EQUITY AND THE WHITE PAPER ON TAXATION

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The Royal Commission on Taxation, in its proposals for tax reform, stated that it assigned the objective of equity the highest priority since it considered that the record of the past indicated clearly that a social and political system could not be strong and enduring if the people became convinced that the tax structure did not distribute the tax burden fairly among the citizens.[1] In the Commission's view equity would be best achieved if taxes were allocated in proportion to the discretionary economic power of the taxpayer and this required that any proposed tax base take into account all of a person's net gains.[2]

The White Paper, on the other hand, does not accord this priority position to equity but rather indicates that "a number of goals and standards have guided the government in its approach to reform". It recognizes that "important forms of income and benefits escape taxation" and "proposes to bring them into taxable income" mainly through the introduction of a tax on capital gains.[3] Although one of its professed goals is "a fair distribution of the tax burden based upon ability to pay" it states nevertheless that:

> The government rejects the proposition that every increase in economic power, no matter what its source, should be treated the same for tax purposes.[4]

How, then, do the proposals for reform in the White Paper compare with those of the Carter Commission? Does the failure to accord first priority to equity lead to significant consequences? Will the White Paper proposals ensure that all important forms of income and benefits will be brought into taxable income so as to produce "a fair distribution of the tax burden based upon ability to pay"? Finally, how would such a reformed tax system compare with the tax systems in the United Kingdom and in the United States in terms of equity?

Horizontal and Vertical Equity

The Carter Commission stressed that:

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1 Kenneth LeM. Carter, Chairman, Report of the Royal Commission on Taxation (Ottawa, 1966), vol. 2, p. 17.

2 *Ibid.*, p. 10.

3 Hon. Edgar J. Benson, Minister of Finance, Proposals for Tax Reform (Ottawa, 1969), p. 6.

4 *Ibid.*, p. 36.

> Equity has two dimensions. Horizontal equity requires that individuals and families in similar circumstances bear the same taxes. Vertical equity requires that those in different circumstances bear appropriately different taxes.[5]

The White Paper says essentially the same thing[6] although it does not use the terms "horizontal" and "vertical" equity. Its recommendations would significantly improve horizontal equity through a number of proposals. For the first time all taxpayers will be permitted to average their incomes over a five year period, something not yet possible in either the United States or the United Kingdom. There is to be included in taxable income unemployment compensation, adult training allowances, fellowships, scholarships, research grants, and bursaries (subject to the deduction of certain educational expenses) while deductions are to be permitted from income for the expenses of child care (where both parents work or where there is only one parent who is also employed) and for certain employment expenses of employees who receive wages or salary. Horizontal equity is also to be improved among high income taxpayers by taxing capital gains. The White Paper points out that:

> The present exemption has also led to an unfair tax load on those high-income Canadians who do not have capital gains. In an attempt to be sure that the rich as a class pay a higher proportion of their income as tax than do the less well off, governments have imposed very high rates on the part of their income that is taxed.[7]

The White Paper also presents the arguments for the taxation of capital gains, in order to ensure both horizontal and vertical equity, as follows:

> The government has decided to include capital gains . . . in income subject to tax. Reviews of this subject by the royal commission and the government led to the conclusion that this is essential in order to be fair between those receiving such gains and others deriving their income from other sources. Moreover the taxation of gains is essential to block loopholes effectively.
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> Those who make substantial capital gains in the stock market or in real estate increase their ability to spend money just as those who earn wages or derive an income from carrying on business.[8]

Thus Mr. Benson seems to recognize, as did the Royal Commission, that capital gains are income and that they must be

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5 Report of the Royal Commission on Taxation, *op. cit. supra* fn. 1, vol. 1, pp. 4-5.

6 Benson, *op. cit. supra* fn. 3, pp. 6-7.

7 *Ibid.*, p. 37.

8 *Ibid.*, p. 10.

included in taxable income if we are to have an equitable tax system. But will the White Paper proposals ensure that capital gains will be brought into the tax system in an equitable manner?

