Osgoode Hall Law Journal

*Volume 16, Number 1 (June 1978)*

Article 6

# Tax Reform: The Continuing Challenge

Wolfe D. Goodman

# TAX REFORM — THE CONTINUING CHALLENGE

By Wolfe D. Goodman*

Everyone who was involved in the decade of intense activity in the area of tax reform which began with the appointment of the Carter Commission in 1962[1] and ended in 1971 with the enactment of Bill C-259, the Income Tax Amending Bill,[2] must struggle against the weariness that this activity engendered, if tax reform is not to become a dead issue. It must not be allowed to die, because the basic criticisms of our federal taxation system which were expressed by the Carter Commission in its 1966 Report[3] are still applicable to the present system; indeed, in a number of cases, the system has become even more inequitable, and reform just as necessary.

While equity is not the only criterion by which a tax system is to be judged, since simplicity and ease of administration and the provision of appropriate tax incentives must also be considered, a grossly inequitable tax system is simply unacceptable. It is astonishing that the Canadian people have been prepared to accept, as part of the allegedly reformed *Income Tax Act*,[4] a system which so obviously and so markedly departs from the principle of taxing in accordance with ability to pay. While other examples could be selected for the purpose of illustrating this situation, this article will concentrate on the integration of corporate and individual taxation, an area in which we seem not merely not to have made any progress towards greater equity since 1971, but to have actually retrogressed.

It will be recalled that under the *Income Tax Act*[5] prior to the major tax reforms of 1971, corporations in Ontario were subject to a corporate tax rate of 23 per cent (11 per cent federal tax and 12 per cent Ontario tax) on the first $35,000 per year of taxable income from any source[6] and to a

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* Mr. Goodman, Q.C., D.Jur., is a member of the firm Goodman and Carr, Toronto, Ontario.

1 Order-in-Council, PC 1962-1334.

2 *An Act to Amend the Income Tax Act*, S.C. 1970-71-72, c. 63.

3 Can. *Report of the Royal Commission on Taxation* (Ottawa: Queen's Printer, 1966) [hereinafter Carter Report].

4 S.C. 1970-71-72, c. 63.

5 *Income Tax Act*, R.S.C. 1952, c. 148, as amended.

6 *Income Tax Act*, R.S.C. 1952, c. 148, s. 39(1) as amended by S.C. 1957-58, c. 17, s. 4(1); S.C. 1961, c. 17, s. 5(1).
*Income Tax Act*, R.S.C. 1952, c. 148, s. 40(1) as amended by S.C. 1952-53, c. 40, s. 59; S.C. 1956, c. 39, s. 9; S.C. 1958, c. 32, s. 17; S.C. 1960, c. 43, s. 12; S.C. 1960-61, c. 49, s. 19(1); S.C. 1962-63, c. 8, s. 9(1); and S.C. 1966-67, c. 91, s. 9(1).
*Old Age Security Act*, R.S.C. 1970, c. 200, s. 24(5).
*Corporations Tax Act*, R.S.O. 1970, c. 91, s. 5(1).

rate of 52 per cent (40 per cent federal tax and 12 per cent Ontario tax) on the excess of taxable income over $35,000.[7] In addition, Canadian resident individuals who received dividends from taxable Canadian corporations were entitled to a dividend tax credit against their ordinary tax liability of 20 per cent of the amount of such dividends.[8] Finally, for each dollar of ordinary dividends paid, a Canadian corporation was entitled to elect to pay a special 15 per cent tax on a further dollar and to distribute the remaining 85 per cent to shareholders as a non-taxable distribution.[9]

This system was strongly criticized by the Carter Commission in its 1966 Report.[10] The Carter Commission commented on the dual rate structure, "the determination of eligibility for, and the prevention of abuse of, the provision has been the source of endless difficulty in the fifteen years since the dual rate was introduced."[11] It also pointed out that where corporate income was subject to tax at the higher corporate rate, the combined burden of corporate and individual taxes on Canadian resident individual shareholders in low tax brackets was enormously greater than the taxes they would have paid on the same amount of income earned directly (more than 2½ times as much, in some cases), while the combined burden on shareholders in high tax brackets could be as much as 1/5th less than on the same amount of income earned directly.[12] On the other hand, if corporate income were subject to tax at the lower corporate rate and if maximum advantage were taken of a 'mix' of salary, dividends and special distributions, the combined burden on shareholders in low tax brackets was similar to that on an income earned directly, but the combined burden on shareholders in middle tax brackets was about 1/5th less and on those in high brackets, about 1/10th less than on income earned directly.[13]

