

1986

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Recommended Citation

Brooks, Neil. "Taxation of Closely-Held Corporations: The Partnership Option and the Lower Rate of Tax." *Australia Tax Forum* 3.4 (1986): 381-509.

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Taxation of Closely—Held Corporations: The Partnership Option and the Lower Rate of Tax

Neil Brooks *

Introduction

PURPOSE

Tax theoreticians and policy-makers have agreed for at least the past forty years that tax theory provides no justification for imposing a separate tax on the income of corporations. However, most have also conceded that there are compelling practical reasons for such a tax, including, the administrative difficulty of attributing undistributed corporate income to shareholders for the purpose of taxing it at their individual marginal rates, the convenience of raising revenue by taxing the thoroughly documented profits of a small number of corporations, the difficulty of changing a system of tax to which the economy has adjusted, and the well accepted convention of indirectly taxing non-residents by taxing the profits of domestic corporations in which they have an interest.

The arguments for and against some form of separate corporate income tax, with or without dividend relief, will not be reiterated in this paper.¹ Instead, the paper addresses the narrower issue of whether, whatever the method of taxing corporations generally, special provision should be made for closely-held corporations. Corporations vary in size from the incorporated proprietorship, in which a single shareholder is in all respects the owner of the business, to the multinational corporation, in which shareholders are little more than passive

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1. For a careful review of the recent Australian literature see R. Krever, 'Companies, Shareholders and Tax Reform' (1985) 20 *Taxation in Australia* 163; see more generally, C.E. McLure, Jr., 'Corporate Tax Integration for Australia: Pros and Problems' in J.G. Head, ed. *Taxation Issues of the 1980s* (Sydney: Australian Tax Research Foundation, 1983), chap. 12.

investors. Also, corporations embrace widely differing shareholder structures and business circumstances. Some are simply incorporated pocketbooks, others carry on diverse business activities in which there is a need for huge capital investments. Finally, compounding the difficulties of imposing a single separate tax on corporations, corporate income bears no relationship to the income of its shareholders. High-income individuals often own small corporations, low-income individuals are often shareholders in large corporations. Little wonder then, as the Canadian Government lamented in its 1971 *Proposals for Tax Reform*, 'it has always been difficult to design a tax system that can be applied appropriately to all ... (the) different types of corporations and corporate relations'.²

Although the drafters of most modern income tax statutes differentiate between widely-held and closely-held corporations for a number of purposes, only those implicit in the following two questions will be discussed in the paper: (1) Should closely-held corporations be given the option to be taxed in the same manner as partnerships? (2) Should a lower rate of corporate tax be imposed on the first slice of a corporation's earnings (for example, the first \$100 000) in order to reduce the tax burden on closely-held corporations relative to widely-held corporations? Small business has a litany of complaints against the tax system, but these are the two most significant general tax policy issues remaining for closely-held corporations.³ Two preliminary matters will be clarified in this introduction: the definition of the term 'closely-held' corporation, and the type of analysis raised by the two questions posed.

2. Canada, Hon. E.J. Benson, Minister of Finance, *Proposals for Tax Reform* (Ottawa: Queen's Printer, 1969), at 45, para. 4.4.

3. Two other general corporate tax issues usually discussed in the context of closely-held corporations but that will not be reviewed in this paper are: (1) whether there should be, and if so the design of, a tax on accumulated profits; and, (2) how to prevent dividend-stripping or, as it is called in the United States, bailouts. One reason these issues are not dealt with in this paper is that they have been the subject of systematic treatment in countless publications. For Australia see, in particular, Y.F.R. Grbich and B. Cooper, *Undistributed Profits Tax: A Critical Analysis* (Sydney: Taxation Institute, Research and Education Trust, 1979); and R.W. Parsons, 'An Australian View of Corporations Tax' [1967] *British Tax Review* 14. Secondly, these two problems are to a large extent being finessed in modern tax systems. The first issue only arises in income tax systems in which the individual marginal tax rates are higher than the corporate tax rate. But increasingly, top individual marginal rates are being lowered to about equal to or even less than the corporate tax rate. The second issue arises because of the tax advantages of extracting corporate earnings in the form of capital gains instead of dividends. But increasingly, the individual tax rate on dividend income is being reduced and, with some exceptions (notably Canada), the tax rate on capital gains is being increased.

DEFINITION OF CLOSELY-HELD CORPORATION

The term closely-held corporation is not used here in any precise sense, but simply as a generic term to refer to corporations that are variously called 'close corporations', 'one-person corporations', 'family corporations', 'small firms', or 'incorporated partnerships'. In most contexts, the term refers to corporations whose voting shares are held by a single shareholder or a closely-knit group of shareholders, whose shares are not publicly traded, and in which management and ownership are substantially identical. Normally, closely-held corporations are incorporated by entrepreneurs who wish to conduct their business essentially as sole proprietorships or partnerships but who wish to realise the advantages of incorporation, in particular, limited liability. In other contexts, the term is used simply to refer to a small business firm, whether measured in terms of income, assets or persons employed.

Although the term closely-held corporation is increasingly used in many areas of law regulating corporate activities, there is no reason why it should be defined the same in each area. Ultimately one of the important goals of the commercial legal structure is to further the growth and development of small business.⁴ However, the countervailing interests in each subject area are likely to be different. Thus, for example, the interests at stake in determining when the public interest requires that a securities offering be registered, or when a corporation should be free to regulate its internal affairs without regard to the normal conventions of company law, might have little relevance to the interests at stake in providing special tax treatment to small firms. Moreover, in this article, the term might have a different meaning in relation to each question posed. The characteristics of a corporation that should be entitled to elect to be taxed as a partnership might be quite different than the characteristics of a corporation that should be entitled to be taxed at a low rate of tax.

TYPES OF ANALYSIS AND SUMMARY OF CONCLUSIONS

The second preliminary matter that needs clarification is the type of analysis required to answer each of the questions posed. The most significant conceptual advance in tax policy analysis in recent years has been the development of the tax expenditure concept and the recognition of the full implications of the fact that income tax acts (indeed all tax statutes) are composed of two analytically distinct kinds of provisions: technical tax provisions and tax expenditure

4. See H.J. Haynsworth, 'The Need for a Unified Small Business Legal Structure' (1978) 33 *Business Lawyer* 849.

provisions. Technical tax provisions establish the basic structural elements of the tax system: the units to be taxed, the tax base, the rate structure, the accounting period and the rules of procedure. They are designed solely to raise revenue (or more accurately to reduce private spending) in an equitable, economically efficient, and administratively simple manner.

In addition to technical tax rules, tax acts frequently contain a myriad of rules designed to provide implicit subsidies to taxpayers who alter their behaviour in ways that the government wishes to encourage or those deserving of relief for some other reason. These kinds of provisions have become known as tax expenditures. They take the form of tax deductions, tax credits, lower rates of tax, or provisions that allow tax to be deferred. Tax expenditures cannot be understood or evaluated using traditional tax criteria such as equity, neutrality and simplicity. Indeed, their explicit purpose is to change people's behaviour from what it would be in a tax-free world. They must be evaluated using budgetary criteria - the same criteria used in evaluating direct government spending programs: target-efficiency, cost-effectiveness, distributional incidence, and so on.⁵

In these terms, the question of whether closely-held corporations should be allowed to elect to be taxed like a partnership is essentially a technical tax policy issue. The issue must be resolved by assuming the basic structure of the tax system in relation to partnerships and corporations generally and then attempting to resolve the proper classification of closely-held corporations by reference to traditional tax criteria. The method of analysis can be clarified by contrasting the normal tax treatment of partnerships with that of corporations. In most income tax systems partnerships are not treated as separate taxpaying entities. Although, for administrative reasons, most tax systems require the income of partnerships to be computed at the partnership level, the income of the partnership is notionally passed through each year to the individual partners, whether or not they actually withdraw the income from the partnership. On the other hand, in most income tax systems the corporation is treated, to some degree at least, as a separate taxpaying entity. So the issue can be restated: In a technical tax system in which partnerships are taxed on a pass-through basis and corporations are taxed at least in part on a separate entity basis, how should closely-held corporations be taxed?

To anticipate my conclusion on this issue, the tax policy case for taxing closely-held corporations as partnerships, that is on a pass-through instead of an entity basis, can be simply

5. See generally, S.S. Surrey and P.R. McDaniel, *Tax Expenditures* (Cambridge: Harvard University Press, 1985).

stated. First, there are no theoretical, only pragmatic, reasons for taxing corporations on an entity basis. Second, none of the pragmatic reasons for imposing an entity-basis tax on corporations apply to closely-held corporations. Furthermore, if closely-held corporations are not allowed to elect to be taxed on a partnership basis the corporate tax system will needlessly distort the decision as to which legal form a taxpayer uses to carry on business and will reduce risk-taking. An additional argument for a partnership election is that it will benefit small businesses by increasing their access to tax expenditures.

I also argue, more generally, that if a tax system provides two models for taxing entities, the pass-through model and the separate-entity model, entities should not be classified for purposes of determining which model applies to them on the basis of their private-law form or even the nature of the legal relationships created between its owners and third parties. Instead, they should be classified on the basis of criteria that relate to the reasons for distinguishing between them for tax purposes. These reasons relate largely to administrative considerations.

The question of whether closely-held corporations should be taxed at a lower effective rate than widely-held corporations raises a budgetary issue not a tax policy issue. Should small businesses be subsidised by the government in the form of a special low rate of corporate tax? This question can be divided analytically into three more specific questions: (1) Is there a need to subsidise small businesses? (2) If so, what policy instrument should be used? (3) If the tax system is to be used to provide such a subsidy, how should the subsidy be designed? Again, to anticipate my conclusion, I argue that even if a positive response is given to the first two questions, the low rate of tax is an inefficient and inequitable way of providing a subsidy to small business. In making this argument I also make a more general point; namely, that although most incentive programs can be written as a tax expenditure or a direct spending program, almost invariably a direct spending program is to be preferred. The use of the tax system to deliver a subsidy imposes severe constraints on the design of the subsidy program and threatens the tax system's revenue raising functions.

OUTLINE OF PAPER

The last two parts of the paper analyse the arguments for a partnership election and a lower rate of tax for closely-held corporations. The next four parts review the history of these issues in the United Kingdom, United States, Canada and Australia. This review is not intended to be an exercise in social history or comparative jurisprudence. It is a

straightforward description of how these issues have arisen and a review of the arguments and concerns that have been expressed in these countries for and against these two forms of special treatment for closely-held corporations. Some of these countries have had a good deal of experience grappling with these issues. The United States, for example, has had a partnership election for closely-held corporations since 1958. The election has been subject to numerous evaluations. Canada has had a rich experience with trying to target a lower rate of corporate tax on closely-held corporations that need their retained earnings for expansion. Indeed, throughout the 1960s and 1970s the issue of whether, and if so how, small businesses should be subsidised through the tax system has preoccupied tax policy-makers in Canada.

Although the review of the history of the corporate tax in each country concentrates on the tax treatment of closely-held corporations, in places a detailed review of the general development of the corporate tax system was necessary. The problems of closely-held corporations can only be understood against the background of the more general corporate tax system. Also, since Australia has recently partially integrated its income tax on corporations and shareholders, the history of the general development of the corporate tax system in these other jurisdictions might be of some interest. In particular, it is somewhat interesting to note that in spite of the fact that an un-integrated corporate tax system is referred to as the 'classical' system, each of these countries initially adopted some form of integrated system. And, with the exception of the United Kingdom, which adopted the classical system in 1965 explicitly to encourage corporate retentions (an integrated system was re-introduced in 1972), each adopted the classical system for reasons unrelated to the economic or even conceptual reasons that have been given by commentators to justify such a system. Another general point that the review highlights is the extent to which these countries borrowed and relied upon each other's experiences as they contended with the almost intractable policy issues posed by the corporate tax.

United Kingdom

The United Kingdom has a lower rate of corporate tax for the first £100 000 of a corporation's income. This dual corporate rate structure was introduced in 1972. Although a partnership election for small firms has been debated from time to time, particularly since 1965, it has never been enacted.

1803 TO 1965: THE INTEGRATED SYSTEM

The genesis of the taxation of corporations and shareholders in the United Kingdom can be traced to Addington's *Income Tax Act* of 1803.⁶ Addington viewed the income tax as being a levy solely upon individuals; however, as part of his plan for a comprehensive system of taxation at source, he imposed a tax on the income of corporate bodies to act as a withholding tax on dividends. When dividends were paid to security holders, since tax had already been paid at the corporate level, they were received tax-free.⁷ Aside from the application of tax principles, it is not surprising that corporations were not treated as separate taxpaying entities under the early English income tax since companies were regarded at that time as being more in the nature of partnerships than separate entities.⁸ A clear statement of this early conception of the corporate tax was given by the Royal Commission on the Taxation of Profits and Income:

Corporation Taxation ... began as part of a tax system which contained only income tax and virtually no progression. In that setting it was a form of taxation at source, the idea being that the income was taxed as soon as it reached the

6. *Income Tax Act, 1803* (UK), 43 Geo. 3, c. 122.

7. See generally, A. Farnsworth, *Addington: Author of the Modern Income Tax* (London: Stevens and Sons Ltd., 1951), at 119-20; S. Reamonn, *The Philosophy of the Corporate Tax* (Dublin: Institute of Public Administration, 1970), pt. II, chap. 1; E.R.A. Seligman, *The Income Tax* (New York: McMillan, 1914), at 89-96. Corporate bodies subject to Addington's tax were not of course limited liability companies, which were not known until the mid-1800s, but chartered and other statutory corporations. *The Joint Stock Companies Act* (UK), 7 & 8 Vict., c. 110-11, which allowed for the incorporation of companies by a process of registration, was not passed until 1844; corporations were not given limited liability until the *Limited Liability Act, 1855* (UK), 18 & 19 Vict., c. 133; and, the first modern companies act was the *Companies Act, 1862* (UK), 25 & 26 Vict., c. 89. See L.C.B. Gower, *Gower's Principles of Modern Company Law*, 4th ed. (London: Stevens and Sons, 1979), at 41-50.

8. Indeed, as the United Kingdom Income Tax Codification Committee noted, the first edition of *Lindley on Companies*, the leading treatise on the subject, treated company law as a branch of partnership law and was entitled, *A Treatise on the Law of Companies considered as a branch of the Law of Partnership*. See United Kingdom, Financial Secretary to the Treasury, Income Tax Codification Committee, *Report*, vol. 1, Cmd. 5131 (London: HMSO, 1936), at 62. In the early cases on the taxation of dividends judges frequently noted that corporations were treated in effect like partnerships under the Act. See *Bradbury (H.M. Inspector of Taxes) v The English Sewing Cotton Company, Limited* (HL) [1923] AC 744, 769-70; 8 TC 481, 518-19 per Lord Phillimore ('the Act of 1842 has apparently proceeded on the idea that for revenue purposes a joint stock company should be treated as a large partnership, so that the payment of Income Tax by a company would discharge the quasi-partners.') Indeed, in an early tax case it was stated that a corporation simply paid the income tax as an agent of its shareholders. See *Brooke v Commissioners of Inland Revenue* (CA) 118 LTR 321, 326, 328; 7 TC 261, 273 per Swinfen Eady, LJ and Scrutton LJ at 276. The analogy was subsequently disapproved of by Viscount Cave in *Commissioners of Inland Revenue v John Blott* (HL) [1921] 2 AC 171, 201; 8 TC 101, 136.

hands of the corporation and the corporation recovered the tax for itself when distributing the income among the members. On that view it was only natural not to assess the dividend over again in the hands of the shareholders.⁹

To implement his scheme for taxing corporations and corporate distributions, Addington provided in his Act that the profits of corporations, fraternities, fellowships, companies or societies were to be computed 'before any dividend shall have been made thereof to any other person' and that all other persons 'shall allow out of such dividends a proportionate deduction in respect of the duty so charged'.¹⁰ In spite of its obscurity, the wording of this section was repeated when the income tax, which had been repealed after the Napoleonic Wars, was revived by Peel in 1842.¹¹ Also, with only slight rewording, it was re-enacted as General Rule 20 in the consolidating Act of 1918.¹² It remained the key provision in the taxation of corporate distributions until the corporate tax was reformed in 1965.¹³

9. United Kingdom, Royal Commission on the Taxation of Profits and Income, *Final Report*, Cmd. 9474 (London: HMSO, 1955), at 15, para. 50. See also the following description by a group of members, including the well known public finance scholar, A.C. Pigou, of the Royal Commission on the Income Tax: 'The income tax is not a corporation tax. It is a tax upon the incomes or profits of individuals and though for convenience it is assessed in the first instance upon companies in which they hold interests the amount of it is always adjusted to the income not of the corporation but of the individual shareholders. It is true that when a company receives profits they are taxed at the standard rate, but it is universally recognised that the reason for this is not that the company as such is liable to income tax but that it is impracticable to tax the separate profits at the rates to which the separate shareholders to whom they ultimately belong are respectively liable.' United Kingdom, Royal Commission on the Income Tax, *Report*, Cmd. 615 (London: HMSO, 1920), at 164.

10. *Income Tax Act, 1803* (UK), 43 Geo. 3, c. 122, s.127.

11. *Income Tax Act, 1842* (UK), 5 & 6 Vict. c. 35, s.54.

12. *Income Tax Act, 1918* (UK), 8 & 9 Geo. 5, c. 40, Sched. E., s.20.

13. Farnsworth, in his thoroughly documented work establishing that Addington, not Pitt, was the originator of the modern income tax, notes that 'Section 127 of the 1803 Act is an interesting example of the ease with which the basic provisions of that Act have been able to be adapted to the complex operations of modern industry and finance ... this simple rule of the 1803 act has, in virtually unaltered language, been effective to deal with a type of company then quite unknown'. See Farnsworth, *supra* note 7, at 119-20.

The provision gave very little clue as to how the law was to be administered, and apparently two methods of declaring dividends developed. Under one method, a dividend was declared to be payable with a 'deduction' for the standard rate of tax. In England, the standard rate was a flat rate that was fixed annually in the *Finance Act*. The corporation withheld from the gross dividend the tax appropriate to that amount. Thus, if the corporation declared a 100 pounds dividend payable with tax deducted, and the rate of standard tax was 30 per cent, the shareholder actually received only 70 pounds. The corporation notionally retained 30 pounds to reimburse it for the tax it had paid on the earnings from which the dividend was paid. The shareholder included the total declared dividend in income, the 100 pounds, but then received a tax credit for the 30 pounds withheld at the corporate level.

Instead of declaring a dividend to be payable with deduction of tax, a corporation might declare the dividend to be 'free of tax'. In this case the

Three details of the early United Kingdom taxation of corporate distributions are significant. First, the rate of tax that the corporation could withhold, and that the shareholder received credit for, was not the rate in force when the corporate-source income was earned, but the rate in force when the dividend was paid.¹⁴ Second, the tax withheld at the corporate level was refundable if shareholders did not pay tax either because their incomes were too low or because they were tax-exempt. Third, shareholders receiving a dividend were credited with tax at the standard rate even though the corporation might not have paid any tax on the earnings out of which the dividend was paid. This could be the case if the earnings were foreign-source income and were entitled to the foreign tax credit or if the earnings were sheltered from tax at the corporate level by a tax incentive measure.¹⁵

So long as only one flat standard rate of tax was imposed on both individuals and corporations, and dividends were exempt from tax, there was no reason to treat closely-held corporations

shareholder was deemed to have received the actual dividend paid but then had to 'gross it up' at the standard rate to arrive at the amount included in income. Thus a dividend of 100 pounds 'free of tax' would be included in total income at 143 pounds if the standard rate was 30 per cent (since that amount, when reduced by the tax, would leave 100 pounds). The shareholder would then receive a credit for the amount of tax withheld at the corporate level.

The Royal Commission on the Income Tax considered in 1920 whether the payment of dividends 'free of tax' should be made illegal. It was submitted to them that this method of paying dividends was misleading, and because the 'gross up' procedure required of shareholders was confusing it undoubtedly lead to a loss of revenue. The Commission, however, concluded that such a method of paying dividends should remain legal, in part because it obscured the high rate of British tax paid by foreign shareholders. But they went on to recommend that all dividend declarations should clearly state: (a) the gross amount of distribution, (b) the income tax applicable therefor, and (c) the net amount payable by the company to the shareholder. (The Royal Commission on the Income Tax, *supra* note 9, at 39.) This recommendation was implemented by the *Finance Act, 1924* (UK), 14 & 15 Geo. 5, c. 21, s.33.

14. Although this was always the practice, it was given statutory sanction in 1927, see Financial Secretary to the Treasury, Income Tax Codification Committee, *Report, supra* note 8, at 64.
15. However, this procedure was complicated by what was called 'the net United Kingdom rate' arrangements. Under these arrangements, if a corporation paid the United Kingdom tax at below the standard rate because of the foreign tax credit, shareholders who paid tax at the standard rate received credit for the full rate. However, tax-exempt and low-income shareholders only received repayment for the amount of United Kingdom tax actually paid.

When England was considering adopting an imputation system in 1971, after adopting the classical tax system in 1965, one of the main reasons they did not simply return to the pre-1965 system was because of the unsatisfactory and complex resolution of the problems that arose when the corporation had not paid tax at the full standard rate on its earnings. See United Kingdom, Chancellor of the Exchequer, *Reform of the Corporation Tax*, Cmnd. 4630 (London: HMSO, 1971), at 2, paras 5 and 6; United Kingdom, Board of Inland Revenue, 'The Choice Between Alternative Systems' in United Kingdom, Select Committee on Corporation Tax, *Report*, HC 622 (London: HMSO, 1971), at 2-3. For a summary of the pre-1965 position, see Australian Treasury Dept., *Company Income Tax Systems* (Treasury Taxation Paper No. 9) (Canberra: AGPS, 1974), App. C., at 43-4.

any different than other corporations. All corporations were taxed, in effect, like partnerships. Low-income taxpayers who did not pay tax at the standard rate were disadvantaged by incorporating because they had to pay tax at the corporate level and then apply for a refund when the income was distributed. However, because few low-income individuals would be likely to carry on an incorporated business, and these individuals would be likely to form a vocal interest group, this presumably was never felt to be a pressing problem.

In 1910 the United Kingdom's income tax system underwent its most dramatic change: a Super-tax was imposed on individuals with high incomes.¹⁶ Corporations, however, continued to be taxed at the flat standard rate. The adoption of a graduated individual tax did not increase the pressure for concessionary treatment for closely-held corporations. Indeed, it had precisely the opposite effect. Although the Act was not explicit on this point, the courts soon held that dividends had to be included in a shareholder's income for purposes of the Super-tax.¹⁷ To avoid the Super-tax, high-income shareholders thus had an inducement to earn and retain profits in corporations. Consequently, pressure to treat corporations as partnerships, in order to tax retained corporate earnings at individual Super-tax rates, came from revenue officials. Rules for 'close corporations', which imposed an extra tax on excess retentions and attributed certain earnings directly to shareholders, were introduced in 1922.¹⁸

The United Kingdom corporate income tax rate was levied at the standard individual income tax rate until 1965. Since dividends were excluded from tax at the standard rate, the corporate income tax was completely integrated with the individual tax during this period. However, beginning in 1915, and for most subsequent years, in addition to the income tax a separate profits tax was levied on corporate income.¹⁹

16. *Finance (1909-10) Act, 1910* (UK), 10 Edw. 7., c. 8, s.66. For a brief description of the political considerations leading up to the introduction of graduation see B.E.V. Sabine, *A History of Income Tax* (London: George Allen and Unwin Ltd., 1966), chap. 8; for the definitive treatment see F. Shehab, *Progressive Taxation* (Oxford: Clarendon Press, 1953).

17. If the dividend was declared free of income tax, the shareholder had to include in income not only the dividend received but had to gross it up to also include in the income the income tax paid at the corporate level. For a discussion of the series of cases that dealt with the various issues that arose out of the need to reconcile the Super-tax with the treatment of dividends see, Financial Secretary to the Treasury, *Income Tax Codification Committee, Report*, *supra* note 8, at 63-9 and Reamonn, *supra* note 7, at 43-6.

18. *Finance Act, 1922* (UK), 12 & 13 Geo. 5., c. 17, s.21.

19. The following is a brief summary of these taxes: (1) From 1915 to 1920 an excess profits tax of 50 per cent was imposed on all business profits to help finance the war. See Sabine, *supra* note 16, at 152. (2) From 1920 to 1924 a profits tax of five per cent was imposed only on corporations in order to attempt to capture some of the expected post-war boom period profits, but was justified in part on the grounds of the advantages that incorporation bestowed on companies and the fact that corporations, unlike unincorporated businesses, were not liable to surtax. See Sabine, *supra* note 16, at 162, 166;

During most of the periods in which these profits taxes were imposed, corporations were thus paying tax at rates in excess of the standard individual rate, and since the profits taxes were not credited to shareholders when dividends were paid, there was an element of 'double tax' on corporate-source income. But, in spite of the imposition of a corporate profits tax, until 1955 there appears to have been little or no pressure to change the basic scheme for taxing corporations, and in particular, little pressure to allow closely-held corporations to be taxed as partnerships, or to provide a special low rate of tax for small businesses.²⁰ In large part this was no doubt due to the fact that since the surtax did not apply to corporations, and since the various profits taxes were for most periods quite low, often applied to both incorporated and unincorporated businesses and frequently contained a large exemption,²¹ most

see also Chancellor of the Exchequer, *Corporation Tax*, Cmnd. 8456 (London: HMSO, 1982), at 124. (3) From 1924 until 1937 corporations only paid income tax at the standard rate. (4) From 1937 until 1946 the National Defence Contribution, which was in effect a profits tax, was imposed at a rate of five per cent. It was imposed on all businesses whether or not incorporated. As its name implies its purpose was to finance the rearmament programme. See Sabine, *supra* note 16, at 192. (5) From 1939 until 1946 an excess profits tax was imposed on all business profits at a rate of 60 per cent. (6) From 1946 until 1965 a profits tax was imposed on corporations. From 1946 until 1958 this tax was imposed at a differential rate. In order to restrain inflation and to encourage productive investment in the form of ploughed-back profits, undistributed profits were taxed at a much lower rate than distributed profits. In 1946 distributed profits were taxed at a rate of 12.5 per cent while undistributed profits were only taxed at a rate of five per cent. By 1955 these rates were 30 and three per cent respectively. In 1958, following the recommendations of the 1955 Royal Commission on Profits and Income, the differential rate was abolished and a flat rate, 10 per cent profits tax was imposed. For a description of this profits tax and its rationale see the Royal Commission on the Taxation of Profits and Income, *Final Report*, *supra* note 9, chap. 20. For a summary of the objectives of the 1958 changes and the empirical evidence of its effects see Organisation for Economic Co-operation and Development, *Company Tax Systems* (Paris: OECD, 1973), at 73-87. A short history of the various profits taxes is given in Reamonn, *supra* note 7, at 41-3 and United Kingdom, Chancellor of the Exchequer, *Corporation Tax*, *supra* note 19, at 124.

20. The Royal Commission on the Income Tax, *Report*, *supra* note 9, had almost nothing to say about that taxation of corporations. In 1927 the Committee on National Debt and Taxation, *Report*, Cmnd. 2800 (London: HMSO, 1927), at 154-5, in discussing generally the effect of taxation on incentives to take risks and investment, noted the important difference between a private joint stock company which 'is virtually a partnership with limited liability' and a public company. However, it did not recommend any specific tax changes in recognition of this difference in economic function. Indeed, one of the first discussions I found of the need for a lower rate of tax for small business was contained in an article written in 1954. The author argued that since a high rate of tax disadvantages small more than large companies because of the necessity for small companies to rely on retained earnings for expansion, there should be a lower rate of tax for small corporations. D. Walker, 'Some Economic Aspects of the Taxation of Companies' (1954) 22 *The Manchester School* 1.
21. For example, in 1955, profits of 2000 pounds or less were exempt from the profits tax, which meant that most small firms did not pay the tax. See Royal Commission on the Taxation of Profits and Income, *Final Report*, *supra* note 9, at 165, para. 556.

business people were better off tax-wise if they incorporated.²² Moreover, the various profits taxes could usually be avoided by paying salaries to owner-employees.

The first careful scrutiny of the corporate tax was made in 1955 by the Royal Commission on the Taxation of Profits and Income.²³ However, the only significant alternative to the then existing system that the Commission considered was merging the corporate income and profits taxes into a single tax and then providing a dividend tax credit to shareholders equal to the standard rate of tax or the actual tax paid by the corporation, whichever was lesser.²⁴ They ultimately rejected this scheme on the grounds that it would be too complicated.²⁵

The only changes the Commission recommended in the corporate tax system were that the profits tax should be levied at a single rate (beginning in 1946 undistributed profits were taxed at a much lower rate than distributed profits) and that the £2000 exemption from the profits tax should be repealed.²⁶ With respect to this latter recommendation, the Commission stated simply that they could see no case for retention of the exemption (which in effect established a dual rate of tax for the profits tax) and that doing away with it would remove the incentive for owners of a single business to establish a number of separate companies so that each could benefit from it.²⁷ However, in recommending the elimination of the exemption they dealt briefly with two arguments that apparently were frequently made for its retention, and that were subsequently to be made as justifying both a low rate of profits income tax and a partnership election for small businesses. First, proponents had argued that a lower rate of tax should be imposed on small businesses since 'financial institutions consider the small company a bad credit risk' and therefore it is 'forced to rely on its own profits to expand its fixed and working capital'. The Commission gave what has become the standard policy response to this argument; namely, that even if this were true 'a blunt tax relief of this kind would help the small and static business as much as the small expanding one and ... [there is] no reason, even on economic grounds, why the small static business should not be subjected to the same tax system as the large companies'.²⁸

22. See D.A. Chaffey, 'Tax-Saving Remuneration to Directors' [1963] *British Tax Review* 156; and P. Bird, 'The Incorporation of Small Businesses: Effects of the Finance Act, 1965' [1965] *British Tax Review* 393 (over a wide range of income small businesses are shown to pay less tax if they were incorporated).

23. *Supra* note 9, at 13-18 and chap. 20. For a summary and commentary see A.R. Ilesic, 'The Royal Commissions' Views on Corporate Taxation' (1955) 3 *Canadian Tax Journal* 347.

24. *Supra* note 9, at 161, para. 545.

25. *Id.*, at 161, para. 546.

26. *Id.*, at 164-6. For a brief description of the profits tax see *supra* note 19.

27. *Id.*, at 165, para. 557.

28. *Id.*, at 166, para. 558.

Second, supporters of the exemption had argued that since smaller companies were more nearly akin to partnerships than to public companies, and since individual partners did not pay surtax on profits under £2000, small companies should not pay profits tax on such amounts. In responding to this argument, the Commission observed that 'the individual or the partnership assumes corporate status voluntarily, presumably because there are practical advantages in doing so, and as we have said elsewhere, it is over-simplifying the picture to equate profits tax and surtax'.²⁹ Although I will deal with the arguments for partnership treatment later it might be noted here that these arguments by the Commission were disingenuous. It is never an answer to tax equity and neutrality concerns that the taxpayer voluntarily assumes a course of action that results in higher taxes. And while it is true that the Commission had earlier stated that the profits tax could not be equated to the surtax, it was to make a point precisely opposite to the implicit point being made here. Their previous position was that the profits tax was an inadequate counterpart for the surtax.³⁰

1965 TO 1972: THE CLASSICAL SYSTEM

No change was made to the corporate income tax for over ten years. But then, in 1965, the United Kingdom departed radically from over 150 years of tradition and adopted a 'classical'³¹ corporate tax system. The introduction of a separate corporate tax by the newly elected Labour government came as no surprise. Nicholas Kaldor, a well-known economist with close ties to the Labour Party, had urged adoption of a separate corporate tax in his Memorandum of Dissent to the *Final Report of the Royal Commission on the Taxation*.³² Kaldor became a special advisor to the Chancellor when Labour formed the government in 1964. The corporate tax that was enacted in 1965 did not differ appreciably from the one he had recommended in his Memorandum of Dissent.³³

29. *Id.*, at 166, para. 559.

30. *Id.*, at 16, para. 53.

31. See A.R. Prest, 'The Select Committee on Corporation Tax', [1972] *British Tax Review* 15, at 16, n.2 where he protests this 'highly idiosyncratic use of language, given the very different system of taxing companies which operated in the UK long before other countries adopted any form of corporate income taxation'.

32. G. Woodcock, H.L. Bullock, and N. Kaldor, 'Memorandum of Dissent' in United Kingdom, Royal Commission on the Taxation of Profits and Income, *Final Report*, *supra* note 9, at 354-424.

33. See N. Kaldor, *Reports on Taxation*, vol. 1 (London: Duckworth, 1980), at xi-xii. Kaldor later wrote a long memorandum defending the 'classical system' which he submitted to the Select Committee on the Corporation Tax that was appointed by the Conservative government in 1971 to consider which form of corporation and shareholder tax integration the UK should

But not only had the Labour Party been committed to introducing a separate corporate tax, but the Conservative government itself was studying a similar reform of the corporate tax system in the early 1960s.³⁴

The Labour government reformed the corporate tax for the following reasons:³⁵ First, considerable simplification could be achieved by integrating the corporate profits and income tax into a single income tax. Second, there was a strong feeling that a reform was needed to correct the perceived anomaly that with increasingly generous investment allowances, and therefore a widening divergence between corporate profits reported for tax purposes and commercial profits, more shareholders were receiving credit for the standard rate on dividends even though the corporation had not paid tax at this rate on its earnings.³⁶ Third, and most importantly, the Labour government adopted the particular reform that they did, a separate corporate tax system, because they wanted the system to favour retentions over dividends in order to promote savings and investment.³⁷ The retention of corporate profits would be favoured not only by increasing the tax on dividend distributions (by no longer offering a credit at the standard

adopt. See United Kingdom, Select Committee on Corporation Tax, *Report*, *supra* note 15, at 248.

34. See Sabine, *supra* note 16, at 239-40.

35. *Id.*, at 242-3. See Reamonn, *supra* note 7 at 172-8, 235-43 for a review of the debate, both in the press and Parliament. For an article giving the economic justifications for the tax see the Right Honourable James Callaghan, M.P., Chancellor of the Exchequer, 'The New United Kingdom Tax Structure in Relation to the Needs of the Economy' (1965) 5 *European Taxation* 212.

36. In 1963 the Comptroller and Auditor General examined the financial records of a number of large companies and estimated that the amount of revenue lost because corporations could deduct tax at the standard rate from dividends paid out of its profits, even though the corporation might not have paid tax at that rate on its profits, was substantial. See United Kingdom, Comptroller and Auditor General, *Civil Appropriations Accounts*, Classes i-v, 1962-3 (London: HMSO, 1963), at x. A year later the Committee of Public Accounts also commented unfavourably on this aspect of the UK corporate tax system. See United Kingdom, Committee on Public Accounts, *Fourth Report*, Sessions 1963-64 (London: HMSO, 1964), at 4-6. As a matter of interest, the Committee's analysis of this problem - the treatment of corporate tax preferences in an integrated system - can only be described as rudimentary. For example, in disapproving of the practice, the Committee simply stated: 'The Treasury stated that they regarded this anomaly as an incidental consequence of the investment allowance system, which was considered to be an important instrument of economic policy. Your Committee cannot, however, agree that this judgement either justifies or disposes of a loss to the Revenue which cannot apparently be quantified but is clearly substantial. They consider it their duty to draw the attention of Parliament to the situation that exists under the law as it now stands, including the risk that tax avoidance may develop and the prospect that, with the further encouragement of industrial development by means of investment allowances these repayments are likely to increase both in area and in scale'. (*Id.*, at 6.) Compare this analysis to C.F. McLure, Jr., *Must Corporate Income Be Taxed Twice?* (Washington DC: The Brookings Institute, 1979), chap. 4.

37. In Mr Callaghan's words the classical system would provide 'a strong incentive to all companies to plough back more of their profits for expansion'. United Kingdom, *House of Commons Debates*, 6 April 1965, at col. 255.

rate) but also by lowering the tax on retentions. Even though the change was revenue neutral, under the pre-1965 system the combined income and profits tax rate on corporations was 56.25 per cent, the corporate tax rate under the new system was only 40 per cent.

No special concessions for small business were made when the classical system of corporate tax was adopted. This was one of the criticisms of the new system. For example, a prominent economist, Prest, suggested that as 'insurance against some of the more serious possible consequences of the new system' small companies should be given the option of being taxed as if they were partnerships.³⁸ However, the government did not seem to feel the need for relief for small businesses, nor did the political pressure appear to be too strong. Generally, the criticism of the 1965 Budget changes from the point of view of small businesses were directed more at the changes related to 'close companies' (the rules taxing the excess accumulated earnings of small corporations) than the switch to the classical corporate tax system. Perhaps the need for relief was not felt to be great since the corporate tax rate (40 per cent) was in fact less than the individual standard rate (42.5 per cent). If the corporation reinvested its earnings, the tax position of small corporations was better, in most cases, relative to the tax position of unincorporated businesses than under the pre-1965 system.³⁹ If the corporation distributed its earnings then there would be double tax and the effective rate would be much higher than the standard rate. However, generally it is the small business that is reinvesting its earnings that has the strongest claim, and is able to generate the most political sympathy, for tax relief.

1972 TO 1986: DIVIDEND RELIEF AND THE LOWER RATE OF TAX

The classical tax system was unacceptable to the Conservative government that was elected in June 1970. In his 1971 budget speech, the Chancellor of the Exchequer announced the government's intention to reform the structure of taxation so as to remove the discrimination against corporate distributions.⁴⁰

38. A.R. Prest, 'The Capital Gains Tax and the Corporation Tax', (London: Department of Economics and Business Studies Woolwich Polytechnic, 1967), at 17. Prest continues to argue for partnership treatment for closely-held corporations, see A.R. Prest, *Public Finance in Theory and Practice*, 5th ed. (London: Weidenfeld and Nicolson, 1975), at 372-3, 375.