Proposals for the Taxation of Capital Gains

Mr. Benson's proposals for the taxation of capital gains are as follows:

> In general we propose to include capital gains fully in income for most classes of assets *whenever they are realized by the sale of such assets* . . . .[9]
>
> . . . all or part of the capital losses suffered by a taxpayer would be deductible from taxable income and so save the taxpayer tax at the marginal rate.[10]
>
> . . . the government proposes that capital gains not be accrued at the time of death but that the person who inherits the assets be treated as if he had purchased them at their cost to the deceased.[11]

The White Paper also adopts Carter's recommendation that when capital gains are brought into income for tax the marginal rate of tax should be reduced to approximately fifty per cent.

The decision not to provide for a deemed realization at death means that a high degree of horizontal and vertical inequity will remain in the tax system. The Royal Commission had emphasized that, in order to ensure equity, capital gains should be taxed on an accrual basis[12] pointing out that:

> It is essential to recognize that the postponement of taxes is equivalent to the reduction of taxes; indefinite postponement is equivalent to the elimination of a tax.[13]

However, the Commission concluded that, because of administrative difficulties, it could not recommend an accrual system of taxing capital gains at that time[14] but it did propose that all such gains be accrued at death. As Conway[15] pointed out, the omission of a deemed realization at death permits accrued gains to be passed on indefinitely without ever being subjected to tax.

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9 *Ibid.* Emphasis added.

10 *Ibid.*, p. 38.

11 *Ibid.*, p. 42.

12 Report of the Royal Commission on Taxation, *op. cit. supra* fn. 1, vol. 3, pp. 378-80.

13 *Ibid.*, vol. 1, p. 21.

14 *Ibid.*, vol. 3, p. 380.

15 Geoffrey A. Conway, *The Taxation of Capital Gains,* Studies of the Royal Commission on Taxation (Ottawa, 1968), Number 19, p.223.

Mr. Benson's explanation for failing to provide for a deemed realization at death is that:

> . . . two taxes could apply at the same time . . . . Further, these taxes could apply at a most inconvenient time.[16]

Why "convenience" for some taxpayers should suddenly take precedence over "equity" for all taxpayers is not clear. There was no mention of "inconvenience" when it was proposed that unemployment compensation and scholarships be taxed yet the taxation of such benefits is likely to be highly inconvenient to the taxpayer. Carter showed the inequity of failing to tax capital gains at death when he said:

> For example, one could compare the lifetime tax burden of two taxpayers with identical lifetime economic incomes, on the assumption that one taxpayer died the day after liquidating all his assets, while the second taxpayer died before any such liquidation. The tax capacity of the two taxpayers would be identical, but their tax liabilities could be drastically different, and would be equalized only if there were a deemed disposition for tax purposes on the death of the second taxpayer.[17]

Admittedly the White Paper proposals represent some improvement over the United States system where accrued gains are, in effect, forgiven at death. However, this provision of the American tax law has never been regarded as equitable. Martin David said:

> . . . providing for presumptive realization of gains upon the transfer of assets would eliminate the most inequitable tax advantages that arise from the present capital gains tax. The revenue obtained could be used to reduce substantially the tax rates on upper-income groups.[18]

In the United Kingdom, where a tax on capital gains was introduced in 1965, accrued gains are subject to tax at death although there is an exemption for five thousand pounds of gains, and up to ten thousand pounds of gains may be exempted where they result from the disposal of a family business anytime after the age of sixty.[19]

The proposal to permit an apparently unlimited loss deduction against ordinary income while not requiring any deemed realization even at death would appear to make the tax system

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[16] Benson, *op. cit. supra* fn. 3, p. 42.

[17] Report of the Royal Commission on Taxation, *op. cit. supra* fn. 1, vol. 3, p. 369.

[18] Martin David, Alternative Approaches to Capital Gains Taxation (Washington, 1968), pp. 163-164.

