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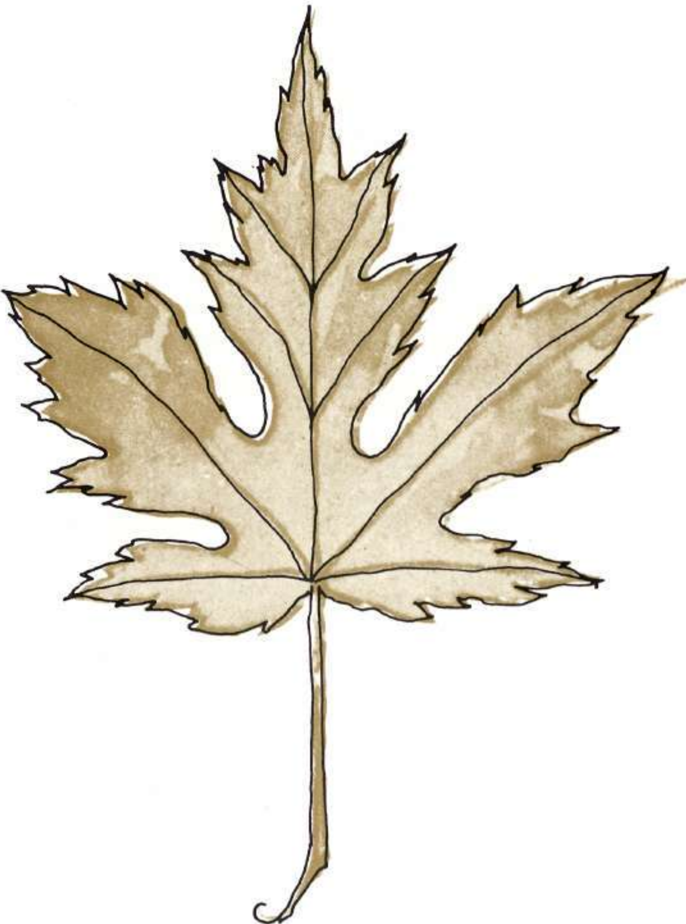
TAX REFORM-
CANADIAN STYLE

by Geoffrey M. Colley



Last November, the Canadian government presented a series of "Proposals for Tax Reform." This White Paper on taxation was brought forward for public examination and discussion in advance of the introduction of definitive legislation.

As those who have followed recent developments in the Canadian tax scene are aware, it has taken some seven years of study, discussion and research to bring the subject of tax reform to its present stage. Strong resistance to certain of the proposals has developed and it now appears entirely possible that the government's January 1, 1971 target date for implementing the package may not be met.

What the proposals mean and how they are likely to affect you are the real questions rather than simply which proposals are apt to be implemented or when.

Scope of the Proposals

The 1967 report of the Royal Commission on Taxation (the Carter Report) dealt with the entire Canadian tax structure and recommended a closely integrated package of drastic tax revisions. The government's present proposals, some admittedly patterned on Carter, have been restricted primarily to the area of income tax. (Major amendments to the estate tax and gift tax laws were enacted in 1969; reform of the sales tax is considered less urgent.)

The proposals do not appear to alter materially the present concept of income, except with regard to the inclusion of capital gains in the tax base. The major changes are in the proposed integration of the corporate and personal taxes, consequent changes in the concept of distribution of corporate earnings, the removal of the low rate tax on corporate income, and drastic revision of the personal tax rate scale.

As with Carter, many of the proposed tax changes tend to interact in such a way that removal of one of them would necessitate radical revisions of the others. Most are ideas which have been tried, and in some cases rejected, by other major countries.

Capital Gains

Although the taxation of capital gains is a new concept for Canada, speculative gains have often been taxed in Canada as gains arising from adventures in the nature of trade, or more explicitly, as business profits. In the past, land transactions have been the main target; primarily for administrative reasons, stock market gains have rarely been taxed in Canada except in the hands of brokers or dealers in securities.

