporations and almost all shareholders in small corporations. Shareholders in general are likely to have high propensities to save, but the saving propensities are particularly high for those two groups who would lose by the proposal. On balance, the distributional changes would be likely to cause a fall in personal saving.

The effect on the level of personal saving that might result from the potential increase in security yields is not analyzed here because of the uncertainties involved.

EFFECTS ON CORPORATE FINANCIAL POLICY

Corporate policy with regard to the choice between paying cash dividends and retaining funds (i.e., paying stock dividends) could in principle be affected in either direction by the proposal. On the one hand, retentions would no longer offer a tax advantage. On the other hand, because of the lower personal tax burden on Canadian shareholders as a group, it would be possible for most companies to pay out less in cash without reducing the cash flow to their Canadian shareholders as a group. But it must be remembered that even if companies were to pay out the same amount as they do now, there would be two groups— high income shareholders and foreigners—who would suffer a lower cash flow. On balance, however, it is thought likely that a higher proportion of corporate profits would be distributed in cash than is the case under the present system.

Some, but probably not all, of the extra sums distributed would be saved. A smaller volume of corporate retentions, while generating an increased demand for share capital, would therefore not automatically generate a corresponding increase in the supply. Thus, maintenance of the capital structure of corporations as a group would probably imply some increase in the rate of return on equities. In addition, the smaller companies in particular would be faced by the transactions costs involved in making new issues.

It could be argued that the proposal would induce corporate managements to raise more money by the sale of stock and less by the sale of debt. This argument would be more or less valid as far as the individual Canadian investor were concerned. But there would continue to be a tax bias against equity financing in respect of several important suppliers or potential suppliers of funds—Canadian exempt institutions, foreign individuals and non-resident corporations unable to claim full credit in their own countries for Canadian corporate tax. It is also relevant to note that the inducement to equity financing would be relevant for corporate financial policy only in so far as the price/earnings ratios of equities were to rise, and it is not possible to be confident that any rise at all would occur. An increase in overall equity/debt ratios is, therefore, not thought likely, though the proportion of equity to debt in new issues would rise as a result of the need to replace the equity capital sacrificed by higher distributions.

EFFECTS ON GROWTH

The foregoing analysis has indicated the following probable effects that are relevant to the rate of economic growth. First, the possible fall in the volume of saving would reduce the amount of investment in real assets possible without producing excess demand on Canadian resources, and so would be unfavourable to growth. Secondly, a reduction in the net capital inflow would reduce the resources made available through an excess of imports over exports, and would therefore reduce the prospects for economic growth. However, this tendency could be more than offset by increased foreign purchases of Canadian bonds, and increased foreign direct investment.

SENSITIVITY OF THE ECONOMIC CONCLUSION TO DIFFERENT VARIANTS OF THE INDUCED DISTRIBUTION METHOD

The conclusions reached above are dependent upon certain characteristics of the specific proposal. The most significant of those are the following. First, while the higher taxation of shareholders with shares in small corporations is necessarily implied by the neutrality of this scheme between corporate and non-corporate incomes accruing to individuals, the higher taxation of shareholders with high incomes depends on the assumption that the top personal rate is lowered only to 65%. Secondly, the equal treatment of interest and dividend income, extended to Canadian persons, does not extend to Canadian exempt institutions. Since the economic conclusions would be somewhat different if these characteristics were changed, it is worth while to indicate briefly what differences there would be.

If the top marginal rate were reduced to about 60%, very few shareholders would be taxed more heavily in respect to their Canadian shares than they are now. The proposal would then be much less likely to cause a fall in saving or a flight of capital, and much more likely to raise the prices of Canadian shares.

If exempt institutions were to be permitted to claim credit for corporate tax on their dividend income (with or without some tax on their investment income as a whole), they would be a major potential source of demand for equities, whereas under the text proposal equities would be likely to become a less rational investment for such bodies than they are at present. In view of the fact that the commitments of the exempt institutions are largely of a long-term nature, it may be questioned whether it is good social policy to discourage them from holding equities as a hedge against inflation.

APPENDIX B

ADDITIONAL TAX ON RETAINED EARNINGS

Description

1. The top personal progressive rate would be 65%, which would be achieved by eliminating the 70%, 75%, and 80% brackets from the present structure.
2. The corporation income would be subject, in the first instance, to a flat rate of tax of 45%.
3. On distribution, dividends and deemed dividends would be taxed in shareholders' hands on the same basis as is currently in effect, and such dividends would be eligible for a dividend tax credit of 20%.
4. On that portion of the corporate income which is not currently distributed the corporation would pay a surtax of 30%, with the result that corporate income not distributed is subject to a total tax of 61.5%. After payment of this surtax, the net corporate income remaining would be tax-paid undistributed income and, on subsequent distribution to the shareholders, would not be taxable in their hands, and would not qualify for the dividend tax credit of 20%.
5. Dividends paid within six months after the end of the paying corporation's fiscal year and declared to be payable out of the preceding year's income would qualify as current distributions.
6. Dividends received by one tax-paying Canadian corporation

from another would be deducted from income for computing ordinary corporate tax but would be included in income for computing the "corporate surtax".

7. The withholding tax on dividends paid to non-residents would be continued as would be the special tax on non-resident-owned investment corporations.

8. Foreign source dividend income would continue to be treated as at present.

9. Corporate losses would be carried forward within the corporation and no carry-back would be permitted.

Revenue Computations

Based on 1962 Taxation Statistics (for 1960) but applying 1962 tax rates, the revenue effects would be of the following order:

	Present Revenue	Proposed Revenue	Increase (Decrease)
	(millions of dollars)		
(a) Assuming continuation of 1960 dividend pay-out ratio (about 50%)			
Corporation income tax	1,470	1,495	25
30% surtax on retentions	-	285 1/	285
Non-resident withholding tax at an average rate of 15%	70	70	-
Individual income tax on Canadian dividends received	70	60	(10)
	1,610	1,910	300

	Present Revenue	Proposed Revenue	Increase (Decrease)
	(millions of dollars)		
(b) Assuming 100% pay-out			
Corporation income tax	1,470	1,495	25
30% surtax on retentions	-	-	-
Non-resident withholding tax at an average rate of 15%	70	130	60
Individual income tax on Canadian dividends received	70	140	70
	1,610	1,765	155

1/ This figure does not include any surtax on retentions of inter-corporate dividends.

