AN EVALUATION OF THE CRITICMS OF THE
CAPITAL GAINS PROPOSALS OF THE REPORT
OF THE ROYAL COMMISSION ON TAXATION

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Introduction

When the Report of The Royal Commission on Taxation, better known as the Carter Report after its Chairman, was released on February 24th, 1967, it was the culmination of almost five years of intensive study of the Canadian system of taxation. Several millions of dollars and uncountable man hours of labour went into the final report which consisted of six volumes comprising more than 2,600 pages.

The Report was released on a Friday, after all North American stock markets had closed for the week-end. The government was undoubtedly aware of the fact that the Report might well have created a panic had the general public not had two full days to digest the news.

Two days, and indeed, two years have not been enough time for certain influential lawyers, accountants and businessmen to absorb and accept the Carter proposals. On the contrary, after a few weeks of indecision, a concerted attack was made on the Report which was so successful that by October of 1968, the consensus was that the Carter Report would join many of its predecessor Royal Commission Reports as an historical curiosity.

Then, in his budget speech of October 22nd, 1968, Mr. Benson, the Minister of Finance, announced sweeping changes in

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1Report of the Royal Commission on Taxation, Queen’s Printer, Ottawa (1967). The six members of the Commission were Messrs Kenneth Le M. Carter, J. Harvey Perry, A. Emile Beauvais, Donald G. Grant, Mrs. S. M. Milne and Charles E. S. Walls. All further references will simply be to Report.
Canadian tax law and indicated there was more to follow. Because many of the changes were patterned after the Royal Commission recommendations, the Commission’s proposals were again a focal point of national interest.

That the Carter Report should be so controversial can hardly be surprising in the light of the fact that two of its six members wrote minority opinions. Further, the main sources of subsequent attacks have come from those who have vested interests in keeping the status quo. Foremost among the attackers are several well-known “tax lawyers” and the Canadian Bar Association, which through a special committee set up to study the Report, presented its recommendations to the Minister of Finance.

In reading through the proceedings of the Canadian Tax Foundation’s conventions of April 1967 and November 1967, one cannot help but be struck by the dichotomy of views of those members of the Foundation who were practising lawyers, chartered accountants and businessmen and those who were economists, academics and foreign observers. The foregoing does not mean to impute bad faith but merely demonstrates the phenomenon described by Eisenstein when he points out that the source of one’s income colours one’s views of taxes. Lawyers and accountants in particular have difficulty in differentiating between a purely objective view of taxation and the interests of their clients. While there is nothing inherently wrong in this, it means that many of the opinion leaders in the field of taxation are unable to view the proposals with a desirable objectivity.

The vast scope of the Report means that a total analysis of the entire Report is an impossibility within the confines of this article. That being so, this article shall concentrate on that area which is the most controversial—the inclusion of capital gains (known in the Report by the term “property gains” for reasons which shall become clear) in the tax base.

Before getting down to this specific area, however, one should have at least a brief idea of the scheme of the Report in general.

Perhaps the most radical and far reaching concept in the Report is the adoption of a modified form of the Haig-Simons definition of income which culminates in a Comprehensive Tax
An Evaluation of the Criticisms

As a corollary to the Comprehensive Tax Base is almost always a lowering of rates, the maximum rate of tax, personal or corporate, is 50%. It is as a part of the Comprehensive Tax Base that those profits now known as capital gains become changed into ordinary income.

Another major change recommended by the Commissioner is the full integration of corporate and personal income. This is a method whereby a shareholder gets full credit for payments of corporate taxes by his company and thereby double taxation is eliminated. For every dollar of dividend income, the shareholder receives a tax credit of fifty cents (assuming the full corporate rate of 50%). Therefore, if the individual’s tax rate is 50%, he pays no tax on the dollar of dividend. If his rate is less, he will get a rebate. This integration will be of importance when the arguments concerning incentive to invest are considered.

The third major change is the creation of the family unit as the unit of taxation rather than the individual. A family unit consists of a husband, wife and minor children. All transfers of property within the family unit, whether at death or inter-vivos are free of tax consequences. All transfers outside the family unit will be taxable to the recipient as income—whether the transfer is inter-vivos or at death. Therefore, one can see that the strict Haig-Simons formula which requires the inclusion in income of gifts and bequests would be adhered to.

Finally, you have under the proposals the elimination of such levies as gift taxes, estate taxes and federal sales taxes.

The foregoing is not even meant as a summary of 2,600 pages. It is intended only to highlight certain aspects of the Report which will be germane to his understanding of the discussion of the capital gains problem.

A word is now in order about the scheme of this article. Tax reform is of critical interest to all Canadians but it will perhaps have the greatest effect upon the ordinary legal practitioner. More than ever before, every lawyer will have to deal with tax problems and therefore lawyers should take a more critical view of the debate surrounding the proposed reforms. The first part of this article deals briefly with the current state of the law of capital gains.

Income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in value of the store of property rights between the beginning and the end of the period.” Haig, R.M., The Concept of Income in The Federal Income Tax (1921): “Income is the money value of net accretion to one’s economic power between two points in time.”
so that the lawyer who at present avoids tax problems will have a grasp of the subject.

The second part will comprise a thorough explanation of the proposal put forth by the Carter Report. Hopefully, upon reading it, the reader will understand the capital gains treatment under Carter as well as if he had read the section himself.

The third part will put forth the major arguments which have been made against the proposed treatment of capital gains. In this part a few selected criticisms have been considered. These criticisms have emanated from the most responsible and influential segments of Canadian tax thinkers.

A note on these sources is in order here. Three sources have been primarily relied upon. Firstly, the published talks given before the two tax conferences7 mentioned earlier have been studied and the major arguments extracted. Secondly, to a lesser extent the brief of the Canadian Bar Association to the Minister of Finance has been used.8 Thirdly, use has been made of a series of monographs published by various individuals and organizations. Sources such as letters to newspaper editors have been ignored because these have had a tendency to hysteria which defies analytical judgment.

By attempting to give an answer to each of the arguments presented, I hope that the reader will have a full picture, pro and con, of the conflict. A measure of objectivity will hopefully be achieved, but it will be clear as one reads this article that I do have a bias in favour of adopting the Report. The validity of my reasons is left to the reader's own evaluation.

I. Current Canadian Treatment of Capital Gains.

The identification and treatment of capital gains in the United States and Canada are subject to great disparity. In the United States, there was an assumption from the first that the term "income" included what we know as capital gains9—an assumption which has great validity to an economist. It was not until 1921 that preferential treatment of capital gains was introduced to this country. At this time, a tax of 12½% maximum was imposed.10 The general consensus appears to be that the reason of this was to avoid the inequities of "bunching".11 Capital gains is a concept

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7 Supra, footnote 4.
9 Merchants Loan & Trust Co. v. Smietanka (1921), 255 U.S. 509.
10 Revenue Act of 1921, s. 206.
specifically recognized, therefore, in the Internal Revenue Code.

In Britain, from whence came the bulk of the Canadian law of income tax, the view prevailed that there was an inherent difference between income and gains of capital—and that the taxation of such gains was inequitable. This view one might style "sociological" as opposed to "economic" because it reflected the popular view of capital gains rather than the economic view. It was not until after the Second World War that Britain began to tax capital gains—but this was a matter of fiscal necessity rather than any inherent change of popular understanding.

Both as a result of inclination and the fact that the ultimate appellate court of the country was the Privy Council, Canadian judges looked towards the British rather than the American jurisprudence in all areas. Nowhere can this influence be seen more than in the field of income taxation.

Perhaps the most quoted and most basic case to the entire structure of the Canadian distinction between income and capital gains is California Copper Syndicate v. Harris,12 a decision of Lord Justice Clerk MacDonald of the Court of Sessions. This case dealt with an English copper exploration syndicate which realized huge profits on the sale of land to a California copper company. In holding that the gain was taxable, Lord MacDonald said:

*It is a quite well settled principle in dealing with question . . . of Income Tax, that where the owner of an ordinary investment chooses to realize it, and obtains a greater price for it than he originally acquired it at, the enhanced price is not profit . . . assessable to Income Tax. But it is equally well established that enhanced values obtained from realization or conversion of securities may be so assessable where what is done is not merely a realization or change of investment, but an act done in what is truly the carrying on, or carrying out, of a business. The simplest case is that of a person or association of persons buying and selling lands or securities speculatively, in order to make gains, dealing in such investment as a business, and thereby seeking to make profits. . . . What is the line that separates the two classes of cases may be difficult to define, and each case must be considered according to its facts; the question to be determined being—Is the sum of gain that has been made a mere enhancement of value by realizing a security, or is it a gain made in an operation of business in carrying out a scheme of profit making?*

The reader will note that on the one hand, accrual to investment is not taxable but if the accrual is to property purchased for speculation or business purposes, that gain is taxable.

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12 California Copper Syndicate v. Harris (1904), 5 Tax Cases 159.
13 Ibid., pp. 165-166.
The history of capital gains in Canada has been one of taxpayers trying to fit their property gains into the niche called investment while the Department of National Revenue, usually with the co-operation of the courts, has attempted to narrow that niche as much as it could. The techniques of this battle and the results they have produced shall now be examined.

The Canadian Income Tax Act is singularly unhelpful in this area. There is no mention of the term “capital gains” throughout—which is logical as in theory, a sum is either income or it is non-taxable. Therefore, the bulk of Canadian tax litigation is over something not in the Act.