39. See Bird, *supra* note 22.

40. In 1972 the Conservative government wished to stimulate the development of capital markets and to encourage corporations to raise money by issuing new shares rather than by way of self-financing. See Chancellor of the Exchequer, *Reform of the Corporation Tax*, *supra* note 15, at 7, para. 1. In both 1965 and 1972 the United Kingdom tax system was changed largely to alter the relative tax burden on dividends and retentions. There has been,

The government issued a Green Paper⁴¹ in which it set out two alternative bases for removing such discrimination, the 'split rate' system⁴² and the 'imputation' system.⁴³ The government eventually adopted the imputation system,⁴⁴ even though this was not their initial preference. However, what is more interesting for the purposes of this paper is the treatment of small business in the ensuing debate. The government, neither in its announcement of the proposed corporate tax changes, nor in the Green Paper, made any mention of special treatment for small businesses under the new regime. However, the tax treatment of small businesses arose frequently throughout the hearings of the Select Committee of the House of Commons to which the Green Paper was referred. In particular, what appeared to concern witnesses who addressed this issue was that if, as suggested in the Green Paper, the corporate rate was to be raised from 40 to 50 per cent, and then reduced to 20 per cent on distributed profits, small companies that needed to retain their earnings for expansion would be considerably disadvantaged. Two alternatives were put forth to deal with this problem: either small businesses should be taxed at a lower rate of tax on their retained earnings or they should be given the option of being taxed like a partnership.⁴⁵

The Inland Revenue agreed that under the new system small companies that needed to retain their earnings for expansion would be considerably disadvantaged. They summarised the argument made by a number of witnesses: 'This is a problem which affects small companies, whether close or not, but particularly those which have no ready access to the capital market. These companies have to plough back their profits for expansion and as a result they are likely to be relatively low distributors and so to benefit less than some other companies

not unexpectedly, an on-going debate in the United Kingdom over whether tax discrimination against undistributed profits helps investment. For a summary of some of the studies see OECD, *supra* note 19.

41. *Reform of the Corporation Tax*, *supra* note 15.
 42. Under this system, distributed profits would be liable to corporation tax at a lower rate than undistributed profits.
 43. Under this system, all corporate profits would be subject to the same rate of tax, but part of the tax on the distributed profits would be available to be set as a credit against the shareholder's own tax liability.
 44. *Finance Act, 1972* (UK), 1972, c. 41.
 45. See, for example, the following memoranda by J.F. Chown, published in the Select Committee on Corporation Tax, *Report*, *supra* note 15, at 76, para. 7, ('An increase in the rate of corporation tax on undistributed profits from 40 per cent to 50 per cent could adversely affect the smaller close company. Consideration should be given either to a reduced rate on (say the first 10,000 pounds of profits) or an option for a smaller company to be taxed as a partnership. The United States has both.');
- by the Unquoted Companies Group, App. 20, at 229; by the National Federation of Building Trades Employers and Federation of Civil Engineering Contractors Joint Working Party, App. 23, at 278-81 (suggesting the possibility of the partnership election on a lower rate of tax for small companies); by the Confederation of British Industry, App. 23, at 286 (arguing that all unquoted companies should be taxed at 40 instead of 50 per cent).

from the distribution relief which will be available under the new system'.⁴⁶ They noted, however, the following objections to the two rate system: (1) It would require complicated rules to prevent corporations from splitting into several small companies. (2) The lower rate would advantage large companies as well as small companies in a year in which their profits were low or they had qualified for substantial capital allowances. (3) It would assist not only small expanding firms but also small static firms.⁴⁷ The Inland Revenue was also unsympathetic to the need for a partnership election. In particular they argued that complex rules were not needed to provide such election since close companies could effectively achieve the same result by paying out large director's remuneration.⁴⁸

In spite of the reservations of Inland Revenue, the Select Committee concluded that there was a strong case for providing some special relief to small businesses when the new imputation system was introduced but that, '[t]his is a political problem and a political answer will have to be found for it'.⁴⁹

In addition to an inquiry into the corporate tax, in 1971 the government also established a Committee to inquire specifically into the problems of small firms. The Committee (Bolton Committee),⁵⁰ whose recommendations were intended to provide a basis for future government policy with regard to small firms, devoted a central position among its recommendations to issues relating to taxation.⁵¹ Among other things, it recommended that members of all close companies be allowed to elect, by unanimous decision of the shareholders, to be taxed as partnerships.⁵² The Committee gave two reasons for this recommendation. First, they reasoned that provisions for such an election followed from the premise that the choice of business status should not be determined by tax consequences. Secondly, and more significantly, they reasoned that a partnership election should be available so that losses realised by a company could be offset against the shareholder's personal income. In particular, they noted that this would assist in attracting private capital to the small business sector.⁵³

46. The Board of Inland Revenue, 'The Choice Between Alternative Systems', *supra* note 15, at 8, para. 17.

47. *Ibid.*

48. See Select Committee on Corporate Tax, *Report*, *supra* note 15, at 180, Questions 733-5.

49. *Id.*, at xix-xx, para. 41.

50. United Kingdom, Secretary of State for Trade and Industry, the Committee of Inquiry on Small Firms, *Small Firms* (Chairman: J.E. Bolton), Cmnd. 4811 (London: HMSO, 1971).

51. For a review see M.A. Pickering, 'Tax and the Small Firm' [1972] *British Tax Review* 163.

52. See Secretary of State for Trade and Industry, *Small Firms*, *supra* note 50, at 220, para. 13.58.

53. *Id.*, at 219, para. 13.58.

Inland Revenue apparently made its usual objection to the partnership election; namely, that it could be achieved without any complication simply by paying out all the company profits as director's remuneration. However, this point does not deal with the ability to deduct losses from the shareholder's income. Also, as pointed out by a commentator, an explicit partnership election simply carries to its logical conclusion the policy implemented by the removal of the restrictions upon the payment of directors' remunerations.⁵⁴

In response to concerns expressed by both the Select Committee on Corporate Tax and the Bolton Committee, when the government introduced its new tax system it proposed a special 'small companies rate'. In a White Paper issued when the legislation was introduced the government explained the case for this special rate as follows:

The Select Committee drew attention to the problems of small companies which because of their size found it more difficult to raise capital than larger companies, and therefore required to retain more of their profits. Such companies, they pointed out, benefit less from the reduction in the rate of tax on distributed profits than they would lose, on paying the higher rate of tax on their retentions. The government have decided therefore that small companies will be charged to corporation tax on their income at a lower rate.⁵⁵

Under the proposed legislation, companies with taxable profits in the year of up to £15 000 paid tax on retained earnings at 40 per cent instead of 50 per cent. However, the benefit of the lower rate was to be taxed back when the profits of the business exceeded £15 000. The tapering provision applied to corporations with profits between £15 000 to £25 000 so that companies with profits over £25 000 derived no benefit from the low rate of tax.⁵⁶

Providing the low rate of tax for small firms seemed to diminish any urgent need to amend the tax system further to deal with closely-held corporations. However, in 1981, in a consultative document on 'A New Form of Incorporation for Small Firms', the possibility of a partnership election for tax purposes for any new form of corporate entity specially adapted to the small family firm was raised, although not

54. See Pickering, *supra* note 51, at 169.

55. *Finance Act, 1972* (UK), s.95. See Chancellor of the Exchequer, *Reform of Corporation Tax*, *supra* note 15, at 9, para. 26. For the debate in the House of Commons, see United Kingdom, *House of Commons Debates*, 26 June 1972, at cols. 1487-1503.

56. For an explanation see J. Chown, 'Small Companies' [1973] *British Tax Review* 194.

discussed in detail.⁵⁷ The suggestion was approved by two commentators.⁵⁸

The government did not review the problem of corporate tax again in a comprehensive way until 1982. In that year, largely in response to a series of liquidity crises in United Kingdom industry during the 1970s,⁵⁹ and the economic distortions caused by the corporate tax, particularly in a period of inflation, the government released a Green Paper on corporation tax.⁶⁰ It dealt primarily with the economic effects of corporate tax concessions, the effects of inflation on the corporate tax base, and possible alternative tax bases, and not with the structural problems of corporate distributions. However, it did examine briefly the small companies rate of corporation tax.⁶¹ In particular, it defended the then existing system both against those who argued that the phase-out provision should be repealed and those who argued that the lower rate should be made more generous.

At the time of the Green Paper, in 1982, corporations with earnings under £80 000 paid tax at a low rate of 40 per cent. If their earnings were greater than £80 000 they paid tax at a rate of 52 per cent on the excess. To withdraw the benefit of the small companies relief from larger corporations, corporations earning between £80 000 and £200 000 paid an additional rate of tax which brought their marginal tax rate up to 60 per cent. The main criticism of the United Kingdom phase-out provision is that it imposes a relatively high marginal rate of tax as relief is withdrawn over the phase-out band of corporate income. It is sometimes argued that this is a disincentive for companies to increase pretax profits within the phase-out band and an incentive for them to increase directors' remuneration or to undertake wasteful or unnecessary expenditures if they are within that band. However, the authors of the Green Paper argued that a vanishing relief provision is the most cost-effective way of providing relief to small businesses. They noted that if the first slice of the income of all corporations qualified for the lower rate, the

57. United Kingdom, Secretary of State for Trade, *A New Form of Incorporation for Small Firms*, Cmnd. 8172 (London: HMSO, 1981), at 20, para. 5.2; at 35-6, para 33; and Annex C: 'Taxation'.

58. See J Chown, 'The future of Corporation Tax' [1981] *British Tax Review* 30, at 40; R. White, 'The Changing Face of Taxation - Corporate Tax' [1981] *British Tax Review* 349, at 350; R. White, 'The Green Paper on Corporation Tax - An Initial Review' [1982] *British Tax Review* 79, at 81.

59. See J.A. King and M.A. King, *The British Tax System*, 3rd ed. (Oxford: Oxford University Press, 1983), at 162.

60. Chancellor of the Exchequer, *Corporation Tax*, *supra* note 19. See Generally, M.T. Summer, 'The Reform of Corporation Tax: An Economic Perspective on the Green Paper' [1982] *British Tax Review* 292; 'Symposium on Corporation Tax' (1982) 3 *Fiscal Studies* 102.

61. Chancellor of the Exchequer, *Corporation Tax*, *supra* note 19, chap. 16.

lower rate would have to apply to a smaller slice of income or the corporate tax rate generally would have to be increased.

Some commentators had suggested that the relief to small businesses should be made more generous by making the corporate tax rates even more progressive. The government rejected this suggestion for a number of reasons: (a) the problem of associated corporations would become more important, (b) the revenue loss would have to be made up by raising rates on larger corporations, and (c) the increased disparity between the rates of company and personal taxes would lead to more avoidance activities.

In response to the Green Paper, in 1984 the United Kingdom embarked on a program of base broadening and rate reduction for corporations.⁶² The main rate of corporate tax is being progressively reduced from 50 to 35 per cent by the financial year 1986.⁶³ For the transitional period, the small companies rate is fixed at 30 per cent for the first £100 000 of income.⁶⁴ The tapering provision will be applied to profits between £100 000 and £500 000.

Some commentators have suggested that once the main rate of corporation tax reaches 35 per cent, it is unlikely that the small companies rate will be retained.⁶⁵ However, since the imputation credit compensates for corporate tax of 30 per cent, the effect of reducing the small business rate to 30 per cent is that there is no effective corporation tax on the distributed profits of small businesses. Thus the tax system has been transformed for such corporations from a partial imputation system to a full imputation system. This might be a position that the United Kingdom government would like to retain.

United States

The United States *Internal Revenue Code* provides both a partnership election for closely-held corporations and a lower rate of corporate tax. The partnership election was adopted in 1958. In 1982 the election was significantly liberalised and now over 20 per cent of the tax-filing corporations take the election. As a result of the recent tax reform efforts in the United States the top individual rate will fall below the corporate tax rate. Because of this, commentators are predicting even more extensive use of the partnership election.

62. See generally, J. Chown, 'The 1984 Budget, the Finance Bill and Corporate Finance' (1984) 5 *Fiscal Studies* 73; J. Edwards, 'The 1984 Corporation Tax Reform' (1984) 5 *Fiscal Studies* 30; M. Gammie, 'Has Nigel Lawson Really Reformed Business Taxation' (1984) 5 *Fiscal Studies* 82.

63. *Finance Act, 1984* (UK), s.18(1).

64. *Id.*, s.20(1).

65. See R. Bramwell, T. Ivory and G. Brannan, *Taxation of Companies and Company Reconstructions*, 3rd ed. (London: Sweet and Maxwell, 1985), at 7.

A graduated corporate tax structure was introduced in 1936 as part of a package of tax changes initiated by President Roosevelt to attack concentrations of corporate wealth. The graduation in the corporate tax rates was substantially increased in 1975 for the express purpose of assisting small business. A number of the recent base broadening, rate reduction tax reform proposals have recommended that a single low rate of tax be imposed on corporations. However, the recently enacted *Tax Reform Act* has retained the graduated rate structure for corporations.

1913-1936: THE INTEGRATED SYSTEM

In the first United States income tax, which was imposed during the Civil War and expired in 1872, all mercantile and industrial corporations were taxed in the same manner as partnerships. The Act provided that 'gains and profits of all companies' were to be the income of 'any person, entitled to the same, whether divided or otherwise'.⁶⁶ In 1894, when Congress re-imposed the income tax, both corporations and individuals were taxed at a rate of two per cent. Integration was achieved by excluding dividends from income. This tax was short-lived. In the year following its enactment, in the infamous case of *Pollock v. Farmers Loan and Trust Company*,⁶⁷ the Supreme Court found that income tax was a 'direct tax'. They therefore held it to be invalid because it was not apportioned to the states according to representation, as required by the Constitution.

In 1909, anxious to re-enter the income tax field, Congress imposed a one per cent 'excise' tax on corporate net income. By enacting the tax in the form of an excise tax, Congress hoped to avoid the constitutional infirmity of an income tax.⁶⁸ Four years later, after the ratification of the Sixteenth Amendment to the Constitution,⁶⁹ Congress passed the modern

66. A flat rate tax was imposed upon financial and public utility corporations, however, shareholders received a credit for the tax withheld by the corporation. For a description of the early United States tax acts see W.A. Sutherland, 'A Brief Description of Federal Taxes on Corporations since 1861' (1940) 7 *Law and Contemporary Problems* 266, at 266-8, 275; E.R.A. Seligman, *The Income Tax* (New York: MacMillan, 1921), at 515; K.K. Keenan, *Income Taxation: Methods and Results in Various Countries* (Milwaukee: Burdich & Allen, 1910), chap. 12; and, J.S. Seidman, *Seidman's Legislative History of the Federal Income Tax Laws, 1861-1938* (New York: Prentice-Hall, 1938).

67. (1895) 157 US 429; (1895) 148 US 601.

68. This tax was held constitutional in *Flint v. Stone Tracy Company* (1910) 220 US 107 on the grounds that it was not a direct tax but an excise tax on the privilege of doing business in a corporate capacity. Generally on the tax see Keenan, *supra* note 66, chap. 13.

69. See *US Constitution*, amend. XVI., adopted February 25, 1913, giving Congress the power to 'collect taxes on incomes from whatever source derived, without apportionment among the several states, and without regard to any census and enumeration'.

income tax. A one per cent 'normal' tax was imposed on both corporations and individuals. In addition a surtax was imposed on personal income ranging from one per cent on income between \$20 000 and \$25 000, to six per cent on income above \$500 000. The 'double' taxation of corporate distributions was prevented by providing that dividends were excluded from income subject to the normal one per cent personal rate, but not from income subject to the surtax rates. Thus, in effect, corporate-source income bore the normal individual tax rate when it was earned by the corporation and the individual surtax rate when it was distributed.

The scheme adopted during the Civil War, of taxing individual shareholders on their pro rata share of the net income of corporations, seems not to have been considered when the income tax was re-imposed in 1913, even though, unlike the income tax passed in 1893, the individual rates exceeded the corporate tax rate. A number of factors might explain this: First, the precedent for imposing a separate tax on corporations had been established in 1909. Second, the 1913 income tax appears to have been modelled on English law, under which the income tax was imposed at the corporate level. Third, by 1913, because corporations had become so common and their financial structures so diffuse, perhaps the administrative difficulties of taxing individual shareholders on their pro rata share of accumulating corporate income seemed self-evidently insurmountable. Finally, perhaps there was a concern that an attempt to tax shareholders on income that they had not received would be unconstitutional.⁷⁰ Although the reasons for not adopting partnership treatment seem reasonably obvious, it is less clear whether Congress intended to impose a separate tax on corporations or only to use the corporation as a convenient vehicle for collecting at source the tax on an individual's corporate-source income.⁷¹ As initially

70. The partnership method of taxing corporations under the Civil War income tax was held Constitutional in *Collector v. Hubbard* (1870) 12 Wall. (US) 1. However, in spite of this, there was some concern that the decision would not be followed. For an exchange of views see T.R. Powell, 'The Stock Dividend Decision and the Corporate Nonentity' (1920) 5 *Bulletin of the National Tax Association* 201 (arguing that the decision could stand in spite of aspersions cast upon it by Mr. Justice Pitney's opinion in *Eisner v. Macomber* (1920) 252 US 189, 217-19, with A. Ballentine, 'Corporate Personality in Income Taxation' (1921) 34 *Harvard Law Review* 573, at 586 ('the method sustained by the court in the Hubbard case would not be sustained today, at least in the case of large and active business corporations employing large capital').

71. The 1909 Act might appear to be premised on assumption that the corporation should be a separate taxpaying entity. However, it has been explained on the grounds that it was the only constitutional way, before the 16th amendment, that the US federal government could impose what was in effect an income tax. See Committee of the National Tax Association on Federal Taxation of Corporations, 'Preliminary Report' (Chairperson: R.M. Haig) in National Tax Association *Proceedings of the Thirty First Annual Conference on Taxation* (Columbia: National Tax Association, 1939) 547, at 576 [hereinafter 'Preliminary Report'].

enacted in 1913, the corporate tax operated almost as a perfect withholding tax.⁷² The corporate tax was one per cent and when it was distributed it was exempt from the one per cent normal tax rate. However, this near perfect scheme of integration was short-lived. During World War I two additional taxes were imposed on corporations: a capital stock tax and an excess profits tax. Neither of these were creditable when dividends were paid to individuals. Then, more significantly, for a period in 1917 a special four per cent tax was imposed on retained corporate earnings. Moreover, after 1919 the corporate tax rate always exceeded the individual normal tax rate available for dividend credit. By 1936, for example, (when the dividend credit was repealed) the corporate rate was 13.75 per cent, while the normal individual rate was eight per cent.⁷³

Since corporate tax rates throughout this period were considerably less than the individual supertax marginal rates of taxation, most incorporated small businesses were not disadvantaged compared to unincorporated businesses. There appears to have been little discussion of the need for allowing small corporate firms to be taxed as partnerships or of providing a low rate of tax for closely-held corporations. Indeed, in the early 1920s the expressed concern about the need to equalise the tax burden on unincorporated and incorporated firms sprang from just the opposite concern: the tax advantage of incorporated over unincorporated firms. This concern, over the unfair competitive advantage enjoyed by incorporated firms, was usually expressed along with a more general concern about retained corporate earnings escaping the individual surtax rates. The method most frequently urged for equalising the tax on corporations and unincorporated businesses was the imposition of a general undistributed profits tax on corporations.⁷⁴

By the mid-1930s, however, the corporate tax rate was considerably greater than the normal individual tax rate (although still much lower than the high individual surtax rates). Therefore, there was some pressure to provide relief

72. It was not a perfect withholding tax since it was not refundable to low-income shareholders who were not subject to the normal tax, and, unlike the British income tax, the tax collected at the corporate level was not included in the shareholder's income for surtax purposes (in this respect there was what might be described as over-integration).

73. For a chart comparing the rates of tax on corporations and the normal rates on individuals available for dividend credit for the period 1913-36 see 'Preliminary Report' *supra* note 71, at 587.

74. See T.S. Adams, 'Federal Taxes Upon Income and Excess Profits' (1918) 8 *American Economic Review* (Supp.) 25; 'Immediate Future of the Excess-Profits Tax' (1920) 10 *American Review* (Supp.) 15; 'Fundamental Problems of Federal Income Taxation' (1921) 35 *Quarterly Journal of Economics* 527. See also F.R. Fairchild, 'Suggestions for Revision of the Federal Taxation of Income and Profits' (1920) 10 *American Economic Review* 789 and 'Federal Taxation of Income and Profits' (1921) 11 *American Economic Review* 158.

for small business. In 1935, Roosevelt proposed, and Congress enacted, a graduated corporate profits tax to replace the flat rate corporate profits tax. The flat rate was replaced with rates graduated from eight per cent on net income below \$2000, through three brackets to a maximum rate of 15 per cent on the excess over \$40 000. The measure was justified, in the main, as one for assisting small business. But the government also saw the measure as an integral part of its determination to halt the growth of large corporations. That is, it was justified, in part, as an anti-monopoly measure. The government also argued that since the income of large corporations was more stable than that of small corporations, the measure would result in greater stability of income tax receipts.⁷⁵

A number of criticisms were made of the graduated corporate rate structure:⁷⁶ it would penalise corporations with fluctuating earnings; it was unfair since a corporation's income is not necessarily an accurate measure of its profitability; and, it was arbitrary since the definition of a 'small' corporation would vary from industry to industry. However, in general the graduated rates appear to have been strongly defended. The arguments were well summarised by Bowen: 'First ... small businesses are peculiarly dependent upon the reinvestment of earnings as a source of funds for development and expansion ... Second, the earnings of small businesses tend to fluctuate from year to year more than big businesses ... Third, the taxation of income tends to increase risks more for small businesses than for large (because of the restrictions on the deductibility of losses) ... Fourth, small companies usually operate under conditions of intense competition (and are thus unable to pass an income tax forward) ... Fifth, small business, unable to afford expensive legal and accounting advice, find difficulty in interpreting complex tax laws and regulations ...'⁷⁷

1936 TO 1958: EVENTS LEADING UP TO THE PARTNERSHIP ELECTION

In an historic address in 1936, President Roosevelt sought to initiate a series of radical tax proposals.⁷⁸ Basically, the President called for repeal of the regular corporate-level tax and repeal of the exclusion of dividends from the normal tax

75. See generally, A.G. Buehler, *The Undistributed Profits Tax* (New York: McGraw-Hill, 1937), at 241.

76. See *id.*, at 242-7, 262-3.

77. H.R. Bowen, 'The Taxation of Small Business' in National Tax Association, *Proceedings of the Thirty-Ninth Annual Conference on Taxation* (Sacramento: National Tax Association, 1946) 394, at 396-7.

78. For a text of President Roosevelt's March 3, 1936, address, see 1939-1 C.B. 668. For relevant excerpts see 'Preliminary Report', *supra* note 71, at 582-3.

base of individual shareholders. He also proposed the imposition of an undistributed profits tax on corporations that would be severe enough to compensate for the amount of tax that would be collected if the corporation had made a complete distribution to shareholders. This undistributed profits tax would be imposed on earnings regardless of the motive of their retention. The President's proposals appeared to have had a number of purposes: to force large corporations to distribute more of their earnings and thus assist in breaking-up large concentrations of economic power; to prevent high-income individuals from avoiding the individual surtax by accumulating profits in corporations;⁷⁹ to relieve the double tax burden on small businesses if earnings were distributed; and, to equalise the tax burden between incorporated and unincorporated business.⁸⁰

Although the House of Representatives adopted the President's proposals, the Senate modified them considerably. At the end of the day, the corporate tax remained, a modest undistributed profits was imposed⁸¹ and the dividend credit for individual shareholders was repealed. Thus, somewhat paradoxically, instead of the corporate tax being abolished, as was Roosevelt's intention, its status as a separate tax was strengthened.

This brief history reveals that in the United States the adoption of a separate tax on corporations did not reflect a carefully thought out and articulated policy judgment, as did the adoption of the classical tax system in the United Kingdom in 1965. The most plausible explanation for it seems to be that the government initially intended to use the corporate tax as a means of collecting the income tax from individuals. However, a series of ad hoc measures, motivated by a desire to raise revenue and to prevent the corporation from being used as a device to avoid high personal surtax rates, resulted eventually in a classical tax system.⁸²

79. At this time the United States had both an accumulated earnings tax and a personal holding company tax for this purpose, but neither of these were felt to be sufficiently effective by the government.

80. For a discussion of the fascinating politics of these tax reform proposals see Buehler, *supra* note 75; S. Ratner, *Taxation and Democracy in America* (New York: John Wiley, 1967), at 472-4; G.E. Lent, *The Impact of the Undistributed Profits Tax 1936-37* (New York: AMS Press, 1968); G. Graham, 'The Undistributed Profits Tax and the Investor' (1936) 46 *Yale Law Journal* 1; H. Hendricks, 'The Surtax on Undistributed Profits of Corporations' (1936) 46 *Yale Law Journal* 19.

81. Only to be repealed in 1938, see *Revenue Act of 1938*, chap. 289, 52 Stat 447.

82. For a similar explanation see the 'Preliminary Report' *supra* note 71, at 576; see also C.S. Shoup, 'The Dividend Exclusion and Credit in the Revenue Code of 1954' (1954) 8 *National Tax Journal* 136, at 137; ('Congress ... (in 1936) was much more concerned over the escape of undistributed profits from full taxation than it was over extra taxation of distributed profits; indeed there is some evidence that the extra taxation was almost a by-product of the confusion over the issue of taxing undistributed profits').

After the changes made in 1936, and throughout the 1940s, there was considerable discussion about integrating the corporate and shareholder tax. Although a few commentators attempted to justify a separate corporate tax,⁸³ most public finance theorists were of the opinion that it had no rational basis and were exploring ways of integrating it with the personal income tax.⁸⁴ The now well-known methods of integrating the corporate and personal tax were all considered at length including abolishing the corporate tax and taxing capital gains at normal rates either when realised⁸⁵ or on an accrual basis,⁸⁶ and providing various forms of dividend relief.

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83. See G. Colm, 'Conflicting Theories of Corporate Income Taxation' (1940) 7 *Law and Contemporary Problems* 281 (discussing sympathetically the benefit justification for corporate tax and the role of the corporate tax as a technique for economic control) and P. Studenski, 'Towards a Theory of Business Taxation' (1940) 48 *Journal of Political Economy* 621 (explaining eight theoretical justifications for business taxation, most of which relate in some way to the benefits received by corporations).
84. See 'Preliminary Report', *supra* note 71, at 588-95.
85. Henry Simons was the best known advocate of abolishing the corporate tax and simply taxing all capital gains when they were realised. H.C. Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (Chicago: University of Chicago Press, 1938), at 168-9 and *Federal Tax Reform* (Chicago: University of Chicago Press, 1950). His proposal was considerably more sophisticated than it is commonly given credit for, and even in the broad outlines sketched by Simons, included a scheme for allowing taxpayers to include accruals of gain or loss in their income as they saw fit (subject to final reconciliation at death, of course), an averaging scheme that would be applied against as well as in favour of the taxpayer, a general policy of using changes in exemption levels rather than tax rates in order to vary revenues in accordance with fiscal needs, and a proposal to allow unincorporated enterprises to be treated like corporations for tax purposes. Simons felt that one of the most significant advantages of his proposal was the assistance it provided to small, growing enterprises. See *Federal Tax Reform*, *id.*, at 139 and 'Federal Tax Reform' (1946) 14 *University of Chicago Law Review* 20, at 60-3. In spite of its simplicity and elegance, even contemporary commentators were skeptical of Simons' proposal because it allowed shareholders to postpone their tax liability. See, for example, H. Groves, *Postwar Taxation and Economic Progress* (New York: McGraw Hill, 1946), at 60. But for a favourable review see W. Vickery 'Book Review' (1950) 3 *National Tax Journal* 187. However, even though the proposal appears to fly in the face of the general tax principles so passionately expounded by Simons, it seems quite consistent with his libertarian philosophy. The following quote from the draft of his book on tax reform is particularly illuminating: '...there should be no levies on business or concerns as such. The impact of taxes should be kept as far as possible from the concern of enterprise, and from the sphere in which operating and investing decisions are made. This means that taxes should fall on the natural person or family as a consumer and saving unit or household, where their effect will be concentrated on consumption and saving and largely removed from productive enterprise and management. If - God forbid - we must tax shareholders qua shareholders, let's do it plainly, directly and straightforwardly and give our good sense a chance to cry out against the folly.' 'Federal Tax Reform' (1946) 14 *University of Chicago Law Review* 20, at 60.
86. Committee on Taxation of the Twentieth Century Fund, *Facing the Tax Problem* (Director: C. Shoup) (New York: Twentieth Century Fund, Inc., 1937), at 477-83. Commentators noted that this method was not perfect integration since it did not take into account the character of the income earned by the corporation (for example, some of the income earned by the corporation might have been tax-exempt at the personal level). Moreover, it was argued that it was not a practical alternative because of the difficulty

However, the method of integration of most interest in the present context is the partnership method. Most commentators noted that the partnership method was the ideal way of integrating the corporate and shareholder tax. However, the familiar objections to it were enumerated: the difficulty of allocating undistributed earnings among various classes of shares (the problem most frequently noted was that funds allocated to common shares in one year might be distributed in a later year to preferred shareholders); the difficulty of allocating undistributed earnings among shareholders who may have changed during the year; the difficulty of allocating income through holding corporations; the administrative problem of annually revising the basis of stock held by shareholders; the problem of adjusting annually reported income if a change were made in a corporation's reported net income for an earlier year as the result of an audit, amended return or litigation; and the unfairness of shareholders having to pay tax on income they have not received.⁸⁷

In spite of these concerns, the first commissioned study of the problem, a study commissioned by the National Tax Association and chaired by Professor Haig,⁸⁸ recommended that 'in the effort to reach corporate profits for personal income tax purposes the use of the partnership method should be extended to the limits of its legal and administrative possibilities'.⁸⁹ Furthermore, the Committee was of the opinion that 'the number of corporations to which the partnership method can be applied without involving formidable administrative difficulties is far greater than is generally realised and includes all but a few thousand, perhaps, of our larger corporations'.⁹⁰

Most commentators doubted if it would be practical to require all, or even most large corporations to report their income as if they were partnerships. However, they were virtually unanimous in suggesting that a partnership election

of obtaining valuation figures for all beneficial interests, and because of the at least questionable constitutionality of taxing shareholders on accrued but unrealised income. See Committee of the National Tax Association on Federal Taxation, 'Final Report' (Chairperson: R.M. Haig) in *National Tax Association Proceedings of the Thirty-second Annual Conference on Taxation* (Columbia: National Tax Association, 1940) 534, at 545-7 [hereinafter 'Final Report']; *Federal Tax Reform*, *supra* note 85, at 74-8. However, Carl Shoup has remained convinced that the idea is not only the ideal solution but is also practical. See C.S. Shoup, 'The Dividend Exclusion and Credit in the Revenue Code of 1954' (1954) 8 *National Tax Journal* 136, at 146 and 'The White Paper Accrual Accounting for Capital Gains and Losses' (1970) 18 *Canadian Tax Journal* 96.

87. See *Personal Income Taxation*, *supra* note 85, at 190-4; Groves, *supra* note 85 at 56; R.E. Paul, *Taxation for Prosperity* (New York: Bobbs-Merrill, 1947), at 360, R. Goode, *The Corporation Income Tax* (New York: John Wiley, 1951), at 185; 'Final Report' *supra* note 86, at 555.

88. 'Final Report', *supra* note 86.

89. *Id.*, at 555.

90. *Id.*, at 506.

should be available for small corporations,⁹¹ even though, as some authors noted, because of the high individual rates it would not significantly benefit small businesses.⁹²

Apparently, the Treasury Department had been considering giving small corporations the option of being taxed as partnerships as early as 1929.⁹³ The first published account of the details of such a proposal was included in a study on the corporate tax by Goode, which he did for the Treasury in 1946.⁹⁴ Goode reviewed the administrative reasons commonly given as to why corporations generally could not be treated for tax purposes as partnerships. He used these reasons to assist in defining a class of small corporations that could be provided with such an election because the administrative problems could be overcome. Among other restrictions, he noted that corporations entitled to the election should be restricted to those with a limited number of individual shareholders and only one class of shares.⁹⁵

The Treasury continued to study the option, and in 1949 it presented an even stronger case for its adoption. It concluded that partnership tax treatment for certain small corporations would equalise the tax burden on small incorporated and unincorporated businesses and might increase the flow of new equity capital into small corporations.⁹⁶ Also, in 1950, the National Tax Association's Committee on the Federal Corporate Net Income Tax (Chairperson: H.M. Groves) noted that there were strong grounds for providing small and closely-held corporations with partnership treatment.⁹⁷

In 1954, the administration, as part of a major tax reform effort, proposed that corporations with a small number of active shareholders should be able to elect to be taxed as

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91. See Groves, *supra* note 85, at 58, 105; Paul, *supra* note 87, at 373; J.W. Devine, 'Taxing Corporations as Partnerships' (1948) 26 *Taxes* 506.
 92. See, in particular, J.K. Butters, 'Should the Profits of Small Corporations Be Taxed Like Partnership Earnings' in R.G. Blakey et al., *How Should Corporations Be Taxed?* (New York: Tax Institute, 1947) 72; Goode, *supra* note 87, at 186-90; Bowen, *supra* note 77, at 394.
 93. See J.L. Weiner, 'Legislative Recognition of the Close Corporation' (1929) 27 *Michigan Law Review* 273.
 94. R.B. Goode, *The Postwar Corporation Tax Structure* (Treasury Department, 1946). The full text of those parts of the work that relate to a partnership election for small corporations are reproduced in J.E. Eustice and J.D. Kuntz, *Federal Income Taxation of S Corporations*, rev'd. ed. (Boston: Warren, Gorham & Lamont, 1985), App. B.1, at A-24.
 95. *Id.*, at 20. In justifying the election, Goode simply noted that in closely-held corporations 'the corporations and its stockholders are substantially an economic identity': *Ibid.*
 96. Division of Tax Research, US Treasury Department *Taxation of Small Business* (Washington: Division of Tax Research, US Treasury Department, 1949).
 97. National Tax Association, Committee on the Federal Corporate Net Income Tax, 'Final Report' (Chairperson: H.M. Groves) in National Tax Association, *Proceedings of the Forty-Third Annual Conference on Taxation* (Sacramento: National Tax Association, 1951) 54, at 61-2.

partnerships.⁹⁸ In justifying the proposal President Eisenhower simply noted that, 'small businesses should be able to operate under whatever form of organisation is desirable for their particular circumstances, without incurring unnecessary tax penalties'.⁹⁹ Although the Senate approved the President's proposal, it was not passed by the House of Representatives and was subsequently abandoned in conference. The legislation that had been proposed by the administration was straightforward, although in some respects more restrictive than subsequent legislation.¹⁰⁰ In particular, under the proposal only new corporations could take the election and all shareholders had to be actively involved in the business. Both of these requirements were abandoned in subsequent legislation, but at the cost of considerable increased complexity. Also, under the proposal, and again unlike the legislation that was eventually enacted in 1958, if a corporation took the election, it was to be taxed almost exactly as a partnership.¹⁰¹

1958 TO 1986: THE PARTNERSHIP ELECTION

The possibility of allowing closely-held corporations to elect to be treated as partnerships was raised again in 1957 when Congress was considering a wide range of legislative changes designed to encourage the growth of small business. The measure that was eventually passed was inserted in the tax legislation almost as an after-thought by the Senate Finance Committee after a member inquired about the demise of the 1954 proposal. However, instead of building upon the partnership election that the Senate had passed in 1954, the Committee used as its model, legislation that had been prepared for the House of Ways and Means Committee in 1957, but which that Committee had decided not to proceed with. Thus, the legislation was quite different to the straightforward partnership election recommended in 1954.

The Finance Committee gave two principal reasons for the adoption of the provision: first, the legislation would permit greater flexibility for business people in selecting their form of

98. For a brief review of legislative history of the partnership election in the United States see Eustice and Kuntz, *supra* note 94, chap. 1; J.A. Moore and R.C. Sorlien, 'Adventures in Subchapter S and Section 1244' (1959) 14 *Tax Law Review* 453, at 456-7; R. Anthoine, 'Federal Tax Legislation of 1958: The Corporate Election and Collapsible Amendment' (1958) 58 *Columbia Law Review* 1146, at 1148-50.

99. President's Budget Message of January 21, 1954, 100 Cong. Rec. 567, at 571, reprinted in Eustice and Kuntz, *supra* note 94, at 1-5.

100. The legislation was contained in s.1351(a) which was inserted in H.R. 8300, 83rd Cong., 2d Sess. (1954), reprinted in Eustice and Kuntz, *supra* note 94, App. B.2.

101. It was contemplated that the partnership rules of the Act would apply to corporations except as varied by regulation.

business organisation by minimising differences in tax consequences; and second, the provision would encourage the growth of small business by eliminating double taxation on income derived by shareholders of closely-held corporations and by allowing such shareholders to deduct from their individual income their share of losses incurred by the business activity.¹⁰²

The rules for allowing corporations to elect to be taxed as partnerships were contained in Subchapter S of the *Internal Revenue Code of 1954* (sections 1371 through 1379) and thus corporations making the election became known as 'Subchapter S Corporations'.¹⁰³ The conditions for making and maintaining a Subchapter S election were originally very restrictive. They included the following: (1) The corporation could not have more than ten shareholders. (2) The corporation could not have more than one class of stock. (3) Basically, all shareholders had to be individuals. (4) All shareholders had to be US residents. (5) All shareholders, including new shareholders, had to consent to the election. (6) No more than a specified portion of the corporation's receipts (normally 20 per cent) could be derived from enumerated types of passive investment income. (7) The corporation could not receive more than 80 per cent of gross receipts from sources outside the US. However, no limitations were placed on the capitalisation or net worth of electing corporations (presumably because of the unlikelihood of large businesses making an election in view of the high individual marginal tax rates).