Basic Considerations

SIMPLICITY AND CERTAINTY OF THE LAW

Greater simplicity in the law would be achieved by the elimination of the dual rate on corporate income and the designated surplus legislation. If a top rate of tax of 61.5% is acceptable for all forms of income that can be channelled through the corporate form, the personal corporation legislation, apart from those provisions dealing with income diversion, could be repealed. Legislation would be required to deal with the possibilities of tax avoidance to be mentioned under the caption "administrative ease and economy".

ADMINISTRATIVE EASE AND ECONOMY

Greater ease and economy would result from the simplification of the law referred to above. The penalty tax on retained earnings would encourage distributions, but possibilities for tax avoidance would still exist by which high tax bracket individual taxpayers could delay indefinitely, or eliminate entirely, the personal tax on distributions without incurring the 30% tax on income not distributed. One way would be to move dividends up through a chain of holding corporations with year-ends manipulated to facilitate delay. This would pave the way for a winding-up scheme similar to those presently used in surplus stripping.

SIMPLICITY OF REPORTING AND COMPLIANCE

To avoid the additional tax on undistributed income while conserving funds, some corporations would distribute by way of stock dividends or notes and this would require some shareholders to find cash from their own resources to pay the resultant tax. This could also result in considerable work and expense in issuing stock dividends in small fractions and notes in small amounts. This transformation of earnings into capital or debt has, of course, legal consequences. If a corporation having cumulative preferred shares in its capital structure were to distribute all earnings currently in order to avoid the additional tax on undistributed income, in a subsequent loss year its directors would be precluded from declaring a preferred dividend. Provisions against the eventuality here described could be made by permitting corporations to retain income, without application of the additional tax, in a restricted form up to some percentage of preferred share capital. If it were thought desirable to provide against more varied eventualities that could arise from transformation of income into capital, the maximum restricted surplus could be related to the total paid-up capital in all forms. In the absence of effective preventive legislation, such a provision creates further opportunities for surplus stripping. Unless adjustments arising from reassessments in subsequent years were made in the year of discovery rather than in the year to which they were applicable, some problems could arise.

EQUITY BETWEEN TAXPAYERS

As shown by Chart 2, the vertical inequity inherent in the present system would continue under this method and to some extent would be aggravated in the case of corporations whose income had previously been taxed largely at 21%. There would be no vertical equity to the extent that corporate income is not distributed currently. Horizontal equity is not as well served as under the present system.

CORPORATE AND NON-CORPORATE FORMS

Corporate income would continue to be taxed in a different manner from other forms of income.

FEDERAL-PROVINCIAL TAX ARRANGEMENTS

Renegotiation may be necessary in respect of the 30% surtax and tax-paid undistributed income features.

INTERNATIONAL TAX CONVENTIONS

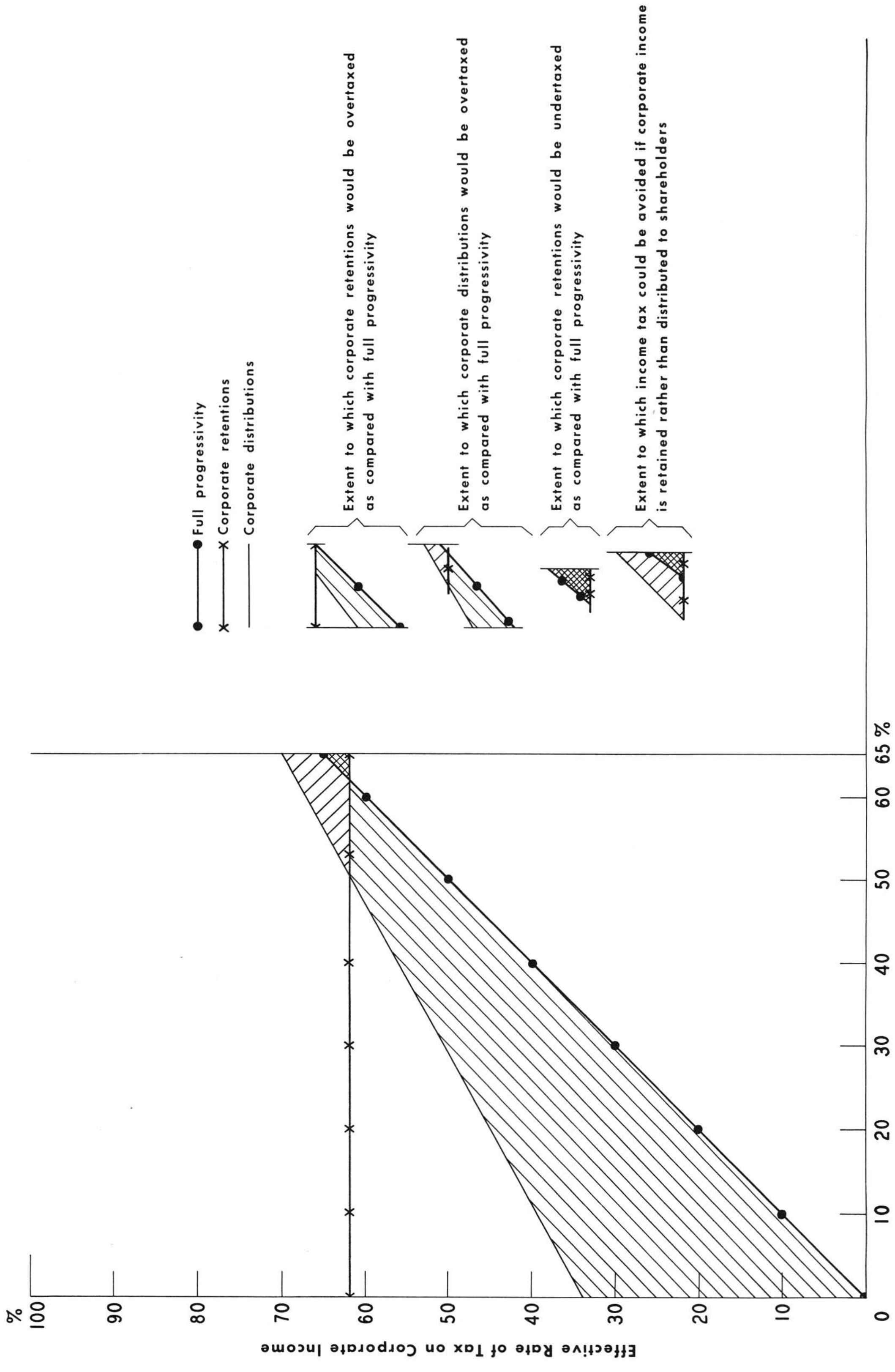
No serious problems are foreseen.