In order to eliminate these inequities, the Carter Commission proposed a system of integrating corporate and individual taxes, so that the combined burden of taxes at the corporate and shareholder level on distributed corporate profits would equal the burden on the same amount of income earned directly by the individual, without the interposition of a corporation.[14] In order to avoid the accumulation of income in corporations by individuals in

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[7] *Income Tax Act*, R.S.C. 1952, c. 148, s. 39(1) as amended by S.C. 1957-58, c. 17, s. 4(1); S.C. 1959, c. 45, s. 13(1); and S.C. 1960-61, c. 17, s. 5(1).
*Income Tax Act*, R.S.C. 1952, c. 148, s. 40(1) as amended by S.C. 1952-53, c. 40, s. 59; S.C. 1956, c. 39, s. 9; S.C. 1958, c. 32, s. 17; S.C. 1960, c. 43, s. 12; S.C. 1960-61, c. 49, s. 19(1); S.C. 1962-63, c. 8, s. 9(1); and S.C. 1966-67, c. 91, s. 9(1).
*Old Age Security Act*, R.S.C. 1970, c. 200, s. 24(5).
*Corporations Tax Act*, R.S.O. 1970, c. 91, s. 5(1).

[8] *Income Tax Act*, R.S.C. 1952, c. 148, s. 38(1) as amended by S.C. 1952-53, c. 40, s. 57(1); S.C. 1957, c. 29, s. 11; and S.C. 1958, c. 32, s. 16.

[9] *Income Tax Act*, R.S.C. 1952, c. 148, s. 105.

[10] Carter Report, *supra* note 3, Volume IV, at 617.

[11] *Id.*, at 94.

[12] *Id.*, at 618, 619.

[13] *Id.*

[14] Carter Report, *supra* note 3, *passim*.

high tax brackets, the corporate tax rate would be set at the same level as the maximum individual rate of 50 per cent.

In essence, the Commission's technique for achieving integration was very simple. Assume that a corporation earned $100, on which it paid $50 tax. When it distributed a dividend of the remaining $50, the shareholder would be deemed to have received a gross dividend of $100, in respect of which $50 tax had already been paid on his behalf. If he was taxed at a marginal rate of 50 per cent, he would pay no more tax; but, if he was taxed at a lower marginal rate, he would receive a refund of part of the tax which had been paid on his behalf.

The system proposed by the Carter Commission was generally similar in effect to the method of taxing investment income of private corporations which was enacted in 1971, as modified by the *Income Tax Amending Act* of 1977[15] which implements the Federal Budget of March 31, 1977. As so modified, the theory is that $100.00 of investment income, initially bears $50.00 of corporate tax. However, $16.67 of refundable dividend tax on hand (RDTOH) is created, which is refunded at the rate of $1.00 for every $4.00 of dividends paid. Accordingly, commencing in 1978, the corporation can distribute a dividend of $66.67, consisting of $50.00 of after-tax income and $16.67 of refunded RDTOH. This dividend is then grossed-up by 50 per cent and treated as a gross dividend of $100.00, on which $33.33 tax has already been paid. Only a shareholder in a personal tax bracket higher than 33 1/3 per cent will have additional tax to pay, while one in a lower bracket can offset the excessive tax against his tax liability on income from other sources, if any.

Viewed in this abstract manner, it is difficult to understand why the Carter Commission's integration proposals (which were initially adopted by the federal government in its White Paper of 1969[16]) created such opposition from taxpayers wishing to retain the existing dividend tax credit system that the government was forced to drop these proposals and to adopt instead a modified dividend tax credit. The reason for the opposition is that it was inherent in the Commission's integration proposals that credit should be given to shareholders only for taxes actually paid by the corporation. The shareholders of corporations in the resource industries, which frequently paid little or nothing in income taxes, because of generous deductions for depletion and exploration and development expenses; and the shareholders of corporations with extensive foreign operations, carried on by foreign subsidiaries or branches, which paid little or nothing in Canadian taxes in respect of these operations, would be subject to much greater taxation of their dividends under the integration proposals than under the existing dividend tax credit system.