Section 4 states:

Subject to the other provisions of this Part, income for a taxation year from a business or property is the profit therefrom for the year.

A definition of “business” is found in section 139(1)(e) and is crucial to an understanding of the development of capital gains treatment.

“business” includes a profession, calling, trade, manufacture or undertaking of any kind whatsoever and includes an adventure or concern in the nature of trade but does not include an office or employment.

It is appropriate here to look at some of the main themes which recur in the continuing battle to determine whether a particular gain is income or capital. The first logical test is whether there was an intention on the part of the taxpayer to invest whether he was speculating or carrying on business. In *California Copper Syndicate*, Lord MacDonald said in reference to the company:

> It is manifest that it never did intend to work this mineral field with the capital at its disposal. Such a thing was quite impossible. Its purpose was to exploit the field and obtain gain by inducing others to take it up on such terms as would bring substantial gain to themselves. This was that the turning of investment to account was not merely incidental, but was... the essential feature of the business, speculation being the appointed means of the company’s gains.

At first glance, this seems to be quite clear cut and straightforward—but it left too large an opening for the revenue authorities to rest easy. The “doctrine of secondary intention” was promulgated by the Supreme Court of Canada in the case of *Regal Heights Limited v. M.N.R.*. In this case, several partners formed a company to purchase land and construct a shopping centre near Calgary. The plan fell through because they were

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14 R.S.C., 1952, c. 148, as am.
15 *Supra*, footnote 12.
unable to get a major department store to locate in their shopping centre—a prerequisite for success. However, Calgary was a fast developing city and they were able to sell the land at a substantial profit. Judson J., speaking for the majority, said in part:17

There is no evidence that these promoters had any assurance when they entered upon this venture that they could interest any such department store. Their venture was entirely speculative. If it failed, the property was a valuable property, as is proved from the proceeds of the sales that they made. There is ample evidence to support the findings of the learned trial judge that this was an undertaking or venture in the nature of trade, a speculation in vacant land. These promoters were hopeful of putting the land to one use, but that hope was not realized. They then sold at a substantial profit and that profit, in my opinion, is income and subject to taxation.

The Supreme Court appeared to back down from the full implications of Regal Heights in the case of Irrigation Industries v. M.N.R.18 but the doctrine of secondary intention is still very much alive. This means that no careful lawyer can with assurance advise a client on the nature of a possible gain, even if the primary intention is undoubtedly investment purposes.

Another major question is one of frequency of transactions. One can readily grasp that if profits from business are taxable and profits from investment are not, there will be some line to be drawn between frequent investment and the carrying on of a business. The problem is further complicated by the use in the definition of “business” of the term “an adventure in the nature of trade” which clearly indicates that even an isolated transaction may yield “business” profits.

The classic case dealing with the meaning of this phrase is M.N.R. v. Taylor19 a judgment of President Thorson of the Exchequer Court. Taylor, in his own, bought 1,500 tons of lead, for future delivery, when prices were rising. He immediately resold the lead to his employer at a substantial profit. Thorson P. delivered a long, detailed and erudite opinion setting forth many rules by which one could determine whether a particular transaction was an adventure in the nature of trade. For the purpose of this survey, a detailed summary is superfluous. But Thorson P. did point out that there was no conceivable way the 1,500 tons of lead could yield income other than by sale at a profit. Therefore, he reasoned, the transaction could not be an investment. On

17 Ibid., at p. 389 (D.T.C.).
the other hand, the taxpayer had never done something like this before, so he scarcely could be said to be in business in the conventional sense. Thorson P. therefore decided that this must be an adventure in the nature of trade.

One can appreciate that in an area as the purchase and sale of land and the purchase and sale of mortgages, the question of "business" or investment becomes acute. It is sufficient to say that no careful lawyer in Canada would give any assurances to a person selling a piece of land at a profit for the third time—and even the second time is risky. It is this lack of certainty as to the status of land gains which makes dealing in land in Canada a hazardous undertaking from a tax point of view.

Still another major factor in determining whether profit is income or capital gain is the question of related business activity. The reasoning seems to be that if one uses the skill which one has acquired in business to select investments, it is likely that a court will hold that the profit is attributable to carrying on business rather than investment. The typical example of this would be a stockbroker who "invests" for himself 20 or a real estate dealer who is involved in land trading on his own account. 21 It is possible to rebut this "presumption", but it is extremely difficult.

It should be noted that there are often other factors which influence a court's decision. Such factors as the "object" clause in the letters patent of a company may be raised. 22 The limits are set not by the jurisprudence but by the ingenuity of lawyers, both for the taxpayer and the government. Any and all factors will be raised if it is believed that the court will be influenced in its decision.

The foregoing will give some idea of the type of technique used in Canada. One should note that the key to the whole matter is total uncertainty—one never knows how a court will react to a given argument, what will be persuasive or what law will be applied. Further, the stakes are high—in this game the winner takes almost all, with rates as high as 82.4%. 23

However, it is now appropriate to turn to the great anomaly—stock market gain—an area in which there is no fighting, huge profit, great inequity and a threat to the self-assessing system.

The key to the foregoing is the fact that except in unusual

22 Anderson Logging v. The King (1924), 6 D.T.C. 1209.
circumstances, stock market profits are not subject to tax. This state of affairs came about not from the jurisprudence of the courts nor from a section of the Income Tax Act but merely as a matter of administrative practice. Thus in the CCH Canadian Tax Reporter is found the statement:

It is understood that the Income Tax Department has not ordinarily imposed tax upon profits realized on securities transactions by individuals who are not stockbrokers or investment dealers.24

Bearing in mind the test of investment versus speculation, the above holds true even if the profit was made in penny mining stocks which have never paid a cent of dividends and even in cases of short sales where the taxpayer never owned the stock. Speculation as to the reason for this state of affairs is merely conjecture. It may be that it is felt that the administrative problems are too large; or that there is some overriding public interest to encourage investment in Canada by Canadians. In any event, it is abundantly clear that were the same rules to be applied to stock market gains as to other property gains, the increase in revenue to the government would be in the tens of millions of dollars.

There are further serious drawbacks in this exemption. It is discriminatory against other forms of investors. As was indicated earlier, those who invest in land have a particularly difficult situation with the definition of capital gains constantly being narrowed. The bias against this form of investment is so great in comparison with stock market dealing that serious questions arise as to why one form of investment should be so preferred. The answer one might suggest, seems to be an innate bias against the land dealer because, at least in the post-war era, he appears to take relatively small risks for relatively large gains.

The second deleterious effect is that because it is comparatively easy to invest small amounts in the stock market and the hoped for gain will be tax free, people who cannot afford to do so invest too much. Recent financial scandals in Toronto indicate that not only is this so, but great numbers of untrustworthy people are helping each other to defraud the public. The tax free nature of these gains only serves to enhance the vision of huge potential profits.

The third concern affects the whole structure of the tax system. The Royal Commission recognized that the essence of a self-assessing system is the belief that all men were paying tax under

the same rules. The system of capital gains being free of tax is a threat to that belief, to taxpayer morale and to the self-assessing system. Further, because the profits in the stock market are never taxed and because this is a highly visible form of profit making, this particular exemption does more to exacerbate the unfairness which many people feel is present.

The reason for dwelling on this subject at such length is that when one refers to capital gains, more often than not the listener immediately thinks of stock market transactions. Many of the criticisms of the Carter Report focus on the stock market and the reader must be aware of the special role of stock market gains.

One of the main points to grasp is that the notion of what is a capital gain in Canada varies greatly from the notion in the United States. One reason why economists find it difficult to analogize from the American to the Canadian situation is that in Canada, many receipts are now being taxed as income which would almost certainly be classified as capital gains in the United States. Further, one should understand the nature of the "war" which is being continually fought over the question of what is a capital gain.

Having read the foregoing, one can now appreciate what the goals of the Royal Commission were when it set about examining the question of treatment of capital gains. One can suppose that it wished to devise a system which had the following attributes:

1. achieve equity among the taxpayers,
2. achieve ease of administration—especially in cutting down litigation,
3. achieve certainty for investors and taxpayers generally,
4. have the system remain neutral,
5. raise revenue—or at least not lose revenue.

Though it should be stressed that the foregoing is not a statement by the Commission but rather a statement of what some consider to be the problems in the present system, it would be useful to the reader to have these five "objectives" in mind as we turn to the recommendations made by the Commission. It is suggested that all five of these criteria would be met by adopting the proposed system.

II. The Royal Commission Recommendations.

Having looked at the general background and major recommendations of the Carter Report as well as the current treatment of capital gains in Canada, we now turn to the specific recommenda-
tions of the Royal Commission with regard to capital gains. These are found in the Report in Chapter 15 entitled, "Property Income". 25

1. Who is taxed?

The Report recommends that residents of Canada be taxed on their world-wide property gains. 26 However, non-residents would be taxed only on gains which are attributable to permanent establishments in Canada. 27

By limiting the taxation of non-residents in this manner, two major hurdles of administration and enforcement are overcome. Firstly, bearing in mind that the bulk of foreign investment in Canada is American, this obviates the need for an amendment to the Canada-United States Tax Treaty which exempts the nationals of one country from the payment of a capital gains tax to the other government. 28

Secondly, the use of the well established and defined rules plus some regulations with regard to permanent establishment allows the Canadian government to levy a tax on that property over which it has actual physical control while allowing it to disregard gains on property which it could not enforce. The obvious example is the difference between a gain on the sale of land situation in Canada and the gain on a sale of shares in a Canadian company which may have been totally negotiated through the New York Stock Exchange.