Economic Comments

EFFECTS ON THE CAPITAL MARKET--DOMESTIC

The introduction of this proposal would have the effect of reducing the attractiveness of shares in general, relative to other forms of earning assets. First, there would be an increase in the effective tax burden on share income for most classes of shareholders. Secondly, because the effective rate of tax on income from bonds and shares would come closer

CHART 2: IMPLICATION FOR VERTICAL EQUITY OF THE ADDITIONAL TAX ON RETAINED EARNINGS METHOD



together than at present, there would probably be a shift by very wealthy individuals from shares to bonds. Therefore, the prices of shares would fall and the prices of bonds and other assets would rise.

The elimination of the split rate on corporate income and the imposition of a flat rate of tax of 45% would sharply increase the tax burden on corporations for whom the present 21% rate is a substantial tax saving. The reduction of the after-tax rate of return for such corporations would cause a fall in the value of their shares. The imposition of a flat corporate tax rate of 45% would reduce the tax burden on large corporations and would tend to raise relatively the prices of shares of such corporations.

A further change in the relative prices of shares would result because, even assuming corporations did not want to retain funds to pay dividends in loss years, the option to retain or distribute earnings presented to corporations under the proposal would vary in attractiveness to different groups of shareholders. Those shareholders with marginal tax rates of 50% would be indifferent (abstracting risk and liquidity considerations) as between distribution out of current income, and retention and later distribution. In either case, the combined tax rate at the corporate and individual levels on corporate earnings would be 61.5%. However, those individuals with marginal tax rates in excess of 50% would prefer retention and later distribution because the combined tax rates on corporate earnings would be limited to 61.5% while current distribution would be subject to higher rates. On the other hand, individuals with marginal tax rates of less than 50% (who hold approximately half the shares outstanding) would prefer current distribution because for them the combined tax rate on corporate earnings would be less than 61.5%. At present only those individuals with marginal tax rates of less than 20% have a clear tax incentive for distributions. It is uncertain whether the high or low income shareholder exerts the greater influence on corporate distribution policy. However, a polarization of shareholders by income class into shares with appropriate pay-out ratios could arise.

EFFECTS ON THE CAPITAL MARKET—INTERNATIONAL

The foreign shareholder, like the domestic shareholder, would be affected by the higher corporate tax on the earnings of small Canadian corporations. Further effects would depend upon the position of the foreign shareholder.

Foreign parents of wholly owned subsidiaries in Canada with large incomes would be affected as follows. The subsidiary would choose to remit all current earnings to the parent and the Canadian tax would amount to 53.25%, compared with the current average rate on distributions of corporate income from large corporations of 57.5%. The parent corporation would then provide needed capital to the subsidiary through loans. It would never be worth while for the subsidiary to retain earnings because the effective tax rate would be 61.5%. The result, therefore, would be to force wholly owned subsidiaries to distribute all their earnings.

Foreign low and middle income individual portfolio investors would also have an incentive to prefer distribution out of current income. Because foreign individuals would not be able to claim a tax credit in their country for the 30% surtax on retentions, retention and subsequent distribution from surplus would be most unwelcome. There would, therefore, be a movement by foreign shareholders in two directions. First, toward large, widely held Canadian corporations who would be subject to a lower corporate tax rate than at present. Secondly, the reduction in the overall after-tax rate of return to foreign corporations with portfolio investments could cause them to reduce their Canadian holdings. The same reduction in the overall after-tax rate of return would cause individuals to re-examine their investments. If they decided to continue to invest in Canada there would be the same polarization by income groups as noted above for Canadians.

EFFECTS ON SAVING

Individuals in high income groups would benefit because of the reduction of the maximum personal tax rate to 65%, but they would be worse off as a result of the increase in the effective rate of tax on income channeled through corporations. The result is likely to be a reduction in saving by this group. The lower income groups who hold shares would be better off to hold shares in large corporations paying out all current income. The savings of such corporations would fall, but the savings of the shareholders would not rise by an equivalent amount because the recipients would spend part of the dividend. It seems likely, therefore, that the volume of domestic saving would be reduced as a result of the introduction of this proposal.

EFFECTS ON CORPORATE FINANCIAL POLICY

The introduction of this proposal would probably induce higher payouts by most corporations, particularly those controlled by foreign corporations. Corporations would then have the alternative of issuing stock dividends or paying cash dividends. The use of stock dividends would be limited because shareholders would have to use other sources of funds to meet their tax liability on dividends. Corporations will therefore need to use external financing more than at present. But this involves substantial transactions costs for most companies and the volume of equity capital available, both from domestic and foreign sources, would probably be less than at present. The cumulative effects on corporate finance are likely to be substantial.

STABILITY AND GROWTH

This proposal retains a substantially heavier tax burden, on balance, on corporate income than on other income. Because corporate income tends to fluctuate more than national income, this tax discrimination against corporate earnings would have some merit as a built-in stabilizer. The rate of accumulation of funds through small corporations probably would fall and, taking into account the effects of greater cash pay-outs and the capital outflow, the net effect might be some fall in the rate of domestic saving, and therefore an adverse effect on the liquidity of the economy and probably on the rate of investment.

