The long-awaited White Paper entitled Proposals for Tax Reform was released on November 7th, 1969. It is far more faithful to the Report of the Royal Commission on Taxation, more frequently referred to as the Carter Report after its chairman, than was generally anticipated. Yet, in spite of this, the White Paper was generally received with equanimity and the stock market initially at least greeted it with enthusiasm. This reaction is, in part, a result of the mass educational experience in the field of taxation which was initiated by the Carter Report. It is a great tribute to the quality of the Carter Report. This lucid and bold work of scholarship prompted much controversy and debate. The compelling logic of the Report and the pre-eminent place accorded to equity appear to have prevailed over many of its critics. This was clearly illustrated by the predominantly cool and critical reception which was accorded to the Report by the Senate Banking, Trade and Commerce Committee on the White Paper which was released in September, 1970. The Canadian public apparently expects to see some fundamental tax reform and will not be

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1 Proposals for Tax Reform (Ottawa, Queen's Printer, 1969), hereinafter cited as White Paper.


3 The Toronto Globe and Mail, November 11th, 1969, p. B14 reported that: "The largest price rise on record yesterday sent stocks on the Toronto Stock Exchange to their highest level since June 10th. It was apparently an endorsement by investors of the white paper tax proposals announced Friday night.

The industrial index rose 2.93 per cent or 5.32 points, the largest rise since the exchange began its present method of calculating the index in January, 1963."

4 The Toronto Globe and Mail on October 2nd, 1970, p. 6, in an editorial entitled, "The servants of privilege" stated: "Canada has been 10 years in search of basic tax reform, and all these senators feel that they can endure is some minor tinkering in some areas where the inequity is patently obvious—such as the lack of a capital gains tax. The whole purpose of the white paper was to find a fair system of taxation for Canadians. The banking committee has devoted itself to shoring up privilege."

There were equally uncomplimentary articles in The Financial Post. For instance, the article by Wolfe D. Goodman entitled, "The Senate unaware of the winds of tax change", Oct. 10th, 1970, p. 35.
satisfied with the application of a few legislative patches to the present structure.

The Carter Report and the ensuing debate has made it politically feasible for the government to accept the challenge of the Report and to propose the sweeping and fundamental reform which is described in the White Paper. Prior to the appointment of the Royal Commission on Taxation on September 25th, 1962, the prevailing opinion was against a capital gains tax. Within three years after the Report of the Royal Commission was tabled in the House of Commons on February 24th, 1967, all major political parties have espoused the need for a capital gains tax. The question is no longer whether capital gains should be taxed but rather how capital gains are to be taxed.

It will be the purpose of this article to discuss the White Paper proposals for tax reform as they affect the individual. A comparison will be made between the White Paper and the Carter Report in instances where a different approach is adopted in the White Paper. Reference will also be made to the Reports on the White Paper on Tax Reform by the two parliamentary committees, one by the Standing Senate Committee on Banking, Trade and Commerce and one by the House of Commons Standing Committee on Finance, Trade and Economic Affairs. In conclusion, the new approach which has been adopted towards tax reform in Canada will be considered.

The individual and tax reform will be discussed in relation to the basic problems which arise in the taxation of personal income. These problems are:

1. To determine the appropriate tax unit.
2. To define the concept of gross income.
3. To decide what deductions are to be permitted in calculating net income.
4. To determine the personal exemptions and allowances in calculating taxable income.
5. To design the appropriate rate structure to determine initial tax payable.
6. To provide tax credits which can be used to reduce tax payable.
7. To devise an averaging provision to mitigate the tax penalty imposed on those with fluctuating as compared with stable incomes.