The new proposals would tax most forms of capital gains, with appropriate (or sometimes less than appropriate) deductions for capital losses. One significant aspect of the proposals is that most such gains would be subject to tax at full rates and not at special reduced rates as in the United States.

A major change in concept is encountered in the area of dispositions of securities. Corporate shares would be segregated into two groups—shares of widely held Canadian corporations and shares of closely held Canadian corporations. The distinction is important because it carries through into the proposed treatment of distributions of corporate earnings.

Widely held corporations are those with shares (not necessarily all classes of shares) listed on a prescribed Canadian stock exchange; those corporations so designated by the Minister (mainly corporations whose shares are traded "over the counter"); and those corporations which can meet specified tests as to numbers of shareholders and which elect to be classified as widely held. Once a corporation acquires "widely held" status, it can never revert to a closely held status even if its share ownership changes.

Although the proposals don't specify, it seems that any Canadian corporation which is not classified as a widely held corporation would, by inference, be classed as closely held. Most Canadian subsidiaries of either Canadian or foreign corporations would be considered closely held.

How does this affect the capital gains treatment? Gains on disposals of shares of a closely held Canadian corporation would be fully taxable; losses would be fully deductible, not only from other capital gains but also from other income. On the other hand, only one-half of the gain arising from the disposition of shares of widely held Canadian corporations would be included in income, and only one-half of such losses would be deductible. Effectively, the tax cost of a capital gain in widely held shares would be limited to approximately 25 percent (one-half the gain at the top marginal rate of approximately 50 percent).

Gains on disposals of assets held for personal use and enjoyment (i.e., other than real estate and marketable securities) would be taken into income only when the sale proceeds exceed $500. For this purpose, cost would be assumed to be at least $500, thereby eliminating the need for detailed cost records for minor purchases of art objects, coins, books, etc. Conversely, losses on such items would be deductible only if the cost exceeds $500 and the loss did not result from the personal use (normal wear and tear as in the case of a car, boat, TV set, etc.) of the asset.

The government anticipates that the sale of a private home would seldom result in a taxable gain. Annual allowances of $1,000 (to cover market appreciation) and $150 (or actual costs if greater) for home improvements would be added to the cost to determine the taxable amount of any gain realized. Any gain resulting would further be subject to a "roll-over" provision, but only if the sale resulted from moving to another locality in connection with a change of job and the proceeds were reinvested in another home. Why the roll-over was restricted in this way has yet to be explained.

Valuation Day

This brings us to another significant point in the proposals. Since capital gains tax is a new approach for Canada, some start-up problems may be anticipated. To avoid unnecessary searching in old records for original costs, and to achieve a certain measure of equity, the cost of existing assets for future capital gains tax purposes will be determined on Valuation Day, a day to be announced close to but not necessarily coinciding with the start of the new system.

Tax on Paper Gains

One proposal which has become a contentious issue is that owners of shares of widely held Canadian corporations would be required to revalue such holdings once every five years and to take into income one-half of the apparent "paper gain." The proposal would apply equally to shares of widely held corporations held by other corporations, and would have the effect of increasing the cost base on which future actual or accrued gains would be based.

This provision was designed to prevent the perpetual deferment of unrealized share gains, but could result in serious hardship for a taxpayer forced to sell part of his holdings to pay the tax. Whether a more acceptable alternative will be found remains to be seen; several possibilities have been suggested including the removal of the not particularly remunerative federal estate tax, which would make it feasible to tax capital gains at death.

Distribution of Corporate Earnings

Another major area of conceptual change is the proposed integration of personal and corporate taxes and the resultant effect on both the method and the timing of profit distributions to shareholders. Expressed in its simplest terms, the proposal is to shift from Canada's traditional two-tax system to one under which the shareholder would treat the corporation's tax as having been prepaid on his behalf—in effect an integrated single-tax system. Well, almost.

If a shareholder of a closely held Canadian corporation received a dividend of $100, he would "gross-up" for the full amount of corporation tax, normally a like amount since the proposed corporate tax rate is 50 percent. If his marginal tax rate was also 50 percent, his tax on the $200 of grossed-up income would be $100 against which he would offset the $100 already paid on his behalf by the corporation. Result: no additional personal tax.