MODIFICATIONS

Two economic effects of the proposal that might be harmful could be mitigated by modifying the basic scheme. One problem is that individual Canadian shareholders could limit their total tax on corporate income to 53.25%. This could be done by setting up a foreign company in a tax-free jurisdiction in a manner that would escape personal corporation status. Then dividends from Canadian corporations would be subject to a 15% withholding tax, but later the surplus could be stripped from the holding company and remitted back to Canada tax free. Such transactions are certain to be relatively small, but if the surtax rate were equal to the withholding rate on foreign dividends, such transactions would not be profitable.

A second problem that might arise from the potential drop in share prices and the disincentives to equity investment could be mitigated by increasing the dividend tax credit.

APPENDIX C

TAX-FREE DISTRIBUTION

Description

1. The top personal progressive rate would be 65%, which would be achieved by eliminating the 70%, 75%,and 80% brackets from the present tax structure.
2. The corporation income would be subject to a flat rate of tax of 50%.
3. Canadian shareholders would have an option of:
   (a) excluding from taxable income dividends received from taxable Canadian companies, or
   (b) including in taxable income dividends received from taxable Canadian companies, and deducting from tax payable a 20% Canadian dividend tax credit as is permitted by existing legislation.
4. The withholding tax on dividends paid to non-residents would be continued as would the special tax on non-resident-owned investment corporations.
5. Foreign dividend income received by residents would continue to be taxed as at present.

Revenue Computations

Based on 1962 Taxation Statistics (for 1960) but applying 1962 tax rates, the revenue effects would be of the following order:

	Present Revenue	Proposed Revenue	Increase (Decrease)
	(millions of dollars)		
Corporation income tax	1,470	1,670	200
Non-resident withholding tax at an average rate of 15%	70	70	-
Individual income tax on Canadian dividends received	70	-5	-75
	1,610	1,735	125

Basic Considerations

SIMPLICITY AND CERTAINTY OF THE LAW

Greater simplicity in the law would be achieved by the elimination of the dual rate on corporate income and the designated surplus legislation. There would be no need for legislation dealing with corporate income once it had been subjected to the corporate tax. If a top rate of tax of 50% is acceptable for all forms of income that can be channelled through the corporate form, the personal corporation legislation could be repealed.

ADMINISTRATIVE EASE AND ECONOMY

Greater ease and economy would result from the simplification of the law referred to above.

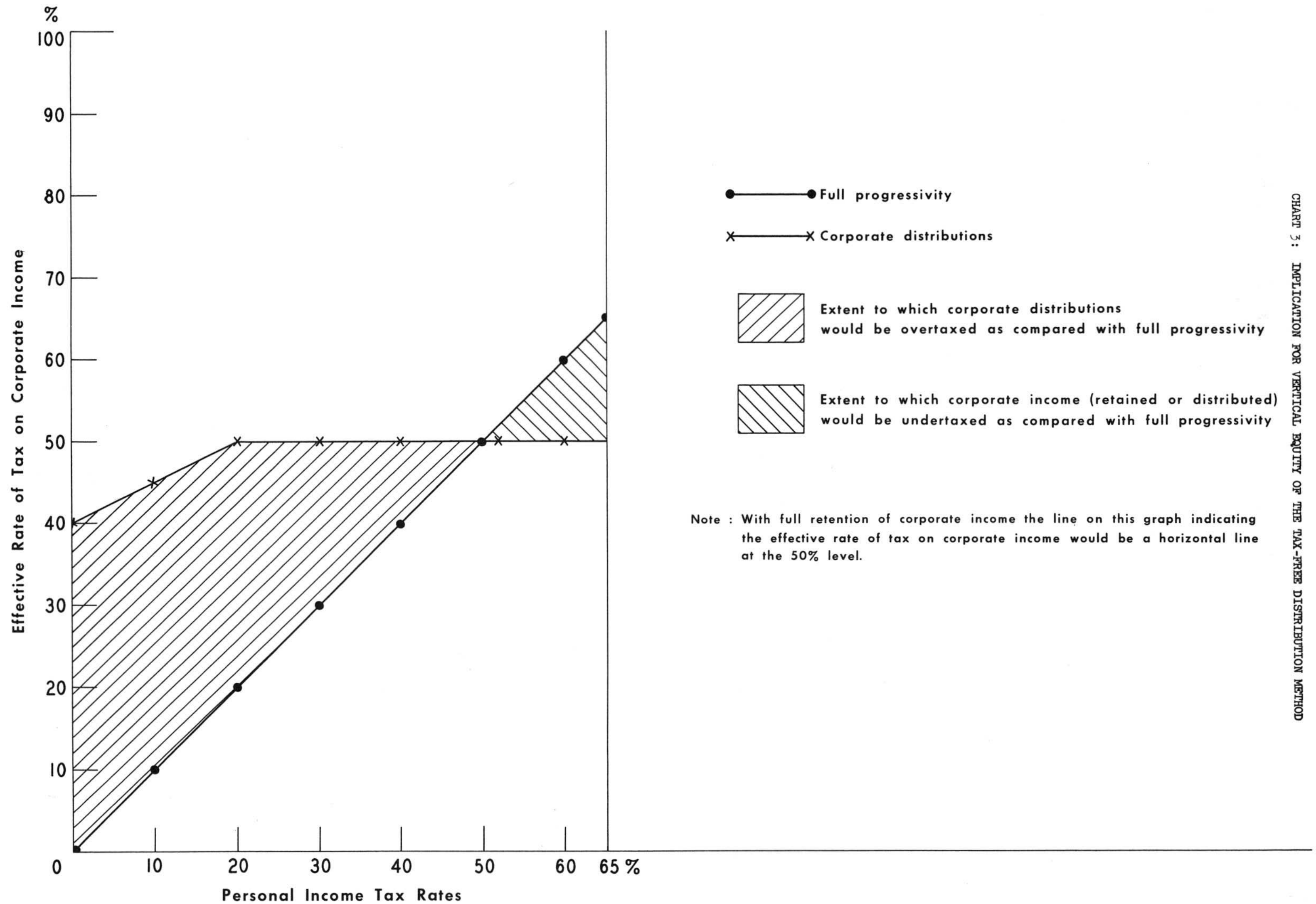
SIMPLICITY OF REPORTING AND COMPLIANCE

Reporting and compliance would be greatly simplified.

