CANADA

REPORT

OF THE

ROYAL COMMISSION ON

TAXATION

VOLUME 3

TAXATION OF INCOME

Part A - Taxation of Individuals and Families

1966

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C A N A D A

REPORT

of the

ROYAL COMMISSION ON TAXATION

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Mr. J. Harvey Perry

Mr. Donald G. Grant

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ROYAL COMMISSION ON TAXATION

VOLUME 3

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PART A

TAXATION OF INDIVIDUALS AND FAMILIES

CHAPTER 7

TAXATION BASED ON ABILITY TO PAY

For centuries men have been seeking some general principle that could be used to apportion the burden of taxation in an equitable manner. Two streams of thought have emerged from this great debate. The benefit approach postulates that equity is served if taxes are apportioned according to the benefits derived from government by particular individuals, or groups of individuals. Under this approach, taxes are treated as a payment for the goods and services provided by the government. If these goods and services reflect the wishes of the people, so goes the argument, the imposition of taxes on those who benefit can be treated as a fair exchange, similar to the exchanges that take place in the market. The other train of thought, the ability-to-pay approach, largely ignores what the government provides to the members of society by way of goods or services, and takes the position that taxes are equitable when they are levied according to a defined tax capacity, or ability to pay, of individuals or groups.

It will be amply evident from earlier statements made in this Report that we favour very strongly the ability-to-pay approach. The benefit approach in our view has very serious practical and theoretical deficiencies 1/. In a few areas of public expenditure where a very close relationship can be established between outlay and benefit, a specific levy may be appropriate. The most obvious example is that of the gasoline tax imposed to support highway expenditure, and to some extent the real property tax where some of the services provided by a municipality are of direct benefit to the owners of property. But the list of such instances is short. A careful examination of the goods and services provided by government or government enterprises does not suggest that greater emphasis should be placed on the benefit approach in Canadian taxation. We base this conclusion on three considerations:

1. The redistribution of purchasing power, which we believe to be an important function of government, would be precluded if all public expenditures were financed by taxes levied according to the benefits received, if benefits are narrowly defined. It is the people with the least economic power who are most in need and benefit most from public expenditures. If the benefit approach were applied exclusively, the more the government did to help this group, the more it would have to pay in taxes. The whole transfer process would thus be frustrated.

2. There are many expensive government services that bestow benefits that cannot be allocated to specific individuals in a generally accepted manner. For example, to assert that a particular individual must pay a certain proportion of the nation's defence bill, because it had been decided that he had enjoyed that proportion of the benefit, would be outrageously high-handed.

3. Some government goods and services, such as education, provide benefits that accrue partly to the users and partly to society as a whole. There is no problem in assigning <u>some</u> of the benefits to the actual users of such government services, but there are serious problems in trying to determine the relative importance of the direct and indirect benefits. Furthermore, the allocation of the indirect benefits among all the people would pose the same problems as the allocation of the benefits from such things as defence expenditures. Any assignment of indirect benefits would be completely arbitrary and, we believe, capricious. Indeed, because some of the indirect beneficiaries may live outside our tax jurisdiction altogether, the complete allocation of the indirect benefits would be futile.

The other concept, taxation according to ability to pay, is inherently as arbitrary as the benefit approach, in the sense that the fundamental propositions on which it is based cannot be proved or disproved. There is, however, an important difference. We do not believe there is an equitable method of allocating taxes according to the benefits of government expenditures. There are, however, principles that we believe provide a fair basis for the allocation of taxes according to ability to pay. We can do no more in designing a tax system than found it upon these principles.

In a democracy, equity questions ultimately must be resolved in terms of the shared values of the people. There is no higher authority. It is our earnest hope that the ability-to-pay principles in which we believe, and from which we have derived our major recommendations, commend themselves to most Canadians.

DEFINITION OF ABILITY TO PAY

In our judgment taxes should be allocated among tax units in proportion to their ability to pay. We believe this would be achieved when taxes were allocated in proportion to the discretionary economic power of tax units. This statement is only meaningful if the term "discretionary economic power" is defined. For this purpose we have found it useful to think of discretionary economic power as the product of the tax unit's total economic power and the fraction of the total economic power available for the discretionary use of the unit. By "tax units" we mean families and unattached individuals. By "total economic power" we mean the power of a tax unit to command goods and services for personal use, whether the power is exercised or not. By the "fraction of the total economic power available for discretionary use", we mean the proportion of the unit's total economic power that does not have to be exercised to maintain the members of the unit. Maintenance is not synonomous with bare, physical subsistence. Rather, it denotes the provision of the services necessary to maintain the appropriate standard of living of the family or unattached individual relative to others.

Later in this chapter we discuss the concept of total economic power. But to be able to derive the major implications of our ability-to-pay principles, we can anticipate that discussion and say that we believe the total economic power of tax units, relative to one another, can best be measured over time by the adoption of what we have called a comprehensive tax base. This base would constitute a great broadening of the present income tax base, but for expository convenience we call the base "income". It should be borne in mind, however, that our concept of "income" encompasses much more than the present tax base.

To be more explicit about the concept of ability to pay, we believe the allocation of taxes in accordance with ability to pay requires adherence to five fundamental principles:

1. Families and unattached individuals should be treated as the basic tax-paying units, that is, the entities with potential ability to pay.

2. Taxes should be allocated among tax units in proportion to ability to pay. Specifically, the tax allocated to unit A should bear the same relationship to the tax allocated to unit B, that the ability to pay of A bears to the ability to pay of B.

3. The ability to pay of a tax unit should be assumed to be proportionate to its discretionary income. In other words, the ability to pay of unit A should be assumed to bear the same relationship to the ability to pay of unit B, that the discretionary income of A bears to the discretionary income of B.

4. The discretionary income of a tax unit should be assumed to be equal to the total income of the unit multiplied by the fraction of that income available for the discretionary use of the unit.

5. It should be assumed that, other things being equal, the greater the income of a tax unit the larger will be the fraction of that income available for discretionary use.

The meaning of these principles can be clarified by a simple hypothetical example. Suppose that tax unit A has an income of $10,000, and that one tenth of this income can be spent or not spent at the discretion of A. Suppose further that B has an income of $20,000 and two tenths of this income is available for the discretionary use of B. According to our ability-to-pay principles the relative taxes imposed on A and B should be as follows:

$$\frac{\text{tax on A}}{\text{tax on B}} = \frac{\text{income of A} \times \text{fraction available for discretionary use of A}}{\text{income of B} \times \text{fraction available for discretionary use of B}}$$

$$= \frac{\$10{,}000 \times 0.10}{\$20{,}000 \times 0.20}$$

$$= \frac{\$1{,}000}{\$4{,}000}$$

From this calculation it follows that the tax on B's income would be four times the tax on A's income. If a total revenue of $1,000 is to be raised from A and B, the rate of tax on the discretionary income of each unit should be 20 per cent (that is, 20 per cent of $1,000 and $4,000).

This example perhaps gives a misleading impression of precision of the principles we espouse. To apply these principles, the concept of income must be defined and applied on a consistent basis. Furthermore, the fraction of a tax unit's income available for discretionary use is not an objective phenomenon. It can only be determined on the basis of judgment. But the foregoing principles have the virtue that they make our fundamental beliefs explicit and provide a framework within which judgments can be made.

Once an income tax base is established that measures the relative total economic power of tax units, an equitable allocation of taxes among units would be achieved when fair and reasonable judgments were made about the relative differences in the fractions of income available for discretionary use in different circumstances. In our opinion the following three factors should be recognized:

1. Differences in income.

2. Differences in family responsibilities.

3. Differences in certain specific non-discretionary expenditures.

We will briefly discuss how each of these circumstances should be taken into account.

Recognition of
Differences in Income

As stated above in the fifth ability-to-pay principle, we believe that the level of a tax unit's income and the proportion of that income available for discretionary use are not independent. Other things being equal, the greater the income of the unit the greater is the fraction available for discretionary use. As illustrated in the foregoing example, we believe a tax unit with an income of $10,000 has a smaller proportion of that income available for discretionary use than an identical family with an income of $20,000.

This general principle must be supplemented by two additional assumptions in order to derive precise rules for allocating taxes among tax units in proportion to their respective abilities to pay. We believe that the following assumptions give fair and reasonable results:

1. All income of a tax unit in excess of some amount is assumed to be available for discretionary use. We have taken this amount to be $100,000. 2/

2. Below this limit, equal proportionate differences in income are associated with equal absolute differences in the fraction of income available for discretionary use 3/.

The first of these assumptions constitutes an implicit rejection of the belief that non-discretionary expenses are those necessary for physical subsistence, for the subsistence approach would imply that non-discretionary expenses do not change with income. This in turn would call for the application of a constant rate of tax to a base consisting of total income less a fixed exemption. We believe that most non-discretionary expenses increase, although not proportionately, as income rises.

The second assumption is the simplest we could make that was consistent with our belief that the fraction of income available for discretionary use rises rapidly at the lower end of the income scale, and that upper middle income tax units have a substantial fraction of their income available for discretionary use.

Although there are various methods that could be adopted to allocate taxes in accordance with the foregoing principles and assumptions, one method of achieving an equitable result under an income tax would be to establish an ascending schedule of proportions of income that would represent discretionary economic power, and then subject these to a proportional tax. However, a more familiar method to achieve the same result would be to apply to a base that measures the total economic power of each tax unit a schedule of progressive rates of tax. We believe this schedule of rates should have the following characteristics:

1. The top marginal rate of tax is reached at an income of $100,000.

2. Brackets encompass equal percentage differences in income.

3. Marginal rates rise by equal amounts from bracket to bracket.

4. The top marginal rate is consistent with revenue requirements.

In Table 7-1 we have drawn up a hypothetical rate schedule consistent with our ability-to-pay principle to illustrate what is involved. The following assumptions are contained in the table:

1. The assumed rate of tax on discretionary income equals the top marginal rate of tax.

2. The marginal rate of tax on the income in each bracket equals the top marginal rate of tax multiplied by the assumed fraction of income in that bracket available for discretionary use.

3. The marginal rates are predetermined once the rate of tax on discretionary income, the lower limit of the top bracket, the number of brackets, and the discretionary income fraction for each bracket have been established.

4. It should be stressed that this rate schedule is hypothetical and is intended only to show the operation of the principles we have developed concerning ability to pay. A number of other objectives and constraints must be taken into account. These are discussed and proposed rates schedules are presented in Chapter 11.

It can also be seen from Table 7-1 that taxes can be allocated in accordance with our ability-to-pay principles in any of the following ways:

1. By the application of a uniform rate of tax to a base that measures the discretionary income of each unit (columns 4 and 5).

2. By the application of an average rate of tax to a base that measures the total income of the unit, where the average rate is greater the greater the total income of the unit (column 7).

3. By the application of progressive marginal rates of tax to a base that measures the total income of the unit (column 6).

The distinction that is often made between systems that impose tax at a constant rate, method 1, and systems that impose tax at progressive rates, methods 2 and 3, is not fundamental. By adjusting the base it is possible to achieve the same result in either way. The important distinction is

TABLE 7-1

A HYPOTHETICAL RATE SCHEDULE CONSISTENT WITH OUR ABILITY-TO-PAY PRINCIPLES

Income Bracket $	Assumed Fraction of Income in the Bracket Available for Discretionary Use	Discretionary Income: From Bottom to Top of Bracket $	Discretionary Income: Cumulative Total to Top of Bracket $	Tax on Discretionary Income at an Assumed Rate of 50 per cent: From Bottom to Top of Bracket $	Tax on Discretionary Income at an Assumed Rate of 50 per cent: Cumulative Total to Top of Bracket $	Marginal Rate of Tax on Income in the Bracket a/ %	Average Rate of Tax on Income at Top of Bracket b/ %
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
0 - 195	0.0	0	0	0	0	0	0.0
195 - 390	0.1	20	20	10	10	5	2.5
390 - 781	0.2	78	98	39	49	10	6.3
781 - 1,562	0.3	234	332	117	166	15	10.6
1,562 - 3,125	0.4	626	958	313	479	20	15.3
3,125 - 6,250	0.5	1,562	2,520	781	1,260	25	20.2
6,250 - 12,500	0.6	3,750	6,270	1,875	3,135	30	25.1
12,500 - 25,000	0.7	8,750	15,020	4,375	7,510	35	30.0
25,000 - 50,000	0.8	20,000	35,020	10,000	17,510	40	35.0
50,000 - 100,000	0.9	45,000	80,020	22,500	40,010	45	40.0
100,000 - 200,000	1.0	100,000	180,020	50,000	90,010	50	45.0

a/ Column (4) divided by width of the bracket or, alternatively the assumed rate of tax on discretionary income multiplied by column (1).

b/ Column (5) divided by the top of the bracket.

between systems that assume that discretionary income is a constant fraction of total income throughout most of the income range and those that do not. We are firmly convinced that the latter assumption is valid. We therefore reject proportionate taxation except for income in excess of a generous limit.

We stressed in Chapter 6 the great importance we attach to the redistributive function of the fiscal system. The adoption of a tax system that would subject a base that measures the total economic power of each unit to a schedule of progressive marginal rates with the attributes we have just specified would ensure that the costs of government transfers and expenditures were allocated among Canadians in proportion to their abilities to pay. Such a tax system, when combined with a progressive transfer-expenditure system that provided relatively greater benefits to low income families and individuals, would achieve the following results:

1. Low income families and individuals would become net beneficiaries of government.

2. Middle and upper income families and individuals would become net contributors to government.

3. The lower the income of the family or individual the greater the relative net benefit obtained from government.

These results are as they should be in a society committed to providing greater equality of opportunity and improving the well-being of those who have the least economic power.

Recognition of Differences in Family Responsibilities

Under the present tax system the individual is treated as the basic tax-paying unit. In our opinion this is too narrow an approach. We believe it is important that the tax system should recognize the existence of the family as the primary social unit. Where there is a family, it is the discretionary economic power of the family, rather than of its separate members, that should be taken into account. In most families incomes are pooled, major decisions are collective, and responsibilities are shared. We therefore advocate a system that treats the family and the unattached individual as the basic units for taxation.

In our opinion, the family should be defined to include husband and wife and, with certain exceptions, minor dependent children. The incomes of the members of the family thus defined should be treated as a unit. Transactions between the members of the family should be ignored for tax purposes. Gifts from one tax unit to another should be brought into the income of the recipient unit. With the exception of certain gifts in support of close relatives, and gifts to recognized charities, the tax system should treat the making of gifts as a discretionary use of income. Therefore, units that make gifts should not have their taxes reduced relative to those that do not.

Although we are convinced that the incomes of all members of the family should be aggregated, tax units with the same total economic power do not have the same fraction of that power available for discretionary use when they have different family responsibilities. To be consistent with our ability-to-pay principles, the taxes payable by units with the same bases but different family responsibilities should reflect these relative differences. The family responsibilities affect the fraction that is available for discretionary use.

This raises three questions:

1. What differences in family responsibilities should be recognized by the tax system?

2. What is the relative difference in the fraction of income available for discretionary use between tax units with different family responsibilities?

3. What specific tax structure provisions should be adopted to bring about the required relative differences in taxes?

The most obvious and substantive differences between tax units that result in differences in the fraction of the unit's total economic power available for discretionary use are differences in marital status and differences in the numbers of dependants. In particular, we believe that the system should distinguish between tax units with the following characteristics:

1. Unattached individuals.

2. Married couples without dependent children.

3. Married couples with different numbers of dependent children.

We believe that, in general, a married couple has a smaller fraction of its total economic power available for discretionary use than an unattached individual with the same total economic power. The popular saying notwithstanding, two cannot live as cheaply as one. Therefore, the tax system should allocate a smaller tax to a married couple than to a bachelor with the same income. We also believe that in general when two people with the same income marry, the total tax on the couple should be greater than the sum of the taxes they paid when single. This increase is necessary to reflect the fact that there are some economies to be realized through living together. The basic relationships we accept are illustrated in Table 7-2. 4/

It is our view that an unmarried man with an income of $10,000 should pay taxes that are higher than those paid by a couple with the same income. This reflects our belief that the bachelor has a larger part of his income to spend as he sees fit than has a married couple with the same income. However, should two people, each with an income of $5,000, marry and continue to receive the same incomes, the tax levied on the couple, while less than the tax on an unattached individual with an income of $10,000, should be greater than the sum of the taxes they paid when single. The higher tax on the couple reflects our belief that because of the economies of living together, a larger fraction of the aggregate income of the couple is available for discretionary use than the fractions that applied to their separate incomes before marriage.

TABLE 7-2

ILLUSTRATION OF THE EFFECT OF MARRIAGE ON THE FRACTION OF INCOME AVAILABLE FOR DISCRETIONARY USE

	Single Individuals		Married Couples	
Income Base	$10,000	$20,000	$20,000	$40,000
Assumed Fraction of Income Available for Discretionary Use a/	0.391	0.501	0.397	0.554
Measure of Discretionary Economic Power	$3,910	$10,030	$7,954	$22,154
Assumed Rate of Tax on Discretionary Income	50%	50%	50%	50%
Tax Liability	$1,955	$5,015	$3,977	$11,077
Average Rate of Tax on Income Base	19.5%	25.0%	19.8%	27.7%

a/ These average rates are consistent with the rate schedules recommended in Chapter 11.

Some figures may not be precise due to rounding.

It is also our belief that the relative differences in the taxes imposed on single individuals and couples should change with income. At the bottom of the income scale there are often diseconomies to marriage. Unmarried individuals with low incomes can, for instance, share living accommodation with more than one other person. On marriage, separate accommodation for the couple is generally required, as are expenses associated with the establishment of a household. When the incomes of the individuals are low, these accommodations and household establishment expenses are probably greater than the savings possible on other living expenses. Consequently, we believe that there should be a lower tax for low income individuals, upon marriage, so that the total tax on the couple would in no case be greater than the sum of the taxes on the separate individuals.

At the very top of the income scale, marital status has relatively little effect on discretionary economic power. When two wealthy individuals marry, their total tax should be greater than the sum of the taxes they paid as single individuals to take into account the economies of living together, but these economies are small when compared to their income. The increase in tax upon marriage for such people should consequently be relatively smaller than for individuals with less income who marry. These more complex relationships are considered in greater detail in Chapter 11.

To achieve the desired relationship between the taxes levied on the incomes of unattached individuals and married couples, we advocate the adoption of two distinct rate schedules; one for each type of tax unit. We reject the use of one schedule and the adoption of a fixed exemption or tax credit to differentiate the taxes levied on the two kinds of units. To use one schedule for both kinds of units and a fixed exemption for the couple would be tantamount to the acceptance of the assumption that the extra non-discretionary expenses of a couple not only increase with income but increase at the same rate as the marginal rates of tax increase with income. This we cannot accept. We believe that when the level of income is substantial, the fraction of additional income available for discretionary use is the same for the couple as for the unattached individual. Adoption of an exemption would give an unwarranted tax reduction to upper income couples and would not be sufficiently generous for low income couples.

The adoption of a credit to differentiate the tax on couples and unattached individuals would pose exactly the opposite problem. This would be tantamount to the acceptance of the assumption that the extra non-discretionary expenses of the couple do not increase with income. If a substantial credit were provided, this would be too generous for low income couples and not sufficiently generous for middle and upper income couples.

By adopting two rate schedules a middle ground can be taken, and the relationship between the taxes on unattached individuals and couples can be more precisely adjusted to achieve an equitable result.

We believe that couples with dependent children have a smaller fraction of their total income available for discretionary use than childless couples. The more children the couple have, the smaller the fraction of income available for discretionary use. The first child is, however, more expensive than subsequent children because the living accommodation adequate for a childless couple is often unsuitable for children. However, the same clothing and equipment can often be used for subsequent children.

The actual expenses of parents which arise from the existence of children probably increase with income, but not as rapidly as the marginal rates of tax increase with income. The use of exemptions for children is therefore an inappropriate technique for differentiating the tax burdens between couples with and without children. The adoption of a system of credits probably errs in the other direction. The most refined technique would be to adopt separate rate schedules for tax units with one child, two children, three children, and so on. But additional rate schedules to differentiate couples with different numbers of dependent children would introduce complexities for taxpayers that would not be justified by the relatively small amounts involved. Credits against tax are simpler and the inherent bias of fixed credits would be in favour of low income families as we think it should be. To recognize the greater expenses associated with the first child, a larger credit should be provided for the first child than for additional children.

The differences in the fraction of income which we assume to be available for discretionary use, for couples without children and couples with one child, are illustrated in Table 7-3.

TABLE 7-3

RELATIVE REDUCTION IN AVERAGE TAX RATES TO REFLECT THE REDUCED FRACTION OF INCOME AVAILABLE FOR DISCRETIONARY USE FOR COUPLES WITH DIFFERENT INCOMES, WITH OR WITHOUT CHILDREN

	Low Income Couple		High Income Couple	
	Childless	With One Child	Childless	With One Child
Income Base	$5,000	$5,000	$30,000	$30,000
Assumed Fraction of Income Available for Discretionary Use	0.183	0.143	0.485	0.478
Measure of Discretionary Economic Power	$ 914	$ 714	$14,554	$14,354
Assumed Rate of Tax on Discretionary Income	50%	50%	50%	50%
Tax Liability	$ 457	$ 357	$ 7,277	$ 7,177
Average Rate of Tax on Income Base a/	9.1%	7.1%	24.2%	24.0%

a/ These average rates are consistent with the rate schedules recommended in Chapter 11.

Some figures may not be precise due to rounding.

Recognition of Differences in Specific
Non-Discretionary Expenses

The data given in Table 7-3 reflect the assumed general relationship between income and discretionary income for tax units with different family responsibilities. However, some specific non-discretionary personal expenses are made by some tax units but not by others. The allocation of taxes in accordance with ability to pay requires that tax units with these expenses should pay lower taxes than units with the same family responsibilities and the same income who do not have the same special expenses. At least some part of the following expenses are, we believe, non-discretionary:

1. Extraordinary medical expenses.

2. Gifts to close relatives to provide them with support.

3. The special expenses of working mothers with young children.

It is implied by our ability-to-pay principles that these specific expenses should be taken into account by providing a credit against tax equal to the top marginal rate multiplied by the amount of the expense. This is equivalent to reducing the discretionary income of the tax unit by the amount of the specific non-discretionary expenditures. This can best be explained by a simple example.

Suppose that a taxpayer with an income of $6,250 has a specific non-discretionary expense of $750. Suppose further that the rates of tax are as provided in the hypothetical schedule given in Table 7-1. As can be seen from the table, it has been assumed in constructing the schedule that a taxpayer with an income of $6,250 has $2,520 in discretionary income. With a rate of tax on discretionary income of 50 per cent, the tax on this income would be $1,260. However, if the taxpayer has a specific non-discretionary expense of $750, his discretionary income is $1,770 rather than $2,520. His tax should therefore be 50 per cent of $1,770, or $885, rather than $1,260. By providing a credit equal to 50 per cent of the $750 specific non-discretionary expense against the $1,260 tax liability on an income of $6,250, the net liability would be reduced to $885 as it should be.

The "ideal" approach poses the problem of estimating the non-discretionary component of actual expenses. What part of the money given to a close relative is "support", and what part is a gift? To what extent does a baby-sitter hired by a working mother perform the services of a maid? These impossible valuation problems can be avoided or reduced, while recognizing these non-discretionary expenses, by providing fixed, arbitrary credits unrelated to the amounts actually expended or by placing limits on the amounts of the credits.

The possibility of the introduction of some form of universal and compulsory medicare introduces special considerations with respect to medical expenses as discussed in Chapter 12.

Later in the Report we recommend special credits for the costs of post-secondary education, deductions for charitable donations, and exemption for certain gifts received. These are recommended as incentives in the first two cases and largely as an administrative convenience in the latter case.

BASIC EXEMPTIONS

In arriving at the income levels at which tax liabilities should begin, we have taken into account, as far as possible, the redistributional effects of other taxes, government transfer payments, and government expenditures.

We have not tried to exclude from personal income tax an absolute amount that purports to be the income necessary to maintain a minimum standard of living. The idea that income taxes should not reduce income below "subsistence" is laudable in its intention but, we believe, misconceived. Subsistence has no absolute meaning. It is the relative positions of individuals and families that are important. Furthermore, neither exemptions from tax nor credits against tax can ensure that every Canadian has a minimum income. This objective can only be achieved through increased government transfer payments including, for example, refundable credits against taxes. The income tax system as such cannot be used to help people without income—those who most need the help.

We are convinced, however, that the first dollars of income should not be subject to tax. Clearly the fraction of income available for discretionary use is extraordinarily small for a family with an income of, say, $2,000. Moreover, such a family bears sales and property taxes that are disproportionately large relative to its ability to pay. To reflect our belief that those with low incomes have little if any discretionary power, and to compensate for these other taxes, we recommend two zero brackets: one for unattached individuals and one for family tax units. These zero rate brackets are equivalent to the adoption of exemptions equal to the zero brackets, or schedules of rates that tax income in the first bracket but allow credits that just offset the tax on the first bracket.

It is sometimes argued that exemptions should reflect regional differences in living costs. There is no doubt that in some remote areas of Canada living costs are extremely high because of high transportation costs. In order to attract workers to these areas employers have to pay high wages and salaries. To exempt a higher proportion of the incomes of people living in these remote areas would be, in effect, to subsidize their employers. We think it would be most unwise to hide the real costs of the development of remote areas through a personal income tax exemption. To introduce regional differences into the tax system would, moreover, produce an endless factious debate. If it is government policy to accelerate such development, we would recommend that subsidies be granted openly and explicitly.

ECONOMIC POWER

In order to allocate taxes in accordance with the equity principles we espouse, we must specify a tax base that would estimate consistently the economic power of each individual and family relative to others. There is, of course, a variety of methods by which economic power, the ability to command goods and services for personal use, can be estimated. Some are conceptually pure but impossible to administer; others are readily administered but depart significantly from the spirit of the concept. The problem is to specify a tax base that maintains the integrity of the concept without creating insuperable administrative difficulties.

At a point in time, a person's economic power can be measured by the market value of his net assets 5/. The money he holds and the money he could obtain by exchanging his other assets for money, determines his personal command over goods and services (given prevailing prices).

But this is not a useful measure in our context. If the tax base of each taxable unit were measured by the market value of the unit's assets, excluding human capital, 6/ on a given date each year, the units that derived all of their income from personal effort could easily arrange their affairs so that they received and spent large sums between these dates but yet had no marketable assets on these dates. Such a tax-planning prodigal who received employment income could arrange to have little if any economic power on the crucial date if such a measure were used, despite the fact that he had exercised economic power whenever he consumed goods and services during the year. The financial or physical assets of the saver would, however, be taxed year after year.

These problems can be avoided by measuring all changes in economic power over a period of time rather than economic power at a particular point in time. The choice of any time period is inherently arbitrary. The conventional choice is, of course, the calendar year. Using this unit of time, a tax unit's economic power can be measured as the sum of the following: 7/

1. The market value of the goods and services used up by the tax unit during the year to satisfy its own wants (consumption).

2. The market value of the goods or services given to other tax units during the year (gifts).

3. The change over the year in the market value of the total <u>net</u> assets held by the tax unit (current saving = change in net worth = change in wealth). This may be either a positive or a negative figure in any time period.

Given our definition of economic power there can be no doubt that item 1, consumption, should be included in the annual tax base. This measures the goods and services that the tax unit actually commanded over the year. The value of gifts made by the tax unit to other tax units, item 2, are included because they represent consumption goods and services the tax unit could have commanded in the year had it chosen not to transfer this command to someone else. The making of a gift is a form of exercise of economic power. Inclusion of item 3, the change in the market value of the unit's net assets over the year, would result in taxing the change in the potential command over goods and services after taking into account the command actually exercised during the period.

By taxing in each year the actual consumption plus the change in potential consumption over the year, rather than the potential at some point of time during the year, the tax base given above avoids the valuation of human capital and avoids the repeated taxation of the same net assets year after year. This is not to deny that taxing this base involves taxing additions to assets and also taxing the returns that may later be earned by these assets. By taxing the change in net assets each year, from the beginning to the end of each person's life, the system would succeed in taxing all the tax unit's wealth once, but only once.

It is not suggested that this concept of the tax base should be written into the Canadian taxing statute. For a number of reasons that we discuss in Chapter 8, this concept must be reformulated and modified to arrive at an administratively feasible tax base. But if these practical problems are ignored for the moment, one of the main points we want to make can be seen. The proposed tax base must of necessity take into account all of a person's net gains over the year. All gains, after meeting the expenses necessary to generate them, must be reflected in the base because all of them must be disposed of in one of the three ways we have specified in the tax base. The distinction between wages, interest, dividends, business income, gains on shares, bequests, sweepstake winnings, and so on, all would disappear. Because it encompasses more than the present tax base, we have called our new concept the "comprehensive tax base".

We believe that the comprehensive tax base would measure the relative economic power of individuals and families on a consistent basis. Its very consistency would in fact produce a radical change from the present income tax base. Whether one wishes to consider it as a great broadening of the concept of income or as a fundamentally different tax base is of little consequence. Certainly we do not think that anything is to be achieved in this context by a debate about the meaning of words. It ultimately does not matter whether capital gains, gifts and bequests are or are not called "income". What does matter is that these things increase the economic power of those who are fortunate enough to receive them, and therefore should be taxed like wages, salaries, rent, dividends, interest and so on. If economic power is increased it does not matter in principle whether it was earned or unearned, from domestic or foreign sources, in money or in kind, anticipated or unanticipated, intended or inadvertent, recurrent or non-recurrent, realized or unrealized. When we use the term "income" in the context of the tax system we are proposing, we mean the comprehensive tax base as we have just described it.

Our acceptance of the comprehensive tax base is an implicit rejection of the allocation of taxes in accordance with either wealth or consumption. We want to make our reasons for rejecting them explicit.

Consumption Expenditure as a Tax Base

To tax consumption expenditure rather than the comprehensive tax base would in effect exempt current saving, that is, additions to wealth, from tax. If adequate aggregate demand were maintained, this exemption probably would increase, although not dramatically, the rate of domestic saving. This in turn would increase the rate of capital formation or reduce Canada's reliance on foreign saving. In either case the future output of goods and services available to Canadians would be increased. As we stressed in Chapter 4, however, this improvement in the future economic welfare of Canadians would not be costless; until Canada realized the potential growth rate that could be achieved virtually without cost, it would seem foolish to recommend that domestic saving be increased in this way. Even if a higher saving rate were required to meet a target growth rate set by government, there are alternative methods by which domestic saving could be increased more equitably. These are discussed in Chapter 4. We can see no reason on equity grounds to discriminate between the dollar destined for consumption and the dollar destined for the acquisition of property rights and interests.

For the vast majority of people, the choice between the comprehensive tax base and a consumption expenditure tax base would probably affect little more than the timing of their taxes. Most of us come into the world with nothing and leave it in much the same state; we neither make nor receive significant gifts; we neither inherit nor leave large estates; over our lives our consumption expenditures approximately equal our income. A more favourable tax treatment of saving would be unlikely to induce most of us to accumulate wealth so that we could give or bequeath it to others. The taxation of consumption rather than income, broadly defined, would therefore serve but to shift the tax burden from middle age, when saving usually is at its peak, to youth and old age when funds are usually being borrowed or assets drawn down. We are convinced that there is no justification for a tax change that would produce this result.

There are, of course, a few people who give or bequeath substantial wealth which has been accumulated out of their lifetime income. The move from income to consumption taxes would reduce their tax burdens relative to those of others. For this small group such a change would certainly tend to encourage saving, except for those who are saving toward a target amount. But we are doubtful whether it would make a significant difference in the number of people who want to accumulate wealth for these purposes or in the amount of wealth accumulated. In any event, we do not believe that the person who is putting funds aside for gifts or bequests has a smaller taxable capacity than another person in the same circumstances and with the same income who does not. We therefore reject consumption expenditure as a tax base.

Wealth as a Tax Base

We have suggested earlier in this chapter one of the reasons why we reject wealth as a tax base. If it were practical to define wealth to include human assets, and if human assets were traded in the market on the same basis as physical and financial assets, we acknowledge that wealth would be a good indication of economic power at a point in time. But in a free society human assets are not treated like other assets. The problems of valuing such assets are great and they cannot be "liquidated" to satisfy a tax liability. Yet to ignore human assets would grossly understate the ability to pay of those who earn and immediately spend employment income.

Furthermore, even if human capital could be included with other assets, to tax both additions to assets (saving), and then to tax repeatedly the stock of assets, while failing to tax consumption, would seriously discriminate against one disposition of the income generated by assets relative to another. For example, suppose there are two men each of whom has a net worth (including human capital) of $200,000. Suppose that no taxes have been paid by either in the past. If the government had to raise $10,000 from them now, it would seem reasonable that each should pay an equal tax of $5,000. Let us suppose that over the following year each earns $10,000 in cash, but one consumes the whole $10,000, while the other spends $5,000 on consumption and saves $5,000. The larger spender ends the year with a net worth of $195,000; the saver ends the year with a net worth of $200,000. If wealth were used as the index of ability to pay the spender would have less ability to pay than the saver. But we can hardly ignore the fact that both received the same increase in economic power during the year. On equity grounds we cannot justify exempting the dollar destined for consumption any more than we can justify exempting the dollar destined for saving.

While we do not think it would be appropriate to recommend exempting savings from tax by placing greater weight on consumption taxes relative to income taxes, we are equally opposed to taxing saving more heavily by imposing taxes on wealth as such. Such a wealth tax would, we believe, not only be inequitable but would also tend to reduce the rate of domestic saving and thus reduce the rate of capital formation or, alternatively, increase Canada's reliance on foreign saving.

Imposing taxes on the comprehensive tax base each year, as we propose, would tax all additions to wealth. Over time, all of a man's wealth would be taxed, but only once. This is substantially more stringent than the present system under which increases in economic power from some sources are not taxed at all.

There are, we acknowledge, some legitimate grounds that can be advanced for taxing wealth as such. First, by levying a low rate of tax on all net worth at regular intervals, the owners of property would be put under pressure to hold assets that yield a high cash return. If administratively feasible, it also would tend to compensate for the exclusion from the comprehensive tax base of imputed income derived from owner-used property. Secondly, a net worth tax could be imposed to increase the redistributive effect of the tax system.

It may be thought by some that a top personal rate of 50 per cent would not result in a sufficiently progressive tax system despite the great broadening of the base that we recommend. If still greater progressiveness in the tax system were desired, a net worth tax at a low rate, say, 2 per cent, levied on net assets over $1 million every few years would probably be administratively feasible and would increase the redistribution effects of the tax system while retaining the 50 per cent top personal rate 8/.