Meanwhile, the shareholder of a widely held corporation who received a dividend of $100, would only be required to gross it up by one-half of the applicable corporation tax or $50. At a 50 percent marginal tax rate, his tax on $150 of grossed-up income would amount to $75, against which he would apply his half credit or $50. Result: additional tax payable of $25.

The foregoing illustrations are perhaps oversimplified and may represent an unfair comparison, but the fact is that the proposal to subject dividends from widely held corporations to only a one-half gross-up-and-credit would result in some additional tax for any individual whose marginal tax rate exceeded 33⅓ percent (to be reached at the level of $7,000 of taxable income).

The proposed gross-up-and-credit procedure would also apply to intercorporate dividends. Dividends paid by a taxable Canadian corporation are at present exempt from tax in the hands of another taxable Canadian corporation. Obviously, with full gross-up-and-credit on dividends paid by a closely held corporation (including a subsidiary), no additional tax would be payable by the receiving corporation.

Where, however, the dividend was paid by a widely held corporation, the one-half gross-up could lead to an additional tax on the intercompany dividend. To avoid this repeated tax impact on dividends flowing from one widely held corporation to another widely held corporation, a special 33⅓ percent tax rate would apply to the dividend in the hands of the receiving corporation. For example, a dividend of $100 from the first widely held corporation would be grossed-up to $150; tax at 33⅓ percent on the grossed-up income of $150 would equal $50; and the credit for the tax would then represent a direct offset.

Dividends may pass through the hands of several corporations on their way to the eventual individual shareholder. From the outline above, it will be seen that dividends would pass through a closely held corporation at little or no additional tax cost. On the other hand, significant additional tax cost would usually result when dividends were received from a widely held corporation, because the shareholder would be entitled to claim credit for only one-half of the corporation tax.

As a corollary, dividends from a closely held corporation would incur significantly more tax if they were to pass through a widely held corporation at any point along the route to the individual shareholder than if they flowed directly from the closely held corporation to the shareholder.

Another significant point regarding the proposed tax treatment of dividends from Canadian companies is that the proposed gross-up-and-credit rules have no relevance to dividends paid to nonresidents of Canada. Nonresident withholding tax on dividends will be based on the actual amount of the distribution payable to the nonresident shareholder.

Low Rate Tax

There are several major changes proposed in the ground rules under which corporate profits are to be taxed and distributed, the first of which is the removal of the present 21 percent rate of tax on the first $35,000 of taxable income. At present a small incorporated business pays its corporate tax at 21 percent and then may defer distribution of its accumulated earnings; the next and perhaps more serious bite of tax in the shareholder's hands is, in that way, postponed indefinitely.

The low rate tax base would be phased out over a period of four years for corporations with taxable business profits below $105,000 and would cease immediately for corporations with profits above that level. After the proposal has been fully implemented the extra tax works out to approximately $10,000 per year for a company now earning $35,000 or more. Most of this would be recovered by the shareholders under the proposed gross-up-and-credit method, but the tax postponement feature would have disappeared.

Partnership Election

Not necessarily next in the order of impact is the proposal to permit certain closely held corporations to elect to be treated as partnerships for tax purposes. Under this proposal, corporate status would be largely ignored and the corporation's profits would flow through to the shareholders for tax purposes in much the same way as if the business were not incorporated. The size of the corporation would not be the relevant factor; the partnership election would be restricted by shareholdings (generally limited to corporations with only one class of shares and requiring all shareholders to be resident in Canada). Where corporate shareholders were involved, the partnership election would only apply if the shareholder-corporation had been incorporated in Canada and if each corporation had the same fiscal year end.

Since presumably the partnership treatment would apply equally to wholly owned subsidiaries of Canadian corporations, this proposal appears to permit the effective equivalent of a consolidated tax return; the subsidiary's profits (or losses) would be considered to have been earned by the parent. Interestingly, the consolidated return approach is a feature which was removed from Canadian tax law twenty years ago. There may be considerable refinement of this proposal before it becomes law, since it raises a variety of technical and administrative problems.