EQUITY BETWEEN TAXPAYER

As shown by Chart 3, this method would provide very little vertical equity because all corporate income would be taxed at

CHART 3: IMPLICATION FOR VERTICAL EQUITY OF THE TAX-FREE DISTRIBUTION METHOD



50%, except that received by shareholders with a marginal rate of less than 20%. Individuals in a tax bracket above 50% would tend to channel as much income as possible through the corporate form.

Because of the flat rate of tax, equity as against taxpayers receiving their income in other forms (horizontal equity) is also lacking.

CORPORATE COMPARED WITH NON-CORPORATE FORM

Although "double taxation" would be eliminated, the taxation of corporate income would be altogether different from the taxation of other forms of income.

DOMINION-PROVINCIAL TAX ARRANGEMENTS

Because of the exemption from tax of dividends, the existing tax arrangements would probably require renegotiation.

INTERNATIONAL TAX CONVENTIONS

It would not appear that existing tax conventions would have to be amended except where non-discriminatory clauses are a factor.

Economic Comments

EFFECT ON THE CAPITAL MARKET—DOMESTIC

The imposition of a flat rate of tax of 50% by the federal government on corporate income would decrease the after-tax rate of return on Canadian shares. The decrease would be greatest for corporations with low earnings, and negligible for corporations with earnings in excess of about $5 million. On the other hand, the removal of personal tax liability on income distributed by the corporation, and the retention of the 20% dividend tax credit, would increase the net value of dividends to persons with marginal tax rates in excess of 20%. The increase would be larger, the larger the dividend and the higher the individual's marginal tax rate.

The net effect would be to increase the attractiveness of the shares of high pay-out, large corporations particularly to those individuals in the higher tax brackets, and to increase the price of shares of large corporations. Low income shareholders who tend to prefer such shares would very likely move from shares into bonds.

EFFECTS ON THE CAPITAL MARKET—INTERNATIONAL

Because the present arrangements with respect to taxes paid to foreigners would be unchanged under this proposal, the movement of foreign capital would be affected directly only by the removal of the split corporate tax rate. This added tax burden would be relatively small, particularly for large corporations where the bulk of equity foreign investment is concentrated. Foreign corporate investment in wholly owned subsidiaries would be affected only to the extent that they could not offset the additional tax against their foreign tax liabilities. The total effect on foreign equity capital inflow would be negligible.

The indirect effects of the proposal would be more likely to affect capital flows. First, the higher pay-outs resulting from the removal of the tax on distributions will increase the revenue from the withholding tax on dividends paid to foreigners. To the extent that the combined burden of Canadian corporate taxes and withholding taxes on dividends is in excess of the tax liability of a foreign corporation on its Canadian income, the increased Canadian tax liability cannot be fully offset against the foreign tax liability. This would make investment in small

Canadian corporations less profitable. Also, high income individuals who prefer to accumulate funds in corporations will want to move away from shares of corporations that decided to raise their pay-outs.

Secondly, the rise in the price of shares and the fall in the price of bonds would induce foreigners to move from Canadian shares to Canadian bonds and to foreign shares. To the extent that this movement will not be sufficient to raise bond prices to their present level, the lower bond prices would attract additional capital from abroad. It is not clear whether this increased inflow of bond capital would be larger or smaller than the outflow of share capital. These movements would probably be quite large but as they are in opposite directions the net result on the capital inflow would be much smaller in magnitude. It is impossible to say, at this stage, what direction the net change in capital movement would take.

Canadian investment abroad would be more seriously affected, because a differential would be created in favour of Canadian relative to foreign dividend income. The reduction in yields that would result from the increase in the price of shares, and the higher effective corporate tax rate would not be of sufficient magnitude to offset this advantage. Some Canadian investment abroad would return to Canada, and the outflow of Canadian capital would decrease.

EFFECTS ON CANADIAN OWNERSHIP

The proposal would make Canadian shares more attractive to Canadians relative to Canadian bonds or foreign shares and bonds. Thus the result would be to increase Canadian ownership of shares and reduce their ownership of bonds. The reverse would be true for foreigners.

EFFECTS ON SAVING

The increase in the effective tax on corporate income and the removal of the incentive to retain earnings would reduce corporate saving. This would not be offset by an increase in personal saving because some part of the increased distribution will be spent. On the other hand, there would be some increase in personal saving because, on the average, the tax burden is shifted from high income to middle and low income groups. However, the increase in the effective tax on corporations with small earnings may have substantial effects on the savings of high income individuals who control such small companies.

EFFECTS ON CORPORATE FINANCE

Small corporations would be faced with higher effective tax rates and all corporations with increased pressure from shareholders for larger dividends. They would therefore have to make more use of external financing. Because bond prices are likely to fall somewhat, the cost of debt would rise while share prices increased, so that more financing is likely to be done by shares than by bonds. Small corporations are likely to meet quite severe liquidity problems as a result of the increase in the cost of debt financing and the higher tax burdens.

These developments are not expected to cause liquidity difficulties to most firms. However, the net effects of the proposal on foreign capital inflow may upset the liquidity balance one way or the other.

STABILITY AND GROWTH

The effects of the proposal upon the stability of the economy would be improved somewhat by the higher reliance on corporate taxes that tend to be very unstable cyclically, so that the cyclical pattern of net income in the hands of the public and corporations will be smoothed out a bit.