2. Tax base and tax rate.

As was mentioned briefly in the introduction to this article the Report called for a comprehensive tax base. Such a notion includes virtually all gains and losses in the notion of income. Therefore, after the transitional period, there would be no such notion as capital gains for what we now think of as a capital gain will simply be another source of income.

Inherent in any discussion of a comprehensive tax base is the notion that if such a base were introduced, then it would be possible to drastically reduce the rates of income tax. This

26 Ibid., p. 353.
27 Ibid.
28 The Canada—United States of America Tax Convention Act, 1943. S.C., 1943-44, c. 21, as am. See Article VIII of the Convention and Protocol. The Commissioners recommended revision of many of Canada's treaties and the negotiation of new ones to eliminate tax havens but there is no indication that Article VIII was the type of section they wished to eliminate.
notion has been followed by the Commission and they have recommended progressive rates culminating with a maximum rate of 50% for family unit earnings of over $100,000.00.  

3. Gains subject to tax.

While the Commission seems to feel that in a state of perfect equity there would be no exceptions to the rule that any and all property gains would be included in income, it has bowed to certain exceptions which for political or business reasons have commended themselves.

The first and most wide ranging exclusion is gains up to a lifetime total of $25,000.00 on the sale or disposition of residential real estate or farm real property.  

To determine the cost basis, the taxpayer may add to his cost price, either the value of actual additions to the property or an allowance of 1% of the cost of the building for each year the property has been held.

A second exclusion is in the nature of a "roll-over" provision in the case of an involuntary disposition, loss or destruction of property. This exemption allows insurance or other proceeds to be re-invested within a stipulated period of time without their being a deemed disposition.

The Report also recommends an exemption where an individual transfers property other than securities to a company in exchange for common shares. There is a proviso that the company must be a new one or one whose shares are held by the transferors in the same proportion in which they were transferring property. This exemption in effect allows individuals or partnerships to change to corporate form without penalty. However, if the common shares received represent less than 25% of all the shares of the company and were or become publicly traded, the transferor would be regarded as having made a realization at the fair market value.

Where property is transferred between a company and its wholly owned subsidiary or sub-subsidiary or between companies wholly owned by the same shareholder, the disposition of each asset or class of assets would be at the cost basis to the transferor, or at the fair market value or at any price between those amounts which was specified by the parties.

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30 Ibid., p. 395.  
31 Ibid.  
32 Ibid., p. 370.  
33 Ibid., p. 372.  
34 This type of test was used at one time in the United States but has since been abandoned.  
In cases of amalgamation of companies, there will be a deemed disposition at the fair market value by the shareholders of the amalgamated companies but not by the corporations themselves.\(^{36}\) This would also be true of the situation where one company sold all its assets to another company and then liquidated itself.\(^{37}\)

A subdivision, consolidation, conversion or exchange of shares in the same or a related corporation would not be deemed a disposition if the shareholders each continued to hold the same percentage of shares in the corporation as previously.\(^{38}\)

Finally, the transfer of an asset as security for a loan and its subsequent transfer back would not be deemed to be a disposition.\(^{39}\) This, one should note, leaves an obvious loophole which shall be discussed later in this article.

One should realize that in considering property gains, gains from personal property will also be included. Thus any gains made on the sale of such chattels as cars, jewellery, furniture, \textit{objets d'art} and the like will yield taxable income in the same manner as the sale of shares of stock.

4. \textit{What is a disposition?}

In the foregoing section, it has been seen that a number of exceptions to the taxation of gains arise when a particular transaction has not been deemed to be a disposition.

A disposition will include all sales, exchanges, transfers, gifts, bequests and loss through theft, damage or expropriation, save for the exceptions to the rule which were mentioned above.\(^{40}\)

When a disposition occurs through a \textit{bona fide} arm's length transaction, the actual proceeds would be included in income of the vendor and a new basis created for the vendee. In the case of other dispositions such as gifts, the fair market value of the property would be deemed to have been received.

There are two cases of deemed disposition which are very controversial but crucial to the system. The first, and most important is the deemed disposition at death (unless the property is passed on within the family unit). This obviates the key weakness in the American taxation of capital gains.\(^{41}\)

\(^{36}\) \textit{Ibid.} \hspace{1cm} \(^{37}\) \textit{Ibid.} \hspace{1cm} \(^{38}\) \textit{Ibid.}, p. 374. \hspace{1cm} \(^{39}\) \textit{Ibid.} \hspace{1cm} 

\(^{40}\) \textit{Ibid.}, p. 394. \hspace{1cm} 

\(^{41}\) \textit{Ibid.}, p. 369; The weakness referred to is the granting of a new basis upon the death of the transferor, to the transferee, of the market value at the time of death. (See s. 1014 of the Internal Revenue Code, 1954). This, of course, means that accrued but unrealized capital gains are not taxed; which in turn creates a relatively simple way to avoid taxation of capital gains. The New York Times, Feb. 3rd, 1969 has a discussion of this problem at p. 23.
Secondly, there would be a deemed disposition of all the taxpayer's property when he ceased to be a resident of Canada unless he elected to continue to be taxed as a Canadian resident on his world-wide income. The converse would also be true and there would be a deemed acquisition when a non-resident became a Canadian resident.

Having looked at the various sources of tax up to this point, we now turn to some of the benefits which would accrue to the taxpayer under the Carter system. We have already considered the fact that the maximum rate of tax would be 50%. Two further major benefits (or as some would have it, rights) are given to the taxpayer. The first we will consider is the question of losses and the next the question of averaging.

5. Treatment of losses.

Any exponent of the Haig-Simons definition of income will recognize that if one is to be both equitable and consistent, any potential source of income is also a potential source of loss of income and equity demands that full deduction of losses be given in situations where there is full taxation of gains.

Therefore, the Report recommends that all losses on the disposition of property, other than those arising from the disposition of property used for personal consumption, should be deductible in full from any other income. There would be allowed a carry-back of two years and an unlimited carry-forward.

The exception for property used in personal consumption should be noted. Because virtually all consumption goods decrease in value over time, deductions would be a great strain on the revenue as well as being administratively difficult. Yet, because gains on personal property are taxed, an inequity results.

Therefore, the Commission recommends the deduction of losses which would otherwise be disallowed from gains realized on similar types of property within the preceding two years, the same year or any succeeding year. A loss on residential property is specifically excluded from this carryover.

The method of assessing a loss would be the same as that for assessing a gain discussed in the preceding section. There would, however, be no allowance for depreciation.

Losses incurred in the holding of property would not be deductible from other income, but would be available on a two

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43 Ibid., p. 393.
44 Ibid.
year carryback, indefinite carry-forward basis for deduction from operating income from the same property.\textsuperscript{46}

The \textit{Report} also gives the taxpayer the option of writing the value of his property up or down at any time, thus in effect opting to take losses or pay taxes on gains when they had not actually been realized.\textsuperscript{47} The new value would then become the cost basis. However, where there had been a write down and the market value recovered, it would be necessary to write the property up to market, but not to an amount exceeding the original cost basis.

6. \textit{Averaging provisions}.

The averaging provisions are contained in Chapter 13 of the \textit{Report}.\textsuperscript{48} The recommendations with regard to averaging were not put forward solely to be used in connexion with capital gains but were designed to alleviate hardship caused by bunching of income, no matter what the reason for the bunching.\textsuperscript{48A}

The primary recommendation was to allow a block averaging system which would be available to both resident individuals and family units.\textsuperscript{49} The block would be a five year period, with the years being consecutive with no year omitted.\textsuperscript{50} Once a year was used in one block, it could not be used again except where there has been a realization at death or a deemed realization upon giving up Canadian residence.

The Commission recommends no restrictions whatever on the kinds of income averaged or the direction of the fluctuations. The only restriction is one imposed for administrative purposes—namely, that the lowest income in the period must be less than 75\% of the highest income and that the tax saving brought about by block averaging would amount to a minimum of $50.00.\textsuperscript{51}

Losses carried forward or backward from years outside the averaging period could be taken into account of the income being averaged. Unused losses in the, averaging period would be deductible in computing the averaged income but of course once used, they could not be used for future carry-forward.\textsuperscript{52}

\textsuperscript{46} \textit{Ibid.}, p. 364.  \textsuperscript{47} \textit{Ibid.}, p. 366.  \textsuperscript{48} \textit{Ibid.}, p. 241.  \textsuperscript{48A} Bunching is a word applied to a lump sum of money which is realized at one particular time, when the sum represents an accrual of monies over a long period of time. The most common example would be the realization of a capital gain which was held over a period of several years and in which the growth of the original investment to the final sum realized took place over that period of years.

\textsuperscript{49} \textit{Ibid.}, p. 262.  \textsuperscript{50} \textit{Ibid.}, p. 263.  \textsuperscript{51} \textit{Ibid.}, p. 264.  \textsuperscript{52} \textit{Ibid.}, p. 268.
In addition to the block averaging, another source of tax postponement is proposed in the establishment of a system of Income Adjustment Accounts. This system would allow a taxpayer to deposit any income from a given year in one of these accounts. Such income would not constitute taxable income until such time as it was withdrawn. There would be no interest paid on these accounts—the cost of tax postponement. There would be no restrictions on deposits, though there might be restrictions on withdrawal to prevent postponement of tax in year one by depositing in December and withdrawing in January.

There would be a refundable withholding tax imposed on withdrawals to prevent evasion.