Creditable Tax

A further and perhaps greater complication is raised by the introduction of the concept of "creditable tax." The gross-up-and-credit proposal as presented requires that the tax paid by the corporation would be subjected to the gross-up-and-credit procedure only to the extent that the profits were distributed within two and one-half years from the end of the fiscal year. After that time profits would still be distributable, but with no gross-up or tax credit. Similarly it is proposed that certain amounts of tax paid by the corporation in respect of disallowed expenses and recaptured depreciation would, by definition, be noncreditable. No one has yet indicated precisely how the noncreditable portion would be determined.

The two and one-half year time limit on profit distributions has been rationalized as being necessary for the maintenance of government revenues. This seems to ignore the fact that, as proposed, most of the total tax would already have been paid by the corporation and relatively little additional tax would be paid by the shareholder when he received the dividend. Distributions of dividends for tax purposes would be permitted to be made in cash or by way of stock dividends, the latter being a concession to relieve the pressure on corporations which would possibly not have the necessary funds to meet a complete profit distribution in cash within the two and one-half year time limit. Even recognizing that distributions could be made by way of stock dividends as well as in cash, the demands on corporate funds under this proposal seem to be unrealistic. Most corporations, especially widely held "public" corporations, follow a policy of financing much of their expansion by retaining part of their earnings.

It is difficult to assess the pressures which may be brought to bear by shareholders, not to mention technical complications such as nonresident withholding tax, if future dividends are paid largely in stock rather than in cash. Hopefully a more realistic "pay out" period will be provided when legislation is actually introduced.

"Old System" Surplus

What is to happen to the surplus already accumulated in existing companies? The answer to that is technical but remarkably simple. Since capital gains have never been taxed in Canada, many companies have surpluses which include substantial amounts of a nontaxable nature. The rule today in Canada is generally that if it hasn't been taxed as income in the corporation, it isn't taxable in the shareholder's hands when it's finally distributed. This is, of course, subject to the proviso that the taxable portion of the surplus must be distributed first.

If a corporation has on hand undistributed income (taxable surplus) accumulated under the present "old system," it is proposed that this be eligible for distribution under the new system by the corporation simply paying 15 percent of it in tax and distributing the remaining 85 percent to the shareholders tax free. A similar, but more limited, provision exists in the present law; the proposal is to extend the procedure to all "old system" undistributed income, including that of controlled subsidiary corporations.

It is understood that corporations with designated surplus will be permitted to tidy up such situations by this method. No specific mention is made of the future disposition of tax-free gains included in the "old system" surplus; it may be that they will simply serve as part of the cost base for determination of future gains on the eventual disposal of the shares.

Personal Tax Rates

All of this eventually has to have an effect on the end man in the line, the individual taxpayer. Some small changes in his tax position are proposed: increases in personal exemptions to $1,400 for a single person and $2,800 for a married man supporting his wife; some alterations in the exemptions for dependents with their own incomes; a new $150 employment expense deduction, etc. These are minor adjustments, designed primarily to ease the tax burden of the very-low-income earner. If the government's projections are accurate, the result will be the removal of some 750,000 taxpayers from the tax rolls.

For the high-income taxpayer at the other end of the scale, the proposals include a reduction in the top marginal rate of personal tax from approximately 82 percent, to take effect gradually over a five-year period. This does not, however, necessarily imply a reduction in tax for those in the upper brackets; it is intended that their taxable incomes will be increased substantially by the inclusion of capital gains in income, and by the intended acceleration of grossed-up dividend payments resulting from the two and one-half year payout rule.

The proposed maximum marginal rate when the new system has been fully implemented would be 51.2 percent, calculated as a maximum 40 percent federal tax rate plus 28 percent provincial tax thereon. The federal rate is designed to consolidate in a single scale all of the varied taxes, surtaxes and tax abatements which complicate the present tax calculation.