We do not recommend such a net worth tax because we do not want to penalize saving and because we are convinced that the comprehensive tax base with the rate structure we recommend would achieve an adequate degree of progressiveness in the tax system. On the other hand, if more progression were required, we would prefer to see the imposition of such a net worth tax rather than the acceptance of a top marginal personal rate that was much above 50 per cent.

Consumption and Wealth Taxes
as Methods of Collection

Acceptance of the comprehensive tax base as the best indicator of economic power does not mean rejection of all taxes on wealth and on consumption. Property taxes and retail sales taxes, to name but two important variants of wealth and consumption taxes, have sufficiently useful attributes to justify their continued existence. In particular, we think it is important that each of Canada's three levels of government have a tax source over which it has primary control, although we do not mean to suggest that each level of government should rely exclusively on one type of tax. The present arrangement under which the municipalities rely extensively on property taxes and the provinces rely extensively on retail sales taxes has a great deal of merit because it gives each level of government a degree of fiscal autonomy and hence fiscal responsibility. While we think it important that there should be more joint decision making between the federal and provincial governments with respect to sales taxes and income taxes, this is not inconsistent with the idea that each level should administer one major tax.

From the point of view of equity, however, we believe that wealth and consumption taxes, other than those imposed on a fee-for-service basis, should be methods of collecting taxes rather than independent levies. Ideally, therefore, taxpayers should be given full credit for some portion of consumption and wealth taxes against their tax liabilities determined by a progressive rate structure applied to the comprehensive tax base. These credits for consumption and wealth taxes should be refundable to the extent that they exceed income tax liabilities. The credits would have to be arbitrary in amount for two reasons. First, it would be impossible to measure the actual consumption taxes paid by a particular taxpayer or the proportion of property taxes levied on a fee-for-service basis, or the property tax component of residential rents. Second, the federal government should not be put in the position of having to raise its taxes every time a province or municipality raises its own, thereby increasing the federal credit required.

We have decided not to recommend this arbitrary refundable credit for sales and property taxes. To do so would be to recommend, in effect, the adoption of a negative income tax. As we have suggested earlier, we strongly recommend that the transfer system as a whole be reviewed. The present system is cumbersome and has important gaps and there is some overlapping. The advantages and disadvantages of a negative income tax can only be appraised in this wider context.

It must be recognized that the full integration of all of these taxes would require a dramatic increase in marginal rates. These higher rates might have substantial disincentive effects that would have to be weighed against the improvement in equity that would be attained.

There is, however, a middle ground between complete integration and no integration of these taxes. By gradually reducing the relative weight of consumption and property taxes in the system, by reducing or compensating for the regressive features of sales taxes, and by reducing the weight of personal income taxes on the lower income brackets, Canada can move closer to the objective of allocating taxes according to ability to pay. We are recommending that a start should be made on all of these fronts. Subsequently, more could be done by increasing the width of the individual and family unit zero rate brackets, or by adopting a system of refundable tax credits in lieu of these zero brackets so that those in the lowest income brackets would obtain a refund (admittedly arbitrary in amount) of sales and property taxes.

We want to emphasize that either course of action would be consistent with our basic approach. Certainly implementation of the second alternative would represent the natural evolution of the tax system we are proposing.

The Income of Organizations as a Tax Base

It is sometimes argued that legal entities and institutions such as corporations and trusts, which we will call intermediaries, have tax-paying capacity. With our concept of ability to pay this cannot be so. For us, tax-paying capacity arises from discretionary economic power, and intermediaries cannot have discretionary economic power—the residual power to command goods and services for personal use. Consumption is a strictly human trait. But the question is not simply definitional; all the assets and net receipts of intermediaries are ultimately held by, or accrue to the benefit of, natural persons. What happens to intermediaries necessarily affects the interests of natural persons whatever the intention. Here too, taxing intermediaries is a convenient collection technique but the ultimate burden is on people. Because there are good and sufficient reasons why income taxes on resident organizations cannot be abandoned (as discussed in Chapter 19), we are convinced that the taxes levied on the incomes of resident organizations and resident individuals should be fully integrated through the provision of a refundable tax credit for the tax paid by corporations and other intermediary organizations against personal income tax liabilities.

Our principles concerning ability to pay relate primarily to residents of Canada and our recommendations reflect this. It is not ordinarily possible or appropriate to measure the tax liabilities of non-residents with respect to Canadian source income by reference to this ability to pay.

Accordingly, for a variety of reasons outlined in Chapter 26, we recommend that, in general, income derived from Canadian sources by non-residents should be subject to withholding taxes at arbitrary rates and that non-residents should not receive refundable tax credits for taxes paid by corporations or other organizations in which they hold interest. However, we believe that in some specified circumstances it is feasible and appropriate to give non-residents the opportunity to have their tax liabilities determined by reference to their ability to pay. We recommend in Chapter 26 that in these circumstances they be given the option to file tax returns as Canadian residents.

CONCLUSIONS AND RECOMMENDATIONS

1. Government expenditures should be financed through taxes allocated according to ability to pay, except in those instances where the direct benefits from a good or service provided by government can be readily allocated to particular individuals in a way that would be generally accepted as fair and where any indirect benefits to others are minor.

DEFINITION OF ABILITY TO PAY

2. The allocation of taxes in accordance with ability to pay requires the proportionate taxation of the discretionary economic power of families and unattached individuals. Discretionary economic power is defined as:

    a) the total power of the unit to command goods and services for personal use; less

    b) the power necessarily exercised to maintain the appropriate standard of living of the unit relative to other units.

3. The fraction of a tax unit's total economic power which is available for discretionary use, relative to the corresponding fractions for other units, is, we believe, determined by relative differences in income, family responsibilities and certain specific non-discretionary expenses.

RECOGNITION OF DIFFERENCES IN INCOME

4. Up to a limit, the greater the total income (as measured by the comprehensive tax base) of the unit, the higher is the fraction of that

income which is available for discretionary use. Beyond that limit, all of the unit's income is available for discretionary use. Below that limit, equal percentage differences in income are associated with equal differences in the fraction of additional income available for discretionary use.

5. Taxes can be allocated among units with the same family responsibilities and the same special non-discretionary expenses in proportion to their respective abilities to pay by imposing on a base that measures the total economic power of each unit a schedule of progressive marginal rates of tax where:

   a) the top marginal rate of tax is reached at $100,000;

   b) brackets encompass equal percentage differences in income;

   c) marginal rates rise by equal amounts from bracket to bracket; and

   d) the top marginal rate is equal to the rate of tax on discretionary economic power and is determined by revenue requirements.

6. Combined with a transfer-expenditure system that provided greater benefits for those with the lowest incomes, the adoption of a tax system with the characteristics we have just described would redistribute goods and services in favour of those at the bottom of the income scale, and would ensure that the costs were allocated in proportion to ability to pay.

RECOGNITION OF DIFFERENCES IN FAMILY RESPONSIBILITIES

7. Both families and unattached individuals should be recognized as basic tax units. The incomes of the members of families should be aggregated for tax purposes. Transfers between members of the same family should not be subject to tax; gifts from one tax unit to another should be brought into the tax base of the recipient unit but should not be deductible by the donor unit.

8. To reflect the heavier responsibilities of a married couple, the tax payable by such a couple should be less than the tax payable by an unattached individual with the same income.

9. To reflect the economies possible when two individuals with substantial incomes marry and live together, the tax on the couple should be greater than the tax on two single individuals each with half the income of the couple. To reflect the extra costs arising upon the marriage of two individuals with low incomes their total tax should be reduced.

10. The desired differences in treatment reflecting different abilities to pay can be achieved by the adoption of two rate schedules, one for families and one for unattached individuals.

11. Couples with dependent children have heavier responsibilities than childless couples, and the taxes allocated to the former should therefore be less than those allocated to the latter. This can be achieved by adopting fixed credits for dependent children, with a larger credit for the first child.

RECOGNITION OF DIFFERENCES IN SPECIFIC NON-DISCRETIONARY EXPENSES

12. Tax units that have extraordinary medical expenses, support close relatives, and have special expenses because the mother works should pay lower taxes than comparable units that do not have these specific expenses. To conform to our ability-to-pay principles the relief should be provided in the form of a tax credit equal to the assumed non-discretionary component of these expenditures times the top marginal rate of tax. There are, however, administrative problems in applying the "ideal" method.

BASIC EXEMPTIONS

13. Income in the first bracket should be free of tax, partially to compensate for sales and property taxes, for which credit is not given against income tax liabilities and partially because the first few

hundred dollars of income are not available for discretionary use. The width of this zero rate bracket should not purport to exempt a minimum subsistence income from tax nor should it vary with regional living costs.

THE COMPREHENSIVE TAX BASE

14. To avoid both understating the total economic power of those individuals whose major asset is human capital and the repeated taxation of the same physical and financial assets, we recommend that the tax base should include the change in each tax unit's economic power each year. This is defined to include:

a) the market value of the goods and services used up by the tax unit during the year to satisfy its own wants (consumption);

b) the market value of the goods or services given to other tax units during the year (gifts); and

c) the change over the year in the market value of the total net assets held by the tax unit (current savings = change in net worth = change in wealth).

We have called this the comprehensive tax base because it includes, in principle, all additions to economic power without regard to source, intention or form, and whether consumed or saved. In Chapter 8 this concept is reformulated and modified to arrive at an administratively feasible tax base.

WEALTH AND CONSUMPTION AS TAX BASES

15. Independent taxes on consumption and on wealth are inconsistent with our ability-to-pay principles except when applied on a fee-for-service basis. They should therefore either be abandoned or integrated with personal income taxes. Abandoning these taxes would be undesirable because each level of government should have a revenue source for which

it is primarily responsible. Full integration would require dramatic increases in marginal rates that could have adverse economic effects. However, partial integration of sales and wealth taxes with personal income taxes could be achieved by providing a refundable arbitrary credit against personal income taxes. To recommend the adoption of a refundable tax credit for these taxes would be to recommend the adoption of a negative income tax. The advantages of such a system should be carefully considered in the context of a review of the transfer system as a whole. We have not extended our inquiry into this area and, therefore, we are not prepared to propose the adoption of negative income taxes.

THE INCOME OF ORGANIZATIONS AS A TAX BASE

16. Intermediaries such as corporations and trusts should not be regarded as entities with tax-paying capacity. It should be recognized that the taxes they pay are borne by people, and accordingly there should be integration of the taxes on resident individuals and families with the taxes imposed on intermediaries. This can be achieved by providing a refundable tax credit to resident shareholders for the income taxes collected from organizations.

17. It is not feasible to measure the ability to pay of non-residents except in certain specified circumstances. Accordingly, in general income derived from Canada by non-residents should be subject to withholding taxes at arbitrary rates and non-residents should not receive refundable tax credits for the income taxes paid by organizations.

REFERENCES

1/ It is sometimes argued that when taxes are allocated among individuals in proportion to, or in increasing proportion to, income this is the best crude apportionment of taxes according to overall benefits received. If this theory is correct, the sharp distinction between benefit and ability-to-pay taxation disappears.

2/ This limit is obviously arbitrary.

3/ This is equivalent to the statement that marginal rates of tax plotted against the logarithm of income constitute a straight line.

4/ For an extensive survey of the tax treatment of the family in many other countries, and a discussion of the propositions in the text, see O. Oldman and R. Temple, "Comparative Analysis of the Taxation of Married Persons", <u>Stanford Law Review</u>, Vol. 12, 1960, pp. 585-605.

5/ Also called net worth or wealth.

6/ For all practical purposes it is impossible to measure the market value of each man's human capital, that is, the present value of his future net earnings arising from his strength, skill and knowledge.

7/ This is a modification of the definition of income advocated by H. C. Simon, <u>Personal Income Taxation</u>, Chicago; University of Chicago Press, 1958, p. 41, following the definition of R. M. Haig.

8/ Retaining the top personal rate of 50 per cent is highly desirable because only if the top personal rate is approximately equal to or less than the tax rate levied on corporate income is the full integration of corporate and personal income taxes feasible. We could not countenance an increase in the rate of tax levied on corporations, both because of its depressing effects on domestic investment and because of the international ramifications.

CHAPTER 8

BASIC FEATURES OF THE COMPREHENSIVE TAX BASE

The present chapter serves as an introduction to the application of the comprehensive tax base in a working income tax system. Its main purpose is to reformulate the comprehensive tax base to take account of some of the limitations imposed by practical considerations, and to examine the implications of the comprehensive tax base in several broad areas where decisions are crucial to the later application of the concept. The general conclusions stated in this chapter are developed in more detail in subsequent chapters.

THE COMPREHENSIVE TAX BASE REFORMULATED

The comprehensive tax base has been defined as the sum of the market value of goods and services consumed or given away in the taxation year by the tax unit, plus the annual change in the market value of the assets held by the unit. It would be futile to write such a definition into a taxing statute because it does not provide sufficient delineation, either to taxpayers or tax administrators, to make compliance and enforcement possible. In particular, it would be impossible to measure directly the value of the goods and services consumed by each Canadian individual or family each year. Similarly, an annual valuation of all assets is impractical.

Fortunately, the comprehensive tax base can be restated in such a way that most of the compliance and enforcement problems can be substantially solved without a major departure from the basic concept. By taxing all the net gains, appropriately defined, of each tax unit on an annual basis, it is possible to achieve the same result as taxing each unit's "consumption plus gifts plus change in net worth", while avoiding the problem of measuring the value of the unit's annual consumption.

The definition of "net gains" is, of course, of crucial importance. The following reformulation of the comprehensive tax base in terms of net gains provides a useful starting point, although we discuss later how this formulation also requires extensive modification, essentially for administration reasons:

1. The tax base of each unit would include the annual net gains less net losses, from:
   a) the provision of personal services;
   b) the disposal of tangible or intangible property;
   c) the receipt of gifts or legacies from other tax units;
   d) the receipt of windfalls;
   e) the ownership of tangible or intangible property;
   f) any combination of these "sources".

2. Gains can take one or all of the following forms:
   a) the receipt of cash;
   b) the acquisition of rights to, or interests in, property;
   c) the receipts of benefits in kind as a quid pro quo;
   d) a change in the value of a right to, or an interest in, property;
   e) the personal use and enjoyment of property that could have been rented to others—that is, gains forgone.

3. Cash, or rights to, or interests in, property disposed of by the unit in the expectation of generating or acquiring a net gain should be deducted from the gross gain to determine the net gain or loss.

4. Net gains and losses should be determined on the basis of fair market value.

5. Net gains that could be realized by the tax unit, but are not so realized because the property in question is transferred to another unit as a gift or for an inadequate consideration, should be included in the tax base of the donor, and the amount

by which the consideration is inadequate should be included in the tax base of the donee.

Some of the salient features of the "net gains" formulation of the comprehensive tax base, as we have just defined it, should be emphasized:

1. The tax base would include gifts and bequests received from other tax units. This is appropriate because these amounts represent an acquisition of economic power. In view of this concept, the estate taxes and gift taxes would be withdrawn.

2. The tax base would include imputed income, that is, the gains realized when a person uses or consumes his own personal services or his own property. In most circumstances, however, as we indicate later, the valuation and administrative problems involved in including such amounts in income are insuperable.

3. The money value of gains in kind would be included on the same basis as money gains. This will be discussed later in this chapter. Here, too, there are valuation problems.

4. When the market value of rights to, or interests in, property changes, the tax unit has a net gain or loss, according to our formulation of the comprehensive tax base. This means, in effect, that gains and losses would be included in the base on an accrued rather than on a realized basis. Once again we are confronted with serious valuation problems. What in our opinion should be brought into the base is clear; what <u>can</u> be brought into the base as a practical matter is discussed later in this chapter.

5. <u>All</u> of the expenses reasonably incurred to earn gains, other than personal living expenses, would be allowed as deductions from such gains. Distinctions between the forms of taxable gains, or considerations of whether a gain was actually made, would not be

relevant in determining whether the expenses were deductible. The major question would be when, not whether, the expenses incurred in the expectation of obtaining a net gain would be deducted. Our basic approach to this question of the timing of business deductions is discussed further in Chapter 9 and in Chapter 22.

6. No personal consumption expenditure would be deducted. This follows from the basic concept we have already enunciated, which involves taxing all changes in economic power defined as "consumption plus gifts plus change in net worth". The need to prevent the deduction of personal consumption expenditure has some far-reaching consequences. Three of the more important can be briefly described:

a) A tax unit which makes gains cannot be allowed to deduct from those gains general living expenses. The problem of separating the expenses incurred to earn income from the general expenses of living is discussed in Chapter 9.

b) The net losses incurred in operating a "business" where there is no expectation of earning a net gain from the business, even in the long run, should not be deductible from income derived from other sources. The presumption must be that the owner is obtaining personal satisfaction from operating the business and that the losses of the business are therefore disguised personal living expenses. This problem will be discussed in Chapter 9 and Chapter 22.

c) Gifts are not expenses incurred in the expectation of generating net gains and should not be deducted from gross gains or receipts.

SOME GENERAL IMPLICATIONS

In the remainder of this chapter we consider the full implications of the comprehensive tax base for several stubborn general questions of income definition and taxation. The general areas we consider are: depreciation of human capital; benefits in kind; transactions not at arm's length; imputed income; realization of gains; and intermediaries.

Depreciation of Human Capital

The health, strength, knowledge and skills of individuals can all be included under the designation of human capital. It has been suggested that human capital should be treated like other productive assets for tax purposes. Under such an approach the returns from employment would be reduced by the expenses of maintaining the worker, and depreciation would be allowed on the worker's health, strength and knowledge in order to arrive at the taxable net return. This approach is, we believe, inappropriate for a tax system. The whole purpose of depreciation is to allow the recovery of costs incurred in order to determine the net return. While no one would deny that raising a human being involves costs, the costs usually are borne by the parents and society as a whole, and would not have been borne by the individual claiming the deduction (as they are when physical assets are acquired).

Furthermore, there would be insuperable administrative problems, because a worker's expenditures on his own maintenance could not be separated from those he incurred for his personal satisfaction.

Benefits in Kind

In our reformulation of the comprehensive tax base we specify that benefits in kind must be included in the tax base. Benefits that "save the pocket" obviously increase the economic power of the recipient, just as do cash receipts that go into the pocket. One of the areas of inequity in the present system is the fact that many such benefits, which are untaxed or only partially taxed, are available to some taxpayers and not to others. If benefits in kind are not taxed, the buyer and seller in a transaction can arrange that the seller be remunerated with tax-free benefits in kind with the tax saving divided between them.

Benefits in kind take many forms, ranging from substantial items like the use of a car or a house, life insurance, retirement benefits, provision of board and lodging, discounts on merchandise, and interest-free loans, to trivial items like a free Christmas turkey. Most such benefits arise from employment or from the operation of a business. The gross gain from any transaction can take the form of goods, services or the use of property.

The failure to tax benefits in kind gives tax units that can obtain their remuneration in this form an advantage over others. Furthermore, if some forms of benefits in kind are not taxed, it is equivalent to subsidizing the goods and services that are available free of tax, relative to all other consumer goods and services that can only be purchased from tax-paid income. The subsidized goods and services will be substituted for other goods and services.

When benefits in kind have an established market value, their taxation is a relatively simple matter. The form of the benefit is frequently the result of a specific deal between the buyer and seller and is not shared with others. Frequently, however, these conditions do not exist.

Some of the relevant circumstances cannot be ascertained objectively because it will always be in the interest of the parties to these arrangements to understate the benefits for tax reasons. Because the possibilities of abuse are so great, we are firmly convinced that a very hard line must be taken toward the taxation of benefits in kind. This involves the adoption of several rules:

1. Ordinarily the recipient of benefits in kind should bring into his tax base what the benefits would cost if purchased in the market.

2. The tastes and preferences of recipients of benefits in kind should be ignored for tax purposes. It must be assumed that the recipient had a choice between the benefit itself and the receipt of a cash payment that would have enabled its purchase in the market. To the extent that the benefit is worth less to the recipient than its market cost, he should arrange to receive his remuneration in a different form or obtain additional remuneration to compensate for the tax liability implicit in the receipt of the benefit in kind.

3. Benefits in kind can be received in the course of performing services for a net gain, for example, the food and shelter consumed while out of town on a legitimate business trip. The objective here must be to bring into the individual's tax base:
   a) the extra cost of providing food and shelter that is of better quality or in greater quantity than would usually be purchased by the individual from tax-paid income;
   b) any reduction in personal expenditure that is made possible by being away from home;
   c) any expense incurred to satisfy the individual rather than to produce income.

Because the tax administration cannot possibly determine the style or preferences of each individual, and therefore cannot determine in an objective fashion the value of these benefits, arbitrary standards should be adopted and the value of benefits in kind in excess of these standards should be brought into the tax base of the recipient.

4. Where a common facility provides benefits in kind to a number of individuals simultaneously, the benefit should be apportioned among them, failing which, a special tax should be imposed on the party providing the benefit.

While we recognize that the application of these rules would not be easy or costless, we are convinced that such benefits have thus far not been dealt with adequately. The result has been a lessening in taxpayer morale and loss of faith in the integrity of the tax system. The revenue loss may not be great, but to those who are able to obtain them, tax-free benefits may be very significant. We feel that the law should be made more explicit and that greater administrative effort should be devoted to enforcing the law dealing with benefits in kind. We also recommend later more stringent reporting requirements in this connection for businesses and organizations.

Transactions Not at Arm's Length

When the two parties to a transaction do not have conflicting interests, the prices at which goods and services are bought and sold, or the terms on which they are bartered, may not reflect market values. The terms may be such that one party is, in effect, making a gift to the other. The net gain of one of the parties will be understated if the transaction is accepted at face value. This can occur when, for example, a proprietor of a business employs his son-in-law at a salary that will allow the proprietor's married daughter to maintain her previous standard of living, rather than at the market value of his son-in-law's services. The net income of the proprietor is understated if the gift to his daughter, by way of his son-in-law, is deducted as an expense of the business.

There can be no completely satisfactory solution to the problem of transactions not at arm's length. Our recommendation that the income of husband and wife and dependent children be aggregated for tax purposes will only remove one of the problem areas. In our opinion it is therefore necessary to maintain the test of "reasonableness" for the deduction of business expenses to prevent an indirect gift from being deductible to the donor. Moreover, it is important that the tax authorities exercise vigilance to prevent the understatement of net gains arising from transactions that do not take place at fair market value.

Imputed Income

When an individual who owns productive assets, or who supplies production services, uses them directly to produce goods and services that he consumes himself, it is extremely difficult to value the net gain. The self-sufficient farmer is the obvious example of a man who, in effect, barters his own time and the use of his own capital for the food he eats. But there are a multitude of less obvious cases. The man who occupies a home that he owns, the carpenter who builds his own furniture, and the handyman who repairs the leaky faucet in his own home all receive a net gain in the sense that had each sold his services or rented his property in the market, the gross gain would be taxable, and few, if any, deductible expenses would be incurred in generating the gain. On the other hand, the expenses of having someone else perform the service or of renting the property from others are general living expenses which would not be deductible.

Imputed gains are extremely difficult to cope with under an income tax system. Indeed, in a country where self-sufficiency was generally the case, a broadly based income tax could not be imposed because of the administrative problem of valuing imputed income. Because of the serious valuation problems involved we have concluded that, generally speaking, imputed gains from rendering services of benefit to oneself cannot be included in the comprehensive tax base.

The most prevalent example of an imputed property gain is imputed rent. Thus, for the person who has an investment portfolio and is renting accommodation, the income from the former is taxable while the rent, being an item of personal living expense, is not deductible. If this taxpayer liquidates his investments to acquire a residence, he no longer receives the cash from his investment nor is he required to make the cash expenditure for rent. Nevertheless, his taxable capacity has not been altered, for in effect he still is enjoying the benefit of his capital investment. To ensure that all taxpayers bore their fair proportion of the total tax burden, it would be necessary to impute rental income to this taxpayer.

A similar comparison could be drawn with respect to the ownership or rental of any consumer durable.

The net imputed gain would be equal to the gross rental value of the property less the associated expenses such as property taxes, insurance, depreciation and interest (the "rent" of the capital borrowed to acquire the property).

Obviously, the determination of this net income for owner-occupied dwellings, even if arbitrary rules were established, would be fraught with uncertainty and would entail detailed administrative examination. In fact, it was demonstrated in the United Kingdom, where the taxation of imputed rent ended in 1962 after being an integral part of the tax system for many years, that the problem of assigning a fair market rental value on an equitable basis is virtually insoluble. On the other hand, it must be recognized that the amounts involved are not immaterial 1/ and that they are growing more rapidly than total personal income. The exclusion from income of imputed rent is therefore a substantial tax preference for home ownership.

An incentive of this magnitude leads to inequities between owners and renters. If it were administratively feasible, we would recommend that imputed net rental income be included in the tax base or, to compensate for not doing so, that the deduction of some portion of the rent paid by individuals who do not own their own homes be permitted.

The inequities in not imputing income of owner-occupied homes or in not allowing the deduction of rent are not as extreme in Canada as in the United States. The net rental value is the only part of the benefit which is not included in income in Canada because mortgage interest and property taxes are not deductible in determining taxable income. In the United States the imputed net income is not brought into the tax base, and mortgage interest and property taxes are allowed as deductions from income. This treatment in the United States compounds the problem: it means that taxpayers are allowed to deduct the expenses of generating gains that are not taxed except through the taxation of capital gains. The individual who rents his living accommodation is severely discriminated against.

Because of the administrative difficulty of properly and equitably determining the amount of the net gain, we suggest that imputed rent continue to be omitted from the tax base. Also, because of the administrative complexities involved, we do not recommend the inclusion of any of the other forms of imputed property income.

The foregoing argument has implications for the question of whether municipal taxes should be deductible by home owners. It is often urged that property taxes should be deductible from income on the grounds that this would stimulate home ownership, increase home construction, and make it possible for municipalities to raise more revenue. To the extent that municipal taxes cannot be regarded as a charge for specific municipal services which benefit the property, municipal property taxes are regressive. It can be argued that some relief for such taxes should be granted against income taxes as a deduction or a credit, in order to bring the burden of taxation more closely in line with ability to pay. However, home owners already have an advantage in regard to income tax through the fact that imputed income is not taxed. It may well be desirable to work out techniques that will give municipalities more revenues without raising property taxes, but this objective can be accomplished in other ways that are not so inequitable between taxpayers.

Realization of Gains

Throughout this Report the term realization will be employed to denote the time when there is a disposition of property or when a right to receive income arises. We will later discuss in detail which kinds of transactions will, and which will not, be considered to be dispositions. The word realization will not be restricted to those transactions in which cash has been received or paid, but will also include transactions in which the taxpayer becomes legally entitled to receive, or obligated to make, payment.

The concept of economic power, as we have defined it, clearly calls for including in the tax base not only what the tax unit actually consumes or gives to other tax units, but also the change in the market value of the net assets retained by the unit. Therefore, it is our view that, in principle, unrealized gains should be brought into the tax base. But some rights to, or interests in, property are both unique and infrequently traded, so that it is difficult and expensive to estimate their market value at a particular point in time. Probably the most important and difficult valuation problems are posed by closely held businesses. In addition, taxing changes in the value of assets that have not been sold would in some cases create liquidity problems, for it may be necessary for the individual to dispose of part of his assets in order to obtain cash to meet the tax liability. In many cases this would not be practical, although this problem, to the extent it exists, could be reduced by allowing taxpayers time to pay their taxes. Although we do not believe that the valuation and liquidity problems are insoluble we recommend that at least initially gains should only be taken into the tax base upon realization.

It should be recognized that where only realized net gains and losses are taken into the tax base, it is possible for tax units to postpone taxes. Just as cash in hand is worth more than cash that will be received in the future, so are postponed taxes less costly than present taxes because the cash that would otherwise be turned over to the government can be invested to earn a return until the tax actually has to be paid.

Because tax postponement can be so valuable, taxpayers may be induced to hold property for a longer period than they otherwise would to avoid realization. This "locking in" can also have unfortunate economic effects. Therefore, we recommend that the legislation should be very definite in designating most transactions to be dispositions, and therefore realizations. Thus, virtually all exchanges of property should be treated as leading to realizations. More important, we feel it is imperative that a realization be deemed to take place at least once in each taxpayer's lifetime (or in the lifetime of his surviving spouse) to ensure that postponement does not become indefinite deferment. Therefore, for reasons of taxpayer equity, and to reduce the economic disadvantages of "locking in", we recommend that when an individual makes a gift of property or gives up Canadian residence he should be deemed to have made a disposition of property, except in the case of a gift or legacy to a member of his family unit. When an individual dies a realization should also be deemed to take place, except in the case of property passing to a surviving member of his family unit. If a child comes of age and takes property from his former family unit, there should be a deemed disposition of the property by that unit. The net gain or loss on a deemed disposition or realization would be brought into the tax base of the individual who is deemed to have made the disposition. He would have the opportunity of availing himself of the averaging provisions which we will recommend.

While valuation and liquidity problems are posed by the taxation of unrealized property gains, it is essential to recognize that when we back away from this approach for administrative reasons other complications are created, particularly when the income is earned by an intermediary in which it can be retained in order to postpone personal income tax liabilities.

Intermediaries

If it were possible to bring into each unit's tax base each year the changes in the market value of all its rights to or interests in property, the tax system could ignore the income of intermediaries, such as corporations, co-operatives and trusts, so far as the interests therein of Canadian residents are concerned. By bringing into each unit's tax base what it actually received from these intermediaries, plus the change in the market value of its property rights, the change in each unit's economic power derived from intermediaries would be fully taxed on a current basis. However, the result of backing away from the taxation of unrealized property gains because of valuation and liquidity problems is that if taxes were not imposed on the income of intermediaries, such income could be retained in an intermediary with no tax until distributed. In this event, individuals would hold property of increased market value, but personal taxes would be postponed until the gains were realized through a later distribution, through the sale of the property, or when a realization of the property was deemed to occur. Because postponed taxes are less onerous than present taxes, and because all individuals would not have the same opportunities for postponement, taxes should be levied on the income of intermediaries that is not allocated to individuals. This is necessary in any event in order to tax the income of intermediaries which is attributable to non-residents.

The specific proposals we put forward in this area involve the following:

1. All forms of business intermediaries should be taxed in the same general way, with differences only to reflect specific problems posed by particular kinds of intermediaries.

2. Full credit should be given to resident tax units for the taxes paid by corporations, mutual organizations and trusts on all the income distributed or allocated to them by the intermediaries.

3. Gains realized from holding interests in intermediaries should be taxed at full personal rates along with other types of property gains.

4. The income allocated to tax units should be taxed and the credit for the tax paid thereon by the intermediary should be allowed when it is allocated, even if it has not been received by the unit.

5. The income of intermediaries that is not allocated to tax units should be taxed at the top personal marginal rate, with the exception of income accumulated in a trust for a specific individual, which should be taxed at his rate.

These proposals should substantially eliminate most of the avenues for personal income tax deferment by Canadians. Although deferment would still be possible in the form of unrealized property gains, many of the difficulties and inequities associated with the present system would disappear. The split rate of corporate income tax, with its attendant problems in dealing with associated corporations, would be eliminated, and the many procedures for minimizing personal tax on the distribution of corporate surplus would also become inapplicable. Differences in the tax treatment of various kinds of intermediaries would largely cease so that sole proprietors, partnerships, corporations and co-operatives would all be taxed in a similar fashion. Similarly, various industries would all be taxed on a similar basis; and the taxation of investment income, regardless of the form in which it was received, or the intermediary through whom it was received, would be uniform. The after-tax rates of return on different kinds of assets and from different kinds of economic activities would be subject to essentially the same tax burden, and would not be taxed at a variety of different rates. Thus, it would no longer be so important to arrange one's affairs in the most advantageous fashion to reduce taxes; much of the uncertainty and complexity of the present system would disappear; competitive inequalities between kinds of business, forms of organization, and forms of saving would be substantially eliminated; and the overall equity of the tax system would be immeasurably improved.

CONCLUSIONS AND RECOMMENDATIONS

NET GAINS FORMULATION

1. We have defined the comprehensive tax base as the market value of goods and services consumed or given away in the taxation year by the tax unit, plus the annual change in the market value of the assets held by the unit. This definition must be reformulated in terms of net gains to make compliance and enforcement possible. Our general conclusions with respect to this reformulation are set out in this chapter, to be developed in more detail in subsequent chapters.

2. Under the net gains formulation, the tax base of each tax unit would include the annual net gains less net losses from the provision of personal services, the disposal of property, the receipt of gifts and legacies, windfall gains, the ownership of property, or any combination of the foregoing.

3. Gross gains can take the form of cash, the acquisition of rights to, and interests in, property, benefits in kind or changes in the value of property held.

4. Expenditures (in cash, or transfers of rights to, or interests in, property) made in the expectation of acquiring a net gain should be deductible from the gross gain in determining the net gain or loss.

5. In the case of transactions between persons not dealing at arm's length net gains and losses should be determined on the basis of fair market value.

PERSONAL EXPENDITURE

6. No personal consumption expenditure should be deducted from gross gains. In particular:

a) general living expenses should not be deducted as expenses;
b) the net losses of operating a business should not be deducted from other income if there is no expectation of generating a net gain;
c) gifts are personal expenses and should not be deducted.

VALUATION OF BENEFITS IN KIND

7. Gross gains that take the form of benefits in kind, rather than cash or rights to, or interests in, property, should be taxed in the same way as other forms of gain. When benefits in kind have an established market value, including them in the tax base is a relatively simple matter; but in many cases there are difficult valuation problems. More stringent reporting requirements for benefits in kind are required, and it will be necessary to adopt arbitrary standards where valuations cannot be made consistently and objectively. We recommend the following general rules:

a) Ordinarily the recipient of a non-cash benefit should bring into his tax base the market value of the benefit.
b) It should be assumed that the recipient of the benefit chose it in preference to the cash required to buy the benefit in the market.
c) When goods and services are received in the performance of one's work the tax base should take into account:
   i) the extra cost of providing goods and services of a greater quantity or better quality than would be purchased by the recipient;
   ii) the reduction in personal expenditures made possible by the consumer goods and services provided by others;
   iii) the extent to which the goods and services were provided to satisfy the individual rather than to produce income.

d) Where a common facility provides a benefit in kind to several people simultaneously, the value of the benefit should be apportioned among them or a special tax should be imposed on the provider of the benefit.