To prevent a conjunction of taxes at death, individuals of advanced age would not be allowed to utilize the Income Adjustment Account.

Thus, one can see that under such a system, an individual has a great deal of power to determine his own income tax liability while the government has the use, interest free, of all the money so deposited.

At this point, a word or two might be in order about two subjects which were considered and rejected by the Commission. These are the holding period and “roll-over” provisions.

7. The holding period.

Many jurisdictions, notably the United States, use some sort of holding period to determine either tax liability or difference in treatment of property gains. The usual justification is that a gain when realized may represent a value that has increased over a large period of time. In rejecting this type of reasoning, the Report says in part:

We propose in this Report the adoption of several methods of averaging but we reject the principle that a substantial part of any income should be exempted from tax simply because the time over which it accrued exceeded six months or one year or some other arbitrary period. We see nothing to distinguish the realization of such a gain on property from a lump sum receipt of income in any other form, and our proposal therefore is that no concession should be granted for realized property gains beyond the averaging devices we propose in Chapter 13.

It should be pointed out that not only is the holding period an attempt to recognize the nature of an increase over a period of time, but it also lends some significance to the distinction between “speculation” and “investment” which plays such a large

role now in the mystique of capital gains. In many cases, the courts have apparently decided that if a piece of property were held for a prolonged period, the intention was to hold it as an investment rather than as a speculative property. Because such a distinction would be a thing of the past under the comprehensive tax base approach, the concept of the holding period becomes an anachronism.

8. "Roll-over" provisions.

One of the areas of greatest controversy under the Carter system is the result of the Commission's rejection of any "roll-over" provisions. "Roll-over" simply calls for a postponement of tax on a realized gain if that gain is within some specified time reinvested in other investments.

The Report rejects the "roll-over" privilege on two grounds. However, we find the proposition to be a serious violation of equity. In effect, the suggestion is that those who accumulate saving from realized but reinvested property gains shall be free of immediate tax, while those who save from other income must pay full rates of income tax at the time the income is received.55

The second reason for the rejection is administrative.

In addition to the serious inequities which would be produced by a roll-over provision, there would also be major administrative problems in determining what income should be eligible for such a provision and to what extent. We examined in detail a number of alternative methods of providing for a roll-over and found them all to be subject to major complexities and serious definitional problems.56

The subject of "roll-over" will be considered in more detail in the final portion of this article.

Subject to the transitional provisions which may be of interest but are not germane to the discussion at hand, one should now have a grasp of the proposed system. A brief recapitulation finds virtually all property gains taxed as ordinary income in the year when realized or deemed realized. To offset this major enlargement of the tax base, the taxpayer is given a maximum tax rate of 50%, virtually full write off of losses and a system of averaging and deferring of income.

III. Analysis.

We shall now turn to a consideration of the major criticisms which have been made of the Report and attempt to evaluate them.

As indicated previously, the selected criticisms are those which

55 Ibid., p. 350.  
56 Ibid., p. 351.
have emanated from the most respectable sources, those which have had the widest circulation among the public at large and those which have about them the most compelling logic.

Naturally, not all the criticisms which have been made are considered here but it is hoped that an analysis of those presented here would be sufficient for an impartial person to decide the merits of the issue as a whole.

It should be stressed that the argument has for the most part been not one of whether a capital gains tax should be adopted in Canada, but rather what form such a tax should take. Those favouring some form of preferential rates for capital gains look most often to the American model and comparisons will occasionally be made with the American system.

It has been arbitrarily decided that unless otherwise stated, the sphere of reference being considered in this article is the stock market. It is not suggested that other fields are not worthy of equal space, but because the stock market gains represent the extreme treatment of capital gains in Canada at the moment, it appears to be the most fertile ground for investigation. Beyond that, data regarding the stock market is more readily available—and has much more applicability than, for instance, the price fluctuations of a particular piece of land in Toronto.

The one area in which this frame of reference takes on an air of unreality is in the discussion of foreign investment in Canada. This lack of realism notwithstanding, discussion will still be made within the stated terms of reference.

The reason this premise is unrealistic is that most of the foreign investment in Canada is made by multi-national corporations whose goals are either the exploitation of natural resources (oil, minerals, potash) or the exploitation of the Canadian consumer market.

While some of these investments may have stock market manifestations, it is abundantly clear that the reason for investment in Canada was not motivated by any preferential treatment of capital gains. It is conceded that there are several aspects of the Report which may affect these forms of investment, but it is submitted, the capital gains section would be a very minor factor in the determination of such companies to invest in Canada or not.

1. Inflation.

The concept that a tax on property gains is a tax on inflation was stated with regard to the Report's recommendations by,
amongst others, Herbert O. Spindler,® John G. McDonald, Q.C.,® I. H. Asper,® and the two dissenting Royal Commissioners, Messrs Beauvais and Grant.® Mr. McDonald appears to have given the matter somewhat more consideration and at the April 1967 Conference of the Canadian Tax Foundation, he said:®

Without delving into technical problems at this point, I think it can be said that the only inequitable aspect of the proposal for taxation of capital gains is that no allowance is made for devaluation of the dollar — that is, creeping inflation at the average rate of 3% per year. The federal government has assumed, for the purpose of the Canada Pension Plan, that inflation will continue in Canada at this rate at least through 1980. The failure of the Royal Commission to take this assumption into account would result in a tax on capital in addition to the proposed tax on capital gains as such.

There are two possible remedies:
1. reduction of a deemed capital gain at the rate of 3% per annum over the holding period of the property, and
2. the allowance of interest at the rate of 6% (taxable) or 3% (non-taxable) on amounts paid by the taxpayers to the Income Adjustment Account.

The basic argument against the concept of allowing a percentage deduction for inflation is quite simple. If all taxpayers were receiving income which were variable because of inflation, equity would be achieved easily because either all get the benefit of the percentage deduction or none would—but the relationship vis-à-vis each other would remain constant. In other words, a form of equity would be achieved.

But the fact is that in Canada only a small percentage of the population has income which is flexible. Those people who live on interest, annuities, pensions and are working under contract, do not find their income varies with inflation. Therefore, while it may be true that gain attributable to inflation does not reflect the capacity to control more goods and services, it is also true that gain of this nature does represent an increase of economic power vis-à-vis those on fixed incomes. If one uses as a test ability to pay, people who realize these gains have more ability to pay than their fellow taxpayers.

® Conference Report of the Canadian Tax Foundation, April, 1967, p. 346. This report shall be cited as the April (1967) Conference. The second report, of the conference in Montreal in November will be cited as the November (1967) Conference.
® Asper, I.H., The Carter Report (1968). This is one of a series of six monographs by the same author.
To carry the matter one step forward—if in an inflationary spiral, a union worker gets more salary as a result of a new contract—or if he gets a contract pegged to the cost of living, he will pay more tax and perhaps move into a higher tax bracket. Should he, too, get a deduction for inflation? If the answer is yes, it would simply require that the marginal tax levels be increased giving the government a lower return in inflated dollars.

Such a step would lead to more equity among taxpayers at a cost to the government of millions in revenue annually—a result which though it would be strictly fair is fiscally unacceptable.

Two other points should be mentioned briefly. First, many investors purchase stocks when they know inflation will come. As this enters into investment decision making, why should the occurrence of a planned for event be a reason for a tax benefit? Secondly, because taxation is considered to be a curb on inflation, it would be a self-defeating move to reduce the tax payable in an inflationary spiral.

In connexion with Mr. McDonald's two suggestions, a few words are in order. The idea of using an inflation index is not a unique idea. In Belgium, inflation co-efficients based on the price of gold are used to compute historical cost to reflect devaluations before computing most property gains. In France, all inflationary factors are used when computing capital gains realized by individuals on the disposal of vacant land.

Mr. McDonald's second suggestion is not appealing. The concept of an Interest-Free Income Adjustment Account was, as we saw, viewed as a device to postpone realization of gains—or more precisely, payment of tax. The price of postponement, which of course has a great value, is the foregoing of interest. If interest is paid, the use of such an account becomes both too attractive to the taxpayer and too costly for the government. Therefore, this alternative should be rejected.

