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1968

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Recommended Citation
Tempo, Vol. 14, no. 1 (1968, March), p. 16-20

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WHAT PRICE EQUITY

by ERIC J. NEWMAN

Nearly a year has passed since the Canadian Royal Commission on Taxation brought down its monumental study (2600 pages contained in six volumes) of the Canadian fiscal system. In the intervening months almost all Canadians have formed strong opinions on its sweeping proposals. The business community, which is so directly concerned, and the legal and accounting professions, have subjected the Commission's findings to the most intensive scrutiny and examination. Indeed it is probable that no Royal Commission Report has been subjected to more detailed analysis and study or has had direct implications for so many people. Nor has any report evoked such world wide interest.

Unlike reports of most Royal Commissions, this one initially received almost universal acceptance of the broad principles set forth by the Commissioners. However, in the succeeding months there has developed, almost without exception, a reluctance to accept many of the more revolutionary changes which the majority of the Commissioners saw as the essential elements of a tax system which would be the envy of every other industrialized country.

The reluctance has taken the form of uneasiness that many of the sweeping provisions recommended by the Commission would not, and could not, be made to operate effectively in Canada today. At the annual meeting of the Canadian Tax Foundation (an independent tax research body), which took place shortly after the Report was published, it quickly became apparent that for every economist who praised the Report for its vision and recognition of pure taxation principles there were probably several businessmen, lawyers or accountants who were equally concerned about the practical effect of the sudden introduction of such radical changes in our fiscal system.

A great deal has been written on the subject since the publication of the Report and a few of the more contentious topics will be discussed in the balance of this article. Apart from the recommendations which would result in substantially higher taxes for the extractive industries and life insurance companies, a few issues appear to be emerging as those of greatest concern to the public at large.

This is not to suggest that these recommendations or some modification of them cannot become part of an improved tax system in the future. What it does demonstrate is that the public is con-concerned about the uncertain effect of the more sweeping proposals. There is also a natural reluctance to plunge into something unknown when what we have could probably be improved and made to operate more effectively in the future. Even the government, after months of complete silence on the subject, announced recently that it would not adopt all of the Commission's proposals; but just what parts they will favour remains to be seen.

Comprehensive Tax Base

The keystone of the Commission's new tax system was equity and an important requirement involved the concept of a much expanded or all-inclusive tax base. Virtually all receipts (as distinct from income under the present system) would be taxable and would be taxed at full progressive personal tax rates. The so-called comprehensive tax base was to include all forms of income, capital gains, gifts, inheritances, and even gambling winnings.

While the Commission was most concerned with broadening the tax base, they also recognized that the present personal tax rates (maximum 80%) would have to be lowered. They concluded that with a comprehensive tax base the maximum personal tax rate should not exceed 50% and that the 50% rate would only apply to taxable income over $100,000.

The result of the foregoing was to reduce the income tax of almost everyone whose income was from business or employment but to increase substantially the tax on other receipts such as capital gains, gifts and any other receipts. The hopeful prospect of lower taxes was quickly dispelled when people realized that a small legacy or other windfall gain (now tax-free) would be added to ordinary income and subjected to full personal tax rates under the Commission's plan.

Integration

Probably one of the most vexing tax problems the Commission had to try to solve was the corporate surplus and dividend income question. The Commission's proposal was to continue to have a 50% corporation tax (the rate had to be kept close to the United States rate and reasonably close to the proposed maximum personal tax rate) but to allow Canadian individuals full credit for the corporation tax against their personal income tax (after including the before corporation tax or grossed up dividend in their income).

What at first glance appeared to be a bonanza for the equity investor was quickly dulled by the realization that any capital gains on stocks would be subject to full personal income tax. One undesirable side-effect would be the tendency for interest rates to increase. The price of equities was expected to rise by as much as 30% because of the integration proposal. The upward pressure on already high interest rates could have serious monetary and economic consequences in a country like Canada which is a heavy importer of capital.