TRANSACTIONS NOT
AT ARM'S LENGTH

8. When the parties to a transaction do not have conflicting interests, the prices at which goods and services are exchanged may provide a gift from one party to another. Because gifts are not deductible to the donor it will be necessary to apply the test of reasonableness to expenses to prevent any element of gift from being deducted. In addition, transactions which take place at other than fair market values should generally be adjusted to prevent the understatement of net gains.

IMPUTED INCOME

9. In principle, the income forgone through the personal use and enjoyment of one's own property and services should be brought into the tax base. Experience in other countries suggests that taxing most forms of imputed income, and in particular the imputed rental income of owner-occupied homes, is impracticable because of valuation problems. To fail to tax imputed income of owner-occupied homes, that is, the income forgone by not renting the house, discriminates against the individual or family that rents accommodation. To allow the deduction of mortgage interest or property taxes would compound this inequity.

REALIZATION OF GAINS

10. To be consistent with the principle of the comprehensive tax base net gains on assets should in principle be brought into income annually, whether the gains were realized or not. This would

preclude tax postponement, and if time were provided to pay the tax on the gains, serious liquidity problems could be avoided. Taxing gains on a realized basis allows for tax postponement and may induce holders of property not to realize their gain in order to avoid the tax. Furthermore, if gains were taxed annually, whether realized or not, the postponement of tax through the retention of income in corporations, trusts and mutual organizations would not pose a problem. There would be no reason to collect tax from these organizations except to obtain tax from non-residents and to prevent tax avoidance.

11. We are convinced, however, that the annual valuation of all property is not practical at this time, and therefore, that property gains should be taxed on realization. However, to prevent permanent deferment we recommend that a realization be deemed to occur on making a gift of property or on giving up Canadian residence. In addition, we recommend that a realization be deemed to take place when an individual dies, except in the case of property passing to a surviving member of his family unit. There should also be a deemed realization to a family unit with respect to property which a child takes with him on leaving the unit.

TREATMENT OF INTERMEDIARIES

12. To prevent tax postponement when only realized property gains are taxed we will recommend that the income of intermediaries, such as corporations, co-operatives and trusts, should ordinarily be taxed at the top marginal personal rate. However, resident tax units should be given a full credit for the taxes collected from the intermediary, when the income of the intermediary is distributed or allocated to them. Accordingly, the tax system would be neutral with respect to the form of business organization, there would be no tax advantage in the retention of earnings, and progressive rates of tax would apply to all income.

REFERENCE

1/ Richard Goode, The Individual Income Tax, Washington: Brookings Institution, 1965, p. 123, has estimated that the net imputed rent (after all expenses and depreciation) of owner-occupied dwellings in the United States is about 2 per cent of personal money income. In addition, interest and property taxes are estimated to be 3 per cent of personal money income.

CHAPTER 9

THE PRESENT AND PROPOSED TAX SYSTEMS

In Chapters 7 and 8 we have taken the position that the Canadian system of taxation should reflect the following basic principles:

1. To be equitable, taxes should be allocated according to ability to pay. This in turn would require the application of progressive rates of tax to a tax base that measured changes in the capacity of an individual to command goods and services for his own use, adjustments being made for non-discretionary expenditures of certain types.

2. The tax base should, as a practical matter, be measured by the net value of virtually all receipts, gains and benefits realized during the year.

3. Not only should net gains of all kinds be taken into account for tax purposes, but they should be taken into account equally and none should be taxed at preferential rates.

4. The capacity to command goods and services for his own use is an attribute of the individual. Intermediaries, such as corporations, co-operatives and trusts, do not have such capacity but it is necessary to collect tax from them to prevent postponement of tax by the individuals they represent. Intermediaries should, therefore, be taxed on the comprehensive tax base and the taxation of intermediaries should, as far as possible, be integrated with the taxation of individuals.

In this chapter we propose to consider in a very general way the extent to which the present Canadian federal system of income taxation is consistent with these principles and, at the risk of over-simplification, we propose to indicate how such principles might be applied in the future. The discussion in this chapter will be brief, and subsequent chapters of the Report will deal in greater detail with most of the points we mention here.

AMOUNTS INCLUDED IN THE TAX BASE

The Present System

There has been a federal income tax in Canada since the Income War Tax Act was passed in 1917. The successor statute, under which this tax is currently imposed, is the Income Tax Act, enacted in 1948 and effective for the 1949 and subsequent taxation years.

Receipts, gains and benefits of various kinds are at present brought into income for the purposes of the tax, but in computing income certain amounts may be deducted; income is, therefore, the balance remaining after any permissible deductions are subtracted from what is brought in. Once income has been computed in this manner, concessionary allowances of various types may ordinarily be deducted in computing taxable income, the amount on which the tax is imposed. Examples of concessionary allowances are the deductions based on the single or marital status of the individual, and on the number and characteristics of his children or other dependants, as well as donations to charity, medical expenses and some educational costs.

Under Part I of the Act, tax is imposed on all of the taxable income of residents and certain taxable income of non-residents of Canada. In the case of residents, income from sources both inside and outside Canada is brought into the tax base, but they are entitled to credits against the Canadian tax on such income for foreign taxes paid. If non-residents are employed in Canada, or carry on business in Canada, they are taxed on their taxable income earned in Canada. Non-resident corporations carrying on business in Canada are also subject to a further tax under Part IIIA of the Act. In addition, under Part III of the Act, non-residents are subject to Canadian taxes withheld by the payer in respect of specified kinds of income such as interest, dividends, rents and royalties paid to them by Canadian residents. The taxation of residents on foreign-source income and of non-residents on Canadian-source income is affected by international tax agreements between Canada and a number of other countries. The international aspects of income taxation are dealt with in Chapter 26.

In considering the present concept of income for tax purposes, it is necessary first to deal with what is brought into income. We have already mentioned that in computing income certain deductions may be permitted and that after income is computed certain concessionary allowances may be deducted in determining taxable income. This is the amount that is taxed under the principal charging section of the Act 1/. We shall consider both of these types of deductions in due course.

The first point to be made with respect to what is brought into income is that the word "income" is nowhere defined in the legislation or for that matter in the numerous decisions of the courts in taxation cases. The Act does provide that a taxpayer's income for a taxation year is his income for the year from all sources, and that it includes income from businesses, property, and offices and employments 2/. It goes on to say that income from a business or property is the profit therefrom for the year, subject to other provisions of the Act 3/. The term "profit" is not defined in the Act, but it is well established in legal decisions as meaning profit as determined under recognized accounting practices, 4/ subject to the express provisions of the statute and to any decisions of the courts to the effect that particular accounting practices do not apply for tax purposes 5/. The Act also indicates with some particularity what constitutes income from an office or employment 6/. In fact, these three sources produce the great bulk of the income taxed under the Act. The determination of what gains constitute income from one or another of these sources has been the subject of many decisions of the courts. We discuss employment income in Chapter 14, income from property in Chapter 15, and business income in Chapter 22.

Apart from the general provisions referred to, there are many sections of the Act which bring receipts, gains and benefits of various kinds into income 7/. Some of these amounts would doubtless be taxed in any event as income from one of the three enumerated sources previously referred to. Others have been specifically taxed under Canadian tax legislation from the outset. Still others have been added over the years on a piecemeal basis to preserve the integrity of, or to add to, the tax base. There have been a good many instances of additions since the enactment of the present Act in 1948. 8/ A number of receipts, gains and benefits, which are generally of a minor nature, are expressly excluded from income under the Act 9/.

The general provision in section 3 of the Act that "income" is income from all sources is susceptible of a very broad interpretation and might have permitted the bringing into tax of receipts, gains and benefits not expressly referred to in any of the specified sources mentioned in the Act. In fact, the corresponding provision of the Income War Tax Act 10/ and the present provision have been given very limited significance in the administration of the legislation and in their interpretation by the courts. The result is that, with few exceptions, to constitute income in Canada today an amount must either be derived from one of the three main sources mentioned or be of a type that is expressly brought into tax under the Act.

The Distinction Between Capital and Income. One of the fundamental rules of the present Canadian system is that a distinction must be drawn between gains of an income and those of a capital nature. Only the former are brought into tax. Capital gains have never been taxed under Canadian income tax law, although some gains that had at certain times been regarded as being of a capital nature have lost that character by legislative amendments or by court decisions. The exclusion of capital gains from tax is not provided for in the legislation, and the terms "capital" or "capital gains" are not defined therein; but the principle of the exclusion is clearly established in decisions of the courts.

The most important application of this general rule is that gains arising from the disposition of property, other than in the course of business, are not ordinarily taxable.

However, there are many types of gains that do not necessarily arise from the disposition of property but which may be treated as being of a capital nature and are therefore not regarded as income. Thus, compensation for loss of an office or employment, which is now treated as income, was not originally taxable. However, by statutory provision, retiring allowances which include compensation for loss of office or employment must be brought into income 11/. The proceeds of life insurance policies are ordinarily treated as capital receipts. Also, the position under the decided cases appears to be that under most circumstances if indebtedness of a business nature is forgiven, the amount forgiven is not income of the debtor 12/.

Many other amounts may be treated as income or capital, depending on the circumstances; examples are premiums for the granting of leases, discounts or premiums on loans, amounts received as a result of the breach or cancellation of a contract, the proceeds of insurance (apart from life insurance), foreign exchange profits, payments of damages, government subsidy payments, and the proceeds of expropriation of property. This list is by no means exhaustive. In many cases difficulties have arisen in determining whether particular gains, in the circumstances of particular cases, are properly regarded as being of an income or of a capital nature, and disputes of this sort continue to arise.

Other Gains Not Brought Into Income. Other items which are not treated in Canada as income include gifts and inheritances, and receipts of a windfall nature such as lottery prizes and winnings from occasional bets.

Influence of the United Kingdom. In considering the Canadian tax system, it is desirable to keep in mind that it has been greatly influenced by the tax system of the United Kingdom. Income tax was introduced in the United

Kingdom in 1799 and has been imposed there without interruption since 1842. The word income is not defined in the legislation, but the tax applies to income from particular sources and to other designated types of receipts. There are basic similarities, although there are also significant differences, between the tax bases in the two countries. The United Kingdom legislation as amended over the years has been extensively interpreted in judicial decisions. These decisions have had persuasive effect in the Canadian courts, with the result that many of the principles and rules established in United Kingdom jurisprudence have been followed in Canada 13/. The same is true to a lesser extent of decisions of tribunals in other parts of the Commonwealth.

The influence of the United Kingdom system may serve to explain why, as indicated above, the broadly worded "sweeping-up" clause in the Canadian Act "income from all sources" has had little real significance. Under the United Kingdom statutes only amounts of a specified type or referable to a specified source are subject to tax. The only provision in the United Kingdom legislation 14/ which might have been treated as a broad sweeping-up clause, bringing additional types of income into tax, has been given a restricted interpretation by the United Kingdom courts. In other words, the fact that in the United Kingdom only income from the specified sources and receipts of the kinds specifically mentioned were taxable, and the fact that the United Kingdom courts approached taxability with this in mind, probably contributed to the restricted interpretation of the sweeping-up clause in the Canadian legislation.

The distinction between amounts of an income nature and those of a capital nature for tax purposes was established in the United Kingdom long before income tax was first imposed in Canada. Even there, however, the basis for the distinction is not entirely clear. It may be that introduction of an income tax in that country when its economy was primarily agricultural gave rise to the view that income was the yield from a productive source. The British came to regard the basic sources of income, that is, property, businesses, and offices and employments, as things which were inherently productive of income, and as being capital substances from which income emerged 15/. The source itself and the proceeds of a disposition of such a source were capital and not subject to income tax; it was the yield from the source which was income and subject to tax. The analogy often used was that of the fruit and the tree. The fruit (or its value) was income, but the tree (or the proceeds of its disposition) was capital and not income.

Another factor contributing to the distinction may have been the distinction drawn under the United Kingdom law of trusts between the rights of the beneficiaries entitled to the income from, and the rights of those entitled to the capital of, the trust property. There may have been other factors. Whatever its origin, however, the basic United Kingdom distinction between income and capital receipts for tax purposes was accepted by the Canadian courts from the time income tax was first introduced in Canada.

In the United Kingdom, gifts, inheritances and windfalls have not been subject to income tax. Here again, the reason for their original exclusion is not clear, although a contributing factor may have been that gifts and windfalls did not emanate from a specified source held by the recipient. In any event the Canadian practice has again followed that of the United Kingdom.

Influence of the United States. The United States income tax law has had relatively little influence on the taxation of income in Canada. From the point of view of what is included in income, there has been a remarkable contrast between the development of the Canadian and United States systems. The present United States income tax was introduced in 1913, and under the current legislation tax is imposed on "all income from whatever source derived", including a list of specified items. The Supreme Court of the

United States has indicated that under this provision it is prepared to treat all receipts which constitute an accession to a taxpayer's wealth as income, except those receipts excluded by specific provisions of the legislation or by settled custom 16/. The result is that, starting with general words which are quite similar to the Canadian terminology, that is to say, "income ... from all sources", the United States courts have evolved a concept of income which embraces all accessions to wealth except those expressly excluded in the legislation. However, the Canadian courts have tended to bring into tax little which is not income from the three specific sources of income, or which is not brought in by other express provisions of the statute. It may be noted in particular that under the United States legislation, capital gains were held by the courts to be income in the ordinary sense. The preferential rates to which capital gains are now subject in that country were provided for by legislative amendment in later years. It will be noted that gifts and inheritances probably would also be income except that they are expressly excluded from the tax on income under the United States legislation.

Appraisal of Present System. The present Canadian tax system, when examined from the point of view of what is brought into tax, is seriously defective in many respects.

The Act does not contain, nor have the courts in interpreting the legislation evolved, any clear, consistent concept of income. What is brought into income is determined under a collection of rules which have been developed over a period of time, to a considerable extent on an *ad hoc* basis; some of them are statutory, others are based on the practice of the tax authorities in administering the legislation, and still others are based on judicial interpretation of the statutes.

It is clear that many items which increase the economic power of the recipient, that is, his ability to pay, and which in our view should in equity be taxed, are not included in the present income tax base. These include, as we have noted, certain gains from the disposition of property, other capital receipts, the proceeds of life insurance, the benefit arising from the forgiveness of business indebtedness, gifts, inheritances and windfall receipts. Other illustrations of exclusions from the tax base and of the preferential treatment of particular types of income will appear in the chapters which follow. The omission of these items from the present tax base is, we are convinced, most inequitable.

It is not surprising in the circumstances that great uncertainty has existed over the years as to what receipts, gains and benefits are properly regarded as being of an income nature for tax purposes. This has led to continual litigation and to frequent changes in the statute law. It has also meant that in many instances the form rather than the substance of a transaction has been important for tax purposes. By careful attention to matters of form, liability to tax has been avoided or minimized. To cite a simple example, the sale of the assets of a company may lead to substantial tax, while the sale of the shares of the company will ordinarily result in a tax-free gain. We believe that these difficulties, and the resultant inequities of the present system, cannot be overcome without radical changes in the present system. What is required is a new comprehensive tax base.

The Proposed System

We would have preferred, in order to emphasize the radical differences between the comprehensive tax base we recommend and the present concept of income, to use some word other than income to describe the basis for tax. We have not, however, been able to find any obviously suitable word and are conscious that there are arguments for the retention of the traditional term. We will proceed in this Report, therefore, on the basis that what is being taxed under the comprehensive tax base will be termed "income" and that the tax with which we are concerned is an income tax. We will use the terms "comprehensive tax base", "profit" and "net gain" interchangeably with the word "income".

Amounts Included in Income. From what we have said earlier in this and previous chapters, it will be clear that what we mean by income is the net value of virtually all receipts, gains and benefits realized during the year. By this definition we intend to bring into tax the value of the realized changes in the capacity of an individual to command goods and services for his own use. We have also made it plain that intermediaries, such as corporations, co-operatives and trusts, should be treated as having income and should be taxed thereon in order to prevent postponement of tax by the resident individuals who hold residual claims against them and in order to impose tax on non-residents who hold residual claims against them. The taxation of intermediaries should be integrated so far as possible with the taxation of resident individuals. Because we speak of net values, it will be evident that we contemplate that, as under the present system, income will be the balance remaining after certain deductions are taken from the amounts which are brought into income.

It seems to us that in any legislation that may implement our proposals the term "income" should be defined in such a way as to give effect to the basic concept we have just mentioned, that is, to include in the tax base all realized changes in ability to pay. In principle, it should not be necessary to specify any particular kinds of income as being subject to tax, for all net gains, as defined, would be brought in under the general all-inclusive definition of income. However, we think it would be desirable, in order to make the implications of the charging section clear to taxpayers at the outset, to specify explicitly in the statute, without limiting the generality of the initial definition, that particular kinds of income should be taxed. This approach is quite important to ensure that all kinds of net gains are taxable.

Under our approach, what is brought into income under the present system would continue to be taxable, but other kinds of receipts, gains and benefits, some of them of major significance, would also be subject to tax.

Income from the three major sources, business, property and an office or employment brought into tax under the present system would continue to form part of the comprehensive tax base and, in subsequent chapters, we will discuss the taxation of these kinds of income under the present system and under our proposals.

We have mentioned that many kinds of gains not attributable to these three sources are taxed under the present system. We anticipate that such gains will continue to be taxable.

Property Gains. We have referred to the fact that so-called capital gains (gains from the disposition of property) are not now taxable. It is clear to us that such gains add to the economic power or ability to pay of the recipient and that they should be taxed in the same way as other income. The only exception we propose is a lifetime exemption, not exceeding $25,000, on gains from the sale of certain residential, including farm, properties.

The comprehensive tax base would also bring into tax other net gains which have heretofore been treated as of a capital nature. Thus, the profit realized on the sale of a business would be income for tax purposes under the proposed tax system. We will discuss the treatment of life insurance from the point of view of the policyholder and will recommend that eventually the net proceeds of such policies should be brought into income. The forgiveness of business indebtedness adds to the economic power of the debtor and should therefore be treated as income. The distinction now drawn between income and capital receipts with respect to such items as lease premiums, loan premiums or discounts, amounts received upon the breach or cancellation of contracts, the proceeds of insurance other than life insurance, profits on foreign exchange, damage payments, government subsidy payments, and the proceeds of expropriation of property should, we believe, disappear, and all should be brought into the tax base.

Gifts and Inheritances. Gifts and inheritances obviously add to the economic power of the recipient. We therefore recommend that, with the major exception of transfers between members of a family unit and with a number of relatively minor exceptions, they should be treated as income for tax purposes. The present gift tax and estate tax would therefore be abolished. We will discuss the treatment of gifts and inheritances and the related question of the taxation of trusts and their beneficiaries in later chapters.

Windfall Gains. Windfall gains of all kinds should, in our opinion, be included in income. These would include sweepstake winnings and gambling gains.

Source of Income. We have indicated that we propose taxing income of all kinds and we have specified particular kinds of income which we think should be taxed. A taxpayer may, of course, have a number of receipts which constitute income of the same kind. He may, for example, in a particular year, hold a number of properties which are productive of income, operate two or more businesses, receive several gifts, or benefit from government transfer payments of more than one type. We will use the term "source" of income to cover anything that leads to the receipt of income, and we emphasize that we do not confine the term to the United Kingdom meaning referred to previously of a capital substance from which income emerges. It will be necessary for one reason or another under our proposals, as it is under the present law, to determine the income from a particular source for a particular period.

Exclusions from Income. Under our proposals, few net gains would be excluded from the comprehensive tax base. However, we have suggested some exclusions, primarily for administrative reasons, to reduce the record-keeping problems of accounting for small amounts. The most substantial exclusion would arise from the proposed treatment of gains arising from dispositions of certain residential, including farm, properties. We have suggested a lifetime exemption of $25,000 of gains on the disposition of such property. We will suggest that, initially, mortality gains and losses on Canadian life insurance policies which are incurred by the tax unit that paid the premiums should be excluded from income. However, once a transitional period had elapsed, and the impact of our other proposals for life insurance had been assimilated, the net proceeds of life insurance policies (after deduction of premiums paid and investment income taxed) should be brought into income. In addition, we have proposed that small exemptions should apply to the earned income of dependent members of the family unit and to gifts.

We mentioned above that a number of relatively minor items are now expressly excluded from income under the Act 17/. We would like to see most of these exemptions eliminated and will refer to most of them in Chapter 18.

Effects of Adopting the Comprehensive Tax Base. It is our view that the adoption of the comprehensive tax base we recommend would greatly improve taxpayer equity by bringing virtually all increases in economic power into tax. Such a tax base would also have the very desirable ancillary benefit of substantially eliminating the uncertainty, and the various opportunities for tax minimization and avoidance, that we have found in the present system, because virtually all net gains would be taxable to residents at full personal rates. The withholding of tax by intermediaries at maximum personal rates is primarily a collection device, but it does have important additional advantages. Thus, the form in which, or the time when, income is distributed by an intermediary would lose much of its significance.

Methods of Computing Income

Because the income tax is an annual tax, the year in which receipts and expenses are to be brought into account is a matter of importance to the taxpayer and the tax authorities.

Both the cash and the accrual methods of computing income are in common use. Under the cash method, gains are included in income when they are received and expenses are deducted from income when they are paid. Under the accrual method, gains that are receivable, in the sense that the right to receive them has arisen, are brought into income notwithstanding that they have not actually been received. Similarly, expenses which have been incurred, in the sense that the obligation to pay them has arisen, are deducted even though they have not actually been paid.

In determining income for tax purposes, accounting methods are, of course, subject to the express provisions of the taxing statute and to the right of the courts to determine whether or not they are appropriate in the computation of income for such purposes. Under the Act it is expressly provided that certain kinds of income are taxable when received, and it follows that such income is computed, subject to the terms of the Act, on the cash basis. Income from employment is one such instance 18/. Other examples are dividends, annuity payments and pension and similar benefits, but many others could be cited 19/. On the other hand, interest is to be brought in when received or receivable, depending upon the method regularly followed by the taxpayer in computing his profit 20/. In the determination of profit from a business, it is generally accepted that the accrual method is the appropriate method 21/. However, where a taxpayer is engaged in farming or practises a profession, the Act expressly permits him to adopt what is substantially the cash method of computing his income 22/. There has been a reasonable amount of latitude in the choice of a method of computing other kinds of income, provided the method adopted accurately reflects profit and is consistently applied.

We consider that the method of computing income for tax purposes should continue to vary according to the kind of income involved. The methods we recommend are designed to ensure certainty and overall equity between taxpayers. The attainment of the latter objective will require the use of some specific rules to eliminate deferment of income.

We think that in general, income of all kinds, other than from employment, business and property, should be brought into the tax base when received so that, in effect, the cash basis would apply.

Income from employment should in our view ordinarily be taxed when received; but in Chapter 14 we will suggest special rules for the taxation of amounts not actually received by an employee but which have been set aside by the employer for the benefit of the employee.

Income from business should, as we have mentioned, be the profit therefrom for the year, and we think that such profit should be determined under the accrual method in all cases except that in specified cases individuals who derive income from farming or a profession with annual revenue below a specified limit should be entitled to continue to use the cash method.

Our proposals with regard to income from property vary as between gains on the disposition of property and income from the holding of property. Gains on the disposition of property should consist of the excess of the net proceeds of disposition over the cost basis of the property and should be brought into account at the time the disposition occurs or is deemed to occur. Income from the holding of property should generally be included either when it is received or when it is receivable. In Chapter 15 we will, however, propose additional rules with respect to the taxation of certain income, for example, interest, which is set aside for the benefit of a taxpayer although it is not actually received or receivable by him.

The method used to compute a loss from a source should, of course, be the same as the method used to compute income from the same source.

We have pointed out that under the cash method amounts of an income nature are included in income when, but only when, they are received. Unfortunately, there is at present some uncertainty as to what constitutes receipt or realization of income. For example, receipt of a cheque will ordinarily be considered to be receipt of cash, and, similarly, amounts placed to the credit of the taxpayer will usually be regarded as having been received by him if he has agreed to this mode of payment and if the amount is at his disposal. However, this result has not been followed in all cases and some taxpayers have obtained an advantage by manipulating the date of receipt.

In many cases the debtor will be able to deduct the amount owing because he is on the accrual basis, but the creditor will not be obliged to take it into income because he is on the cash basis. In our view this result is inequitable and should be corrected, at least in those cases where the parties concerned are not dealing at arm's length. Accordingly, we recommend that the rules now contained in section 18 of the Act should be amended to provide, in effect, that no taxpayer is entitled to a deduction of any amount payable to a person who is resident or carrying on business in Canada and with whom the taxpayer was not dealing at arm's length, unless in the year of deduction that amount is included in the income of the creditor. Subject to the above modifications, the present provisions of section 18 appear to be satisfactory.

However, the postponement of income through the use of the cash method is not limited to transactions between persons who are not dealing at arm's length. We have mentioned the introduction of special rules concerning employment income and some property income in those cases where the recipient is usually on a cash basis and currently does not record any income until payment is actually received. Such a deferment of tax is inequitable, and either the deduction to the payer should be denied, a tax should be withheld at source, or the beneficiary should be required to include the amount in income. We concluded that one of the latter two alternatives is preferable and later recommend the one that appears most appropriate in each of the cases which we discuss in the relevant chapters.

At the present time it is generally acknowledged that income will arise if it is received in money or in money's worth. The rules which have been developed by the courts, subject to the present statutory provisions, such as section 24, appear to us to be satisfactory.

Another question of general application with respect to the receipt of income will arise when a taxpayer receives an amount subject to an obligation. The general problem in cases of this nature is whether the taxpayer's right to the amount in question is absolute and under no restriction, contractual or otherwise, as to its disposition, use or enjoyment. For example, if property has been left to a beneficiary under terms that require him to pay an annuity to some other person, the general rule is that the beneficiary will be taxable on the entire amount of income, and will not be able to make any deduction for the annuity payments. However, if the property is given subject to a charge or trust to secure payment of the annuity, the beneficiary may be able to assert successfully that, to the extent of the amount charged or held in trust for another, the annuity never formed part of his income and accordingly is not taxable to him. In Chapter 17, we suggest that any payment required to be made as a condition of receiving a gift should be deductible therefrom.

Application of Accounting Practices in
Determining Income from Business or Property

Under the present legislation, income from a business or property, subject to other provisions of the Act, is the profit therefrom for the year 23/. Profit for this purpose has been found by the courts to mean profit as determined under recognized accounting practices, subject to any overriding provisions of the statute or decisions of the courts. In 1948, when the present legislation was being drafted, it was proposed that the Act should include a provision to the effect that, except as otherwise provided in the statute, income from a business or property should be determined in accordance with generally accepted accounting principles. This approach was eventually abandoned in favour of the present provision, in part because of uncertainty as to the accounting principles which could be said to be generally accepted.

Having regard to the passage of time since the present Act came into effect, we thought it advisable to question the Canadian Institute of Chartered Accountants, as a group representative of the accounting profession, as to whether the determination of business and property income for tax purposes should be based on recognized accounting practices. As will appear later, their conclusion was adverse to this approach. We have decided that we should follow their conclusion. A letter from the Canadian Institute of Chartered Accountants is referred to in more detail in Chapter 22 and is reproduced in Appendix A to Volume 4.

Generally speaking, we recommend a somewhat greater reliance on accounting practices. We discuss this in Chapter 22. However, it will still be necessary for the statute to specify some rules with respect to the determination of annual income.

Timing of Revenue. The Act now contains a general prohibition on the deduction of amounts transferred to reserves, except as expressly permitted by the Act 24/. We think that such a provision is no longer necessary because of the development of accounting practices, and we recommend that it should be deleted.

For the same reason, we suggest that the present provisions of the Act dealing with doubtful and bad accounts receivable 25/ and unearned income 26/ should be repealed and replaced by general provisions to the effect that such items should be reasonable. However, specific, statutory provisions may be necessary for instalment sales, guarantees, indemnities and warranties. These matters are discussed more fully in Chapter 22. We also suggest in Chapter 24 that specific provisions be permitted to banks and in respect of mortgages.

DEDUCTIONS IN COMPUTING INCOME

The Present Tax System

We have already pointed out that income for tax purposes is the balance remaining after any permitted deductions are subtracted from what must be brought into the tax base. We have also mentioned that income is not defined in the Act. Nor is there a provision in the present legislation which explicitly confers a general right to deductions and establishes a concept of net income. The legislation does, however, contain provisions permitting some deductions and prohibiting others, either generally or for particular kinds of items. Decisions of the courts have also thrown light on what is, or is not, deductible in particular situations. We will now refer to the principal general statutory provisions of this kind.

<u>In Computing Income from Employment</u>. So far as deductions in computing employment income are concerned, the Act is quite specific. It lists particular deductions which may be taken and states that no other deductions whatsoever may be made in computing such income 27/. It should be noted, however, that there are certain deductions which may be made by an officer or employee in computing income generally in addition to those that relate to the computation of income from his office or employment. Nevertheless, the present restrictions on deductions from employment income are more stringent than those applicable in computing income from business or property.

<u>In Computing Income from Business and Property and Other Sources</u>. Income from a business or property is the profit therefrom for the year 28/. Profit is determined according to recognized accounting practices, subject to any express provisions of the Act and to any applicable legal decisions. Under recognized accounting practices, profits are ascertained by deducting from the income earned the cost of earning it. On this basis, the first step in determining whether a particular amount is deductible in computing income from a business or property is to determine whether it would be deductible in determining profit under recognized accounting practices; if it is not, that is the end of the matter unless the deduction is expressly permitted by the legislation. If, however, the deduction is permitted under recognized accounting practices, it is then necessary to determine whether it is prohibited or limited by any express provision of the Act.

The first provision of the present Act to be considered in this connection is section 12(1)(a) which states that in computing income no deduction may be made in respect of "an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from property or a business of the taxpayer" 29/. The Income War Tax Act provided that in computing profits or gains a deduction should not be allowed in respect of "disbursements or expenses not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income" 30/.

The provision of the earlier Act was quite restrictive and, for business income at any rate, was construed by the courts in a number of cases as precluding the deduction of expenses unless they were, in effect, working expenses directly related to the earning of the income. This narrow construction was, however, not uniformly adopted by the courts. Under the present provision, the prohibition applies to expenditures not made "for the purpose of gaining or producing income". It now seems clear from decisions under this provision that the narrow construction referred to has been overridden. If the purpose of an expenditure bears a reasonable relationship to the production of income, its deduction will not be prohibited by section 12(1)(a). It is not necessary to show a causal connection between such an expenditure and the actual receipt of income 31/. Whether a particular expenditure was made for the purpose of gaining or producing income from a business or property must be determined on the facts of the particular case.

Section 12(1)(a) of the Act is open to the interpretation that it prohibits any deduction in the computation of income unless the income is from business or property. As we have seen, this is because it provides that outlays or expenses may not be deducted except to the extent they are made to gain income from property or a business. If this interpretation is correct, the resultant prohibition on deductions in computing income of other kinds and from other sources is of general application and is subject only to provisions such as sections 5 and 11 which expressly authorize particular deductions from employment income and other income. This interpretation of the effect of section 12(1)(a) was disapproved in a recent Exchequer Court decision 32/. The right of a taxpayer to a particular deduction was considered both on the basis that the expenditure was made in a business venture and on the alternative basis that it related to a source of income other than business, property or employment. The view was expressed in the reasons for judgment that, on the alternative basis mentioned, section 12(1)(a) should not be interpreted as prohibiting the deduction of expenses involved in earning income from sources other than business and property. Under this approach, section 12(1)(a) would be concerned only with income from business or property.

In addition to the restrictions of section 12(1)(a), there are other prohibitions and limitations in the Act which are applicable to expenditures generally, and not simply to expenditures related to particular kinds of income.

The first of these is the provision which prohibits the deduction of capital losses or expenditures or of allowances in respect of depreciation, obsolescence or depletion, except as expressly permitted by the Act 33/. We have seen that the exclusion from income of capital gains or receipts was established in the courts rather than by statute. In the case of capital losses or expenditures, however, there is a statutory denial of a deduction. Such denial extends not only to losses on the disposition of property, but to other losses and expenditures which are regarded as being of a capital nature. Just as certain items on the receipts side are income or capital according to the particular circumstances, many expenditures and losses are of an income or capital nature, depending on the facts of the case. Over the years there has been a very large amount of litigation on the question as to whether particular items were, or were not, deductible under this clause or its predecessor. There is continuing uncertainty in this area.

In some cases where expenditures of a capital nature are made, the asset acquired or the amount expended is eligible for capital cost allowance as permitted under the legislation, 34/ so that the amount involved is deductible over a period in computing income for tax purposes. However, there are a number of types of expenditures which are quite properly made in the course of carrying on business and which are not deductible from income either currently because they are of a capital nature, or over a period of time because capital cost allowance regulations do not apply to them. They have become known as "nothings". We refer to this problem at greater length later in this chapter.

Exempt Income. Another general prohibition on deductions in the present legislation relates to expenditures made to produce exempt income or in connection with property the income from which would be exempt 35/. In practice, the principal importance of this provision is that it precludes the deduction of interest on money borrowed by one resident corporation to purchase shares of another resident corporation because, under the Act, dividends on the shares received by the purchaser are exempt income 36/.

Personal or Living Expenses. Under a further provision of the Act the deduction of personal or living expenses of a taxpayer is specifically prohibited 37/. The provision contains an exception for travelling expenses incurred by the taxpayer while away from home in the course of carrying on his business.

Unreasonable Expenditures. Another statutory restriction on deductions is that which provides that expenditures which would otherwise be deductible may not be deducted except to the extent that they are reasonable in the circumstances 38/. This provision permits the administration to challenge a particular expenditure as excessive but leaves the taxpayer the right to substantiate it in the courts.

Expenditures Which Artificially Reduce Income. The last prohibition on deductions to which we will refer here is the provision that a disbursement or expense may not be deducted if this would unduly or artificially reduce the income 39/. In view of the other restrictions we have discussed it is unlikely that this provision would be applicable, except in extreme cases.

Specifically Permitted Deductions. Having referred to the more important general restrictions on deductions contained in the Act, we must mention that there are other provisions of the Act which expressly permit certain deductions to be made in computing income. Reference has already been made to the fact that particular deductions may be taken in computing employment income. Many deductions are expressly permitted under section 11 of the Act which applies notwithstanding certain of the general restrictions on deductions which we have mentioned 40/. The deductions provided for under section 11 include amounts in respect of depreciation, depletion, interest, doubtful accounts of a business, contributions under employee benefit plans, and alimony and maintenance payments as well as many others. In many cases there are limitations or restrictions relating either to the circumstances in which they may be taken or to the amounts which are deductible. Other sections of the Act also provide for the deductibility of amounts of particular kinds. Many of these provisions will be referred to later in this Report.