On the other hand, the higher component of bond purchases in the foreign capital inflow would limit the scope of monetary countercyclical policy with fixed exchange rates, as variation of the rate of interest will cause greater difficulties in the balance of payments.

The effects on growth will depend mainly on foreign capital movements. If foreign capital inflow is severely hampered, the liquidity of the economy may drop very substantially raising the rate of interest. This may in turn cause a curtailment of investment.

APPENDIX D

CURRENTLY ACCUMULATED UNDISTRIBUTED INCOME

In introducing any new method of taxation of corporate income that involves a basic departure from the present structure, it is essential that consideration be given to that body of corporate income that has not been subjected to the application of the final personal tax. This undistributed income in general terms is represented by that portion of the after-tax corporate income earned in 1917 and subsequent years which has not been distributed by way of dividend or deemed dividend. (An exception would be tax-paid undistributed income.) This undistributed income will have borne corporate tax at varying rates dependent upon the years in which it was accumulated.

Because several proposals considered in Chapter 5 of this study would tax corporate income finally in the year in which it was earned or otherwise alter the personal tax level, the undistributed income at the date of introduction of any such proposal would have to be dealt with separately.

Such undistributed income might be dealt with in one of the following ways (there are others):

1. Deem it to be tax-paid undistributed income without application of any tax to it.
2. Levy a flat rate of tax on it, payable over a specified time, and then consider it to be tax-paid undistributed income.
3. Segregate it for tax purposes from other forms of undistributed

income and have it held in suspense until such time as it is distributed whereupon the distribution would be taxed as if the present legislation were in effect.

4. Levy a flat rate of tax on it, require this amount to be removed from the surplus and to be shown as a long-term liability to the government; require payment of a reasonable rate of interest on this amount until it is paid, but leave the time of repayment to the corporations' discretion, subject to payment being exigible prior to winding-up or immediately on transfer to non-resident status. The interest could be made deductible or not for tax purposes as a policy matter.

The implications of each of these proposals is discussed below:

1. To deem the undistributed income to be tax paid without the application of tax would have the advantage of simplicity and would not work any financial hardship on the corporations involved. It can be criticized on the following grounds:
   (a) the shareholders of corporations that had either distributed their income or that had paid the special tax contemplated by section 105 of the present Act would have been prejudiced in relation to shareholders of corporations that had followed the practice of retaining a large percentage of their income;
   (b) the Treasury would forgo the revenue that, at least potentially, it would have obtained on ultimate distribution of the undistributed income.

2. To levy a flat rate of tax on the undistributed income before considering it tax paid would overcome the criticisms indicated in 1(a) and 1(b) above but, dependent upon the rate of tax, could cause financial hardship to the corporations affected. To indicate the magnitude of the problem, the following figures, which are based on <u>1962 Taxation Statistics</u>, (for the 1960 taxation year) have been prepared:

   (a) the net surplus (which need not correspond exactly with undistributed income) of fully tabulated companies amounts to approximately $18 billion;

   (b) a flat rate of tax of 15% applied to this figure would amount to $2.7 billion and, for example, if collected at the rate of 1/2 of 1% of the surplus over 30 years, would involve corporate payments of $90 million annually. A flat rate of tax of 15% payable over 30 years without interest is equal (at a rate of discount of 5%) to a flat rate of tax of 7.68% payable now;

   (c) as a percentage of before-tax corporate income (1960) this $90 million would represent 3.25%, and vary from 2% to 8% by industry classification with an overall average of approximately 6%. It might therefore be considered necessary to permit payment of this tax at a rate which is the lesser of, say, 0.5% per annum or some percentage of income.

3. To segregate the undistributed income and treat it as described in 3 above avoids most of criticisms that can be made of proposals 1 and 2 but is subject to the following

limitations:

(a) this undistributed income would still require application or measures to prevent surplus stripping;

(b) in the case of corporations with probable infinite life, this undistributed income is never likely to be distributed and the transitional provisions would be required indefinitely.

4. The method described in 4 above appears to have the following merits:

(a) it levies a tax on the undistributed income;

(b) the requirement that it be removed from surplus account and recorded as a liability will, at least to some extent, afford the Treasury the protection of company law in general;

(c) it leaves the payment of the tax to the discretion of the corporation;

(d) the interest charge produces a certain amount of revenue to the government until payment of the tax.

This method has the disadvantage that, in fact, it places on corporations not only the total financial burden indicated in 2 above but an additional burden arising from the interest charge. 1/ However, the actual tax levy may be postponed, at the corporations' discretion, until winding-up or transfer to non-resident status.

1/ If 3.33% interest were charged, and if the interest were not deductible for tax purposes, and no payments were made on account of the tax, in 30 years the corporation would have paid in interest an amount equal to the tax payable. The annual cash outflow would be the same and the tax would still have to be paid.

APPENDIX E

SPECIAL TREATMENT OF LOW INCOME CORPORATIONS

The Problem Outlined

It is not intended to discuss at this time whether small businesses should be accorded favourable treatment, whether the tax structure is the best medium for the purpose, or whether special treatment is effective and equitable when its application is limited to businesses conducted through the corporate form. It is relevant, however, to consider whether a satisfactory solution to the surplus-stripping problem can be found if special tax treatment of the retained earnings of small corporations is to be continued.

Legislation has been in effect in this country for some fifteen years by which the first part of corporation income has been subject to a much lower rate of taxation than the remainder. The primary purpose of this legislation was, and still is, to take less out of the internally generated funds of small businesses required to be reinvested if such businesses are to grow. However, the legislation actually granted two benefits, the first in respect of all shareholders of low income corporations through the reduced rate of corporate tax. The second benefit—that of postponement of tax at personal rates—was available to those shareholders who caused their corporations to retain earnings rather than distribute them.

The differential treatment in other countries of closely held corporations strongly implies that such corporations are the ones in respect of which surplus-stripping operations are conducted, and there is no reason to believe the situation is otherwise in Canada. While surplus stripping is open to those who control any corporation, limited distribution of shares would seem to be almost a prerequisite to the arrangements. While closely held corporations are not synonymous with small income corporations, most closely held corporations would be small ones and most small corporations are closely held. This leads to a conclusion that endeavours to prevent surplus stripping are aimed primarily at the shareholders of low income corporations.