[19] G. S. A. Wheatcroft and A. E. W. Park, Wheatcroft on Capital Gains Taxes (London, 1967), ss. 2.01, 16.43.

even more inequitable than it is at present. Mr. Benson, in referring to the need for certain transitional provisions when a capital gains tax is introduced, says:

> It would be perverse if a change that was designed to increase the percentage of the income of the wealthy that is brought to tax should in this particular instance create an exemption for the speculator.[20]

Yet this appears to be precisely what he has done in respect to the long-run arrangements, since it would appear to be possible for taxpayers to realize their losses and use them to offset ordinary income while not being required ever to bring their gains into income for tax purposes. As Conway has pointed out:

> . . . every country reviewed that has taxed capital gains has also found it necessary to limit the deductibility of capital losses to protect the revenue and as a safeguard against income manipulation by the taxpayer.[21]

The United Kingdom only permits losses to be used to offset gains (even though it has a provision for a deemed realization at death) while in the United States any losses unused in this way can be offset against ordinary income, but only to the extent of one thousand dollars a year (although there is no time limit on the carryover of such losses). Mr. Benson has recognized the inequity of permitting the deduction of losses from ordinary income when gains do not have to be brought into tax in the case of his proposal to bring gains and losses into income for tax every five years, in the case of the shares of "widely-held Canadian corporations"; he has since pointed out, in a press release of March 10th, that if the deemed realization every five years, in the case of such shares, were to be dropped, the right to offset losses against ordinary income would have to be restricted.

The proposal that the gains and losses on shares of widely-held Canadian corporations be accrued every five years for tax purposes seems to follow the logic of the Royal Commission's arguments (although the Commission referred to "publicly-traded" securities). This simply seems to be a recognition of the advantages that the securities industry has for so long pointed to in the case of publicly-traded securities; they have an established value and the owners have liquidity. However, the precise arrangements are somewhat puzzling. The omission of debt securities from the requirement of periodic valuation seems reasonable since, where an investor buys such a security on issue and holds it until maturity, there will be little if any gain or loss. Recognizing

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20 Benson, *op. cit. supra* fn. 3, p. 44.

21 Conway, *op cit. supra* fn. 15, p. 165.

interim gains or losses (largely a result of changing interest rates) which would offset each other in the long run seems unnecessary. Where a debt instrument is sold, any gain or loss would be caught under the realization principle. However, it should be recognized that perpetual debt obligations (such as the Canada perpetuals or the C.P.R.'s consolidated debenture stock) should be treated as "shares" for tax purposes since they have no maturity date.

It is not clear why all marketable securities were not subjected to the five year valuation rule.[22] Even though only one half of the gains on Canadian shares will be taxable compared with full taxation of gains on all other shares, so long as losses can be fully deducted from other income, when realized, and so long as gains need never be realized, even at death, it would seem to be more attractive for Canadians to invest in foreign shares than in Canadian shares.

The Realization Principle

How appropriate is the "realization" principle as a criterion for the appropriate time at which to levy a tax on capital gains? Where a tax is to be levied on the basis of the value of something then two conditions must be met. First, it must be possible to determine the value of the item with a reasonable degree of precision and without undue cost, and, second, the taxpayer must be in a position to pay the tax without undue hardship. When people receive wages, salary, interest and dividends, these are normally received in cash and thus there is neither a valuation problem nor a liquidity problem. Thus it is *convenient* to tax these benefits, which probably accounts, in part, for them normally being subject to excessive taxation. (The White Paper proposes that the tax rate on ordinary income will reach fifty per cent at the twenty-five thousand dollar level although it is prepared to permit important capital gains to escape taxation indefinitely because it would be "inconvenient" for the taxpayer to have them taxed even at death.)

Are the problems of valuation and of liquidity so serious that considerations of equity must be foregone? Mr. Benson apparently thinks so since he reiterated on March 10th that deemed realization on death was impractical since "there are some assets where the lack of marketability makes this treatment com-

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22 Of course shares subject to exchange control would have to be exempted but such an exemption is already provided for in the case of ordinary income by s. 54 (7) of the Income Tax Act, R.S.C. 1952, c. 148, as amended.

pelling". But the Royal Commission clearly thought otherwise when it said:

> If the full taxation of property gains would result in dire economic consequences or hopelessly complex administrative questions, some backing away from equity principles could be justified. We are satisfied that neither result would come about.[23]

Clearly in the case of marketable securities there would hardly seem to be any significant problems of valuation or of liquidity. However, even here objections are sometimes raised. For example, substantial blocks of shares might have a different value than that indicated by small transactions. A controlling interest is usually worth a premium but this should cause no difficulties since the accrued gains would be less and the accrued losses more than what would probably have occurred under realization. Although large minority interests might actually bring less than the "market" price the resulting inequity would probably be less than what would result from permitting such accrued gains to escape tax indefinitely.