When an election was made, the corporation was not taxed as a partnership, although it is often referred to as a partnership election. Instead, the corporation computed its income under the normal rules applicable to corporations. Distributions of current earnings and profits that were received by shareholders during the year were taxed as dividends in the ordinary manner. Then, any income remaining undistributed at the end of the year was attributed to shareholders, each of whom paid tax on their rateable share. With one exception, this share was taxed as dividend income in the shareholder's hands, although it was not eligible for the dividend credit.

102. S. Rep. No. 1983, 85th Cong., 2d Sess. 87, reprinted in 1958-3 CB 922, 1008.

103. Prior to 1982, the legislation referred to a corporation that met certain of the requirements for electing to be taxed pursuant to Subchapter S as a 'small business corporation' and a corporation that actually elected to be taxed pursuant to those provisions as an 'electing small business corporation'. However, in part because other provisions in the IRC also referred to small business stock, most commentators referred to an electing small business corporation as a 'Subchapter S corporation'. In 1982 Congress sought to remove any confusion caused by using similar terms in the Code by referring to corporations electing under Subchapter S as 'S corporations'; all other corporations are to be referred to as 'C corporations': IRC, ss.1361(a)(1) and 1361(a)(2).

The one exception was long-term capital gains. These retained their capital gain character in the shareholder's return.

The corporation's net operating loss for an election year could also pass through to the shareholders and be deducted by them as a loss attributable to a trade or business.¹⁰⁴ To prevent last-minute transfers of stock for the purposes of redistributing loss deductions, losses were allocated to shareholders on a daily basis. That is, shareholders were given a loss pass-through which corresponded to their pro rata share of the corporation's net operating loss attributable to the length of the period that they held stock in the corporation. Thus, if shareholders sold their stock halfway through the taxable year they would be allowed one half of the loss which they would have received had they held the stock for the full year. The purchaser of the stock would be entitled to the remaining portion of the loss. This method for allocating losses might be contrasted with that used for allocating undistributed taxable income. All income for the year was attributable to those who owned the shares at the end of the fiscal year.

Although generally welcomed by the tax community, the Subchapter S election was subject to considerable criticism. Commentators felt that the requirements for making the election were much more restrictive than necessary to accomplish its objectives, that the legislation was too complex and consequently expensive to comply with, and that it was replete with traps for the unwary. Aside from technical deficiencies, the basic criticism of the proposal was that it did not conform closely enough with the tax treatment of partnerships. A year after its enactment, Caplin, later to be Commissioner of Internal Revenue, wrote: 'Despite only one year's experience under these provisions, Congress would be justified in striking it from the Code as bad law, not worthy of retention even in modified form'.¹⁰⁵

104. However, losses were deductible only to the extent they exceeded the shareholder's basis in stock and debt held in the corporation.

105. M. Caplin, 'Subchapter S vs. Partnership: A Proposed Legislative Program' (1959) 46 *Virginia Law Review* 61, at 81. See also R. Anthoine, 'Federal Tax Legislation of 1958: The Corporate Election and Collapsible Amendment' (1958) 58 *Columbia Law Review* 1146, at 1175 ('at best, it is highly questionable whether the electing corporation has any proper place in a tax law that is already extremely complex'); J.D. Driscoll, 'Subchapter S - Its Role in the Tax Law', K.R. Price, 'Subchapter S - Some Policy Questions', and F.A. Nicholson, 'Report on Subchapter S' in United States, Committee on Ways and Means, *Tax Revision Compendium: Compendium of Papers on Broadening the Tax Base* (Washington: GPO, 1959), vol. 3, at 1723, 1731, 1741 (respectively); E.S. Cogen and C.H. Schmidt, 'Subchapter S: A New Concept in the Tax Status of Business Associations' (1959) 44 *Cornell L.Q.* 560; C.B. Lowrie, 'Subchapter S After Three Years of Operations' (1962) 18 *Tax Law Review* 99 and 'Subchapter S After Tax Years of Operation: An Analysis of its Advantages and Defects' (1965) 22 *Journal of Taxation* 166 ('Subchapter S should not be repealed. Despite its defects and complexity it has granted desirable relief and positive advantages to taxpayers who have been able to utilize its provisions').

Throughout the 1960s and 1970s the Subchapter S rules were subject to continual evaluation. In the mid-1960s, the Section of Taxation of the American Bar Association and the Treasury Department undertook a joint study of Subchapter S. Their work culminated with the submission of a joint proposal to Congress as part of the Treasury Department's 1969 *Tax Reform Studies and Proposals*.¹⁰⁶ The aim of the reform was to tax Subchapter S corporations as much like partnerships as possible. Ultimately very few of the provisions were incorporated into the *Tax Reform Act of 1969*.¹⁰⁷ In 1970 the Section of Taxation of the American Bar Association formed a special Committee on Subchapter S Corporations and it continued to participate in a joint project with Treasury Department officials. Although several bills were introduced into Congress, little became of them.¹⁰⁸ Then, in 1977, the staff of the Joint Committee on Taxation began a study of Subchapter S. It published a tentative set of recommendations in May 1979, which were extensively commented on by the Treasury Department, members of the subcommittee of the A.B.A. Section of Taxation and members of the Federal Tax Division of the AICPA, among others. On April 30, 1980, the staff of the Joint Committee released a report containing its recommendations for restructuring the Subchapter S rules.¹⁰⁹

In 1982, Congress adopted the *Subchapter S Revision Act* which incorporated essentially all of the staff recommendations.¹¹⁰ The legislation had three major results.

106. US Treasury Dept., *Technical Explanation of Treasury Tax Reform Proposals* (1960), reprinted in J.S. Eustice and J.D. Kuntz, *Federal Income Taxation of Subchapter S Corporation*, 1st ed. (Boston: Warren, Gorham & Lamont, 1982), App. B.16.
107. On the 1969 proposals see S.W. Rosenkranz, 'Subchapter S: The Presidential Proposals' (1969) 55 *American Bar Association Journal* 1181; W.J. Fischer, 'Proposals to Revamp Subchapter S' (1971) 49 *Taxes* 407; J.H. Landon, 'An Approach to Legislative Revision of Subchapter S' (1971) 26 *Tax Law Review* 799; J.S. Pennell, 'Subchapter S - The Need for Legislation' (1970) 24 *Tax Lawyer* 249; S.W. Rosenkranz, 'Subchapter S - An Illusory Promise?' (1971) 6 *Georgia Law Review* 109.
108. See R.A. Shaw, 'Subchapter S: The Maturation of an Immature Statute' in *Proceedings of the Twenty-Fourth Annual Tulane Tax Institute* (Baton Rouge: Claitor's Publishing, 1975) 372. However, in 1976 a number of largely technical amendments were made. For a summary see Eustice and Kuntz, *supra* note 94, App. B.13.
109. Staff of the Joint Committee on Taxation, *Staff Recommendations for Signification of Tax Rules Relating to Subchapter S Corporations*, 96th Cong., 2d Sess. (1980), reprinted in Eustice and Kuntz (1st ed.), *supra* note 106, App. B.17. A comparative summary of the recommendations of the Joint Committee Staff, the comments of the Treasury Department Staff and the Section of Taxation task force can be found in G.G. Chang, 'Recommendations for restructuring of Tax Rules Relating to Subchapter S Corporations: A Comparative Summary' (1981) 34 *Tax Lawyer* 403.
110. Pub. L. No. 97-354, 96 Stat. 1669 (1982). For detailed analysis see M.N. Newmark and D.M. Lang, 'The Subchapter S Revision Act of 1982' (1983) 37 *Tax Law* 93; and G.E. Doven and A.M. Hess, 'The Subchapter S Revision Act: An Analysis and Appraisal' (1983) 50 *Tenn. L. Rev.* 569. As the above short summary of the events leading up to the passage of this Bill makes clear, one notable aspect of its passage was that it was

First, the eligibility requirements are materially liberalised. The permitted number of shareholders is increased to thirty-five. Although the one class of stock limitation remains, differences in voting rights are ignored.¹¹¹ New 'safe harbour' rules ensure that debt which the Treasury reclassifies as equity, and consequently treats as a second class of shares, is not mistakenly issued.¹¹² In addition, the excessive passive income receipts rules are greatly diminished in importance. Second, the distribution rules are changed so that instead of being treated as a dividend distribution, most types of corporate income passes through directly to shareholders. Thus, the treatment of Subchapter S corporations conforms much more closely with the partnership model. Third, numerous technical deficiencies of the rules are corrected; for example, the termination rules are considerably eased in order to remove a number of traps for the unwary.

Notwithstanding that the amendments moved in the direction of treating Subchapter S corporations more like partnerships, the leading commentators have argued that the rules could go considerably further in assimilating the treatment of these two kinds of entities.¹¹³ Simply by way of example, even under the new revisions, 'S corporations', as they are now called, are: limited in the number of shareholders they can have (thirty-five); limited in the type of shareholders (basically shareholders have to be resident individuals); and, limited in the type of capital structure they can have (basically they are limited to one class of shares). Yet, none of these restrictions are imposed on partnerships.

developed by the collegial efforts of not only various government departments, the congressional staffs and the Treasury, but also private organisations, most notably the tax bar. In this respect it follows a pattern established in the recent technical reforms of the instalments sales and bankruptcy rules in 1980. See J.S. Eustice, 'Cancellation of Indebtedness Redux: The Bankruptcy Tax Act of 1980 Proposals - Corporate Aspects' (1980) 36 *Tax Law Review* 1; M.D. Ginsberg, 'Future Payment Sales After the 1980 Revision Act' (1981) 39 *New York University Institute of Federal Taxation* 43.

111. This liberalisation makes sense since the purpose of the rule suggests that it should only be directed at classes of stock which have different dividend and liquidation rights.
112. Under the proposal, straight debt, debt that has no voting rights, a fixed interest rate and a fixed amount of redemption, will never be considered a second class of stock for purposes of Subchapter S even if it is reclassified as equity for other purposes.
113. See, in particular, Eustice and Kuntz, *supra* note 94, at 1.40-1.65; J.S. Eustice, 'Subchapter S Corporations and Partnerships: A Search for the Pass Through Paradigm (Some Preliminary Proposals)' (1984) 39 *Tax Law Review* 345; G.E. Coven and A.M. Hess, 'The Subchapter S Revision Act: An Analysis and Appraisal' (1983) 50 *Tennessee Law Review* 569.

1936 TO 1986: THE LOWER RATE OF TAX

The United States adopted a graduated corporate rate structure in 1936, with rates ranging from eight to 15 per cent.¹¹⁴ From 1938 to 1950 the benefit of graduation was 'recaptured' from firms with incomes over \$25 000. This was done by applying a flat rate to all taxable income, including the first \$25 000, on firms with income in excess of \$25 000. In order to ease the large jump in tax liabilities that a company might face by earning just over \$25 000, the full flat rate was phased in over a certain income range.

In the *Revenue Act of 1950*, the recapture provision was repealed and the four step graduated rate structure was replaced by one with just two steps. This dual corporate rate structure remained in effect from 1950 until 1975. Over this period the first \$25 000 of a corporation's income was taxed at rates ranging from 22 to 30 per cent, while income over \$25 000 was taxed at rates ranging from 42 to 52.8 per cent.

Then, beginning in 1975, a series of amendments were made to the graduated rate structure to make it even more favourable to small business. By 1984, the rate structure had five brackets: the first \$25 000 was taxed at 15 per cent; the next \$25 000 at 18 per cent; the next \$25 000 at 30 per cent; the next \$25 000 at 40 per cent; and taxable income over \$100 000 at 46 per cent. All of the changes made in increasing the graduation of the rate structure over this period were made for the express purpose of encouraging growth in small business.¹¹⁵

As part of a series of revenue raising measures, the *Deficit Reduction Act of 1984* reintroduced a provision to recapture the benefit of graduated rates from large corporations. The Act imposed a five per cent tax on corporate income in excess of \$1 million up to \$1405 million. Thus the full \$20 250 of tax benefit from the graduated rate was recaptured from large corporations.

Graduated corporate income tax rates seem firmly entrenched in the United States tax system and over the past thirty-five years there has been little pressure to remove them. However, in the past two years a number of the proposals made in the base broadening, rate reduction tax reform movement sweeping the United States have called them into

114. See text, *supra* note 75. Before this date the corporate tax applied at a flat rate, however a small exemption was generally allowed. For a listing of the corporate tax schedules over the years see J.A. Pechman, *Federal Tax Policy*, 4th ed. (Washington, DC: Brookings Institution, 1983), Table A-6.

115. See, for example, United States Senate, 95th Congress, 2d. Sess., Committee on Finance, *Revenue Act of 1978* (Report No. 95-1263) (Washington: GPO, 1978), at 118-9. Reducing the impact of the tax laws in the selection of a form of organisation for operation of a small business was also a frequently stated rationale for increasing graduation.

question. The Treasury Department, in its far-reaching 1984 tax reform proposals, *Tax Reform for Fairness, Simplicity and Economic Growth*, recommended that the corporate tax base be defined more comprehensively and that the corporate tax rate be reduced to a flat 33 per cent. The Treasury gave a number of reasons for recommending the abolition of the graduated corporate rate structure.¹¹⁶ (1) The concept of ability to pay, which justifies the graduated rate for individuals, is irrelevant in the case of corporations because corporate income is either reinvested or paid out to shareholders. Moreover, high-income individuals can own small corporations and low-income individuals commonly own shares in large ones (for example, through pension plans). (2) If the corporate tax rates remain about equal to the top individual marginal rate there will be no need for complex and often ineffective rules to limit the use of corporations to avoid the higher individual rates. (3) A flat corporate rate would also render unnecessary the complex and often ineffective rules designed to prevent the use of multiple corporations in order to maximise income taxed at the lowest rates. (4) Small corporations can, in any event, avoid the flat corporate tax rate and double taxation of dividends by electing pass-through treatment as an S corporation. (5) Preferential rates for small corporations would be unnecessary under the Treasury's proposals since the base broadening measures would substantially increase the competitiveness of small business.

Two other well-known tax reform proposals were being discussed about the same time as the Treasury proposals were published. One would have abolished the graduated rate structure, the other would have retained it. The Bradley-Gephardt proposals would have imposed a flat 30 per cent corporate rate.¹¹⁷ The Kemp-Kasten proposals would have retained a dual corporate rate structure; 15 per cent on the first \$50 000 and 30 per cent on the excess.¹¹⁸

The small business lobby in the United States strenuously objected to the Treasury's proposals to repeal the graduated corporate rate scheme. Small business lobby groups typically argued that unlike bigger businesses that can issue securities to raise money to fund growth, small business must get much of their capital from retained earnings, and so lower tax rates are needed to even things up. Also they noted that under the present law, many small corporations paid tax at rates lower than 33 per cent, which meant that the Treasury plan would

116. United States Treasury Department, *Treasury Department Report to the President*, vol. 2 (Chicago: CCH, 1984), at 128-9.

117. S. 1421, 98th Cong. 1st Sess. (1983), ss.101-102.

118. H.R. 6165, 98th Cong., 2d Sess. (1984), s.102.

substantially increase the tax burden on many small businesses.¹¹⁹

In May 1985, the President published his proposals for tax reform.¹²⁰ Yielding to the pressure from small business he recommended retention of the graduated corporate tax rates. He explained:

The proposal retains a modified graduated rate structure for small corporations in recognition of the fact that complete elimination of the graduated rate structure would dramatically increase effective tax rates for many smaller corporations, thus nullifying the positive effects, for such corporations, of the proposed reduction in the maximum marginal rates.¹²¹

The President proposed that the corporate tax be imposed under the following schedule: (1) 15 per cent on taxable income up to \$25 000; (2) 18 per cent on taxable income between \$25 000 and \$50 000; (3) 25 per cent on taxable income between \$50 000 and \$75 000; and (4) 33 per cent on the excess. To phase out the benefits of the graduated rates for corporations with taxable income over \$140 000, an additional five per cent tax would be imposed on corporate taxable income in excess of that amount and up to taxable income of \$360 000. Both the House of Ways and Means Committee¹²² and the Senate Finance Committee¹²³ recommended the adoption of a graduated corporate tax rate structure similar to that proposed by the President.

Finally, in the *Tax Reform Act of 1986*, effective for taxable years beginning on or after July 1, 1987, a three-bracket graduated corporate rate structure was adopted: (1) 15 per cent on taxable income up to \$50 000; (2) 25 per cent on taxable income between \$50 000 and \$75 000; and (3) 34 per cent on the excess. Thus the structure reduces from five to three the number of corporate income tax brackets, and lowers from 46 to 34 the tax rate applicable to large corporations. The benefit of graduated rates is fully phased out for corporations with more than \$335 000 of taxable income (compared to \$1 405 000 under present law).

119. See, for example, J.H. Birnbaum, 'Small Business Sees Itself as Victim and Lobbies Against Abolishing Graduated Tax Rates System', *The Wall Street Journal*, 5 March 1985, at 64.

120. United States, *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* (Chicago: CCH, 1985).

121. *Id.*, at 119.

122. United States, House Ways and Means Committee, *Tax Reform Bill of 1985* (Washington: GPO, 1985), at 231-3.

123. United States, Joint Committee on Taxation, *Summary of H.R. 9838 (Tax Reform Act of 1986) As Reported by the Senate Committee on Finance* (Washington: GPO, 1986), at 21-3.

Canada

Like the other countries in this survey, Canada initially had an integrated corporate tax system. It was the first to change to the classical tax system, in 1926. In that year it also enacted a partnership election for closely-held corporations to alleviate fears about the effect of the change on small businesses. The election was repealed, without explanation, in 1932. Although the partnership election has been recommended for adoption in Canada on a number of subsequent occasions, it has never been re-enacted.

Canada adopted a lower rate corporate tax in 1949. It came under considerable criticism during the tax reform debate in the 1960s. It was replaced, therefore, in 1972 with a small business credit that attempted to target the tax relief provided by the lower rate of corporate tax at small business firms that used their retained earnings for expansion. Throughout the 1970s and 1980s the small business credit was subject to continuous amendment: first in an effort to simplify it, then in an effort to re-target it, and finally in an effort to simplify it once again. By 1986 the Canadian small business credit has an effect very analogous to a lower rate of corporate tax. The attempt to target the relief was largely a failure.

1917 TO 1926: THE INTEGRATED SYSTEM¹²⁴

The corporation was not viewed as a separate taxpaying entity in the provincial corporate tax acts passed in the late nineteenth century. Although a tax was imposed on profits at the corporate level, corporate distributions were exempt from tax at the shareholder level. In 1917, when the Canadian

124. See generally, J.R. Allan, *The Income Tax Burden on Canadian Stockholders* (Toronto: Canadian Tax Foundation, 1966), chap. 2; J.R. Petrie, *The Taxation of Corporate Income in Canada* (Toronto: University of Toronto Press, 1952), chap. 2; A.K. Eaton, 'Recent Developments in Corporate Taxation in Canada' (1950) 3 *National Tax Journal* 75; J.H. Perry, *Taxes, Tariffs and Subsidies: A History of Canadian Fiscal Development* (Toronto: University of Toronto, 1955), vols 1 and 2, in particular, at 213-22, 408-21; Canada, Royal Commission on the Taxation of Annuities and Family Corporations, *Report* (Chairperson: W.C. Ives) (Ottawa: King's Printer, 1945), at 52-60 [hereinafter Ives Commission]; W.H. Wynne, 'Taxation of Corporations in Canada' (1941-42) 27 *Bulletin of the National Tax Association*, at 66 and 98; J.H. Perry, 'Development of the Canadian Corporation Income Tax' (1951) 58 *Canadian Chartered Accountant* 3, and Canadian Tax Foundation, *Report of the Fourth Tax Conference, 1950* (Toronto: Canadian Tax Foundation, 1950), at 16; J.R. Petrie, 'Some Special Aspects of the Corporation Tax', in Canadian Tax Foundation, *Bulletin to Members*, Nov., 1950, at 1-8, and (Sept.-Oct. 1950) 17 *Tax Policy* 1.

Government first imposed a tax on individual and corporate income, it followed this basic approach.¹²⁵

Individuals were subject to what was called a 'normal' flat rate of four per cent and a graduated surtax at rates ranging from two to 25 per cent on personal income in excess of \$6000. Corporate earnings were taxed at the normal flat rate of four per cent. When corporate income was distributed it was exempt from the individual normal rate, but taxed at the surtax rates.¹²⁶ Furthermore, corporations were entitled to the \$3000 basic exemption that was available to married persons. Two details might be noted about the scheme: First, dividends were excluded from the normal individual rate if they were paid by a corporation liable to taxation, whether or not the corporation actually paid tax on its distributed earnings at the normal rate. Consequently, in modern jargon, tax preferences were flowed through. Second, dividends subject to the surtax did not have to be grossed-up by the amount of tax paid at the corporate level. Thus, for high-income taxpayers dividend income received preferential tax treatment.

This almost perfect scheme of integration began being eroded the year after enactment. In 1918 the corporate tax

125. However, the government appeared to be ambivalent about whether corporations should be treated as separate taxpayers. In commenting on the exemption of dividend income from the individual normal tax rate the Minister of Finance, the Honourable Sir Thomas White, stated: 'I have always thought it was a mistake to assume that there is double taxation when a company is assessed and when its shareholders are also assessed. My honourable friend knows that a corporation in law is different from any or all of its shareholders ... Therefore, it has never appealed to me very strongly that a corporation should not be assessed and that its shareholders should not be likewise assessed. But while I believe that the time will come when in dealing with legislation of this kind a corporation will be assessed in respect of its income and its individual shareholders will be assessed in respect to their incomes, we have not probably progressed to the point yet where we could give that doctrine the effect which I think it should have'. Canada, *House of Commons Debates*, 2 August 1917, at 4072.

126. The details of the Canadian scheme for integration, like so many other aspects of the first Canadian income tax system, were borrowed directly from the United States *Internal Revenue Code*. In explaining the new Canadian system, the Minister of Finance, the Honourable Sir Thomas White stated: 'In the United States they have an income tax called the normal tax to be paid by corporations and joint stock companies. They provide - and we have similarly provided - that, while the shareholders of these companies are subject to the supertax, the amount of the normal tax upon dividends shall be deducted from their income'. Canada, *House of Commons Debates*, 2 August, 1917, at 4074. The extent to which Canada borrowed from the United States can be seen by comparing the wording of the Canadian deduction for dividends with that of the United States. Section 5(b) of the Federal Revenue Law, 1916 (US) provided: 'For the purpose of the normal tax only, the income embraced in a personal return shall be credited with the amount received as dividends upon the stock or from the net earnings of any corporation, joint stock company or association, trustee or insurance company, which is taxable upon its net income as hereinafter provided'; Section 3(1)(b) of the *Income War Tax Act*, 1917 (Can.) read: 'For the purpose of the normal tax, the income embraced in a personal return shall be credited with the amount received as dividends upon the stock or from the net earnings of any company or other person which is taxable upon its income under this Act'.

rate was raised to six per cent, but the normal individual rate remained at four per cent. Thus, the offset allowed at the personal level was no longer sufficient to compensate fully for taxes paid at the corporate level. This discrepancy continued, with variations in magnitude, until 1926, when the dividend exemption from the normal tax rate was repealed altogether. The chief reason given by the government for the dramatic change in 1926 was the need to equalise the tax burden on earned and unearned (dividend) income.¹²⁷

1926 TO 1949: A CLASSICAL CORPORATE TAX SYSTEM AND EXPERIMENTING WITH A PARTNERSHIP ELECTION

When the government adopted a separate corporate tax in 1926, concern was expressed about its effect on small businesses. In response, the government agreed to introduce a partnership election for 'family corporations'. Mr. Boivin, speaking on behalf of the Minister of Finance, explained the rationale of the change: 'The government proposes to remedy ... the discrimination against small corporations ... placing in the bill a clause ... giving to these corporations the opportunity of making their own option of paying their taxation as joint stock companies or as individual partnerships, as they may desire'.¹²⁸ The provision providing for the election was straightforward.¹²⁹ A family corporation was defined as a corporation 75 per cent of the stock of which was owned by the members of one family, at least one of whom took an active part in the business; or, a corporation 80 per cent of the stock of which was owned by persons actively employed in the business, or by them and their families.¹³⁰ The section providing for the election then simply stated that the shareholders of a family corporation could elect to be taxed as a partnership and 'each shareholder shall then be deemed to be a partner and shall be

127. A Member of Parliament, speaking on behalf of the Minister of Finance, justified the full taxation of dividends by stating: 'I maintain in the House and I will maintain it on any platform in the country that a man works eighteen hours a day in order to earn \$10,000 should not pay one cent more in income tax, than a man who does not one tap of work and who receives \$10,000 in dividends from the Canadian Pacific or the Bank of Montreal'. George H. Boivin, Canada, *House of Commons Debates*, 27 May 1926, at 3771.

128. *Id.*, at 3792.

129. When legislative draft—persons refer to the good old days, it is undoubtedly sections like this that they are recalling. The measure was only four short subsections long. A key term in the provision, 'family members', was undefined, the number of shareholders who had to make the election was not stipulated and the manner or time of making the election was not provided for. A residual subsection provided: 'The decision of the Minister upon any question arising under this section, including any question as to the application of the term "family" shall be final and conclusive'. *Income Tax War Act*, R.S.C. 1927, c. 97, s.22(4).

130. *Id.*, s.2(d).

taxable in respect of the income of the corporation according to his interest as a shareholder'.¹³¹ In 1930, to prevent non-residents from escaping the corporate level tax, the provision was amended to provide that the corporation had to pay tax on any income accruing to the benefit of non-resident shareholders.¹³² It appears that the government did not think many corporations would take the election. Mr. Boivin said in the House:

I am still of the opinion that most of these small corporations will take advantage of the law as it stands and continue to pay their taxes as corporations, and not as partnerships. If they pay their taxes as corporations, they will pay nine per cent on their entire earnings, it is true, but the individual partners will pay taxes only on what they withdraw from the company. The surplus that remains in the company is not taxed over and above the nine per cent.¹³³

In 1932, without any explanation in the House of Commons, the measure was repealed. A number of years later the Royal Commission on the Taxation of Annuities and Family Corporations suggested that the measure had been repealed because a large number of corporations had qualified and the election was seen as 'an unwarranted departure from the principle of double taxation of corporate profits'.¹³⁴

Even though relief from the separate corporate tax was provided small businesses, the Canadian Manufacturing Association and other business groups pressured the government after 1926 for more general relief from double taxation.¹³⁵ For example, a representative of the Canadian Manufacturers' Association, in reviewing the 1926 Budget before the Canadian Tax Conference of the Citizen's Research Institute said:

The most drastic change was that which cancelled the exemption from normal tax of dividends from Canadian companies, the new provision requiring shareholders in Canadian companies, to pay to the full on their dividends regardless of the fact that the companies themselves have already paid income tax.

It is hoped that the government will see fit to abolish double taxation in the next budget.¹³⁶

131. *Id.*, s.22.

132. *Ibid.*, as amended by S.C. 1930, 20-21 Geo. V, c. 24, s.5.

133. Canada, *House of Commons Debates*, 27 May 1926, at 3792.

134. Ives Commission, *supra* note 124, at 69.

135. See Perry, *supra* note 124.

136. *Id.*, at 23.

By 1931 their petitions seemed to reach the government. In that year, R.B. Bennett, the Prime Minister and Minister of Finance, in a rather complicated budget resolution, proposed that dividends up to one-half of the taxpayer's income be exempt from tax.¹³⁷ An acrimonious debate followed in which the opposition members accused the Prime Minister of attempting to benefit primarily himself and his friends. It was alleged that Bennett personally would save \$25 000 a year in taxes.¹³⁸ Bennett withdrew the proposal along with all other tax amendments proposed in the budget, including a substantial rate reduction for high-income taxpayers.¹³⁹

The issue of double taxation was taken up again by the Royal Commission on Dominion-Provincial Relations, which reported in 1940.¹⁴⁰ The Commissioners expressed concern about the double taxation of corporate-source income and noted in particular that it discriminated against the corporate form of organisation and resulted in undue reliance upon debt financing.¹⁴¹ The report went on to make a rather vague recommendation for removing double taxation by providing for a tax credit at the shareholder level.¹⁴² The need to raise revenue for the War precluded any action on the Commission's recommendation.

The issue of allowing closely-held corporations to elect to be taxed as partnerships arose again in 1945 in the course of the hearings of the Royal Commission on The Taxation of Annuities and Family Corporations (Ives Commission).¹⁴³ The Commission was established to inquire into, among other things, the tax problems faced by owners of family corporations when a major shareholder died. Under the separate corporate tax system, in which corporate rates were lower than top individual rates, there was a strong inducement for closely-held corporations to retain their earnings. In this situation, when the majority shareholder died, it was alleged that often the combined effect of the succession duties and income tax liabilities required family members to sell the

137. Canada, *House of Commons Debates*, 1 June 1931, at 2176.

138. *Id.*, 16 July 1931, at 3854-6.

139. See generally, R.B. Bryce, *Maturing in Hard Times: Canada's Department of Finance Through the Great Depression* (Kingston: McGill-Queen's University Press, 1986), at 104-5.

140. Canada, Royal Commission on Dominion-Provincial Relations, *Report*, (Ottawa: King's Printer for Canada, 1940). The Commission's terms of reference included a direction to examine the equity and efficiency of the tax system.

141. *Id.*, Book I, at 213; Book II, at 153.

142. *Id.*, Book II, at 153. For a detailed description of the background surrounding the Commission's recommendations on taxation, and an acknowledgement of the reliance placed on American commentators on corporate tax see Wynne, *supra* note 124.

143. Ives Commission, *supra* note 124.

business. One of the solutions to this problem that the Commission considered, and which several witnesses suggested, was the re-introduction of a partnership election for family corporations. In this way, the accumulating income of the corporation would be taxed each year as it was earned at the shareholder's rates. Thus there would not be a large bunching problem at death when income was withdrawn to pay the succession duties. For two reasons the Commission did not think this was a satisfactory resolution of the problem. First, the Commission stated that, since such a large proportion of Canadian corporations were family or closely-held corporations (the Commission estimated that about 30 per cent of Canadian companies would be entitled to take such an election if the 1926 provisions were re-introduced), 'it would seem an unwarranted departure from the principle of double taxation of corporate profits to grant a single tax basis to them unless it was a part of a basic change in the whole field of taxation of corporate profits'.¹⁴⁴ Second, they noted that in periods of high individual marginal tax rates such a solution would result in many closely-held corporations paying much higher taxes. In 1945, the corporate rate was 40 per cent, the top personal rate was 85 per cent. Thus the Commission concluded that, '[t]he adoption of the old "family corporation" principle would, in many cases, prevent a company from retaining a reasonable proportion of its earnings for unforeseen contingencies and for the normal growth and expansion of the business'¹⁴⁵ and that it 'might well act as a serious limitation on the development of Canadian business'.¹⁴⁶

1949 TO 1972: DIVIDEND RELIEF AND A LOWER RATE OF TAX

After World War II, the business community renewed its agitation for relief from double taxation. In 1945, the Minister of Finance, the Right Honourable J.L. Ilsley, promised at a Dominion-Provincial Conference on Reconstruction that if the federal government were given exclusive occupancy of the personal, corporate, and succession tax fields, it would eliminate a portion of the double taxation corporate-source income. Even though it did not obtain such agreement at the conference,¹⁴⁷ in 1949, as part of a major tax revision effort, the government responded to the pressures for both relief from double taxation in general and relief for small business in particular. Shareholders were given a tax credit equal to ten per cent of the amount of their dividend income as a way of

144. *Id.*, at 69.

145. *Id.*, at 70.

146. *Ibid.*

147. See Allan, *supra* note 124, at 16-17.

partially compensating them for the tax paid at the corporate level. Small businesses were given the benefit of a lower rate of tax of ten per cent on their first \$10 000 of corporate income.

The primary purpose of enacting a dividend tax credit was to provide an incentive for corporate investment.¹⁴⁸ The dividend relief took the form of a dividend-received credit instead of a withholding type arrangement, that is, a gross-up and credit arrangement. This method was used because it was simpler and because it was felt that it would be easier to justify making it non-refundable, particularly to non-residents.¹⁴⁹ This last point was particularly significant since it was estimated that over 60 per cent of dividends paid by Canadian companies went to non-resident shareholders.¹⁵⁰

As first enacted, the credit was limited to dividends paid to common shareholders, apparently on the assumption that the incidence of the corporate income tax fell only on the common shareholders. It was later extended to preferred shareholders because of the technical difficulties of distinguishing between the two classes of shares, uncertainty about the incidence of the corporate tax, and the desire to accomplish the related objective of the credit which was to encourage equity

148. In introducing the credit the Minister of Finance, the Honourable D.C. Abbott, explained: 'Today we find governments in this country as well as in most other countries, taxing away at least a third of corporate profits. In addition, the personal income tax rates apply in full to what is distributed out of the remaining two-thirds. The tax may be as high as 80 per cent upon distributions to shareholders. It seems to me that under a system of private enterprise which depends for its existence on a steady flow of venture capital we cannot afford to neglect the implication of this defect in our tax system, which has been accentuated by the increase in both corporate and personal tax rates'. Canada, *House of Commons Debates*, 22 March 1949, at 1799.

In addition he explained: 'My second proposal introduces a measure of reform which has long been a declared objective of this government. I refer to the removal of double taxation of corporate profits ... As a first step in dealing with this problem I am proposing that parliament should allow individuals a credit against their personal income tax equal to 10 per cent of the dividends they receive from common shares of Canadian taxpaying corporations': *Ibid.*

149. See Eaton, *supra* note 124, at 76.

150. Note, 'Corporate Profits and Dividends under the Income Tax Act', Report of the Fourth Tax Conference, Dec. 1950 (Toronto: Canadian Tax Foundation, 1950), at 11. The inadequacies of the dividend-received credit, including the fact that it was less equitable than a gross-up and credit arrangement, were well-recognized. However, at a meeting of the Canadian Tax Foundation, after considering a number of alternative proposals in what was obviously a spirited debate, the members concluded that the dividend-tax-credit to Canadian shareholders '... was at least as satisfactory a method of dealing with the problem at this stage as any other so far considered: that it had the advantages of simplicity, flexibility, low-revenue cost, and neutrality as regards non-residents; and that it was an encouraging first step which should go forward': *Id.*, at 12. The merits of the dividend-received credit were still being debated in 1971. For a defence of the dividend-received credit over a gross-up and credit arrangement see Ontario, Hon. W. Darcy McKeough, *Taxation of Corporations and Shareholders* (Ontario Proposals for Tax Reform in Canada III) (Toronto: Department of Treasury and Economics, 1970).

investment.¹⁵¹ In 1953 the dividend tax credit was increased to 20 per cent¹⁵² and in 1957 it was extended so that it could offset any personal tax liability (as originally enacted it could only be applied against personal tax liability incurred on the dividend income). Otherwise, the design of the credit remained essentially unchanged from 1949 to 1972.

In addition to the dividend tax credit, a dual rate structure for corporations was introduced in 1949. The corporate rate on the first \$10 000 of corporate profits was set at ten per cent; the rate on the excess was set at 33 per cent. When the dual rate was introduced an interesting trade-off was made. Before the introduction of the dual rate the corporate tax rate had been 30 per cent. In order to make the change revenue neutral, when the lower rate of ten per cent was introduced the basic rate was increased by three percentage points to 33 per cent. Thus, even though the lower rate of tax applied to all firms, overall small firms gained (it was estimated that all firms earning under \$77 000 would gain), while the burden on large firms was increased. In introducing the proposed change the Minister of Finance indicated that it was designed to encourage the growth of small businesses by leaving them more income after tax for reinvestment.¹⁵³

When coupled with the ten per cent dividend tax credit, the low rate for small business achieved almost complete integration for small businesses with profits less than \$10 000.¹⁵⁴ Thus, the dividend tax credit served two purposes: First, it encouraged Canadian investment in Canadian companies in a general way by increasing the after-tax value of dividends and thus the value of Canadian shares. Second, in conjunction with the dual corporate rate, it provided a measure of tax structure balance by roughly equating the tax

151. See Eaton, *supra* note 124, at 77.

152. The Minister of Finance, the Honourable Mr. Abbott, justified the increase on the basis that it was a second step in removing double taxation on corporate source income and that it would further encourage Canadians to invest in Canadian equities. Canada, *House of Commons Debates*, 19 February 1953, at 2128.

153. The Liberal Minister of Finance, the Honourable Mr. Abbott, justified the measure in the following terms: 'The house will at once recognise this as tax relief for small businesses and will, I trust, be heartily in accord with the policy. Our country as a whole owes a great deal to the small family type of business. They have to struggle along, grow and develop in competition with large and well financed corporations whose activities may be nation-wide. My own belief is that small businesses should be encouraged and it seems to me that a useful way to do this is to lower the tax and take less out of the funds they need for growth and expansion'. Canada, *House of Commons Debates*, 15 November 1949, at 1798.

154. Contrary to assertions by the government, see Abbott in *Debates*, *id.*, at 1799, the integration was not perfect. The 10 per cent tax imposed on small businesses was greater than the 10 per cent credit on dividends paid that shareholders received. For example, a corporation with income of \$100 would pay tax of \$10. If it distributed all of its after-tax earnings, \$90, its shareholders would only be entitled to a credit of \$9. Thus an element of double tax remained even for small businesses.

position of small incorporated businesses with their unincorporated counterpart.

The rate of tax on small businesses and the amount of taxable income eligible for the low rate were increased from time to time. By 1971, when the system underwent radical reform, the standard corporate tax rate was 50 per cent and the lower corporate tax rate was 21 per cent on the first \$35 000 of taxable income.