It is because of the split rate of corporate tax that there has developed substantial amounts of income on which corporation tax has been paid at low rates, and upon which personal income tax has been postponed. The implication of surplus stripping is that those who engage in it escape their fair burden of income taxation, which can only be measured in terms of the personal tax rate structure. Through surplus-stripping shareholders manage to avoid that partial burden of taxation, which the government obviously meant only to postpone, in its attempt temporarily to lighten the burden of taxation on low income corporations.

It appears that a solution to surplus stripping, through change in the basic tax structure alone, can be found only through taxing, once and for all, all corporate income as earned. If, under such circumstances, the structure continued to provide for a lower rate of tax on low income corporations and/or their shareholders, it would mean that the tax deferment currently possible would in effect become a straight tax remission. Surplus stripping would be eliminated, but only as a result of converting the tax avoidance now being practised into a tax concession available immediately. Furthermore, such a concession to low income corporations would cease to be directly related to their needs for earnings-retention and growth, in that it would apply equally to income withdrawn from the business. If the growth of small corporations is to be encouraged within the context of a solution to the surplus-stripping problem, it would seem illogical to attempt it through the continuation of the split rate of corporate tax. Other solutions, not necessarily tied to the tax structure, might well be considered.

Some Comments in Respect of the Imposition of a Flat Rate of Corporate Tax

TAX BURDEN

Several of the methods advanced as solutions to the surplus-stripping problem contemplate the replacing of the present dual rate of tax with a flat rate of tax. If a flat rate of tax of 45% were imposed the tax burden on the small companies would increase very substantially. Of the 63,312 profit companies reported in the 1962 Taxation Statistics, (for 1960), 56,729 (89.6% of the total) had taxable incomes of less than $35,000, if the low rate of tax had applied to all of this income, they would have paid approximately $70 million in tax (6% of the total federal portion of corporate tax collected). Under a flat rate of tax of 45%, these companies would have paid over $100 million in additional tax, or a total amount equal to 14% of total federal corporate tax collected.

SOME ALTERNATE METHODS OF MITIGATING THE TAX BURDEN

If some mitigation of the possible substantial increase in tax burden on low income companies is desirable regardless of whether their income is distributed or reinvested, the following are some of the alternatives which might be considered.

Exemption of the First $5,000 of Income

On the basis of 1962 Taxation Statistics (for 1960), this provision would eliminate entirely the tax burden on 26,012 companies (41% of total) and would reduce by at least 50% the tax burden on a further 10,716 companies, that is, those with taxable incomes between $5,000 and $10,000 A further comparison of this method with other methods is set out below.

Corporate Tax Incidence for Various Corporate Taxation Methods

(1) Taxable Income	(2) Existing Dual Rate of Tax	(3) 45% Flat-Rate Tax	(4) Col. (3) with $5,000 Exemption	(5) Col. (3) with $1,000 Tax Credit
$	$	$	$	$
5,000	1,050	2,250	-	1,250
10,000	2,100	4,500	2,250	3,500
15,000	3,150	6,750	4,500	5,750
20,000	4,200	9,000	6,750	8,000
25,000	5,250	11,250	9,000	10,250
30,000	6,300	13,500	11,250	12,500
35,000	7,350	15,750	13,500	14,750
50,000	14,850	22,500	20,250	21,500
100,000	39,850	45,000	42,750	44,000
200,000	89,850	90,000	87,750	89,000

It is estimated that the loss in revenue caused by applying the flat rate of 45% only to income in excess of $5,000 is $90 million, distributed among corporate income groups as follows:

$ 0 — 35,000	$75 million
35,000 — 100,000	8 "
100,000 — over	7 "
	$90 million

It should be noted that under the induced distribution and tax-free distribution methods the $5,000 exempt income would escape all tax since the latter method does not contemplate taxing dividends in shareholders' hands, and under the former this profit on distribution presumably but not necessarily would be a capital receipt and therefore exempt.

Tax Credits

The use of tax credits provides a fair amount of flexibility in adjusting the tax burden of corporate income. Tax credits of particular amounts could be considered, as could tax credits based on a percentage of taxable income, or a combination of the two. The attraction of a flat-rate exemption or credit is that it is of greater proportionate benefit to the small income taxpayer and of relatively smaller proportionate benefit to the large income taxpayer.

The granting of tax credits could be limited to companies with taxable income under a designated amount, although the revenue implications are minor and may not warrant such a consideration.

A $2,250 tax credit granted to all companies against a flat-rate tax of 45% would have the same implication as the $5,000 exemption discussed above. A $1,000 tax credit against the flat-rate tax of 45% would mean a revenue loss of $40 million, and would mean that of the 26,012 companies earning under $5,000, those earning over $4,100 would have their tax burden slightly increased, and all others would have it reduced or eliminated.

The use of a tax credit could perhaps avoid the possible comparison of the $5,000 exemption mentioned above with the present $1,000 personal exemption. The socio-political implications of exempting large numbers of companies from payment of any tax at all, as would be the case with the proposed tax credit or $5,000 exemption schemes, would bear close scrutiny.

Free Depreciation Policy

A different approach to easing the tax burden on small income companies would be to consider permitting them to utilize available depreciation charges at their own discretion, up to a maximum of 100% in any year. This of course does not grant any extra tax saving over the long run, but does permit them to adjust better for fluctuating profit years and to provide funds for expansion.

In the year 1960, 1962 Taxation Statistics indicates that for profit companies under $50,000, the capital cost allowance claimed represented 40% of total profit before capital cost allowance. This would indicate that a free depreciation policy at least in the initial year, would permit most companies to eliminate or substantially reduce their tax liability. Based on the present dual rates of tax, the federal government would have collected $81 million from such companies. In addition, Ontario and Quebec collected an estimated $45-$55 million from these companies. These two figures together represent the maximum tax deferment possible in the first year that free depreciation is instituted. The deferment would diminish in subsequent years as the undepreciated capital cost is used up, subject of course to new acquisitions of depreciable assets.