Liquidity is probably a greater problem than valuation, but it seems inequitable to tax the investor who shifts from one investment to another yet to leave the investor who continues to hold the same assets free of tax. One consequence of such treatment is to create a "locked-in" situation since the investor will prefer to avoid tax. As Conway has pointed out,[24] it is not the existence of a capital gains tax that creates this "locked-in" effect but rather the possibility of deferring the tax for long periods or indefinitely. In any case, an investor who sells, say, Polaroid (on which he has a gain) to invest in Xerox, has hardly realized anything. Liquidity problems would only arise where the appreciation in value had been substantial and in such cases the owner would probably be able to borrow against his shares to pay the tax. And, as the Royal Commission pointed out, the shareholder need not wait until the taxes are due in order to begin an orderly liquidation. Furthermore, the taxpayer should be given a reasonable time to pay any tax where there has been no realization. Conway suggests ten years at death[25] and the United Kingdom legislation permits installment payments over an eight year period with interest[26]. The new Canada Estates Act permits payments to be spread over six years and there seems to be no reason why the same

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23 Report of the Royal Commission on Taxation, *op. cit. supra* fn. 1, vol. 1, p. 14.

24 Conway, *op. cit. supra* fn 15, p. 309.

25 *Ibid.*, p. 198.

26 Wheatcroft and Park, *op. cit. supra* fn. 19, s. 23.13.

option should not be available for capital gains tax although, where both estate and capital gains taxes are payable, a longer period might well be appropriate. Interest should, of course, be charged on any unpaid taxes.

A final objection is that owners might lose their controlling interest. This might be avoided by borrowing against their shares as already suggested or by another method to be described later. But in any case should those who control businesses be permitted to escape taxes on their capital gains forever just because of that fact?

In the case of closely-held corporations, partnership interests and real estate holdings, valuation and liquidity problems would be more serious than with marketable shares. In the case of real estate, neither problem seems to have prevented municipalities from levying taxes assessed on the valuation of such properties. The problem of valuation is, in any case, becoming easier all the time since, with the growth of government transfer payments (particularly for educational purposes) provinces are now taking steps to ensure that all real estate will be valued on the same basis throughout the province. These valuations are usually at "market" and are normally kept up-to-date. Such valuations might well be accepted by the federal government with the values being adjusted by an appropriate percentage in those cases where a particular municipality did not assess at current "market".

The valuation of a business is a more difficult matter but such a valuation must be made at death in any case for estate tax purposes so no additional work would be involved at that time. Of course an initial valuation at "valuation day" would be required. To ease this problem the government might adopt the recommendation of the Carter Commission that taxpayers have the option of valuing property by using their original cost and prorating their gain or loss between the taxable and the tax-free periods on the assumption that the gain or loss had accrued uniformly over time.

The liquidity problem is a more serious one since the sale of a minority interest in a business would likely be difficult, if not impossible, where the business was a small one. However, it should be recognized that the owners of some businesses are illiquid by choice. Obviously companies such as Eaton's and other large private companies could be converted into widely-held companies and a market established for their shares if the owners chose to do so. Is there, then, any justification for permitting the owners of such large, closely-held businesses to defer taxes on their capital gains even until death, just because *they*

choose to keep their assets illiquid and avoid establishing a market value for them? Corporations beyond a designated size might be deemed to be widely-held corporations with gains and losses on their shares being accrued every five years.[27] To simplify valuation problems and to increase their liquidity, some of these firms might choose to "go public". Where they did not do so it would probably be necessary to permit minority shareholders (who were not members of the controlling group) to defer accruing capital gains until death since they could face very serious liquidity problems over which they would have no control. In any case, the private company may be in the process of disappearing. The British have already abolished it, and amendments have been introduced into Parliament this session which, if passed, would require all federal corporations with sales or assets in excess of three million dollars to publish their financial statements. Were the provinces to follow the federal lead the chief advantage of the private company — privacy of its financial affairs — would be ended.