Under the modified dividend tax credit system which Canada adopted in 1971, Canadian resident shareholders became entitled to the benefit of the credit in respect of all taxable dividends received from a Canadian corpora-

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[15] *Income Tax Act*, S.C. 1970-71-72, c. 63, ss. 82(1), 121, as amended by (Bill C-11) S.C. 1977-78, c. 1, ss. 36, 58.

[16] Can. *Proposals for Tax Reform* (Ottawa: Queen's Printer, 1966).

tion, whether or not the corporation actually paid any Canadian taxes.[17] For example, assume that a Canadian corporation receives a dividend of $1,000 from its wholly-owned Ruritanian subsidiary, subject only to Ruritanian withholding tax of $50. Even though the Canadian corporation will pay no Canadian tax on this dividend, if the remaining $950 is then distributed as a dividend to a Canadian resident shareholder under the rules enacted in the 1977 *Income Tax Amending Act*[18] he will be treated as having received a gross dividend of $1,425 on which $475 tax has already been paid on his behalf. If he is in a 50 per cent marginal personal tax rate, he will have to pay only $237.50 in tax on this dividend, even though Canada collected no tax at all at the corporate level.

It is perhaps arguable that it is inherent in our system of tax incentives for resource industries that tax concessions at the corporate level should not be taxed away when resource industry profits are distributed to shareholders: If they are taxed away on distribution to shareholders they become merely a tax deferral which, while significant, still offers considerably less incentive to invest in these industries. No such justification, however, can exist for extending the benefit of the dividend tax credit to Canadian corporations which pay no Canadian tax on the income they earn on their foreign operations.

In 1975, when the United Kingdom enacted its imputation system,[19] (really another name for a dividend tax credit), in order to provide a substantial degree of integration of corporate and individual taxation, care was taken to ensure that this situation would not arise. Advance corporation tax (ACT) of £35 is payable currently by a corporation when it pays a dividend of £65. As its name implies, advance corporation tax is treated as a prepayment of the corporation's tax liability. Consequently, if the dividend has been declared out of income which has not actually borne U.K. corporation tax, the ACT which the corporation pays in respect of the dividend will not be offset against its current tax liability, but it can be carried forward and offset against any future liability. The U.K. system has the merit of avoiding much of the complexity of the integration system proposed in the Carter Commission's Report[20] or in the 1969 White Paper,[21] while at the same time protecting the Revenue against having to grant shareholders a dividend tax credit in respect of corporate taxes which have not actually been paid. It would not be unduly difficult to modify this system for Canadian use. In fact, the Carter Commission's proposals included a somewhat similar provision in respect of corporate income from foreign sources.[22] If Canada were to adopt the U.K. system, it might also require a sort of notional advance corporation tax for resource industries which benefit from tax incentive legislation, if it were considered essential to pass their incentives through to shareholders.

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[17] *Income Tax Act*, S.C. 1970-71-72, c. 63, ss. 82(1), 121 as amended by S.C. 1977-78, c. 1, ss. 36, 58.

[18] S.C. 1977-78, c. 1.

[19] *Finance Act*, 1972, 20 & 21 Eliz. 2, c. 41, ss. 84, 86.

[20] *Supra* note 3.

[21] *Supra* note 16.

[22] Carter Report, *supra* note 3, Volume IV, at 89.

The Canadian system of full integration for investment income of private corporations, but only partial integration for active business income, defies common sense. A private corporation earning $100,000 of investment income, is, in theory, subject to corporate tax of $50,000, which creates $16,667 of RDTOH (under the provisions in the 1977 *Income Tax Amending Act*[23]). It can distribute a dividend of $66,667 to its shareholders, which is grossed-up to $100,000 in their hands. If they are in a 50 per cent personal marginal tax rate they will, in theory, pay an additional $16,667 of personal tax, so that they will have $50,000 after tax income out of the $100,000 of corporate investment income, exactly the same amount as if they had earned this income personally. This is entirely reasonable.