I. Determining the Appropriate Tax Unit.

Since 1917, when the income tax⁵ was first imposed, the individual has been regarded as the taxable unit for Canadian personal

⁵ The Income War Tax Act, S.C., 1917, c. 28.
income taxation. Tax liability falls on the person receiving the income and is calculated primarily in relation to the amount of income earned by the individual. There has never been any general requirement for the aggregation of incomes of members of an economic or social unit such as married persons or the family. It is only through personal exemptions that the tax law has recognized differences in tax paying ability between individuals and families of varying sizes. The Carter Report recommended that the family and the unattached individual be the basic tax units. The Report states:

Taxation of the individual in almost total disregard for his inevitably close financial and economic ties with the other members of the basic social unit of which he is ordinarily a member, the family, is in our view another striking instance of the lack of comprehensive and rational pattern in the present tax system.

The tax law, by insisting on focusing only on the individual, has created the incentive for income splitting. Section 4(4) of the Income War Tax Act 1917 provided that property transferred by a person to his spouse should be taxed to the transferor, if the purpose was to evade tax. This provision in a more comprehensive form, which omits any reference to the purpose of the transfer, is now section 21(1). Section 22(1) of the Act deems all income from property transferred to any person under nineteen years of age, whether related to the transferor or not, to be the income of the transferor. Income from a trust is deemed to be the income of the settlor if the property may revert to the settlor, if he retains a power of appointment or if the corpus can only be disposed of with his consent. There is a provision for aggregation where there are multiple accumulating trusts established by the same settlor for the benefit of the same beneficiary or class of beneficiaries. Section 22(1) requires that salary paid by the employer spouse to the employee spouse be considered the income of the employer spouse for tax purposes. This provision has created a specious reason for incorporating a business in that this provision can be simply circumvented by incorporation and then the only limitation on salary paid to a wife is the general limitation of section 12(2) that the outlay is reasonable. The failure to recognize married persons as a basic tax unit has also resulted in the need expressed in section 21(4) to delegate discretion to the Minister to determine who shall be taxable on the income of a husband and wife partnership.

The Royal Commission recommended the family tax unit not

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6 Report, p. 122.
8 Income Tax Act, s. 22(2).
9 Ibid., s. 63(2).
simply to eliminate the problem of income splitting but primarily to improve the equity of the tax system. Currently, the total taxes paid by a married couple depend upon the proportion of income received by the husband and wife. The total tax paid by the couple is greatest when all the income is received by the husband. The total tax is least when the incomes of the husband and wife are equal. The Carter Report believed that a couple should pay considerably less tax than a single individual with the same aggregate income. The Commission with a dual rate schedule, one for unattached individuals and one for family units, would have increased the burden of taxation on the unattached individual relative to the married couple with the same income and with one wage earner. For instance, at an income of $15,000.00 the differential would be about $800.00 rather than the present differential of $400.00.

Probably the most doubtful aspect of the Commission's recommendation was the inclusion of minor children in the tax unit and the requirement that their income be aggregated except for an exemption of $500.00 for employment or business income. It seems likely that the major reason that the Commission wished to do this was that their proposed comprehensive tax base included gifts and inheritances and in order to have tax-free transfers within a family, a solution was to include the minor children in the tax unit for all purposes. The government has rejected the inclusion of gifts and inheritances in the tax base of the recipient. Therefore, there was little likelihood of the government recommending the Carter family tax unit. What is surprising is the failure of the White Paper to adopt the married couple as the basic tax unit. The revised Estate Tax Act and the new gift tax provisions of the Income Tax Act in effect treat the husband and wife as an economic partnership and the trans-

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10 3 Report, p. 143.
12 For taxable incomes of between $12,000.00 and $15,000.00 the marginal tax rate is 40%, Income Tax Act, s. 32(1), and therefore the $1,000.00 additional personal deduction of a married person reduces the tax payable by $400.00.
14 Ibid., p. 135.
15 Mr. Benson stated in his budget speech that: "While respecting the intellectual coherence and elegance of the case made by the Royal Commission on Taxation on this matter—crudeiy summed up in the phrase that 'a buck is a buck is a buck'—I believe that the overwhelming weight of Canadian opinion is against it now, and many Canadian practices and institutions would be seriously disrupted if we embraced this proposal. Instead, I propose that the estate and gift taxes continue to be levied on the transferor and that they be reformed along different lines." House of Commons Debates, 22nd October 1968, II, p. 1685.
17 Ibid., s. 1.
fer of property between spouses is tax-free. It appears inconsistent to perpetuate section 21(1), which treats the income of the property transferred by a husband to a wife as exclusively the husband's income rather than as their joint income.