After 1949 there appears to have been no pressure for partnership treatment of small corporations. In large part this was no doubt due to the fact that, because of the reduced rate on small business, and the dividend tax credit, most business people paid less tax if they were incorporated.¹⁵⁵ Indeed, most commentators were positively opposed to the idea. Prior to the 1949 amendments, a discussion group of the Canadian Tax Foundation, in considering the same problem addressed by the Ives Committee, recommended, on balance, the creation of a new type of company having a right of election similar to that enjoyed by the 'family corporation' as it existed prior to 1933. However, they suggested that at the existing high rates of individual tax this alone would not be an effective solution to the problems of small businesses.¹⁵⁶ Petrie, a leading commentator and Director of Research at the Canadian Tax Foundation, concluded in his exhaustive study of the Canadian corporate tax that compulsory partnership treatment for closely-held corporations was unacceptable since it would expose the retained earnings of growing small corporations to highly progressive rates of personal income tax.¹⁵⁷ He also rejected optional partnership treatment for closely-held corporations on the grounds that it would create inequities between those corporations that elected such treatment and those that did not.¹⁵⁸

155. See D. Ivor, 'The Present Status of the Corporation Income Tax' (1957) 4 *Canadian Tax Journal* 112, at 118-9 ('It is difficult to see why the private corporation should be taxed in a way that is different from the partnership or the sole proprietorship. However, as mentioned previously, recent Canadian legislation ... has in almost every case, placed the private corporation in a preferred position to other forms of organisation insofar as income taxation is concerned').

156. See M. Douglas, 'Tax Treatment of Closely-Held Corporations' in Canadian Tax Foundation, *Report of the [Second] Tax Conference*, Nov. 1948 (Toronto: Canadian Tax Foundation, 1949) 5.

157. See *The Taxation of Corporate Income in Canada*, *supra* note 124, at 289-90. He quoted Professor Butters with approval, who stated: 'Probably there is a general agreement that such a tax policy would be intolerable'. Butters, *supra* note 92, at 79.

158. *The Taxation of Corporate Income in Canada*, *supra* note 124, at 290 ('If the plan were made optional, the corporations concerned would presumably select the tax basis more favourable to them. The very principle underlying a plan to allow certain companies to choose a method of taxation which allows the shareholders to select one tax that is lower than another violates all canons of tax equity and tax neutrality').

1967: THE ROYAL COMMISSION ON TAXATION

The issue appears not to have been canvassed again until the Royal Commission on Taxation (Carter Commission) reported in 1967.¹⁵⁹ The Carter Commission, whose report is widely regarded as one of the most comprehensive and detailed blueprints for tax reform, proposed a radical plan for tax reform in Canada based upon a comprehensive tax base. One of its major recommendations was the integration of the corporate and shareholder tax. The Commission did not recommend integration be achieved by the partnership method, for all of the familiar reasons: (1) 'A complete and theoretically consistent allocation of the year's income would require that the various persons who had held the shares of the company for varying periods during the year would be allocated their share of the year's income. This would be extremely difficult.' (2) 'The final order or priority of the rights of individual shareholders would have to be settled every year for the sharing of the year's income among them. This might be contrary to contractual arrangements already in existence.' (3) Liquidity problems would be created for shareholders deemed to have received substantial amounts of income in a year in which it was not possible for the corporation to pay out cash. (4) The partnership option would not provide an acceptable basis for the taxation of income flowing to non-residents.¹⁶⁰

Instead of full partnership treatment for corporations, the Carter Commission recommended the optional allocation of retained earnings to shareholders. Under the Commission's scheme of integration: (1) A withholding tax of 50 per cent of taxable earnings would be imposed on corporations. (2) Shareholders would include all dividends in income, grossed-up to account for the corporate tax paid, and then receive a tax credit for the corporate tax paid. (3) Resident shareholders would also include in their income each year, at the corporation's election, their share of the corporation's undistributed income for the year, grossed-up to account for the corporate tax paid, and then receive a tax credit for the corporate tax paid. (4) The adjusted cost basis of the shares would be written up by the amount of allocated retentions.¹⁶¹

Even though the Commission recommended nearly full integration of corporate and shareholder tax, it recommended

159. Canada, Royal Commission on Taxation, *Report*, vol. 4 (Chairperson: Kenneth L.M. Carter) (Ottawa: Queen's Printer, 1966) [hereinafter Carter Commission].

160. *Id.*, at 45.

161. For a brief description of the scheme see *id.*, at 7-8; for details see *id.*, at 49-81. For an argument that this less ambitious approach to integration still entails most of the problems of full integration by the partnership method see McLure, *supra* note 36, at 160-6.

that certain small corporations be allowed to elect to be taxed as partnerships, for two reasons.¹⁶² First, under the Commission's proposed system of integration, corporations would have to pay a withholding tax at a rate of 50 per cent, which would later be refunded to the shareholders. In recommending the partnership option the Commission noted that the 50 per cent corporate withholding tax might cause liquidity problems for small corporations whose shareholders were in lower income tax brackets. Second, under its proposed system of integration the Commission recommended that losses not be passed through to shareholders but instead simply be carried forward to be applied against corporate income.¹⁶³ Under the partnership option losses could be allocated to individual shareholders.

Essentially, a corporation that made the election would be taxed like a partnership. However, to ensure that the provision could be easily administered, and to prevent abuses, the Commission proposed that the following restrictions be imposed upon the ability to take the election: the election would have to be approved by 90 per cent of the shareholders; the income of the corporation for the taxation year in which the election was made could not exceed \$200 000; only corporations with 15 or fewer shareholders could take the election; all shareholders would have to be resident in Canada; and, an election could only be made if the corporation had distributed all of its prior year's income.

The Commission also recommended that the low rate of tax for small businesses be abolished. It opposed it as a form of assistance for small businesses for the following reasons:¹⁶⁴ (1) Even though its rationale was to assist small businesses, it was only available to small businesses that were incorporated. (2) Even though non-profitable small businesses might be in greater need of assistance, the subsidy was only available to profitable small businesses. (3) Even though its purpose was to assist businesses to expand, it was received by corporations that used their increased profits for purposes unrelated to the business or to increase the amount of distributions to shareholders. (4) Even though the low rate was intended to subsidise small firms that had difficulty raising outside capital for expansion because of imperfections in the capital market, it was available to firms irrespective of the value of their assets, gross sales, or the income or wealth of their owners. (5) It applied to the first \$35 000 of corporate income regardless of the magnitude of the total income of the corporation. (6) By reducing the tax on low-income corporations in perpetuity it tended to cushion the market pressures on inefficient and

162. Carter Commission, *supra* note 159, at 68-70, 91.

163. *Id.*, at 60.

164. *Id.*, at 270-3 and App. I, at 703-24.

declining firms. (7) The concession created many potential avenues for abuse; in particular, it was largely responsible for the complex associated-corporation legislation.

The Commission considered a number of alternatives to the dual rate of corporate tax as a means of assisting small businesses. They did not consider that the partnership option that they had recommended would be 'a sufficient amelioration of the serious results of complete withdrawal of the low rate of corporation tax'¹⁶⁵ because 'in most cases the net result of this option would be an increase in the overall tax burden'.¹⁶⁶ Also, they noted that 'corporations whose shareholders are all employees or possibly directors effectively have this option available to them now in their ability to fix levels of remuneration'.¹⁶⁷ With some considerable reluctance they recommended that within certain stringent restrictions, new and small businesses should be allowed a 100 per cent write-off for certain capital assets. The available write-off would be limited to \$250 000 over a ten-year period.¹⁶⁸

Unlike many other recommendations in its report, the Commission's recommendations with respect to small businesses met with approval, or at least resignation. For example, in commenting on the reaction to the abolition of the dual rate one commentator noted 'most people recognise defects in the dual rate and are prepared to consider abolition with or without a substitute'.¹⁶⁹ It is interesting to speculate why the Carter Commission's proposal to abolish the dual rate provoked so little response when, three years later, a similar proposal by the government provoked so much adverse reaction that it threatened the whole tax reform exercise.¹⁷⁰ Perhaps, the seemingly apathetic reaction of the small business community to the Carter Commission proposals was simply due to the fact that small business was not organised in 1967, or perhaps they

165. *Id.*, at 719.

166. *Ibid.*

167. *Id.*, at 718-9. However, they noted that it would be of advantage to small corporations where the shareholders are not employees.

168. *Id.*, at 276-82, 286-7. This suggestion by Carter - to provide an accelerated capital cost allowance for new and small businesses - was never seriously pursued in the ensuing tax reform debate largely because, while it would assist small manufacturing firms, for example, it provided no assistance to firms in the service industry which wished to expand. See *White Paper on Tax Reform: Summary of Public Hearings* (Toronto: CCH, 1970), at 331-2.

169. E. Saunders, 'Tax Treatment of New and Small Business', in Canadian Tax Foundation, *Report of the Twentieth Tax Conference, Nov. 1967* (Toronto: Canadian Tax Foundation, 1968), at 274. See also D.B. Fields; *Id.*, at 279; W.D. Goodman, 'Integration', *Id.*, at 67; S.D. Thom, 'Taxation of Corporations' in Canadian Tax Foundation, *Report of the Nineteenth Tax Conference, April 1967* (Toronto: Canadian Tax Foundation, 1968) 48, at 57 ('In the face of the obvious anomalies resulting from the present two-rate schedule and the severe problems for government and taxpayer alike encountered in maintaining the associated company concept, the Commission's proposals are eminently superior').

170. See *infra* text, note 198.

did not feel threatened because the Commission maintained that small business did warrant some special attention.

The partnership election also met with general approval,¹⁷¹ although, for many businesses it would not be significant since it could be achieved, in effect, under the existing law simply by paying salaries.¹⁷² One commentator referred to it simply as 'integration in a hurry'.¹⁷³ The ability to pass out losses was regarded as the most significant aspect of the election.¹⁷⁴ Commentators noted that this aspect of the election would stimulate investment in new and risky businesses.¹⁷⁵

1969: THE WHITE PAPER

Three years after the Carter Commission published its report, the government published its own *Proposals for Tax Reform (White Paper)*.¹⁷⁶ Although the proposals were not as far reaching as those of the Carter Commission, they still represented a substantial tax reform effort.¹⁷⁷ The over-riding objective of the *White Paper* proposals was to ensure that the tax system facilitated economic growth by not interfering with business decisions. With respect to the taxation of closely-held corporations, the *White Paper* began with the assumption that closely-held corporations competed with proprietorships and partnerships.¹⁷⁸ Therefore, the principal objective of the proposals in relation to small businesses was 'to design a system that will produce the same tax on a Canadian whether he carries on his business in his own name or whether he incorporates it'.¹⁷⁹

To achieve this objective, the *White Paper* made three significant recommendations in relation to small businesses. First, closely-held corporations meeting certain requirements would be given the option of being taxed as partnerships.¹⁸⁰

171. See Saunders, *supra* note 169, and Fields, *supra* note 169.

172. D.R. Huggett, 'Integration' in Canadian Tax Foundation, *Report of the Twentieth Tax Conference, Nov. 1967* (Toronto: Canadian Tax Foundation, 1968) 81, at 87 ('The Commission recognised that [abolition of the low rate of corporate tax] might cause some problems to small businesses in that there would be a time lag between the payment of the 50 per cent corporate tax and the refund to the shareholders of the excess tax. This is not a grave problem since most small businesses could eliminate the corporate tax or reduce it by crediting the shareholders with salaries.').

173. Fields, *supra* note 169, at 282.

174. *Id.*, at 283.

175. C. Shoup, 'Economic Implications' in Canadian Tax Foundation, *Report of the Nineteenth Tax Conference, April 1967* (Toronto: Canadian Tax Foundation, 1968) 70, at 73-4.

176. Hon. E.J. Benson, Minister of Finance *Proposals for Tax Reform* (Ottawa: Queen's Printer, 1969).

177. See generally, J.G. Head, 'Evolution of the Canadian Tax Reform' (1973) 1 *Dalhousie Law Review* 51.

178. *Proposals for Tax Reform*, *supra* note 176, at para. 4.19.

179. *Id.*, at para. 4.20.

180. *Id.*, at para. 4.21.

Second, shareholders of closely-held corporations which did not meet these requirements, or did not elect to be taxed as partnerships, would be given credit for the full amount of the tax paid by the corporation when profits were distributed.¹⁸¹ Third, the lower the rate of tax on corporate income would be abolished.¹⁸² All corporate income would bear tax at a rate of 50 per cent.¹⁸³

Although it is clear from the *White Paper* that the details of the 'partnership option' had not been thought through, it was proposed that a corporation would qualify to be treated as a partnership only if:¹⁸⁴ (1) It was a closely-held corporation (basically, a corporation whose shares were not widely traded).¹⁸⁵ (2) All shareholders of the corporation signed an election agreeing to be so taxed. (3) It was clear what portion of the profits each shareholder would receive. (4) All shareholders were individuals resident in Canada or corporations incorporated in Canada. (5) All corporate shareholders had the same fiscal year-end as the electing corporation.

To foster discussion, the *White Paper* was referred to the House of Commons' Standing Committee on Finance, Trade and Economic Affairs, which held public hearings on the proposals. It received over 500 briefs, mainly from business organisations.¹⁸⁶ A large number of the briefs commented on the *White Paper's* proposal that closely-held corporations be given a partnership option.¹⁸⁷ The reaction to the proposal was coloured by the fact that the government proposed partnership treatment for closely-held corporations (which would include wholly-owned subsidiaries of widely-held corporations) not only as a way of equalising the tax burden on unincorporated and incorporated small businesses, but also as an indirect way of allowing related corporate groups to report their income on a consolidated basis.¹⁸⁸ On this latter issue, most business groups argued that the government should have gone all the way and allowed the filing of consolidated returns; however, in the absence of this they supported the partnership election as a means of allowing some form of consolidated reporting among corporate groups.¹⁸⁹ However, those presenting briefs were

181. *Id.*, at para. 4.24.

182. *Id.*, at para. 4.30.

183. *Id.*, at paras 4.24, 4.35.

184. *Id.*, at paras 4.20 to 4.23.

185. *Id.*, at para. 4.43.

186. See *White Paper on Tax Reform: Summary of Public Hearings*, *supra* note 168.

187. *Id.*, at 327-9.

188. *Proposals for Tax Reform*, *supra* note 176, at para. 5.22.

189. Many briefs suggested, however, that unless the subsidiary was wholly-owned, the partnership option would not be available to achieve consolidated reporting either because some of the shareholders might be non-residents, the subsidiary might have two classes of shares, a minority shareholder

generally unexcited by the partnership method as an option for small businesses. Most noted that the 50 per cent individual tax rate, which was equivalent to the corporate tax rate, was reached at only \$24 000. Therefore, the election would be of no benefit to shareholders in income brackets greater than this. Furthermore, the election would provide no assistance to small businesses which were attempting to retain capital for expansion. One or two briefs noted that it would be of assistance to start-up firms since it would allow them to offset losses against their individual income; however, for some reason this was not a point that was emphasised in the *White Paper*, or even explicitly mentioned, and very few briefs commented on it.

The second significant recommendation made in the *White Paper* in relation to small business was that, for closely-held corporations that did not satisfy the requirements for the partnership election, or otherwise did not elect to be taxed as a partnership, shareholders would receive a credit against their individual tax liability for the full tax paid by the corporation on distributed profits. Under this integration proposal:¹⁹⁰ to receive credit for the corporation tax, a shareholder would be required to 'gross up' the dividend received by adding the applicable portion of the tax paid by the corporation on the distributed earnings;¹⁹¹ the dividend tax credit was to be refundable (thus low-income taxpayers would receive the full amount of the credit); the credit could be claimed on both cash dividends and stock dividends (thus corporations did not have to pay out cash in order to give the shareholders the benefit of the creditable tax); shareholders could claim the creditable tax only on dividends that were paid from income upon which tax had in fact been paid at the corporate level (thus if no tax was paid at the corporate level because the corporation was able to claim a tax expenditure, for example, no credit was given when the income was distributed); and, the credit was to be available only on dividends paid out of surplus that had been earned by the corporation within two and one-half years of the dividend distribution (in order to limit the amount of

might not consent, or the year-end of the subsidiary corporation might not coincide with the year-end of the parent corporation. To meet some of those concerns a number of briefs suggested that the option should be allowed where non-resident shareholders undertake to file Canadian income tax returns reporting their Canadian source income, and where the electing shareholders agree to assume the tax liability in respect of income allocatable to a minority shareholder who does not agree to sign the election. See Canadian Institute of Chartered Accountants, 'Submission to the House of Commons Standing Committee on Finance, Trade and Economic Affairs' in Canada, House of Commons, Standing Committee on Finance, Trade and Economic Affairs, 28th Parl., 2d. Sess., *Proceedings* (Chairperson: G. Clermont) (Ottawa: Queen's Printer, 1970), No. 49, App. B-46, 91, at 136.

190. *Proposals for Tax Reform*, *supra* note 176, at paras 4.25 to 4.27.

191. *Id.*, at para. 4.24.

outstanding claims against the government). As an integral part of its objective to make the tax system as neutral as possible, the *White Paper* also proposed that shareholders of closely-held corporations be required to include in ordinary income the full amount of any capital gain realised from the sale of the corporation's shares.

The *White Paper* proposed only partial integration for publicly-held corporations.¹⁹² Shareholders were to be given credit for only one-half the corporate tax paid on the income from which the dividend was paid. The authors of the *White Paper* apparently assumed that only one-half the corporate tax was borne by shareholders (the other half was shifted to consumers) and therefore shareholders should be entitled only to a credit for one-half the corporate tax paid on distributed income. To compensate, in some sense, for the limitation on the shareholder credit, only one-half of the capital gains from the disposition of shares of widely-held companies were to be taxed. Then, in a radical move, to prevent long accruals and the bunching of capital gains the *White Paper* proposed that shares of public corporations should be re-valued every five years and the accrued gains taxed at that time.

The following criticisms were made of the *White Paper's* integration proposals.¹⁹³ First, tax practitioners argued that the distinction between closely-held and widely-held corporations was too arbitrary to justify the significant distinctions with respect to integration and capital gains tax. (Clearly many closely-held corporations would be as large as widely-held corporations and would be competing with them.) Second, investors argued that the deemed realisation of publicly-traded shares at five-year intervals would discourage long-term investments in those securities. Moreover, controlling shareholders of such corporations argued that such a rule would force sales of large blocks of shares, force down the market price of the shares and disrupt continuity of ownership and management. Third, there was strong objection to the washing out of corporate tax preferences when dividends were paid. Finally, accountants and tax lawyers expressed concern about the complications introduced by providing that the dividend tax credit would only be available for corporate income that had borne the corporate level tax and the rule that the dividend tax credits on income earned in a year would be lost if the income was not distributed to shareholders within two and one-half years. In response to these criticisms the

192. *Id.*, at paras 4.34 to 4.42.

193. See *White Paper on Tax Reform: Summary of Public Hearings*, *supra* note 168. See also, generally, S.E. Edwards, 'The White Paper: Corporations' (1970) 18 *Canadian Tax Journal* 83; L.J. Smith, 'Taxation of Corporations' in Canadian Tax Foundation, *Report of the Twenty-Second Tax Conference*, Nov., 1970 (Toronto: Canadian Tax Foundation, 1971), at 101.

government considerably modified its integration proposals, as described below.¹⁹⁴

It is significant that the *White Paper* had recommended a partnership election even though it proposed full imputation for closely-held corporations. The partnership election could benefit small business in three ways: First, for low-income shareholders it would obviate any liquidity problems posed by having to pay the 50 per cent corporate tax and then not receiving a refund, in effect, until the payment of dividends. Second, it would allow owners of closely-held corporations to pass out losses. Third, it would allow small businesses to receive the same benefit from tax expenditures as sole proprietors and partnerships. By way of elaboration on this last advantage, under the *White Paper's* integration proposals shareholders would only receive a dividend tax credit if the distributed corporate earnings had in fact borne tax at the corporate level. Thus if the corporation was entitled to claim a tax incentive, its effect would be washed out when corporate earnings were distributed because shareholders would have to include the full amount of the earnings in income. Therefore, tax incentives would benefit shareholders of closely-held corporations only as long as the income was retained in the corporation. However, by electing partnership treatment the shareholders of closely-held corporations could derive the same benefit from tax incentives as if they were operating as partnerships.

In addition to the partnership election and integration, the third major recommendation of the *White Paper* that directly affected closely-held corporations was the abolition of the lower rate of corporate tax.¹⁹⁵ The authors of the *White Paper* gave two reasons for proposing the removal of the low rate of corporate tax. First, consistent with their concern with a neutral tax system, they noted that the low rate gave small corporations 'a significant advantage over those persons with similar incomes who did not or could not incorporate their business'.¹⁹⁶ Second, the low rate encouraged taxpayers to incorporate several corporations to take advantage of the low

194. In addition to the explicitly asserted criticism of the form of integration recommended by the Carter Commission and the *White Paper*, there were very likely two other explanations for the vociferous attacks on it. First, most business people linked integration with the taxation of capital gains and therefore perhaps felt that if they could get the government retreat on integration it would also withdraw the capital gain's proposals. Second, many of the business briefs opposing tax reform would have been prepared by corporate managers not shareholders. Corporate managers might be expected to oppose integration because it would place pressure on them to increase pay-out ratios.

195. *Proposals for Tax Reform*, *supra* note 176, at paras 4.15 to 4.18. The dual rate was to be removed by lowering the \$35 000 limit by \$7000 annually over a five year period.

196. *Id.*, at 47, para. 4.15.

tax rate when for business purposes one corporation would do.¹⁹⁷

No aspect of the *White Paper* aroused so much political opposition as its proposal to eliminate the lower corporate tax rate without substituting an alternative incentive.¹⁹⁸ Large corporations, investment firms, and boards of trade all joined small business representatives in criticising the proposal. Many briefs argued that the dual rate was the optimal way of subsidising small businesses. Others admitted the defects in the subsidy program but suggested that it should stay at least until an alternative program was in place. Over 60 briefs commented adversely on this proposal.

Before reviewing the House of Commons Committee's recommendations, it is worth noting how well the *White Paper* had achieved its objective, namely the neutrality of the tax system, in this area. The logic and symmetry of the *White Paper* is not always appreciated by tax commentators. Basically, under the proposals, the tax system would be neutral as to whether a person carried on a small business as a sole proprietorship, partnership or as a corporation. If the business was carried on as a corporation, the same tax would normally be paid whether the owner left the earnings in the corporation or extracted them either in the form of salary or as dividends. Approximately the same tax would be paid whether the owners extracted the corporate earnings every year or allowed them to accumulate and then subsequently sold the business and realised a capital gain. Finally, upon sale, the same tax would be paid whether the owners decided to sell the company's assets or its shares.

1971: THE PARLIAMENTARY COMMITTEE REPORTS AND THE ONTARIO GOVERNMENT PROPOSALS

In view of the adverse reaction to the *White Paper's* recommendations, the House of Commons Committee recommended that half of the corporate tax be integrated for all corporations, but that full integration be extended to \$50 000 of taxable income annually of closely-held corporations.¹⁹⁹ With respect to the partnership option, the Committee noted that it would be a useful device and 'we should like to see it extended as far as is consistent with our

197. *Id.*, at 47, para. 4.16.

198. See *White Paper on Tax Reform: Summary of Public Hearings*, *supra* note 168, at 331-40; J.J. MacIntyre and D.B. Fields, 'The White Paper: Black Looks from Small Corporations' (1970) 18 *Canadian Tax Journal* 131.

199. Canada, Standing Committee on Finance, Trade and Economic Affairs, *Eighteenth Report: Respecting the White Paper on Tax Reform* (Chairperson: G. Clermont) (Ottawa: Queen's Printer for Canada, 1970), at 42.

general recommendations for half integration'.²⁰⁰ Finally, although the Committee agreed that the lower rate of corporate tax was an inappropriate subsidy for small business, they concluded that small business should obtain some form of tax relief and encouraged the government to replace it with a more appropriate tax subsidy.²⁰¹ If the government could not formulate a better plan, they recommended that the small business incentive be available to a business with taxable income of up to \$35 000 and that when this figure was passed, the relief be phased out under a notch provision so that it would be withdrawn altogether when taxable income reached \$105 000.²⁰²

Two further significant proposals for taxing small business were made at about the same time as the House of Commons Committee reported. When the government's *White Paper* was tabled the Senate referred it to its Standing Committee on Banking, Trade and Commerce. This Committee also held hearings and ultimately published a report of its recommendations.²⁰³ Not surprisingly, given the make-up of the Canadian Senate, their report was essentially a defence of the status quo. They wrote a particularly strong defence of the low rate of tax for small business.²⁰⁴ After reviewing the usual arguments about the importance of retained earnings to the growth of small businesses and the importance of small businesses to the economy,²⁰⁵ they responded to both of the *White Paper's* arguments against a low rate of corporate tax. First, they argued that the fact that the credit did not benefit unincorporated firms was of trivial consequence since unincorporated business 'usually fall into the non-growth category' and seldom compete against corporated firms.²⁰⁶ Second, they argued that the problem of the incorporation of several related firms in order to obtain the benefit of the low rate in each corporation was not as serious as the authors of the *White Paper* had suggested. They argued that the broad discretion that was given to the Minister of National Revenue to 'associate' corporations whose existence had no business purpose had largely solved the problem.²⁰⁷ However, the Senate Committee went on to make two recommendations as to how the lower rate of tax could be better targeted. First, they suggested that it should be restricted to the 'business' income

200. *Id.*, at 49.

201. *Id.*, at 52.

202. *Id.*, at 53.

203. Canada, Standing Senate Committee on Banking, Trade and Commerce, *Report on the White Paper Proposals for Tax Reform* (Chairperson: Salter A. Hayden) (Ottawa, 1970).

204. *Id.*, at 65, para. 6 and Appendix 'The Small Business Corporation', at 79.

205. *Id.*, at 79-80.

206. *Id.*, at 81.

207. *Ibid.*

of small business corporations. Second, to prevent large corporations from benefiting from it, when a firm's net income exceeded \$100 000 they recommended that the low rate be gradually withdrawn.²⁰⁸

In responding to the *White Paper*, the Ontario Government also presented an alternative proposal for small business taxation.²⁰⁹ Along with the two Parliamentary Committees, the Ontario Government also felt strongly that small businesses should be encouraged through the tax system. However, it admitted that the dual rate structure had disadvantages. In addition to disadvantages pointed out by others, the Ontario Government emphasised the following points. First, the low tax rate benefited high-income taxpayers proportionately more than low-income taxpayers.²¹⁰ Second, the low rate (particularly a disappearing incentive) penalised success and encouraged tax manipulation to keep income down in order to avoid the higher rates.²¹¹ Third, the low rate, or any incentive based on a size of business test, discouraged mergers that might increase efficiency through increased scale of operations.²¹² Finally, '[a]n incentive related only to business earnings does nothing for the business which one might argue needs it most - the business suffering losses or not yet profitable. While it has the merit of being success related, it may jeopardise success, by not becoming available early enough in the life of a business'.²¹³

In place of the low rate of tax, the Ontario Government proposed a small business incentive tax credit that would be given directly to an individual investing in a small business. Although this is not the place to describe and analyse it in detail, it would have been a vastly superior instrument, in my view, to the small business credit ultimately passed by the federal government.²¹⁴

208. *Id.*, at 65, para. 6 and at 81-2.

209. Ontario, Hon. Charles MacNaughton, Treasurer and Minister of Economics, *Tax Reform and Small Business* (Ontario Proposals for Tax Reform in Canada II) (Toronto: Department of Treasury and Economics, 1970).

210. *Id.*, at 18 ('it does not begin to provide any significant tax relief until personal incomes exceed about \$10,000 and becomes proportionately more valuable as individual incomes increase').

211. *Id.*, at 26.

212. *Ibid.*, n.3 ('if four owner-operators each had a business of the maximum qualifying size, then however sensible it might be for them to join together, the tax cost would be \$30,000 a year under the present option ...').

213. *Id.*, at 26.

214. For a description of, and suggestions for a number of improvements in, the proposal, see J. Bossons, 'The Ontario Proposals for a Small Business Tax Incentive' (1971) 19 *Canadian Tax Journal* 173. Policy instruments similar to that proposed by the Ontario Government have subsequently been enacted by many provincial governments.

1972: TARGETING THE LOWER RATE OF TAX - THE SMALL BUSINESS CREDIT²¹⁵

Following almost a decade of study, the government introduced its tax reform legislation on 18 June 1971. The bill was passed by the end of the year and made effective for 1972 and subsequent years.²¹⁶ Determined to repeal the lower rate of corporate tax, but yielding to pressure to provide some form of general relief for closely-held corporations, the government enacted a tax credit of 21 per cent of taxable income for qualifying small businesses.²¹⁷ The effect of the credit is to reduce the federal corporate tax rate for qualifying corporations from 46 to 25 per cent.²¹⁸ Before examining the details of the small business credit, the changes in the dividend tax credit will be briefly reviewed. The combined effect of the small business credit and the reformed dividend tax credit was to completely integrate the corporate and shareholder tax on distributions from income that qualified for the small business credit.

Two important changes were made in the dividend tax credit. First, it was increased from 20 to 33.3 per cent of dividends paid.²¹⁹ Thus, the credit offset 25 points of corporate tax in the hands of the individual shareholders. For most corporations this was about one-half of their corporate

215. For a general description of the small business credit and subsequent developments see Symposium, 'The Small Business Credit' (1979) 1 *Canadian Taxation* (No. 2) 29; W.J. Strain, 'The Small Business Rules: "O What a Tangled Web ...!"' in Canadian Tax Foundation, *Report of the Thirty-Fourth Tax Conference, 1982* (Toronto: Canadian Tax Foundation, 1983) 53; B. Shinder, 'The Taxation of Small Business: An Historical and Technical Overview' (1984) 32 *Canadian Tax Journal* 1.

216. *Income Tax Act*, R.S.C. 1952, c. 148, as amended by S.C. 1970-71-72, c. 63.

217. *Id.*, s.125. The credit was actually set at 25 per cent in 1972 and then reduced by one percentage point a year until it reached 21 per cent in 1976. The reduction in the credit paralleled the reduction in the corporate tax rate from 50 per cent in 1972 to 46 per cent in 1976. *Id.*, s.123(1).

218. Forty-six per cent is the basic federal corporate tax rate. The federal government provides a tax credit of 10 per cent of a corporation's taxable income earned in the year in a province. Each province then imposes its own tax on corporations. In 1985 these rates varied from 10 to 16 per cent, and three to 10 per cent on taxable income that qualified for the federal small business credit. Consequently, the combined corporate tax rate varied from province to province from 46 to 51 per cent. The combined tax rate on income that qualified for the small business credit varied from 18 to 25 per cent.

219. *Income Tax Act*, S.C. 1970-71-72, c. 63, s.12. The dividend tax credit is not expressed as a percentage of dividends paid in this section, but instead as a percentage (3/4 in 1972) of the amount the shareholder has to gross the dividend up by pursuant to s.82(1)(b) in including it in income. The gross-up was 1/3 of dividends received. The dividend tax credit in the federal income tax act was expressed as a percentage of this amount, instead of the full amount, since the dividend tax credit has the effect of lowering both the federal and provincial personal taxes. On the assumption that the provincial individual tax rate was 33 1/3 per cent of the federal tax payable, the dividend tax credit reduced federal taxes by 3/4 of the gross-up and provincial taxes by 1/4 of the gross-up.

tax paid, but for corporations that qualified for the small business credit, whose effective corporate tax rate would be about 25 per cent, it essentially eliminated the corporate tax on distributed earnings (by giving the shareholders full credit for all corporate taxes paid). Second, the post-1972 dividend tax credit was made taxable by introducing a gross-up technique for dividends received by individuals. The gross-up technique required shareholders to include in their income an amount approximating the pre-tax earnings of the corporations to which the dividend tax credit applied.

In view of the criticism the government received about its integration proposals made in the *White Paper*, a number of characteristics of the dividend tax credit that it had recommended there were not included in the legislation: no distinction was made between public and private corporations in applying the dividend tax credit; the dividend tax credit was extended to shareholders whether or not the corporate tax was paid; it was not made refundable; and, the proposed requirement that earnings be paid out within two and one-half years in order to be creditable was dropped.

The small business tax credit, while providing a subsidy to small businesses, was designed to meet the criticisms that both the Royal Commission on Taxation and the *White Paper* had made about the lower rate of tax. Therefore, the characteristics of the small business credit can be understood most easily by reviewing the criticisms that were levelled against the dual rate structure, and examining how the small business credit was designed to meet those criticisms. The effect of all of the changes was to more selectively target the subsidy. As the government noted in its explanation of the new provision, 'The changes ... will limit the incentive to smaller Canadian-controlled corporations that require, and in fact use, the tax savings to invest in their businesses or to pay dividends to shareholders'.²²⁰

First, the major criticism that was levelled against the lower rate of tax was that it was available to all corporations regardless of their size. Therefore, the small business credit was restricted in three ways in order to target it at small firms. First, it was not available to public corporations. Presumably this reflects a judgment that if a corporation is able to raise financial capital by offering an issue of shares to the public there is no need to provide it with a subsidy so that it can retain more of its earnings for expansion. Second, the credit was available only on the first \$50 000 (the 'business limit') (raised in 1974 to \$100 000, in 1976 to \$150 000, and in 1982

220. Canada, Hon. E.J. Benson, *Summary of 1971 Tax Reform Legislation* (Ottawa: Department of Finance, 1971), at 37.

to \$200 000)²²¹ of a corporation's earnings. Third, when a corporation had accumulated \$400 000 (the 'total business limit') (raised in 1974 to \$500 000, in 1976 to \$750 000 and in 1982 to \$1 million)²²² of business income that had benefited from the credit it was no longer eligible for the credit. Accumulated business income was measured by a concept called the cumulative deduction account.²²³

A second perceived problem with the lower corporate tax rate was that a corporation benefited from it regardless of what type of income it earned. Thus, for example, investment income earned by a corporation frequently benefited from the low rate of tax even though earning passive investment income was clearly not the kind of activity that the low rate was designed to subsidise. Therefore, in 1972 the small business credit was restricted to a qualifying corporation's 'income from active business carried on in Canada'.²²⁴ The expression 'active business' was not defined in the legislation, but left for the courts to determine.

Third, firms benefited from the lower rate even though they did not use their retained earnings in order to expand their operations. Therefore, the Act attempted to regulate the uses for which funds, that had benefited from the credit, could be employed.²²⁵ Basically, the retained profits that had benefited from the small business credit had to be used for 'the purpose of gaining or producing income from an active business'. If the corporation made an 'ineligible investment', an investment not made for the 'purpose of gaining or producing income from an actual business', it was subject to a special refundable tax of 50 per cent. This was 25 per cent more than if an eligible investment had been made and thus the effect was to temporarily recapture the small business credit. When a corporation disposed of an ineligible investment and either reinvested the proceeds for the purpose of earning business income or distributed them to shareholders, the ineligible investment tax was refunded. A number of ineligible investments were expressly excluded from the special refundable tax such as cash on deposit, shares and debt obligations in Canadian-controlled private corporations controlled by the purchaser, and interest on accounts receivable and conditional sales contracts arising from normal business operations. Presumably, these investments were excluded because they were considered to be either reasonably incidental

221. *Income Tax Act*, S.C. 1970-71-72, c. 63, s.125(2), as amended by S.C. 1974-75-76, c. 26, s.81(1); S.C. 1976-77, c. 4, s.49(1); and S.C. 1980-81-82-83, c. 140, s.86(1).

222. *Ibid.* The 'total business limit' was repealed in 1985. *Income Tax Act*, S.C. 1984, c. 45, s.40.

223. *Income Tax Act*, S.C. 1970-71-72, c. 63, s.125-6(b).

224. *Id.*, s.125(1).

225. *Income Tax Act*, S.C. 1970-71-72, c. 63, ss.188-89 ('Part V').

to the active business operations of the corporate or short-term investments that could be liquidated for the purchase of additional capital property.

Finally, the dual rate benefited even foreign controlled firms. In order to remedy this, the tax credit was restricted to Canadian-controlled private corporations.²²⁶ Obviously, the policy implicit in this change did not relate to assisting small businesses but instead related to the more general policy of discouraging foreign domination of the Canadian economy.²²⁷ Moreover, in furtherance of this policy, if a firm that had benefited from the credit was sold to non-residents, a special tax was imposed that had the effect of recapturing the small business credit.²²⁸

Although the small business credit was generally a well designed subsidy, two obvious criticisms could be made of it, given its objectives. First, it did not apply to unincorporated small businesses. Clearly there was no reason in principle for not extending it to unincorporated businesses and indeed this was a criticism of the credit made by both the Royal Commission on Taxation and the *White Paper*. However, the government suggested that the credit had to be restricted to incorporated firms for administrative reasons. The 1971 budget speech introducing the tax reform changes noted:

It had been my hope that a system might be developed to aid unincorporated as well as incorporated business. A great deal of time and effort has been spent towards achieving this goal both inside and outside government. Unfortunately, all the proposals were found to be unworkable. Accordingly, we reluctantly decided to restrict the small business incentive to incorporated business.²²⁹

A second criticism that could be made of the subsidy was that only firms with taxable income received it: It was a

226. *Ibid.*, s.125(1).

227. In justifying this limitation the Minister of Finance stated: 'We intend that the small business incentive be available only to Canadians and that it encourage Canadian ownership of our expanding businesses'. Canada, *House of Commons Debates*, 18 June 1971, at 6897 (per Hon. E.J. Benson). This restriction was criticised in the House of Commons: 'If the government intends to restrict the sale of Canadian companies to foreign countries, which is synonymous with America, they are going about it in a heavy-handed way. Whatever we may decide about American capital in Canada, this particular device of preventing the sale of Canadian industry does not seem valuable ... I would suggest that the various restrictions to tax relief for small businesses are so confirming that they defeat the purpose of furthering business incentive in a substantial way.' Canada, *House of Commons Debates*, 12 October 1971, at 8610 (per G. Ritchie). Later this same member explained 'This required refund of the small business deduction tax savings is likely to depress the price a non-resident is willing to pay for the shares of the corporation...' *Id.*, 18 October 1971, at 8795.

228. *Income Tax Act*, S.C. 1970-71-72, c. 63, ss.190, 191 ('Part VI').