Adequacy of the Present Deduction Provisions. Our view is that the present position with regard to the deduction of expenses for tax purposes leaves much to be desired. Deductibility does not appear to be based on any general principle. In the area of employment income the rules are unduly restrictive. In determining income from business or property, the position with respect to the deduction of current expenditures does not now seem to be unreasonable. However, just as we consider that gains on the disposition of property and other capital receipts should be included in income, so are we critical of the principle that losses on the disposition of property and other losses or expenditures of a capital nature are not deductible at some time. It is clearly unreasonable that many of the so-called "nothings" should be denied deductibility either currently or over a period. The confusion and uncertainty which arise as to the deductibility of expenses and losses under the present system seem to be no less than that existing on the revenue side. We think that this confusion and uncertainty will be materially dispelled under our proposals.

The Proposed System

The question of deductions becomes more important when additional kinds of income are brought into the tax base. In keeping with our approach that all income, in the broad sense in which we use the term, should be taxable, it is clear that in principle all expenditures, other than those that confer personal benefits on the taxpayer, should be deductible in the determination of income. The two basic problems in this area are to devise methods of preventing the deduction of personal expenditures and to decide when non-personal expenditures should be deducted. Similar problems exist in formulating principles for the treatment of losses that are both equitable and administratively feasible. The comprehensive tax base logically requires the deduction of all losses unless they in fact represent a type of personal expenditure. The question of when losses should be deductible is just as significant as determining when expenditures should be deductible. The problems of the timing of deductions and the treatment of losses are dealt with under separate headings later in this chapter.

As we discussed in the previous chapter, we consider it important that taxpayers be prevented from deducting personal expenditures in the determination of taxable income. We propose to tax the increase in each taxpayer's capacity to command goods and services for his own use. To allow the deduction of expenses that confer personal benefit on the taxpayer, either because they provide tax-free goods or services for the taxpayer, or because they constitute gifts from the taxpayer to others, would result in a serious understatement of the tax base of some taxpayers. Although the objective is perfectly clear, it is a difficult task to design a simple and fully enforceable system that will preclude the deduction of personal expenses.

In our view the problem should be approached in two ways simultaneously. There should be general rules that deny the deduction of personal expenditures, and there should be specific provisions in the legislation that explicitly deny particular kinds of expenditures where there is likely to be a substantial personal benefit involved. To rely solely upon general rules would make full enforcement virtually impossible; to rely solely upon specific provisions denying deductions would place a premium on the skilful manipulation of the affairs of the taxpayer to avoid the letter of the prohibition.

It seems to us that there are three general rules which should govern the deductibility of expenditures, regardless of the type of income involved. We will deal with each of them briefly here, but their application to income of particular kinds will be dealt with in more detail in subsequent chapters where it will be made clear that the general rules will have to be supplemented by specific rules applicable to income received from certain sources. The first of these rules has both positive and negative aspects in that it contemplates that certain expenditures should and others should not be deductible. The other two rules are essentially restrictive in that they disallow expenditures which might otherwise be deductible.

<u>Expenditures "Reasonably Related" to the Gaining of Income</u>. The first general rule is that expenditures should be deductible only if they are reasonably related to the gaining or producing of income. The positive side of this rule is that all expenditures reasonably related to the gaining or producing of income should be deductible; the negative side is that any expenditures not so related should not be deductible. It seems to us that both aspects might well be reflected in the legislation. We emphasize that under our proposals the present distinction between income expenditures and so-called capital expenditures would disappear and therefore would not affect

entitlement to deductibility, although, of course, questions of the timing of deductions would remain.

The words "reasonably related to the gaining or producing of income" are intended to state a general principle rather than to suggest any specific wording for the statute. We doubt that the terminology now used in section 12(1)(a), which is "for the purpose of gaining or producing income", would be suitable under the comprehensive tax base, even if it were clearly made applicable to income of all kinds and not only to income from business or property. The comprehensive tax base would bring into income such items as gifts which may not result from purposeful activity of the recipient but from which deductions may be appropriate. In any event, we emphasize that whatever words are used should be capable of a broad interpretation so that, subject to any other statutory rules, any expenditure made in the expectation of producing a net gain or as a consequence of an activity or situation which might reasonably be expected to produce a net gain would be deductible.

For a number of reasons, we have concluded that there must be a restriction on deductions of the type implied in this general rule. Cases decided under section 12(1)(a) have shown that taxpayers claim deductions when their relationship to the earning of income is too remote to warrant deductibility under a taxing statute. What constitutes a satisfactory relationship should, we think, be determined on the facts of the particular case. As we have already stated, gifts should not be deductible to the donor, because they are, in substance, expenditures of a personal nature. The "reasonably related" rule should preclude the deduction of that part of an expenditure that constitutes a gift by the taxpayer rather than a payment for goods and services at market prices.

Summing up the position under the first general rule, we think that on the positive side it gives the taxpayer a statutory right to deductibility which is broader than any he now has. On the negative side, it gives the tax authorities a type of residual protection against the deduction of expenditures which the taxpayer may think are reasonably related to the earning of income but which the tax authorities, and, in the event of dispute, the courts, may consider not to be so related. This rule would result, among other things, in the disallowance of some expenditures which are of a personal nature and are not related to the earning of income, and will be supplemented in this respect by our other general rules.

Unreasonable Expenditures. The second general rule is related to the first and would assert that expenditures otherwise deductible should not be allowed to the extent that they are unreasonable in the circumstances. This rule is concerned primarily with the amount of an expenditure whereas the first relates more to the nature of the expenditure. The rule has a parallel in the present legislation, 41/ and we consider that it is also necessary under the comprehensive tax base to prevent tax avoidance.

Expenditures of a Personal Nature. The third general rule is that expenditures of a personal nature, that is, expenditures made for personal use or consumption, should not be deductible. The present legislation prohibits the deduction of personal or living expenses 42/. Under the comprehensive tax base this rule would have a very broad application. Thus, it should exclude the deduction at any time of any part of the cost of the acquisition of property for personal use or consumption, except in computing the gain or loss arising from the disposition of the property. It would also exclude the cost of carrying or maintaining such property. Property acquired for personal use or consumption may, of course, later be used for some other purpose, and vice versa, and we will recommend that there should be a deemed disposition of the property when such changes in use occur.

Application of Rules to Particular Expenditures. We now refer briefly to the application of these rules to expenditures related to employment, to the holding of property and to business. Detailed discussion is contained in the chapters concerned with the major sources of income.

1. We have suggested that there should be a more liberal approach than currently exists to employee expense deductions. We believe that the best way to achieve an equitable treatment of expenses related to employment is generally to apply the same rules to these expenditures as are to be applied to business expenditures. Thus, the present prohibition on the deduction of most employment expenses should be withdrawn, and the three rules outlined above should apply. To reduce the administrative problems of accounting for many small expenditures, we suggest the use of an optional standard deduction of 3 per cent of employment income, with a maximum deduction of $500, in respect of the expenses of earning such income; but we also recommend that the employee should be entitled to substantiate a larger deduction if he can do so. However, there are some expenditures, of which commuting expense is an example, which have some relation to employment but which have been, and in our view should continue to be, disallowed as being more of a personal nature. Therefore, it will be necessary for greater certainty to have specific provisions in the legislation disallowing a number of expenditures that might otherwise be deductible under the general rules.

2. It seems apparent that the average individual acquires much of his property, for example, household furnishings and equipment, for personal use or consumption and not for the purpose of deriving income. Expenditures required to carry and maintain such property should not be deductible. There will, however, be cases where property is acquired partly in anticipation of earning income and partly for personal use. An obvious example is the purchase of a home a portion of which is rented. Here the part of the expense of carrying and maintaining the property which represents an expenditure of a personal nature should not be deductible in computing the income from the holding of the property.

An asset that a taxpayer holds, whether or not it is acquired for personal use or consumption, may be disposed of at a gain. Under the comprehensive tax base such a gain would be taxable (unless it comes within the lifetime exemption for gains on residential and farming property). However, a taxpayer may incur deductible expenditures related to the holding of property which exceed the annual income therefrom and so produce an annual operating loss, although the property is eventually disposed of for an amount exceeding the total costs. For this reason, we later recommend that a taxpayer should be allowed to elect to add certain deductible expenditures related to the holding of property to his cost basis of such properties, rather than to treat them as operating items. Where, however, the property is held for personal use, we do not consider that he should be entitled either to deduct the expenses from operating income or to add them to the cost basis.

3. Problems may also arise for a business with respect to expenditures of a personal nature. The general rules we have discussed would serve to prevent the deduction of most of these expenditures. There are, however, expenditures (other than normal remuneration) that are a reasonable cost of doing business but also confer a benefit on an employee, supplier, customer, proprietor, partner, shareholder or member. In later chapters we make specific suggestions for the taxation of these benefits, either in the hands of the recipient or the provider.

Capital Outlays. We have discussed some of the existing restrictions on deductions from income and have indicated that there are now restrictions on the deduction of outlays of capital 43/. Our basic approach is that all expenditures reasonably related to the production of income should be deductible, subject to the other statutory rules. A restriction on outlays of a capital nature would be incompatible with that approach, although the timing of the deduction of expenditures would remain important.

Exempt Income. The present legislation also disallows expenditures made to produce exempt income 44/. Under the comprehensive tax base, virtually all gains would be subject to tax. We therefore do not believe that such a provision would continue to be necessary.

Provisions in the Legislation for Specific Deductions. There remains the question of the extent to which the legislation should provide for specific deductions in computing income. Under our proposals most expenditures reasonably related to the production of income would be deductible at some time. We anticipate that a significant number of the detailed provisions in the Act relating to specific deductions 45/ would cease to be required. However, some provisions for specific deductions would continue to be necessary because some types of expenditures are not related to the earning of income, as in the case of alimony and maintenance payments. With respect to certain expenditures, the legislation should continue specifically to limit the amounts which are deductible for tax purposes, as in the case of charitable donations and contributions to registered retirement income plans.

Timing of Deductions. All deductible expenditures should be deductible currently except for the three following specified classes of expenditure which will provide benefits for periods extending beyond the taxation year:

1. Expenditures for the acquisition of business inventories, to which we refer below.

2. Expenditures for the acquisition of the long-term assets specified in capital cost allowance schedules which would become deductible through the claiming of capital cost allowances. Most of the so-called "nothings" would be currently deductible or would fall within one of the present or new capital cost allowance classes.

3. Expenditures to acquire securities, land, goodwill, trade marks and other assets of indefinite life. We think that any deduction in respect of such expenditures should be permitted only on disposition of the asset or upon a proven loss in value.

We recommend that the provisions of the Act and the Regulations with regard to inventory valuation should be repealed, and that inventories should be valued in accordance with recognized accounting practices. However, we later suggest certain limits on the extent to which the last-in-first-out method of inventory valuation may be utilized.

The principles applicable to the determination of business income should also be applicable, in appropriate cases, in computing income from other sources. Thus, we think that the capital cost allowance system should apply in determining income from the holding of property, and that a reasonable provision for bad debts should be permitted in connection with the sale of an asset on credit.

General Treatment of Losses. A taxpayer may sustain losses rather than make gains from carrying on an activity which he anticipates will be productive of income. Losses usually result from the holding or disposition of property or from carrying on a business. We have seen that losses of a capital nature, whether they arise from the disposition of property or not, are not at present deductible in computing income.

Under our proposals, gains of all types would be brought into the tax base. These would include gains from carrying on business, gains from the disposition of property and other gains which have heretofore been treated as being of a capital nature. There would be losses corresponding to each of these types of gains, for example, losses sustained in holding or disposing of property, or losses sustained in carrying on a business.

Under the present system, income is treated as an aggregate concept, and it is possible, in computing income for the year, to deduct from the income realized from certain sources, losses of an income nature realized from other sources. The one exception is the provision which limits the amount of the loss from hobby farming which may be deducted from other income 46/. In addition, subject to certain restrictions, business losses of one year may be carried back against business income of the previous year and forward against business income of the following five years 47/.

Our general approach is that all losses, other than those of a personal nature, should be deductible for tax purposes from any income and that there should be liberal rules relating to the carry-over of such losses.

We now turn to an outline of our proposal which includes certain limitations intended to prevent the deduction of items that are largely of a personal consumption nature.

Losses from Holding Property. The holding of property during a particular year may result in an excess of operating expenditure over operating income. Where the property is held for personal use or consumption, such expenditure should, as we have said, be disallowed. Therefore, the question of an operating loss on such property for tax purposes should not arise. However, operating losses will occur in other cases; for example, where land or a security is held in whole or part for purposes other than personal use or consumption. Because a taxpayer is not required to bring unrealized property gains into income, we do not consider that he should be entitled to deduct a loss from the holding of property from other income for the year. However, in order to obtain a matching of income and expense while limiting the deduction of personal expenditures, the taxpayer should ordinarily be entitled to two alternative types of relief in respect of such an operating loss:

1. To carry such a loss forward against operating income from the holding of the same property for an indefinite period.

2. Because some of the annual expenditures might be related to the gain which might ultimately be realized on the disposition of the property, to elect to add the amount of certain expenditures to the cost basis of the property,

rather than to treat them as operating expenses to be deducted in the computation of the annual income. As we explain in Chapter 15, such amounts would be specified and might include interest costs, expenses incurred in preserving title to the property, the amount of any damages for which the taxpayer became responsible as the holder of the property, and property taxes. It is not intended that this election would be employed as a means of deducting personal expenditures, so the interest and property taxes applicable to a residence and the adjacent land should not be deductible under this election. The general prohibition against the deduction of personal expenditures should accomplish this. Under this second type of relief, the taxpayer would be able to reduce or eliminate an operating loss which he might not have been able to deduct from subsequent income from the holding of the property prior to disposition, and his gain or loss on the ultimate disposition of the asset would be affected by the increase in the cost basis.

Losses on Disposition of Property. Because we contemplate that all gains on the disposition of property, except limited gains on certain residential, including farm, properties, should be taxable, equity requires that all losses on such dispositions should be deductible in computing income. With minor limitations to preclude the deduction of items of personal expenditure, we recommend that such deductibility be permitted.

In substance, our approach is that a loss on the disposition of a property should be deductible if the property is of such a kind that expenditure on its acquisition would be deductible at some time under the general statutory rules we have proposed. The principal effect of this approach would be to deny deductibility to losses on property held for personal use or consumption. We are convinced that such a denial is essential. Moreover, we would expressly deny a deduction for losses on the disposition of real property used by the taxpayer as a residence, even though the general rule would partially cover this, to match the exclusion already mentioned for gains on such property.

We recommend that losses on the disposition of property, which are not disallowed under a specific provision, should be deductible from income of all kinds in the year of loss and that it should be possible to carry them back two years and forward indefinitely against income of all kinds. This treatment is the same as that suggested below for business losses.

For losses on the disposition of property that would not be deductible, because the property had been employed in personal use, we suggest another type of relief. It seems to us that a loss on the disposition of property of a particular class, such as works of art, should be deductible from gains on the disposition of other properties of the same class in the year of loss, in the previous two years, or in the following six years. The classification of such properties might be established by regulation in order to provide a degree of certainty in this area.

We deal at some length in Chapter 15 with the treatment of losses on the disposition of property and suggest an alternative approach to the problem in the event that the treatment recommended above is regarded as too generous or proves difficult to administer.

Business Losses. We have already mentioned that, under the present system, an operating loss of a business ordinarily may be applied against income of other kinds in the year in which it is sustained and may also, subject to certain restrictions, be carried back against business income of the previous year and be carried forward against business income of the following five years. We think that such losses should continue to be applicable against income from all other sources in the year of loss, but that the present loss carry-over provisions should be liberalized. It should be possible to carry business losses back two years and forward indefinitely. It should also be possible to apply all deductible business losses against income from all sources, rather than simply against business income during the carry-over period. The requirement that a loss is deductible only to the extent that it was not deductible in a prior year should be retained.

However, there is one limitation which we think should be imposed on this liberal treatment of business losses to ensure that expenditures that are mainly of a personal consumption nature are not deducted from other income. Although the proposed general rules should be effective, they are difficult to apply to a business operation that is maintained despite persistent losses because the owner is obtaining a non-monetary personal benefit from the operation. The so-called "hobby farm" is one example of such an operation, although loss activities for personal satisfaction are by no means limited to farming. The suggested limitation would apply where a particular business sustains net losses over a lengthy period. It does not seem reasonable to us that it should be possible to apply such losses against gains from other businesses or against other income of the taxpayer. We realize that difficulties may arise in determining whether one or more businesses are being carried on by a particular taxpayer and in segregating businesses in such cases, but we do not think such difficulties are insurmountable 48/.

We appreciate that it is necessary, in considering a limitation of this kind, to take into account the special position of a new business. It will frequently take such a business a number of years to establish itself. We also appreciate that it is necessary to consider the position of an established business which encounters new conditions and as a result incurs consistent losses.

We propose that losses of a business (whether or not it is a new business) should be deductible from income from all sources in the year of loss, in the two preceding years and in future years, unless and until losses have been sustained in three years which fall within a five-year period. However, if losses have been incurred in three such years, any further loss incurred following the third such loss year should not be deductible from any income of the taxpayer, either in the year of loss or any other year, from sources other than the loss business. Such subsequent losses could be carried back two years and forward indefinitely and applied against income of the same business. If, after sustaining such losses, the business then becomes profitable, and the profits realized in the years subsequent to the loss years exceed all losses from the same business deducted in previous years (including the losses deducted from other income), such business would again become eligible to claim an unlimited write-off of losses against other income unless and until the three-year rule again becomes operative.

The limitations which we have suggested should prevent the erosion of tax revenue by the continued application against gains from other sources, of losses sustained by businesses that are carried on with no reasonable expectation of profit. We think the limitation we have suggested, in conjunction with the direct disallowance of personal expenditures, should substantially eliminate the hobby farm problem so that there would be no need for continuation of the present provision of the Act on that subject 49/. In addition, we think that a completely general provision of this nature has merit in that it should be capable of useful application in many areas other than that of farming as now defined 50/.

It should be noted that in computing a loss a taxpayer need not claim capital cost allowance, and therefore a limitation of this nature should usually be of little concern to a genuine business operation. In addition, we later recommend that certain specific expenditures such as property taxes and interest, should, on election, be capitalized rather than be included in operating expenses. Again this would reduce the possibilities of a loss being sustained in a genuine business operation.

It might also be provided that any losses sustained subsequent to the three years would be deductible from all other income if the business had an overall profit, that is, if the profits exceeded the losses, during a period of, say, seven years beginning with the year of loss. A provision of this nature would permit, for some businesses, the deduction of a loss from other income in the year of loss, rather than requiring it to be carried forward for deduction from income of the same business.

It is not our intent that our proposals should inequitably worsen the position of the bona fide farmer who needs to take off-farm employment to assist in maintaining and expanding his farm. If it is felt that our proposals would deter such farmers from taking off-farm employment, consideration should be given to a modification of the loss limitation to provide additional relief in this case.

We also recommend later that the legislation should continue to restrict the transferability of losses, although the introduction of the comprehensive tax base, and the liberal loss carry-over provisions would mean that most losses would be deductible at some time.

Other Losses. In the event that losses arise which are not from the holding or disposition of property or from the carrying on of business, it seems to us that they should be allowed, assuming they have been computed in accordance with the general rules for computing income. Here again we think it should be possible to apply the losses against any other income in the year of loss and to carry them back two years and forward indefinitely against all income.

Summary of Proposed Treatment of Deductions. It is therefore our view that the introduction of our comprehensive tax base would greatly improve taxpayer equity by allowing the deductions of all expenditures involved in earning income. Thus, the category of "nothings" would be eliminated from legitimate business expenditures.

In addition, all expenditures laid out to earn income would be similarly deductible, regardless of the type of income involved. In this connection, we recommend the removal of the limitation on the deduction of expenses related to employment income.

We have pointed out, however. that expenditures of a personal consumption nature should not be allowed to reduce the comprehensive tax base. We are very conscious of the difficulty of determining when an expenditure is in fact of a personal nature. It is obviously necessary for overall taxpayer equity to ensure that this aspect of the comprehensive tax base does not become the subject of widespread taxpayer abuse. It is also important that any uncertainty as to the meaning of the tax legislation should be reduced to a minimum. We have therefore proposed that the existing statutory provisions prohibiting the deduction of personal or living expenses should be retained and that it should be left to the courts to continue to establish general principles of what is, and is not, deductible. However, to reduce the uncertainty in borderline areas, we propose that the legislation should also specifically define certain expenditures to be of a personal nature. We appreciate that many taxpayers will feel that the arbitrary nature of the latter rules and the proposed limits are unduly restrictive. However, we feel this is an area where the limits must not be liberal.

On the other hand, we recommend that a liberal approach be taken as to the timing of properly deductible expenditures. Although we do not recommend that all income should be taken into account as soon as it arises, we do suggest that, in general, expenditures should be deductible as soon as incurred, even if they provide substantial benefits for future periods. Although this severely twists the concept of matching income and expenses, to the substantial benefit of the taxpayer, we feel that such liberality would minimize the inequities that would arise if the general principles were applied rigorously, would reduce the uncertainty that could arise if many items had to be allocated in some fashion over a number of time periods, and would provide some economic benefit in permitting the immediate write-off of expenditures such as research, staff training and product development, that have some longer run value.

Thus, not only should all the costs of obtaining income be deductible but most of them should be deductible when incurred. This liberal approach should also be carried over into the treatment of losses to ensure that when the expenditures on one endeavour exceed the revenue therefrom, the taxpayer would be able to offset such losses against other income as rapidly as possible. Similarly, the approach that all income-producing expenditures should be deductible at some time should be carried over to permit the allowance of all losses (other than those of a personal nature) at some time.

It should also be noted that our recommendations have been designed to treat all income in a similar fashion, regardless of its source. Thus, the current importance of the differentiation between business and investment income would disappear. Whether a property or business yields a gain or a loss, and whether the gain or loss is of an operating nature or arises from the disposition of an asset, the tax position would be the same. Thus, where we have suggested limitations, such as on the deductibility of some expenditures and on the allowance of some losses, we recommend that they apply in a similar fashion to both kinds of income. As a result, we would expect that much of the uncertainty and litigation arising under the present system, because of the attempt to differentiate between sources of income, would disappear.

CLASSES OF TAXPAYERS

Individuals and Families

Under the present legislation the individual is the tax unit for purposes of personal income tax. We propose that a husband and wife and their dependent children should constitute a tax unit. This would ordinarily involve the aggregation of their incomes in a joint return and the income of the family unit would be taxed according to a particular rate schedule applicable to such units. There would be tax advantages, which are referred to in Chapter 11, to membership in a family unit. An individual who was not a member of a family unit would constitute a separate tax unit and be taxed on a separate rate schedule.

Sole Proprietorships, Partnerships and Syndicates

Where an individual carries on business as a sole proprietor, the income of the business is now treated as his income. Partnerships and syndicates are not treated as separate taxpayers, and, under the Act, partners and members of syndicates must include in personal income their share of partnership income for the year whether or not they withdraw it 51/. We propose that these treatments be continued.

Intermediaries

Speaking generally, under the present system, corporations are treated as separate tax-paying entities and are taxed on their corporate income; when they distribute their after-tax income to the shareholders, the latter bring the amounts distributed into income. Under our proposals, the corporation would be taxed on its income, but the rules with regard to distribution from such taxed income to resident shareholders would be materially changed. In effect, resident shareholders would be taxed on their portions of the pre-tax corporate income that the distribution or allocation represents, and they would receive full credit against their own tax for the corporate tax paid on such income. The effect of this proposal would be that the treatment accorded to corporate income would be similar in principle to that applied to individual proprietors or partners.

Our approach to the tax treatment of corporate income brings the taxation of the ordinary corporation and its shareholders much closer to the present taxation of the co-operative and its members or patrons. We later suggest changes in the taxation of co-operatives which would bring the taxation of corporate and co-operative income flows even more closely into line. We also suggest changes in the taxation rules applicable to other mutual organizations such as credit unions, caisses populaires and mutual insurance companies, and to charitable organizations, private clubs and non-profit organizations.

Under the Act, trusts and estates are treated as individuals for tax purposes, and special rules apply to the taxation of the income therefrom 52/. We will make recommendations under which the taxes imposed upon them would be integrated with the tax liabilities of resident beneficiaries, in much the same way as is recommended in the case of other intermediaries. We have already mentioned that we recommend treating gifts and inheritances as income of the recipient for tax purposes and abolishing the present gift and estate taxes.

We believe that the taxation of intermediaries, such as corporations, co-operatives and trusts, should be integrated so far as possible with the taxation of the individual shareholders, members, or beneficiaries who hold residual claims against these entities. Our specific proposals are designed to reduce opportunities for tax avoidance and to remove any discrimination against income passing through such intermediaries.

Residence

In this chapter, we have noted the differing tax treatment of residents and non-residents of Canada under the present law. Under our proposals this basic distinction would remain. However, residence would be of added importance with regard to income from intermediaries since, in general, only the taxation of resident individuals would be integrated with the taxation of intermediaries.

THE DETERMINATION OF TAX

Under the present Act, once net income, the aggregation of all gains and losses, has been ascertained, certain amounts are deductible therefrom in computing taxable income 53/. For an individual, they include amounts based upon his single or marital status, the number and age of his dependants, and his medical expenses. For taxpayers generally, they include charitable donations and gifts to the Crown. In the case of resident corporations, they also include, subject to certain restrictions, dividends from other resident corporations and dividends from other corporations of specified types in which the recipient has a particular share interest 54/. We recommend a number of alterations in this treatment.

Our general approach to the treatment of non-discretionary expenditures of individuals, and to the granting of certain concessionary allowances, has already been discussed. We have suggested that the present system of deductions from the income of individuals, which depends on their personal status and dependants, should be replaced by a system of credits against tax, and that credits should also be granted to working mothers with school age children, and in respect of certain expenditures on post-secondary education. However, we recommend that the present general approach of permitting deductions in respect of certain medical and related expenses and charitable donations should be continued.

The Rate Schedules

The tax now imposed on the taxable income of individuals is calculated from a rate schedule in the Act under which the initial rate is 11 per cent and the top marginal rate is 80 per cent 55/. In Chapter 11 we propose that there should be two rate schedules for personal taxation. One of these would be applicable to family units and the other to individuals not in a family unit. The top marginal rate in each schedule should be 50 per cent.

Under the Act there is a dual rate of tax on corporate income 56/. We recommend that this dual rate of tax be replaced by a single rate of tax equal to the proposed top marginal personal rate of 50 per cent. To compensate for this change, particular types of concessions for new and small businesses, both corporate and otherwise, are proposed in Chapter 22.

Deductions from Tax

The Act permits certain deductions to be made from the tax otherwise payable by individuals and corporations. The basic deductions are summarized below.

Provincial Abatements. The provinces of Canada all impose taxes on the income of individuals and corporations. Under the Act, deductions from tax are allowed both to individuals 57/ and to corporations 58/ in respect of income earned in the year in a province. These deductions are referred to in Chapter 38, where we emphasize the importance we attach to harmonizing the federal and provincial tax systems in the future.

Dividend Tax Credit. Individuals who are resident in Canada are presently entitled to deduct from tax 20 per cent of the net dividend income received from taxable Canadian corporations 59/. This dividend tax credit was designed to mitigate the effect of taxing corporate income both to the corporation and, on distribution. to the shareholder. Under our proposals for the taxation of corporate income, this provision would no longer be required, because resident shareholders would receive full credit for the corporate tax paid on income distributed.

Foreign Tax Credit. Residents of Canada are taxed under the Act on income from sources outside as well as from inside Canada, but they are entitled to credits against the Canadian tax on such income in respect of the foreign taxes they pay on foreign source income 60/. These credits and our proposals with respect to the treatment of foreign source income are dealt with in Chapter 26.

Provincial Mining and Logging Taxes. The Act contains a provision for a deduction from tax in respect of provincial logging taxes 61/. It also provides for a deduction in respect of provincial mining taxes 62/. However, the latter is not a deduction from tax but a deduction in computing income. We recommend in Chapters 23 and 25 that all such taxes be allowed in the future as deductions in computing income.

Credits Against Tax Generally. The present deductions from tax mentioned above relate, with the exception of the dividend tax credit, to taxes paid to other governments whether provincial or foreign. Under our proposals this kind of deduction from tax would continue, but there would be two other basic types of credits against tax. The first is exemplified by the credit that would be available by virtue of family status; here there would have been no prior payment to another government. The second arises when the taxpayer receives credit in respect of a tax paid by someone else. This type of credit may arise, for example, when the taxpayer receives a distribution from an intermediary such as a corporation, co-operative or trust.

Concessions to Certain Industries and Special Types of Corporations

As the present system has developed, special rules have become applicable to the taxation of particular industries, particular types of taxpayer, and particular types of income. We have considered these special cases critically and in many instances suggest modification of the present rules. We discuss, for example, the taxation of the mining and petroleum industries, certain financial institutions, farming, fishing, forestry, the construction industry and general insurance. In each of these cases we propose alterations to the present treatment. We also indicate that the present tax treatment of personal corporations and diversified investment companies would have no place under our proposals. In addition, we consider that the preferential treatment of non-resident-owned investment corporations and foreign business corporations should be withdrawn over a period of time.

Averaging

The Act now provides for relief in isolated cases from the tax impact which results under the progressive rates from the receipt of unusual types or amounts of income in a particular year. Receipts of this kind would become more frequent under the comprehensive tax base, which includes in income such gains as gifts and bequests, gains on the disposition of property, and windfalls. In Chapter 13, we consider the problem of irregular or fluctuating income and we make comprehensive proposals for averaging the income of individuals.

TAX AVOIDANCE

The propensity of taxpayers to avoid tax probably tends to follow tax rates, and with the rates of tax as high as they are today, the temptation is strong. Tax avoidance probably came into its own during World War II and in the postwar period when the rates were sufficiently high to make the tax saving outweigh the expense and inconvenience of tax avoidance measures. A large number of ingenious devices have been invented and perfected to enable the well-advised taxpayer to pay less than he otherwise would. Indeed, tax avoidance has been described as "hydra-headed", for as one escape contrivance is discovered and cut off by Parliament, the taxpayer raises another. This process has been aided considerably by the anomalies and inconsistencies in the present tax system.

It is probably true that the present heavy incidence of income tax is bringing more and more Canadian businessmen to plan their affairs to minimize their tax liability. The complaint is often made that the high tax rate structure is designed in such a way that it discourages expansion, economic progress, individualism, and the intelligent use and increase of capital by risk taking. In practical terms, if the businessman can minimize his taxes he will have generated funds which he may use for expansion and so be able to compete more effectively. As a result many taxpayers resort to every stratagem open to them under the law to keep their taxes at a minimum.

There is a striking difference in the approach of the courts in the United States of America toward tax avoidance, and the approach taken by the courts in Canada and in the United Kingdom. It is our view that the taxing statute should be interpreted by the courts fairly and equitably and in such a way as to give effect to the legislative scheme, without any presumption being made either for or against the taxpayer. In our view the courts should also have regard to the true nature and effect of transactions and take into account their economic substance as well as their legal effect. We discuss this question further in Chapter 32.

The Act now contains a number of provisions which are designed to prevent tax avoidance. Some of these relate to specific circumstances, while some are very general in their application. Other provisions apply to transactions between persons related in certain defined ways who are deemed not to deal with each other at arm's length.

In Appendix A to this Volume we discuss the various approaches to the problem of dealing with tax avoidance. We believe that our basic proposals concerning the tax system would eliminate many inconsistencies and reduce the areas in which tax avoidance would be feasible or attractive. There would, of course, still be possibilities for avoidance or reduction of tax, particularly in transactions between residents and non-residents.

We indicate our views in Appendix A as to the kinds of anti-tax avoidance provisions which in our opinion would be effective and equitable. We also state there a number of conclusions which include the following:

1. Tax avoidance provisions should normally be expressed in sufficiently general terms that the courts will be able to interpret the words in the context of the legislative scheme and apply them according to the merits of the particular case. However, they should not be so broad and general that they have no clear meaning.

2. The irrebuttable presumption that certain related persons are not dealing with each other at arm's length should be made rebuttable in the case of relationships between brothers, sisters, brothers-in-law and sisters-in-law, but should remain irrebuttable as between spouses, parents and their children, and corporations subject to common control.

3. Transactions between persons not dealing with each other at arm's length should be adjusted to reflect fair market values or to satisfy a test of reasonableness. Such adjustments should be applied to the tax accounts of both parties and for all purposes of the legislation. However, these provisions would not be applicable in the case of transactions designated as tax-free reorganizations or transfers.

4. Discretionary powers should be granted only in extreme circumstances and then ordinarily as a temporary measure. There should not be a general tax avoidance provision such as section 138 of the Income Tax Act.

The foregoing is a brief outline of the more important changes in the present tax system which we will recommend. Our specific recommendations are outlined in detail in the chapters which follow.

CONCLUSIONS AND RECOMMENDATIONS

1. The tax base should be defined in the statute to include the value of net gains of all kinds realized during the year.

2. All of the kinds of income presently taxed would continue to be taxed under the system we propose, although in some cases the basis of taxation would be changed.

AMOUNTS INCLUDED IN THE TAX BASE

3. Gains on the disposition of property should be taxed like other income with the exception of a $25,000 lifetime exemption for gains on the sale of certain residential, including farm, properties.

4. Gains which are now treated as being of a capital nature, or which may be so treated depending on the circumstances, such as the proceeds on the sale of a business, compensation for loss of an office or employment, forgiveness of debt, lease premiums, loan premiums and discounts, amounts received on breach or cancellation of contracts, proceeds of insurance policies other than life insurance, profits on foreign exchange, damage payments, government subsidy payments and proceeds of expropriation of property, should all be brought into the tax base.

5. With certain exceptions, gifts and inheritances should be subject to tax like other income, while the present gift and estate taxes should be abolished.

6. Windfall gains should be included in the comprehensive tax base.

7. Generally speaking, there should be no exclusions from the tax base other than those already mentioned. Mortality gains and losses on Canadian life insurance policies incurred by the tax unit that paid the premiums would be excluded at the outset but the net proceeds after deduction of premiums and investment income which had been taxed should be included in the tax base at a later stage.