In the case of independent private businesses — as distinct from private companies that are subsidiaries of public corporations — there are additional factors to be considered in addition to equitable treatment for all taxpayers. Since there seems to be a tendency for large firms to grow larger by absorbing competitors, any action which would encourage such consolidations would seem to be undesirable. So would anything which led to more Canadian firms being sold to foreign interests. Furthermore, it has been argued that there is a distinct social benefit to be obtained from the existence of small businesses controlled by independent businessmen.[28] Obviously, anything which increases the liquidity problems of small firms is likely to cause more of them to be sold to other firms or to foreign owners. The estate tax

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[27] Some indication of how large a firm must be to be able to "go public" might be inferred from the fact that half of the two hundred stock issues of firms which went public in Canada from 1956 to 1968 were under $500,000. See David C. Shaw, *Hot New Issues; How Well Do They Perform?*, 34 Business Quarterly 42 (No. 2, 1969). Somewhat the same picture is obtained in the United States where more than half of the new (non-rights) issues of stock in the 1950s and early 1960s were for less than $500,000 (These figures do not distinguish between firms going public and additional issues from firms already public): Irwin Friend *et al.*, Investment Banking and the New Issues Market (Cleveland, 1967), p. 32.

[28] See Estes Kefauver, In a Few Hands; Monopoly Power in America (Baltimore, 1965), c. 5, entitled "Monopoly and the Community", for a discussion of the social advantages said to result from retaining small businesses and small businessmen.

already creates liquidity problems in spite of the provision for installment payments. Although it is sometimes argued that some businesses should be exempt from estate taxes — the argument has been made most recently on behalf of independent newspapers— it would appear to be impossible to justify such an exemption on grounds of equity to all taxpayers.

A Possible Solution to the Liquidity Problem

The British who, interestingly enough, do tax capital gains at death (subject to certain exemptions) have taken additional steps — beyond installment payments — to ease the liquidity problems for owners of small firms. In 1952, a number of insurance firms and investment trusts created Estate Duties Investment Trust Ltd. (EDITH) which:

> If satisfied about the soundness of the management and the prospects of a private company, . . . will supply the funds needed to meet estate duty liabilities without requiring representation on the board of directors. Thus EDITH acts as a minority shareholder of undisputed financial strength without the control or policy of the business being affected. Arrangements can be undertaken in anticipation of death duty liabilities . . . . EDITH also acquires shares in small public companies with a restricted market.[29]

There would seem to be no reason why the Canadian government should not encourage the creation of EDITHs; in addition, the long-heralded Canada Development Corporation might serve the same purpose. It would seem to be desirable to have more than one source of funds available to owners and they would probably prefer that at least some of the sources were non-government. Such corporations could also provide a market for shares of widely-held corporations where substantial blocks have to be disposed of for tax or other reasons and where the market is thin. Thus, the same institutional arrangements would alleviate the problems created by estate and capital gains taxes, and would help to prevent increased concentration of industry and the sale of Canadian firms to foreign owners.[30]

Of course not all firms will qualify to have their shares purchased by EDITHs. But should the government grant tax con-

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[29] C. T. Sandford, Taxing Inheritance and Capital Gains (2nd ed., London, 1967), pp. 37-38.

[30] The seriousness of the liquidity problem may well be over-estimated. A study made for the Royal Commission claimed that small businesses were seldom sold either to meet or in anticipation of estate taxes, but rather for other and purely business reasons. See J. G. Smith, D. B. Fields, and E. J. Mockler, *Death Taxes*, Studies of the Royal Commission on Taxation (Ottawa, 1964), Number 11, pp. 18-20.

cessions to enable managements to remain in control where there are doubts about "the soundness of the management and the prospects of a . . . company?"

Assets Held for Personal Use and Enjoyment

The Royal Commission had pointed out that the tax base should:

> . . . include imputed income, that is, the gains realized when a person uses or consumes his own personal services or his own property.[31]

The justification for this approach is that when a person purchases services in the market, income is created which would be subject to tax. Where a person invests his money in earning assets and then rents a house for his own use, both his income from the investments and the landlord's rental income will be subject to tax while, if he uses the same funds to buy a house which he occupies, there is no investment income subject to tax and there is no tax on the imputed income from occupying the house. However, after making the case for including imputed income in the tax base on the grounds of equity, the Royal Commission concluded that:

> In most circumstances, however, . . . the valuation and administrative problems involved in including such amounts in income are insuperable.[32]

The Commission supported its position by reference to the abandonment of the taxation of imputed rent in Britain in 1962 after many years, because of the difficulty of determining fair rental values, but it pointed out that this provides a substantial preference for home ownership.[33]

The tax treatment of these assets can conveniently be dealt with by treating "the principal residence" separately from the other assets.