Having only achieved tax-free transfers between spouses in 1968, it seems a regressive and illogical step to reimpose a tax at the time of such a transfer. Although no gift tax will be imposed, it would appear that a capital gains tax will be levied if appreciated property is transferred between spouses in that there is to be a deemed realization when a gift is made. The White Paper does not suggest that the transferee spouse might simply take the property at the same cost basis as that of the transferor spouse. The Commons Committee does make this proposal but it notes that in the absence of the family unit concept, there would be an incentive for the spouse with the lower marginal rate to realize the capital gain. As a result, the Committee recommended that the income attribution rule of section 21(1) should also be made applicable to capital gains so that the capital gain realized by the donee spouse would be taxed to the donor spouse. If there is not to be a deemed realization on gifts between spouses and if the five-year revaluation rule for widely-held shares is enacted, section 21(1) would also have to comprehend the accrued gain on widely-held shares in the year of the original transferor's appropriate birthday. Otherwise, shares in widely-held companies would present a problem in that spouses might transfer such securities back and forth immediately preceding the birthday on which he or she attains an age divisible by five in order to avoid the compulsory revaluation recommended in the White Paper. Both the Commons and the Senate Committees have recommended against the adoption of the five-year compulsory revaluation rule for widely-held shares.

The White Paper states that "there is logic in the argument that the family or at least the husband and wife together is the basic spending unit". The reason advanced for rejecting married persons as the tax unit is that it would impose a tax on marriage. The White Paper states "that a husband and wife each having an income would pay more tax than two people with the same incomes who were not married". However, if the increase in tax

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18 White Paper, p. 42.
20 White Paper, p. 41.
21 Commons Report, p. 32.
23 White Paper, p. 15.
24 Ibid.
is not more than say 10%, it would be reasonable to argue as the Carter Report does, that there should be an increase in tax in that there are economies to be realized in two persons living together and therefore, they have the capacity to pay a higher tax than two single persons each having half the couple's total income. With the two rate schedules proposed by the Commission, one for single persons and one for married persons, the tax on marriage was very small at low incomes even if the parties had equal-sized incomes. If two persons with taxable incomes of $5,000.00 married, they would pay a total of $1,467.00 in tax as opposed to each paying a tax of $725.00—a tax on marriage of only $17.00. If two persons with taxable incomes of $15,000.00 each were to marry, it was proposed that they pay a total tax of $7,277.00, whereas single persons would each pay $3,415—a tax on marriage of only $447.00. It is not difficult to draw up two rate schedules so that the tax on marriage is not substantial even for persons having equal incomes. If this is done, then for persons who have substantially different incomes, there will usually be tax saving flowing from marriage. This was the case for low and middle income tax payers under the tax schedules proposed by the Commission.

The tax on marriage argument contained in the White Paper only has substance because the government is not at this time prepared to formulate two separate rate schedules. The other argument advanced in the White Paper against the aggregation of the incomes of husband and wife is the substantial tax disincentive against wives entering the working force. The White Paper states that “a wife who goes to work would have her income added to her husband’s income and in effect taxed at the rates that would apply if his income were increased by the amount of her income.” This is a very valid argument. The tax disincentive which aggregation would have on working wives could be partially offset as the Commission recommended by rate concessions incorporated into the tax schedule for married persons and with tax relief offered to working wives with dependent children.