While there can be no argument that a certain percentage of capital gains does represent inflation, a germane question is what

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62 Conway, G.S. and Smith, John G., Studies for The Royal Commission on Taxation, # 1913, p.71.
63 Conway, G.S. and Smith, John G., op. cit., ibid., p. 79: Where SP is the selling price and AC is the acquisition cost, Y is the re-evaluation co-efficient and N, the number of years the land is held, the formula for computing the capital gain without inflation is:

\[
SP - Y = \left\{ \frac{AC + 25\ AC}{100} + \frac{3N(125\ AC)}{100} \right\}
\]
percentage? It is obviously not possible to determine this in connexion with the sale of a Renoir oil or a particular piece of land. But the Dominion Bureau of Statistics has come up with a table which is a great interest.⁶⁴

Table 1
Consumer Price Index Increase Over Certain Time Periods Expressed as a Percentage of the Investor's Index Increase Over the Same Time Period

<table>
<thead>
<tr>
<th>Period of Time</th>
<th>% Change in Investor's Index</th>
<th>% Change in Consumer Price Index</th>
<th>Price Index Change as % of Investor's Index Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>1961-62</td>
<td>(3.6)</td>
<td>1.2</td>
<td>—</td>
</tr>
<tr>
<td>1960-62</td>
<td>22.4</td>
<td>2.1</td>
<td>9.4</td>
</tr>
<tr>
<td>1959-62</td>
<td>15.9</td>
<td>3.3</td>
<td>20.8</td>
</tr>
<tr>
<td>1958-62</td>
<td>35.9</td>
<td>4.5</td>
<td>12.5</td>
</tr>
<tr>
<td>1957-62</td>
<td>32.1</td>
<td>7.2</td>
<td>22.4</td>
</tr>
<tr>
<td>1952-62</td>
<td>97.4</td>
<td>12.2</td>
<td>12.5</td>
</tr>
<tr>
<td>1947-62</td>
<td>222.2</td>
<td>59.1</td>
<td>24.3</td>
</tr>
<tr>
<td>1942-62</td>
<td>432.9</td>
<td>97.3</td>
<td>22.5</td>
</tr>
<tr>
<td>1937-62</td>
<td>195.4</td>
<td>107.5</td>
<td>55.0</td>
</tr>
<tr>
<td>1932-62</td>
<td>576.7</td>
<td>111.8</td>
<td>19.4</td>
</tr>
<tr>
<td>1927-62</td>
<td>202.8</td>
<td>75.2</td>
<td>37.1</td>
</tr>
</tbody>
</table>

The last column indicates, for an investor who sold shares in 1962, what percentage of the gain would be attributable to inflation, depending upon what year he bought the shares. The discrepancy, ranging from under 10% to more than 50% indicates that many of the bland assumptions about inflation and capital gains are inaccurate—because there appears to be no consistency whatever to the relationship. Further, one could use more startling figures. For example, between 1953 and 1956 the Investor's Index gained 66.7% while the cost of living rose by 2.3%.⁶⁵

This being so—and looking at the table, one can see that an allowance of 3% per year would be overly generous for everything over the very short run.

On a more mundane level the administrative difficulties imposed by an inflationary deduction would be so great as to be a serious drawback. To quote from one of the Royal Commission studies:

First there is the difficulty of accurately determining in each case the amount of inflationary gain (or deflationary loss), as no one, two or three indices would be satisfactory for all purposes. Secondly, there are

⁶⁴ Ibid., p. 74. ⁶⁵ Ibid., p. 76.
administrative problems involved for the Government in computing, recording and explaining the indices to be employed by the taxpayer in computing his taxable income. Finally, if only gains that exceed inflationary increase are to be taxed, then any increment which falls short of the inflation index would result in a deductible deficiency. The computation of such losses and the reduction in tax revenues that would result are formidable barriers to the introduction of inflation adjustments.66

We now turn to a second area which has stirred up a lot of criticism—what is usually referred to as the “deeming” provisions.

2. Deemed realization.

The concept of deemed realization has come under two types of attack—from those who wish no deemed realization whatever and from those who reject the circumstances upon which the Report recommends realization to be deemed to have occurred.

The case is summed up by I. H. Asper who said:

The Commission laments that Canadians are long holders and often do not liquidate and realize their gains.

To discourage that untaxworthy habit, the Commission introduces the ‘deemed’ realization concept. It is difficult to defend on any ground. If capital gains are to be taxed, then the tax should be levied only as and when the gain is received, and not as some time which is fictionally created by the Commission.67

Perhaps the first and least significant point to be made is that the Commission did not “introduce the deemed realization concept”. This concept, as applied to fields other than capital gains has long been a part of the Income Tax Act. For instance, what else but deemed realization is the allocation to partners of partnership profits whether received or not?

But the issue is deeper than this. Ideally, in a non-political and non-practical world, a comprehensive tax base would include profits as they accrued, not as they were realized. This was referred to by Messrs Simons,68 Bittker69 and Musgrave.70 But the problems of taxing gains as they accrue are political, administrative and, for the taxpayer, economic. Thus, it is clear that by not taxing accrued gains, the taxpayer receives a preference, the

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66 Ibid., p. 79.
magnitude of which is demonstrated by Mr. Bittker in a short table.\textsuperscript{71}

Translated into dollars, the value of postponing for 5, 10 or 20 years the payment of a liability of $1000 is set out in the following table, depending upon whether the taxpayer discounts the future at five, ten, fifteen or twenty per cent.

<table>
<thead>
<tr>
<th>Years</th>
<th>5%</th>
<th>10%</th>
<th>15%</th>
<th>20%</th>
</tr>
</thead>
<tbody>
<tr>
<td>5</td>
<td>$216</td>
<td>$379</td>
<td>$503</td>
<td>$598</td>
</tr>
<tr>
<td>10</td>
<td>386</td>
<td>614</td>
<td>753</td>
<td>838</td>
</tr>
<tr>
<td>20</td>
<td>623</td>
<td>851</td>
<td>939</td>
<td>974</td>
</tr>
</tbody>
</table>

Thus, the ability to postpone realization is a matter of dollars of profit to a taxpayer. While the Commission recoiled from the problems of taxing accrued gains on a yearly basis, it was not willing to create the problem which has plagued American revenue authorities over the years—indefinite postponement until death at which time a new basis is made, meaning ultimate escape from tax.\textsuperscript{72}

It is not feasible, at this time, to deal with the so-called "locked-in" problem. Walter Heller has done an admirable analysis of this.\textsuperscript{73} However, it should be clear to the student of taxation that the ultimate result of the American tax treatment is that investors with large capital gains are discouraged from realizing them in order to establish a new basis for their heirs. In a country as starved for equity shares as Canada, this would cause even more financial difficulties than it has in the United States. This problem will be commented on at greater length below.

Under the American system, certain corporate reorganizations also allow a "dealing" with stocks without tax consequences. As we have seen, certain situations of this type are not to be considered deemed realizations under the proposed Canadian section. This, too, will be commented on shortly.

But to return to the general issue, it is suggested that the following statements sum up the situation. First, in different forms, deemed realizations have always been a part of the Income Tax Act. Secondly, postponement of tax on accrued gains is a form of government loan to the taxpayer, interest free, which is a violation of the equity principle. Thirdly, from a practical point of view, accrued gains cannot be taxed. Fourthly, the avoidance of ultimate tax payment and the "locked-in" problem are two of the most

\textsuperscript{71} Op. cit., footnote 69, at p. 959.

\textsuperscript{72} Supra, footnote 41.

serious situations facing the Internal Revenue Service in the United States.

It should be pointed out that the deemed realizations occur at climactic points in a man's life or business—death, leaving the country or a total reorganization of his business.

The complaint about realization at death is that for large estates, putting aside the various averaging provisions—the tax will be 75% of all capital gains, 50% on the gain and 50% on the balance as it passes from the family unit. However, one need feel little sympathy for the taxpayer in this situation as he has had either the opportunity to pay his gains taxes when he chose throughout his life or, on the other hand, has had an interest free loan from the government.

On leaving the country, asking a man to settle up his tax liabilities is a reasonable request. After all, he is leaving the tax jurisdiction and current private international law rules forbid the enforcement of a foreign tax.

As far as business reorganizations are concerned, because taxes are always a basic consideration, this will simply require the taxpayer to arrange the reorganization to fit within one of the exemptions or to make provision in his arrangements for the tax consequences—as he does now in connexion with other taxes.

The problem of liquidity will always be with us as long as some people invest in items not readily convertible into cash. The fact that it might arise as a result of deemed realizations is not too distressing. If it arises because of death, the problem is not different than is faced now as a result of the Estate Tax. If it arises from one of the other two "deeming" situations, it means that a conscious decision will have been made bringing the provisions into operation.

The liquidity problem could be solved, either under Carter or under the current tax system without great difficulties. The government might set up a low interest loan fund specifically to meet this type of contingency. Or, it might act as the Canadian government did at the end of January, 1969, to allow taxpayers five years to pay their estate taxes if this were done in some form of pre-arranged instalments.74

Mr. McDonald raises some questions specifically about takeover and amalgamation questions—though interestingly enough he seems to feel that in the Commission's proposals there are too

74 At the time of writing, these proposals have not the force of law but there is every indication that they will be adopted.
many “loopholes”. The Commission is refreshingly candid in dealing with the proposed exemptions and it is for this reason it is not necessary to go into Mr. McDonald’s criticisms at any length. The Report says:

We appreciate that our list of exempt dispositions is limited and perhaps should be extended. We think, however, that additions should be made only after careful consideration of the problems of administrative complexity, uncertainty, and possibilities of tax avoidance which may be involved.  

Basically, what the Commission was attempting to exempt are “cases where there has been no change in the essential continuity of an investment, although there may have been some change in the form of the investment”.  

The problem is one of drafting. One might hope that if the Report were adopted, the courts could be obliged to accept the general guideline suggested and apply the notion of appraising the intent of the transaction. It this were done, a broad general instruction could be inserted into the statute. It should be noted that the problem would not be one of avoidance but at worst, deferral. This “preference” might be justified in carrying out the intent of the Commission.

One specific loophole mentioned by Mr. McDonald is the situation where the disposition of an asset is pledged. This is not considered to be a deemed realization. As he puts it: “All a shareholder has to do is to live on borrowed money and die broke. The bank will sell his shares to cover his debts, and the revenue will have a worthless claim against an insolvent estate.”  

The Commission, it is clear, agonized over this exemption. On the one hand, a deemed realization on this type of transaction would seriously inhibit borrowing. On the other hand, the “loop-hole” is there. This simply is one of those hard cases where Parliament may have to legislate at a later time if there are abuses. But the Commission seems willing to take the chance that the average taxpayer will not deliberately die impecunious in order to cheat the Government—especially if he has dependants.