Actually, this is not the exact result, since both corporate and individual rates differ slightly from these figures. If we use the current rates of 36 per cent federal corporation tax[24] and 12 per cent provincial corporation tax[25] and if we assume a federal individual tax rate of 35 per cent and a provincial individual tax rate of 44 per cent of the federal tax, then, as the following calculation shows, there is a slight advantage in earning investment income indirectly through a corporation rather than directly.

| | |
|---|---|
| Corporate income | $100,000 |
| Corporate tax @ 48% | 48,000 |
| After-tax corporate income | 52,000 |
| RDTOH | 16,667 |
| Total possible dividend | 68,667 |
| Gross-up 50% | 34,333 |
| Grossed-up dividend | 103,000 |
| Gross federal tax @ 35% | 36,050 |
| Less: federal dividend tax credit | 25,750 |
| Net federal tax | 10,300 |
| Provincial tax @ 44% | 4,532 |
| Total personal tax | 14,832 |
| After-tax income | 53,835 (53.83 percent) |

If $100,000 of investment income had been earned directly by an individual in a 35 percent federal marginal tax rate (combined federal and provincial rate, 50.4 percent), the tax would have been $50,400 and the after-tax income would have been only $49,600, a difference of $4,235, indicating that an individual earning investment income indirectly through a corporation has over 8 percent more after-tax income than one earning such income directly.

Contrast this with the taxation of $100,000 of Canadian active business income which is earned by a corporation which has already used up its small business deduction[26] or which does not qualify for this deduction:

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[23] S.C. 1977-78, c. 1.

[24] *Income Tax Act*, S.C. 1970-71-72, c. 63, ss. 123(e), 124.

[25] *Corporations Tax Act*, S.O. 1972, c. 143, s. 102.

[26] *Income Tax Act*, S.C. 1970-71-72, c. 63, s. 125.

| | |
|---|---|
| Corporate income | $100,000 |
| Corporate tax @ 48% | 48,000 |
| After-tax corporate income | 52,000 |
| Gross-up at 50% | 26,000 |
| Grossed-up dividend | 78,000 |
| Gross federal tax @ 35% | 27,300 |
| Less: federal dividend tax credit | 19,500 |
| Net federal tax | 7,800 |
| Provincial tax @ 44% | 3,432 |
| Total personal tax | 11,232 |
| After-tax income | 40,768 (40.77 percent) |

When one considers that corporations which carry on active business in Canada usually employ substantial numbers of people and provide further employment through their purchases of Canadian materials, equipment and services, it is difficult to understand why a shareholder in a Canadian corporation earning the same amount of investment income, perhaps by merely clipping bond coupons, ends up with 32 percent more after-tax income than a shareholder in a corporation which actively participates in the Canadian economy.

This situation is ameliorated to some extent, but not entirely eliminated, if the corporation carries on an active business which qualifies for the tax reduction in respect of manufacturing and processing profits.[27]

| | |
|---|---|
| Corporate income | $100,000 |
| Corporate tax @ 42% | 42,000 |
| After-tax corporate income | 58,000 |
| Gross-up @ 50% | 29,000 |
| Grossed-up dividend | 87,000 |
| Gross federal tax @ 35% | 30,450 |
| Less: federal dividend tax credit | 21,750 |
| Net federal tax | 8,700 |
| Provincial tax @ 44% | 3,828 |
| Total personal tax | 12,528 |
| After-tax income | 45,472 (45.47 percent) |

While the goal of encouraging manufacturing and processing industries may be commendable, it should be remembered that since World War II there has been a significant reduction in the percentage of the labour force employed in such industries and an increase in the percentage of those employed in service industries. This means that shareholders in the service industries, upon which we are primarily relying to expand employment, are bearing a relatively greater burden of taxation.