The White Paper does not close the door to reform of the tax unit. It states that after “the basic reforms proposed in the present paper are in effect it would be possible to reconsider separately a family unit basis, or a more complicated system ... as a further instalment of reform”. The Commons Committee has urged that this be given high priority. It is probable that the

25 3 Report, p. 143.
27 Ibid., p. 191.
28 White Paper, p. 15.
30 White Paper, p. 15.
31 Commons Report, p. 13.
husband and wife will eventually become a basic tax unit and that a dual rate system will be introduced. Dependent children will probably not be included in the tax unit at least in regard to employment or business income, but there might be aggregation of property and investment income of dependents to combat income splitting.32

The development of the tax unit in the United States merits consideration in that it might also have occurred in Canada. Until 1948, the United States adopted the individual as the basic taxable unit. However, in the 1930's and 1940's a great pressure for reform of the tax unit developed. In Poe v. Seaborn,33 the Supreme Court held that a husband and wife who were residents of the State of Washington, a state having a community of property regime, were entitled to file separate returns, each treating one-half of the community income as his or her respective income. When tax rates and the degree of progression were increased significantly in the 1940's, Oklahoma, Oregon, Nebraska, Michigan and Pennsylvania adopted community of property regimes simply to enable their residents to enjoy the advantage of lower taxes through the splitting of their incomes.34 Other states were prepared to follow suit. It was evident that either the tax law would have to be amended or states in which married persons were separate as to property would be compelled to adopt community of property regimes.

Professor Surrey, writing in 1946, urged the adoption of aggregation and income splitting for all married persons.35 In 1948, this solution to the problem was adopted by Congress.36 This measure had the great advantage that married persons with the same aggregate income now pay the same tax, regardless of their state of residence or the proportion of income earned by each spouse. It had the incidental benefit of eliminating the advantage of tax avoidance techniques such as property transfers and business partnerships between spouses.37 It did, however, have the effect of shifting some of the burden of taxation from the married person to the single person, particularly in the middle and upper middle income brackets. Joseph A. Pechman stated that: "The practical effect of this step was to double the width of the taxable income brackets for married couples; as a result, the tax on married couples was automatically set at twice the tax of a single

32 This has been proposed in Australia. See Downing, Arndt, Boxing and Mathews, Taxation in Australia: Agenda for Reform (1964), p. 136.
person with half as much taxable income."

This preferential treatment of married persons engendered political pressure for tax relief for widows, widowers and other single persons with dependents. This relief took the form of the enactment of the "head of the household" provision in 1951, under which a special rate schedule granted half the tax reduction available to a married couple filing a joint return. The Tax Reform Act of 1969 granted tax relief to single persons through a new separate rate schedule which limits the maximum tax liability for single persons to between 17 and 20% above that of married couples having the same taxable income falling between $14,000.00 and $100,000.00. There is a new rate schedule for heads of households which is midway between the new rates for single persons and the existing rates for married couples filing joint returns. The former rate schedule for single persons will remain but it will now be applicable to married individuals who opt to file separate returns and also to estates and trusts.

For tax years beginning after 1970, there will thus be four separate rate schedules. This appears to be a rather complicated and indirect method of introducing compulsory aggregation for married persons. Aggregation is not required but even if married persons opt not to file a joint return, it is not possible for them to obtain the benefit of being taxed on the new lower rate schedule for single persons. It will mean that if two persons having equal incomes in excess of $4,000.00 marry, they will pay more total tax after marriage than before. There will also in many instances be a "tax on marriage", where persons with unequal incomes marry. This is, probably, as it should be. However, the structure does appear to be unduly complicated.

There has not been as much pressure for some form of aggregation in Canada. One of the chief factors being that the Supreme Court in Sura v. Minister of National Revenue came to the opposite conclusion from the United States Supreme Court in Poe v. Seaborn. The Canadian court rejected the contention that earnings of the husband, resident and domiciled in Quebec and subject to the regime of community of property, was the income of himself and his wife in equal parts for the purpose of taxation. Another reason that there has not been as great a need in Canada for some form of aggregation is that the provisions against income splitting have been more stringent than they were in the United...
States. As a result, there has not developed the widespread use of tax avoidance techniques for splitting income which were prevalent in the United States prior to 1948.