METHODS OF COMPUTING INCOME

8. The following treatment is recommended:

a) With a few specific exceptions employment income should be taxed when received.

b) Income from a business should be taxed on an annual accrual basis except in the case of farming or professional income of certain taxpayers with low revenues.

c) Gains on the disposition of property should be taxed when realized or deemed to be realized.

d) Income from holding property could be taxed on either basis, but with specific provisions requiring some items to be taxed when set aside for the taxpayer.

e) Other types of income should in general be taxed when received.

APPLICATION OF ACCOUNTING PRACTICES

9. As at present, the profit from a business or property should be determined in a manner consistent with generally accepted accounting practices except where otherwise provided in the statute; but no specific reference to accounting practices should appear in the Act. However, fewer statutory rules should apply to the determination of such income, so that accounting practices would play a larger role in this area.

GENERAL APPROACH TO DEDUCTIONS

10. Consistent with our approach that all gains should be brought into the tax base, all expenditures reasonably related to producing those gains should be deductible.

THE RULES OF DEDUCTIBILITY

11. The Act should contain three general rules governing the deductibility of expenditures.

<u>Rule 1</u>. Expenditures "reasonably related" to the gaining or producing of income should be deductible. This rule has positive and negative aspects. It would prohibit the deduction of:

a) expenditures of a personal nature; and

b) gifts.

It would permit the deduction of any expenditures made with a reasonable expectation of profit or made as an incident of earning income.

<u>Rule 2</u>. Expenditures should only be deductible to the extent to which they are reasonable in the circumstances. This rule is primarily concerned with the amount of an expenditure.

<u>Rule 3</u>. To reinforce the above rules, expenditures of a personal nature should be explicitly denied deductibility.

In addition to these general rules, some deductions should be specifically denied in the Act, for example, commuting expenses, and expenses of carrying or maintaining property for personal use or consumption.

CAPITAL OUTLAYS AND OUTLAYS TO GENERATE EXEMPT INCOME

12. There should be no restrictions on the deduction of capital expenses except for questions of timing. Since virtually all income would be taxable under the comprehensive tax base, there would be no need to prohibit the deduction of expenses incurred to earn exempt income.

SPECIFIC DEDUCTIONS PROVIDED IN THE LEGISLATION

13. Most of these provisions in the Act could be deleted, but some exceptions would remain for expenditures unrelated to the generation of net gains, such as alimony and maintenance payments, charitable donations, and contributions to registered retirement income plans.

TIMING OF DEDUCTIONS

14. Current deductibility should be permitted except where explicitly denied. The exceptions would be expenditures on the acquisition of:

a) business inventories;

b) long-term assets specified in capital cost allowance schedules;

c) securities, land, purchased goodwill, trade marks and other assets of indefinite life; these costs would be deductible on disposal of the asset or on a proven loss in value.

15. Business inventories should be valued in accordance with recognized accounting practices but with specific limits on the use of the last-in-first-out inventory valuation method.

16. No general prohibition on the deduction of amounts transferred to reserves is necessary.

17. All reasonable provisions for bad debts should be allowed with specific statutory provisions in certain cases.

LOSSES GENERALLY

18. In principle, all losses should be deductible in computing income for tax purposes, with liberal rules relating to the carry-over of losses.

LOSSES ON HOLDING PROPERTY

19. Losses from the holding of property, other than property held for personal use, should be:

a) carried forward against operating income from the same property for an indefinite period; or

b) reduced by the amount of certain expenditures related to the property which would be added to the cost basis of the property.

LOSSES ON DISPOSITION OF PROPERTY

20. The deduction of losses from other income on the disposition of property held for personal use should be denied. However, most of such property losses (the exception being certain residential property which we recommend be excluded from income) should be deductible from gains on the dispositions of other properties in the same class in the year of loss, in the previous two years, or the following six years.

21. Losses on the disposition of other property should be deductible from income of all kinds in the year of loss, and it should be possible to carry such losses back two years and forward indefinitely against all kinds of income.

BUSINESS LOSSES

22. Generally, the tax treatment of business losses should be the same as for losses on the disposition of property not held for personal use. To prevent the deduction of personal expenditures certain limitations are necessary. A business with persistent losses should not be allowed to deduct such losses except against gains from the same business. Thus, if a business produces losses for three years within a five-year period, the taxpayer should not be allowed to apply subsequent losses against income from sources other than the same business, until such income derived from the business has exceeded all losses claimed earlier, including the losses deducted from other income. The losses of the first three years would be deductible from all income.

CLASSES OF TAXPAYERS

23. Both families and unattached individuals should be treated as tax-paying units. Members of families would be entitled, with certain restrictions, to elect to be taxed as separate individuals.

24. The present treatment of sole proprietorships, partners and syndicates should remain unchanged.

25. Intermediaries, such as corporations, trusts and mutual organizations, should be taxable, with full credit for such tax being given to resident shareholders, beneficiaries, and members on the distribution or allocation of the income of the intermediary to these residual claimants.

RESIDENCE

26. Distinctions between the tax treatment of residents and non-residents would remain.

DETERMINATION OF TAX

27. The present system of deductions for personal status and dependants should be replaced by a system of credits against tax; credits should also be given to working mothers and in respect of certain expenses on post-secondary education.

28. Deductions from income should be permitted for medical expenses over certain limits and for charitable donations with certain qualifications.

29. There should be two personal rate schedules: one for families and one for individuals.

30. Full credit for taxes paid by intermediaries should be allowed to the beneficiary of a distribution or allocation. Therefore, the dividend tax credit should be withdrawn, the dual corporate rate should be abolished and a flat rate of corporate tax equal to the top personal

rate of 50 per cent should be established. New and small businesses should be granted certain concessions.

31. Mining and logging taxes should be allowed only as deductions in computing income.

32. Foreign tax credits should be allowed under most circumstances.

TAX AVOIDANCE

33. Tax avoidance provisions should normally be expressed in general terms but should not be so broad and general that they have no clear meaning.

34. The irrebuttable presumption that certain related persons are not dealing with each other at arm's length should be made rebuttable in the case of relationships between brothers, sisters, brothers-in-law and sisters-in-law but should remain irrebuttable as between spouses, parents and their children, and corporations subject to common control.

35. Transactions between persons not dealing with each other at arm's length should be adjusted to reflect fair market values or to satisfy a test of reasonableness for both parties except in transactions designated as tax-free reorganizations or transfers.

36. Discretionary powers should be granted only in extreme circumstances and then ordinarily as a temporary measure. There should not be a general tax avoidance provision such as section 138 of the Income Tax Act.

REFERENCES

1/ Section 2.

2/ Section 3.

3/ Section 4.

4/ The court decisions refer variously to commercial and accounting principles and practices and similar terms, but in this Report for purposes of convenience we adopt the phrase "recognized accounting practices" as covering this general area and treat the phrase as including the principles underlying the practices.

5/ A leading decision to the effect that accounting practices are not necessarily determinative of income for tax purposes is M.N.R. v. Anaconda American Brass Ltd., [1956] A.C. 85, where the Judicial Committee of the Privy Council refused to recognize the last-in-first-out method of inventory valuation as acceptable for tax purposes.

6/ Section 5.

7/ Examples are dividends, pension benefits, interest, alimony and maintenance payments in certain events, benefits of an income nature from estates or trusts, and amounts dependent on the use of or production from, property. These examples are taken from section 6 of the Act.

8/ For example, sections 6(1)(p), 19A, 25, 85B, 85D and 85E.

9/ Section 10.

10/ Section 3 which treated as income various items "and also the annual profit or gain from any other source".

11/ Section 6(1)(a)(v) and the definition of "retiring allowance" in section 139(1)(aj).

12/ The treatment of cancellation of indebtedness is discussed in Chapter 18.

13/ Until recently, the final court of appeal in Canadian cases was the Judicial Committee of the Privy Council in the United Kingdom, and its decisions in such cases were binding here.

14/ Case VI of Schedule D.

15/ Royal Commission on the Taxation of Profits and Income, Final Report, Cmd. 9474, London: H.M.S.O., 1955, paragraphs 30 and 31.

16/ Harvard Law School, International Program in Taxation, Taxation in the United States, World Tax Series, Boston: Little, Brown and Company, 1963, p. 367.

17/ Section 10. Also, under section 62(1)(a), the taxable income of certain employees of foreign governments serving in Canada is exempt from tax, subject to certain conditions.

18/ See section 5.

19/ The specific examples given and a number of others are to be found in section 6.

20/ Section 6(1)(b).

21/ In Chapter 22 we will refer to the treatment of instalment sales, and, in the part of Chapter 25 dealing with the construction industry, we will discuss certain aspects of the determination of profits in that industry.

22/ Section 85F.

23/ Section 4.

24/ Section 12(1)(e).

25/ Section 11(1)(e) and (f).

26/ Section 85B.

27/ Section 5(1), but note also section 5(2).

28/ Section 4.

29/ Section 12(1)(a).

30/ Section 6(1)(a).

31/ See, for example, Royal Trust Company v. M.N.R., 57 DTC 1055.

32/ Steer v. M.N.R., [1965] Ex. C.R. 458, a case which is under appeal to the Supreme Court of Canada.

33/ Section 12(1)(b).

34/ Section 11(1)(a) of the Act and a number of regulations. The question of capital cost allowances is referred to later in this chapter and is discussed in Chapter 22.

35/ Section 12(1)(c); the term "exempt income" is defined in section 139(1)(o).

36/ See section 28 and the definition of exempt income in section 139(1)(o).

37/ Section 12(1)(h); the term "personal or living expenses" is given an extended meaning in section 139(1)(ae).

38/ Section 12(2).

39/ Section 137(1).

40/ Sections 12(1)(a), (b) and (h) referred to above.

41/ Section 12(2).

42/ Section 12(1)(h).

43/ Section 12(1)(b).

44/ Section 12(1)(c).

45/ Such as some of those contained in section 11.

46/ Section 13.

47/ Section 27(1)(e).

48/ See section 139(1a) of the Act and the discussion in Chapter 22.

49/ Section 13.

50/ The definition of "farming" is contained in section 139(1)(p).

51/ Section 6(1)(c).

52/ Section 63.

53/ See section 2.

54/ The deductions from income in computing taxable income are set out in sections 26 to 31A.

55/ See section 32 which should be read with section 33(4). Under section 32, there is provision for a 4 per cent surtax on investment income from sources outside Canada; we recommend in Chapter 15 that this surtax be abolished. Apart from the tax under the normal rate schedule, a tax of 4 per cent of taxable income with a limit of $120 is imposed under the Old Age Security Act; we recommend in Chapter 18 that the separate taxes imposed by that Act be discontinued and be merged into the ordinary rates.

56/ Under section 39, the rate of tax is 18 per cent on the first $35,000 of taxable income and 47 per cent on the excess. An additional tax of 3 per cent of taxable income is imposed under the Old Age Security Act; we recommend in Chapter 18 that the separate taxes imposed by that Act be discontinued and be merged into the ordinary rates.

57/ See section 33.

58/ See section 40.

59/ See section 38.

60/ See section 41.

61/ See section 41A and section 700 of the Regulations.

62/ See section 11(1)(p) and section 701 of the Regulations.

CHAPTER 10

THE TAX UNIT

Throughout the history of Canadian federal personal income tax, the tax unit has been the individual. By this we mean that tax liability falls on the person receiving the income, whether that person be single, married, a child, or of any other status, and it is calculated primarily in relation to the amount of income earned by that individual. There is no general rule for the aggregation of incomes of members of an economic or social unit, such as the family. The closest approach to recognition of the fact that the incomes of closely connected persons may have some interrelationship is in the adjustment of certain of the general deductions where a statutory dependant has income. Thus, the deduction of $1,000 which is, in effect, given to a man who supports his wife, is reduced by the amount of her income in excess of $250 and is therefore eliminated if that income reaches $1,250. A child having an income in excess of $950, except from employment as a nurse in training, may not be claimed as a dependant, although a full deduction may be taken if the income is less than that amount. But these are provisions that do not in any way override the basic statement that the individual is the taxable unit under Canadian personal income tax.

Because the individual is the tax unit serious equity and enforcement problems arise.

PROBLEMS OF EQUITY IN THE PRESENT APPROACH

As we have said, in equity an individual should pay higher taxes than a married couple with the same income because the non-discretionary expenses of a couple are greater than those of an individual. However, while two cannot live as cheaply as one, economies are possible when two people share bed and board. To recognize this reduction in total non-discretionary expense on marriage, we believe that in the upper and middle income brackets the tax payable by a married couple should be greater than the sum of the income taxes payable by two single individuals, each of whom has one half the income of the couple.

The present system does not meet the latter requirement. It is true that the couple pays less tax than an individual with the same income, but when husband and wife have equal incomes the tax on the couple is the same as the tax on two single individuals with the same incomes. The failure to impose higher taxes on a couple under these circumstances is, we believe, unfair, for it ignores the economies of living together.

The taxes paid by a married couple under the present system depend upon the proportion of the income received by each of the members. The tax on the couple is least when the incomes of husband and wife are equal; the tax is greatest when all of the income is received by either the husband or by the wife. This leads to ludicrous results. Consider two couples with no dependants. Each has an income of $8,000 a year. Under the present system (1965), if all of the income of one couple was received by the husband, the federal tax (excluding old age security tax and taking the standard deduction) would be $976.60. If, in the case of the other couple, husband and wife each received $4,000 the total federal tax on the couple would be $765.70. We can see no justification whatsoever for this difference of about $200, 1/ particularly if all the income is from property and neither spouse is employed.

Complications are introduced when comparisons are made between couples that have no wage earner, one wage earner, and two wage earners (we ignore dependants for purposes of this discussion). It can be argued that where there are two couples with the same total money income the couple with one wage earner should pay higher taxes than the couple with two wage earners, because the one-worker couple should be taxed on the imputed income of the housewife. This justification of one of the features of the present tax system cannot be dismissed out of hand. As we pointed out in Chapter 8, imputed income should, in principle, be brought into the tax base. But, as we also said, there are insuperable valuation problems. Admittedly, arbitrary adjustments can be made, but there seems to us no justification for taxing the imputed income of the housewife and not taxing other forms of imputed income. We can think of no way of arriving at even an arbitrary method of taxing the imputed income under these circumstances; the unemployed individual may be retired, unable to find work, unemployable, or just plain indolent. If imputed income cannot be taxed with even a modicum of consistency, we do not think it should be taxed arbitrarily when it is convenient to do so and ignored when there are difficulties. We therefore reject the idea that there should be differences in tax between couples with the same aggregate income as a method of taxing the imputed income of husbands and wives who are not working outside the home.

Where a married couple has children, under the present system the only effect on the tax liabilities of the parents is that they can claim a deduction for each dependent child unless he or she has income in excess of $950 or is a nurse in training. If a dependent child has income of less than $950, that income is available to discharge expenses that would otherwise be borne by the parents, but it is free of tax. If a minor child who is a member of a household has taxable income, while the income is available to meet expenses of the family, it is taxable at the child's graduated rates which would normally be much lower than if the child's income was treated as additional income of the parents. Thus, under the present system, income of children which increases the family's ability to pay is either free of tax or is taxed at relatively low rates.

Other anomalies exist in connection with the gift tax and estate tax. In view of the liberal annual gift tax exemptions, transfers can be made over a period of years in such a way as to avoid gift tax and avoid or reduce estate tax. However, if this is not done and substantial assets are accumulated, they may eventually be subject to a heavy estate tax which is imposed on the same basis regardless of whether the assets are left to a member of the donor's family. Suppose that two families contrasted as A and B, have each accumulated $200,000. In each case the husband and wife presumably have both contributed to the earning and saving of this amount in one way or another. In the case of Family A the assets may all be owned by the husband. In the case of Family B they may be owned as to one half by each spouse (either as a result of a gift programme or otherwise). If the husband in each family should die before his wife, the estate tax payable on the death of the husband in Family A would be much greater than that payable on the death of the husband in Family B. If in each family the wife were to die first leaving the assets to her husband, the estate taxes would be greater in Family B than in Family A. A third family, Family C, might avoid estate taxes on the death of both spouses by having part of the assets accumulated in a trust for their children. If the husband in Family A were to make a substantial gift to his wife or children in his lifetime, this might result in a gift tax which would have been avoided by Family B and Family C. While in most families the earning and saving of income is a co-operative effort, the taxes which arise on transfers between family members under the present system can vary widely, depending on the arrangements made as to legal ownership of assets, on what programmes of gifts are carried out, and on the circumstance of which spouse dies first.

PROBLEMS OF ENFORCEMENT IN THE PRESENT SYSTEM

The present system, with its emphasis on taxation of the individual, has had the effect of producing a tax penalty and at the same time the means for avoiding it. A taxpayer whose income comes from investments or rents could give some of his income-producing assets to his wife, with resulting tax saving, were it not for special statutory provisions. This income-splitting possibility was recognized from the inception of the income tax in Canada, and the original Income War Tax Act, 1917, provided that the income from property transferred by a person to his spouse or a member of his family should be that of the transferor and not that of the transferee, unless the Minister was satisfied that the transfer was not made for the purpose of evading tax 2/.

Constant pressure, caused by higher tax rates and the administrative difficulties of distinguishing between bona fide cases and tax devices, has resulted in a steady broadening of this original provision through the years. The provisions of the Act now cover not only transfers between spouses but also transfers to persons under 19 years of age by anyone, 3/ and certain transfers in trust; 4/ they disallow salaries paid by one spouse to another in a proprietorship or partnership; 5/ and give the Minister power in his discretion to allocate to one spouse the income of a husband-and-wife partnership 6/.

These provisions were subject to sharp criticism by many of the witnesses appearing before us. It was said that they are inconsistent and discriminatory as between taxpayers, and are too rigid and restrictive in dealing with relationships between spouses. The following are some examples of anomalies that have arisen.

Section 21(1) of the Act provides that if a person transfers "property" to a spouse, the income from that property, or property substituted therefor, shall be deemed to be income of the transferor and section 22(1) likewise deems to be income of the transferor the income from property transferred to a person under 19 years of age. However, it has been held by the courts that a loan is not a transfer of property. Consequently, where money supplied by a husband to acquire for his wife an interest in a partnership venture was supplied by way of repayment of a loan previously made by the wife, section 21(1) did not apply; the repayment was not a transfer of property and in any event the income derived from its use was not income from property but income from a business 7/. And where a father made a loan to trustees, the loan being used for the purchase of a building to be held in trust for the lender's minor children, it was held that the rental income from the building was not the income of the father 8/. However, a sale of property to a spouse in return for her promissory note was held to be a transfer of property which was caught by section 21(1). 9/

If a husband is the employer of his wife, he is prohibited by section 21(2) from deducting remuneration paid to his wife for her services to his business; but if the business is incorporated the corporation may deduct a reasonable amount paid to the wife of the controlling shareholder for her services to the business, since the corporation is an entity separate from its shareholders.

We conclude that the present system is lacking in essential fairness between families in similar circumstances and that attempts to prevent abuses of the system have produced serious anomalies and rigidities. Most of these results are inherent in the concept that each individual is a separate taxable entity. Taxation of the individual in almost total disregard for his inevitably close financial and economic ties with the other members of the basic social unit of which he is ordinarily a member, the family, is in our view another striking instance of the lack of a comprehensive and rational pattern in the present tax system. In keeping with our general theme that the scope of our tax concepts should be broadened and made more consistent in order to achieve equity, we recommend that the family be treated as a tax unit and taxed on a rate schedule applicable to family units. Individuals who are not members of a family unit would continue to be treated as separate tax units and would be taxed on a schedule applicable to individuals.

THE FAMILY AS A TAX UNIT

We regard the family as consisting of husband, wife and dependent children, if any. The main result of taxing the family as a unit would be that the income of the members of the family would be aggregated, and that allowances and tax rates would be applied which were appropriate to that combined income. There are, however, several further consequences that we examine in the balance of this chapter. Many of these are of importance to the aggregation of income and in some instances represent substantial reductions or increases of tax by comparison with present arrangements.

Our first responsibility is to establish clearly our grounds for recommending the family as the basic tax unit. In a sense, we have already made the case by establishing the inadequacies of taxing the members of a family as individual tax units, the inference being that only by taxing the total family income can these shortcomings be removed. But the case is much stronger than that. We believe firmly that the family is today, as it has been for many centuries, the basic economic unit in society. Although few marriages are entered into for purely financial reasons, as soon as a marriage is contracted it is the continued income and financial position of the family which is ordinarily of primary concern, not the income and financial position of the individual members. Thus, the married couple itself adopts the economic concept of the family as the income unit from the outset. In western society the wife's direct financial contribution to the family income through employment is frequently substantial. It is probably even more true that the newly formed family acts as a financial unit in making its expenditures. Family income is normally budgeted between current and capital outlays, and major decisions involving the latter are usually made jointly by the spouses. Budget decisions indirectly influence family saving and provisions for retirement, although these are frequently determined on a contractual basis through insurance and pension arrangements, both of which have implications for the family rather than for the individual directly involved.

Where the family grows by the addition of children, further important financial and economic decisions are made in the family as a unit. Questions of the extent of education, time of entrance into the labour force and, frequently, choices of a career are decided on a family basis, although of course there are many exceptions to this statement. In some circumstances the income of the child is added to the family income, and, even where this is not done directly, the fact that a child has income of his own will have some bearing on the main family expenditure decisions. Certainly when the child becomes self-supporting he is normally expected to relieve the family of further expenditure on his behalf. Thus, the income position of children has an important bearing on the family income, although frequently in an indirect way.

With the marriage of the children a new cycle commences, with attendant financial consequences for both the old family unit and the new. The old family unit survives in the persons of the parents, usually with drastically different financial circumstances from those of the new unit. Where assets have been acquired during the lifetime of the old family unit, arrangements must be made for their disposition during retirement or at death. Again, the primary considerations are not those concerning the individual but the family as a whole and, in particular, those concerning the future maintenance of a surviving spouse. Moreover, the prospect of ultimate dissolution of the family unit when both spouses have died is also usually foreseen, and arrangements are made for the disposition of any remaining assets at that time.

We should emphasize that the preceding description is not an attempt to present an idyllic picture of family life in Canada. We are not concerned in this Report with sociological issues, but with taxation, and our firm conclusion is that the family, as we find it in our modern society, continues to be the basic economic and financial entity. We therefore propose that this fact should be reflected in our tax system and that the family should be adopted as a basic unit for income tax purposes. As we have said, where the individual is not part of a family, he should continue to be a separate tax unit as at present.

Some element of aggregation is now a common feature of the tax systems of nearly all important countries in the world, including the United States, the United Kingdom and nearly all European countries. Canada is a conspicuous exception in its adherence to the individual basis of taxation. The concept of aggregation, simple enough in itself, takes on added significance when it is recalled that, under our proposals for a new comprehensive tax base, "income" would include virtually all gifts and inheritances received as well as gains realized on property dispositions, with a deemed realization at death of an individual taxpayer or of the surviving spouse in a family unit and a deemed realization on giving up Canadian residence. As we have said, the adoption of the family as one of the basic units for income taxation would mean that transfers of property within the family unit would not be subject to taxation. It is not that transfers between husband and wife, or between parents and their minor children, would be exempt from tax; it is simply that these transfers would be removed from the purview of the tax system. Similarly, with regard to realizations of property gains, because it is only transfers between family units that should have tax implications, we later recommend that it should be deemed that no realization takes place on a transfer of property between members of a family unit. Gifts or bequests from one member of a family unit to another would not give rise to tax on any accrued gain on such property. Only the flows of income into the family unit and the transfers of property between family units would generally be of tax significance.

To remove any misconception, we would point out that our proposals do not involve any change in the ownership of assets of the members of the family unit or in their respective rights to income; our proposals relate simply to the treatment of income for tax purposes.

We deal separately with two types of family unit, one composed of the couple without dependent children, the other of the couple with dependent children. Later in this chapter we recommend that dependent children should be included in the family unit; but for expository purposes it is better to discuss first the family unit without dependants.

FAMILY UNIT CONSISTING OF SPOUSES ONLY

Husbands and wives 10/ resident in Canada would be required to use the family unit rate schedule in the determination of tax. Normally, the couple would aggregate their incomes and the tax on this aggregate would be calculated under the family unit rate schedule. However, spouses who do not wish to disclose their incomes to one another could, at the option of either, 11/ file separate returns with the tax calculated as follows: each spouse would multiply his or her income by two; the tax on this doubled income would be computed from the family unit rate schedule; the tax payable by the spouse would be one half of the amount of the tax computed in this manner. This would usually result in somewhat higher family taxes than if they had aggregated their incomes.

Commencement of a Family Unit

A family tax unit would commence at the beginning of the taxation year in which a resident couple were married. Following that date, the husband and wife (unless they elect to file separate returns) would be required to aggregate their incomes and to determine their joint tax liability using the family rate schedule. Property held by either husband or wife at the time of the marriage would not be brought into the income of the new family unit. In Chapter 17 we recommend that each individual should have a lifetime exemption for gifts in the amount of $5,000. On marriage, the unused portion of this exemption for each spouse would be available to the family. Thus, if both husband and wife lost their dependent status as a result of their marriage, the couple would have a lifetime gift exemption of $10,000. Similarly, if husband and wife had unused higher education tax credits (discussed in Chapter 12), these could be carried forward and used to offset the tax levied against the family.

To prevent taxpayers from averaging income received prior to marriage when the rates for a different unit were applicable with income received after marriage, it would be necessary to require that years prior to the formation of a family unit could not be included with years subsequent to the formation of a family unit for purposes of block averaging. However, taxpayers willing to make Income Adjustment Account deposits 12/ while filing as individuals would not be required to take them into income before marriage because we believe that Income Adjustment Account deposits effectively reduce economic power and should be taxed without regard to changes in the tax unit of the depositors when brought into income.

Aggregation of Income

Other things being equal, the sum of the tax bases of husband and wife filing separately would be equal to the tax base of a couple filing jointly. In neither case would transfers of property between spouses be brought into the tax base nor would there be a realization of property gains on property transferred between spouses 13/. In all other respects the tax base (or bases) of the couple would be determined in the same way as for an unattached individual. Income flowing to the couple from outside the family unit would be included in their aggregate tax base or in their separate tax bases; gains on the disposition of property, other than on transfers between the two spouses, would be included in their aggregate tax base or in their separate tax bases.

Childless Marriages Lasting Less Than Five Years

The only restriction we propose on tax-free transfers between spouses is one we believe necessary to reduce tax avoidance through artificially arranged marriages. We recommend that with one exception, property should be permitted to be transferred from one spouse to the other free of tax only after the marriage has lasted for five years, or after the couple has a natural-born child, whichever is earlier. The exception would be that one spouse could make tax-free transfers to the other spouse during this period equal to one half of the income after tax reported by the family unit during the marriage. This is an administratively simple method of permitting transfers of property which may have been accumulated after marriage as a result of sacrifices made by both husband and wife.

Income Splitting

If this approach is adopted, the advantages of income splitting between husband and wife would be removed. Indeed, unless the incomes of the spouses were identical, a small penalty would be imposed on those couples who elect to file separately. Therefore, it would be possible to eliminate all the provisions intended to prevent income splitting between husband and wife found in section 21 of the Act. This would end the unfair discrimination against a woman working for her husband, husband-and-wife partnerships, and the anomalies arising under the present income attribution rules.

Termination of a Family Unit

A family unit for tax purposes would not terminate on the death of one of the spouses. There would be no tax consequences resulting from a transfer of property from the decedent spouse to the surviving spouse 14/. However, where the surviving spouse had no dependants, even though the family unit would continue, the annual tax liability of the survivor should be determined according to the individual rate schedule. If this were not the case, a childless woman widowed at age 25 who did not remarry would have, for the rest of her life, a lower tax rate than a spinster with the same income.

The family unit with no dependent children would terminate under four circumstances. These circumstances, and the attendant tax consequences, are spelled out below. It is assumed that the couple was married for at least five years prior to the termination of the unit.

1. On the death of both spouses or on the death of a surviving spouse who has not remarried, the family unit would terminate and the following tax consequences would ensue:

    a) There would be a deemed realization of property gains to the defunct family unit.

b) Property passing from the terminating unit to other units would be brought into the income of the recipient units.

2. On the remarriage of a surviving spouse the family unit would terminate, but there would be no tax consequences. The following would be the position:

a) There would be no deemed realization of property gains to be dissolved family unit except with respect to any property passing to third parties.

b) Property passing from the original unit to the new unit would not be included in the income of the new unit.

We appreciate that in a few cases this may result in deferment of tax, but we do not think that this would be serious. In our view the consequences of marriage should be the same regardless of the source from which either of the partners derived his or her property. Any transfer from the former spouse which had been held in trust and not transferred to the surviving spouse until after the remarriage should be free of tax even though the transfer is to another tax unit.

3. On the divorce or legal separation of the spouses the family unit would terminate, but there would be no tax consequences. To be specific, we note the following:

a) There would be no deemed realization of property gains to the dissolved family unit except with respect to property passing to third parties.

b) The two new tax units created by the dissolution of the old family unit would not be required to bring property taken from the old unit into income, regardless of which spouse originally held the property.

c) Alimony and maintenance payments made after the divorce or separation would continue to be treated substantially as at present. The payments would be deductible to the tax unit making them and would be taxable as income to the recipient tax unit. This treatment should apply whether or not the payments are made on a periodic basis.

4. If both spouses ceased to be resident 15/ the family unit would be terminated with the same tax consequences as we have described under 1. If one spouse ceased to be resident, while the other remained resident, the family unit would not be terminated, but there would be a deemed realization of property gains with respect to the property of the spouse leaving the country.

To sum up the above proposals, for the great majority of married couples, that is, those who remain resident in Canada and are not divorced or separated, the family unit described would offer the right of taxation under a family unit rate schedule for joint incomes, tax-free transfer of property within the family unit during its existence, and no deemed realization of property gains until the death of both spouses. In terms of the present tax structure, this would mean that neither gift tax nor death tax would be levied on transfers between spouses. Only at the death of both spouses would a tax become payable on the deemed realization of the gains on property accrued by the family at that time. Under our proposed comprehensive tax base, transfers to persons outside the family unit, including transfers made at the death of the surviving spouse, would result in deemed dispositions by the family unit and the net amount after tax which is transferred would be included in the income of the recipient tax unit.

FAMILY UNIT WITH DEPENDENT CHILDREN INCLUDED

Persuasive arguments can be advanced for both the inclusion and exclusion of dependent children from the family unit. In most families the income of dependent children is taken into account in family decision making. In low income families the children are often expected to make a contribution to the general support of the family; in well-to-do families the child with income is often expected to buy such things as clothing and entertainment. These expenditures would otherwise have to be made, at least in part, by the parents. In either case the income of the child increases the economic power of the family and should be taxed at the marginal rate of the family. The inclusion of a child's income with that of his parents would nullify tax avoidance schemes under which property income could be diverted to the children. In addition to these considerations, there is an administrative argument in favour of including children in the family unit. If children were included in the family unit the transactions between parents and their children would have no tax consequences for the same reason that transactions between spouses would have no tax consequences. But if children were excluded from the family unit, it would be necessary to define and to value the "gifts" made by parents to their children. Obviously the provision of sustenance to a child within the requirements of the law of support would not be defined as a gift; but at some point the distinction between sustenance and gifts would have to be drawn. Where is the line to be drawn between the use of the family car, the gift of an inexpensive used car, the gift of an extremely expensive car that can be disposed of for thousands of dollars, and the gift of a block of shares or the title to real property that can be sold for tens or even hundreds of thousands of dollars? To fail to tax these "big" gifts would result in the complete avoidance of tax by the child on substantial increases in his or her economic power.

On the negative side it can be argued that to include in family income the part-time earnings of the schoolboy and to tax them at full marginal family rates would be too harsh. It would also be unenforceable because these earnings would not be reported by many families, and would discourage the labour effort of minors.

Another argument can be made against the inclusion of children in the family unit. Some children receive large gifts from outside the family from benevolent grandparents, aunts, uncles and other relatives or friends. If children were included in the family unit without any relieving provisions these gifts would have to be brought into the income of the family and, if not consumed before the child left the family, again brought into the income of the child when he or she left the family. This would be the appropriate treatment if the gift to the child was considered by the child, and by the child's parents, as an addition to the economic power of the family, to be spent or saved by the family as it wished. However, if the gift were considered by the family as property "in trust" for the child, to be available to the child when he or she was no longer a member of the family, to tax it both to the family and then again to the recipient of the gift on leaving the family would be unfair, for the gift would not increase the economic power of the family.

We have come to the conclusion that the better of the two alternatives would be to hold to the principle that the family should be treated as an economic unit and generally to require that children 21 years of age or less be included in the family unit, with the income of these children aggregated with the income of the parents for tax purposes. However, we recommend several mitigating provisions that would, we believe, substantially reduce, if not entirely eliminate, the problems which this would create. These mitigating provisions are reviewed as we proceed with the discussion.

Definition of the Family Unit

We recommend, under the broader concept of the family unit we favour, that the following resident persons be treated as family units:

1. Husband and wife.
2. Husband and wife and dependent children.
3. A surviving spouse 16/.
4. A widower or widow and one or more dependent children.

5. A divorced or separated parent and one or more dependent children.
6. One or more dependent children who previously have been in a family unit but are separated from both their parents because the parents have died or have ceased to be resident or for some other reason.
7. A single individual and one or more dependent children. This would include an unmarried person with one or more adopted children, or an unmarried mother and her child or children.

Dependent children would be defined as unmarried children who are resident in Canada, natural-born or adopted, who were: 21 years of age and under; or over 21 years of age and mentally or physically infirm 17/.

Two options would also be provided. Under the first option, a child 21 years of age or under, but over the school-leaving age in the province in which he resided, not living with his parents and employed or carrying on a business on a full-time basis, could, at the option of the child or of the parents, withdraw from the family unit for tax purposes and file as an individual tax unit. This should accommodate the circumstance where a child, for one of a multitude of possible reasons, becomes self-sufficient at an early age.

Under the second option, a child over 21 but not over 25 years of age, attending a recognized institution of post-secondary education on a full-time basis could, if acceptable to both the child and his parents, elect to remain a member of the family unit. Under this option parents of a child attending university could obtain the credit which we recommend in Chapter 12 in recognition of the fee expenses incurred in attending university and the usual credit for a dependant which we propose in Chapter 11. The special credit for the living expenses of a student which is discussed in Chapter 12 would not be available to the parents as they would already be claiming the child as a dependant. The gift of a university education from the parents to the child would not be taxed to the child. The part-time employment or business income of the child in excess of the exemption specified below would, however, be taxed to the parents if the child remained in the family unit.