When corporate income fully qualifies for the small business deduction

[27] *Income Tax Act*, S.C. 1970-71-72, c. 63, s. 124.

and also qualifies for the 9 percent Ontario corporations tax rate[28] for small businesses, the total corporate tax is only 24 percent. In this case, there is actually a substantial advantage, over 20 percent, in carrying on business through a corporation rather than directly, as a proprietor or partner.

| | |
|---|---|
| Corporate income | $100,000 |
| Corporate tax @ 24% | 24,000 |
| After-tax corporate income | 76,000 |
| Gross-up @ 50% | 38,000 |
| Grossed-up dividend | 114,000 |
| Gross federal tax @ 35% | 39,900 |
| Less: federal dividend tax credit | 28,500 |
| Net federal tax | 11,400 |
| Provincial tax @ 44% | 5,016 |
| Total personal tax | 16,416 |
| After-tax income | 59,584 (59.58 percent) |

The figure of $59,584 of after-tax income shown above should again be compared with the after-tax income of $49,600 which is available to a proprietor or partner carrying on a similar business in unincorporated form. Particularly when one bears in mind the advantage of being able to accumulate income in the corporation, at a tax cost of only 24 percent, and to defer payment of dividends until it is convenient to do so, the tax advantage of operating through a corporation seems indefensible.

This extraordinary disparity is enhanced if the small business corporation also qualifies for the tax reduction in respect of manufacturing and processing profits.

| | |
|---|---|
| Corporate income | $100,000 |
| Corporate tax @ 19% | 19,000 |
| After-tax corporate income | 81,000 |
| Gross-up @ 50% | 40,500 |
| Grossed-up dividend | 121,500 |
| Gross federal tax @ 35% | 42,525 |
| Less: federal dividend tax credit | 30,375 |
| Net federal tax | 12,150 |
| Provincial tax @ 44% | 5,346 |
| Total personal tax | 17,496 |
| After-tax income | 63,504 (63.50 percent) |

It seems impossible to justify a situation in which an individual can increase his after-tax income on $100,000 of manufacturing profits from $49,600 to $63,504, an increase of over 28 percent, simply by incorporating his business. Nor is this the only advantage which he obtains by incorporating. The profits which the unincorporated proprietor reinvests in his business will have borne tax at his personal rate, which we have assumed to be 50.4 per-

[28] *Corporations Tax Act*, S.O. 1972, c. 143, s. 106(a) as amended by S.O. 1976, c. 32, s. 11; amended S.O. 1976, c. 63, s. 1.

cent, while the profits which the incorporated manufacturer reinvests have borne tax of only 19 percent.

The federal government's refusal to adopt a dividend tax credit system which would provide, in effect, for full integration of corporate and individual taxation is sometimes defended on the basis that corporation tax is probably not fully borne by shareholders and that it may be in part shifted back to employees and suppliers and in part shifted forward to customers. However, when Parliament decides how much income tax a taxpayer should pay, it does not appear, usually, to take into account whether or not he can recoup his tax burden in whole or in part. The Carter Commission therefore quite sensibly rejected this line of argument.[29] In any event, it is much more likely that it was simply the loss of tax revenue which a system of full integration would have entailed which persuaded the government to adopt the present system in 1971.

In theory, the present system provides for full integration of income earned from an active business and fully qualifying for the small business deduction; partial integration for income earned from an active business which does not so qualify; and full integration for investment income earned by a private corporation. In practice, however, as the illustrations given above demonstrate, the present system falls short of even these limited objectives. Active business income of a corporation qualifying for the small business deduction is likely to bear less total tax than similar income earned by an individual and this disparity is enormously increased if the corporate income is derived from manufacturing or processing. On the other hand, even with the far more generous dividend tax credit enacted as a result of the Federal Budget[30] of March 31, 1977, active business income which is not derived from manufacturing or processing and which is earned by a corporation which does not qualify for the small business deduction still suffers a substantial burden of double taxation, even though it is the expansion of such businesses which may have to be relied upon to an increasing extent to provide Canadians with new jobs.

Clearly, we are even further removed today than we ever were from the Carter Commission's very desirable goal of subjecting income earned indirectly through a corporation and distributed to a shareholder to the same total amount of corporate and individual taxes as income earned directly by an individual. It behooves us to ask how we managed to create this unfortunate result and whether we shall ever be able to achieve this goal. It is submitted that short term political expediency and an undue concentration on tax incentives has created most unjust results. A self-assessment system of income tax, such as we have become accustomed to in this country, ultimately depends on the vast majority of the population considering that the burden is being shared fairly equitably by all segments of the population. When more Canadians realize how grossly unfair our tax system has become the self-assessment system is likely to break down and we shall then require a vast army of tax collectors to enforce the law.

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29 Carter Report, *supra* note 3, Volume I at 27; Volume IV at 27.

30 Budget message, March 31, 1977.