II. Defining the Concept of Gross Income.

The Carter Report advocated a tax base which measures the change in each tax unit's economic power. This it defined to include:

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

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

c) The change over the year in the market value of the total net assets held by the tax unit (change in net wealth). This is basically the Haig-Simons definition of income. The Carter Report modified this definition of the tax base to arrive at one that was administratively feasible. The major modifications were that gains and losses, at least initially, would only be included on a realized basis instead of an accrued basis, and imputed income, the advantage derived from the use of one's own property, (for instance, owner-occupied dwellings), would be excluded. The Carter tax base would include "the annual net gains less net losses from the provision of personal services, the disposal of property, the receipt of gifts and legacies, windfall gains, the ownership of property or any combination of the foregoing." The White Paper states that: "The government rejects the proposition that every increase in economic power, no matter what its source, should be treated the same for tax purposes." In spite of this refutation, the White Paper is remarkably and, I believe, admirably faithful to the Carter Report. The major difference is the exclusion of gifts and inheritances from the tax base of the recipient. The levying of what is tantamount to a succession duty at income tax rates was a very controversial feature of the Carter Report. It was logically consistent with taxing on the basis of the change in economic power. Yet it represented such a great departure from the existing mode of taxation that it did not win wide acceptance. The Carter recommendation would have increased the taxation of gifts and inheritance and a relatively greater tax would have been imposed in regard to small and medium-sized

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43 Report, p. 23.
44 The intellectual debt owed by the Royal Commission was acknowledged by the Chairman, Kenneth Le M. Carter in article entitled, Canadian Tax Reform and Henry Simons (1968), 11 J.L. and Econ. 231.
45 3 Report, p. 54.
46 White Paper, p. 36.
The rejection of this approach was signalled when the government decided to revise the Estate Tax Act and gift tax provisions. This revision did incorporate a number of defects to which the Carter Report drew attention. It did provide for the tax-free transfer between husband and wife, as would the Carter Report. It did make the Estate Tax much more effective through the aggregation of gifts and through the integration of the gift and estate tax by making the gift tax in effect a prepayment of estate taxes.

Except for gifts and inheritances, the White Paper advocates a broad base that is consistent with the Carter Report. Capital gains are to be included in income and taxed at full progressive rates with the most important exception being that only half the gain on shares of widely-held Canadian companies are to be included in income. Widely-held companies are defined as Canadian companies whose shares are listed on a Canadian stock exchange or are traded in Canadian over-the-counter markets. Taxing only half the gain on such shares does not appear to be an acknowledgment that capital gains are different than any other kind of income, but rather to compensate for the different tax treatment to be accorded to closely-held and widely-held corporations.

Under the White Paper all corporations are to be taxed at a flat rate of 50%, except for closely-held companies, which may elect, under certain conditions, to be taxed as a partnership of its shareholders. For the closely-held company, not electing partnership treatment, there will be full integration of corporate and personal taxation. The shareholder of a closely-held company will gross up the cash or stock dividend, both of which are taxable, by the amount of tax paid on the earnings represented by the dividend. He will include in income the grossed-up amount, but he will be given a tax credit equal to corporate tax paid. If his marginal tax rate is less than 50% and the company has paid tax at the full corporate rate, he will receive a tax rebate. There will be a strong incentive for closely-held companies paying tax at the full corporate rate and owned by Canadian residents to distribute all the earnings either in the form of cash or stock dividends. A stock dividend will have a cost basis equal to the earnings which are capitalized. This means that there will be a capital gains tax levied at full income tax rates on the goodwill gains of closely-held company shares, but no tax on gains which equal the earnings retained which have been capitalized through a stock dividend.

For shareholders of widely-held companies, the White Paper

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49 Ibid., p. 52.
50 Ibid., pp. 48-49.
recommends that there be partial integration of corporate and personal tax. The Canadian resident will gross-up the cash or stock dividend received from a widely-held company by an amount equal to half the corporate tax paid on the earnings from which the dividend is paid and he will be entitled to a credit of half the corporate tax paid. If the company pays tax at the full corporate rate of 50%, a shareholder whose marginal rate is 33 1/3% will pay no tax on a dividend. If his marginal rate is less, he will receive a tax rebate and, if his marginal rate is more than 33 1/3%, he will pay additional tax. The *White Paper* also proposed that accrued gains or losses on widely-held shares should be taken into account every five years. An individual resident in Canada would be required to revalue his holdings of widely-held Canadian shares in the year in which he attains an age divisible by five. Taxing only half the gain on widely-held Canadian shares is intended to compensate for the fact that half the tax levied on such companies will be an unintegrated tax and for the required revaluation of these shares every five years.