229. Canada, *House of Commons Debates*, 18 June 1971, at 6897.

success-related subsidy. However, start-up or other firms with no taxable income are presumably as much in need of the subsidy as firms with taxable profits. Indeed start-up firms are the most risky and most difficult to finance and therefore arguably have a greater claim to the credit than on-going, stable firms with taxable income.

1972 TO 1986: THE DEMISE OF THE SMALL BUSINESS CREDIT AND THE RETURN TO THE LOWER RATE OF TAX

Although the small business credit appeared to be a well designed tax subsidy, it soon began to unwind. By 1986 it acts as little more than a lower rate of tax. The following is a brief description of the demise of the small business credit as a well targeted subsidy.

The most fatal blow to the credit was struck the year following its enactment. In 1973, the special refundable tax on 'ineligible investments' was repealed retroactively.²³⁰ It appears that it was abolished because it was too restrictive,²³¹ too complex,²³² and unnecessary since, as the Minister of Finance explained, 'I believe that these small corporations which enjoy the benefit of the lower rate of tax will, in fact, use these tax savings to expand their businesses, to improve their technology and to create more jobs for Canadians'.²³³ With this design feature of the credit gone, other aspects of the credit became unstable. In particular, it meant that even businesses that did not normally reinvest their earnings would attempt to qualify for the credit.

The second blow to the credit was struck by the courts. They gave a very broad interpretation to the phrase 'active business income'. That concept was used in the provision to target the credit to firms that were likely to contribute to employment, innovation and productivity gains. However, the courts construed virtually any profit making activity as a

230. Supra note 225, retroactively repealed in *Income Tax Act*, S.C. 1973-74, c. 14, s.60(1)(2).

231. A member of Parliament complained that it had caused a 'serious lack of liquid assets in Canadian small business', Canada, *House of Commons Debates*, 28 February 1973, at 1761 (per Yves Demers). It is difficult to see why this should be the case since there was a liberal exemption for short-term investments; moreover the tax was refundable so that when retentions were subsequently used in the business the tax was refunded to the corporation.

232. See Canada, *House of Commons Debates*, 19 February 1973, at 1433 (per Finance Minister, Hon. J. Turner); *Id.*, 26 February 1973, at 1660 (per G. Clermont). It is difficult to see why this should be the case since corporations would presumably record the value of these assets on their balance sheets and concepts such as the 'preferred rate amount', which were used in the provision, were also used elsewhere in the Act.

233. Canada, *House of Commons Debates*, 19 February 1973, at 1433 (per Finance Minister, Hon. J. Turner), subsequent events proved him wrong.

business and any effort on the part of the taxpayer as carrying it on actively. Virtually all service corporations and all decent sized investment corporations were held to qualify for the credit.²³⁴

A third event that led to the demise of the credit was the enrichment of the dividend tax credit in 1977.²³⁵ In that year the dividend tax credit was increased from 33.3 to 50 per cent of dividends received.²³⁶ This increase in the dividend tax credit meant that there was over-integration of tax on income flowing through corporations entitled to the small business credit. Even though a corporation entitled to the small business credit paid tax at a rate of 25 per cent, or lower, when dividends were paid out shareholders were compensated by the dividend tax credit on the assumption that the corporation had paid tax at a rate of 33.3 per cent. This meant that anyone's total tax liability could be reduced if their income was earned through a corporation and distributed as a dividend instead of being earned personally. A taxpayer could save up to \$4500 in taxes on income of \$50 000 by merely channelling it through a corporation.²³⁷

With over-integration, and the fact that income that could qualify for the small business credit had been increased to \$150 000 annually by 1977, there was an enormous incentive for taxpayers to incorporate their income-earning activities. The government tolerated this situation for two years, then in 1979 and again in 1981 it introduced a series of complex measures designed to once again target the credit and to remove the unjustified over-integration that had been introduced in 1977.

In 1979 legislation was passed denying the small business credit, and thus the advantages of deferral and over-integration, to certain specified non-qualifying businesses and to corporations carrying on primarily an investment business.

234. See K.A. Lahey, "Active Business" as a Technique of Source Discrimination in the Formulation of Corporate Tax Policy' (1978) 16 *Osgoode Hall Law Journal* 35.

235. *Income Tax Act*, S.C. 1977-78, c. 1, s.58, amending S.C. 1970-71-72, c. 63, s.121.

236. The government increased the dividend tax credit for two reasons primarily: first, to increase investments in Canadian entities by Canadian residents; second, to establish a closer 'tax neutrality' with regard to the taxation of capital gains. After the changes a taxpayer in the 50 per cent tax bracket paid tax on both dividends and capital gains at an effective rate of about 25 per cent. This latter effect allowed the Act to be considerably simplified by abolishing the surplus-stripping rules. After the change the government was essentially indifferent as to whether a taxpayer extracted corporate surplus in the form of a capital gain or dividend. See Budget Speech, Hon. D.S. McDonald in Canada, *House of Commons Debates*, 31 March 1977, at 4536.

237. Not surprisingly total dividends paid by Canadian-controlled private corporations quadrupled from 1977 to 1979. See Shinder, *supra* note 215, at 17.

The following is a brief description of this legislation and the kinds of corporations at which it was directed.²³⁸

Incorporated Employees

After 1977 many individuals who would otherwise provide their services directly to an employer formed corporations and provided such services to their employer through their personal corporation. This practice became particularly prevalent amongst high-income earners such as athletes, executives and life insurance salespersons. To deny the credit to these kinds of corporations, the legislation provided that a corporation would not qualify for the small business credit if more than two-thirds of its gross revenue was derived from the business of providing services and (i) was derived from services provided to one 'entity' and (ii) could reasonably be attributed to the services performed by persons who were 'specified' shareholders of the corporation or related persons. A corporation was not treated as carrying on a non-qualifying business, even if the above conditions were met, if it employed in the business more than five full-time employees who were not specified shareholders of the corporation or related persons.

Incorporated Professionals

In some provinces professional associations were placing pressure on provincial legislatures to allow them to incorporate in order to reap the tax advantages. The new tax legislation singled out some professions - accountants, dentists, lawyers, medical doctors, veterinarians and chiropractors - and provided that income from these professional practices would not qualify for the small business credit. These professions were singled out because they do not face the same business risks as encountered in most other businesses because of a relatively fixed demand for their services and the restrictions of entry into them, and because they are not a material source of productivity growth and job opportunities. Moreover, in some

238. *Income Tax Act*, S.C. 1979, c. 5, s.38. For a discussion of these changes see R.A. Friesen, 'A Perspective on Recent Changes to the Small Business Deduction and the Refundable Tax Provisions', in Canadian Tax Foundation, *Report of the Thirty-First Tax Conference, 1979* (Toronto: Canadian Tax Foundation, 1980) 66; H.J. Kellough, 'Review and Analysis of the 1979 Amendments to the Small Business Deduction', in Canadian Tax Foundation, *Report of the Thirty-First Tax Conference, 1979* (Toronto: Canadian Tax Foundation, 1980) 79; R.B. Goodwin, 'Corporate Partnerships and the 1980 Draft Amendments to the Income Tax Act', in Canadian Tax Foundation, *Report of the Thirty-Second Tax Conference, 1980* (Toronto: Canadian Tax Foundation, 1981) 225; D.P. Jones, 'Further Reflections on Integration: The Modified Small Business Deduction, Non-qualifying Businesses, Specified Investment Income, Corporate Partnerships, and Personal Service Corporations' (1982) 30 *Canadian Tax Journal* 1.

provinces some of these professionals could incorporate but in others they could not. Thus if the small business credit were available to them there would be a large tax differential between identical taxpayers who resided in different provinces.

Management Service Corporations

Professionals who could not incorporate their practice because of relevant provincial law frequently established a management service corporation to provide managerial, financial, administrative and similar types of services to their professional proprietorship or partnership. The management service corporation would mark up the cost of providing these services by 15 to 20 per cent, thus a significant amount of professional income would be converted into income qualifying for the small business credit. The new legislation provided that income of a 'management service corporation' derived from a business that was 'connected' with it did not qualify for the small business credit.

As initially proposed in the budget of 16 November 1978 all three of these businesses were to be defined as 'non-qualifying businesses' and were not to be entitled to any special corporate tax credit. However, these proposals died on the order paper in the spring of 1979 when a federal election was called. In October 1979, the newly elected Conservative government, relenting to pressure from the professional community in particular, re-introduced the provisions defining these businesses, but extended them a special corporate tax credit of 12.6 per cent.²³⁹ This had the effect of reducing the effective corporate tax rate on such income to 33.3 per cent so that when dividends were paid the corporate and shareholder tax would be integrated. But, of course, so long as the income was retained in the corporation there was a substantial deferral advantage if the individual's personal marginal tax rate was greater than 33.3 per cent.

Specified Investment Business

Another type of income that the courts had held was 'active business income', and that the government wished to deny the small business credit to, was income earned essentially from passive investment. Thus, in 1979 the concept of a 'specified investment business' was also introduced into the Act.²⁴⁰ If the

239. *Income Tax Act*, S.C. 1979, c. 5, s.38(3), adding s.125(1.1) to S.C. 1970-71-72, c. 63.

240. *Income Tax Act*, S.C. 1979, c. 5, s.38(6), amending s.125(6)(h) to S.C. 1970-71-72, c. 63, now numbered s.125(7)(e).

'principal purpose' of a business was 'to derive income from property' then (with some exceptions) it was denied entitlement to any credit. The income would be taxed at the normal corporate rate of 50 per cent. However, like all other forms of income from property, the corporation would be entitled to a dividend refund of 16.6 per cent when the income was paid out in the form of a dividend. Thus, the effective corporate tax on these distributed earnings would be reduced to 33.3 per cent, and since this was the corporate rate that the dividend tax credit compensated for there would be complete integration upon distribution.

In the federal budget of 11 December 1979 another tax planning technique that involved what the government considered an abuse of the small business credit was also dealt with. All jurisdictions that have a low corporate tax rate must also have a concept of 'associated' corporations to ensure that individuals do not multiply the availability of the low rate by establishing multiple corporations to carry on their business or businesses. The concept is based on the premise that each individual should be entitled to receive the benefit of the low rate for only one corporation and business. However, in Canada, prior to 1979, these rules did not prevent two unrelated individuals who were carrying on a business from qualifying business income of twice the annual business limit for the small business credit by the simple expedient of each incorporating a corporation and then carrying on the business as corporate partners. Consequently, in 1979 the concept of 'specified partnership income' was introduced into the Act.²⁴¹ Where a business is carried on by corporate partners these rules have the effect of imposing the annual business limit at the partnership level. Thus, only \$200 000 of income (which is the current annual business limit) from each business will receive the small business credit no matter how many corporate partners carry it on.²⁴²

In the 12 November 1981 budget, three more changes were proposed, and subsequently enacted, in an effort to make the small business credit more target efficient.²⁴³ First,

241. *Income Tax Act*, S.C. 1979, c. 5, s.38(10), amending *Income Tax Act*, S.C. 1970-71-72, c. 63, s.125(1)(a)(ii).

242. As enacted these rules were dreadfully complex because they tried to deal in detail not only with the case of a simple partnership but also the case of where the business was carried on by several partnerships under common control. In 1985 these rules were 'simplified' by repealing the detailed rules and introducing a general discretionary anti-avoidance provision. *Income Tax Act*, s.127(6).

243. See generally T.E. McDonnell, 'The Taxation of Investment Income of Private Corporations and Personal Services Business Income' in Canadian Tax Foundation, *Report of the Thirty-Fourth Tax Conference, 1982* (Toronto: Canadian Tax Foundation, 1983) 103; M.A. Denega, 'Tax Breaks and Grabs: Part II Tax and Owner-Manager Salary/Dividend Mix', in Canadian Tax Foundation, *Report of the Thirty-Fourth Tax Conference, 1982* (Toronto: Canadian Tax Foundation, 1983) 87.

corporations were prohibited from 'refreshing' their cumulative deduction account by paying out dividends.²⁴⁴ Thus, once a corporation had earned \$1 million (the total business limit) that had benefited from the small business credit it lost its entitlement to the credit whether or not it had paid out this amount, or any part of it, as dividends. It is not clear that this change was consistent with the rationale for the small business credit as it was enacted in 1972. It appears that originally the government was prepared to allow all small businesses, earning less than the annual business limit, full integration (if they paid out dividends). That is, so long as the corporation's annual income was less than the annual business limit, and the corporate-source income was distributed and taxed at the individual's marginal tax rates, the government was not concerned about collecting 'double' tax. However, with this change, once a corporation had earned over \$1 million then, since it lost the small business credit, there would be 'double' taxation even though all the earnings were distributed. The government justified the change in the following terms:

The ability of small businesses to maintain their eligibility for the low tax rate by paying out dividends had led to certain anomalies. One problem is that small businesses can avoid this limit by paying out dividends to shareholders who then loan the funds back to the company. As a result, corporations continue to qualify for the low rate long after they have exceeded any reasonable definition of a small business. As well, small business owners can stay under the \$750,000 limit by paying out dividends to themselves for their personal use; the funds are thus not used for business expansion, yet the business can continue to qualify for the low tax rate. To target the benefits of this important incentive to growing small businesses and businesses in their start up phase, dividends paid out after December 31, 1981 will no longer regenerate the firms entitlement to the small business deduction.²⁴⁵

The second change announced in the 12 November 1981 budget was that the 12.6 per cent credit for non-qualifying small businesses would be denied on income earned by a corporation from a 'personal service business'. A 'personal service business'²⁴⁶ is defined as a corporation's service business where the individual providing the services on behalf

244. *Income Tax Act*, S.C. 1980-81-82-83, c. 140, s.86(5)(6), amending *Income Tax Act*, 1970-71-72, c. 63, s.125(6)(b).

245. Canada, Hon. A.J. MacEachen, Deputy Prime Minister and Minister of Finance, *Budget Papers* (12 November 1981) (Ottawa: Department of Finance, 1981), at 33-4.

246. *Income Tax Act*, S.C. 1980-81-82-83, c. 140, s. 86(7)-(9).

of the corporation, or a related person, is a 'specified' shareholder of the corporation (basically a person who owns at least 10 per cent of the shares), and, if he or she were not employed by the corporation and had been personally paid for providing the services, the individual could reasonably be regarded as an officer or employee of the person for whom the services are performed.²⁴⁷ A corporation that employs throughout the year more than five full-time employees who are not specified shareholders are excluded from the definition of personal service business.²⁴⁸ This provision prevents individuals from converting employment income into business income and thus qualifying for the small business credit.²⁴⁹ Although there was considerable overlap, the 'personal service business' provision applied to a slightly narrower range of businesses than those defined in the 'incorporated employee' provision enacted in 1979 and that were eligible for the 12.6 per cent non-qualifying small business credit.

A third change announced in the 12 November 1981 budget was that the over-integration of corporate and shareholder tax, which occurred because the small business credit brought the effective corporate tax rate down to 25 per cent and the dividend tax credit compensated for corporate tax of 33.3 per cent, was to be removed. This was done by the imposition of a 12.5 per cent tax on distributions by corporations that had retained earnings that had benefited from the small business credit.²⁵⁰ This 12.5 per cent tax on dividends brought the effective corporate tax rate on distributed active business income up to 33.3 per cent. The government explained the change in the following terms:

Unfortunately, the mechanics of this integration system are now defective. Rather than the tax being neutral between income flowed through a private corporation or received directly, it results in less tax on small business corporate income than on income from wages or salaries or from an unincorporated business. This occurs because the dividend tax credit given to shareholders of a small corporation consistently exceeds the tax paid by the corporation. The result is that up to \$10 000 in taxes can be saved annually. This defect in the tax system is leading to serious inequities

247. *Income Tax Act*, s.125(7)(d).

248. *Income Tax Act*, s.125(7)(d)(iii).

249. Further, to ensure that individuals who channel their employment income through a personal service corporation do not receive any tax advantage not available to an individual employee, such a corporation is unable to claim expenses for the personal service business that would not normally be deductible in calculating income from employment: *Income Tax Act*, s.18(1)(i).

250. *Income Tax Act*, S.C. 1980-81-82, c. 140, s.109, adding ss.181-183 ('Part II') to *Income Tax Act*, S.C. 1970-71-72, c. 63.

and unnecessary distortions including incorporations solely for the purpose of obtaining these tax savings. These tax benefits have generally gone to owner-managers and other senior employees of small businesses, many of whom are in the higher-income groups.

The budget proposes to end these anomalies by imposing a new 12.5 per cent tax on dividend distributions of small business companies.²⁵¹

Even though over-integration had caused small business owners to artificially convert their wages into dividends to obtain tax savings, there was considerable agitation from the small business community because of the imposition of the distributions tax. Many felt that imposing the tax unfairly diluted an intended tax advantage for small businesses.

Although it was a major political issue in the debate following the form of integration proposed both by the Carter Commission and the *White Paper*, there has been very little analytical discussion in Canada on the problems posed by tax preferences in implementing a system of dividend relief.²⁵² Although the issue is complicated, and was only considered in Canada in 1981 in the context of small business credit, prima facie there would appear to be a strong case for washing out the tax advantages of the small business credit, as was done by the 12.5 per cent distribution tax, instead of flowing its advantages through to the shareholders. The credit is only available to the corporate sector and thus not washing it out exaggerates the inequities between those who are able to incorporate their businesses and those who cannot. Furthermore, the objectives of the credit are only achieved so long as the earned income remains in corporate solution so that it can be reinvested in the business.²⁵³ Another reason for imposing the 12.5 per cent distributions tax was that over-integration created large compliance costs in operating a small business since the optimal tax mix of dividends and salary became extremely complicated.

The changes made in 1979 and 1981 resulted in the small business credit being more targeted. However, they considerably complicated the legislation and alienated a number of powerful interest groups. In 1983 the government announced that it was studying ways to simplify the rules

251. Canada, Hon. A.J. MacEachen, Deputy Prime Minister and Minister of Finance, *The Budget in More Detail* (Ottawa: Department of Finance, 1981), at 45.

252. Yet as Warren has observed, their existence 'creates the greatest conceptual problem in meshing integration with existing [tax] provisions'. A. Warren, 'The Relations and Integration of Individual and Corporate Income Tax' (1981) 94 *Harvard Law Review* 719, at 784.

253. See generally, McLure *supra* note 36, at 131-5.

relating to the small business credit.²⁵⁴ In the budget of February 1984 the Department of Finance issued a discussion paper on 'Simplifying Taxes for Small Business'²⁵⁵ in which a number of important changes were suggested. First, it was proposed that the \$1 million total business limit on income qualifying for the credit be eliminated. The government suggested that this limitation had led to considerable legislative complexity in attempting to define a corporation's cumulative income that had benefited from the tax credit (the cumulative deduction account). In addition, the government contended that the requirement to compute a 'cumulative deduction account' imposed a burdensome accounting requirement on many small firms.²⁵⁶ Moreover, the government noted that it was almost impossible to ensure that small corporations did not avoid the 'total business limit' through various complex tax avoidance manoeuvres.²⁵⁷

As a second simplification measure the government proposed to abolish the concept of non-qualifying business income. Thus incorporated professional practices, some personal service corporations, and corporations providing administrative services to a related corporation would once again be eligible for the full 21 per cent small business credit instead of the smaller 12.6 per cent credit. The government admitted that although these provisions affected a relatively small number of firms (invariably high-income it might be noted), they added 'much complexity to the legislation' and required 'that professional advisers to small business - many of whom are not themselves tax specialists - be familiar with the provisions'.²⁵⁸ Moreover, the government noted, when these provisions were introduced there was over-integration with respect to corporate-source income entitled to the small business credit, but that with the enactment of the 12.5 per cent tax on dividend distributions this was no longer the case.

Third, although the 'personal service business' and 'specified investment business' rules would remain in the Act (thus corporations falling within these categories would not be entitled to the small business credit) they were to be

254. In the summer of 1983 the Canadian Tax Foundation held a symposium on the subject, *Symposium on the Simplification of the Small Business Provisions of the Income Tax Act* (Toronto: Canadian Tax Foundation, 1983) [unpublished].

255. Canada, Hon. M. LaLonde, Minister of Finance, *Simplifying Taxes for Small Business* (Ottawa: Department of Finance, 1984).

256. *Id.*, at 15-16.

257. After several attempts at enacting specific rules to deal with the problem of taxpayers artificially extending their ability to claim the small business credit, in 1983 the government had enacted a general anti-avoidance rule. See D.A.G. Birnie, 'Capping the Small Business Deduction', in Canadian Tax Foundation, *Report of the Thirty-Fifth Tax Conference, 1983* (Toronto: Canadian Tax Foundation, 1984) 13.

258. *Simplifying Taxes for Small Business*, *supra* note 255, at 16.

simplified. In particular, under the law then in force a corporation had to have more than five 'arm's length' employees in order to escape this definition. The government proposed to drop the 'arm's length' requirement since it introduced 'unnecessary complexity'.

Fourth, the detailed, anti-avoidance corporate partnership rules that were designed to prevent the use of multiple partnerships to increase recourse to the small business credit were to be replaced by a generally-worded anti-avoidance provision.

Finally, the tax that was designed to recapture the benefits of the small business credit if a Canadian-controlled private corporation was sold to non-residents was to be repealed. The government simply stated, '[T]hese rules are unduly complex and technically deficient'.²⁵⁹

Not unexpectedly, the business community, particularly professionals, were excited about these proposed changes. The government released draft legislation implementing the proposed reform in August 1984. The legislation was passed by the new Conservative government at the end of 1984.²⁶⁰

A further amendment affecting the small business credit was proposed in the February 1986 budget. The government proposed to reduce the dividend tax credit from 50 to 33.3 per cent of dividends received. Thus instead of compensating for corporate tax of 33.3 per cent the credit will once again only compensate for corporate tax of 25 per cent. One effect of this reduction in the dividend tax credit will be to allow the government to repeal the 12.5 per cent corporate distribution tax that was imposed on distributed income that had benefited from the small business credit.

After this series of amendments, Canada is back to almost where it was prior to 1972. Essentially it has a lower rate corporate tax. Some effort is made to target the credit by denying it to public corporations and to private corporations carrying on personal service or investment businesses, but otherwise none of the objections to the dual rate so eloquently expounded by the Carter Commission and in the *White Paper* are met by the small business credit.

259. *Id.*, at 17.

260. *Income Tax Act*, S.C. 1984, c. 45, s.40. On the simplification amendments see H.L. Doane, 'The Cumulative Deduction Account and Part II Tax' in Canadian Tax Foundation, *Report of the Thirty-Sixth Tax Conference, 1984* (Toronto: Canadian Tax Foundation, 1985) 156; H.A. Gordon, 'Management Companies, Personal Service Businesses, Incorporated Professional, and Specified Investment Businesses' in *id.*, at 165; E.C. Harris, 'Associated Corporations, Corporate Partnerships, and the Purchase of Closely-Held Corporations' in *id.*, at 183.

Australia

Australia adopted a lower rate of corporate tax in 1948, eight years after adopting a classical corporate tax system. This rate was abolished in 1973, apparently without any strong resistance. A partnership option for closely-held corporations was proposed by the Asprey Committee and has been recommended by a number of commentators, but has never been enacted in Australia.

1915 TO 1940: THE INTEGRATED SYSTEM²⁶¹

The Australian Government adopted its first income tax in 1915.²⁶² Although the method was different, like the prevailing United Kingdom system, the double taxation of corporate-source income was avoided. Corporations were taxed only on their undistributed profits. Dividends out of current income were deducted by the corporation in arriving at taxable income, but were taxed in the hands of the shareholders. If corporate distributions were made out of profits previously taxed, shareholders received a rebate of tax at the lesser of the company tax paid on the profits or their own individual rate.

The system proved difficult to administer. It was necessary to determine whether a dividend was paid out of current or accumulated earnings. If a dividend was paid out of current earnings, it was necessary to determine how much, if any, of the income was exempt from corporate tax since if it was exempt from tax it was tax-free to the shareholders. If the dividend was paid out of accumulated earnings, it was necessary to determine the rate of tax those earnings had borne since the shareholders rebate was determined by the precise amount of tax that the corporation had paid on the earnings out of which the dividend was paid. Although in these respects it was more complicated than the United Kingdom system, unlike that system, dividends were not grossed up to account for the corporate tax paid on the dividend. Thus shareholders received a tax-free dividend equal to the amount of the rebate. Furthermore, unlike the United Kingdom system, a shareholder whose individual rate was less than the company's rate did not receive a refund of tax.

261. This brief description of the early history of the Australian system is taken largely from R.W. Parsons, 'An Australian View of Corporation Tax' [1967] *British Tax Review* 14; Australia, Department of the Treasury, *Company Income Tax Systems* (Treasury Taxation Paper No. 9) (Canberra: AGPS, 1974) Appendix B; Australia, Royal Commission on Taxation, *First Report* (Canberra: Comm. G.P., 1934); Australia, Commonwealth Committee on Taxation (Ligertwood Committee), *Report* (Canberra: Comm. G.P., 1961), chap. 1.

262. *Income Tax Assessment Act, 1915* (Comm. of Austr.), Act No. 41 of 1915 and *Income Tax Act, 1915*, Act No. 48.

In 1923 the tax treatment of corporations was changed in order to reduce some of the administrative complexities and to bring it into greater uniformity with the treatment in the various Australian jurisdictions, all of which taxed corporations on the whole of their profits. Basically, all company profits were made subject to tax and the rebate system was extended to all dividends. This system remained in effect until 1940. However, in 1934, following the recommendations of a Royal Commission of Taxation,²⁶³ changes were made in the details for the scheme. Prior to 1934, if income was exempt in the hands of the recipient corporation, it could be distributed tax free to shareholders; moreover, the rebate that each shareholder received depended in part on the tax that the corporation had paid on the earnings out of which the dividend was paid. Largely because of the administrative problems that this system posed, it was amended to provide that all dividends were taxable and that the shareholder rebate was the standard rate payable by the corporation in the year in which the shareholder was assessed on the dividend income.²⁶⁴

It is not surprising that there was little concern for small corporations under these regimes. The corporate rate of tax was considerably lower than individual marginal rates²⁶⁵ and double taxation was avoided on distribution. Indeed, the preoccupation of Australian tax reformers during this period was with preventing taxpayers from using corporations to shelter income from the higher individual tax rates.²⁶⁶

1940 TO 1948: THE CLASSICAL SYSTEM

In 1940, in what was considered a temporary measure designed to raise revenue by increasing the effective tax rate on corporate-source income, and to reduce the administrative costs of the tax system during wartime, the government abolished the rebate of tax on dividends.²⁶⁷ At the same time the corporate income tax rate was increased.

263. *Supra* note 261.

264. It is interesting that the Royal Commission was one of the first tax inquiries to face the vexing question of whether tax preferences should be washed out or flowed through in an integrated system. *Id.*, at 16–22.

265. From 1922 to 1939 the corporate tax rate was one shilling per pound (five per cent).

266. For a description of these efforts see Parsons, *supra* note 261, at 18–21; 1934 Royal Commission on Taxation, *supra* note 261, at 28–36.

267. In his Budget Speech of 1940–41, in introducing the measure, the Treasurer said: 'A good deal could be said in favour of a complete rebate of all company taxation, but consideration of revenue and of administrative difficulties made that out of the question at the present time. It is proposed as a war-time measure to discontinue the rebate with the hope of reconsidering the whole question when the urgencies of our finance are behind us.' As quoted in *Company Income Tax Systems*, *supra* note 261, at 41.

1948 TO 1973: THE LOWER RATE OF TAX

In 1948, as part of a general tax reduction, Australia adopted a lower rate of corporate tax. The reduction was at a rate of 1s per pound (five per cent) on incomes up to £5000. Thus, at this time, corporations paid tax at a rate of 5s per pound (25 per cent) on the first £5000 and 6s per pound (30 per cent) on the remainder. In 1951 the lower rate was abolished for public corporations, and the general corporate tax rate was increased to 7s per pound (35 per cent). In 1952, the differential rate was reintroduced for public companies; however, it was only 1s per pound (five per cent) less than the standard rate, while the lower rate for private corporations remained at 2s per pound (ten per cent) less.²⁶⁸

In 1950 a Commonwealth Committee on Taxation (Spooner Committee) considered whether the pre-1940 rebate system should be restored. It rejected this proposal on three grounds: the revenue cost; the apparent incongruity of salary and wage earners paying tax on all their personal income but not shareholders; and, the fact that the classical system of corporate tax had become well accepted, as evidenced by its adoption in the United States (a number of members of the Committee had toured the United States).

Another Commonwealth Committee on Taxation (Ligertwood Committee)²⁶⁹ reported in 1961. It considered in detail both the taxation of corporate distributions and the lower rate of corporate tax. Following an extremely conceptual analysis, the Committee reaffirmed the legitimacy of taxing both corporations and shareholders on corporate-source income.²⁷⁰ However, in view of the relatively heavier tax on corporate source income compared to other sources of income, the Committee did recommend that a rebate of 2s per pound (ten per cent) should be granted to resident companies in respect of dividends paid during the year. That is, the Committee recommended a split-rate form of integration under which retained earnings would be taxed at a rate of 40 per cent and distributed earnings would be taxed at a rate of 30 per cent.²⁷¹ This proposal was not adopted because the Treasury felt that the principle of dividend relief represented an unnecessary concession to the separate-entity theory of corporations that had been widely accepted in Australia. Furthermore, the Treasury objected that the system would favour companies that distributed earnings over those that did not and thus would bias the tax system against those

268. For a chart of the rates from 1940 to 1960, see 1961 Commonwealth Committee on Taxation, *supra* note 261, at 12.

269. *Ibid.*

270. *Id.*, at 2, para. 7.

271. *Id.*, at 4, para. 17.

corporations that used their retained earnings for reinvestment.²⁷² Furthermore, if dividend relief was to be provided, the Treasury did not think that it should be done by a split-rate method as recommended by the Ligertwood Committee. Such a method would provide unjustified relief to tax-exempt shareholders and nonresidents, would provide relief for corporate profits that might not have borne corporate tax, and would encourage foreign controlled Australian corporations to reduce their Australian tax payable by repatriating earnings.²⁷³

The Ligertwood Committee also recommended that the lower tax rate on corporate income under £5000 be discontinued.²⁷⁴ The Committee noted that: the lower rate benefited many corporations that were not small, even public corporations;²⁷⁵ that small private corporations did not need to suffer from double tax since their earnings could usually be paid out in the form of remuneration to working proprietors; that small private corporations benefiting from the lower rate might be owned by wealthy shareholders; and, finally, that the lower rate lead to abuses by 'company splitting'.²⁷⁶ However, the Committee recommended that private corporations should be subject to a primary rate of tax that was 1s per pound (five per cent) less than public companies, largely because they could be subject to the undistributed profits tax.²⁷⁷ The recommendation of the Committee to repeal the lower rate of tax was not acted upon by the government.

The next noteworthy study of the Australian tax system was undertaken in 1964 by four economists and sponsored by the Social Science Research Council.²⁷⁸ They make a unique proposal for corporate tax reform. Although the authors made no special recommendation for small business, the effect of their proposal would be to require all corporations to distribute their earnings. Basically, the authors suggested that a flat rate 20 per cent tax should be levied on all corporate earnings. Then to ensure corporations would not be used to shelter income from the individual marginal tax rates a tax equal to the highest individual marginal tax rate, 66.6 per cent at the time, would be imposed on all retained earnings.²⁷⁹

In 1965, when Australia switched from pound sterling to a dollar monetary system, the taxable income subject to the

272. See *Company Income Tax Systems*, *supra* note 261, at 42.

273. *Ibid.*

274. Commonwealth Committee on Taxation, *supra* note 261, at 13, para. 55.

275. *Id.*, at 13, para. 53.

276. *Id.*, at 13, para. 54.

277. *Id.*, at 14-15, para. 60.

278. See R.I. Downing, H.W. Ardnt, A.H. Boxer, R.L. Mathews, *Taxation in Australia: Agenda for Reform* (Melbourne: Melbourne University Press, 1964).

279. *Id.*, at chap. 9.

lower rate was changed to \$10 000.²⁸⁰ The difference between the primary corporate rate and the lower rate remained at about ten percentage points; however, in 1970-71 this gap was narrowed to five percentage points. Then in 1973, in their first budget, the newly elected Labor government abolished the lower rate of corporate tax. In the budget speech, Mr. Crean, Treasurer, noted:

The general public company tax rate is 47.5 per cent, but private companies, life insurance companies and certain other companies pay less on some or all of their income. The differentials arose on no grounds of principle - indeed, there are no reasons why private and public companies should not be treated alike so far as the company rate is concerned.²⁸¹

There appeared to be surprisingly little objection to the repeal of the lower rate. Liberal members in the House of Representatives suggested that it would stultify the expansion of private business enterprise;²⁸² however, their attacks were not sustained. The Liberal Party has remained committed to the low rate of tax for small businesses and in both the 1982 and 1984 election campaigns promised to reintroduce it,²⁸³ but the pressure for its reintroduction does not seem great.

1973 TO 1986: PRESSURES FOR REFORM

In the late 1960s and early 1970s a number of authors called for repeal of the classical system of taxation.²⁸⁴ In 1972 the government appointed The Taxation Review Committee (Asprey Committee) which undertook a comprehensive examination of the tax system and published a final report in 1975.²⁸⁵ With respect to the general issue of the taxation of corporate distributions, the Committee concluded that ideally corporations would be required to allocate their profits to shareholders each year. However, largely because of practical difficulties, in particular the problem of determining the

280. The following is largely taken from B.L. Johns, W.C. Dunlop and W.J. Sheehan, 'Taxation and the Small Firm in Australia' in Australia, Taxation Review Committee, *Commissioned Studies* (Study No. 9) (Canberra: AGPS, 1975) 223, at 255-6.

281. Australia, *House of Representatives Debates*, 21 August 1973, at 44.

282. See, for example, Australia, *House of Representatives Debates*, 12 September 1973, at 882-3 (per P.S. Fisher).

283. See P.D. Groenewegen, *Everyone's Guide to Taxation in Australia* (Sydney: Allen & Unwin, 1985), at 175.

284. See P.D. Groenewegen, *Australian Taxation Policy: Survey 1965-1980* (Sydney: The Taxation Institute Research and Education Trust, 1981), at 56.

285. Australia, Taxation Review Committee, *Full Report* (Chairperson: K.W. Asprey) (Canberra: AGPS, 1975).

correct allocation of profits where there were different classes of shares, and the problem of taxing non-resident shareholders, they did not recommend such a change.²⁸⁶ Instead they recommended the adoption, in stages, of a system of full imputation.²⁸⁷ Even though the Commission recommended the eventual adoption of a system of full imputation, they also recommended that small corporations should be allowed to elect to be taxed as partnerships. The Committee reasoned that since this was the ideal treatment of corporations, and could not be achieved for some corporations only because of administrative reasons, there was no reason why it should not be available in those situations where the practical problems could be surmounted.²⁸⁸ The Committee went on to consider some of the details of such an election.²⁸⁹ Essentially, they recommended that the election be available to a corporation irrespective of its income,²⁹⁰ contrary to the recommendation of the Carter Commission in Canada. Also, unlike the United States provisions, they recommended that the election should be available even though the corporation was deriving a substantial amount of its income from investment income or foreign sources.²⁹¹ They also recommended that it be restricted to corporations with less than ten shareholders, only one class of shares²⁹² and in which all shareholders were individuals.²⁹³ These restrictions were to be imposed largely to minimise the compliance and administrative costs of the system. As experience was gained with the election, it was contemplated that these requirements would be liberalised.

The Committee also considered the appropriateness of re-introducing a lower rate of corporate tax in order to assist small businesses.²⁹⁴ They recommended against its adoption on the grounds that 'an election by shareholders to be taxed as a partnership ... is sufficient to afford protection to shareholders in a small enterprise from any element of over-taxation'.²⁹⁵ Furthermore, they noted that if assistance was to be provided to small enterprises it should be offered in a form which benefited both incorporated and unincorporated businesses.²⁹⁶

The issue of the taxation of corporations arose again during the course of hearings on the Australian Financial System Inquiry (Campbell Committee). Numerous submissions to the

286. *Id.*, at 228, paras 16.22–16.26.

287. *Id.*, at 233–4, paras 16.52–16.61.

288. *Id.*, at 239, para. 16.80.

289. *Id.*, at 239–40, paras 16.84–16.96.

290. *Id.*, at 239–40, para. 16.85.

291. *Id.*, at 240, paras 16.86, 16.87.

292. *Id.*, at 240, para. 16.88.

293. *Id.*, at 240, para. 16.89.

294. *Id.*, at 241–2, paras 16.97–16.101.

295. *Id.*, at 242, para. 16.101.

296. *Ibid.*

Campbell Committee raised the problem of the 'double' taxation of corporate source income. In response, the Committee organised a seminar on business taxation in which the form of company taxation became the central issue. Two of the commissioned papers, which provided the basis for the seminar, argued that full integration ought to be adopted for all corporations.²⁹⁷ In spite of reservations expressed about these recommendations,²⁹⁸ they were endorsed by the Committee. Basically, the Campbell Committee recommended that a 46 per cent withholding tax be levied on corporations and that all company profits be notionally distributed to shareholders and taxed at their appropriate marginal tax rates.²⁹⁹

Even though it suggested a fully integrated tax system for all corporations, the Campbell Committee also suggested a partnership option for small corporations.³⁰⁰ To prevent misuse of this option, the Committee recommended that the restrictions suggested by Asprey upon such an election should apply.³⁰¹ It is not clear whether the Committee envisaged that the partnership option would be available after full integration was adopted or if it saw it as an interim or alternative measure, should full integration not be adopted. In justifying the recommendations the Inquiry said:

The Committee is however concerned that under the existing provisions some lower income shareholders, particularly those whose incomes consist solely or substantially of dividends from a private company, may be relatively disadvantaged compared to individuals in an unincorporated enterprise situation, this may have the effect of discouraging share participation in private companies.³⁰²

297. P.L. Swan, 'Is There a Case for Complete Integration of Corporate and Personnel Income Tax', in Committee of Inquiry into the Australian Financial System, *Commissioned Studies and Selected Papers, Part 3: Business Taxation and the Financing of Industry* (Chairperson: J.K. Campbell) (Canberra: AGPS, 1982), at 1; R.R. Officer, 'Company Tax and Company Financing' in *id.*, at 101.