The Family Unit

Many countries have acknowledged that a husband and wife form a practical tax unit. This has been recognized in the United States for many years and also to some degree in the United Kingdom. It remained for the Royal Commission to recommend that the family was the proper tax paying unit and that the family unit would be comprised of husband, wife and minor children.

One of the stated objectives of the Commission was to prevent income and estate splitting which have become very popular under the present tax laws. In support of the concept of including children in the family unit, the Commission suggested that it is the family which exercises its "discretionary economic power" and except for certain exemptions for individuals ($500 for employment or business income earned by each dependent child), the income of all members of the family should be aggregated and subjected to tax at progressive rates. While the Commission also recommended lower personal tax rates, this would undoubtedly result in some pyramiding of income which does not happen today.

People ask if the employment or business income of a child really contributes to the combined spending power of the family unit or whether it simply adds to the discretionary spending power of the child. Is his income, after tax has been paid by the taxpaying unit, likely to contribute to the cost of maintaining the home and paying the grocery bill or to finance a new motor cycle or electric guitar?

Some people question whether the one-vote principle does not also imply a one-taxpayer principle. While the family may be an appropriate unit in sociological studies, there appears to be grave doubt that to require a group of individuals to pay tax at progressive rates because they are members of the same family is not practical in the context of the family in Canada today.

Gifts and Bequests

Canada has a tax on estates and in addition imposes a tax on the donors of gifts. The two methods of taxation accomplish some redistribution of wealth and act as a final accounting on the total income and capital accumulation of an individual during his lifetime. The Royal Commission on Taxation suggested a shift in the incidence of these taxes.

The Commission argued that a dollar received in the form of a gift or bequest enhances the taxpayer's discretionary economic power just as much as a dollar of employment income. Such amounts should be part of the comprehensive tax base and should be taxed the same as any other dollar (a buck is a buck is a buck).

If one goes along with the "buck is a buck" concept, there is no doubt that the person who receives a gift is in a position to spend or invest

more. However, some people believe that the Commission's method of taxing gifts, and particularly bequests, strikes at the very foundation of our society and what is normally considered to be the virtuous act of a father in providing for his children and grandchildren. The Commission set this argument aside completely. Equity demands, they said, the full taxation of the receipts of all individuals.

One can foresee numerous problems, of course, especially when this theory is coupled with the full taxation of capital gains. It is possible that the estate of a deceased father may be called upon to pay personal tax on unrealized capital gains and that his son could also be required to pay personal income tax on the value of the same assets when he receives them.

To alleviate the immediate tax impact new procedures were suggested, such as the use of a non-interest-bearing income adjustment account with the government into which cash receipts could be put to defer taxation. Unfortunately, such a plan is of little use to the taxpayer holding only non-cash assets such as a farm or fishing boat.

Many people have expressed concern at the thought of taxing the father's capital as income in the hands of the son. They claim that this will encourage the rapid disappearance of pools of capital and the eventual loss of the distinction between capital and income. There may not be too much strength to this argument, and yet one wonders whether the boy who receives what is called capital in his father's will and which represents the results of the old gentleman's lifetime of work wouldn't be less inclined to spend it than if it were simply a receipt of income and were taxed on the same basis as his salary.

Unfortunately, the Commission's recommendations for the taxation of gifts and bequests are intended to yield a significant amount of revenue. If these provisions were not adopted, an increase in the Commission's recommended tax rates would be necessary to ensure sufficient revenues to meet the needs of government.

Capital Gains

There is no doubt but that, long before the Royal Commission reported, most people were resigned to the eventual introduction of some method of taxing capital gains, which Canadians have escaped to date. The Commission's proposals, therefore, did not in the first instance shock many people. What has developed since that time, however, is the growing awareness that as part of the comprehensive tax base a dollar of capital gain is to be considered for tax purposes as the same as a dollar of earned income. Here again, the full impact of the recommendation takes some time to be felt.