3. Personal property.

Another area of some contention is the decision of the Com-
mission to tax personal property gains. This is particularly so when there is a denial, with the exceptions earlier noted, of deductions for losses on personal property because these are the expenses of living.

P. N. Thorsteinsson put it this way:

I would have thought that very little revenue, and not much of the Commission's ideal of equity would be sacrificed if these 'assets held for personal use' were taken entirely out of the scope of taxation. Anyone who was able to take any large advantage of that exclusion would doubtless soon run afoul of the definition of property held for personal use, and reporting requirements for everyone would be that much reduced. A substantial inequity would as well be removed—the taxation of residence gains with no allowance for losses.78

Undoubtedly there is something appealing about Mr. Thorsteinsson's idea. The question of how much revenue is produced, however, raises an interesting point. If one were to suggest that we not tax anybody who earned a million dollars or more a year on the grounds that (a) they were contributing to the growth of the country, (b) it would alleviate administrative problems and (c) not much revenue is gained, the idea would be laughed at as absurd. Why? Because our inherent notion of equity demands that notwithstanding the cost or the comparatively small revenue, it would be unfair to all taxpayers earning less than a million dollars per year.

To digress, it is for this reason the idea is not seriously considered in this article that capital gains should not be taxed because of the administrative cost and comparatively small revenue.

Therefore, if a few people make large profits on personal property, equity demands that they be taxed.

It is not necessarily true that any person who "takes large advantage" of the exclusion would necessarily fall within the category of a "businessman". Bearing in mind that the type of items we are discussing here would usually be antiques, paintings, silver and jewellery, it would be very difficult to categorize a man a dealer if he chooses to live among Louis XIV furniture, eat off Georgian silver, have his walls covered with the paintings of impressionists and his wife draped with diamonds. This is a "life style", not a business.

Yet the facts are, at least with regard to the first three, that prices are rising faster and demand is greater for these than for securities. There is, after all, only a limited world supply. It is noteworthy that Dr. Morton Shulman, a former Toronto coroner,

78 Ibid., p. 360.
and now an Ontario M.P.P. in his book *Anyone Can Make a Million*, published in 1966 devotes a chapter to the subjects of paintings and antiques—and has followed his own advice. But even under the rather broad current definition of "business" the revenue authorities have not attempted to classify him as a dealer.

Mr. Thorsteinsson has pointed with regard to losses on houses. Yet, in view of the fact that gains on home sales are allowed to a maximum of $25,000.00 over a lifetime as an exemption, equity would require that only losses exceeding $25,000.00 be allowed. This provision could be made without too much difficulty—though it is hard to conceive of any person in Canada today losing $1,000.00 much less $25,000.00 on a house sale when the lack of housing is one of the crises facing the country. This notwithstanding, consistency demands that fair treatment be given and Mr. Thorsteinsson's point should be adopted.

Putting the emotional question aside, the reader should consider that apart from a house, and the "luxury items" mentioned above, almost no personal property is sold at a gain. Therefore, the average family will rarely be bothered with these particular provisions of the Act, beyond filling in "no" to a question on his tax form. Major sales are usually fairly easy to trace as they occur through firms whose books are checked or through well publicized auctions. Further, the buyer must keep records to prove his own basis. This is the ultimate check which the government has against the evader.

In connexion with this subject, it might be well to point out that the *Report* assumes a self-assessing system as Canada now has. This in turn is postulated on the premise that most taxpayers are fundamentally honest. To assume huge expenditures on manpower to "enforce" these or other provisions in an Income Tax Act is to assume people are basically dishonest. Yet the experience of more than fifty years has shown this not to be true. Thus, when the Canadian Bar Association suggests that the recommendations will be an incentive to avoidance, it is making assumptions about the Canadian taxpayer which are not substantiated by the record. If these assumptions are correct, then no system of self-assessment can succeed.

It has been one of the assumptions of virtually all North American tax reformers that the self-assessing system must be retained. To assume otherwise is to postulate a system which varies radically from that used in both Canada and the United

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States since the inception of the income tax. It has been suggested that recent reports of widespread cheating in drawing unemployment benefits in Canada indicates the likelihood of cheating on an income tax which assesses personal property.80

However, it is submitted that because the very fact that these provisions will touch few people and the fact that many major sales are a matter of public record (for instance auction sales) the amount of probable evasion would not require a radical change in the area of assessment.

4. "Roll-over".

The problem of "roll-over" is closely related to the "locked-in" problem. The primary purpose of "roll-over" provisions is to allow an investor to change his investments to "like" investments without tax consequences. As has been seen, one of the reasons for the exemption from the "deemed realization" provision was to allow a change in form of holding an investment without tax consequences.

Surprisingly little comment has been made in connexion with the Report's rejection of roll-over provisions. The Canadian Bar Association suggested "some form of reasonable but stringently enforced roll-over provision" but as this was in the context of advocating an "American style" capital gains tax, it does not substantively deal with the issue at hand.81

The reasons for the Commission's rejection of "roll-over" provisions have already been set out above. To briefly recapitulate, the provisions were rejected first, on the grounds of equity, and secondly, because the administrative problems were of such complexity, especially in determining what property would be eligible for "roll-over".

"Roll-over" is not necessary in order to cope with the locked-in problem. The deemed realization provisions, along with the opportunities available to revalue stock and pay tax, are sufficient to give the knowledgeable investor both the opportunity and desire to invest as the economy demands rather than be locked-in.82

80 The Winnipeg Tribune, Jan. 27th, 1969 carried an article which indicated that in December, 1967 there were 27,600 cases of overpayment of unemployment benefits.
82 It might be argued that no investor will prepay his taxes for to do so would be to lose the value of deferral. But by the same token, investors worry about the liquidity problem at death and it is suggested that the possibility of the conjunction of both capital gains tax at death plus the tax on the recipient of his estate at ordinary income rates will be sufficient to force a substantial number of investors to forego the deferral.
There is, however, one area where "roll-over" might be useful. The small businessman who either has a sole proprietorship or is a partner or is virtually the sole owner of his own company might be allowed this privilege to a limited extent. One might allow him to sell one business and buy another or to sell his business and invest the proceeds. Any excess over investment would be taxed at full rates—an expenditure tax, in effect.

Such a provision would, of course, be a departure from equity which is one of the five criteria which were listed as being the goals of a good tax system. The exception which is proposed, in allowing the change over from one business to another, is merely an extension of the rules which allowed exceptions to the rules on deemed realizations.

The type of business being considered is one which is chronically short of capital. In normal circumstances, all profits are put back into the store or business. The owner has very little in the way of savings or investment as they are normally thought of—though in an economist's view he has both in his business.

While it is true that at the moment he sells his business he is in a liquid position (assuming he gets cash) and could pay his tax, he could not, perhaps, buy an equal business with his after-tax money. Therefore, it is suggested that if he wishes to re-invest the pre-tax money in another business or in some form of investment as the layman commonly thinks of it, he should be allowed to do so.

Any realization on this investment would be taxed at normal rates using as a basis not the price paid for the investment but the original capital value of the first business.

The only rationale for giving this sort of preference to a small businessman (in which group farmers are included) is that it recognizes the unique difficulties he has in raising capital for his business and that a preference may be necessary to keep this segment of Canada's economy operative—bearing in mind that there will no longer be preferential tax treatment in the form of lower corporate rates for low income businesses.\(^8\)

It should be pointed out that this preference takes the form not of an exemption but of a deferral which may be the price required to keep farms and small businesses from being abandoned.

Such a provision would have to be strictly drawn and enforced to prevent abuses and to ensure that the preference is...
extended only to those for whom it was intended. If it appeared that many other segments of society had equally valid claims to such preferences, it would be better to abolish the preferences than to extend them.

5. Foreign investment.

We now turn to the question of foreign investment—or more blatantly, can Canada expect to continue to lure American capital? Many writers including Messrs McDonald, Thorsteinsson and S. C. Legge have commented on the fact that Canada, under these proposals would have a different capital gains system than the United States and Britain and there is an inference that a different system would lead to economic disaster. Commissioner Grant in his dissent said in part:

But there are other reasons why capital gains should not be taxed at full rates. Capital investment of savings in Canada by Canadians is to be encouraged. Also, it must be kept in mind that Canada's two principal trading partners, the United States and the United Kingdom, impose this form of tax at modified rates.

In his budget address of 1967, Finance Minister Sharp made much the same point, stressing the Canadian need for foreign investment. He suggested that the Commission did not give enough weight to this factor.

Interestingly, the Canadian Bar Association saw the matter differently. In their brief, they said:

We are concerned that the inclusion of capital gains in the income tax base, taken together with integration, might have the effect of making conservative Canadian shares relatively more favourable for residents in relation to non-residents, because the residents would be getting the benefit of integration and the full capital gains tax would be less significant for such shares, while growth Canadian shares might be relatively more attractive to the non-resident who is more lightly taxed on capital gains and who, in many growth share situations, might not be materially adversely affected by the absence of integration.

To reiterate the point made earlier in this article, major investors from outside Canada are not primarily interested in capital gains. Some companies come to exploit the natural resources of the country and it is these resources, not the tax structure which

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attracts them. The other major investing group, as was pointed out, is geared to exploiting the Canadian consumer market. Again, any question of making a capital gain is secondary.

That leaves two other types of foreign investors—those who are purchasing Canadian securities and those who are buying up Canadian companies as investment.