The proposed scale of personal tax rates starts later (because of increased exemptions, etc.) and rises more sharply than the present rate scale; the 51.2 percent maximum rate is reached at the $24,000 of taxable income level. The man in the middle, the taxpayer with the $10,000-$25,000 income, is faced with the sharpest increase (proportionately, at least) in his taxes. Judging by the loud cries of anguish, this is an area in which a fair number of taxpayers are to be found.

Tax Averaging

A new general formula has been proposed for averaging personal taxes over a five-year span. It is designed to replace a variety of three-year and five-year averaging provisions contained in various sections of the Income Tax Act. Unfortunately, it is apparent that the new general averaging formula, as proposed, would be of little or no value to anyone with an average annual income in excess of $18,000.

International Income

A number of primarily technical amendments have been proposed with regard to the taxation of foreign-source income received by a Canadian taxpayer. In common with the proposed taxation of income paid to non-residents, these have a proposal to amend and extend Canada's network of bilateral tax treaties as their central theme. The aim is to establish a uniform international withholding tax rate of 15 percent, and to raise the withholding rate in respect of payments to non-treaty countries to 25 percent, at least until such time as a suitable tax treaty can be negotiated.

It is anticipated that some difficulties may be encountered in renegotiating some of Canada's existing treaties, particularly with respect to the taxation of capital gains. To allow for the inevitable delays in negotiations, the proposals include several transitional provisions which would postpone the effective dates of some of these changes to 1974 or even later.

Federal-Provincial Problems

Canada is a federation with eleven taxing jurisdictions: one federal and ten provincial. While the proposals under discussion are federal in scope, personal and corporation income taxes are revenue fields which have traditionally been jointly occupied by the two levels of government. The continuing concern of the provinces is that the federal authorities would carve out such pieces of tax territory for themselves that little if any additional tax room would be left for the provincial revenue collectors.

The proposed system of corporate tax is based on a notional rate of 50 percent, made up of 40 percent federal and 10 percent provincial, substantially the same as the present federal-provincial split.

In fact, however, several of the provinces already levy corporate income taxes at rates significantly in excess of the 10 percent national rate. It is not clear precisely what the effect of these premium rates would be if they were continued under the new proposals. Would they distort the theoretical 50 percent balance of the proposed system, or simply continue to make it more expensive fo carry on business in certain provinces?

A similar disparity exists between the existing and proposed federal-provincial split of personal income taxes. Except in Quebec where special circumstances apply, the present split of the basic federal tax rates is 72/28. Again the problem arises as to what happens to the system if the provinces wish to raise their tax rates, as some of them already have.

In the interests of tax "harmony," the federal authorities have proposed that the provinces tie their tax legislation to the federal rules, permitting the federal government to act as collection agent for the provinces. It remains to be seen whether this proposal will be acceptable or whether the provinces will feel the need for separate tax collection systems.

Revision of the Proposals

As may be apparent from what has already been said, the tax reform program as submitted by the federal government has so far met with something less than universal acceptance. The Minister of Finance, Hon. Edgar Benson, has said repeatedly that these are only proposals, not government policy, and that the government is willing to consider any reasonable alternative proposal. What has not come through quite so loudly is that the package as presented took a long time to put together and is not likely to be altered materially unless the authorities can be convinced that there is a better way to approach the problem.

These main proposals, along with many others having specific application to certain segments of the economy, e.g. special rules regarding percentage depletion and exploration costs in the mining and oil industries, tax treatment of real estate rental operations, taxation of mutual funds and trusts, etc., are undergoing searching scrutiny by those who feel that they are likely to be affected. The difficulty is that many of the proposals are simply broad outlines of what might be expected when the enabling legislation is introduced. The details have yet to be supplied and are, in any event, subject to change if the pieces eventually don't fit.

(Copies of a Touche Ross booklet containing a more detailed analysis of the Tax Reform Proposals may be obtained by writing to National Tax Office, Touche Ross & Co., 90 Sparks St., Ottawa 4, Ontario, Canada)