(i) The "Principal Residence". Not only did Carter give up the idea of taxing imputed income of owner-occupied housing, but he proposed a lifetime exemption of twenty-five thousand dollars of gains on such homes from tax. The United States has always included capital gains on residences in income subject to tax but the roll-over provisions and the forgiveness of tax at death have

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[31] Report of the Royal Commission on Taxation, *op. cit. supra* fn. 1, vol. 3, p. 41.

[32] *Ibid.*

[33] *Ibid.*, p. 48.

meant that most such gains escape tax.[34] In the United Kingdom all such gains are exempt. Mr. Benson's proposal for an exemption of one thousand dollars a year of gains is probably an improvement over the Commission proposals, although the arguments used in support of the exemption are questionable. A system which excludes from tax the gains on most homes might well be justified on the grounds of administrative convenience, and it might also be considered politically expedient if the necessary support were to be obtained for a broad programme of tax reform. Nevertheless, these are not the arguments Mr. Benson uses when he says:

> Nevertheless, the government does not feel that it would be appropriate to treat the homeowner's gain as ordinary income. Home ownership is part of the Canadian way of life, and within reasonable limits the profit on the sale of a personal residence would be treated as a recovery of the *personal expenses of the homeowner.*[35]

Homeownership is part of the "Canadian way of life" in the sense that about two-thirds of dwellings are owner-occupied, although Quebec differs significantly from the rest of Canada since there only half are owner-occupied (and only a third in metropolitan areas). More significantly, in recent years two-thirds of accommodation built in metropolitan areas of Canada — and this is where most of the construction has been — has been rental accommodation. The desirability of added preferences for homeowners over those who occupy rental accommodation is asserted rather than justified.

The argument that homeowners should be entitled to "the recovery of . . . personal expenses" is difficult to reconcile with the position taken only two pages later in the White Paper when, in dealing with "other personal assets", it is asserted that:

> . . . it would also be necessary to impose some overall limitations on the deductibility of losses. Otherwise, some taxpayers could reduce their taxable income by deducting *personal expenses.*[36]

The roll-over provision for housing also seems to be inequitable since it is to be provided that:

> . . . a taxpayer who moves from one area to another within Canada in connection with a change of job should be entitled to treat the sale of his home and the purchase of a home in the new area as a non-taxable transaction.[37]

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[34] There is also a partial exemption on sales by persons 65 or over. See Martin David, *op. cit. supra* fn. 18, p. 13.

[35] Benson, *op. cit. supra* fn. 3, p. 37. Emphasis added.

[36] *Ibid.*, p. 39. Emphasis added.

[37] Ibid.

It seems difficult to justify this discrimination against the taxpayer who finds it necessary to move in order to get a larger home to accommodate an expanding family or one nearer to schools. If roll-overs are to be permitted they should be available to everyone, but there should be a deemed realization at death.

The further restriction that the receipts from the sale of a residence must be reinvested within a year (this is also the provision in the United States) seems unduly restrictive since some people may not be able to find suitable property within that time or may be in the course of a series of short-term moves where it would not be reasonable to acquire a new residence until the series of moves was completed. This problem could be dealt with by permitting the taxpayer to deposit the funds with the government for up to, say, five years (Carter had recommended such "income adjustment accounts" to permit taxpayers who received large windfalls to distribute them over a number of years but the technique would seem equally suitable for handling roll-overs).[38]

(ii) Other Assets Held for Personal Use and Enjoyment. Losses on non-depreciable assets such as sculptures, paintings and jewellery are to be deductible but only from gains on other assets of the same class. This seems reasonable except that the taxpayer is only to be permitted to carry losses backward or forward for one year rather than backward two years and forward indefinitely as recommended by Carter. This seems quite inequitable since, as Conway pointed out:

> . . . a limitation on the loss carry-over will usually operate to the disadvantage of the lower income taxpayer, while it is only a limited restriction on the higher income taxpayer for the higher income taxpayer will have gains available that can be realized before the loss expires.[39]

The Incentive to Convert Income to Capital Gains

The White paper says:

> . . . it has been possible for the sophisticated to arrange their transactions in such a way that they receive as capital gains amounts that would have been income had the transaction been carried out in the normal manner.[40]
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> The exemption for capital gains has also encouraged taxpayers to make determined and persistent efforts to receive their income in that form, since then it would not bear tax.[41]

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38 Report of the Royal Commission on Taxation, *op. cit. supra* fn. 1, vol. 3, p. 259.