298. See generally, 'Commentary Papers on Business Taxation' in *id.*, 160-255.

299. Committee of Inquiry into the Australian Financial System, *Final Report* (Chairperson: J.K. Campbell) (Canberra: AGPS, 1981), at 217, para. 14.41 [hereinafter Campbell Committee].

300. *Id.*, at 223, para. 14.89.

301. *Id.*, at 224, para. 14.91.

302. *Id.*, at 223, para. 14.88. Since the Campbell Inquiry appeared to be relying heavily upon its commissioned studies, it seems likely that the partnership option was regarded as an alternative option. After making an argument for full integration the author of one of the commissioned studies argued: 'If it is judged "inappropriate" to adopt a fully integrated tax system for all companies a form of integrated tax should be considered for private companies. This would involve allowing private companies to elect to be taxed as partnerships, the current practice in the US for limited sized private companies ... Such a system would continue to limit the benefits afforded private company shareholders in the top tax bracket without penalising those who did not belong in this bracket. It would be unwise to

There are, of course, important differences between integration and partnership taxation. For example, with a partnership election presumably there would be no withholding of tax at the corporate level, the character of the corporate income would flow through to the shareholders, and, corporate losses would flow through.

1986: FULL IMPUTATION

In the recent Australian tax reform exercise there was little discussion of the need to make special provision for small businesses. The *Draft White Paper*³⁰³ discussed generally the possibility of integrating the company and personal income tax systems, but implied that, at best, full or partial dividend relief might be adopted.³⁰⁴ There was no discussion of any special provision being made for small businesses. At the Summit following the publication of the *White Paper*, and in the tax reform discussion generally, there appeared little pressure to provide a partnership option for small businesses, or to provide a low rate of corporate tax.³⁰⁵

The government is committed to introducing a full imputation system with no special concessions for small business. The proposed changes were reviewed favourably from the point of view of small businesses in a paper prepared for the Economic Planning Advisory Council by the Bureau of Industry Economics.³⁰⁶ Prior to the tax reform exercise, however, some Australian commentators had suggested that a partnership election for small businesses should be considered.³⁰⁷

force all private companies to be taxed as partnerships and at the same time allow public companies to be taxed under a classical system since this would discriminate against those private company shareholders in the top tax bracket relative to this class of shareholders in the public companies'. Officer, *supra* note 297, at 135-6.

303. Australia, *Reform of the Australian Tax System: Draft White Paper* (Canberra: AGPS, 1985).
304. *Id.*, chap. 17, at 199, para. 17.33.
305. A quick perusal of the Summit proceedings revealed that only one group suggested that small business might be given a partnership option. See Ms. Perel, President, Australian Federation of Business and Professional Women, in Australia, *National Taxation Summit: Record of Proceedings* (Canberra: AGPS, 1985), at 191.
306. See Economic Planning Advisory Council, *Some Features of Small Business and Its Policy Environment* (Council Paper No. 12) (Canberra: EPAC, 1986), at 13-16.
307. See B.L. Johns, W.C. Dunlop and W.J. Sheehan, *Small Business in Australia: Problems & Prospects*, 2nd ed. (Sydney: George Allen & Unwin, 1983), at 164. Also in its 1983 submission to the Treasury, the Taxation Institute of Australia recommended that small corporations be allowed to elect to be treated as partnerships. See 'Submission by the Taxation Institute of Australia' (1983) 18 *Taxation in Australia* 551, at 555. See also, for earlier suggestion for a partnership election, Parsons *supra* note 238, at 39; and B. Andrew, 'The Reform of Private Company Taxation' (1978) *Australian Tax Review* 169.

The Case for a Partnership Election for Closely-Held Corporations

The case for a partnership election for closely-held corporations rests upon two premises. First, no theoretical reason justifies treating corporations as separate taxpaying entities, and the administrative reasons for doing so do not apply to at least some types of closely-held corporations. Second, the economic benefits and equity gains of providing a partnership election outweigh the increased complexity costs of doing so. After reviewing these two premises, I also argue more generally that a tax system should not treat some entities using a pass-through model and other entities using a separate-entity model on the basis of their legal form; that is, whether they are constituted in private law as partnerships or corporations, for example. Instead, in categorising entities for tax purposes, tax-relevant criteria should be used. In this context, entities should be subject to separate-entity taxation only when the administrative reasons for imposing the separate tax are thought to outweigh the economic and equity costs of doing so, irrespective of the legal form of the entity.

THE THEORETICAL CASE FOR A PARTNERSHIP ELECTION

With respect to the first premise, the arguments about the theoretical inappropriateness of the corporate tax will not be reviewed here; this proposition is now widely accepted.³⁰⁸ Indeed, the last time that anyone has seriously tried to make a case for the corporate tax on theoretical grounds was probably in 1961 by the Ligertwood Committee.³⁰⁹ However, to illustrate the case for pass-through taxation of all entities in its simplest terms, imagine the most straightforward case. If two persons are conducting separate businesses and they decide to combine their resources, but their incomes do not change, it seems obvious that their tax positions should not change. If the two partners each contribute 50 per cent of the capital and 50 per cent of the labour and agree to share all profits and losses 50/50, their respective share of all income, deductions, credits and losses should be passed through to each. There is no theoretical reason why the character of the income they receive or the deductions and credits that they are entitled to should change simply because they decide to pool their resources. However, for ease of administration and to prevent abuses, the partnership entity might have to be recognised for some tax purposes. This becomes more obvious when instead

308. See generally, Krever and McLure, *supra* note 1.

309. Commonwealth Committee on Taxation, *supra* note 261.

of only two members the partnership has ten members and each has a different economic interest in the partnership property and income and each has agreed to assume a different degree of risk. However, the basic point is that no theoretical tax principle would require the partnership entity to be recognised for tax purposes.

If the partners decide to carry on their business as a corporation instead of a partnership, then in private law normally their business entity will have different characteristics. Most notably, it will have continuity of life, centralisation of management, limited liability and interests in it will be freely transferable. But again, in terms of tax principles, why should these characteristics be of any significance? Of what importance is it in a tax system designed to measure economic power that a person's liability for an investment in an income source is limited, or that the investment has potentially an unlimited life, or that it is freely transferable? Moreover, under most modern company law statutes shareholders of closely-held corporations are able to elect a set of rules to govern their relationships that provide them with many of the characteristics of a partnership, for example, decentralised management and restrictions on the transfer of shares. Thus, it seems obvious that the only possible reason for not extending pass-through treatment to corporations is administrative. I will not analyse here the alleged administrative problems with pass-through taxation for corporations;³¹⁰ however, even accepting that they foreclose such treatment for widely-held corporations,³¹¹ the United States experience with its S Corporation rules reveals that it is possible to draft rules that restrict the election for partnership treatment to those corporations in which the taxpayer and the tax department can cope with the administrative problems.

The above first premise for a partnership election for closely-held corporations seems uncontentious. The more difficult question is whether the benefits of providing such an election outweigh the costs of increased complexity and the opportunities for abuse.

THE BENEFITS AND COSTS OF PROVIDING A PARTNERSHIP ELECTION

The major benefit of allowing closely-held corporations to elect to be taxed as partnerships is that such an election would

310. For a summary see McLure, *supra* note 36, at 232-3.

311. Compare Swan and Officer, *supra* note 297 (arguing that full integration of the corporate and shareholder tax is administratively possible) with R. Vann, 'Legal Implications of Reform of Business Taxation' in D.J. Collins, *Reform of Business Taxation* (Sydney: Australian Tax Research Foundation, 1985), at 167 (arguing that technical problems preclude a system of full integration).

increase the neutrality of the tax system. A separate corporate tax necessarily creates a number of tax distortions. Moreover, in the absence of a partnership election a separate corporate tax leads to three distortions that affect small businesses in particular: (a) It discourages some business people from conducting their business in the corporate form. (b) It reduces risk-taking by entrepreneurs. (c) It diminishes the value of tax expenditures to small businesses. The seriousness of each of these distortions will be discussed in turn.

Lessen the Tax Distortion Relating to the Choice of a Business Form

Large businesses must incorporate. However, if the tax cost of operating a small business in an incorporated form is greater than the tax cost of operating it as a partnership, some taxpayers will continue to conduct their business as a partnership or a sole proprietorship even though there are good business reasons for incorporating. The seriousness of this distortion is speculative. It depends on how many people might be lead to conduct their business as a partnership or sole proprietorship because of the tax cost of incorporating, and the economic consequences of businesses being conducted in an unincorporated as opposed to an incorporated form.

The tax cost of incorporating, and therefore the number of small business persons who will be deterred from incorporating, will depend upon the details of the tax system and therefore vary greatly from jurisdiction to jurisdiction. By way of illustration, it will depend upon the following attributes of the tax system: the relation of the individual marginal rates to the corporate rate (the lower the individual marginal rates in relation to the corporate rate the greater the tax cost of incorporating); the ability of employees to withdraw amounts as salaries or interest payments from closely-held corporations (if the tax system places few hurdles in the way of shareholders withdrawing corporate surplus in the form of salaries and interest payments, there will only be an additional cost to incorporating if the corporation has non-employee equity investors); and, the tax advantages that incorporation might provide by permitting more generous tax treatment of pension plans or other fringe benefits and by providing increased opportunities for tax planning in the form of income splitting and estate freezing.

Although it is impossible to generalise about the tax cost of incorporating across jurisdictions as individual marginal rates are lowered, which appears to be the trend in most countries, the tax cost of incorporating will become greater. In the United States, for example, where the top marginal rate is now about equal to the flat corporate rate, and where individual

rates under the *Tax Reform Act of 1986* will for the first time in history fall below the corporate rate, there is evidence that the partnership option will become increasingly popular.³¹²

Even if the tax cost of incorporating causes some business people to operate their businesses in an unincorporated form, in assessing the need for a partnership election it is necessary to estimate the seriousness of any resulting economic distortion. The most significant effect of the use of the corporate form is that by providing for unlimited liability it might lead business people to take greater risks. In small enterprises this might not be a significant factor since invariably the entrepreneur will have to assume personal liability for advances of credit even if incorporated. However, if the business is in need of outside equity capital, then limited liability might be important. Although unincorporated forms such as limited partnerships and trusts can sometimes be used to provide outside equity investors with limited liability, the corporate form has many business advantages over these other forms. So, although the efficiency loss of imposing a tax cost on small business people is impossible to quantify, it likely exists.

Increase Risk-Taking

The second distortion caused by a separate tax on closely-held corporations is more serious. Individuals who start new ventures in partnership form are able to deduct their start-up costs and business losses from their personal income. Thus, if the person has other income, the government becomes (through the tax system) a partner in the venture, sharing in potential profits and losses. With a uniform sharing in gains and losses, taxes do not distort risk-taking. However, if the business person incorporates, the government, although it shares in future profits, no longer bears an equal burden for losses. If the business suffers losses they cannot be attributed to the shareholders to be deducted from their personal income but must instead be carried forward to be offset against future corporate income, if any. Since most new, risky business ventures must be incorporated, one can assume that this restriction upon the deductibility of corporate losses distorts the allocation of investment funds away from risky investment in new ventures.

Most income tax systems contain, a variety of restrictions on the effective deductibility of losses, all of which operate to reduce risk-taking. For example, invariably, capital losses can be deducted only from capital gains in order to prevent taxpayers from realising capital losses each year while accruing

312. See R.A. Kessler and G.L. Richmond, 'Has Congress Made the C Corporation Obsolete for the Small Business?' (1984) *Corporation Law Review* 293.

their gains. Because of the obvious bias this introduces against risk taking, most tax systems provide an exception to this rule to encourage investment in small businesses.³¹³ For example, in the United States a loss realised on 's.1244 stock' (stock issued by a 'small business corporation') issued to an individual or to a partnership which would otherwise constitute a capital loss is treated as an ordinary loss. The express purpose of s.1244, which was enacted in the same year as Subchapter S, was to encourage the flow of new funds into small businesses. Many tax systems have rules analogous to this. However, under these rules normally a loss can only be taken when the business has been terminated or when the shareholders sell their stock so as to wind up their interest in the business. A partnership election goes further and permits individual shareholders to offset business losses from their other income in the same year that the loss is incurred by the corporation. To this extent, it is a far greater incentive for investment in small businesses, and could materially increase the flow of equity available to small businesses. Of course, the effects of a partnership election on risk-taking should not be exaggerated. It will increase risk-taking only in those cases where the business could not otherwise be carried on in a partnership form and where the investor has an independent source of income with which to offset business losses.

Increase Small Business Access to Tax Expenditures

A partnership election could remove another tax distortion that impinges in particular on small businesses. It is well documented that corporate tax expenditures benefit large and highly diversified corporations more than small corporations.³¹⁴ There would appear to be two important reasons for this. First, most tax expenditures reduce the after-tax cost of new capital goods; large firms tend to be more capital intensive than small firms. Second, since most tax expenditures are in the form of a tax deduction or non-refundable tax credit a firm has to have taxable income in order to obtain full benefit from them. Small start-up firms are less likely than large diversified firms to have sufficient taxable income to utilise the full deduction provided by tax incentives.

The bias of tax expenditures in favour of large firms further increases the riskiness of new ventures. The

313. See generally, Moore and Sorlien, 'Adventures in Subchapter S and Section 1244' (1959) 14 *Tax Law Review* 453.

314. Canada's experience is typical. Because of the effect of tax expenditures, in 1982 corporations with assets under \$1 million paid tax at an effective rate of 34 per cent, corporations with assets over \$25 million paid tax at an effective rate of only 24 per cent. Statistics Canada, *Corporation Taxation Statistics, 1982* (Ottawa: Minister of Supply and Services, 1984), at 25, Table 3. See Generally, A.L. Feld, *Tax Policy and Corporate Concentration* (Lexington, Mass.: Lexington Books, 1982), at 24-38.

partnership election would in part correct this bias by allowing corporate tax incentives to be offset against the shareholders' personal incomes.

Assessment

The above three benefits of providing a partnership election for closely-held corporations must be balanced against the increased cost of complexity such an election would impose on the tax system and the possibilities for abuse it might give rise to. In the United States some commentators have questioned whether the benefits of the Subchapter S rules outweigh these costs.³¹⁵ However, judging from the United States experience it would seem that there are a sufficient number of situations in which a partnership election is helpful to warrant its presence in an income tax act. The number of firms electing Subchapter S treatment has increased gradually over the years until by 1982 there were approximately 565 000 firms utilising the Subchapter S form. This was about 20 per cent of the total corporate tax-filing population.³¹⁶ Of course, there are economies of scale to be realised in tax administration, and rules that can be effectively administered in a large jurisdiction like the United States might be too costly to administer in Australia or Canada. On the other hand, the United States S Corporation rules could be considerably simplified if they only applied to new firms. A good deal of the complexity of their rules is necessary to prevent existing corporations taking the election and then avoiding shareholder level tax on accumulated earnings and profits.³¹⁷

In a tax system providing for some form of dividend relief, the tax cost of incorporating can be considerably decreased. Therefore, it might be argued that a partnership election is unnecessary in a tax jurisdiction like Australia that provides for full imputation of the corporate tax upon the distribution of corporate surplus. However, even in such systems, if there is an advanced corporate tax, for example, a partnership election might alleviate liquidity problems faced by small firms. Much more significantly, the strongest arguments for a partnership election - the ability to pass-through losses and tax preferences - are still present. Thus, it would still serve to reduce some of the tax system's biases against small firms.

There are two further incidental advantages of introducing a partnership election for closely-held corporations. First, it should relieve the pressures to deal on a more ad hoc basis with some of the problems posed by the corporate tax for

315. See *supra* note 105.

316. See Department of Treasury, IRS, *Statistics of Income - Corporation Tax Returns* (Washington, DC: GPS, 1984).

317. See *supra* note 113.

small businesses. Second, it could provide the experience necessary to eventually move to the full integration of the corporate tax.

Virtually every recent tax reform study in the United Kingdom, Canada and Australia has recommended the adoption of a partnership election for closely-held corporations. In view of this overwhelming endorsement, and the strong case in principle, for the measure, the fact that none of these countries have adopted a partnership election requires explanation. In Canada and the United Kingdom the lower rate of tax for small corporations undoubtedly relieved a considerable amount of pressure for the partnership election. In Canada, for example, the lower rate of corporate tax has resulted in small businesses almost invariably paying less taxes if they are incorporated. In Australia, the pressure for a partnership election has presumably not been great since most small businesses have been able to avoid the separate corporate tax by conducting their businesses through trusts. Also, in all of these tax jurisdictions the double taxation of corporate-source income could normally be avoided by paying out salaries. The partnership election would enable incorporated entrepreneurs to deduct business losses against personal income. However, provision for the deductibility of losses, even though justified in tax policy terms, does not appear to have the same political appeal as provision for more direct tax concessions, even though not justified in tax policy terms.

Whether a partnership election is adopted in the United Kingdom, Australia or Canada will depend in part on the future relation of personal and corporate tax rates. If the top personal rates fall below the top corporate rates, as appears to be the case in the United States, there might be increasing pressure for such a move. Indeed, if the rates move in this direction there will undoubtedly be resumed consideration of partnership treatment for all corporations.

GENERAL: THE CLASSIFICATION OF LEGAL ENTITIES FOR TAX PURPOSES

The question of whether corporations should be given a partnership election raises a more fundamental tax policy issue that I will not discuss in any detail, but only raise here. The only point I wish to make is that providing a partnership election for closely-held corporations can be seen more generally as a step in the direction of developing a more rational system for classifying legal entities for tax purposes. Assume a tax system provides two techniques for taxing legal entities, the pass-through model and the separate-entity model, which correspond roughly to the way partnerships and corporations are now taxed. The fundamental tax policy issue

is, on what basis should particular legal entities be assigned to one category or the other?³¹⁸

One obvious way to classify entities is simply by reference to their name in private law. Entities referred to as partnerships in private law would be provided with pass-through tax treatment. Entities referred to as corporations would be taxed on a separate entity basis. This is essentially the Canadian and Australian approach. The problems with this system are obvious. Tax policy considerations have been surrendered to the whims of private law-makers. Normally, the application of tax laws should depend upon the rights and liabilities formed under private law, not upon the characterisation placed upon them by private law-makers. A jurisdiction might change its corporate laws so that closely-held corporations can elect to have characteristics analogous to partnerships, or its partnership laws so that limited partnerships have characteristics more analogous to corporations than traditional partnerships. Also, as apparent in so many areas of tax policy, private law categories can usually be manipulated to achieve virtually any economic result the parties wish. Thus a country whose tax laws rely on private law categories has really lost control of its tax system. This is evidenced in Australia where on a massive scale taxpayers have done an end run around the classical corporate tax system by using trusts.

Another way to classify entities is to look at the legal rights and obligations the parties have created and then classify the entity on the basis of these, regardless of the legal form the parties use in creating these legal rights and obligations. Thus if the taxpayers create an entity that has the characteristics normally associated with a partnership, it will be classified as a partnership. If the parties create an entity that has the characteristics normally associated with a corporation, it will be taxed as a corporation. This is essentially the American approach.³¹⁹

In the United States a corporation is defined as follows: 'The term "corporation" includes associations, joint-stock companies, and insurance companies'.³²⁰ In distinguishing between 'associations' that will be treated as corporations from others, the regulations list six major characteristics that are 'ordinarily found in a pure corporation': (i) associates, (ii) an

318. This question arises with respect to both domestic and foreign entities. Only the problem of classifying domestic entities will be discussed here. Criteria for classifying foreign entities must accommodate a wider range of interests. For a discussion of relevant considerations, see New York State Bar Association, Tax Section, 'Report on Foreign Equity Characterisation for Federal Income Tax Purposes' (1980) 35 *Tax Law Review* 167.

319. See B.I. Bittker and J.S. Eustice, *Federal Taxation of Corporations and Shareholders*, 4th ed. (Boston: Warren, Gorham & Lamont, 1979), chap. 2.

320. IRC, s.7701(a)(3).

objective to carry on business and divide the gains therefrom, (iii) continuity of life, (iv) centralisation of management, (v) liability of corporate debts limited to corporate property, and (vi) free transferability of interests.³²¹ Since the last four of these characteristics are common to both trusts and corporations 'the determination of whether a trust ... is to be treated for tax purposes as a trust or as an association depends upon whether there are associates and an objective to carry on business and divide the gains therefrom'.³²² Under this test, virtually all trusts carrying on a business are classified as corporations.³²³ Partnerships generally have associates and an objective to carry on business for joint profit; therefore, when attempting to distinguish between a partnership and an association taxable as a corporation, the decision is made by reference to the other four characteristics. To characterise a partnership as a corporation it is necessary to find three out of the four other characteristics: continuity of life, centralised management, limited liability and free transferability of interests.³²⁴ Under this test, partnerships, even publicly traded limited partnerships, have generally been held not to be corporations.³²⁵

Although generally for tax law purposes the actual rights and obligations created by the parties should determine tax consequences, and not the private law characterisations, in this area this approach does not lead to satisfactory results. First, given the large number of factors that may vary from one legal entity to another, a 'resemblance test' is almost impossible to apply consistently. Answers to such questions as what features should be looked at, how they should be weighed, and whether a particular number of features should be required before an association is classified as a corporation, for example, will all necessarily be arbitrary. Although some United States commentators have suggested that a more realistic resemblance test than at present applied in the United States could be developed,³²⁶ it is doubtful if any meaningful test could be applied. For example, even in large general partnerships like law and accounting firms, continuity of life is realistically

321. Reg. 301.7701-2(a)(1).

322. Reg. 301.7701-2(a)(2).

323. See generally, J.V. Karlinsky, 'Tax Classification of Trusts: The Howard Case and Other Current Developments' (1986) 19 *Loyola of Los Angeles Law Review* 803; C.J. Doolin, 'Determining the Taxable Status of Trusts That Run Businesses' (1985) 70 *Cornell Law Review* 1143.

324. Reg. 301.7701-2(a)(3).

325. See generally, E.W. Hecker, Jr., 'The Tax Classification of Limited Partnerships Revisited' (1983) *Commercial Law Review* 537; F.W. Peel, 'Definition of a Partnership: New Suggestions on an Old Issue', [1979] *Wisconsin Law Review* 989; R. Hall, 'Tax Classification of Limited Partnerships: Opportunity for Reform' (1977) 30 *Rutgers Law Review* 1260; Note, 'Tax Classification of Limited Partnerships' (1977) *Harvard Law Review* 745.

326. See *supra* note 325.

present. Also, through managing partner agreements partners of such firms enjoy the benefits of centralised management. On the other hand, many closely-held corporations have restraints on the transferability of shares, and limited liability for the owners is not an economic reality.

More fundamentally, the resemblance test is flawed because the characteristics of an entity that are used in classifying it have no significance in tax policy. Tax policy analysts, in rejecting the case for a separate tax on corporations, have been unanimous in agreeing that legal characteristics such as limited liability, free transferability of interests and centralised management are irrelevant facts in tax policy terms. If this is so, why should they be resorted to in classifying legal entities for tax purposes? Thus, one reason why a satisfactory resemblance test has never been developed in the United States is that the courts and the IRS have been faced with the task of formulating standards for distinguishing among businesses without knowing the precise goals their line-drawing is to serve.³²⁷

The history of the regulations on entity classification in the United States illustrate the arbitrariness that arises when clear policy reasons do not underlie the categorisation.³²⁸ In the 1950s statutory changes made it desirable for professionals, in particular, to have their organisations classified as corporations in order to take advantage of lower corporate income tax rates and deferred compensation arrangements available to corporate employees. After losing an important case,³²⁹ the IRS promulgated entity-classification regulations in 1960 that were pro-partnership in order to deny these tax benefits to professionals. However, after a protracted struggle on this issue, and in the face of state laws allowing professionals to incorporate and judicial hostility to the IRS's apparent arbitrariness in drafting the new regulations, the IRS conceded defeat in the late 1960s. No sooner had the IRS lost its battle against professional organisations, than it faced the problem that the business community began using the pro-partnership regulations to form tax shelters using limited partnerships. Tax shelter limited partnerships afforded investors the business advantages of the corporate form without losing the tax advantages of partnerships, most notably the flow through of losses. Because of the promulgation of its earlier pro-partnership regulations, throughout the 1970s the IRS was largely unsuccessful in having these limited partnerships classified as corporations.

327. For an insightful discussion of this point see M.B. Hyman and P.M. Hoffman, 'Partnership and "Associations": A Policy Critique of the Morrissey Regulations' (1976) 3 *Journal of Real Estate Taxation* 377.

328. See articles cited in *supra* note 325.

329. *United States v. Kinter*, 216 F. 2d 418 (9th Cir. 1954).

In the absence of any compelling tax policy for distinguishing between legal entities, the only sensible way to classify them into the pass-through or separate-entity taxation models is by taxpayer election. The two distinct regimes of taxation for entities should be provided in the act and taxpayers allowed to elect which regime they wish to be taxed under, regardless of the legal form of their legal entity or the rights and obligations it created. Some taxpayers would undoubtedly find it advantageous to be taxed at their individual rates. Others would find it advantageous to pay the separate tax at the entity level and defer paying tax at the individual level. Essentially immediate taxation at high individual rates or deferral at lower corporate rates would be seen as an acceptable trade-off.

One might ask, if there are no tax policy justifications for distinguishing between partnerships and corporations why bother with an elective system? Why not simply put all legal entities on a pass-through basis? The election is premised on the assumption that there are administrative difficulties with placing some large entities on a pass-through basis. Providing taxpayers with an election enable those entities for whom pass-through taxation would pose high compliance costs to elect to be taxed as a separate-entity. If it was felt that pass-through taxation by some entities might pose high administrative costs on the tax department, then the characteristics of entities that give rise to administrative problems when pass-through taxation is used might be identified and entities classified on the basis of the presence or absence of these characteristics. By way of example, one characteristic of entities that is alleged to give rise to problems for pass-through taxation is the free transferability of interests. If the interests in the entity are sold frequently during the year, allegedly this gives rise to problems in establishing a record date for allocation purposes and can give rise to tax audit problems. Another characteristic of entities that gives rise to administrative problems in a system of pass-through taxation is the existence of complex and multiple interests. It is often difficult to allocate an entity's profits, in the absence of an actual distribution, if the parties with an interest in the entity have different rights, some of which might be contingent on future events. If these are the characteristics of business entities that give rise to administrative problems in a pass-through model, it would make sense to restrict pass-through taxation to those business entities in which, for example, the interests cannot be publicly traded and in which the economic interests are straightforward. Obviously, this is not the place to work out the details of such a regime, but my point is that under it entities would be classified for tax purposes regardless of the term used to identify the legal entity or even of the legal rights and

obligations created. Instead classification would be based upon tax-relevant factors.

There are two obvious arguments against an elective system or one that divides entities according to the administrative difficulties of providing for pass-through taxation. First, it might be argued that the present Canadian and Australian systems are effectively elective systems. If taxpayers wish pass-through taxation they can operate their business as a partnership or trust. If they wish separate-entity taxation they can operate their business as a corporation. Moreover, the legal concept of a partnership acts as a good surrogate for an entity whose interests are not frequently traded and whose economic interests are straightforward, whereas the legal concept of a corporation acts as a surrogate for an entity with the opposite characteristics.

However, a system that requires taxpayers to elect, in effect, how to be taxed by operating their business as either a partnership, trust or corporation, depending upon the election they wish to make, is highly inefficient. In order to make the tax election they wish, taxpayers might be required to operate their business in a legal form that is unsuited to their business needs. Moreover, as surrogates for the characteristics of legal entities to which pass-through taxation is or is not easy to apply, these two legal categories are far from perfect. By way of example, closely-held corporations are obviously closer to partnerships in this respect than they are to publicly-traded corporations and limited partnerships can be more like publicly traded corporations than general partnerships.

Another objection to permitting taxpayers to elect whether legal entities owned by them will be taxed on a pass-through or separate-entity basis might be that the tax department loses some control over the claiming of artificial tax losses. This is indeed the context in which the classification issue has arisen in the United States in the last number of years. Because each partner is allowed to deduct his share of any partnership losses, partnerships are an effective means for joint participation in tax shelters. Limited partnership interests can be used to protect investors from loss in excess of their investment and to enable them to freely transfer their interest. Thus by using limited partnerships investors can achieve the tax advantages of partnership treatment, but the legal advantages of the corporate form.³³⁰ For this reason, a number of tax reform proposals in the United States have suggested that limited partnerships should be treated as corporations for tax purposes.³³¹

330. See 'Publicly Traded Limited Partnerships: An Emerging Financial Alternative to the Public Corporation' (1984) 39 *Business Lawyer* 709, 710.

331. Department of Treasury, *The President's 1978 Tax Program* (Washington, DC: GPO, 1978), at 117-31; Treasury Department, *Tax Reform for Fairness, Simplicity and Economic Growth* (Washington, DC: GPO, 1984), vol. 2, chap. 7.03.

However, instead of using entity-classification rules to limit the pass-through of losses, a better approach is simply to limit loss flow-through on particular investments directly. Thus, for example, if the government is concerned about widespread exploitation of the tax advantages that can often be realised by investing in real estate, instead of attacking the vehicles used for such investments (by classifying certain limited partnerships as corporations) the better approach is simply to limit the amounts deductible from such investments to the income earned from them.³³²

In conclusion, in this general section on the classification of legal entities for tax purposes I have argued that if for administrative reasons all legal entities cannot be put on a pass-through basis for tax purposes, then taxpayers should be allowed to elect pass-through or separate-entity taxation or legal entities ought to be classified by reference to tax-relevant criteria. The more narrow point I wish to make is simply that a partnership election for closely-held corporations can be justified as a move in that direction.

The Case Against the Lower Rate of Corporate Tax

A lower rate of tax for closely-held corporations is usually justified by reference both to tax objectives - it increases the equity and neutrality of the tax system - and to budgetary objectives - it is a good policy instrument for providing financial assistance to small business.³³³ Each of the rationales will be discussed in turn.

332. When an effort is made to limit the accessibility to tax expenditures by attacking limited partnerships for example, the benefits of the tax shelter are only effectively denied to middle-income investors. High-income taxpayers generally do not have to invest in limited partnerships to invest in tax shelters. They can often simply invest directly. Of course, any indirect rule limiting tax shelter activity will create inequities. For example, none of the indirect rules limiting tax shelter activity will distinguish real economic losses from tax losses. Also, the broader the category of investments to be restricted, the larger the group of investors who will continue to benefit from the tax rules. A rule limiting the loss from rental property to related income will not, for example, impinge upon the investor with a large, diversified rental property portfolio. There seems little way around this problem. But the point here is simply that limitation of artificial loss rules are invariably more effective in limiting accessibility to tax expenditures than entity-classification rules.

333. Controlling corporate monopoly or bigness is another justification sometimes put forward for graduated corporate tax rates. This justification would suggest that all low- and middle-income and even some large corporations should pay at the same rate, but that truly large corporations should pay at a higher rate. Using corporate tax rates to control corporate monopoly has been discussed from time to time, but it is never propounded seriously since a firm's market share is obviously unrelated to its income. Some

TECHNICAL TAX POLICY ANALYSIS OF THE LOWER RATE OF CORPORATE TAX

The following two tax policy considerations have been put forward from time to time as justifying the lower rate of corporate tax: large corporations have greater ability to pay than smaller corporations; and, by reducing the tax burden on small corporations, a lower rate of tax mitigates the tax cost of incorporating for the typical partnership or proprietorship and thus increases the neutrality of the tax system.

Many jurisdictions that adopted graduated corporate tax rates in the first half of the century did so because of a belief that large corporations had more ability to pay than small ones.³³⁴ The intuitive appeal of this justification is obvious:

industries can be dominated by relatively small firms, in others even giant firms may not dominate. See A.G. Buehler, 'Should the Tax System Be Used to Check Monopoly?' in R.G. Blakey, *How Should Corporations Be Taxed?* (New York: Tax Institute Inc., 1946), at 91; R.A. Musgrave and P.B. Musgrave, *Public Finance in Theory and Practice*, 4th ed. (New York: McGraw-Hill, 1984), at 389; and, A.L. Feld, *Tax Policy and Corporate Concentration* (Lexington, Mass.: D.C. Heath, 1982), at 139-42. This defect could be remedied by levying a progressive corporate tax based on market shares. See W.G. Shepherd, *The Treatment of Market Power: Antitrust, Regulation, and Public Enterprise* (New York: Columbia University Press, 1975), at 196-300. However, aside from any other consideration, the administrative problems with such a tax appear to be almost insurmountable. A more serious but related justification for progressive corporate tax rates is to curb corporate bigness. If economic power leads to political and social power, reducing the size of a country's business corporations might lead to a more equal distribution of political and social rights. This justification for progressive corporate tax rates has been put forward by numerous commentators, most recently by J.L. Simon. Simon suggests, based on 1968 income levels, a tax of 75 per cent on all corporate income in excess of \$80 million annually. J.L. Simon, 'Antitrust and the "Size" Problem: The "Graduated" Corporate Income Tax as an Anti-Bigness Device' (1972-73) 6 *Antitrust Law and Economics Review* 53. See also, S.M. Loescher, 'Limiting Corporate Power' (1979) 13 *Journal of Economic Issues* 557. But, although high corporate tax rates appear to be a better instrument to curb bigness than monopoly power, they are an ill-suited instrument even for this purpose. Once corporations reach a particular size, their income might be more a measure of their profitability than their bigness in any other sense, for example, asset size. And yet, a corporation with a large asset size might have more political or social power than a corporation with a large income. Thus, if a tax is to be designed to mitigate the problems posed by corporate bigness, it is unclear that its base should be income. Moreover, such a tax would be difficult to enforce. For example, somewhat ironically, if it were based on taxable income it could be avoided so long as the firm continued to expand by acquiring new depreciable assets. Tax deductions generated by such purchases would keep a firm's taxable income low. Also, it would be extremely difficult to formulate rules to associate the income of related corporations for purposes of the tax. Large public corporations can often be controlled by one individual or a related group of individuals with a small shareholding.

334. See M. Newcomer 'European Taxation of Business' in *How Shall Business be Taxed?* (New York: Tax Policy League, Inc., 1937), at 69 (in 22 countries levying the corporate tax, 11 used progressive rates); R. Blough, 'Flat versus Graduated Rates for Business Net Income Taxes' *id.*, at 74; E.G. Keith, 'Flat Rate Corporation Tax vs. Present Tax' in H.M. Groves et al., *Reappraisal of Business Taxation* (Princeton: Tax Institute, 1962) 175. In the United States, the greater ability-to-pay of large corporations was one of the justifications given for imposing graduated corporate rates in 1935. See A.G. Buehler, *The Undistributed Profits Tax* (New York: McGraw-Hill,

large corporations have greater resources than small corporations. However, tax theoreticians are now unanimous in agreeing that corporations do not have ability to pay as that concept is normally used in tax theory.³³⁵ Although the concept lacks precision, it is normally assumed to call for some sort of equality of sacrifice. Legal constructs, such as corporations, cannot suffer the kind of psychological pain that the concept contemplates.³³⁶

In individual taxation the concept of ability to pay when used to justify progressive rates sometimes refers not to notions of marginal sacrifice but to the idea that it is fair to use the tax system to redistribute income. But even in this sense the concept cannot be used to justify progressive corporate tax rates. Ultimately, the corporate tax must be borne by individuals. It must reduce the income of shareholders, all capitalists, consumers or employees. If the corporate tax is borne by consumers in the form of higher prices, or employees in the form of lower wages, it would be regressive, whether the rates were flat or progressive. If the corporate tax reduces corporate profits, and therefore in the short-run is borne by shareholders, it increases the

1937), at 235. In 1941, in noting that six states had imposed progressive tax rates on corporations, J.R. Sundelson stated 'there is every evidence that the ability-to-pay concept was considered to be as pertinent to the income of corporations as it is to the income of the individuals'. 'Taxation of Corporate Income at Progressive Rates: The State and Federal Experience Compared' (1941) 26 *Bulletin of the National Tax Association* 167, at 171. The ability-to-pay rationale appears to have had the support of at least some early tax theoreticians. For example, Sir Josiah Stamp, although admitting several difficulties with the argument, noted that progressive taxation 'has been justified on the "production" side by reference to the fact that the larger the income the greater its power on being focused or grouped for the production of further income, and therefore, the more it can be tapped without hurt'. *The Fundamental Principles of Taxation* (London: McMillan, 1929), at 41.

335. See R.M. Bird, *Taxing Corporations* (Montreal, Institute for Research on Public Policy, 1980), at 12-15; R. Goode, *The Corporation Income Tax* (New York: Wiley and Sons, 1951), at 32-7 (but suggesting that a tax on corporations might be justified if ability to pay is interpreted as 'the capacity of paying with minimum interference with socially approved aims'); R.A. Musgrave and P.B. Musgrave, *Public Finance in Theory and Practice*, 4th ed. (New York: McGraw-Hill, 1984), at 388; J.A. Pechman, *Federal Tax Policy*, 3rd ed. (Washington, D.C.: The Brookings Institution, 1977), at 128; and J.R. Petrie, *The Taxation of Corporate Income in Canada* (Toronto: University of Toronto Press, 1952), at 102-5.
336. Economists, uneasy with the subjective nature of the traditional ability to pay concept, often attempt to convert it into a more objective sounding concept. Frequently, its application is said to depend upon the distinction between non-discretionary and discretionary income. For example, in arguing against a progressive rate structure for corporations, the authors of the United States Treasury report on tax simplification and reform reasoned, 'The progressive rate structure for individuals is premised on the ability-to-pay concept, which in turn reflects an assumption that additional amounts of income are increasingly available for discretionary, nonessential consumption. These concepts have no relevance to corporate income, all of which is either distributed, or used to produce additional income'. United States, Treasury Department, *Tax Reform for Fairness, Simplicity, and Economic Growth* (Washington, D.C.: GPO, 1984), at 127.

progressivity of the tax system since shares are held disproportionately by high-income individuals. However, even if the corporate tax could be justified on this ground, a progressive corporate tax could not be since there is no relationship between the size of a corporation and the net income of its owners. Many small corporations (which would benefit most from graduated rates) are owned by high-income individuals and many middle- and low-income individuals own shares in large corporations.