The parliamentary committees studying the *White Paper* did not accept the Haig-Simons and Carter definition of income. Although the Commons Committee recognized that "from the standpoint of measuring ability to pay and minimizing the complexity of the tax system there are many administrative and equity advantages to the full inclusion of capital gains in the income base", it recommended that as a general rule only half the gain realized from capital assets be taxed. The Committee stated that this recommendation resulted from its view that with minor exceptions all capital gains should be subject to the same weight of tax and that gains on the shares of widely-held companies should not receive favoured treatment over other capital gains. There appears to be no strong reason why the gains on widely-held shares should not receive more favourable treatment than other assets in view of the fact that it is government policy to encourage Canadians to acquire equity stock. The Committee recognized that the proposals for only half integration for shareholders of widely-held companies and half loss write-off together with the five-year revaluation proposal would assist to "balance the taxation of such gains with the taxation of other capital gains". Undoubtedly, the Committee was strongly influenced by another factor which it mentioned, "the repeated representations from the private sector and provincial governments that capital gains should not suffer the same weight of tax as other income". Their recommenda-

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52 Commons Report, p. 25.
54 *Ibid*.
55 *Ibid*.
tion about capital gains probably stems from a concern about taxpayer acceptance. The Committee in the introduction to its Report states:

The White Paper proposals have been viewed uneasily by many taxpayers, and sometimes with suspicion or hostility. Yet an effective self-assessing tax system must win taxpayer acceptance as well as meet the requirements of growth and equity. Because of this consideration a number of the Committee’s suggestions for modifying White Paper proposals stem not from a belief that those proposals are inequitable or detrimental to economic growth, but from a concern for taxpayer understanding and acceptance.

The Commons Committee recommended that there should be half integration for Canadian resident shareholders with respect to all Canadian corporations resident in Canada whether the companies were widely or closely held but with the exception that the benefit of full integration should be accorded to $50,000.00 annually of the taxable income of a Canadian closely-held corporation controlled by Canadian residents. The differing treatment of the widely-held and the closely-held corporation was disapproved of by the Senate Committee as was the integration proposal. The Senate Committee recommended the continuation of the dividend tax credit system but with an increase to 25% for the first $500.00 of dividends, the application of the existing 20% credit to the next $4,500.00 of dividends and a 15% credit for dividends in excess of $5,000.00.

The Senate Committee reluctantly advocates a form of capital gains tax but it completely rejected the idea that a capital gain like any other form of gain increases a taxpayer’s ability to command goods and services and should therefore be taxed in the same way. The Senate Committee states that it “wishes to ensure that the law be drafted in such a way that under no circumstances will a taxpayer have a higher effective tax rate or a higher marginal tax rate on his other income by virtue of such taxpayer having made net long term capital gains in a taxation year”. It therefore advocates that net long term capital gains should be taxed at the lower of 25% or one-half of the taxpayers’ marginal tax rate calculated on a tax base which excludes long term capital gain. The Senate Committee does recommend that short term capital gains, gains on capital assets held for less than a year, should be treated as ordinary income. The Senate Committee did not explain the rationale for taxing a person who realizes a gain on a capital asset after holding it for 366 days differently from a person who held

56 Ibid., pp. 10-11.
57 Ibid., p. 42.
58 Senate Report, p. 30.
59 Ibid., p. 63.
60 Ibid., p. 60.
61 Ibid., p. 59.
the asset for 364 days except to say "it felt that it was more appropriate to give benefits to those taxpayers who constitute the patient long term, solid investors as against those who make a 'fast killing' turn over". The Commons Committee thought that the introduction of a time period would create needless complexity and introduce a bias which would encourage a retention of assets beyond the time period if they had appreciated and a sale within the time period to realize a loss if the asset had fallen in price.