39 Conway, *op. cit. supra* fn. 15, p. 194.

40 Benson, *op. cit. supra* fn. 3, p. 36.

41 *Ibid.*, p. 37.

Presumably, it is loopholes of the above type that the introduction of the capital gains tax is intended to close. But so long as capital gains need never be brought into income for tax, even at death, there remains every incentive to receive as much "income" as possible in the form of "capital gains". The existence of a capital gains tax in the United States has not led taxpayers there to give up this practice. So long as the tax rate on capital gains is less than on income (which it will be for shares of widely-held Canadian corporations), or tax on such gains can be postponed indefinitely, capital gains will be more attractive than income. Thus, although it is no doubt true that:

> If capital gains are included in income for tax purposes, the portion of the total income of the well-to-do that is brought to tax would be dramatically increased.[42]

not all capital gains would be brought to tax. Conway estimates that if there were a deemed realization on death or at gifting of capital gains it would add ten per cent to thirty per cent to United States capital gains tax revenue.[43]

Mr. Benson seems to have assumed that those who are currently able to receive "income" as "capital gains" realize their "capital gains" in order to consume the benefits. But in most cases this is unlikely to be the case since recipients of large incomes typically save a substantial portion, and if they can receive that portion as a capital gain it will still escape tax (except where it is in the form of shares of widely-held Canadian corporations, although even here gains will be taxed at only half the rate applicable to "income"). In this connection it would appear that firms (such as subsidiaries of foreign corporations) that can offer their executives stock options in the form of shares of the foreign parent would have an advantage over Canadian corporations, since there would apparently be no deemed realization of gains on the foreign shares subsequent to acquisition.

The only loophole that seems to have been firmly closed is the one that permitted shareholders to get their benefits through the retention of earnings by the corporation and the subsequent tax-free appreciation of the shares, rather than through taxable dividends. In future, Canadian corporations will, in effect, be forced to distribute their earnings in order to make the "creditable" tax available to their shareholders (this can be done through stock dividends so that no cash need be paid out). The loophole is closed by the decision to eliminate a source of capital

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42 *Ibid.*, p. 38.

43 Conway, *op. cit. supra* fn. 15, p. 259.

gains — *i.e.* retained earnings — rather than by any attempt to tax the resulting gains.

Electric, Steam and Gas Utilities

The White Paper proposes to deny to holders of shares in these utilities any creditable tax on their dividends, even though the corporation has paid tax. It is argued that:

> The whole scheme of the present proposals contemplates that shareholders of Canadian corporations receive a credit from the federal government for part or all of the federal corporation tax paid by their corporation. It would be contrary to this general scheme if the federal government gave to shareholders of these utility corporations credit for taxes which the federal government has turned over to the provincial government, and it does not propose to do so.[44]

But the creditable tax for other corporations is not, in fact, to be limited to the federal tax of forty per cent but is to be provided at a fifty per cent rate, which means that there will be a federal creditable tax equal to a provincial levy of ten per cent. In addition, the federal government makes grants to provinces for specific purposes including many which are not available to all provinces on equal terms. There seems to be no inherent reason why this grant, which is based on the amount of taxes paid by certain utility companies, should have any effect on the shareholders of those utilities. Mr. Sharp, when he introduced the Public Utilities Tax Transfer Act of 1966 said:

> . . . the purpose of this legislation is to avoid giving an artificial inducement to any province to nationalize its public utilities . . . .[45]

The denial of the tax credit to shareholders would seem likely to result in an increased cost of capital to such companies, and thus possibly negate the benefit intended by the Act. It is, in fact, not easy to predict just what will happen. The provinces could return the funds to the companies and they could pay higher dividends. Relatively higher yields on such securities would seem to make them relatively more attractive to foreign investors than to Canadians (for whom they would be no more attractive than lower yield shares carrying the tax credit). This could produce results in conflict with our apparent desires to encourage Canadians to invest in Canadian equities. Another possibility is that such companies would cease to pay dividends since no creditable tax would be involved. Shares should grow in value through the retention of earnings and the increase in value would accrue to the

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[44] Benson, *op. cit. supra* fn. 3, p. 57.