A tax system should be neutral between the various legal forms taxpayers may use in carrying on their businesses. A flat-rate corporate tax, since it must be set at a rate about equal to the highest individual marginal rate to prevent undue deferral advantages when a business is carried on in an incorporated form, will invariably impose a substantial tax cost on the incorporation of businesses operated by middle- and low-income individuals. Some jurisdictions have, therefore, adopted graduated corporate tax rates as a way of increasing the neutrality of the tax system.³³⁷ Graduated corporate tax rates that closely parallel the graduated individual rates ensure that middle- and low-income individuals who incorporate their businesses do not experience an abrupt increase in their tax liabilities. This rationale for graduated corporate tax rates is unconvincing for two reasons. First, graduated rates achieve this objective at too high a cost. Graduated corporate rates allow high-income individuals to use corporations to split their income between two sets of income tax brackets. Second, the additional tax cost of incorporating can in most tax systems be easily avoided by a business person by simply withdrawing corporate source income as salary. To the extent that the tax cannot be avoided, the sensible policy response is a partnership election for small corporations not graduated corporate tax rates.

Thus, the lower rate of corporate tax cannot be justified as a technical tax measure. Since the corporate tax is not based on the concept of ability to pay, graduated rates do not further the equity of the tax system. Although graduated corporate rates might increase the neutrality of the tax system, they do so only marginally, at a considerable revenue cost, and by making the tax system less equitable.

337. This was one of the reasons that graduated corporate tax rates were adopted by a number of states in the United States. See J.R. Sundelson, 'Taxation of Corporate Income at Progressive Rates: The State and Federal Experience Compared' 26 *Bulletin of the National Tax Association* 167, at 171 ('It was believed ... that a flat rate tax on corporations would be discriminatory and that it was undesirable to tax the small unincorporated business more heavily than the small incorporated concern.') Also, in 1978, when the generosity of the graduated corporate rates was increased in the United States, both the House on Ways and Means Committee and the Senate Finance Committee gave this as one of the justifications for doing so. See *infra* note 349.

IS A LOWER RATE OF CORPORATE TAX A TAX EXPENDITURE?

Many countries now account for the tax expenditures in their tax systems.³³⁸ The question of whether a lower rate of corporate tax is a technical tax measure or a subsidy for small business has thus arisen in this context: Should the reduced tax liability, due to a lower rate of corporate tax or graduated corporate tax rates, be included in a country's tax expenditure account? Therefore, before examining the small-business-subsidy case for a lower corporate tax rate, I will review the debate over the purpose of the lower corporate rate as it has arisen in the context of deciding whether to include it in a tax expenditure account.

Recently, the United States Office of the Management and Budget has removed the lower rate of corporate tax from its list of tax expenditures. The debate surrounding the removal of this and other tax provisions from this list of tax expenditures sheds some light both on the purposes of the lower rate of tax and the nature of the tax expenditure concept. Therefore, in addition to reviewing the treatment of the lower rate of a corporate tax in tax expenditure lists, I will make a more general comment about the tax expenditure concept.

In most tax expenditure analysis the lower rate of tax has been treated as a tax expenditure. In Canada, the small business credit has been treated as a tax expenditure by the federal government in its tax expenditure account,³³⁹ and by most commentators.³⁴⁰ The income of Canadian-controlled private corporations that qualifies for the federal small business credit is also eligible for a lower rate of provincial tax. Most commonly, the general provincial corporate tax rate is about 15 per cent and the small business rate is about 10 per cent. All of those provinces that have published an account of their tax expenditures have included in it the revenue lost because of this lower rate of tax.³⁴¹

338. See generally, S.S. Surrey and P.R. McDaniel, *International Aspects of Tax Expenditures: A Comparative Study* (Deventer, Netherlands: Kluwer, 1985).

339. Department of Finance, *Account of the Cost of Selective Tax Measures* (Ottawa: Department of Finance, 1985), at 122 (cost estimated to be \$1.4 billion in 1982).

340. See, for example, R.S. Smith, *Tax Expenditures: An Examination of Tax Incentives and Tax Preferences in the Canadian Federal Income Tax System* (Toronto: Canadian Tax Foundation, 1979), at 95; and, K. Lahey, 'The Small Business Credit: A Tax Expenditure Analysis' (1979) 1 *Canadian Taxation* (No. 2) 29.

341. See Ministry of Finance, Province of British Columbia, *Background Papers to the 1982 Budget* (1981), at 32, (estimated cost for 1982-83, \$82.1 million); Hon. Eugene Kostyra, Minister of Finance, *Manitoba Budget Address, 1986* (Queen's Printer), at C-9 (estimated cost for 1986, \$14.4 million); Ministry of Treasury and Economics, *Ontario Tax Expenditures*

The United Kingdom does not have an official tax expenditure list. However, the small companies reduced rate of corporate tax is listed as a tax relief in the government's annual Public Expenditure White Paper.³⁴² The reduced rate was not included as a tax expenditure (without discussion) in the leading treatise on tax expenditures in the United Kingdom.³⁴³

In the United States, until 1978, graduated corporate tax rates took the following form. The permanent corporate income tax consisted of a normal tax rate of 22 per cent and a surtax of 26 per cent, for a total tax rate of 48 per cent. The first \$25 000 of profits were exempt from the surtax. In 1975, temporary provisions reduced the normal tax rate to 20 per cent on the first \$25 000 of profits and 22 per cent on the next \$25 000 of profits, and raised the exemption from the surtax to \$50 000. All three government agencies that prepare tax expenditure lists - the Office of Management and Budget (OMB),³⁴⁴ the Congressional Budget Office (CBO)³⁴⁵ and the Joint Committee on Internal Revenue Taxation (JCT)³⁴⁶ - treated the exemption from the surtax as a tax expenditure.

The *Revenue Act of 1978* repealed the normal corporate tax and surtax and in their place imposed a five-step tax rate structure on corporate income. The rates ranged from 17 per cent on the first \$25 000 of taxable corporate income to 46 per cent on income over \$100 000. In passing the new graduated rate schedule, both the House Ways and Means Committee and the Senate Finance Committee stated that they did not consider the new tax structure to be a tax expenditure.³⁴⁷ Neither

(1986), at 13, (estimated cost for 1984-85, \$210 million); and, Hon. J. Gary Lane, Minister of Finance, Saskatchewan, *Budget Address, 1986*, at 54 (estimated cost for 1986, \$18.8 million).

342. See *The Government's Expenditure Plans 1979-80 to 1982-83* Cmnd 7439 (London: HMSO, 1979), at 25. There is no attempt in this list to identify the reliefs that should be considered tax expenditures and no effort to link them to particular spending programmes.
343. See J.R. Willis and P.J.W. Hardwick, *Tax Expenditures in the United Kingdom* (London: Heinemann Educational Books, 1978), chap. 7.
344. See Executive Office of the President and Office of Management and Budget, *Special Analysis, Budget of the United States Government, Fiscal Year 1987* (Washington: GPO, 1986), Special Analysis G. This special analysis is undertaken pursuant to the *Congressional Budget Act of 1974*, Public Law 93-344, which requires a listing of tax expenditures in the Budget.
345. See Congressional Budget Office, 97th Cong., 1st Sess., *Tax Expenditures: Budget Control Options and Five-Year Budget Projections for Fiscal Years 1983-1987* (1982). The CBO is required by the *Congressional Budget Act of 1974*, Public Law 93-344, to issue a report each year that projects tax expenditures for each of the next five fiscal years.
346. See Joint Committee on Taxation, 98th Cong., 1st Sess., *Estimates of Federal Tax Expenditures for Fiscal Years 1983-88* (1983). The Joint Committee has since 1971 submitted this data on a regular basis to the House Ways and Means Committee and the Senate Finance Committee.
347. House Ways and Means Committee, *Revenue Act of 1978*, H.R. Rept. 1445, 95th Cong., 2d Sess. (Washington: GPO, 1978), at 143; Senate Finance

committee gave any reason for this approach. The Senate Finance Committee for example, simply noted, 'The Committee believes that the graduated tax rate becomes part of the normal tax structure, departures from which are considered as tax expenditures'.³⁴⁸ In giving reasons for the increased generosity of the tax relief for small businesses both committees gave both a tax expenditure and a tax structure argument. For example, the House Ways and Means Committee report stated, 'the committee believes that ... the application of graduated rates to corporations will encourage growth in small business and provide tax relief to those companies ... Moreover, application of the graduated rates to corporations should reduce the impact of tax laws in the selection of a form of organisation for operation of a small business'.³⁴⁹ Nothing came of the committees' suggested change in treatment of the lower corporate tax rates for small business. Both committees noted that the Congressional Budget Office did not agree with their position that the graduated corporate tax rate structure should not be treated as a tax expenditure,³⁵⁰ and the tables on changes in the cost of tax expenditures which accompanied the committee reports included the increased cost of the lower graduated corporate tax rates.³⁵¹

However, in 1983, the Office of Management and Budget changed its method of classifying tax expenditures. This resulted in a number of tax provisions, including graduated corporate tax rates, no longer being treated as a tax expenditure in Special Analysis G of the Budget. Prior to 1983, the OMB, like the JCT and the CBO, defined tax expenditures as deviations from a 'normal' income tax determined by reference to the Haig-Simons definition of income.³⁵² In 1983 the OMB changed its approach so that only those tax provisions that were comparable in design to direct subsidy programmes would be labelled as tax expenditures.³⁵³ Consequently, if deviations from the 'normal' tax structure were general they would not be classified as tax expenditures. A two-step procedure for identifying tax expenditures was proposed. To be classified as a tax expenditure both of the following two questions in relation to a provision has to be answered in the affirmative. First, if the provision in question

Committee, *Revenue Act of 1978*, S. Rept. 1263, 95th Cong., 2d Sess. (Washington: GPO, 1978), at 253.

348. S. Rept. 1263, *supra* note 347.

349. H.R. Rept. 1445, *supra* note 347, at 110.

350. *Supra* note 347.

351. H.R. Rept. 1445, *supra* note 347, at 144; S. Rept. 1263, *supra* note 347, at 262.

352. For the development of the definition of tax expenditures in the United States see S.S. Surrey and P.R. McDaniel, 'The Tax Expenditure Concept and the Budget Reform Act of 1974' (1976) 17 *Boston College Industrial and Commercial Law Review* 679, at 682-8.

353. See *supra* note 344.

did not exist, does the enacted tax law (the 'reference law') provide a generally applicable rule by which taxpayers could determine their tax liability?³⁵⁴ Second, does the provision in question apply to only a narrow class of transactions, or taxpayers, so that its differential effects on particular market prices and quantities can be identified and measured?³⁵⁵ Under these criteria, graduated corporate tax rates are not tax expenditures: there is no general provision to which they are an exception,³⁵⁶ and the rates do not apply to a narrow class of taxpayers.

This method of determining tax expenditures appears nonsensical. Aside from other criticisms,³⁵⁷ most notably that it is not obvious what purpose such a definition serves, it leads to two perverse results: First, by accepting the existing tax law as the 'reference law' it provides no standard by which that law can be evaluated. Second, by labelling only tax provisions that apply to a narrow class of transactions or taxpayers as tax expenditures, it fails to identify as spending programs those provisions of the tax system that are designed to achieve particular social or economic objectives but that are general in their application and therefore are the most poorly targeted subsidy programs.

The only possible explanation for the change in the approach by the OMB is that the Treasury wished to obscure the nature of a number of expensive and ineffective tax expenditures that the government introduced in 1981, such as the expansion of the investment tax credit and the accelerated cost recovery system of depreciation through the device of 'safe harbour leasing'. In 1985, the OMB, noting the lack of uniformity between its tax expenditure list and those of the CBO and JCT, began providing revenue estimates for both those items classified as a tax expenditure under its 'reference tax' approach and those items that would be so classified under the 'normal tax' approach.³⁵⁸

Because tax expenditure analysis is central to my criticism of the lower rate of tax, and because there appears to be a considerable amount of confusion in the literature over its uses, if not its validity, I will digress slightly here to clarify the nature of the concept. Some of the most interesting literature in tax policy has been devoted to attempting to define, or to point out the difficulties of defining, a

354. This question, in theory, removes any normative content from the question of whether a provision is a tax expenditure.

355. This question ensures that only tax provisions for which a comparable subsidy programme could be designed are classified as tax expenditures.

356. Unless the top rate could be considered the general rule.

357. See S.S. Surrey and P.R. McDaniel, *Tax Expenditures* (Cambridge: Harvard University Press, 1985), at 194-6.

358. For fiscal year 1986, the cost of the reduced rates on the first \$100 000 of corporate income was estimated to be \$9.8 billion. See *supra* note 340.

comprehensive tax base.³⁵⁹ Many of the authors critical of the comprehensive tax base, and therefore the tax expenditure concept, argue that it is necessarily a normative concept and therefore of little value unless its normative premises can be agreed upon. The comprehensive tax base (and therefore any concept that purports to identify deviations from it) is unquestionably a normative concept. Any tax base must be defined in relation to the policy objectives that it is designed to serve. However, the tax expenditure concept has value even though the definition of a comprehensive tax base cannot be agreed upon.

The real value of the tax expenditure concept has been to clarify the analysis of tax provisions. Basically, the concept makes clear that two distinct types of criteria must be used to evaluate tax measures: just tax criteria such as equity, neutrality and simplicity and, second, budgetary criteria such as cost-effectiveness and the degree of government control over and accountability for the measure. Thus, the concept suggests that if the lower rate of corporate tax is defended upon the grounds that it promotes the neutrality of the tax system then it should be analysed by applying this and other tax criteria. However, if it is defended upon the grounds that it promotes small business, it should be analysed as a spending program, using budgetary criteria. That is, if a tax provision is justified as serving some particular government social or economic objective it is always fair to ask: (a) Whether the objective is a legitimate and priority concern of government? (b) Whether some other policy instrument might better achieve the objective? and, (c) By comparison to a spending program, whether the tax provision could be better designed? It has only been in the last twenty years, since the popularisation of the tax expenditure concept, that tax analysts have fully appreciated the need, and have developed the sophistication needed, for answering these types of questions. In these terms, so long as the type of analysis called for is understood, at the end of the day whether a measure is labelled a tax expenditure is insignificant. Furthermore, the concept will have served its purpose of clarifying the analysis of tax provisions even though no agreement has been reached upon the design of the normal tax structure.

Of course, for some purposes it is necessary to prepare a list of tax expenditures, to integrate tax provisions into the budgetary process, for example. However, since the purpose of most tax expenditure lists is purely informational, there would appear to be little danger in including in the list all those provisions for which spending-type arguments might conceivably be made. Some commentators have expressed the

359. See, for example, B.I. Bittker et al., *A Comprehensive Tax Base?* (Brandford, Conn.: Federal Tax Press, 1968).

fear that including a tax provision in a tax expenditure budget or list might result in the measure being repealed on the grounds that it is not an effective spending measure when in fact there were good tax policy reasons for it. That is, they fear that including a provision in the tax expenditure list might squelch serious exploration of its tax policy rationale. However, this danger could be met simply by inserting a footnote in the tax expenditure list explaining the tax policy arguments that could be made on behalf of the provision. Moreover, the same argument could be turned on its head. If a measure for which there is a respectable spending argument is not included in the list, the measure might be repealed on the ground that it is a bad tax measure without sufficient regard to its spending justifications. But the fundamental point I wish to make is that to serve its purpose of clarifying analysis the tax expenditure concept does require the tax act to be unambiguously divided into 'normal' and special provisions.³⁶⁰

This confusion - that the tax expenditure concept requires the classification of each tax provision - was apparent in a series of Canadian articles on the small business credit in which the authors argued that the Canadian small business credit is not a tax expenditure.³⁶¹ They suggested that the credit serves the technical tax policy purpose of achieving the integration of corporate and shareholder tax in small businesses. It reduces the corporate tax to 25 per cent, and this is the amount of corporate tax for which the gross-up and dividend tax credit compensates upon the distribution of earnings. However, this argument ignores the fact that the

360. See for an insightful discussion of this point, M.J. McIntyre, 'A Solution to the Problem of Defining a Tax Expenditure' (1980) 14 *University of California Davis Law Review* 79. Stanley Surrey, the originator of the concept of tax expenditures, usually refused to be drawn into debates over the 'normal' tax structure by insisting there was wide agreement upon its general contours. However, at least when he initially formulated the concept he appears to have always insisted that a judgment about the design of the normative tax structure was important to sustaining the usefulness of the tax expenditure concept. S.S. Surrey, *Pathways to Tax Expenditure Reform: The Concept of Tax Expenditures* (Cambridge: Harvard University Press, 1973), at 7. More recently, however, he and a co-author have suggested that in classifying a given tax provision as a tax expenditure the only really important question is whether non-tax arguments are advanced in its support. P.R. McDaniel and S.S. Surrey, eds., *International Aspects of Tax Expenditures: A Comparative Study* (Deventer, the Netherlands: Kluwer, 1985), at 10-11. ('To classify properly a given provision as a tax expenditure or as part of the normative structure requires resort not only to tax theory, but also to the legislative history of existing provisions, to the reasons offered by proponents of a new tax proposal, and to the defenses relied upon for rules that are proposed to be modified or terminated ... [if the] arguments are spending arguments, not tax structure arguments ... classification of the items as a tax expenditure is appropriate.')

361. See J.E. Hersfield, 'Is an Unintegrated Corporate Tax Regime a Small Business Subsidy' (1979) 1 *Canadian Taxation* (No. 4) 51; D. Jones, 'Is the Small Business Credit a Tax Expenditure' (1979) 1 *Canadian Taxation* (No. 4) 53.

small business credit, by reducing the effective corporate tax rate to 25 per cent, provides a large tax reduction or deferral (whether measured in relation to the normal corporate tax rate or the marginal rate of individual shareholders) to shareholders of eligible corporations. This deferral has been justified by the government and others by reference to the need to subsidise small business. If the government only wished to increase the neutrality of the corporate tax system by integrating the corporate and shareholder tax of small business, it could do so technically in a way that did not at the same time provide a large implicit subsidy for shareholders of qualifying corporations. Therefore, not subjecting the measure to tax expenditure analysis would seriously distort evaluation of the provisions.

Finally, to conclude this digression, although I have argued that any tax provision for which spending-type arguments might be made should be treated as a tax expenditure, it is true that spending-type arguments are often made for broad tax rate changes. For example, reducing corporate tax rates, increasing an investment tax credit, or enacting a broad-based direct spending program are often analysed as alternative instruments for spurring the economy by stimulating capital formation. But that does not make it useful to think about a general reduction of the corporate tax rates, or any rate structure less than 100 per cent, as a tax expenditure. It simply does not clarify thinking about this issue to refer to them as such. To construe the concept so broadly would rob it of its usefulness.³⁶²

TAX EXPENDITURE ANALYSIS OF THE LOWER RATE OF CORPORATE TAX

Tax expenditure analysis, that is, the evaluation of tax provisions using criteria normally applied to direct subsidy programs, suggests that at least three broad questions should be asked about each tax expenditure: (a) What government objective is being served by the tax measure, and does this objective have a sufficiently high priority to justify the expenditure of government funds? (b) Is a tax expenditure an appropriate instrument for achieving the particular objective or would some other instrument be more cost-efficient or more

362. For an argument that the term subsidy is a purely normative concept and is simply 'a tax which is too small' see M. Ricketts, 'The Subsidy as a Purely Normative Concept' (1985) 5 *Journal of Public Policy* 401. At one level this argument is undoubtedly sound. There are similarities in the arguments made to support a reduction in the corporate tax rate, for example, or to support the provision of an investment tax credit. However, if the term subsidy (or tax expenditure) is going to be of any use in our language, it seems sensible to restrict it to government intervention covering a narrower range of activity than that covered by a general tax rate reduction.

nearly satisfy other important budgetary criteria? (c) If a tax expenditure is an appropriate instrument, is the particular tax provision a well designed spending program.

I will briefly review each of these questions in relation to a lower rate of corporate tax. The main point I wish to make with respect to the first question is that there is no case for subsidising small business generally. Whatever the justifications for subsidisation, they only apply to some types of small businesses. Therefore, any subsidy program for small business should be structured so that it can be targeted on these types. Next I will review the several types of instruments that can be used to subsidise small business. The policy instruments implemented by the Canadian federal and provincial governments will be used to illustrate these. Here the object is not to do a serious evaluation of each of these instruments, but only to illustrate that there are a broad range of instruments available for subsidising small businesses. Finally, using criteria traditionally used in evaluating spending programs, I will show why the small business credit is such a badly designed policy instrument.

My conclusion that a lower rate of corporate tax should not be used to finance small business is not novel. This conclusion has been reached by virtually every tax law reform body that has studied the issue.³⁶³ However, because of the persistence of the use of the lower rate of corporate tax, repeating the arguments seems worthwhile. Also the tax expenditure analysis used here clarifies some of the arguments. I will also use this analysis, and particularly the experience in Canada with attempts to target a small business tax credit, to illustrate why the tax system is almost always an inappropriate instrument for delivering government largess.

Is There a Need to Subsidise Small Business?

Normally the market is assumed to achieve an optimal allocation of resources. Unrestrained capital markets, therefore, should ensure that savings are channelled into their most productive use. If government interferes with the allocation of capital, capital will not flow to its highest rate of

363. For reports in United Kingdom, see *supra* note 27, 41 and 50; for report in United States, see *supra* note 116; for reports in Canada see *supra* note 164 and 195; for reports in Australia, see *supra* note 274 and 294; for New Zealand, see Taxation Review Committee, *Taxation in New Zealand* (Wellington: G.P., 1967), at 151 ('On the grounds of efficiency, equity, the prevention of tax avoidance, and ease of administration, the Committee concludes that company income should bear tax at a single flat rate.');

for Ireland, see Commission on Taxation, *First Report: Direct Taxation* (Dublin: S.O., 1982), at 373 ('If the furthering of economic growth is thought to justify tax concessions or other financial incentives to small enterprises, we believe that they should be confined to specific sectors and offered irrespective of the form of business organisation.')

pre-tax return, the GNP will be lowered, and everyone will be worse off. However, two kinds of market failure, it is alleged, warrant government intervention in financial markets in favour of small business. First, obstacles to the proper functioning of the financial markets themselves result in an 'equity gap' for small businesses. Second, small businesses generate externalities; that is, in addition to the benefits received by the individual entrepreneur, small businesses benefit society at large by furthering national goals. Since the lower rate of tax must be evaluated in terms of how well it achieves the specific government objective it is aimed at, each of these justifications for government intervention in the market flow of capital to small businesses will be discussed. The discussion will be brief. Probably few other subjects have received more attention in the past decade than the financial needs of small businesses.³⁶⁴

The Equity Gap

The most common argument for government intervention in favour of small businesses is that there are biases in financial markets against them that must be compensated for. Although a number of factors are said to result in an 'equity gap',³⁶⁵ only two categories of capital market imperfections will be reviewed here: the high information and transaction costs necessary in extending equity to small firms and the government-induced distortions that cause the small business equity market to clear at a price in excess of the opportunity cost of capital.

Financial markets will only allocate capital to its most productive use if investors are fully informed about the returns and risks of all available investments. However, information about small businesses is often difficult and expensive for investors to acquire. Moreover, transaction costs relating to extending equity to small businesses are likely to be higher

364. For example, in Australia alone see Australian Academy of Technological Sciences (Chairperson: Sir Frank Espie), *Developing High Technology Enterprises for Australia* (Canberra: AGPS, 1983); Bureau of Industry Economics, Small Business Research Unit, *Small Business Review 1984* (Canberra: AGPS, 1985); Committee of Inquiry on the Australian Financial System (Chairperson: J.K. Campbell), *Final Report* (Canberra: AGPS, 1981); Department of Industry and Commerce, Report of the Finance Committee, Small Business Advisory Council, *Finance for Small Business* (Canberra: AGPS, 1980); Department of Science and Technology, Proceedings of a Conference, *Finance for Technology Ventures: Courses of Action* (Canberra: AGPS, 1983); Office of the Economic Planning Advisory Council, *Some Features of Small Business and Its Policy Environment* Council Paper No. 12 (Canberra: Office of EPAC, 1986); K.M. Renfrew, W.J. Sheehan and W.C. Dunlop, *Financing and Growth of Small Businesses in Australia*, Bureau of Industry Economics Contribute Paper 2 (Canberra: AGPS, 1985); Review Group into the Australian Financial System (Chairperson: V.E. Martin), *Report of the Review Group into the Australian Financial System* (Canberra: AGPS, 1984).

365. Generally, there appears to be no bias against small firms in debt markets, see *ibid.*

than for larger businesses since most transaction costs are independent of the size of the loan, resulting in economies of scale for larger loans. Larger firms also have more collateral to offer and generally have a record of success which provides clues to their prospects, thus further reducing the need for, and the cost of, acquiring information about their prospects. Consequently, it is frequently suggested that small businesses are denied equity on terms and conditions commensurate with those available to other groups with a comparable credit risk.

Various forms of government intervention in the financial marketplace also accounts, in part, for the 'equity gap' within which small business falls. Most countries, including Australia, have recently reformed their direct regulation of financial institutions - by removing interest rate controls, allowing the licensing of foreign banks, and placing greater reliance on open market operations for regulating the money supply - to reduce the adverse impact of credit restrictions on small firms. However, most tax systems continue to divert the market flow of financial capital away from small businesses: (1) Generally, corporate tax systems, even partially integrated systems, tend to favour corporate retentions over distributions. Although this may increase overall investment in the economy, existing firms that can finance expansion out of retained earnings are favoured over new firms that must raise capital from external sources. Also, existing large corporations that are able to retain more earnings in absolute dollars derive a greater benefit from this policy bias than existing small corporations. (2) The numerous tax expenditures that encourage individuals to save through life insurance policies and pension funds divert funds from small businesses. Invariably these savings institutions are more conservative in their investment policies by law and custom than individual investors. (3) More generally, since aggregate savings in the economy are limited, any measure that is successful in directing savings into a certain area will result in a lower level of financing available to other uses. Thus, for example, the exemption of principal residences from the capital gains tax undoubtedly results in a considerable amount of capital being diverted from small business investment to residential housing. (4) Some of the special rules relating to the taxation of financial institutions themselves might also introduce biases against extending credit to small firms. In Canada, for example, banks, trust companies and credit unions are allowed to deduct an amount for bad debts from their taxable income, but the permissible deduction is related more closely to the volume of loans outstanding than the portfolio risk. Thus to the extent that such institutions invest in low-risk investments they obtain a windfall deduction. (5) Tax systems are also normally biased against risk investment, and small businesses in particular, because of the various

restrictions they impose on the deductibility of losses. Losses are never refundable. Instead, if business losses exceed income they can normally only be carried back a couple of years then forward several. Larger firms are advantaged in two ways under these rules. First, larger firms are usually diversified, therefore, they will have other lines of business income against which the losses from any one line can be offset. Second, even if that is not the case, larger established firms will often have sufficient income in prior years to fully utilise the loss carryback provision. Smaller firms are more likely to have to resort to the less valuable (because of discounting) carry-forward allowance. And, if the firm has a number of successive years of losses, it may not be able to offset all of its net operating losses. (6) Finally, tax incentives provided in most tax systems for the purchase of capital property, such as investment tax credits and accelerated capital cost allowances, will invariably benefit large firms more than small ones. Compared to large firms, small firms will less often have sufficient tax payable to offset the tax savings provided by these incentive measures. Also, larger firms are generally more capital intensive than small firms and thus benefit more from subsidies for capital purchases. If the tax incentive measures increase the profits of larger firms they will have the effect of increasing the rate of return in large firms compared to small firms. On the other hand, if competition requires large firms to pass some or all of the benefits of tax incentives forward to purchasers of their goods and services in the form of lower prices then in some cases the incentives might actually result in small competitors being squeezed out of an industry altogether.

There is a considerable amount of disagreement over whether there is in fact an 'equity gap' in financial markets. However, for purposes of this paper, the important point is that even accepting this rationale for subsidising small business, the rationale would suggest that only a small number of the firms in the small business sector should be subsidised; namely, those small firms that wish to raise capital to expand their operations and that wish to do so by means of equity financing.

Positive Externalities

Even if there is no bias in the equity market against small firms, it is frequently argued that there will still be an insufficient allocation of financial resources to them. This is because, in addition to the rate of return that an individual investor receives from a small business, small businesses yield a

social rate of return. They contribute to the achievement of national goals.

The arguments that are often advanced with respect to the social contribution of small businesses and their owner-entrepreneurs appear to be constrained only by the limits of the imagination of their proponents. For example, it is frequently alleged that small businesses develop a range of personal qualities that ultimately benefit the community, such as entrepreneurial ability, self-reliance, stability and so on; provide a means of reducing alienation and social tension; and, contribute to the cohesiveness and quality of life in local communities.

These arguments might support a broad-based subsidy for all small businesses in order to induce more employees to become entrepreneurs and thus enrich the lives of all of us. Indeed, these and similar arguments were propounded with great eloquence in Canada during the debate over the small business credit.³⁶⁶ However, since these arguments are unquantifiable and rest upon contentious value judgments, they pose a serious problem for the policy analyst. Would employees be prepared to transfer income from themselves to self-employed persons (the effect of the lower rate of corporate tax) on these grounds? And, if so, why wouldn't their preference be manifested in a willingness to pay slightly more for the goods and services of local independents?

Fortunately, the case for the positive externalities of small business does not have to rest exclusively on 'closer to God' arguments. Small business is alleged to serve a number of other national goals: (1) Small firms have lower implementation costs and owner-managers have a longer time horizon and are more driven by high relative pay-offs than professional managers and engineers. Therefore, small firms contribute disproportionately to invention, innovation and non-technological research and development. (2) Small businesses tend to locate in economically depressed areas or rural areas where larger businesses would not locate. Therefore, they further government policies in supporting local communities, decentralising employment and removing regional economic disparities. (3) Small firms tend to further government employment goals. They are more labour intensive than large firms, grow faster once established, and often hire workers who might not be hired by larger firms.

The extent to which small business furthers these national goals is contentious. For example, referring only to the role of small business in job creation, the evidence is mixed. Some well-known studies have reported that small businesses are

366. See for example, Canada, *House of Commons Debates*, 6 December 1969, at 784-5.

responsible for most of the job creation over the last decade.³⁶⁷ However, recently a number of re-evaluations of the numbers has thrown some doubt on this conclusion.³⁶⁸ Moreover, any program designed to increase long-term employment should be concerned with the quality of the jobs created. Studies in the United States have found some evidence that job quality is not as high among small firms as it is among large firms: wages tend to be lower, fringe benefits such as health insurance plans less prevalent, and job security more precarious in small firms than in large firms.³⁶⁹

But, more importantly, in terms of designing an instrument to subsidise small business, the additional employment generated in the small business sector appears to have been created by only 12 to 15 per cent of the firms.³⁷⁰ The same point could be made about the other externalities generated by small businesses. A small percentage of small businesses are involved in research and development or locate in economically depressed areas. A policy instrument designed to further these objectives but aimed at the small business sector generally would be grossly over-inclusive. Consequently, if the government wishes to increase employment, innovation, or reduce regional disparities it ought to fashion instruments that reward these activities directly. To the extent that small businesses further these national goals they will benefit disproportionately from such programs.

Policy Instruments Available for Subsidising Small Businesses

A number of well accepted criteria are used in guiding the choice of policy instruments. However, the first principle is that the instrument should be directed as closely as possible at the cause of the problem that prompted the intervention. If the cause of the problem is mis-diagnosed, the policy response will be ineffective. The lower rate of corporate tax, and the alternative instruments that will be reviewed below, assume that the equity gap for small business is a problem on the 'supply-side'. However, before reviewing these policy instruments, it should be noted that the perceived equity capital problem may not be caused exclusively or even primarily by a lack of venture capital funds. The cause of the problem of small business might be on the 'demand-side'.

367. The leading and much-cited study is D.L. Birch, *The Job Generation Process* (Cambridge, Mass.: M.I.T. Program on Neighborhood and Regional Change, 1978).

368. See studies cited in Organisation for Economic Co-operation and Development, *OECD Employment Outlooks* (Paris: OECD, 1985) and US Small Business Administration, *The State of Small Business: A Report of the President* (Washington: GPO, 1983), chap. 3.

369. See *The State of Small Business*, *ibid.*

370. *Id.*, at 67.

There is little point in subsidising venture capital if there is no demand for it. A critical mass of entrepreneurs and people with managerial skills that can put venture capital to productive use is an obvious prerequisite to a high level of small business activity. This involves educating potential small business persons, coaxing entrepreneurial talent out of large companies and into their own firms, creating an awareness of the availability and role of venture capital, and encouraging entrepreneurs to share their enterprises with others and to accept financial, managerial and marketing assistance from external sources.³⁷¹ A firm's lack of managerial skills might manifest itself in the capital market through higher financing costs and refusals for the advancement of equity capital. However, intervention to provide such a firm with funds would not alleviate its basic problems.

As another example of the importance of determining the cause of the problem, to the extent there appears to be a problem with the level of equity capital for small businesses it might simply be a symptom of economy-wide factors, not a cause of them. Thus the best way to deal with the problem might be through initiatives directed at improving a country's general economic performance, its industrial structure, its competitiveness, the returns from research and development and so on. For example, lowering general interest rates by a few percentage points might be much more likely to cause success in stimulating venture investments than more specifically targeted instruments.

On the assumption that there is an equity gap, and that it is a problem on the supply side, what policy instruments should be chosen to deal with it? The wide range of instruments that could be used as alternatives to the lower rate of corporate tax will not be evaluated in depth here. However, to place the discussion of the small business credit in a wider context, to illustrate the substantial subsidies received at present by small business through the tax system, and to indicate the alternative instruments available, the provisions in the Canadian *Income Tax Act* and some of the tax provisions that have been enacted by provincial legislatures in Canada, that favour small businesses, will be briefly mentioned. Practically all of these provisions have parallels in other jurisdictions. Indeed, the extent to which western industrialised countries borrow ideas from one another in this area is quite surprising. In part, this is no doubt due to the fact that small business interest groups in each country remain in close contact with one another.

371. There is a substantial and growing body of literature on the encouragement of entrepreneurship. See D.W. Conklin, 'Entrepreneurship, Innovation and Economic Change', in D. Laidler, ed., *Responses to Economic Change* (Toronto: University of Toronto Press, 1986); R. Ronstadt et al., eds., *Frontiers of Entrepreneurship Research 1986* (Wellesley, Mass.: Center for Entrepreneurial Studies, Babson College, 1986).

*Exemption from Corporate Surtax*³⁷²

Frequently, the federal government enacts a temporary corporate surtax. For example, for income earned after 30 June 1985 and before 1987 the surtax is five per cent. Almost invariably income eligible for the small business credit is exempt from the corporate surtax.

*Capital Gains Exemption*³⁷³

In 1985 the government introduced a personal lifetime \$500 000 exemption for capital gains. This exemption was intended to encourage individual Canadians to invest in new or growing enterprises.

*Full Offset of Capital Losses on Sale of Securities of Small Business Corporations*³⁷⁴

Ordinarily, a taxpayer can offset allowable capital losses against taxable capital gains only. However, an allowable capital loss realised on the sale of security of a small business corporation is treated as a business loss and can be offset against any income.

*Employee Stock Options*³⁷⁵

If employees receive an option to purchase shares in their corporate-employer, the difference between the amount they have to pay for the shares when they exercise the option and the fair market value of the shares has to be included in their income as a taxable employment benefit. If employees of Canadian-controlled private corporations exercise such an option, the employment benefit does not have to be included in their income until the shares are sold. Furthermore, under the general rule, if the shares are held for two years, one-half of the employment benefit can be deducted from income but only if certain conditions are met. One of these conditions, that the exercise price must not be less than the fair market value of the shares covered by the option at the time the option is granted, does not apply to Canadian-controlled private corporations.

372. Section 123.1.

373. Section 110.6.

374. Sections 3(d) and 39(1)(c).

375. Section 7(1.1).

*Non-taxation of Provincial Assistance for Venture Investments*³⁷⁶

Normally, when a taxpayer receives provincial assistance in relation to the purchase of capital property the cost of the property must be reduced by the amount of the assistance. Thus when the property is sold the amount of the assistance is taxed as a capital gain. However, if the taxpayer receives the assistance in relation to the purchase of shares in a prescribed provincial venture capital program (for example, in Ontario a taxpayer investing in a 'Small Business Development Corporation' receives a 25 or 30 per cent cash grant), the cost of the shares is not reduced by the amount of any grant. The grant is income tax free.³⁷⁷

*Labour-sponsored Venture Capital Investment*³⁷⁸

The Quebec Federation of Labour established a 'Solidarity Fund' for the purpose of investing in small and medium-sized Quebec businesses and thus creating new jobs in the province. The Quebec Government provides a tax incentive for individuals investing in the fund. The federal government provides a complimentary tax credit of up to 20 per cent of the net cost of the shares acquired in the Quebec Solidarity Fund or similar funds established in other provinces. To be eligible, funds must be set up under provincial legislation, be managed by labour, and invest in small and medium-sized businesses.

*Refund of Investment Tax Credit*³⁷⁹

The Canadian investment tax credit is partially refundable. If the credit exceeds the taxpayer's tax liability for a year, up to 20 per cent of the credit may be refunded. For small Canadian-controlled private corporations, 40 per cent of the credit is refundable.

376. Section 53(2)(k)(i)(C).

377. Two other less significant federal income tax concessions benefit provincial venture capital corporations. First, normally if a corporation is controlled by one or more public corporations it is not eligible for the small business credit. However, this disqualification does not apply if the public corporation is a 'prescribed venture capital corporation'. Section 125(7)(b). Second, normally when a private or controlled public corporation receives an inter-corporate dividend a special refundable tax is imposed on the dividend to prevent investors from obtaining a tax deferral advantage by holding their investments in a corporation. However, if the private or controlled public corporation is a 'prescribed venture capital corporation' it is exempt from this tax. Section 186.1.