We suggest that in no circumstance should actual support be the test of dependency for purposes of inclusion or exclusion of a child from the family unit.

Commencement of a Family Unit

The family unit would usually come into being at the commencement of the year in which a couple are married and this would have the tax consequences we discussed earlier in the chapter. However, a family unit for tax purposes would also be started when an unmarried woman has a child and retains custody of her child or children; when an unmarried individual adopts one or more children; or when a divorced or separated spouse retains custody of one or more dependants. In each case the first taxation year of the family unit would be the calendar year in which falls the event which causes its creation. The tax consequences in these circumstances would be the same as for a family tax unit created through marriage.

Aggregation of Income

If the parents were filing jointly, the income of a dependent child would be aggregated with the income of the family for tax purposes, in the same way that the income of spouses would be aggregated, and be subject to tax under the family rate schedule. If the spouses were filing separately, one of the parents would be required to aggregate, for tax purposes, the income of the dependent child with his or her income. In neither case would the parent(s) be required to have the tax return signed by the dependant. The parent(s) would be held responsible for the accuracy of the return.

It would be necessary to make provisions concerning the liabilities of the members of the family unit for the tax payable by the unit. We recommend that where there are two parents and they file a joint return, the parents should be jointly and severally liable for the full amount of the tax. If they were not willing to assume this liability they could file separate returns on the basis mentioned earlier in this chapter. If there were only one parent in the unit that parent should be liable for the full amount of the tax payable by the unit. In addition, any dependent child should be liable for that portion of the tax allocable to his income which had been included in the family unit income. There should also be a provision that if a parent who has filed a separate return, or a child, has received a transfer of property from another member of the unit, he will be liable for the tax payable by the unit to the extent of the amount so received in addition to any other liability which he has under the above rules.

Primarily to reduce the problems of enforcement, the family unit would be granted an annual deduction of $500 for employment or business income earned at arm's length by each dependent child. Only the amount in excess of $500 would be aggregated with the income of the family. This provision is designed to exclude from tax the small sums earned by children from casual employment because it would be impossible to enforce the reporting of such sums. We have not suggested an amount larger than $500 because we feel that this amount would be sufficient to meet the administrative problems.

Transfers of Property

Transfers of property within the family unit would have no tax consequences for the donor or the donee. Transfers between parents and dependent children would be treated in the same way as transfers between parents; they would be ignored for tax purposes. Transfers to a dependant from outside the family unit would, however, be taxable to the family unit, with one exception.

To avoid the problem of taxing large gifts to a dependent child from outside of the family unit, first to the family and then to the child when he or she leaves the family, we recommend that the child (or the child's parent or guardian) should be permitted to deposit in the name of the child the amount of any gift or bequest to the child from outside the family unit in an interest-bearing Income Adjustment Account 18/ in the year in which it was received. These deposits would be deductible from the income of the family unit. The interest on such deposits would be paid only on withdrawal and would be brought into income at that time. Any withdrawals from these Accounts made while the child was a member of the family unit would be brought into the income of the family. Withdrawal would have to be made when the child ceased to be a member of the family unit and would be brought into the income of the new tax unit of the child at that time. Withdrawals from such an Account could be averaged in one of the ways described in Chapter 13.

Saving of Dependants from Employment or Business Income

The employment or business income earned at arm's length by dependants in excess of the allowance of $500 noted above, may be considered, both by the dependant and the family of the dependant, as funds to be put aside to cover future expenditures by the child after leaving the family unit. Here, too, it would seem unfair to require that these funds be brought into family income and then into the income of the child on leaving the family. We therefore recommend that the child should be permitted to deposit these amounts in excess of $500 in an Income Adjustment Account, and that such deposits should be deducted from the income of the family. These deposits would be brought into the income of the tax unit of which the depositor is a member at the time of withdrawal in the manner discussed above, and would have to be brought into the income of the new tax unit when the child ceased to be a member of the original family unit.

Withdrawal of a Child From a Family Unit

A child would cease to be a member of his original family unit on marriage, on death, on ceasing to qualify as a dependant because of age, on ceasing to be a resident, or if he "opted out" under the conditions specified above, or if he is adopted by another family.

Two questions arise when a child has ceased to be a member of the original family unit. How should unrealized gains on property which the child takes from the original family unit be taxed? How should property transferred from the original unit be taxed to the new unit?

We recommend that unrealized gains on property withdrawn by the child from the original family unit should be taxed as income to the original family unit in the year in which the child withdraws. There would be an exception to this rule in the case of a dependent child who was an orphan and who was adopted by another family. In that case there would be no deemed realization, but the property belonging to the orphan would retain the cost basis which it had in the original unit.

In order to preserve the concept that gifts are part of the comprehensive tax base, we recommend that the child be required to include in his income, as a new tax unit, in the year in which he ceased to be a member of the original family unit, unless this was due to his adoption, the market value of any property taken with him from the original unit in excess of his lifetime exemption of $5,000 and his annual exemption for the year. The lifetime exemption should be sufficient to ensure that most individuals establishing a new tax unit would be free of any tax on their starting assets. We have not suggested a larger exemption because we feel that it would unduly increase the inequity inherent in any exemption that only applies to one kind of income. The exclusion of up to $5,000 is a lifetime concessionary allowance which would be available to every individual who has ceased to be dependent. As recommended in Chapter 17, it could be used for gifts and bequests from outside the unit at any time.

If a child should become non-resident while the parents remain resident, the child would cease to be a member of the family unit unless he elects to continue to be taxed as a resident. If he does not so elect and ceases to be a member of the family unit, he would be required to include in income all property (in excess of the exemptions) which he takes with him from the unit. In addition, there would be a deemed realization to the family unit of that property. Any subsequent gifts of property to the child by his parents would likewise result in deemed realizations to the family unit and would be subject to withholding tax. For these reasons a child who becomes non-resident, to attend university or otherwise, would probably elect to continue to be taxed as a resident as long as he is qualified to continue to be a member of the family unit.

If the child has ceased to be a member of the family unit by reason of his marriage, and has thereby formed a new family unit, the latter unit would bring the property transferred from the original family unit, in excess of the aggregate unused lifetime exemptions of the couple, into the income of the new family unit in its first taxation year. This property would be taxed according to the family rate schedule like any other income. The child leaving the family for reasons other than marriage would bring the property transferred from the old unit, in excess of the $5,000 lifetime exemption, into his individual tax unit, and it would be taxed with other income on the individual rate schedule. In either case, the new tax unit would be able to take advantage of the income-averaging provisions discussed in Chapter 13. Any further gifts or bequests to the new unit from any source would be brought into the tax base of the new unit, subject to the unused lifetime exemption and the annual exemptions we recommend in Chapter 17. The suggested annual exemptions are $250 for a person filing as a single individual, $250 for each spouse in a family unit, and $100 for each child family unit. Such a provision should exempt from tax the normal flow of personal gifts.

The aggregation of a dependant's income with the income of his family would eliminate any income-splitting advantage in gifts to dependent members of the family unit. To this extent, the sections attributing income from property transferred to persons under 19 years of age could be eliminated from the Act as well as the sections regarding transfers in trust 19/. Income splitting could still be a motive in gifts from outside the family unit to minors who had "opted out". A substantial gift from a grandfather to minor grandchildren would be a typical example. However, the conditions we recommend under which opting out would be permitted are so stringent, we doubt that this alternative would be used for tax minimization purposes. Moreover, the tax payable on the transfer, both by the donor and the donee, would usually offset any advantage of the lower tax rate on the subsequent income of the donee. For these reasons we recommend that the anti-income-splitting provisions of sections 21 and 22 should be repealed in their entirety. It is not possible, with all the changes in tax bases and rates we recommend, to be sure that possibilities for income splitting would not arise, so that it would be necessary to review this area from time to time.

Termination of a Family Unit

A family unit in which there are no dependent children would terminate in the ways and with the consequences already discussed. Where the family unit contained a dependent child or children, however, additional rules would be necessary.

In the event of divorce or legal separation of the spouses, the family unit would terminate but there would be no tax consequences. There would be no deemed realization of property gains to the dissolved family unit and the two tax units created on the termination of the old family unit would not be required to bring into income property taken from the old unit. A divorced or separated spouse who retained custody of one or more dependent children would form a new family unit with those children. A spouse who did not retain custody of any dependent children would form a new single tax unit.

In the event that one of the spouses in a family tax unit ceased to be resident in Canada but the other remained resident, the family unit would be deemed to continue. Similarly, if the sole parent or both parents in a family unit ceased to be resident in Canada but they had one or more dependent children who continued to be resident in Canada, the unit would continue. In all of the circumstances referred to in this paragraph there would be a deemed realization of property gains to the original family unit only with respect to the property of a member or members of the unit who ceased to be resident in Canada. In the event that all members of a family unit became non-resident, the family unit would terminate and there would be a deemed realization of all of the property of the family unit at the fair market value.

In the event of the death of a spouse, the family unit would be deemed to continue in two circumstances:

1. Where a spouse survived, with or without a dependent child or children.
2. Where there was no surviving spouse but a dependent child or children survived.

In each of these circumstances there would be no deemed realization of property gains to the family unit on property passing to continuing members. The continuing members would not be taxed on property passing to them by reason of the death.

Where there was a family unit consisting only of a dependent child or children, it would continue until the last dependent child ceased to be a dependant (as defined). At that time there would be a deemed realization of the previously unrealized gains on property of the family unit unless the last dependent child ceased to be a member by reason of being adopted.

The tax liability of a family unit consisting of one dependent child would be determined by the individual rate schedule, as would the tax liability for a tax unit consisting of a surviving spouse with no dependants.

In the event of the marriage of a surviving spouse or an unmarried person who had a dependent child or dependent children, their tax unit would terminate and they would become members of a new tax unit with the new spouse. In this event there would be no deemed realization to the former unit and the value of their property would not be added to the income of the new unit.

OTHER DEPENDANTS

We have also considered whether dependants other than children should be included in the family unit for tax purposes. There is no doubt that another dependant, such as a parent, is often an integral part of the family unit, both in physical presence and by reason of affecting family expenditures. However, there are other cases where this social relationship exists only in part, if at all. In addition, we were unable to develop adequate provisions to prevent a number of tax minimization devices, particularly in the area of gifts and bequests, that could be employed if the family unit were expanded beyond the limits we have already recommended.

Therefore, we recommend that the family unit should only encompass spouses and dependent children (as defined). This does not mean, however, that no recognition should be given to expenditures by the family to support close relatives who form, in effect, part of the family group. We recommend in Chapter 12 that a tax credit be granted of up to $100 for such expenditures made to or on behalf of a close relative. More important, we recommend that complete dependence should not be a requirement for the claiming of this credit. It should also be noted that although gifts and bequests to relatives must be included in the income of the recipient to the extent that they exceed the proposed exemption, the tax rate schedules and credits that we propose would mean that little or no income tax would be payable by a relative who only received a moderate amount of assistance.

Common Law Wives

Couples sometimes live together in common law relationship but are not legally married. They live as a family, often with children. Sometimes one or both of the partners have a legal spouse but are separated legally or otherwise. We think it is equitable that such couples and their children should be treated as family units for income tax purposes regardless of the legal status of their marriage. However, to make this administratively feasible there would have to be a definite rule for determining when such a relationship should be recognized for income tax purposes. This could be accomplished by a provision that a man and woman who were not legally married would be regarded as spouses if they had cohabited as man and wife for at least a year and had filed a joint declaration that they wished to be treated as man and wife for income tax purposes. If a person who was legally married to someone else and not legally separated made such a declaration, this would terminate the former family unit in the same way as a legal separation. It should be provided that when such a declaration was filed each of the parties would be deemed to be the spouse of the other and not of any other person. Any child who was dependent for support upon either or both of the parties, and not on any other person, would be included in the family unit on the same basis as the children of any other family. If the parties separated and remained separated for a period of at least one year this would have the same effect as a legal separation of a married couple.

CONCLUSIONS AND RECOMMENDATIONS

1. The present tax system treats the individual rather than the family as the basic unit for tax purposes. In our view this leads to inequities because we believe it is the ability to pay of the family, rather than of the individual members of the family, that should be taken into account in determining tax liabilities.

2. In our opinion a married couple should pay less tax than a single

individual with the same aggregate income. However, we believe that at most income levels a married couple should pay higher taxes than two single individuals, each of whom has half the income of the couple, because of the economies that can be realized when two people live together. This result is not achieved with the present system.

3. The tax liabilities of married couples should be independent of the proportion of total income received by husband or wife. This result is not achieved under the present system, for the couple comprised of a husband and wife who have identical incomes pays a lower tax than a couple with the same income received by one of the spouses.

4. These problems could be eliminated by the aggregation of the income of husband and wife. By taxing the total income of the couple under a rate schedule that bears an appropriate relationship to the rate schedule applicable to individuals, a more equitable allocation of taxes between single individuals and couples could be achieved.

5. The aggregation of the income of husband and wife would have the important result that transactions between the two would have no tax consequences. In particular, inter vivos and testamentary transfers of property between spouses would not be subject to tax notwithstanding the general rule that gifts are included in the income of the donee tax unit.

6. Adopting the family as one of the basic units for tax purposes would have the advantage that the problems created by income splitting between husband and wife under the present approach would be largely eliminated. The restrictive sections of the Act that are now necessary to prevent income splitting have been sharply criticized as discriminatory and inconsistent. These restrictions could be abolished.

7. There are both advantages and disadvantages to the aggregation of the income of dependent children with family income. Except under unusual

circumstances, compulsory aggregation of the income of dependent children with that of their parents would be preferable from an equity point of view, and the administrative problems would probably be less with aggregation. We therefore recommend compulsory aggregation of the income of dependent children with family income, with modifications that would provide the flexibility necessary to accommodate the diverse relationships that prevail between parents and their children and the unique character of the income sometimes received by dependent children.

THE COMPOSITION OF THE FAMILY UNIT

8. A husband and wife, if they are Canadian residents, should be treated as a tax unit (the "family unit") for tax purposes. The family unit would commence at the beginning of the taxation year in which the marriage occurred.

9. Where there were resident dependent children, they should also form part of the family unit for tax purposes. With two exceptions, dependent children should be defined as unmarried children 21 years of age or less, or over 21 and infirm. Actual support should not be a test of dependency. Other close relatives dependent upon the family unit for support should not be included in the family unit for tax purposes. However, a tax credit should be available that would be related to expenditures made to support such dependants.

10. A family unit should also be formed at the commencement of the year in which any of the following events occurred: an unmarried woman has a child; an unmarried individual adopts one or more children; or a divorced or separated spouse retains custody of one or more dependent children. The unit would consist of the parent and the dependent child or children.

OPTIONS FOR DEPENDENT CHILDREN

11. Two options should be available with respect to dependent status:

    a) An unmarried resident child 21 years of age or less, but over school-leaving age, who lived away from home and was employed or operated a business on a full-time basis, should be permitted to file as an individual, at the option of the child <u>or</u> of the child's parents.

    b) An unmarried resident child over 21 years of age but not over 25 who attended a recognized institution of post-secondary education on a full-time basis should be permitted, if acceptable to <u>both</u> the child and his or her parents, to remain a member of the family unit.

FAMILY RATE SCHEDULE

12. Normally, the income of the family unit would be aggregated on a joint return and this aggregate taxed on a "family unit rate schedule". Under that schedule family units would pay less tax than an individual with the same income.

13. Either spouse should be permitted to elect that they would not aggregate their incomes. In that event they would file separate returns and be taxed separately on the family unit rate schedule in a way that would usually involve somewhat higher taxes (in total) than if they had aggregated. A dependent child's income (in excess of the exemption referred to below) if any, would be aggregated with that of either parent.

LIABILITY FOR TAX PAYABLE BY FAMILY UNIT

14. The spouses should be jointly and severally liable for the tax payable by the family unit unless they file separate returns. If there is

only one parent, he or she would be liable for the tax. A dependent child with income should be liable for the tax allocable to that income.

EXEMPT INCOME FOR DEPENDENT CHILDREN

15. Employment or business income up to $500 earned at arm's length by a child in a family unit should be exempt from tax and would therefore not be subject to aggregation. Only the dependent child's income in excess of that sum should be aggregated with the income of the family unit.

INDIVIDUAL RATE SCHEDULE

16. A person who was not a member of a family unit should be treated as an "individual unit" and should be taxed on the "individual unit rate schedule".

TRANSFERS OF PROPERTY WITHIN FAMILY UNIT

17. With one exception, transfers of property, either _inter vivos_ or on death, between members of a family unit should not involve a deemed disposition or the receipt of income. For example, a husband would be able to make _inter vivos_ and testamentary gifts to his wife or dependent child free of any tax.

18. To prevent abuse through marriages undertaken solely for the purpose of reducing taxes on transfers of property, it should be provided that tax-free transfers would not be permitted until the marriage had lasted for five years or until there was a natural-born child of the marriage, whichever was earlier. One exception to this would be that tax-free transfers would be allowed during this period up to one half of the income after tax reported by the family unit.

TRANSFERS OF PROPERTY BETWEEN UNITS

19. Gifts of assets from outside the family unit to a member of the family unit should be treated as income of the family unit, with the exception noted below.

20. The following special rules should apply to dependent children:

a) A dependent child who received gifts or bequests from outside the family unit should be permitted to deposit such gifts or bequests, or the monetary value thereof, in an interest-bearing Income Adjustment Account. Such deposits would be deducted from family income for tax purposes. Withdrawals from these deposits would be taxable to the unit of which the donee is a member at the time of the withdrawal. Withdrawal would be compulsory when the child established a new tax unit.

b) A dependent child with income earned at arm's length from employment or business in excess of the $500 annual allowance should be permitted to deposit the excess in an Income Adjustment Account on the same basis as gifts from outside the family unit.

c) On marriage, on ceasing to be a resident, and on ceasing to qualify as a dependent child under the definitions given in 9 above:

i) there should be a deemed realization of gains or losses to the original family unit, on the property the child takes to the new unit;

ii) the child should bring this property into the income of his or her new tax unit in its first taxation year at the fair market value, subject to a lifetime exemption of $5,000 and the applicable annual exemption for gifts; if the child has ceased to be resident the property would be subject to withholding tax as a gift.

d) On the adoption of a dependent child who is an orphan by another family unit there should be no deemed realization and the property of the child should not be included in the income of the new unit.

TERMINATION OF THE INDIVIDUAL TAX UNIT

21. The individual tax unit should terminate on death, on marriage or on giving up Canadian residence. Except on marriage there would be a deemed realization of property gains to the terminating unit and the property passing to other resident units would be brought into the income of the recipient unit. On marriage there would be no deemed realization and the property taken from the individual tax unit to the new family unit created by the marriage would not be brought into the income of the new unit. All deemed realizations of property would be at the fair market value.

TERMINATION OF THE FAMILY TAX UNIT

22. The family tax unit should terminate if both spouses ceased to be resident and there were no resident dependent children. There would be a deemed realization of property gains to the terminating unit. Property passing from the terminating unit to resident tax units would be brought into income by the latter. If a person becoming non-resident elects to continue to be taxed as a resident, he should be regarded as a resident for all purposes.

23. If one spouse became non-resident there should be a deemed realization of gains on the property of that spouse. However, the family tax unit would not terminate if one spouse remained resident or if there were resident dependent children.

24. The family tax unit should terminate if the spouses were divorced or legally separated. However, there would be no deemed realization of property gains to the family unit, and the property taken by any of

the members of the family from the terminated unit would not be brought into the income of the new tax units they formed.

25. The family unit should terminate:

a) On the death of the surviving spouse if there were no resident dependent children.

b) On the remarriage of the surviving spouse.

c) On the surviving spouse ceasing to be resident if there were no resident dependent children.

d) On the loss of dependent status by all members of the family unit of parents who have died or have ceased to be resident leaving dependent children resident in Canada.

In the circumstances referred to in paragraphs (a), (c) and (d) there would be a deemed realization of all property gains to the family unit. In cases (a) and (d) all property transferred from the terminated unit, after providing for its tax liability, would be brought into the income of recipient tax units. In the case of remarriage of a surviving spouse there would be no deemed realization and the property of the surviving spouse would not be included in the income of the new unit. In the event of the marriage of a surviving spouse or of an unmarried person who has a dependent child or dependent children, all members of the tax unit would presumably become members of the new tax unit and there would be no deemed realization to the former unit or income to the new unit.

REFERENCES

1/ This difference is reduced to about $80 if the separate old age security tax is included.

2/ Section 4(4) of the Income War Tax Act, 1917, Chapter 28.

3/ Sections 21(1) and 22(1).

4/ Sections 21(1), 22(1) and (2).

5/ Under section 21(2), where a person has received remuneration as an employee of his spouse, the amount is not deducted in computing the spouse's income and is not included in the employee's income. Section 21(3) provides that where a person has received remuneration as the employee of a partnership in which his spouse was a partner, the proportion of the remuneration that the spouse's interest in the partnership was of the interests of all the partners is deemed to have been received by the spouse as part of his income for the year from the partnership.

6/ Section 21(4).

7/ Robins v. M.N.R., [1963] Ex. C.R. 171.

8/ Dunkelman v. M.N.R., [1960] Ex. C.R. 73.

9/ Campbell v. M.N.R., 63 DTC 493; 32 T.A.B.C. 203.

10/ See the discussion of the treatment of common law wives later in this chapter.

11/ We see no major difficulty in allowing the couple to decide whether to file separately or jointly each tax year if the procedure described above were followed.

12/ An Income Adjustment Account is a government-supervised account which we recommend and which is described in Chapter 13.

13/ Property transferred between spouses would be recorded at a cost basis equal to that of the donor spouse.

14/ As an alternative it could be stipulated that in these circumstances the family unit would terminate, but that there would be no tax consequences, as in the case of a divorce or legal separation. However, we believe the approach recommended not only puts greater emphasis on the tax significance of the family unit, but it also facilitates the treatment of life insurance and retirement income received by the surviving spouse.

15/ Unless both spouses elect to continue to be taxed as if they were resident in Canada. This procedure is discussed in Chapter 26. If such an election is made in any case where a person becomes non-resident, the tax consequences would be the same as if that person had continued to be resident.

16/ As stated above, where there is a surviving resident spouse without dependent children the family unit would continue but income would be taxed to the surviving spouse under the individual rate schedule. The continuation of the family unit on the death of one spouse would ensure that transfers of property accumulated by a couple would not be taxed on the death of the husband or of the wife.

17/ The age which we have suggested as the principal test for determining whether a child is dependent is 21. It is arguable that, since most children who do not attend university become self-sufficient before they are 21 years of age, this age should be lowered to 18 years.

18/ See reference 12 supra.

19/ Sections 22(1) and 22(2).

CHAPTER 11

RATES OF PERSONAL INCOME TAX

In the four preceding chapters, we have defined what the tax base should be and the units for which this tax base should be calculated. In this chapter, we recommend how taxes should be calculated for tax units having various attributes and different incomes.

For the tax system to be fair, the taxes paid by upper income tax units should be a larger proportion of their total income than the taxes paid by units with less income. If the income tax were the only tax levied, a mild progressiveness in marginal rates would suffice. However, as Chapter 6 has shown, other forms of taxation are regressive. The income tax therefore must be progressive merely to achieve a proportional tax system. To obtain a progressive tax system the income tax must be markedly progressive.

The schedules of personal income tax rates recommended in this chapter, when combined with our proposed reforms of the tax base, would increase the average progressiveness of the tax system over what it is now. The evidence supporting this contention is presented in Chapter 36. We believe this would achieve a more equitable distribution of the burden of taxation. Because the adoption of a comprehensive definition of income would increase the tax bases of upper income individuals and families more than others, this increased progressiveness could be achieved with substantially lower marginal tax rates at the upper end of the schedule. As we indicate in Chapter 37, lower marginal tax rates should make profitable investment more attractive, increase labour force participation rates and increase labour, managerial and professional effort. Lower marginal rates should consequently enhance the rate of economic growth in Canada. The fact that marginal rates could be lowered at the same time that the average progressiveness of the tax system was increased is an indication of the inefficiency of the present tax system and the need for tax reform.

CRITERIA GOVERNING THE SELECTION OF A RATE SCHEDULE

In developing the rate schedules presented in this chapter we have been guided by several objectives and constraints. Our principal objective has been to allocate taxes among tax units in proportion to each unit's ability to pay. Consequently, we have tried to devise schedules that are consistent with the criteria established in Chapter 7. In addition, we believe that the rate schedule should be consistent with the realization of the following objectives:

1. Because sales taxes are, at best, proportionate to income, and property taxes are regressive, there should be compensatory reductions in the weight of income taxes on low income tax units to achieve the allocation of all taxes according to ability to pay.

2. The weight of taxes on middle income tax units should be reduced to narrow the unfavourable income tax differential between Canada and the United States.

3. The maximum rate of tax on any form of income should be no greater than 50 per cent, to minimize disincentive effects 1/.

Only the first objective in the list is concerned with ability to pay, but we believe that the others are of sufficient importance to be taken into account in developing the rate schedules we recommend.

Our selection of rate schedules has been subject to the following constraints:

1. In accordance with the Order in Council establishing this Commission, the tax system we recommend must raise approximately the same revenue as the present tax system.

2. Apart from the industries affected by eliminating inefficient concessions in the present tax law, the weight of taxation on

equity investments should be no greater than at present, despite the widening of the tax base to include the full taxation of capital gains.

Were it not for the binding nature of the revenue constraint, it would be relatively easy to choose a rate schedule that was consistent with all of our objectives. There is no conflict among our objectives that could not be resolved by decreasing the revenue yield of the tax system. Because we are not able to reduce revenue, however, it is necessary to determine the emphasis that should be given to each objective. With some exceptions that we discuss below, primary emphasis has been placed on the first objective: making the income tax system equitable by allocating taxes in accordance with the ability to pay of tax units.

Taxation According to Ability to Pay

In Chapter 7, we concluded that taxes should be allocated in proportion to ability to pay. This result would be achieved, we believe, if the tax base was defined in accordance with our comprehensive definition of income, and if the taxes on this base were determined by schedules of rates that reflected the differences in the discretionary economic power of tax units with different incomes and different family characteristics.

The "ideal" rate schedules which we developed in accordance with the ability-to-pay principles explained in Chapter 7 are later modified to meet the other objectives and constraints. In developing these "ideal" schedules, several important assumptions have been made.

1. We assume that the first few dollars of a tax unit's income are not available for discretionary use. Below some limit, therefore, the marginal rate of tax should be zero. We have adopted a lower limit of $300 for single individuals and $700 for families. These limits, together with the other assumptions, determine the rate of progression of the marginal rates. The $300 and $700 limits would be appropriate

if personal income taxes were the only taxes levied. However, as we explain later, these limits must be increased to compensate for sales and property taxes. Accordingly, in the rate schedules we recommend, the amounts subject to a zero rate of tax are higher than these limits.

2. We assume that all income in excess of some limit is available for discretionary use. Above some limit, therefore, the marginal rate of tax on additional income should be constant. Both in arriving at our "ideal" rate schedules and the recommended rate schedules, we have accepted $100,000 as the upper limit. This limit may be excessive, even though it is only one quarter of the present limit.

3. We assume that, between these limits, equal percentage differences in income are associated with equal differences in the fraction of additional income available for discretionary use. The income brackets should, ideally, encompass equal percentage differences in income. Marginal rates should rise by equal amounts from bracket to bracket 2/.

4. Up to an income limit of $40,000 we assume that the fraction of income available for discretionary use is less for families than for individuals with the same income. Above this limit we assume that the fraction is the same for both. Consequently the rate schedule for individuals and families should merge at this point.

If these assumptions are accepted, if personal income taxes were the only taxes levied, and if equity were the only objective, the construction of rate schedules that raised sufficient revenue and allocated taxes according to ability to pay would be a straightforward, mechanical task.

Compensatory Adjustments for Other Taxes

If personal income taxes were the only taxes levied, rate schedules with the characteristics described above would, we believe, allocate taxes according to ability to pay. Personal income taxes are not, however, the only revenue source.

Our proposed integration of personal and corporate taxes would mean that corporate source income attributable to residents would be taxed according to the ability to pay of individuals and families. But we have not recommended the integration of sales and property taxes, although we suggest that study be given to the possibility of providing arbitrary refundable tax credits against personal income tax liabilities for these taxes. Sales taxes are at best proportionate to income, and property taxes, where they are payable, decline as a proportion of income as income rises. Consequently, to allocate personal income taxes according to ability to pay, while ignoring sales and property taxes, would mean that low income tax units would be taxed too heavily relative to their ability to pay. To compensate for these non-income taxes we believe that the marginal income tax rates imposed on the first brackets should be reduced relative to what would be appropriate if personal income taxes were the only taxes.

To this end we recommend that, for unattached individuals, the first bracket should encompass the first $1,000 rather than the first $300 of income. We also recommend that this bracket should be subject to a zero rate of tax. This would be equivalent to maintaining the basic exemption of $1,000 for individuals. For families, we recommend a zero rate bracket that would encompass the first $2,100 of income. This would be slightly more generous than the present exemption for couples of $2,000.

Zero rate brackets serve exactly the same purpose, and have exactly the same consequences, as exemptions equal to the width of such brackets.

In addition to maintaining, in effect, the present exemptions, we also recommend small reductions in marginal rates at the lower end of the schedule. These measures, together with the reform of the sales tax base that we also recommend, should go some distance in moving closer to the allocation of all taxes according to ability to pay.

International Tax Comparisons

For many Canadian workers, the market for their services is continental, not Canadian. This is especially true for highly skilled and professional employees who are increasingly sought by United States and other foreign employers as well as by employers in Canada. The so-called "brain drain" from Canada has been widely noted and deplored by many observers 3/. We are anxious that the Canadian tax system should not contribute to that drain.

Taxes are not the only factor that affects an individual's decision to emigrate from Canada. For example, the persistently large differential between Canadian and United States mortgage interest rates may be as important a factor as taxes for many individuals 4/. As is emphasized in Chapter 4, differences in tax burdens are probably not as important as differences in salaries, working conditions and living costs. For reasons that need not concern us here, Canadian employers generally do not offer competitive salaries and frequently have not been able to offer work as interesting as that offered by United States employers. We are, however, concerned with reducing Canadian taxes on skilled workers and professionals to the point where there are no major tax incentives for emigration to the United States 5/.

Examples of the difference between the income taxes currently paid by taxpayers in equivalent positions in the United States and in Canada are provided in Table 11-1. This table shows, for several different situations, the total income taxes paid to all levels of government by a family with two children, both of whom are assumed to qualify for family allowances, with an income of $12,000 earned by the head of the family. Comparisons are provided for the average taxpayer earning this amount in the United States and in the Canadian provinces with the lowest tax rates, as well as for the average taxpayer residing in the State of New York and Saskatchewan. In both of the latter cases, taxes are substantially above the average for the respective countries 6/. As can be seen from the data given in the table, income taxes are higher in Canada in all examples. In fact, income taxes

TABLE 11-1

INCOME TAXES PAYABLE BY A FAMILY WITH TWO CHILDREN AND INCOME OF $12,000 IN THE UNITED STATES AND IN CANADA (1966 RATES)

	United States			Canada	Percentage difference
Typical home owner					
New York State	$ 1,419	Saskatchewan		$ 1,914	-25.9
Average for United States	1,318	All provinces other than Saskatchewan, Manitoba and Quebec		1,827	-27.9
Average taxpayer filing itemized deductions					
New York State	1,529	Saskatchewan		1,914	-20.1
Average for United States	1,409	All provinces other than Saskatchewan, Manitoba and Quebec		1,827	-22.9
Average taxpayer using standard deduction					
New York State	1,843	Saskatchewan		2,178	-15.4
Average for United States	1,634	All provinces other than Saskatchewan, Manitoba and Quebec		2,060	-20.7

Note: Income taxes include provincial income taxes and old age security tax in Canada, and average state and local income taxes on the United States. They do not include compulsory contributions to government pension plans in either country. In all cases, the percentage difference is calculated using the Canadian tax figure as base.

Source: Appendix H to this Volume.

paid by a Canadian family living in the provinces with the lowest tax rates are even higher than those paid by a family residing in New York State. The differential is especially large for a family living in a house that it owns because mortgage interest payments and property taxes are deductible in computing taxable income in the United States 7/.

The examples in Table 11-1 show only the higher taxes paid by a Canadian family with two children at one income level. The percentage differences between Canadian and United States income taxes for different taxpayers with different incomes is given in Table 11-2. In all cases the comparison is between United States taxpayers with average state and local income taxes and Canadian taxpayers in provinces with the lowest income taxes. The data given in the table thus compare average United States income taxes with income taxes in all provinces other than Quebec, Manitoba and Saskatchewan. Because thirteen states in the United States do not levy any state income tax at all, this comparison is somewhat biased in favour of Canada. In spite of this bias, it is apparent from Table 11-2 that middle income taxpayers pay substantially higher taxes in Canada than in the United States. The difference in taxes arises in part from more liberal deductions in the United States, in part from lower tax rates and in part from the right of husbands and wives in the United States to file joint returns 8/.

The difference is lowest for a single individual with no dependants who does not claim itemized deductions. Such an individual, on the average, pays less income tax in the United States than in Canada if his income is between $8,000 and $30,000. If the United States taxpayer lives in a state such as Pennsylvania, which has no state income tax, his income taxes are less for incomes ranging from $5,000 to $30,000.

For a married couple, average income taxes are less in the United States if the couple's income is greater than $7,000, even if only the standard deduction is claimed. However, over 60 per cent of United States taxable returns filed jointly by husbands and wives claim itemized deductions 9/.