Some disadvantages of this alternative are:

1. it favours those companies which have substantial amounts

of depreciable assets and provides little benefit for those companies with few depreciable assets;

2. an income limit is established (in order to protect the Revenue) which could lead to associated company problems. As a partial remedy, a certificate of eligibility could be required, to be granted only on application and requiring full disclosure of each shareholder's other corporate holdings;

3. it creates inequity for the companies whose incomes just exceed the established limit.

It should be noted that until recently Sweden permitted 100% depreciation as an incentive for modernization, which is now being withdrawn. However, 100% depreciation is suggested here not primarily as an incentive but as an offset to the loss of a preferred tax rate.

Special Reserves for Receivables or Inventory

This type of reserve is similar to the depreciation reserve in that it is primarily intended to offset the proposed tax burden that would otherwise fall on the low income company. These companies require a substantial cash flow for financing and expansion.

Deductions from taxable income would be allowed in order to establish and maintain a reserve of a specified percentage of accounts receivable or inventory. This concession would only be available to companies with incomes under a specified limit (say, $50,000). It could be considered as an alternative to free depreciation or might be considered as a supplement to it, of particular benefit to those companies that have few depreciable assets. Revenue considerations would presumably be of prime importance in making this decision, although it should also be noted that there is no precedent in Canada for such a measure, and therefore it could meet opposition. Also, while the depreciation reserves represent a temporary postponement of tax otherwise payable, these reserves would result in a permanent postponement (i.e., until liquidation of the company).

The 1962 Taxation Statistics (for 1960) for profit companies indicate the following:

Taxable Income $	Inventories (millions of dollars)	Accounts Receivable (millions of dollars)
0 - 4,999	450.3	392.2
5,000 - 9,999	346.3	303.2
10,000 -24,999	743.0	822.2
25,000 -34,999	334.6	397.6
	1,874.2	1,915.2
35,000 -50,000	190.7	213.0
	2,064.9	2,128.2

If a 20% reserve were allowed for both inventories and accounts receivable, the maximum deduction in the first year, on the basis of the above figures, would be $839 million. However, taxable income of these companies in 1960 was only $554 million. The revenue loss in the initial years would be limited to the present tax collections from these companies, which were estimated above at $130 million.

Election to be Taxed as a Partnership

Because this election would permit the shareholder to be taxed at personal rates on his share of corporate earnings, it has the same effect as the induced distribution method. However, under the methods of levying an additional tax on retained earnings and of tax-free distributions it would provide some relief to the shareholder of the small company. Under the tax-free distribution method as long as a shareholder's average rate of personal tax were less than the flat-rate corporate tax (50%) it would be to his advantage to make the election. This average rate of tax is reached at slightly under $90,000 of taxable income. Under the additional tax on retained earnings method it would be to the shareholder's advantage to elect as long as his average rate was less than 61.5% (taxable income of approximately $225,000).

The following table sets out the tax effects on various incomes of this election under the methods discussed above. Note that at the levels of income shown, all shareholders would make the election.

	1962 Rates of Tax 2/		Proposed Methods 2/		
Company Taxable Income 1/	Without Additional Salary	With Additional Salary	Tax on Retained Earnings Without Election	Tax-Free Distribution Without Election	Election to be Taxed as Partnerships
	(a)	(b)	(c)	(d)	(e)
$	$	$	$	$	$
10,000	2,100	2,100	4,810	5,000	3,060
15,000	3,150	3,150	7,460	7,500	5,260
25,000	5,250	5,250	13,198	12,500	9,960
35,000	7,350	7,350	19,072	17,500	14,960
50,000	14,850	12,610 3/	28,210	25,000	23,160

1/ This figure is net of shareholder remuneration equal to personal exemptions plus $4,000.

2/ Columns (a) and (b) ignore the tax, if any, on eventual distribution of company income not paid out as salary. Column (c) assumes full distribution to avoid the penalty tax, while column (e) is in effect full distribution. Under column (d) distributions are tax free.

3/ This figure includes the personal tax on the additional salary sufficient to reduce taxable income to $35,000.

While election to be taxed as a partnership would in some cases reduce the tax burden contemplated under the other methods discussed above, it is evident that there is still a substantial additional burden compared with the present system. Also, it should be noted that in practice many small companies now minimize total taxes by paying various salaries and directors' fees depending upon marginal personal tax rates, so that in effect, this election is at present being utilized to a great extent. However, this election would provide certainty of the right to this treatment for borderline cases.

Higher Dividend Tax Credit

Increasing the dividend tax credit on dividends paid by small income companies (say, up to $50,000 of income) would only slightly reduce the overall tax burden contemplated under the tax on retained earnings and tax-free distribution methods, and would not be applicable at all to the induced distribution method. Under the tax-free distribution method this alternative would apply only to rebates made to people whose marginal tax rates are less than the rate of dividend tax credit. Furthermore, this proposal would be effective only in respect of distributions, and would not directly assist companies in preserving working capital. It would of course be an incentive to distribute.

Under this alternative, companies would have to establish their eligibility for the higher credit in order to eliminate the associated company problem. Eligibility could be established in the same manner as outlined above. As indicated above, the problem of how to deal equitably with companies whose earnings just exceed the $50,000 income limit still exists.

It is difficult to assess the cost of increasing the tax credit to, say, 40% for dividends issued by companies earning $50,000 or less. However, <u>1962 Taxation Statistics</u> (for 1960) indicates that companies in this earning bracket accounted for approximately one tenth of all cash dividends paid by profit companies. If this same percentage is applied to the figure for total dividends received by individuals in 1960 as in <u>1962 Taxation Statistics</u> (approximately $315 million) we obtain a very rough estimate that $31 million in net dividends were received by tax-paying Canadian individuals from companies earning less than $50,000. An increase of 20% in the dividend tax credit would therefore cost approximately $6 million.