There is a growing concern, for instance, that the Commission's recommendation gives absolutely no recognition to inflation, whether creeping or galloping. Undoubtedly, over a period of time there would be a tax on the capital itself (as distinct from any gain) and, as a result, private capital will be eroded and transferred to the public sector.

What at first appeared to be general acceptance of a tax on true capital gains has now resolved itself into resistance to a tax on capital transactions. Unless some better measurement of the true capital gain element can be established, it may well be that some system like the American tax on capital gains may be necessary.

Under the American system, a reduced rate of tax on capital gains provides rough justice by giving recognition to the time element, inflationary factors and various other considerations which are part of the capital gain and which distinguish it from an annual income receipt. The Commission's proposal, in its attempt to achieve equity, ignores any rate differential which in other countries has been an important part of the system of taxing capital gains.

Foreign Capital

Few would dispute that the present Canadian corporation tax has many weaknesses and that the double tax system which involves taxation of corporate profits and the taxation of dividends paid to shareholders may not be a theoretically perfect one. The Commission's proposal for the full integration of corporate and personal taxation eliminates many of the problems with which both the tax administration and taxpayers and their advisors have struggled for many years.

Again, what at first glance appears to be a simple solution gradually emerges, on the basis of scrutiny and closer examination and questioning, as a complex conceptual approach which may have serious practical deficiencies.

Take, for example, the question of foreign capi-

tal investment in Canada. The Commission quickly recognized that the integration proposal could not be applied to non-residents without a substantial reduction of tax revenues to the benefit of non-residents. The Commission, therefore, suggested that the benefits of integration should be available only to residents and that non-residents would continue to be taxed on pretty much the same basis as at present.

The Commission argued that little complaint would be justified, first because the non-resident would likely not be taxed more harshly in Canada than in his own country and, in the second instance, because no change from the present situation was being recommended. Foreign investors, of course, might accept these arguments but they might, on the other hand, detect some discrimination.

Canada's reliance on, and need for, continued massive injections of foreign capital is a matter of great importance for the growth of the Canadian economy. Can our tax system which, if not discriminatory, is at least not completely neutral, afford to create an idea in the minds of foreign investors that their capital and the yield from it are to be taxed differently than they would be in the hands of Canadian residents? How would say the U.S. investor view the fact that the American subsidiary in Canada would pay 50% tax on its profits plus a 15% non-resident withholding tax on any dividends while the Canadian-owned company would pay a 50% tax on its profits but the shareholders would get it all back when they received a dividend?

One is reminded of the husband who told the story that he and his wife shared everything on a 50-50 basis. He would explain that when his wife bought a $50 dress he was allowed to buy a 50¢ tie. There is an unfortunate similarity here with the proposal which would see virtually all of the 50% corporation tax refunded to Canadian residents while foreign investors, in addition to receiving no corporation tax refund, would be subject to non-resident withholding tax on dividends paid out of Canada.

Conclusion

Equity has been proclaimed by the Commission as the most fundamental and important criterion for their tax system. Administrative simplicity and the problems of taxpayer compliance have only been recognized where they outweighed equity. This happens very seldom. Many people, it appears, are beginning to question the price which must be paid to achieve the high degree of equity which the Commission feels should be built into our tax system. They point out that the federal income tax system is only a part of the total tax structure of Canada. Direct taxes levied by the provinces and real estate taxes levied by the municipalities all take a substantial portion of the taxpayer's dollar. Without some greater recognition of the total incidence of all levels of tax, the degree of equity for which the Commission searched is not attainable.

While few will dispute the desirability of equity, there are many who would go further in compromising equity with administrative ease, taxpayer satisfaction and social customs. Now that serious study and consideration have replaced the immediate and initial mass appeal of the Commission's findings, it is time to question whether the system is worth the possible cost and general business dislocation which might develop.