TABLE 11-2

PERCENTAGE DIFFERENCES BETWEEN
UNITED STATES AND CANADIAN INCOME TAXES

Assessable Income	Percentage Difference for Single Persons, No Dependants, Using Standard Deduction	Percentage Difference for Married Couples, No Dependants, Using Standard Deduction	Percentage Difference for Family With Two Children, Itemizing Deductions
$ 1,500	76.5	-	-
2,500	34.8	249.0	-
3,500	16.2	55.4	13.4
5,000	5.2	11.6	18.4
6,500	1.5	1.8	- 18.4
8,000	- 1.3	- 3.7	- 17.3
10,000	- 4.7	- 11.9	- 19.1
12,000	- 5.6	- 15.2	- 22.9
15,000	- 6.5	- 21.5	- 27.3
25,000	- 2.4	- 28.5	- 36.6
40,000	4.5	- 23.7	- 35.0
70,000	7.2	- 14.8	- 28.1
100,000	8.5	- 10.9	- 26.7
200,000	5.3	- 6.6	- 24.3

Note: The percentages shown in this table are calculated so that a "plus" figure shows United States income taxes being higher than Canadian income taxes; a "minus" figure shows United States taxes being lower. In all cases the base of the comparison is the Canadian income tax payable on that income. United States taxes include average state income tax; Canadian taxes include only the lowest provincial income tax. Old age security taxes are included in Canadian tax figures. Compulsory contributions to government pension plans are not included in either United States or Canadian tax figures.

Source: Appendix H to this Volume.

The typical family has two children, and the taxes for such a unit appear in the third column of Table 11-2. This shows that, even including average state and local income taxes, United States income taxes are lower for such families with income over $6,000. This amount is reduced to $5,000 in a state with no state income tax. For a family with an income of $25,000, total average income taxes paid are about $2,500 less in the United States than in Canada.

Higher Canadian income tax rates might, of course, be expected if income taxes accounted for a larger share of total tax revenues in Canada than in the United States. However, the situation is actually the reverse. Even without taking into account recent increases in provincial sales taxes, in 1964 direct taxes accounted for only 45 per cent of total tax revenues of all levels of government in Canada, compared to 63 per cent in the United States 10/. The average rate of sales tax in Canada is roughly double the United States rate, and is among the highest in the world.

To reduce the relative tax advantage enjoyed by residents of the United States, we have adopted as a third objective the establishment of a rate schedule that would result in roughly equal income taxes for middle income taxpayers in Canada and in the United States. Because of the lower average income of Canadians and the higher ratio of government spending to GNP, this objective cannot be achieved completely 11/.

The Maximum Marginal Rate

If equity were the only consideration, the top personal rate of tax would be determined solely by revenue requirements. Given the size of the base and the assumed upper and lower limits between which marginal rates should vary, the top marginal rate would, in effect, be predetermined by revenue requirements.

We are persuaded that high marginal rates of tax have an adverse effect on the decision to work rather than enjoy leisure, on the decision to save rather than consume, and on the decision to hold assets that provide monetary returns rather than assets that provide benefits in kind. We think there would be great merit in adopting a top marginal rate no greater than 50 per cent. With such a maximum marginal rate, taxpayers would be assured that at least half of all gains would be theirs after taxes. We think there is a psychological barrier to greater effort, saving and profitable investment when the state can take more than one half of the potential gain.

We recommend elsewhere that the corporate base be increased by the removal of certain concessions to some industries. Aside from this change, acceptance of the integration of personal and corporate taxes at a maximum rate no higher than 50 per cent would mean that the marginal rate of tax on income from new investments in plant and equipment would generally be reduced.

A top personal rate no greater than 50 per cent has another important advantage. With a corporate rate of 50 per cent and higher personal rates, upper income shareholders could defer personal income taxes by retaining earnings in the corporation and postponing the realization of their share gains. This would continue the existing conflict of interest between low and upper income shareholders and the lack of tax neutrality in the decision to retain or distribute corporate profits.

The Revenue Yield of the Rate Schedule

The tax system we propose must raise sufficient revenue. To ensure that this constraint is not violated, we have made an extensive analysis of the revenue-producing potential of our proposals. The results are described in Chapter 35. We are confident that the rate schedules we recommend, when taken together with our other recommendations and including transitional costs, would raise as much revenue as the present system 12/. Further reductions in the rate schedule could be made after a transitional period of a few years.

The Taxation of Income from Equity Investments

We have made a number of recommendations that should enhance the attractiveness of equity investments independently of the tax rate applicable to them. These include provisions for the more neutral treatment of income from different sources, full write-off of losses on investments and accelerated capital cost allowances for new, small businesses. The provisions should reduce the risk of equity investments and so enhance their attractiveness. Nevertheless, we believe it would be desirable to reduce marginal rates of tax on corporate source income 13/ and unwise to increase the average rates paid by residents.

The decision to undertake additional capital expenditures is presumably determined by the expected after-tax rate of return on additions to plant and equipment. Assuming that they are not shifted through lower prices or higher costs, we believe that reductions in marginal tax rates on corporate source income should stimulate equity investment. We have accepted as an objective that the rate schedules we recommend, combined with the integration of personal and corporate taxes and the full taxation of share gains, should result in a reduction in marginal rates on this kind of income for most residents.

Corporate income is a major source of saving. A higher proportion of this kind of income is saved than of other kinds of income. By holding the average rate of tax on corporate source income to no more than present levels, any adverse effects on saving of taxing capital gains should be eliminated. Consequently, we have accepted the constraint that the average burden of tax on equity investment by residents should not be increased, except for the resource industries and some financial institutions that have been too lightly taxed in the past.

RECONCILIATION OF CONFLICTING CRITERIA

Because of the revenue constraint, we have not been able to meet all our objectives in the personal income tax rate schedules we recommend.

We have set the maximum tax rate at 50 per cent, the upper limit that we are willing to accept. A higher rate would raise more revenue but result in an unacceptable increase in the weight of taxation on equity investment income and, we believe, would have appreciable disincentive effects.

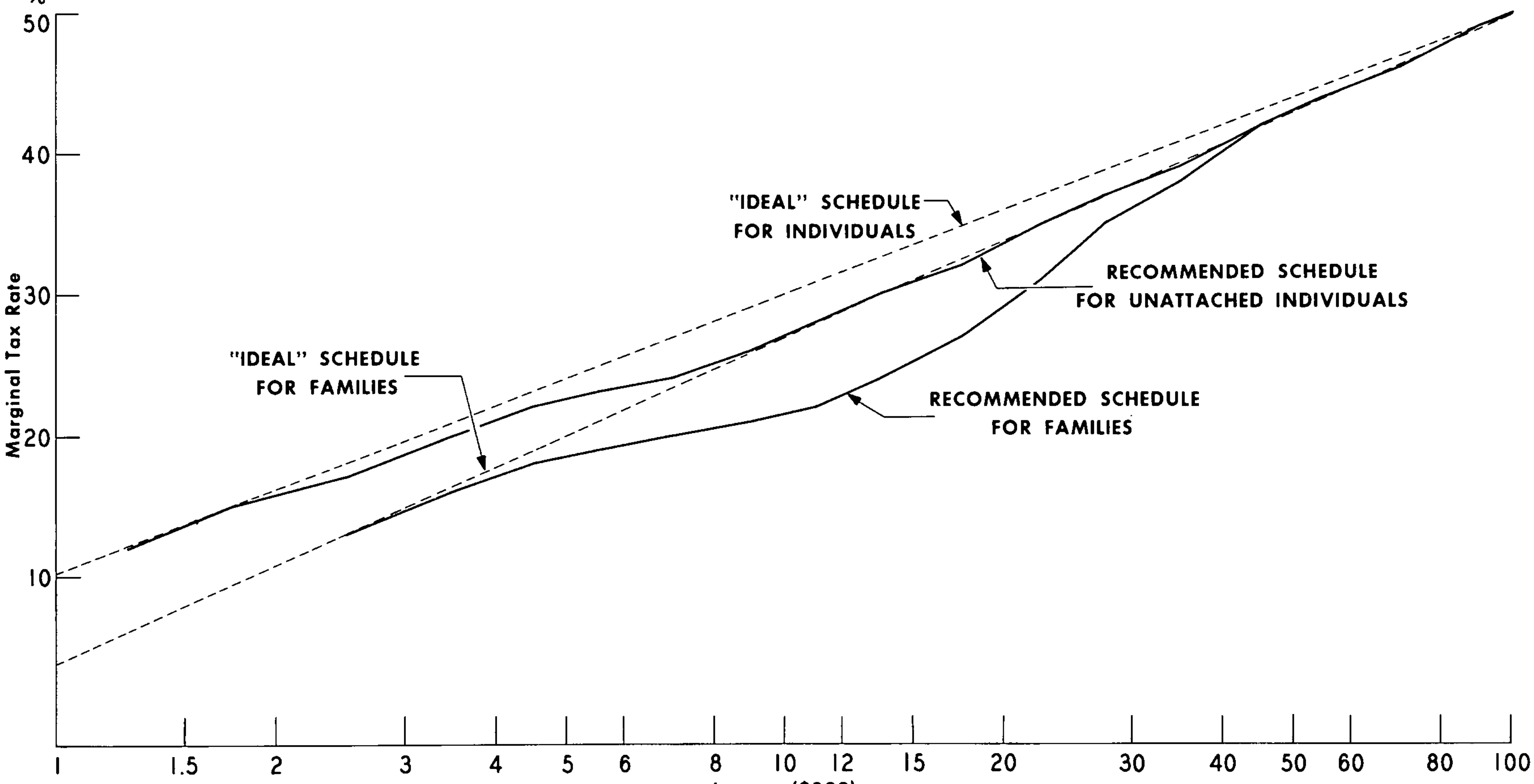
We have been able to increase progressiveness by raising the tax on upper income individuals (by broadening the tax base) and by reducing taxes at the lower end of the income scale. We have also been able to reduce taxes on middle income taxpayers so as to more closely approach United States levels. But we have not found it possible to eliminate the unfavourable differential altogether.

The rate schedules we recommend as a result of these considerations are shown in Chart 11-1. The effect of having to reconcile conflicting objectives in selecting the rate schedules is roughly illustrated by the difference between the recommended schedules shown in the chart as solid lines and the more "ideal" schedules shown as dashed lines. By "ideal" we mean consistent with all of the assumptions that would result in taxes being levied strictly in accordance with ability to pay. These assumptions are referred to earlier in this chapter and are explained more fully in Chapter 7. There are two primary differences between the rate schedules we recommend and those we regard as ideal.

1. Marginal tax rates have been reduced below ideal levels particularly on incomes between $5,000 and $40,000 to reduce taxes in middle income brackets.
2. The family rate schedule has been reduced in the middle income

Chart 11-1

RECOMMENDED RATE SCHEDULES



Source : Tables 11-4 and 11-6

brackets to an even greater extent than the rate schedule for unattached individuals in order to bring taxes paid by middle income families closer to the income taxes which would be paid in the United States 14/.

These "distortions" have been introduced in order to obtain a rate schedule that is closer to the several objectives we have specified. As has been pointed out, our analysis has been based on what we believe to be a conservative evaluation of the revenue yield of the proposed tax system. At a later date, these distortions might be removed.

We have not included among the distortions the large amounts of income "exempted" from tax ($1,000 for individuals and $2,100 for families) under the zero brackets specified in our recommended rate schedule. These exemptions reflect considerations that cannot be overcome by the foreseeable growth in revenue, namely, the lack of progressiveness of federal, provincial and municipal sales and property taxes, which are not integrated with the income tax. However, if the weight of sales or property taxes was reduced, it would be appropriate to narrow the zero rate brackets.

The rate schedules we recommend are as consistent as seems possible with current revenue needs, with our objectives and with our other recommendations. Nevertheless, as we have emphasized before, the construction of rate schedules involves a number of assumptions which are entirely a matter of judgment. Throughout our analysis of the various component factors affecting the determination of the rate schedules, we have attempted to isolate the elements of the problem that involved judgment. We hope that in our decisions we have reflected the judgments most Canadians would make. We also hope that the framework of analysis presented in Chapter 7 and in this chapter provides an effective basis for taking into account alternative judgments in constructing rate schedules.

We turn now to a more detailed examination of the rate schedules and credits we recommend.

THE RECOMMENDED RATE SCHEDULES

We discuss the recommended rate schedules under three headings: (1) the rate schedule for individuals without dependants, (2) the rate schedule for family units and (3) the treatment of dependants. Where a family unit includes dependent children, we recommend the use of tax credits to allow for the additional non-discretionary expenses which are attributable to the children. We should emphasize that the income to which the rate schedules apply does not reflect any deduction of personal exemptions. For comparison, the current (1966) rate schedule is shown on this basis in Table 11-3. This table incorporates the old age security tax, which we believe should be eliminated as a separate tax, as well as the effect of the special reduction in rates for 1966.

The Rate Schedule for Unattached Individuals Without Dependants

The rate schedule we recommend for unattached individuals is shown in Table 11-4. Major points of similarity and of difference between this schedule and the current rate schedule are as follows:

1. The rates at which income under $8,000 is subject to tax are virtually unchanged.

2. In the current rate schedule, the increase in marginal rates accelerates rapidly after the $8,000 level. Under the recommended rate schedule, the rate of increase of the rates accelerates at a higher income level, thus reducing rates in the $8,000 - $20,000 range.

3. The maximum marginal rate in the recommended schedule is 50 per cent and is reached at an income of $100,000.

Because the top marginal rate would be reduced from 80 per cent to 50 per cent, those high income taxpayers who did not have their tax bases

TABLE 11-3

CURRENT SCHEDULE OF INCOME TAX RATES FOR INDIVIDUALS AND MARRIED COUPLES WITHOUT DEPENDANTS

Taxable Income Before Deducting Personal Exemptions	Taxes Paid By Individuals Without Dependants		Taxes Paid By Married Couples Without Dependants	
	Tax At Bottom of Bracket (dollars)	Marginal Rate (per cent)	Tax At Bottom of Bracket (dollars)	Marginal Rate (per cent)
Less than $1,000	none	—	none	—
$ 1,000 - 1,909	none	12.8	none	—
1,909 - 2,000	116	15	none	—
2,000 - 2,909	130	18	none	12.8
2,909 - 3,000	294	18	116	15
3,000 - 4,000	310	21	130	18
4,000 - 5,000	520	19	310	21
5,000 - 6,000	710	22	520	19
6,000 - 7,000	930	22	710	22
7,000 - 8,000	1,150	26	930	22
8,000 - 9,000	1,410	26	1,150	26
9,000 - 10,000	1,670	30	1,410	26
10,000 - 11,000	1,970	30	1,670	30
11,000 - 12,000	2,270	35	1,970	30
12,000 - 13,000	2,620	35	2,270	35
13,000 - 14,000	2,970	40	2,620	35
14,000 - 16,000	3,370	40	2,970	40
16,000 - 17,000	4,170	45	3,370	40
17,000 - 26,000	4,620	45	4,170	45
26,000 - 27,000	8,670	50	8,220	45
27,000 - 41,000	9,170	50	8,670	50
41,000 - 42,000	16,170	55	15,670	50
42,000 - 61,000	16,720	55	16,170	55
61,000 - 62,000	27,170	60	26,620	55
62,000 - 91,000	27,770	60	27,170	60
91,000 - 92,000	45,170	65	44,570	60
92,000 -126,000	45,820	65	45,170	65
126,000 -127,000	67,920	70	67,270	65
127,000 -226,000	68,620	70	67,920	70
226,000 -227,000	137,920	75	137,620	70
227,000 -401,000	138,670	75	137,920	75
401,000 -402,000	269,170	80	268,420	75
Over -402,000	269,970	80	269,170	80

Note: This rate schedule includes all taxes on income, including the separately calculated old age security tax of 4 per cent on the first $3,000 of taxable income. The 12.8 per cent rate on the first $909 of taxable income reflects the 20 per cent decrease up to a maximum of $20 announced in the 1966 Budget. Provincial taxes in excess of the federal abatement are not included.

TABLE 11-4

RECOMMENDED SCHEDULE OF INCOME TAX RATES
FOR AN UNATTACHED INDIVIDUAL

Taxable Income			Tax Payable			
Less than	-	$ 1,000	$		None	
$ 1,000	-	1,500			12% of income over $	1,000
1,500	-	2,000	60	+	15% of income over	1,500
2,000	-	3,000	135	+	17% of income over	2,000
3,000	-	4,000	305	+	20% of income over	3,000
4,000	-	5,000	505	+	22% of income over	4,000
5,000	-	6,000	725	+	23% of income over	5,000
6,000	-	8,000	955	+	24% of income over	6,000
8,000	-	10,000	1,435	+	26% of income over	8,000
10,000	-	12,000	1,955	+	28% of income over	10,000
12,000	-	15,000	2,515	+	30% of income over	12,000
15,000	-	20,000	3,415	+	32% of income over	15,000
20,000	-	25,000	5,015	+	35% of income over	20,000
25,000	-	30,000	6,765	+	37% of income over	25,000
30,000	-	40,000	8,615	+	39% of income over	30,000
40,000	-	50,000	12,515	+	42% of income over	40,000
50,000	-	60,000	16,715	+	44% of income over	50,000
60,000	-	80,000	21,115	+	46% of income over	60,000
80,000	-	100,000	30,315	+	49% of income over	80,000
Over		100,000	40,115	+	50% of income over	100,000

Note: No personal exemption is deducted in computing taxable income.

increased as a result of our other reforms would have their taxes substantially reduced. This would be particularly important for taxpayers who received large incomes primarily in the form of wages, salaries, professional income and business income. In the past, such people have generally been taxed too heavily on their incomes. Relative to the comprehensive tax base, individuals receiving income largely from investments, bequests, or other sources have not been adequately taxed. By adopting our recommendations the latter would have their taxes substantially raised, despite the lower marginal rates. The disparity in the taxes borne by high income individuals is one of the most glaring inequities of the present tax system. The broader base and lower marginal rates we recommend would eliminate this inequity.

The taxes payable by an individual at different comprehensive income levels under our proposed rate schedule are shown in Table 11-5, where they are compared to what the individual would pay under the present rate schedules in Canada and in the United States. In Table 11-5 it is assumed, for illustrative purposes, that an individual deducts only uses the optional standard deduction. Additional examples are provided in Appendix I to this Volume and in Chapter 36. The examples given in Appendix I to this Volume show the effect of our recommendations on taxpayers who have wage and salary income exclusively and claim only the standard optional deduction. The data presented in Chapter 36 show what the effect of our recommendations would have been in 1964 for all taxpayers who filed tax returns in that year.

If the tax base was unchanged, the rate schedule we recommend for unattached individuals would provide a reduction in taxes at all income levels over $10,000. Below the $10,000 level, taxes would be approximately the same as at present. Under the proposed rate schedule, Canadian taxes would be below United States levels for the top and bottom income classes. In the $6,500 - $12,000 range, Canadian taxes would be only slightly higher than United States taxes.

Because of the substantial changes in the base we recommend, these results must be interpreted with caution, however. As shown in Appendix I to this Volume, most unattached individuals who depended exclusively on employment income would have tax reductions even if their incomes were less than $10,000. Similarly, as shown in Appendix M to Volume 4, unattached individuals at the lower end of the income scale who held investments in corporate equities and relied exclusively on corporate source income would have large tax reductions.

TABLE 11-5

INCOME TAXES PAYABLE BY AN UNATTACHED INDIVIDUAL UNDER THE CURRENT RATE SCHEDULES IN CANADA AND THE UNITED STATES AND UNDER THE RECOMMENDED RATE SCHEDULE

	Income Taxes Payable		
Income	Canada (1966 Rates)	United States (1966 Rates)	Recommended Rates
$ 1,500	$ 51	$ 90	$ 54
2,500	202	267	211
3,500	394	459	395
5,000	691	727	714
6,500	1,018	1,033	1,063
8,000	1,384	1,366	1,423
10,000	1,940	1,849	1,942
12,000	2,585	2,441	2,501
15,000	3,730	3,488	3,400
25,000	8,175	7,977	6,747
40,000	15,620	16,300	12,495
70,000	32,510	34,842	25,692
100,000	50,955	55,298	40,090

Note: United States taxes include state and local income taxes of an average state; Canadian taxes include the provincial tax abatement but not provincial taxes in excess of the abatement, and the old age security tax. In all cases, it is assumed that the taxpayer claims only standard deductions. Under our recommendations, the standard deduction of $50 proposed in Chapter 12 is used.

The Rate Schedule for Family Units

The rate schedule we recommend for family units is shown in Table 11-6. This rate schedule indicates the taxes which would be payable by a married couple without dependent children. It would also be used by a couple with dependent children and, as we shall explain later, tax credits would be allowed for those children. If a family unit consisted of only one parent and one or more dependent children, this schedule would be used and no tax credit would be allowed for the first child but only for subsequent ones. Where a family unit consisted of a surviving spouse and no dependent children, this schedule would not be used, but rather the individual rate schedule.

As can be seen most clearly by referring back to Table 11-4, the principal differences between the recommended rate schedule for a family tax unit and the recommended rate schedule for an individual are as follows:

1. The entire schedule is lowered for income below $40,000, and the amount of income exempted from tax through the adoption of a zero rate bracket is increased from $1,000 to $2,100.

2. The amount of income subject to tax at marginal rates below 20 per cent is increased (i.e., from $3,000 to $6,000). To compensate, marginal rates for families are increased more rapidly than for unattached individuals at incomes above $15,000 until the $40,000 level is reached.

The effect of these differences upon the relationship between taxes paid by a single individual and by a married couple with the same income is shown in Table 11-7, which also provides comparative data for the current United States and Canadian tax rates. The present Canadian tax law provides only an additional $1,000 exemption for a married couple. Consequently, the current reduction in tax for a married couple below that of a single individual diminishes quickly as income rises. The United States federal income tax allows income splitting by a married couple, and so provides substantially greater reductions in middle income brackets 15/. It is difficult to justify the favoured position of middle and high income married taxpayers as against that of lower income taxpayers under the United States schedule. One would expect the additional non-discretionary expenses associated with support of a wife to be a steadily decreasing proportion of income. The recommended rate schedule has been constructed to achieve this result 16/.

TABLE 11-6

RECOMMENDED SCHEDULE OF INCOME TAX RATES
FOR A FAMILY UNIT

Taxable Income			Tax Payable	
Less than		$ 2,100	None	
$2,100	-	3,000	13% of income over	$ 2,100
3,000	-	4,000	$ 117 + 16% of income over	3,000
4,000	-	5,000	277 + 18% of income over	4,000
5,000	-	6,000	457 + 19% of income over	5,000
6,000	-	8,000	647 + 20% of income over	6,000
8,000	-	10,000	1,047 + 21% of income over	8,000
10,000	-	12,000	1,467 + 22% of income over	10,000
12,000	-	15,000	1,907 + 24% of income over	12,000
15,000	-	20,000	2,627 + 27% of income over	15,000
20,000	-	25,000	3,977 + 31% of income over	20,000
25,000	-	30,000	5,527 + 35% of income over	25,000
30,000	-	40,000	7,277 + 38% of income over	30,000
40,000	-	50,000	11,077 + 42% of income over	40,000
50,000	-	60,000	15,277 + 44% of income over	50,000
60,000	-	80,000	19,677 + 46% of income over	60,000
80,000	-	100,000	28,877 + 49% of income over	80,000
Over		$100,000	38,677 + 50% of income over	100,000

Note: No personal exemption is deducted in computing taxable income.

TABLE 11-7

PERCENTAGE REDUCTIONS IN TAXES FOR A MAN WHO MARRIES A WOMAN WITH NO INCOME UNDER THE CURRENT RATE SCHEDULES IN CANADA AND THE UNITED STATES AND UNDER THE RECOMMENDED RATE SCHEDULE

	Percentage Reductions In Taxes		
Income	Under 1966 Canadian Rates	Under 1966 United States Rates	Under the Recommended Rates
$ 1,500	100.0	96.7	100.0
2,500	74.2	33.3	76.4
3,500	48.7	31.4	51.4
5,000	27.7	23.4	37.0
6,500	21.6	21.4	30.5
8,000	18.5	20.5	27.0
10,000	15.3	21.6	25.0
12,000	13.3	22.2	24.2
15,000	10.7	25.1	23.1
25,000	5.5	30.8	18.3
40,000	3.2	29.3	11.5
70,000	1.8	22.0	5.6
100,000	1.3	19.0	3.6
200,000	0.6	11.8	1.6

Note: The figures shown are the percentage differences between taxes paid by a married couple without children and taxes paid on the same income by a single individual, using taxes of the single individual as the base of the comparison. In all cases, it is assumed that optional standard deductions are claimed. United States taxes include average state and local income taxes; Canadian taxes include the provincial tax abatement but not provincial taxes in excess of the abatement, and the old age security tax. In all cases in the United States, it is assumed that a joint return is filed.

As Table 11-7 indicates, the reduction in taxes of a married couple over those of a single individual with the same income would be larger under our recommendations than under either current Canadian or United States provisions for incomes below $12,000.

This reduction is not sufficient to reduce a married couple's taxes significantly below the total taxes of two single individuals each with half the income of the married couple, except at incomes of $3,000 or below. The relationship between taxes paid by a married couple and by two single individuals combined under the proposed rates is shown in Table 11-8, along with comparative data for the United States. As can be seen from the table, we have established the relationship between the rate schedules applicable to single and married persons to reflect our belief that the principle "two cannot live as cheaply as one, but can still live more cheaply than two people living apart" applies primarily to married couples with combined incomes in excess of $5,000. For married couples with low incomes, it is likely that the expenses of establishing a household more than outweigh other costs saved by living together. Because non-discretionary expenses upon marriage are relatively higher for taxpayers with low incomes, we recommend tax rates that reflect these higher expenses.

Because of the extent to which the family rate schedule has been lowered to reduce the tax liabilities of middle income taxpayers, the principle of increasingly "cheaper togetherness" for incomes above $5,000 is not entirely satisfied for incomes between $6,500 and $25,000.

The primary differences between the schedule presented in Table 11-6 and the 1966 Canadian rate schedule for married couples are as follows:

1. The amount of income not subject to tax (i.e., taxed at a zero rate) is increased in the proposed rate schedule by $100 and the rates at which income is taxed are considerably reduced. As a result, a married taxpayer with taxable income of $5,000

TABLE 11-8

PERCENTAGE CHANGES IN TAXES UPON MARRIAGE FOR MEN AND WOMEN WITH EQUAL INCOMES UNDER THE CURRENT RATE SCHEDULES IN CANADA AND THE UNITED STATES AND UNDER THE RECOMMENDED RATE SCHEDULE

Combined Income of Husband and Wife	Percentage Changes in Taxes: Under 1966 Canadian Rates	Under 1966 United States Rates	Under Recommended Rates
$ 1,500	0	0	0
2,300	-100	0	-27.3
2,400	- 50	0	-18.2
2,500	0	0	-13.3
3,000	0	0	- 2.5
3,500	0	0	1.0
5,000	0	0	3.9
6,500	0	0	5.2
8,000	0	0	3.7
10,000	0	0	1.2
12,000	0	0	-0.2
15,000	0	0	-0.1
25,000	0	0	3.7
40,000	0	0	10.4
70,000	0	0	14.9
100,000	0	0	15.7
200,000	0	0	10.5

Note: The figures shown are the percentage differences between taxes paid by a married couple without children and taxes paid by two single individuals each with half the income of the married couple. The income referred to is that of the married couple, and the taxes of the two single individuals are the standard of comparison. In all cases, it is assumed that optional standard deductions are claimed. United States taxes include average state and local income taxes; Canadian taxes include the provincial tax abatement but not provincial taxes in excess of the abatement, and the old age security tax. In all cases in the United States, it is assumed that a joint return is filed.

before deducting personal exemptions would have his taxes reduced by $51, or by more than 10 per cent.

2. The reduction in marginal rates is relatively the greatest in the middle income brackets.

3. The maximum marginal rate of 50 per cent is attained with an income of $100,000.

A comparison of taxes paid by a married couple without dependants under our recommendations with what they now pay in Canada and the United States is presented in Table 11-9.

As the data in the table indicate, taxes would be reduced substantially below 1966 rates for a middle income married couple: by $61 at an income of $6,500; by $188 at an income of $10,000; and by $715 at an income of $15,000. <u>These reductions, of course, would apply only to taxpayers whose taxable income was unchanged by our recommendations</u>. For such taxpayers these tax cuts would be large enough to virtually eliminate the United States-Canadian differential for married couples <u>17</u>/.

Treatment of Dependants

As has been previously mentioned, we recommend the use of tax credits rather than separate rate schedules to allow for the non-discretionary expenses associated with dependent children. It might seem preferable to establish a separate rate schedule for each different family type that had different responsibilities and, therefore, different amounts of non-discretionary expenses. However, there are many differences between family responsibilities, such as the difference between families with dependent children and families with other dependants, the difference between either of these families and a tax unit supporting a student at a university or post-secondary vocational school, and the differences between otherwise similar families with school-age children where the wife is or is not working.

TABLE 11-9

INCOME TAXES PAYABLE BY A MARRIED
COUPLE WITHOUT DEPENDENT CHILDREN UNDER THE
CURRENT RATE SCHEDULES IN CANADA AND THE UNITED STATES
AND UNDER THE RECOMMENDED RATE SCHEDULE

	Income Taxes Payable		
Income	Canada (1966 Rates)	United States (1966 Rates)	Recommended Rates
$ 1,500	$ -	$ 3	$ -
2,500	51	178	46
3,500	202	314	189
5,000	499	557	448
6,500	798	812	737
8,000	1,128	1,086	1,037
10,000	1,644	1,449	1,456
12,000	2,240	1,899	1,896
15,000	3,330	2,614	2,615
25,000	7,725	5,523	5,511
40,000	15,120	11,538	11,058
70,000	31,910	27,186	24,254
100,000	50,305	44,772	38,652

Note: United States taxes include state and local income taxes of an average state; Canadian taxes include the provincial tax abatement but not provincial taxes in excess of the abatement, and the old age security tax. In all cases, it is assumed that the taxpayer claims only standard deductions. Under our recommendations, the standard deduction of $50 proposed in Chapter 12 is used. It is assumed in all cases in the United States that an election is made to file a joint return.

Because of the many combinations of these differences, it is not administratively feasible to provide for them by establishing a separate rate schedule for each situation. Consequently, we must allow for these differences either by deductions from income or by tax credits 18/.

Under the present system, deductions are allowed under section 26 of the Income Tax Act in computing taxable income. The deduction for a child who is qualified for family allowances is $300 while the deduction for a dependent child not so qualified is $550. These deductions are frequently referred to as "personal exemptions". In addition, under the existing system, family allowances of $72 or $96 a year per child are exempt from tax. In this part of the chapter, the personal exemptions allowed for children qualified for family allowances and the exemption of family allowances, assumed to be $72 per child, are together referred to as the present exemptions.

The difference between tax credits and exemptions is simple. A tax credit involves a reduction in taxes of a given amount, while an exemption grants a reduction in taxable income. The latter results in a tax reduction that increases with income. Because an exemption excludes from tax the last dollars of income received by a taxpayer, the value of an exemption depends upon the marginal rate applicable to the taxpayer. A tax credit, on the other hand, in effect exempts a given amount of the first dollars of a taxpayer's income. A tax credit thus affects all taxpayers in the same amount, while an exemption provides an allowance which increases in value as income increases 19/. To put this in other terms, the revenue loss resulting from the use of exemptions is higher than from the use of credits, where credits and deductions achieve the same result for low income families.

We believe that the primary purpose of the additional allowances for dependants, working wives, educational support, and so forth is to reduce the tax burden on low income families whose ability to pay is most heavily affected by the additional non-discretionary expenses resulting from each of these circumstances. We therefore regard the use of tax credits as a more efficient means of achieving this objective. Accordingly, we have recommended the adoption of tax credits in place of exemptions to reflect the effect of family responsibilities upon ability to pay, and have used the tax revenue gained from this substitution both to increase the effective allowances to low income families and to reduce marginal tax rates below what they would otherwise be.

As we explained previously in connection with the family rate schedule, a married couple with dependent children would calculate their tax liabilities under that schedule and would then deduct the tax credits allowed for their children. However, if a family unit consisted of only one parent and one or more dependent children, the same schedule would be used but no credit would be allowed for the first child. In this situation, credits would be allowed only for the second and subsequent dependent children. In the discussion which follows, it should be considered that where there is only one parent, the first child is disregarded, in effect replacing the other parent for tax purposes, and the second child would be regarded as the first child in determining the available credits.

We recommend the following credits: for the first child, $100; and for each additional child, $60. These credits would result in an average credit per child which decreased as the number of children increased. The average credit per child would be as follows:

One child	$100
Two children	80
Three children	73
Four children	70
Five children	68
Eight children	65

These credits have been determined so as to make them worth more than the existing exemptions to a family with median income, all of whose children are qualified for family allowances. We acknowledge that they are low in relation to the non-discretionary expenses of raising children. However, to adopt larger credits would reduce revenues and necessitate higher marginal rates with their unfavourable effects on incentives.

The effect of the $100 tax credit for the first child in a family upon the taxes paid by the family is shown in Table 11-10. As can be seen from the data given in this table, the use of the tax credit results in a greater decrease in taxes for low income families than is provided by either the present Canadian or United States exemptions. However, the percentage decrease in taxes falls off much faster under the proposed tax credit than it does under either of the current exemptions.

TABLE 11-10

PERCENTAGE DECREASES IN TAXES FOR FAMILIES UPON THE BIRTH OF THE FIRST CHILD UNDER CURRENT RATE SCHEDULES IN CANADA AND THE UNITED STATES AND UNDER THE RECOMMENDED RATE SCHEDULE

	Percentage Decreases In Taxes		
Combined Income of Husband and Wife	Under 1966 Canadian Rates	Under 1966 United States Rates	Under Recommended Rates
$ 1,500	-	-	-
2,500	74.5	81.9	100.0
3,500	26.7	38.2	50.8
5,000	12.6	19.8	21.9
6,500	8.3	15.4	13.4
8,000	5.9	11.4	9.6
10,000	4.7	8.5	6.8
12,000	4.0	7.4	5.2
15,000	3.6	6.1	3.8
25,000	1.7	3.6	1.8
40,000	1.0	2.4	0.9
70,000	0.6	1.2	0.4
100,000	0.4	0.8	0.3

Note: Family allowances are not taken into account in this table. The effect of including family allowances can be seen from the comparison of exemptions and credits in Tables 11-12 and 11-13.

A comparison of Canadian, United States and the proposed taxes for a family with a dependent child is provided in Table 11-11. The table shows that taxes are, in all cases, substantially reduced from their present levels. At an income of $5,000, they are reduced by $75; and at an income of $10,000, by $238. However, because the United States allows a deduction of $600 for each dependent child, they are not reduced sufficiently to wipe out all differences between Canadian and United States taxes. Canadian taxes would still be higher for incomes between $6,500 and $40,000. At an income of $15,000, for instance, Canadian taxes would still be $182 higher than United States taxes. This gap would be partially offset by family allowances.