The White Paper would accord special tax treatment to capital gain arising on the sale of a home which is the taxpayer's principal residence. Only gain in excess of $1,000.00 per year of occupancy is to be taxed and, in calculating the gain, account may be taken of any improvements which have been made. If the taxpayer does not keep records, he will be permitted to claim a home improvement allowance of $150.00 per year of occupancy. This special capital gains treatment for the sale of a residence appears superior to the Carter recommendation of a life-time exemption of $25,000.00 for gains on the sale of a residence both in terms of equity and of administrative convenience. In addition, a "roll-over" will be permitted for a taxpayer who moves from one part of Canada to another in connection with a change of job. If the taxpayer purchases another house within one year, the profit which would have been taxable on the sale of the former residence may be deducted from the cost basis of the new house.

As the imputed net rent of owner-occupied dwellings is not included in the income of a taxpayer, the attractiveness of home ownership is much greater relative to other investments that yield income which is subject to tax. The preferential treatment accorded to home ownership is not as great as in the United States in that mortgage interest payments and real property taxes are not deductible. However, the special treatment to be accorded to the gain on the sale of the home will increase the preferential treatment accorded to the home owner vis-à-vis the person who rents. The White Paper does not suggest that even if mortgage payments on account of interest exceed $1,000.00 per year that the excess mortgage interest payments should be added to the cost basis of the house. Thus, among home owners the preferential capital gain treatment will tend to be greater for those with the greatest equity in their homes in that their mortgage interest payments will tend to be less. The exclusion of the imputed rent of owner-occupied dwellings also extends the greatest tax benefit to those with the greatest equity in their homes. The deductibility of interest payments including mortgage interest on owner-occupied homes in the

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62 Ibid., p. 25.
63 Commons Report, p. 38.
United States does tend to provide more equal treatment among home owners who have differing amounts of equity in their homes. It does, however, increase the preferential treatment of the home owner as compared with the person who rents. The preferential treatment accorded to home ownership has the disadvantage that the greatest tax relief accrues to those with high incomes and high marginal tax rates.

The Carter Report recognized that the tax base should include imputed rent but did not recommend its inclusion because of the problem of determining its value. With the prospect that there will soon be a uniform assessment of real property within Ontario and several other provinces, the inclusion of the imputed rent of owner-occupied dwellings may become administratively feasible. If the gross rental value, estimated at a certain percentage of assessment of the residence, were to be included in the owner occupier's tax base, it would then be necessary to permit the deduction of associated expenses such as property taxes, insurance, mortgage interest, and depreciation. The inclusion of the net rental value of a home in the income of the owner would treat the home owner and the person who rents more equitably. Such a proposal would probably not be acceptable to the majority of Canadian taxpayers. The Commons Committee in the introduction to its Report provided a succinct reason applicable in this case and it is that the Royal Commission and the government seek equity as between taxpayers but that the average Canadian tends to seek equity between himself and the government.

The White Paper by advocating that capital gains should be fully taxable and by providing an exception in favour of the home owner would add to the already substantial preferential tax treatment enjoyed by the home owner as compared with the tenant. The Commons Committee would increase the preferential treatment even more through its recommendation that the United Kingdom approach be adopted, that no gain or loss should be taken into account for tax purposes on the sale of a principal residence together with up to one acre of land surrounding it. The Senate Committee following the Carter Report advocates a life-time exemption for gains derived from the sale of a principal residence but substitutes $50,000.00 for the Carter recommendation of $25,000.00. The Senate Committee also recommends that a roll-over provision should not be limited to the case where the sale and purchase resulted from a job transfer but should be available provided the taxpayer purchased another home within a year. The Senate Committee also recommended a $75,000.00