[45] House of Commons Debates (1966), 15 Eliz. II, vol. 7, p. 6903.

shareholders as capital gains taxable only at fifty per cent of normal rates for income if the firms are widely-held.

Summary and Conclusions

One of the major weaknesses of the present tax system, as the White Paper points out, is that although the marginal tax rate rises above seventy-five per cent when taxable income exceeds $250,000, few people pay tax at such a rate, since the well-to-do can usually manage to arrange to obtain any substantial benefits in the form of capital gains, which are currently tax-free. Although the White Paper claims to correct this inequity by proposing a tax on capital gains, there will still be major loopholes which will permit some people to escape both income and capital gains taxes.

Although the White Paper makes the entirely laudable proposal that capital gains should be taxed at full income tax rates, in most cases, in order to remove the incentive to seek to convert income to capital gains, nevertheless by failing to provide for a deemed realization at death it will still be possible for some people to avoid taxes on their benefits indefinitely. Thus most of the incentives to convert income into capital gains will remain, and therefore it is essential to provide for a deemed realization at death.

Even if there were a deemed realization at death, the apparent intention to permit an unlimited right to offset capital losses against income could make the new system even more inequitable than the present one. Taxpayers would be able to obtain the tax benefits from any losses without having to bring any of their gains into income for tax purposes, at least until death. This inequity can only be prevented by allowing losses to be used only to offset gains. There might, however, be provision for a modest offset — say, of $1,000 as in the United States — against ordinary income. Such a provision would be of primary benefit to the person of moderate income who might well never have a gain to offset a loss. Of course, when gains are brought into tax at death there should be a generous averaging provision over previous years.

Where gains and losses are to be accrued every five years there would seem to be no inequity in permitting losses to be offset against ordinary income since all gains will also be brought into income. However, the five year accrual provision should be extended to include all marketable shares and not just those of widely-held Canadian corporations. Consideration should also be given to designating all Canadian corporations that are large enough to "go public", as widely-held corporations.

In cases where assets are not liquid at the time of death the taxpayer should be permitted to pay any tax due in installments

over a period of years — as is now permitted under the Estate Tax Act — provided that interest at the going rate is charged on any unpaid balance. In addition, the government should take steps to ease the liquidity problem by arranging for the creation of financial institutions, like the British EDITH, which could acquire some of the shares of closely-held firms without necessarily forcing the owners to give up control. Provision might even be made for payment in "kind" with the shares so acquired being turned over to the Canada Development Corporation or the Industrial Development Bank.[46]

The above provisions should remove any excuse for permitting any capital gains to escape taxation indefinitely. However, if it is still thought that there would be undue hardship it would certainly be more equitable to reduce the tax rate on capital gains — and if necessary even on estates — but ensure that all gains would be taxed than to introduce the proposed system which would levy taxes at full income tax rates on some capital gains, but allow others to go untaxed indefinitely.

The roll-over provision for the "principal residence" should be made available regardless of the reasons for the change of residence, but there should be a deemed realization on the death of the owner — or of the surviving spouse. There should be a right to carry forward losses on "assets held for personal use and enjoyment" indefinitely in order to provide equitable treatment for the less wealthy taxpayer.

Investors in the shares of electric, gas or steam utilities should be entitled to creditable tax on the same basis as investors in other Canadian shares. What the government subsequently does with the tax collected seems irrelevant.

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[46] See I. H. Asper, The Benson Iceberg (Toronto, 1970), p. 3, where it is pointed out that "as far back as 1400 B.C. the Egyptian pharoahs permitted the wealthy to pay their taxes in 'kind'. Thus each year the subjects would bring to the pharoah their most favoured or valued possessions, including wives and animals." Probably the government would wish to limit this option to corporate shares.