It appears that this latter investor will be hurt by the capital gains proposals. He now finds that if he is interested in a business for investment purposes and finds two prospects, identical in every way except that one is Canadian and one American—he will buy Canadian because the price will be lower.\(^90\) The price will be lower because the Canadian seller does not have to calculate a capital gains tax into his final "net" price. If the Carter proposals are adopted, this will no longer be the case, and in fact the American business might well be more attractive.\(^91\)

But the key question really is whether the Carter proposals will tax the foreign investor any differently than he is taxed now. Currently, the foreign investor is not subject to capital gains tax in Canada, but usually will have to pay such a tax in his home country. Therefore, he is at a disadvantage vis-à-vis Canadians. Further, he will not get the 20% dividend tax credit which accrues to Canadians and is subject to a 15% withholding tax on dividends. Whether he ever gets full tax credit at home for his withholding tax is a question of the law of his own country. Therefore, it will be seen that at the present time, the foreign investor is at a disadvantage vis-à-vis the Canadian in the area of both dividends and capital gains. Yet he continues to invest. Why? The obvious answer is that despite these drawbacks, he nets more after tax dollars than he otherwise would from other investments.

Under the proposals of the Report, the situation changes somewhat, but only on a comparative basis. For instance, the American investor still will not be taxed on capital gains, if for no other reason than because of Article VIII of the Canada-United States Tax Convention exempting capital gains from taxation. He will not get the benefit of full integration unless the American tax authorities are willing to grant a tax credit—which is unlikely. And there will continue to be a 15% withholding tax. Therefore under Carter, his tax position is virtually unchanged from the present. The only difference is that now he is in a more favourable

\(^{90}\) The assumption here is that the owners of the American company will not accept a lower after-tax price than the Canadian would.

\(^{91}\) The same assumption is made here as in footnote 90, vis-à-vis the Canadian seller.
position vis-à-vis capital gains than the Canadian and in a much poorer position vis-à-vis dividends. It was on this basis that logic indicated that the foreign investor would move into the risk area leaving the conservative investment to Canadians.

However, Professor Richard Musgrave interprets the situation in a very different manner. He points out, as it is generally conceded, that as a result of integration, stock prices will rise in Canada. Because of this, the yields will be much less than before, and certainly below American yields. Therefore, Americans will invest their equity funds in American stocks.

But at the same time, bond prices will fall in Canada, making their yield much more attractive. Investors will then put their funds not into Canadian equities but into Canadian bonds.

There is a further consideration. One of the major issues in Canadian economic and political circles is the extent to which Americans "own" Canada's economy and the effect this has on foreign policy. To make a broad generalization, the "left" wishes to curtail American investment in Canada and "buy back" Canada. The "right" says that there is a continuing need in Canada for foreign investment because there is neither the business know-how or financial resources in Canada to develop all the resources of the country.

If Professor Musgrave's analysis is correct, the economic results of Carter might provide the happy solution. Foreign capital will continue to flow in, attracted by the large yields on bond issues, but at the same time, equity in Canadian stocks will be less attractive to foreigners and more attractive to Canadians.

The interpretation of the criticisms above are much a matter of opinion. It depends upon whether one views Canada as a country which desperately needs foreign capital or one which needs to reduce foreign investment. This in turn depends upon such factors as where one lives in Canada and his occupation or profession.

However, one factor is clear—putting aside the *Carter Report* which makes no overt statement on the issue, a Royal Commission and a Government *White Paper* have already indicated that not only should Canada attempt to discourage foreign equity investment, but that Canada should enter upon patterns to repurchase firms already American controlled.92


93 The Gordon Report (1956), and the Watkins Report (1968). This statement is to some degree an oversimplification, but it is true that the
Finance Minister Benson is quoted as saying:

Oh, I'd prefer it if people were buying bonds rather than companies, but I don't think we'll do anything to discourage foreign investment. Rather, we'll encourage Canadians to invest.94

According to Professor Musgrave, adoption of the Carter proposals will take care of this problem.

To recapitulate, it is contended here that changes in the Income Tax Act will have a minimal effect upon the individual foreign investor. It is further suggested, though there are no statistics to indicate it, that this investor is primarily interested in capital gains, not dividends and, therefore, his disadvantage vis-à-vis Canadians in receiving dividends should not bother him. We can exclude the American corporate investors from consideration for they have major direct investments which they could not give up. If they were to relinquish these shares (that is, Canadian subsidiaries wholly owned) not only would there be a ready market for the shares,95 but the opportunity to purchase these shares would be consistent with the political feeling of the country.

The criticism that it is somehow undesirable to have a tax system different from our major trading partners is ludicrous because this has been the case, vis-à-vis the United States for fifty years—without complaint.

The major questions are, therefore, (a) whether foreign investment in Canada would decline and (b) if it did, whether this would be bad. It appears that there is no rational reason why investors should not continue to invest in Canada because essentially there will be no change in the tax they pay; and secondly, while a lack of foreign capital would be undesirable, it would be better that it be in the form of debt rather than equity.

It is likely that this situation will be encouraged by the adoption of the Carter Report.

6. Investment incentive.

The problem of the effect a capital gains tax would have on investment incentives is very difficult because not only is this the major area of criticism, having been commented on by Messrs Spindler, McDonald, Thorsteinsson, Sedgewick, Asper and Legge, Gordon Report stimulated discussion on a broad national level about the issue of foreign capital in Canada. The reader may find of interest an interview with Professor Watkins in The New York Times, January 20th, 1969, at p. 53.

95 Conway, G.S., The Supply of, and Demand for, Canadian Equities, a study commissioned by the Toronto Stock Exchange (1968), p. 18.
but also because it is such a hard area in which to develop any factual thesis. To a great extent, one must depend upon "gut" reaction—and this is really the case on both sides.

A sample of the varying quality and rationality of the critics of the Carter Report may be of some interest.

Mr. R. M. Sedgewick, Q.C. said:*6

I do not hold the view that capital gains by their very nature are entitled to a lower rate if appropriate averaging is permitted. Indeed, I do think it is quite arguable that capital gains as such should be taxed at a rate higher than that applied to earned income. I agree, however, that rates of that magnitude would have an adverse effect on the incentive to invest. The United States taxes capital profit at a rate which cannot exceed 25%. I presume that this is an incentive rate rather than a simple averaging device.

Mr. H. O. Spindler stated:*7

The taxation of capital gains would discourage taxpayers from investing in risk ventures under the present scheme of things. By recommending accelerated depreciation for new and small businesses, the unlimited carry-forward of losses and the right to take up unrealized capital losses, the Commission has offered positive inducement to risk taking. We should all have views on how effective they are likely to be.

Mr. I. H. Asper said:*8

Can it really be said that a dollar earned by substantial risk should be treated the same as a risk-free dollar earned from employment? Is the Canadian economy so mature that we no longer need incentives to encourage risk capital? Will risk-taking be impeded by a capital gains tax? Why would one invest in a common share (risk) when the after tax return from buying government bonds will not be much less after taking into account the gains tax?

The most rational arguments are put forward by Mr. Thorsteinsson. His major focus of attention is on the loss provisions. He goes on at great length, but to paraphrase the gist of his argument, he says that it is a "fundamental conceptual error" to consider write-off of losses as an incentive because a businessman invests for gain, not losses. The removal of a chance at tax free gain is not offset by the fact that if one sustains losses, they can be written off.

The answer to this is twofold. It is quite clear even under the present system that there are times when the use of a tax loss company is most desirable. The very fact that a company whose

*6 November (1967) Conference, p. 388. As noted in footnote 11, this assessment of the reasons for the preferential rate is, at least as to its initiation, incorrect.
only asset is a tax loss is a valuable commodity that speaks for itself. It is also suggested that no rational investor places his money without considering the possibility that he may lose all or part of it. The knowledge that at the upper tax brackets the government will absorb 50% of the loss is a good "hedge" and will help to offset the knowledge that it would take 50% of the gain. Further, it is clear that with all the devices given, it would be an unusual situation where the government could take 50% of the gain, because there are so many vehicles available to postpone payment of tax until such time as the tax rate would be lower. Thus, it would be possible for an investor to have the government pay 50% of his losses but only tax a smaller percentage of his gains.  

Let us now look at some other matters which bear on why people invest—and the situation in Canada now—and under the Carter proposals.

A major study was done by the Harvard Business School entitled, Effects of Investment on Taxation of Individuals. It is not an unfair assumption that reasons for investment by Americans and Canadians are the same. After pointing out that the tax structure cuts heavily into the investment capacity of the upper income classes, the author states:

However this may be, it is clear that the combined impact of these effects fell far short of drying up the supply of equity capital which private investors were willing and able to make available to business. The evidence indicates that the accumulation of investable funds by the upper income classes has been consistently large during postwar years, despite the existing tax structure, and that individuals with large incomes and substantial wealth continue as a group to hold and invest a large proportion of their funds in equity type investment. 

... individuals with capital appreciation as a major investment objective typically react very differently to the tax structure than do those whose major emphasis is on income yield or security. To the extent that taxes influence investment decisions at all, they drive the great majority of investors with the latter objectives into more conservative investments, whereas they typically induce investors interested mainly in capital appreciation to make even more venturesome investments than they otherwise would. 

Income-minded and security-minded investors, in deciding on an investment policy, tend to balance the current income yield of their in-

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99 The typical situation would be that an investor would write off losses in the years when he had large amounts of income, but would postpone the realization of gains, by use of the income adjustment account until such time as his other income had fallen off.