The credits that we propose for dependants are equivalent to a liberalization of exemptions for lower income families and a tightening for upper income families. For families with income under a certain level, the proposed system of credits would reduce taxes from what they would be with current personal exemptions. For families with higher income, the effect would be the reverse. The "break-even" level for families in each income group would depend on the number of children in the family. This is shown in Table 11-12.

A more precise indication of the effect of substituting tax credits for personal exemptions is provided by Table 11-13. This shows the personal exemptions required to yield the same tax as the set of tax credits we propose with the proposed rate schedule. As can be seen by comparing the figures in Table 11-13 with the current personal exemptions listed in Table 11-12, the use of tax credits results in a substantial reduction of taxes for low income families. Indeed, the proposed rate schedule and tax credit system would remove the obligation to pay income taxes from many low income families with children.

TABLE 11-11

INCOME TAXES PAYABLE BY A FAMILY WITH ONE CHILD UNDER CURRENT RATE SCHEDULES IN CANADA AND THE UNITED STATES AND UNDER THE RECOMMENDED RATE SCHEDULE

Taxable Income	Income Taxes Payable: Canada (1966 Rates)	United States (1966 Rates)	Recommended Rates
$ 1,500	$ -	$ -	$ -
2,500	13	28	-
3,500	148	170	101
5,000	436	402	361
6,500	732	629	651
8,000	1,062	886	952
10,000	1,566	1,228	1,372
12,000	2,150	1,644	1,812
15,000	3,210	2,310	2,533
25,000	7,590	5,084	5,435
40,000	14,970	10,880	10,986
70,000	31,730	26,180	24,187
100,000	50,110	43,500	38,588

Note: As in Table 11-5, it is assumed that all taxpayers claim only the optional standard deduction. Family allowances are not included in taxable income shown on the stub of the table but are added to taxable income to arrive at the figures reported as taxes payable under the recommended rate schedule. United States taxes include average state and local income taxes; Canadian taxes include the provincial tax abatement but not provincial taxes in excess of the abatement, and the old age security tax.

TABLE 11-12

INCOME AT WHICH THE PROPOSED TAX CREDITS FOR ADDITIONAL DEPENDENT CHILDREN RESULT IN THE SAME AMOUNT OF TAX AS PRESENT EXEMPTIONS

Number of Children in Family	Total Exemptions for Children Under Present Law, Including Exempt Income From Family Allowances	Proposed Credits	Income at Which Credits and the Present Exemptions Both Yield the Same Tax
1	$ 372	$100	$15,360
2	744	160	10,365
3	1,116	220	6,786
5	1,860	340	5,744
8	2,976	520	5,885

Note: Family allowances of $72 a year are assumed to be payable in respect of each child, and accordingly, under the current law, a $300 exemption for each child would be available. Taxes are computed using the proposed family rate schedule.

Many low income taxpayers are, we believe, now being unfairly taxed. Under the present system of exemptions as applied under the proposed rate schedule, the dependent exemption of $600 now allowed for a family with two children, plus the exemption of family allowances, would be worth $162 to a family with an income of $12,000. They would be worth only $98 to a family with an income of $3,000. Only if it is assumed that the responsibilities of raising children are less onerous for low income families than for higher income families can such a disparity be justified.

TABLE 11-13

THE MAGNITUDE OF EXEMPTIONS EQUIVALENT TO RECOMMENDED CREDITS FOR CHILDREN

Taxable Income	Number of Children in Family 1	2	3	5	8
$ 2,500	$ 400*	$ 400*	$ 400*	$ 400*	$ 400*
3,500	654	1,115	1,400*	1,400*	1,400*
5,000	556	889	1,250	2,000	2,900*
6,500	500	816	1,132	1,778	2,812
8,000	500	800	1,100	1,700	2,632
10,000	476	762	1,048	1,619	2,500
12,000	454	727	1,000	1,545	2,381
15,000	417	667	917	1,417	2,167
25,000	323	516	710	1,097	1,677
40,000	263	421	579	895	1,368
70,000	217	348	478	739	1,130
100,000	204	327	449	694	1,061

Note: An asterisk indicates that the recommended credit is more than sufficient to eliminate the tax liability. The figure shown in such cases is the total amount of income which would have been taxed were it not for the tax credit.

A comparison of Canadian, United States and the proposed rates for a family with two dependent children is shown in Table 11-14. As noted before, a majority of United States families, and substantially more than a majority of families with children, claim itemized deductions. The comparisons in Table 11-14 are based upon average deductions claimed by United States taxpayers who itemize 20/.

As can be seen from Table 11-14, adoption of the recommended rate schedule and credits would result in a substantial reduction of taxes for all taxpayers. Tax reductions would be on the order of $60 to $85 for incomes between $5,000 and $8,000 and from $130 to $500 for incomes between $10,000 and $15,000. For incomes over $6,000, Canadian taxes would be higher than those of the United States. For a family earning $25,000, for instance, taxes under our recommendations would be $616 higher than in the United States. Removal of this higher tax should be an objective of any future tax reductions.

ADDITIONAL CONSIDERATIONS

Additional considerations affecting the rate schedules arise because of three factors:

1. The aggregation of incomes of members of a family resulting from adopting the family as the tax unit.
2. An allowance for the additional non-discretionary expenditures of a family with dependent children in which both spouses are working.
3. Flexibility in the rate schedules to allow for tax rates to be changed for countercyclical fiscal policy.

Multiple Income Recipients

Aggregation of incomes of members of a family results in higher taxes being paid by that family, provided that the same rate schedule is applicable to the amounts being taxed in each way. Suppose for instance that a husband and wife each had a comprehensive tax base of $5,000 including family allowances, and that each, as an individual taxpayer, could claim support of a dependent child. Both could then file as married persons under the current law.

TABLE 11-14

INCOME TAXES PAYABLE BY A FAMILY WITH TWO CHILDREN
FILING AVERAGE ITEMIZED DEDUCTIONS UNDER
CURRENT RATE SCHEDULES IN CANADA AND THE UNITED STATES
AND UNDER THE RECOMMENDED RATE SCHEDULE

	Income Taxes Payable		
Income	Canada (1966 Rates)	United States (1966 Rates)	Recommended Rates
$ 1,500	$ -	$ 3	$ -
2,500	-	23	-
3,500	67	76	1
5,000	294	348	235
6,500	586	478	505
8,000	865	715	779
10,000	1,316	1,065	1,185
12,000	1,827	1,409	1,586
15,000	2,744	1,996	2,251
25,000	6,758	4,284	4,900
40,000	13,666	8,886	10,056
70,000	29,362	21,117	22,460
100,000	46,571	34,145	36,018

Note: Itemized deductions under the current Canadian and United States tax laws are the average deductions shown in Appendix H to this Volume. Itemized deductions under our recommendations are assumed to be the same as the average deductions under current Canadian tax law. United States taxes include average state and local income taxes. Canadian taxes include the provincial tax abatement but not provincial taxes in excess of the abatement, and the old age security tax.

If they were allowed to file separately, using the family rate, their taxes under the proposed rate schedule, if they took a standard deduction, would amount to $448 each, or $896 taken together. With incomes aggregated, the couple would file as a family with two children and their taxes would be increased to $1,296.

Aggregation, while equitable, may increase taxes over what they would otherwise be. It thus raises two potential problems:

1. An enforcement problem which would arise from the advantage for families that were able to avoid aggregating.

2. An incentive problem, which would arise from the effect of higher marginal rates upon the after-tax compensation received by working wives 21/.

To deal with the first problem, we have proposed in Chapter 10 that the taxes of husbands and wives filing separately be calculated in a manner that would ensure that their taxes would generally be higher, and never lower, than if they filed a joint family return. We recommend that all standard deductions and limitations on itemized deductions claimed by each taxpayer be reduced by one half for spouses filing separately, and that each spouse then calculate his or her tax liability by doubling taxable income and applying to that figure the rate schedule for family units, and then reduce the resultant tax liability by one half.

The second problem has been taken into consideration in setting the relationship between the individual and family rate schedules and by the tax credits for working mothers that we shall recommend.

Because the family rate schedule that we recommend involves a reasonably large reduction at most income levels from the rate for single individuals, the tax increase that would result from aggregation if there were no change in the applicable rate is, in most cases, more than offset by moving to the lower schedule. For instance, if a husband and wife with no children had incomes of $8,000 and $2,000 respectively, their taxes under the proposed rate schedule for single individuals would be $1,435 and $135 respectively, or $1,570 in total, ignoring standard deductions. If they filed as an aggregated family unit, their taxes would be reduced to $1,467.

A summary of the effect of aggregating the incomes of two taxpayers filing separate returns is shown in Table 11-15 for different total family incomes and three different percentages of income accounted for by the wife. This table essentially shows the amounts of "marriage tax" or "marriage tax saving" which would result under our proposed rate schedules when two taxpayers receiving income married and both continued to receive the same income. As can be seen from the table, there would be either a tax saving or very little additional tax for families with incomes of $15,000 or less.

The effects of aggregation on incentives are most clearly seen by examining the effective tax rates applicable to income earned by the wife. These rates are presented for different combinations of husbands' and wives' incomes in Table 11-16, where they are compared with the effective rates of tax now being paid by a working wife. As can be seen from the table, these effective rates are very much dependent upon the husband's income. This is also the case under the present tax law, simply because the $1,000 exemption which the husband gives up through his wife's working is worth more if the husband's income is higher. Because the loss to the husband is complete once a wife earns more than $1,250, the effect of the partial aggregation existing in the present system diminishes as the wife's income increases.

Because aggregation is complete under the proposed tax system, rather than partial as it is under the existing system, the effect of aggregation by itself is more pronounced. Nevertheless, because marginal rates under the rate schedule for married couples are so much lower than at present, the effective tax rates applicable to a wife's income are not increased

TABLE 11-15

CHANGE IN TAX RESULTING FROM THE AGGREGATION OF INCOME OF HUSBANDS AND WIVES WHO WOULD OTHERWISE BE TAXED AS SINGLE

Total Taxable Income of Husband and Wife	Additional Tax		
	20 Per Cent of Income Received By Wife	35 Per Cent of Income Received By Wife	50 Per Cent of Income Received By Wife
$ 1,500	$ -24	$ -	$ -
2,500	-83	-27	-8
3,500	-74	-12	2
5,000	-48	4	17
6,500	-60	11	37
8,000	-79	5	37
10,000	-103	-13	17
12,000	-147	-29	-3
15,000	-193	-46	-3
25,000	-213	82	197
40,000	247	827	1,047
70,000	1,807	2,862	3,147
100,000	3,347	4,697	5,247

Note: Minus figures indicate a tax saving on marriage. Positive figures indicate a "marriage tax". Standard deductions are not taken into account.

TABLE 11-16

EFFECTIVE TAX RATES ON WAGE AND SALARY INCOME EARNED BY A WIFE
UNDER THE CURRENT AND RECOMMENDED RATE SCHEDULES

	Income of Wife							
	$1,500		$2,500		$3,500		$5,000	
Income of Husband	Current	Proposed	Current	Proposed	Current	Proposed	Current	Proposed
$ 1,500	.068	.066	.101	.100	.127	.120	.148	.140
2,500	.135	.143	.141	.154	.156	.162	.168	.171
3,500	.162	.166	.158	.172	.167	.178	.177	.183
5,000	.162	.185	.158	.188	.167	.191	.177	.194
6,500	.181	.194	.169	.197	.175	.199	.182	.202
8,000	.205	.202	.183	.203	.186	.206	.189	.210
10,000	.231	.211	.199	.213	.197	.218	.197	.223
12,000	.264	.227	.219	.230	.211	.230	.207	.240
15,000	.301	.252	.241	.259	.227	.262	.218	.264
25,000	.334	.335	.261	.341	.241	.344	.228	.346
40,000	.367	.405	.281	.411	.255	.414	.238	.416
70,000	.434	.460	.321	.460	.284	.460	.258	.460
100,000	.467	.496	.341	.498	.298	.498	.268	.499

Note: The effective tax rate applicable to a wife's income is the ratio between the additional tax paid as a result of the wife's working and the additional income received by the wife. It is assumed that all income is from wages and salaries, that there are no children in the family unit, and that only standard deductions are claimed.

materially except when the combined income of husband and wife is substantial. We would consequently expect that there would be little disincentive effect on working wives' participation in the labour market as a result of aggregating family incomes.

Allowances for Working Mothers

When wives work, some additional family housekeeping expenses may result, but it is unlikely that a significant portion of such added expenses is non-discretionary for a family with no children 22/. However, for a family with children, additional non-discretionary expenses clearly arise when both parents work.

As with other allowances which are not built into the rate schedule, it is possible to make arbitrary allowances which adjust tax payments so as to reflect a different ability to pay. The additional expenses associated with the care of children, when both husband and wife work, are highly variable. We recommend allowances that attempt to reflect these expenses. Because they are greatest when children are below school age, the allowance should take into account the age of the children in the family.

It is desirable to focus the impact of these allowances on lower income taxpayers whose relative ability to pay is most heavily affected by non-discretionary expenses, and we recommend that these allowances be made as tax credits. Specifically, our recommendations are as follows:

1. A tax credit of $80 should be allowed to any family unit containing one or more children receiving family allowances in which both husband and wife were engaged in employment or in carrying on a business for more than 120 days a year 23/.

2. An additional tax credit of $120 should be allowed to such a family unit if it contained a child under the age of seven.

These credits are roughly equivalent to additional exemptions of $400 and $600 respectively for a family with an income of $7,000. They may also be regarded as equivalent to an assumed non-discretionary expense of $400 for a family with pre-school children and $160 for a family with school-age children but no pre-school children 24/. Their impact is, of course, relatively greater for families with lower incomes.

The effect of these allowances upon the income of working mothers can be seen by examining Table 11-17, which presents data on the effective tax rates under our proposals on different incomes earned by working mothers. From a comparison of Table 11-17 with the current tax rates shown in Table 11-16, it is evident that effective tax rates would be substantially reduced below current rates for families with total incomes ranging as high as $15,000. Though the primary reason for recommending credits for working mothers is to reflect a changed ability to pay of the family, the credits would encourage female participation in the labour force.

Future Tax Reductions

In selecting the rate schedules, we have been unable to meet some of our objectives fully because of the necessity of raising sufficient revenue. As per capita incomes increase, the tax system we propose should yield a greater flow of tax revenues than would be required to meet government expenditures if these expenditures grow no faster than they have in the past. Quite beyond this, a substantially greater amount of revenue will be yielded by our rate schedule after an initial transitional period has elapsed. We have pointed out in Chapter 3 that the resultant revenue drag can be offset in a number of ways. To the extent that it is decided to offset this drag by reducing taxes, we strongly recommend that such reductions be designed to bring the tax system more into line with our objectives. This could be achieved to varying degrees through any of the following:

1. Reducing all marginal income tax rates in the same proportion.
2. Reducing further the marginal income tax rates levied in middle income brackets.

TABLE 11-17

EFFECTIVE TAX RATES ON WAGE AND SALARY INCOME
EARNED BY A MOTHER OF SCHOOL-AGE CHILDREN
UNDER THE RECOMMENDED RATE SCHEDULE

Income of Husband	Income of Wife			
	$1,500	$2,500	$3,500	$5,000
$ 1,500	—	.028	.069	.104
2,500	.047	.096	.121	.142
3,500	.113	.140	.155	.167
5,000	.131	.157	.168	.178
6,000	.141	.165	.176	.186
8,000	.148	.171	.183	.194
10,000	.158	.181	.196	.207
12,000	.174	.198	.208	.224
15,000	.199	.227	.239	.248
25,000	.282	.309	.321	.330
40,000	.352	.379	.391	.400
70,000	.407	.428	.437	.444
100,000	.443	.466	.476	.483

Note: The effective rate of tax on a wife's income is the ratio between the additional tax paid as a result of the wife's working and the additional income received by the wife. It is assumed that all income is from wages and salaries and that only standard deductions are claimed. Taxes of the family unit are reduced by the $80 credit for a family with both spouses working and with children under 16, but not by the additional $120 credit for families with both spouses working and with children under 7.

3. Reducing marginal income tax rates at the bottom and top of the income scale while keeping middle rates unchanged to make the schedules more consistent with our ability-to-pay principles.

4. Providing additional tax credits for individuals and families to counter the regressiveness of sales and property taxes levied by all levels of government.

5. Reducing the federal sales tax rate.

The first two types of tax reductions would have the most favourable economic effect. Reducing marginal tax rates in middle and upper brackets would lower taxes on new investments made by Canadian residents and so would enhance the profitability of capital expenditures and increase the growth rate of the Canadian economy. In addition, both types of tax reduction would benefit middle income individuals and families,and so, by making Canadian-United States tax comparisons more favourable to Canada, would help retard the emigration of skilled workers and professionals.

But neither of the first two types of tax reduction would improve the equity of the tax system. Indeed, if marginal middle income rates deviated even more from the rates consistent with ability-to-pay principles, the tax system would be less equitable.

The third alternative would have almost as favourable an effect as the first two upon new equity investments made by Canadian residents, and would increase the equity of the system. By reducing marginal rates sufficiently, so that these rates would rise proportionately with percentage changes in income, it would be possible to make the income tax fully consistent with the ability-to-pay principles stated in Chapter 7.

The last two alternative tax reductions would have the least favourable effect on economic growth, but would increase the equity of the system.

There is, in general, a conflict between increasing the equity of the tax system and making the tax system more conducive to economic growth. In recommending the rate schedules specified in this chapter, we have been able both to increase equity and increase incentives. This is possible because the present system is inefficient.

In any future tax reduction, the specific types of reductions chosen would have to reflect a decision as to the relative importance of further increases in the equity of the tax system or in incentives for the encouragement of investment and effort. Other than to specify the range of alternatives consistent with the objectives specified in this chapter, we do not make a recommendation as to which of the alternatives should be chosen.

Short-Term Adjustments to the Rate Schedule

We have suggested how the rate schedule could be changed as long-term growth in revenue permitted. In addition to such long-term changes, it will be necessary to raise or lower the revenue yield of the system for short periods of time for stabilization purposes. We recommend that this be done simply by multiplying the tax liability of each individual by a factor chosen to increase or decrease all taxpayers' tax liabilities by the same percentage amount.

Our main concern in devising a rate schedule has not been to present an "ideal" set of rates, but rather to achieve a suitable progression within the rate schedules. More importance should be attached to the ranking contained in our suggested schedules than to the absolute figures or to the total revenue yield. With the progression of the rate schedules established, the total revenue could be varied by changing the level of the whole schedule. The most important change we recommend is not a change in rates but a change in progression.

CONCLUSIONS AND RECOMMENDATIONS

SELECTING RATE SCHEDULES WHICH RESULT IN TAXATION ACCORDING TO ABILITY TO PAY

1. Our primary objective in specifying the rate schedules we recommend is to make taxes paid by individuals and families with different incomes and with different responsibilities proportionate to their ability to pay. It is first necessary to construct a rate schedule to meet this objective before modifying it to take account of other objectives and constraints.

2. The principles governing the specification of rate schedules which would result in taxation according to ability to pay were described in Chapter 7. To construct a rate schedule in accordance with these principles, it is necessary to:

   a) Decide upon the upper and lower limits to the range over which the proportion of income available for discretionary use varies.

   b) Select the basic tax rate (or rate of tax on discretionary income) that yields the desired amount of revenue. This will be the maximum marginal rate which is applicable to income above the upper limit.

   c) Select intervening tax brackets between the lower and upper limits that cover roughly equal percentage changes in income.

   d) Select intervening tax rates that increase equally between zero and the maximum rate and apply these rates to the intervening brackets.

3. It is clear from these rules that the major judgment in constructing a rate schedule in accordance with ability-to-pay principles is in deciding upon the upper and lower limits of the range of income over which some, but not all, of each dollar of additional income is available for discretionary use. Once this is done, the relationship among rates follows from our ability-to-pay principles.

4. For unattached individuals, we have arbitrarily assumed an upper limit of $100,000 and a lower limit of $300. This gives the range over which marginal rates should vary if the impact of sales and property taxes were not to be considered.

5. For family tax units we have assumed an upper limit of $100,000 and a lower limit of $700. We have also assumed that, of income below $40,000, the proportion available for discretionary use is less for family units than for unattached individuals, and that the proportion of income in excess of $40,000 which is available for such use is the same for both family units and individuals. Tax credits are recommended to reflect the responsibilities of raising children.

COMPARISONS OF TAXES IN CANADA
AND THE UNITED STATES

6. For a typical family that itemizes deductions and supports 2 children, income taxes are roughly 20 per cent lower in the United States than in Canada on incomes over $6,000.

7. Other taxes are a higher proportion of income in Canada than in the United States. The average rate of sales tax in Canada is roughly double the average rate in the United States.

8. Because these differences can affect an individual's choice between working in Canada and working in the United States, we believe it is important that they be made less unfavourable to Canada.

OTHER CONSIDERATIONS AFFECTING THE SELECTION OF RATE SCHEDULES

9. Because of the regressive incidence of taxes other than income taxes, the weight of income taxes should be reduced on low income tax units relative to what would be appropriate if these other taxes did not exist. Consequently, we recommend maintaining the present exemptions roughly at current levels through the adoption of zero rate brackets of $1,000 and $2,100 for individuals and family units respectively.

10. To reflect the difference between Canadian and United States tax burdens on middle income families, taxes should be reduced for middle income taxpayers.

11. To reduce the disincentive effects of high marginal rates which could not be avoided, the maximum marginal tax rate should be held down to 50 per cent.

12. Apart from the effect of eliminating inequitable concessions to a few industries, the weight of tax on equity investments owned by Canadian residents should not be increased over present levels.

REVENUE REQUIREMENTS

13. In accordance with the instructions given to us in defining our terms of reference, we have specified a rate schedule which, when taken together with our other reforms, would raise as much revenue as the present tax system.

14. It has not been possible to raise enough revenue and at the same time meet all of our objectives. We have consequently had to decide which objectives to compromise.

15. In order to make substantial reductions for middle income taxpayers, tax rates in middle income brackets have been reduced below the levels which would be implied by a 50 per cent top rate together with appropriate progressiveness. In spite of this, we have not been able to overcome completely the gap between Canadian and United States taxes for all middle income taxpayers.

16. Tax reductions in lower income brackets result from combining the rate schedules having a 50 per cent top rate and based on ability-to-pay principles with the current levels of exemptions for individuals and families, in order to allow for the regressive incidence of property taxes and the regressive, or at least non-progressive, incidence of sales taxes.

THE RECOMMENDED RATE SCHEDULES

17. The rate schedules we recommend are shown in Table 11-18.

18. In addition, we recommend that the following tax credits be allowed:

For the first child (or the second child if there is only one parent in the family unit)	$100
For each additional child	60
For a working mother with school-age children	80
For a working mother with pre-school children	200

19. The rate schedule for unattached individuals would result in modest tax increases for individuals at the bottom of the scale whose taxable income would not be increased by our other reforms. The reductions for the middle income brackets would eliminate most of the unfavourable differences between United States and Canadian income taxes for single individuals.

TABLE 11-18

RECOMMENDED RATE SCHEDULES

Taxable Income	Unattached Individuals: Tax at Bottom of Bracket	Unattached Individuals: Marginal Tax Rate on Income In Bracket	Family Units: Tax at Bottom of Bracket	Family Units: Marginal Tax Rate on Income In Bracket
	$	%	$	%
Less than $ 1,000	None	—	None	—
$ 1,000 - 1,500	None	12	None	—
1,500 - 2,000	60	15	None	—
2,000 - 2,100	135	17	None	—
2,100 - 3,000	152	17	None	13
3,000 - 4,000	305	20	117	16
4,000 - 5,000	505	22	277	18
5,000 - 6,000	725	23	457	19
6,000 - 8,000	955	24	647	20
8,000 - 10,000	1,435	26	1,047	21
10,000 - 12,000	1,955	28	1,467	22
12,000 - 15,000	2,515	30	1,907	24
15,000 - 20,000	3,415	32	2,627	27
20,000 - 25,000	5,015	35	3,977	31
25,000 - 30,000	6,765	37	5,527	35
30,000 - 40,000	8,615	39	7,277	38
40,000 - 50,000	12,515	42	11,077	42
50,000 - 60,000	16,715	44	15,277	44
60,000 - 80,000	21,115	46	19,677	46
80,000 - 100,000	30,315	49	28,877	49
Over 100,000	40,115	50	38,677	50

20. The rate schedule for family units would result in tax reductions at all levels of income. The reductions would be sufficient to make Canadian income taxes lower than United States income taxes at lower and higher income levels and approximately equal to United States income taxes at middle income levels for married couples without children whose taxable income was unchanged by our other reforms.

21. When combined with the tax credits we have recommended, the family rate schedule would result in a substantial decrease in taxes for most families with dependent children. However, the reduction would be insufficient to reduce Canadian taxes below United States income taxes for most such families.

THE EFFECT OF THE RECOMMENDED RATE SCHEDULES UPON THE PROGRESSIVENESS OF THE TAX SYSTEM

22. When combined with all the other reforms we have recommended, the effect of the rate schedule in this chapter would be to increase substantially the progressiveness of the tax system. Because this increased progressiveness would result from a comprehensive definition of income, this increase in progressiveness would be achieved with a schedule which reduced marginal tax rates at most levels of income. This reduction in marginal rates should result in greater incentives for the expenditure of effort and for the profitable investment of capital.

23. We recommend that in determining the method of implementing any future tax reductions, consideration should be given to the objectives which we have not been able to achieve fully because of the necessity to maintain present revenues. Any combination of the following changes would assist in the realization of one or more of these objectives:

a) Reducing all marginal income tax rates proportionately.

b) Reducing further the marginal income tax rates levied at middle income brackets.

c) Reducing marginal income tax rates by varying amounts to make them more fully in accord with our ability-to-pay principles.

d) Providing additional tax credits for individuals and families to counter the regressiveness of sales and property taxes levied at all levels of government.

e) Reducing the federal sales tax rate.

The first two would have the most favourable economic effect, while the last three would improve the equity of the system.

REFERENCES

1/ If we were concerned only with ability to pay, we would recommend that the top marginal rate of tax be made equal to the rate of tax on the income available for discretionary purposes. This rate would be determined by the size of the base and revenue requirements. This additional objective reflects economic considerations.

2/ Setting the rate schedule in this way can be facilitated by using semi-logarithmic paper to plot the marginal tax rates against the logarithm of income, because equal changes in the logarithm of income are equivalent to equal percentage changes in income. Using semi-logarithmic paper, a rate schedule can be constructed in accordance with ability-to-pay principles by simply drawing a line between a zero rate at the lower income limit and a given maximum rate at the upper income limit. By varying the maximum rate, and hence the slope of the line relating marginal rates to income, different amounts of revenue can be obtained from the same tax base.

3/ See, for instance, the First Annual Report of the Economic Council of Canada. As we have noted in Chapter 4, the net emigration of professionals and skilled workers is partially offset by a net immigration of such individuals from Europe and from other areas. However, it should be emphasized that the offset is only partial and that the loss is important whether or not it is offset.

4/ Interest costs on a conventional home mortgage have been 15 per cent to 20 per cent higher in Canada than in the United States in recent years. United States Federal Reserve Bulletin, July 1966, and Report of the Royal Commission on Banking and Finance, p. 281.

5/ In this context, we have not concerned ourselves with tax comparisons with European or other countries because the opportunities for emigration are few. The direct and indirect moving costs are obviously much higher in the case of moving outside North America, and consequently, the labour market is, for the most part, continental rather than global. The relevant factors are mostly favourable to Canada as compared with countries other than the United States.

6/ Supporting data for all statements about United States taxes are provided in Appendix H to this Volume.

7/ As we point out in Chapter 8, we do not believe that mortgage interest and property taxes should be deductible, because the allowance of these items discriminates against the individual who rents his living accommodation. Our point here is that these deductions result in income taxes being lower than they would otherwise be for many families in the United States and so further increase the gap between United States and Canadian income tax burdens on middle income families.

8/ In addition, the difference is increased for families with children by the greater exemptions allowed for dependent children.

9/ Deductions were itemized on 26.5 million United States tax returns in 1962. Of these, 19.1 million returns were taxable joint returns of husbands and wives. Statistics of Income, 1962: Individual Income Tax Returns, Washington; Internal Revenue Service, 1965, Table 13.

10/ "Direct taxes" in this context include personal and corporate income taxes, taxes on gifts and bequests, and social security taxes. This definition is slightly broader than that used in the remainder of this chapter, where compulsory contributions to government pension plans are included in indirect taxes. The United States figure includes the effects of the March 1964 income tax reduction that cut personal and corporate income taxes by 16 per cent. Data are from Dominion Bureau of Statistics, National Accounts, 1964, Table 36, and O. Eckstein, "Comparison of European and U.S. Tax Structures and Growth Implications", in the Role of Direct and Indirect Taxes in the Federal Revenue System, Princeton; Princeton University Press, 1964, p. 221. It is of interest to note that direct taxes account for between 51 per cent and 59 per cent of total taxes of all levels of government in France, Germany, Italy and the United Kingdom.

11/ Expenditures per capita by all levels of government are only 10 per cent lower in Canada than in the United States, even though GNP per capita is about 25 per cent lower. If defence expenditures are excluded per capita government expenditures are actually higher in Canada. Consequently, taxes must be a higher fraction of Canadian GNP. In addition, the lower average incomes of Canadian taxpayers result in a higher proportion of taxable income being at the low end of the rate schedule. Less than 4 per cent of Canadian taxpayers had incomes in excess of $10,000 in 1964, compared to more than 10 per cent in the United States. Because of the lower incomes of Canadian taxpayers, any rate schedule with progressive rates will result in a smaller fraction of total income being taxed in Canada than in the United States. To raise the same amount per capita through income taxes in both countries would require higher tax rates in Canada.

12/ In setting the rates, we have limited ourselves to providing as much revenue as was produced by the tax system in 1964, the most recent year for which detailed data are available. This is a conservative estimate of the amount of revenue which we believe the proposed rates would raise.

13/ The term "corporate source income" is intended to include dividends, retained earnings and goodwill gains in the value of shares.

14/ This reduction has had the effect of making the relationship between the tax rates applicable to individuals and families differ slightly from what would be consistent with our ability-to-pay principles. However, the deviation is sufficiently minor to be ignored.

15/ The United States figures shown in Table 11-7 include state and local income taxes. Excluding state and local taxes makes little difference to these figures except at the lower levels of income: the reduction in taxes is then 58.0 per cent at $1,500; 17.9 per cent at $6,500; 30.7 per cent at $25,000; and 18.9 per cent at $100,000.

16/ Our comments should not be taken as overly critical of existing rate schedules. The interacting elements of a rate schedule, associated concessionary allowances and changes in the tax base make it difficult to construct a schedule which adequately reflects all the various objectives considered. We have been able to do so only as a result of having developed a computer programme which could, for any rate schedule, quickly calculate the tables presented in this chapter, in Chapters 35 and 36, and in Appendix I to Volume 3 and Appendices M and N to Volume 4. Over 30 variants of the recommended schedule were analyzed under this programme before the final version was arrived at.

17/ It should be emphasized that the comparisons presented in Table 11-9 are made on the assumption that taxpayers claim only the standard deductions. As can be seen from the data contained in Appendix H to this Volume the range of incomes for which Canadian taxes would be lower than United States taxes is decreased if comparisons are based on average deductions claimed by taxpayers. United States taxes would also be lower than those shown in the table for taxpayers having property gains, because such gains are taxable in the United States at preferential rates. On the other hand, the United States does not integrate the corporate tax with the personal tax and, accordingly, Canadian taxes under our proposals would be relatively lower for taxpayers receiving corporate distributions.

18/ If it were administratively feasible to have any number of rate schedules, the need for either credits or exemptions would disappear. The effects of any credit or exemption can be fully incorporated in a rate schedule. For instance, the rate schedule for individuals shown in Table 11-4 yields exactly the same taxes for all individuals as the combination of a $1,000 exemption and a rate schedule formed by deducting $1,000 from the limits of each taxable income bracket. Likewise, the schedule in Table 11-4 yields taxes which are identical to those calculated by applying a tax credit of $100 to a gross tax calculated from a rate schedule formed by taxing income under $1,000 at 10 per cent and adding $100 to the taxes at each bracket shown in Table 11-4. One can make up a rate schedule which, when combined with a given tax credit, yields the same taxes as another rate schedule for any given tax credit. For instance, by putting a 200 per cent tax on the first $1,000 of income one could "give" taxpayers a $2,000 tax credit. The net effect would still be the same as exempting the first $1,000 of income. Any tax credit may thus be made the equivalent of any exemption, provided that the relevant rate schedule may be varied.

19/ The benefit received from a tax credit is, of course, the same for all taxpayers, provided that these taxpayers have tax liabilities against which to offset the credit. For non-taxpayers, the benefit of either an exemption or a credit is irrelevant, since they have no taxes which can be reduced. To equalize these benefits would require the use of transfer payments that would be, in effect, "negative taxes". Such approach should be considered in the detailed examination of the transfer payments of the federal government which we have recommended be undertaken.

20/ Comparisons which incorporate the effect of changes in the tax base that we recommended are presented in Chapter 36.

21/ As has already been noted in Chapter 4, the rate of economic growth is substantially affected by the growth of the labour force. Removing some of the tax disincentives for working wives and mothers would increase female participation in the labour force and so increase the rate of economic growth.

22/ Many of these expenses are nothing more than a purchase of increased leisure time and freedom from unpleasant household tasks. As we have previously noted in Chapter 8, in principle it would be desirable to tax imputed income obtained in the form of leisure. If this were administratively feasible, it would be appropriate to allow the deduction of household expenses associated with obtaining the imputed income. However, since it is obviously completely infeasible to tax imputed income, it would not be equitable to allow such expenses to be deducted.

23/ Where a wife worked for her husband or for a business in which he had a substantial interest, she should have the onus of establishing bona fide full-time employment for the required period. She should also be required to make a declaration to this effect if she claimed the credit. Alternatively, if this proved impossible to administer, it may be necessary to deny the credit where the wife worked for her husband or a corporation controlled by him.

24/ As noted in Chapter 7, a tax credit given to reflect any particular circumstance is equivalent to an assumption that the additional non-discretionary expenses resulting from that circumstance are equal to the tax credit divided by the rate of taxation of income available for discretionary use. Because our rate schedules would levy a 50 per cent tax on what we believe to be discretionary income, the credits we recommend reflect an allowance for additional non-discretionary expenses that is twice the amount of the credit.