378. Section 127.4.

379. Section 125.1.

*Small Business Development Bonds*³⁸⁰

Small businesses are able to obtain 'after-tax financing' by issuing Small Business Development Bonds (SBDBs). Normally, the issue of a bond deducts the interest expense from income and the recipient includes it in income. However, if a small business is in financial difficulty it can issue a SBDB in which the interest payment is treated as a dividend for tax purposes. Because inter-corporate dividends are tax-exempt to the recipient, financial institutions which purchase these bonds are able to offer reduced rates of interest to eligible small business borrowers. The issuer of the SBDB is not permitted to deduct the interest expense from its income, but if the issuer does not have taxable income or a high rate of tax this is of little concern.

*Small Business Capital Investment by Pension Funds*³⁸¹

The *Income Tax Act* and regulations were recently amended to encourage pension funds to invest in equity capital of small and medium-sized businesses. Under the previous law, the statutory retirement plans provided for in the Act generally could not invest in small businesses and could only invest 10 per cent of their assets in foreign securities. Although the new rules are complex, basically they allow registered retirement savings plans (plans established largely by the self-employed) to invest in shares of eligible small businesses. Registered savings plans (retirement plans established by employers) are allowed to invest in shares of eligible small businesses either through wholly owned small business investment corporations or through independent investment limited partnerships or trusts established to facilitate new investment in small and developing businesses. To encourage pension funds to invest in eligible small businesses directly or through the provided for investment vehicles, for every \$1 a pension plan invests in qualifying investments the plan's foreign property investment limit is increased by \$3.

380. Sections 15.1 and 15.2.

381. See in particular, s.5100 of the Regulations. For a critical assessment of the proposed legislation see M. MacDonald and J. Perry, *Pension Funds and Venture Capital: The Critical Links Between Savings, Investment, Technology, and Folio*, Discussion Paper prepared for the Science Council of Canada (Ottawa: Minister of Supply and Services, 1985). The proposed legislation was changed slightly prior to enactment in light of this and similar studies.

*Tax Exemption for New Corporations*³⁸²

In 1984, the Ontario Government introduced a three-year corporate income tax exemption for companies starting up in Ontario. Four other provinces have since followed this lead. Basically, to qualify, a company must be privately controlled by Canadians, and unrelated to any other company.

*Stock Savings Plans*³⁸³

In 1979, the province of Quebec enacted the *Quebec Stock Savings Plan Act*. The plan allows taxpayers residing in Quebec to claim an income tax deduction of up to \$15 000 annually for purchases of new equity issues of Quebec-based companies. Although the generosity of the tax deduction was reduced slightly in 1986, for large corporations the deduction was 50 per cent of the value of the shares, for medium-sized firms the deduction was 100 per cent and for small firms the tax write-off was 150 per cent. Judged by the number of subsidised stock issues, the Quebec plan is overwhelmingly successful. Some commentators have claimed that this tax scheme has been responsible, in fact, for fundamentally transforming Quebec society into one that is more entrepreneurial and incentive oriented.³⁸⁴ Other provinces have recently copied the Quebec Stock Savings Plan. However, in the other provinces the subsidy takes the form of a tax credit instead of a deduction. For example, under the *Alberta Stock Savings Plan Act*, which came in force in 1986, taxpayers can claim a tax credit of 30, 15 or 10 per cent depending upon the assets and revenues of the corporation, up to a yearly maximum of \$3000. Saskatchewan has similar legislation. Nova Scotia, British Columbia and Ontario have all proposed similar plans.

*Venture Capital Corporations*³⁸⁵

Recognising that a successful private program of financing small business must bring together all the principal participants in venture capital activities - entrepreneurs, venture capital firms (involved in the middle-person role or arranging and monitoring start-up investments), and investors - small business investment companies are used in many jurisdictions as a mechanism for providing for the formation of pools of

382. Ontario, *Corporations Tax Act*, R.S.O. 1980, c. 97, s.33.

383. Quebec, *Taxation Act*, R.S.Q., c. I-3, s.965.

384. See T.J. Courchene, 'Market Nationalism' [October, 1986] *Policy Option* 16.

385. See S.M. Badali, J.A.C. Dolan and C.H. Evans, *Venture Capital Investments: Ontario-Quebec-Nova Scotia* (Toronto: CCH Canadian Ltd., 1983); Clarkson & Gordon, *An Evaluation of the Small Business Development Corporations Program* (Toronto: Clarkson & Gordon, 1984).

private risk capital. The United States pioneered the use of this policy instrument for mobilising venture capital in 1958 when it established small business corporations. After a failed attempt at establishing a Venture Investment Corporation program, in 1979 the Ontario Government established a program for investment vehicles called Small Business Development Corporations (SBDCs). They must invest most of their funds in new eligible small businesses. Individuals purchasing shares of SBDCs received a cash grant equal to 25 per cent of the cost of new equity investment made by the SBDC (30 per cent if the investment is made in northern or eastern Ontario); investing corporations receive an equivalent tax credit. Quebec, Nova Scotia, and Alberta have adopted similar programs.³⁸⁶

In addition to these tax-based programs the Canadian Government has virtually countless specific direct programs for small business which are engaged in innovative projects or which might contribute to national goals such as regional development. Two of the more general programs might be mentioned here since they have a parallel in most jurisdictions.

An obvious instrument the government might use in financing small businesses is the direct provision of venture capital. In Canada, the Federal Business Development Bank was originally established to provide loans or loan guarantees to Canadian business where credit was not otherwise available to the business on reasonable terms. In 1983 it established an Investment Banking Division as a result of a revised mandate it received from the government to mobilise risk capital in Canada. The Division is funded by equity from the government (current total \$48 million), which is used to invest, and to serve as a catalyst for private sector investment, in small and medium companies with high growth potential. The Bank performs this role by full syndication of private sources of equity financing, by underwriting a company's stock issue, and by investing jointly with the private sector.³⁸⁷

As an alternative to supplementing the private credit market directly, the government might endeavour to offset the costs of extending credit to small firms through insurance or guarantees. In Canada, under the *Small Business Loans Act* the government guarantees loans made by private lending institutions to small businesses.³⁸⁸ Basically, only small

386. The federal government has from time to time considered adopting such a program, but never has. See Canada, Minister of State for Small Business, 'Improving the Equity Financing Environment for Small Business in Canada', a discussion paper (Ottawa: Minister of State for Small Business, 1978).

387. See Canada, Federal Business Development Bank, *Annual Report 1986* (Ottawa: Federal Business Development Bank, 1986).

388. *Small Business Loans Act*, R.S.C. 1970, c. S-10. See generally J. Hatch, L. Wynant and M.J. Grant, *Government Loan Guarantee Programs for Small*

businesses with gross revenues of under \$2 million qualify; the government guarantees only 85 per cent of the loan; the maximum loan is \$100 000; the loan rate is a maximum of prime plus one per cent; the loan proceeds can be used to purchase or improve equipment or business premises or buy land; and, the aggregate principal amount of loans is limited to \$2.5 billion.

Evaluation of the Lower Rate of Corporate Tax as a Spending Program

In the following evaluation of the lower rate of corporate tax I want to make both a specific and a general point. Specifically, I will argue that the lower rate of corporate tax is a badly designed subsidy program. I will use a methodology that has now become commonplace in evaluating tax expenditures; namely, to convert the tax expenditure into an analogous direct spending program and then to evaluate it using the traditional criteria used in evaluating government spending programs.

Business people often seem to turn instinctively to the tax system as a method of receiving subsidies. The appeal of this instrument to them is obvious: They can receive their subsidy without the interference of government bureaucrats, the programs have a low visibility and they seem compatible with the free market economy. For these same reasons, and others, tax reformers have traditionally opposed the use of the tax system to deliver subsidies. Particularly since the mid-1960s, buoyed up by the insights of the tax expenditure analysis, tax policy analysts have been almost unanimous in agreeing that the tax system is an inequitable and cost-inefficient instrument for delivering subsidies. Writing in the 1970s, Stanley Surrey seemed opposed to all tax expenditures. In his classic treatise, *Pathways to Tax Reform*, he said, 'Most of the tax expenditure programs should either be scrapped because the federal financial assistance they provide is not warranted by the nation's priorities or be replaced by direct assistance measures that can readily be devised'.³⁸⁹ At a conference in Canada on tax expenditures, he reiterated at this point, '... I do have some difficulties in finding programs I would run, if I were running a government, through the tax system rather than as direct programs'.³⁹⁰ However, in a more recent analysis Professor Surrey and his frequent co-author on tax expenditure analysis, Paul McDaniel, appear to have moderated this position somewhat. They now appear to be of the view that the

Business (London: School of Business Administration, University of Western Ontario, 1985).

389. S.S. Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (Cambridge: Harvard University Press, 1973), at 209.

390. 'Tax Expenditure Analysis: A Reply by Professor Surrey and Discussion' (1979) 1 *Canadian Taxation* (No. 2) 26.

significant issue in tax expenditure analysis is not the question of whether a subsidy should be in the form of tax expenditure or a direct program, but instead how government subsidy programs should be designed. They state that, '[m]ost perceived differences between tax and direct expenditure programs are not inherent in the two approaches. Instead they generally reflect differences in program design'.³⁹¹ Thus, they seem to suggest that if a subsidy program is properly designed, whether it is delivered directly or through the tax system is a matter of indifference. It is undoubtedly true that a spending program of any design can be delivered directly or placed in the tax system and delivered as a tax expenditure; however, a general point that I will make below is that the tax system imposes severe constraints on the design of a program that can be delivered effectively through it. Moreover, I will argue that the fundamental purpose of the tax system is threatened when it is used to deliver specific subsidy programs. For both of these reasons, the tax system is in almost all cases a bad instrument for delivering a spending program. In illustrating the inherent characteristics of the tax system that impose severe constraints on program design, I will refer, in particular, to Canada's experience in attempting to target the small business credit during the 1970s.

An application of all of the following spending criteria reveal the lower rate of corporate tax to be a badly designed subsidy. Although some of its faulty features could be corrected by redesigning the subsidy, because of the inherent characteristics of the tax system most could not be.

Equity

Given the purpose of the lower rate of corporate tax, there is no reason why, in otherwise similar cases, persons with high-income should receive a greater subsidy than persons with low-income. Yet this is precisely the effect of a lower rate of corporate tax: the greater the business person's income the greater the subsidy. The cost of the lower rate of corporate tax is frequently calculated in tax expenditure accounts as being the revenue lost because corporate-source income is taxed at the lower instead of the higher corporate rate.³⁹² However, since the owner of an incorporated small business will normally have the option of withdrawing all the corporate profits as a salary, or of operating the business as a sole proprietorship, a more realistic estimate of the amount of subsidy implicit in the lower rate of tax would be obtained by comparing the difference between the lower rate of corporate

391. S.S. Surrey and P.R. McDaniel, *Tax Expenditures* (Cambridge: Harvard University Press, 1985), at 114.

392. See *supra* note 339, at 29.

tax and the owner's personal rates. Thus, if the lower rate of corporate tax is 25 per cent, low-income owners of small businesses, whose personal marginal rates are below 25 per cent, derive no benefit from the subsidy program. On the other hand, high-income owners whose marginal rates are 50 per cent receive a substantial subsidy. So long as their corporate-source earnings are retained they are taxed at 25 instead of 50 per cent.

This perverse distributional pattern of benefits is characteristic of most tax expenditures and where it is present it should be fatal to their use. In some cases it can be corrected by delivering the tax expenditure in the form of a taxable, refundable tax credit. However, when the subsidy is given at the corporate level, and the amount of the subsidy is fairly determined by comparing the corporate tax rate paid with the owner's marginal rates, there would appear to be no obvious way to remove the inequity.³⁹³

Another at least peculiar distributional effect of the lower rate of tax is that the more owners there are of a business, automatically the less subsidy each receives. For example, under the Canadian provision where the small business tax credit is 21 per cent of the business's first \$200 000 of income, if only one individual owns a business that individual can defer paying tax on a maximum of \$42 000 a year (assuming they are in the 50 per cent marginal tax bracket). But if five individuals co-own the business, each will only be able to receive a maximum interest-free loan of \$8400.

Target-efficiency

In order for a governing instrument to be cost-efficient, it should provide benefits to all those units that come within its rationale, but provide no benefits to those units that do not. One of the most serious flaws of the lower rate of tax is that it is grossly over- and under-inclusive of its intended target. On the one hand, most of its benefits go to firms that do not further its objectives. On the other hand, it does not extend

393. It is sometimes argued that the lower rate of corporate tax is also inequitable since shareholders of small corporations likely enjoy higher incomes than the average taxpayer, and thus by providing a tax expenditure to these people the credit blunts the progressivity of the individual income tax rates. However, this argument would appear to confuse tax with spending criteria. If small business owners tend to be wealthier than the average taxpayer, any subsidy to small firms will have the distributional consequence of making the rich richer. Although this should be a matter of concern, if the tax system is vertically equitable, these distributional consequences should not be a matter of grave concern. The purpose of every subsidy program cannot be to redistribute income.

any benefits to a large number of firms to whom its rationale obviously applies.

Two types of small businesses that the credit does not benefit, but many of which come squarely within the rationale of the subsidy, are those that are unincorporated and those without taxable income. A lower rate of corporate tax obviously does not benefit unincorporated firms. Yet, in Canada, substantially less than one-half of all active small businesses are incorporated.³⁹⁴ Admittedly, the seriousness of this under-inclusiveness of the credit can be overstated. Most unincorporated firms are likely static not expanding firms, and most will be able to incorporate to take advantage of the increased after-tax cash flow provided by the lower rate of tax if it is to their advantage. Firms that might be prejudiced would include those operated by the unsophisticated and those that are anticipating making a loss in a year, and therefore remain unincorporated, but in fact make a profit that could have been sheltered by the small business credit. However, the Canadian Government in designing the small business credit, stated that it was administratively not feasible to provide it to unincorporated firms.³⁹⁵

The lower rate of tax is more seriously under-inclusive in that it provides no benefits to firms without taxable income. The subsidy is 'success-related' - only a firm with taxable income receives it, and up to the cut-off point, the more profit a firm has the greater the subsidy it receives. This type of success-related subsidy might make sense if there were a correlation between a firm's profits and its need for funds for expansion. However, a firm might have no profits, and in particular no taxable income, because, for example, it is a start-up firm. Almost invariably start-up firms, because they will have a substantial capital investment that they will be writing-off, will have no taxable income. The irony of this is that these are the very firms that would appear to have the strongest claim on the subsidy. Normally a firm has the most difficulty obtaining equity financing in its initial years.

More serious than its under-inclusiveness, the lower rate of corporate tax is grossly over-inclusive. It provides a substantial subsidy to a great number of firms that do not come within its rationale. The most obvious way in which a lower rate of tax is over-inclusive is that, if it is implemented

394. See D.G. McFetridge, 'Small Business, Economic Development and Tax Policy', in Canadian Tax Foundation, *Symposium on the Simplification of the Small Business Provisions of the Income Tax Act* (Toronto: unpublished, 1983), Tab. 3, at 4. (In a survey of active businesses in Canada, excluding such business as farmers, professionals, real estate operators, it was found that of firms with annual sales under \$100 000, about 75 per cent were unincorporated, of the firms with sales between \$100 000 and \$30 million, about 30 per cent were unincorporated.)

395. *Supra* note 229.

simply by making the corporate tax rate progressive, it benefits all firms regardless of size. Of course the subsidy will be much less significant to large firms than to small firms since as a percentage of their income it will be trivial, nevertheless this over-inclusiveness substantially increases the cost of the measure. This kind of over-inclusiveness can be corrected. In Canada, in 1972 the subsidy was restricted to private corporations and to corporations which only had a certain amount of retained earnings that had benefited from the credit.³⁹⁶ However, this latter restriction led to a considerable amount of complexity and was repealed³⁹⁷ so that now the Canadian small business credit benefits all private corporations.

Of course, in some sense, the criticism of the low rate of tax on the grounds that it benefits large corporations might be taken as an observation on the corporate rate structure as much as a criticism of the low rate. The purpose of the low rate of tax is simply to change the relative burden between low- and high-income corporations. If it is concluded that high-income corporations should bear more of the corporate tax burden this could be done simply by increasing the normal corporate tax rate. Indeed, when the low corporate rate was introduced in Canada in 1949 the normal corporate tax rate was increased by three per cent in order to pay for the concession. Thus, even though the low rate applied to the income of all firms, as the Minister of Finance explained at the time, the changes resulted in a decreased tax burden on the corporations whose profits were less than \$77 000, and an increased burden on those with greater profits.³⁹⁸ Thus, all the low rate of tax does is make the corporate rate structure progressive. If it is seen as reducing the burden on high-income corporations too greatly, this can be compensated for by raising the higher corporate tax rates.

Ostensibly, to remove the benefit of the lower rate from large firms, the United Kingdom, and more recently the United States, tax back the benefits of the low rate from large firms. The United States *Tax Reform Act of 1984*, for example, imposed an additional five per cent tax on a corporation's taxable income in excess of \$1 million. The additional tax had a ceiling of \$20 250, which was the maximum amount of benefit provided by the progressive rate structure. The effect of the tax was to phase-out the benefit of the lower rates of tax for corporations having taxable incomes between \$1 million and \$1 425 000. However, the only difference between a corporate tax rate structure in which the lower rate is explicitly taxed back and one in which the normal corporate tax rate is higher than it would be in the

396. *Supra* note 222.

397. *Supra* note 255.

398. *Supra* note 153.

absence of the low rate is that the former is progressive only over income ranges up to the level at which the tax back rate phases out, while the latter is progressive over all income ranges. The question of whether the tax break provided by the lower rate of tax should be recovered from large firms by simply raising the higher rates slightly, or taxing it back over a particular income range, depends upon a consideration of whether the marginal rates of all corporations should be increased slightly or the marginal rates of medium-sized firms only (those within the tax bracket ranges) increased slightly more. In 1985, when Canada abandoned its attempt to target the lower rate of tax at small firms, it considered and rejected the imposition of a phase-out rate on the grounds that it would complicate the Act and introduce adverse incentive effects because of the higher marginal rates within the phase-out range of income.

The subsidy is also over-inclusive because, even if it is phased out for high-income firms, taxable income is not a good measure of 'smallness'. The definition of smallness should relate in a logical manner to the objectives that the definition is being asked to serve. In this case the definition is being used to identify those firms for which there might be an equity market bias. Any one of a number of measures such as asset size, number of employees, or gross receipts would appear to be a better indication of 'smallness' for this purpose than income. Most subsidy programs for small businesses do not use as a measure of smallness only one index, and in particular they do not use income.

Accepting that income or gross receipts is to be used as an exclusive measure of smallness, 'taxable income' is a particularly inappropriate measure. A corporation with substantial accounting profits may report only a small percentage of that amount as taxable income because of the availability of other tax expenditures. Thus, a corporation that may qualify as a 'small' business when measured by taxable income may actually have considerable economic income. Taxable income is also a poor indication of smallness since it is based on an annual assessment. Thus the previous income history of the corporation is ignored (except for the effect of loss carry-forwards and carry-backs). In a particular year, two corporations having the same amount of qualifying income would receive the same assistance, regardless of whether one corporation consistently had low income while the other, with the exception of the particular year, consistently had high income. A consistently high-income corporation might have low income in a year for reasons that do not indicate the need for state assistance because of equity market biases.

The rationale for the subsidy would suggest that it should be granted to those small firms that are using their retained

earnings for expansion; that can contribute to export development, innovation or productivity gains; and, that are having difficulty raising equity capital. It is difficult to obtain precise numbers about the nature of the economic activities engaged in by small firms, however, recent studies in Canada reveal that small firms with these characteristics constitute a small percentage of the total universe of small firms benefiting from the small business credit.³⁹⁹ These studies found that most firms in the small business sector were small because they serve local markets or because the businesses required the detailed participation of an individual who was also a major equity holder.⁴⁰⁰ Thus for most of these firms there is little possibility of expansion. This is not to say that the activities in which these firms are engaged are unimportant. It is simply that it is difficult to make a case for the type of tax advantages which would encourage resources to flow into these sectors rather than to other sectors.

It would of course be possible to try to target the lower rate of corporate tax on those small firms to whom the subsidy might legitimately be given, but the Canadian experience with trying to target its small business credit reveals a number of inherent limitations in attempting to target tax expenditures. One important characteristic of the tax system is that because of its self-assessment nature private parties must claim subsidies delivered through it before their entitlement is reviewed by a government agency. Therefore, the conditions that must be satisfied in order to claim the subsidies must be simple and easy to apply. The government conducts audits to ensure that individuals have only claimed those subsidies to which they were entitled, but it can only audit a small number of returns. The whole system depends upon the great majority of taxpayers declaring and reporting their correct amount of tax payable.⁴⁰¹ When the Canadian small business credit was introduced in 1972, for example, the tax was to be recaptured unless the taxpayer invested in eligible investments. This concept proved too difficult for accountants to administer. It made it difficult for them to ascertain a small business person's

399. See McFetridge *supra* note 394.

400. The author of one of the studies in Canada concluded that '75 per cent of the small business community is ... small because the personal nature of the business in which they are engaged demand it'. *Ibid.*

401. It is possible to have a system of administrative review and approval before a tax subsidy is paid. In some cases Canadian tax expenditures have been conditioned on approval from a government agency other than the revenue department. For example, in order to claim the accelerated capital cost allowance for a film investment or for pollution control equipment, the taxpayer had to obtain a certificate from the appropriate government department. However, if such a procedure were used for a more general subsidy like the small business credit there would appear to be little advantage in delivering the subsidy through the tax system as an offset against tax liability.

tax liability. Thus it was repealed.⁴⁰² Later the government tried to target the credit by excluding professional corporations, some management firms, and service corporations. In order to ensure that these kinds of corporations could be identified with certainty the rules were extremely detailed. Eventually, the rules were repealed because they were perceived as being too arbitrary and complex.⁴⁰³

A second characteristic of the tax system that makes targeting a subsidy delivered through it difficult is that if the legislation is cast in general terms, or if there is any ambiguity about its application, the responsibility to develop a matrix of more detailed rules, or to resolve the ambiguity, is delegated to the courts. The courts are normally not an appropriate forum for resolving these kinds of policy issues because of their institutional characteristics and because of the inexpertise of the judges. Again, as an illustration, in Canada in an effort to target the small business credit the legislators restricted it in 1972 to 'active businesses'. Presumably, they intended to exclude from the ambit of the provision essentially personal service corporations and investment corporations. However, the courts threw their hands up at this expression once they could see that they would have to resolve literally hundreds of cases along its borderline. They in effect held that any profit-making activity was an active business.⁴⁰⁴ Both the inexpertise of the judges and the nature of judicial adjudication made this an impossible concept for the courts to apply.⁴⁰⁵

Finally, the lower rate of corporate tax functions bluntly in that it benefits many firms that have no shortage of capital, or would have no difficulty raising it, because the owners have high-incomes or are wealthy. Low corporate income does not mean that the company is owned by low-income shareholders.

Distorting Effects

Policy instruments should be designed so that they have as few unintended distorting effects as possible. In addition to the distortions caused by its target inefficiency, the low rate of corporate tax has the unfortunate effect of discouraging consolidations. So long as small businesses remain separate each can qualify for the subsidy implicit in the lower rate of tax. If they merge, then only one subsidy will be received. In

402. *Supra* note 230.

403. *Supra* note 258.

404. *Supra* note 234.

405. Some of the problems caused by asking the courts to develop detailed rules on policy issues such as this could be solved by giving the Finance Department the authority to draft interpretive regulations, as can be done in the United States. See B.I. Bittker, *Federal Taxation of Income, Estates and Gifts* (Boston: Warren, Gorham and Lamont, 1981), vol. 4, s.110.4.

Canada, if three owner-operators each have a business that is qualifying for the maximum credit, if they merge or form a partnership the tax cost would be \$84 000. Thus, the lower rate of tax, which is designed to encourage small businesses to expand into more productive units, can have just the opposite effect. Also, where a number of individuals are operating a business the small business credit encourages them to break it up into smaller units. This would appear to be an undesirable distortion in a country such as Canada in which in other respects the government attempts to encourage efficiency through increased scale of operations.

Administrative Costs

One of the frequently asserted advantages of tax expenditures is that the administrative costs of delivering programs through the tax system are lower than other spending alternatives. When the tax system is used to deliver a spending program no new forms have to be filed, no new reports have to be written, and no new bureaucracy has to be created. However, none of these administrative savings are inherent in the use of the tax system; instead, they relate to the basic design of the spending program. The lower rate of corporate tax is an inexpensive subsidy to deliver only because it is essentially an automatic cheque-writing program. Once the business person files a tax form claiming that the business is incorporated and has taxable income, the corporation qualifies for the credit. If this same program were delivered as a direct subsidy it would be as inexpensive to deliver. A government official would essentially write cheques to business owners upon evidence that a business was incorporated and upon receipt of the business's financial statements.

When people assert that using the tax system imposes fewer administrative costs in delivering a program, they are usually comparing a simple program delivered through the tax system with a complicated, discretionary program delivered directly. While unfair, the natural tendency to make this comparison is understandable. If a program equivalent to the lower rate of tax were delivered directly (by a civil servant simply writing cheques to corporations that applied and filed a statement of their income), almost inevitably people would insist that the government distinguish between certain corporations. Furthermore, there would be pressure for the government to audit each individual application, instead of the one or two per cent that would normally be audited if the program were delivered through the tax system. Thus the program would likely end up being more expensive to deliver than the lower rate of tax. However, this increased cost is not an argument in favour of the lower rate of tax, indeed it is precisely the

opposite. If the legislature would not adopt a direct spending program without providing the necessary conditions to ensure that it was efficient and properly administered, why should it eliminate these safeguards when the same money is spent through the tax system? But the basic point I wish to make, is that in selecting a tax or direct instrument it is important that instruments with a similar design are being compared. It is meaningless to compare the administrative cost of the lower rate of corporate tax and a discretionary loan program delivered by a government investment bank and then argue that the tax instrument is preferred to the direct instrument since the administrative costs are lower. This is an argument that goes to program design, not to whether the program should be in the tax system or not.

Moreover, even with tax expenditures that have the appearance of automatic-cheque writing programs, often the administrative costs are fairly high. However, they are obscured because they are borne by the private sector. For example, when Canada attempted to target its small business credit the legislation became extremely complex. Although the government's administrative costs may not have increased, high legal and accounting fees were incurred by taxpayers in attempting to qualify for the credit. Therefore, often the only difference between a direct subsidy and a tax expenditure is that with a tax expenditure more administrative costs are borne by the private sector in complying with the legislation and fewer costs are borne directly by the government. However, whether the costs are incurred in the government sector or the private sector they are still a deadweight loss to the economy. Indeed, an advantage of having them borne by the government sector is that they can be more equitably distributed.

Government Control

The lower rate of corporate tax is an open-ended form of government spending. Every small business that incorporates and earns taxable income qualifies. Thus government revenues can be eroded by events beyond its control. Normally, the government should be able to control its spending to ensure that its expenditures reflect government priorities. Some direct government spending programs, such as entitlement programs like unemployment insurance or welfare payments, are necessarily open-ended forms of government spending; however, normally the government designs spending instruments that enable it to budget how much it is prepared to spend in one spending area as opposed to another.

The open-endedness of a program is arguably not so serious if the government can predict how much revenue will be spent each year since it can fashion the instrument to take account

of its spending priority. However, it is difficult to think of any reason why a subsidy program for small businesses should be open-ended, and none of the direct spending programs for assistance to small businesses are. In Canada, and presumably in other countries as well, the government even limits the amount of loans it is prepared to guarantee each year under its loan guarantee programs for small business.⁴⁰⁶

Implementation

In recent years it has been increasingly recognised in public policy literature that the implementation of a program is as important as its design. Three unique aspects of the tax system affect the implementation of programs embedded in it, and render it in most cases an inappropriate spending instrument. First, when a subsidy program is delivered through the tax system it is administered not by an expert bureaucracy (expert, that is, in the subject area of the program), but by the tax department and the courts. So long as the subsidy is simple and its administration does not depend upon the exercise of judgment, this does not pose any serious problems. However, if matters of judgment are involved in the dispensation of the subsidy the lack of expertise of these implementing bureaucracies can create difficulties.⁴⁰⁷

A second implementation problem that arises when spending programs are delivered through the tax system is that people do not view the abuse of tax subsidies in the same way that they view the abuse of direct subsidies. Most people take the maximum advantage of tax subsidies, always giving themselves the benefit of any doubt with respect to their entitlement. Moreover, the use of any scheme, no matter how artificial or complex, in order to increase access to tax subsidies appears to be sanctioned by public opinion. In short, unlike the deliberate and contrived abuse of direct spending programs, no moral opprobrium attaches in most social circles to tax avoidance. Therefore, when a program is implemented through the tax system invariably a great deal more abuse must be tolerated in its delivery than otherwise would be the case.

A third characteristic of delivering a spending program through the tax system, and one that appears to create insurmountable problems for its fair implementation, is that tax lawyers and accountants become involved in its

406. *Supra* note 388.

407. An illustration of these difficulties is provided by the attempt in Canada to target the small business credit by making it available only to small businesses earning 'active business income'. A sympathetic interpretation of this phrase by a bureaucracy that understood the rationale of the credit might have gone a long way in preventing abuses of the credit. However, the courts proved incapable of giving the term a sensible meaning. See *supra* note 234.

administration. This group consists invariably of a country's most dedicated and highly paid individuals. One of their main societal functions is, by their own admission, to find ways to abuse tax programs for clients. In Canada, the complex schemes that they concocted to abuse the small business credit are a monument to their ingenuity. Indeed, one reason why Parliament eventually had to abandon efforts to try to target the small business credit and return to essentially a lower rate of corporate tax is that the government discovered it did not have the resources (any medium sized accounting firm in the country would be likely to have more tax specialists than the whole of the Department of Finance) to match wits with the tax advising community in attempting to prevent abuses.⁴⁰⁸ The phenomena of tax incentives with an initially narrow focus being turned into abusive tax shelters is a recurrent one in the tax systems of most countries.

Political Accountability

Tax expenditures are not subject to the same budgetary or review processes as other forms of government spending. Thus generally government is much less accountable for them. This was recently dramatically illustrated in Canada. In 1984 the newly elected Conservative government established a task force to examine all of the government's spending programs with a view to rationalising them and suggesting ways that they might be made more cost-effective. In the area of small business assistance the task force recommended changes in the government's direct spending programs, but failed even to examine the most costly and cost-inefficient program, namely, the small business tax credit.⁴⁰⁹

Of course the budgetary process could be changed and tax expenditures could be more closely co-ordinated with related direct spending programs. But this task is more difficult than commonly appreciated and in spite of numerous attempts has not been accomplished in Canada or any other country so far as I am aware. The importance of reforming the 'tax' reform process cannot be over-stated. Meaningful tax reform is ultimately dependent upon it. In particular, ways must be found to ensure that the trade-offs between increasing one tax expenditure and cutting back on another or a related direct subsidy program are made explicit. New tax expenditures should not always be financed out of general revenue. For example, in Canada in 1985 when the small business credit was extended to professional and other small firms,⁴¹⁰ that

408. *Supra* note 257.

409. See Canada, Task Force on Program Review, 'Introduction to the Process of Program Review' (Ottawa: the Task Force, 1986).

410. *Supra* note 258.

extension should have been financed by cutting back other programs to small business (or an explicit budgetary decision made to increase the financing of the small business sector). If a trade-off between the financing of different small business policy instruments could have been made explicit, then other interest groups in the small business sector would have appreciated their stake in the cost-efficient delivery of the small business credit. They very likely would have opposed its extension to professionals. Until tax expenditures are integrated into the government budgetary programs so that the government is more accountable for them, they should be used sparingly.

Tax System Considerations

A final consideration that must be weighed before a subsidy is placed in the tax system is the effect it will have on the tax system's ability to achieve its primary goal of raising revenue equitably. Tax expenditures impair the tax system's ability to achieve its primary goal in a number of ways.

First, tax expenditures must be co-ordinated with the technical provisions in the tax act, otherwise they might make changes to the technical tax system difficult. When the small business credit was enacted in Canada in 1972 it was directly related to the dividend tax credit. The small business credit reduced the corporate tax to 25 per cent, and this was the rate of corporate tax for which the dividend tax credit compensated. Thus there was complete integration for business income earned through small corporations. In 1977, for reasons unrelated to the taxation of small businesses, the government decided to increase the dividend tax credit so that it compensated for corporate tax of 33.3 per cent.⁴¹¹ Consequently, the combination of the new enriched dividend tax credit and the small business credit, which for political reasons the government did not reduce, resulted in over-integration of business income flowing through a small business. Although small corporations would only pay tax at an effective rate of 25 per cent at most, upon the payment of dividends the dividend tax credit compensated shareholders for a corporate tax rate of 33.3 per cent. Needless to say the rate of incorporation and the rate of dividend payments increased dramatically.

Tax expenditures not only affect and must be co-ordinated with technical tax provisions, but they often have peculiar interactive effects with other tax expenditure provisions. One effect of a lower rate of corporate tax is to reduce the value to small corporations of all other tax expenditures provided in the

411. *Supra* note 235.

form of tax deductions. To illustrate, a tax expenditure that takes the form of a \$100 tax deduction will provide a \$50 subsidy to a large corporation that is paying tax at a rate of 50 per cent, but only a \$25 subsidy to a small business that is paying tax at a lower rate of 25 per cent. If the lower rate of tax were converted to a direct subsidy program it would not have this peculiar interactive effect.

A third effect that tax expenditures have on the tax system is that they enormously complicate it. It is true that if the spending program implicit in a tax expenditure were converted into direct spending programs no overall simplicity would be gained. However, even though there would be no overall increase in simplicity, at least for those applying for the subsidy, there is some value in reducing the complexity of the tax system. Each tax expenditure adds to the enormity of the income tax law, requires a separate line on the tax return, and increases the information required to explain the tax system to taxpayers. Tax expenditures not only make filing a tax return more difficult, even though the expenditures might not affect each taxpayer, but also they give the whole system the perception of complexity. Thus they increase taxpayer's feelings of alienation.

Tax expenditures also normally increase complexity generally in government regulation since tax rules must be to a large degree self-executing. Thus if a spending program is placed in the tax system it often requires detailed and complex rules to prevent avoidance. With respect to the lower rate of corporate tax, for example, complex rules are necessary to ensure that taxpayers do not use multiple corporations in order to increase their entitlement to the subsidy. These rules are invariably arbitrary, give rise to a substantial amount of litigation, and are often a trap for the unwary. Moreover, like all anti-avoidance rules, they place a high premium on tax planning. If the tax expenditure were simply converted into a direct automatic cheque-writing program presumably these same complex rules would be needed. However, invariably if the program were converted into a direct spending program a form of bureaucratic discretion that would be less arbitrary and ultimately simpler would replace these detailed rules.

Finally, tax expenditures threaten the primary goal of the tax system by creating a perception that the system is unfair. If tax expenditures were simply converted into direct subsidy programs, the total fiscal incidence of government activities, and thus ultimately the fairness of government intervention in the economy would be unchanged. However, direct subsidy programs that are perceived as being unfair generally are singled out for taxpayer wrath, whereas when the spending programs are embedded in the tax system, the tax system becomes tainted with unfairness - and ultimately in a self-

assessment system the perception of tax fairness is paramount. If the tax system loses its moral acceptability, the enforcement of compliance becomes an impossible task.

Moreover, when spending programs are put in the tax system, the need to ensure the perceived fairness of the tax system can result in the programs having peculiar design features. Thus, for example, in most tax systems the amount of charitable contributions that a taxpayer can deduct is limited to some percentage of the taxpayer's income. One purpose of this limitation is to ensure that high-income taxpayers cannot reduce their tax liability to zero and thus threaten the perceived fairness of the tax system. Although the limitation might make sense in these terms if the deduction for charitable contributions is regarded as a scheme for allocating government funds to voluntary organisations by matching private donations, and if the matching were done directly, surely no one would suggest this limitation should be a feature of the program. The imposition of a minimum tax on taxpayers who make extensive use of tax expenditures is a similar illustration of the effect the need for tax fairness has on the design of spending programs implemented through the tax system. The minimum tax might be necessary to increase the perceived fairness of the tax system, but in terms of government spending policy, why should subsidies delivered through the tax system be subject to this tax-back feature but not subsidies delivered directly?

Conclusion

The lower rate of corporate tax is so flawed as a subsidy program that it would be unthinkable that it would exist as a direct grant program: it provides greater benefits to the well-to-do than to lower-income business owners, it is grossly over- and under-inclusive, it imposes high tax costs on small business mergers, the government has no control over the amount it spends through the program, it is administered by a bureaucracy that is unfamiliar with the needs of small business or the rationale of government support for the sector, and it is a spending program for which the government is essentially not accountable.

The lower rate of corporate tax could be redesigned in order to make it more equitable and cost-efficient; however, the Canadian experience with its small business credit points up the extreme difficulty, if not impossibility, of attempting to target a program delivered through the tax system. First, the program must be designed to accommodate the structural aspects of the tax system and to properly interact with other expenditure programs in the tax system. Second, since the tax

system is a self-assessment system the rules must be clear and simple so that they can be applied by individual taxpayers and administered by a bureaucracy not expert in the policy area. Third, since for numerous reasons any spending program implemented through the tax system will be subject to more abuse than a program delivered directly, it must be designed so that it is virtually fool-proof. Fourth, because the government is generally less accountable for tax expenditures than direct spending programs, tax expenditures are especially vulnerable to pressures from powerful interest groups. Finally, no matter how well designed, in addition to being subject to these constraints in program design, tax expenditures impair the tax system's primary function of raising revenue by increasing its complexity and contributing to its perceived unfairness.