100 Butters, J.K., Effects of Taxation on Investments by Individuals (1953).

101 Ibid., p. 51.

102 Ibid., p. 36.
vestments against the risk of capital loss and give very little weight in their investment decision to the possibility of capital gains usually present in investments which also present high risks of capital loss.103

The implications of the foregoing are several. Firstly, tax factors are not as great an influence on investment decision as is commonly supposed—a thesis which is validated throughout the study. Secondly, for the conservative investor, the ability to write off losses would probably make him somewhat more venturesome. Thirdly, a Carter type system, rather than discourage the venturesome would spur him on to greater risk taking.

It is submitted that the investor has in mind the kind of yield he wants after taxes and, therefore, finds that type of investment. He does not decide to sit back happily with one-half of his desired return because taxes make it harder to achieve. The capital gains tax in the United States has not deterred capital accumulation investment—and in fact the Americans have a surplus of investment funds which are invested abroad.

If it is said that it is the differential tax rate which attracts the venturesome, it should be equally true that averaging and loss write-offs are more attractive to him too—and these will in all probability offset the lack of a differential rate.

Let us now turn to another aspect of the investment question. One of the goals of the Report was to achieve "neutrality"—that is, a system whereby the same tax consequences occur no matter in what form a transaction takes place. One example is the raising of corporate funds.

Currently, equity financing is desired by shareholders because they have a chance at a capital gain and they receive, from Canadian companies, the 20\% dividend tax credit. Corporations on the other hand desire debt financing because interest payments are deductible expenses while dividend payments are not. Under the Carter Report, neutrality would be achieved and we could expect a lot more equity financing—especially because dividends could be paid in "tax credits" as was explained earlier.

At the present time, there is a huge gap between equities available in Canada and equities which are demanded. On a per capita basis, there are only \( \frac{2}{3} \) as many equity shares "available" in Canada as in the United States.

At the same time, Canadian demand for equities is growing rapidly. It is estimated that the combined annual needs of both institutional and private investors will be about 1.3 billion dollars

103 Ibid.
(constant) for the next few years. This will be about double the supply projected if Carter does not come in. This money will, therefore, flow out of the country.

Recent studies now indicate that contrary to popular opinion, Canadians not only are not conservative investors, but, except in the lowest and the very high income groups, are more aggressive than American investors.

The following conclusions may be drawn.

Implementation of the Carter Report will increase the amount of equity shares available in Canada. There will be more than sufficient money in Canada to take up these new shares. If Canadian tax policies do deter foreign investment, there is sufficient Canadian capital to fill the gap.

Because Canadians are taxed on world-wide income, their situation vis-à-vis capital gains will be the same whether they invest at home or abroad, but the integration of corporate and personal taxes gives a bonus for “investing Canadian”.

In view of the fact that it now appears that Canadians are aggressive investors, there is no reason why risk ventures cannot get the required capital. It is in this area that the full write-off of capital losses looks so very attractive.

In the long run, the whole question of investment incentive becomes one of opinion. But the foregoing suggests that it is more likely that Canadians will invest more—both in terms of dollars and in terms of quantity of risk.

If one is a genuine investor, all risks are considered—and contrary to Mr. Thorsteinsson’s statement, the write-off of losses against other income mitigates the risk. This is doubly true if as suggested earlier, the facts indicate that losses will be used up in high tax periods and gains realized in lower tax periods.

The foregoing being the case, there appears to be no rational reason for the assumption that the adoption of the Carter proposals will result in Canadians investing less in Canada. The logical implications of the Carter Report would appear to lead to exactly the opposite conclusion.

Conclusions

It might be noted that some of the problems have been discussed by the relatively simple method of the use of logic. Whether the logic is compelling depends upon one’s own assumptions. For


\[105\] Ibid., p. 10.
instance, the equity argument in connexion with the problem of inflation is a compelling one if one accepts as valid the concept of equity as used in that context. The validity of the arguments made in connexion with the taxation of property gains requires no special training or background for intelligent assessment.

On the other hand, questions dealing with such matters as foreign investment or incentive to invest are not susceptible to resolution by intellectual speculation.

The critics of the Report have for the most part attempted to use cerebral and emotional arguments in putting forth their cases, bolstered seldom, if ever, by factual data. This sort of argument, characterized by Eisenstein as "the ideology of barriers and deterrents" has been a mainstay of tax critics since the earliest days of income taxation in North America.

What I have attempted to do is to collect as much factual information as possible before making judgments. Rather than accept an emotional but uninformed position, reliance has been placed upon the opinions of those most capable of assessing economic arguments and probabilities. Though a lawyer, I do not share the, unfortunately, common view held by many lawyers that economists are dreamers whose views do not correspond to reality. Much of the case presented here is based upon the opinions of such noted Canadian economists as Messrs Melville Watkins and Geoff Conway as well as Professor Musgrave of Harvard. The conclusions presented herein are based as often as possible on data rather than instinct.

All the available data indicates that the proposals of the Royal Commission will result in a more equitable tax system without major disruptions to the Canadian economy.

It goes without saying, however, that if the proposals are viewed from the vantage point of certain individuals and industries, they will be less well off than previously. The question then becomes one of whether the existence of fifty years of tax preferences is sufficient reason to continue favoured treatment. This view is rejected if no more compelling reason can be made for preferences.

One of the general questions raised is the extent to which the Canadian economic system will be disrupted by this new tax system. The proposed transitional provisions have not been enumerated, but they are generous; for instance, the commissioners recommended that in valuing property initially for capital gains purposes, all doubts are to be resolved in favour of the taxpayer.

A similar "crisis" occurred in Canada some twenty years ago
when the capital cost allowance provision, declining balance depreciation with full recapture, was introduced. Logically, the argument seemed irrebuttable that real estate values would plunge and huge losses would be sustained. The advocates of the doctrine of barriers and deterrents had a field day. In fact, businessmen and investors became attuned to the new system in a relatively short time and now real estate is the area in which the largest gains are being made. Investment in real estate is at an all time high.

A word is now in order about those Canadians who eye the American system of capital gains taxation so eagerly. It is probably true to say that most of them are not aware of the constant attempts of the Treasury Department to close both loopholes and preferences within the Internal Revenue Code. The most recent recommendations came out in January of 1969. To cite one very troublesome area, the lack of a deemed realization at death produces not only a huge loss of revenue and the perennial locked-in problem but also helps to perpetuate huge moneyed dynasties which, at least in popular American mythology, are an anathema to the concept of equality of opportunity. Statistics reveal that those in income brackets of over $100,000.00 actually pay tax at lower rates than those who have lesser incomes.106

It therefore appears to be at least incongruous to advocate a system which is under constant attack and which to most thinking people is extremely unsatisfactory. The very problems which the Commission set out to eliminate are inherent in the American system—lack of equity, uncertainty, loss of federal revenue, difficulty of administration and lack of neutrality.

It is submitted that the key to understanding the Carter Report is not the much bandied about term “equity” but rather the concept that a dollar is a dollar. If one agrees that the test of a good income tax Act is ability to pay, is it not illogical to say that one dollar is not the equal of another? The key to ability to pay is the notion that a dollar represents some measure of control over the resources of the community. This being so, it is difficult to accept the proposition that a dollar which comes from the sale of stock at an increased price differs from the dollar which is earned sitting at a desk or driving a taxi.

It has not as yet been demonstrated to the satisfaction of the author that there is a difference. It is suggested that if his prop-

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106 A chart recently published in Saturday Review, March 22nd, 1969 prepared by the Office of the Secretary of the Treasury graphically illustrates this phenomenon.
osition cannot be demonstrated, it should be accepted that it is false. If it is false, there is no reason to tax the capital gains dollar any differently that the earned dollar.

History indicates that changes in tax structures do not come about gradually. There are too many competing interests who can muster an effective political lobby when their own interests are threatened because the public is both uncaring and uneducated about matters which touch them only indirectly. In all likelihood, the only way satisfactory changes will come about is when the public is made aware of the whole scope of the taxation issues through such a medium as the *Carter Report*.

In one sense, the Commissioners were hardly radical. They adopted a system which has been written about in more or less detail for half a century. They were unadventurous in their consideration of such alternatives as an expenditure tax or a negative income tax. But perhaps we should accept that for the moment taxation, like diplomacy, should be simply considered the art of the possible.

Whether the recommendations are adopted or not, issues have been raised which have and will spur writing and debate in Canada about the tax system and it may be that this will be the greatest lasting contribution of the Royal Commission.

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107 The publication of the White Paper on November 7th, 1969 surprised many people with the faithfulness it showed to the Carter capital gains proposals.

There remains, however, some critical assessment to be made. While there may be some reasons for differentiating between closely-held and widely-held corporations, the distinctions drawn in the White Paper were unconvincing. It appears that a preference results from a sale of shares of widely-held corporation in that the maximum effective tax rate is 25%.

It may be argued that the fact that a shareholder gets only 50% credit for the taxes paid by such a corporation offsets the preference. However, when the market in effect capitalizes earnings many years in advance, there is little relationship between what amounts to a dividend tax credit and the capital appreciation. Full adherence to equity would require the government to reconsider this favourable rate.

It is likely that the proposals will encourage American parents to allow Canadians to invest heavily in what are now fully-owned subsidiary companies, probably a very desirable occurrence.

Much of the discussion of the effect of tax reform on foreign investment must await the negotiation of new treaties but I suggest that a system as proposed will not have a markedly deleterious effect upon such investment.