63 Commons Report, p. 10.
66 Ibid., p. 30.
life-time exemption for gains on the sale of farms and orchards where the vendor's principal occupation is farming.\textsuperscript{68}

The general rule espoused by the \textit{White Paper} is that capital gains should be fully taxable and capital losses should be fully deductible. However, special rules are proposed for property held for personal use and enjoyment. The gain will not be taxed unless the sale price is more than $500.00 and in determining the gain the greater of cost or $500.00 may be deducted.\textsuperscript{69} This will simplify the record-keeping that will be necessary. As a corollary, losses will not be deductible unless the item costs more than $500.00 and the loss is to be computed by deducting from the cost either the sale price or $500.00, whichever is greater. Property held for personal use is to be divided into two categories, assets which do not decrease in value through use and assets which depreciate through use. Losses in the first category may only be deducted from other gains on the sale of property held for personal use. If the taxpayer has insufficient income from such source in the current year to permit the loss to be deducted fully, the balance may be carried back one year or forward one year and offset against the same type of income. Losses which arise on the sale of property held for personal enjoyment, which depreciate through use, are not to be deductible as such losses represent personal consumption expenditure.

The Commons Committee agreed with the approach adopted by the \textit{White Paper} but recommended that the figure of $1,000.00 per item or set should be substituted for $500.00 for compliance reasons.\textsuperscript{70} The Senate Committee states that it rejects the proposed differentiation between personal property that depreciates with use and personal property that does not depreciate with use and other assets. The Senate Committee does differentiate between property held for personal use and enjoyment and other assets and proposes that in computing capital gain or loss in regard to an asset held for personal use, no gain or loss should be considered unless the proceeds of the sale exceed $5,000.00.\textsuperscript{71} The Senate Committee proposal will prevent most lower and middle income taxpayers from reducing their long term gains through the deduction of losses on property held for personal use and enjoyment in that it is unlikely that these persons possess personal use assets which have a resale price in excess of $5,000.00. It will not have the same effect on high income taxpayers in that they may have some assets of a personal-use nature which might be sold at a price in excess of $5,000.00. Presumably, if a person purchased a Rolls Royce for $12,000.00 and sold it for $6,000.00, his long

\textsuperscript{68} \textit{Ibid.}, p. 59.
\textsuperscript{69} \textit{White Paper}, p. 39.
\textsuperscript{70} \textit{Commons Report}, p. 30.
\textsuperscript{71} \textit{Senate Report}, p. 13.
term gains would be reduced by $6,000.00. However, if a person purchased a Ford for $3,000.00 and sold it for $1,500.00, the $1,500.00 loss would not be deductible from long term gains. Both losses represent personal consumption expenditure and neither should be deductible.

Gains and losses according to the White Paper are generally only to be taken into account for tax purposes when there is a sale. However, half the accrued gains or losses on widely-held shares are to be taken into account every five years. This proposal goes beyond the initial recommendation of the Carter Report. However, the Carter Report does state that some time after the adoption of a comprehensive tax base, provision should be made for the periodic revaluation of publicly traded securities by taxpayers, who would take any changes in value into account in computing their income. The time period suggested for periodic revaluation was five years, and the Report went on to suggest that periodic revaluation might eventually be extended to other forms of property. Both the Senate and Commons Reports reject the compulsory five-year revaluation for shares of widely-held Canadian companies. The Senate Committee states that it, on the basis of all its hearings, “must unquestionably recommend the total elimination of all attempts to impose capital gains tax on unrealized gains and losses”. The Commons Committee, although indicating a more balanced eclectic approach, also rejects the five-year revaluation primarily because of concern about taxpayer acceptance. The Commons Report states:

Undoubtedly the proposal for quinquennial revaluation has considerable merit. It has been approved by many eminent economists as a desirable innovation which would simplify problems of reorganizations and minimize lock-in effects. However, more than any other proposal in the White Paper, this one illustrates the difference in viewpoint between economists and others on the question of when a capital gain or loss should be taken into account for tax purposes.

If a person makes a gift of his property, the White Paper would treat him as though he had sold the asset for its fair market value and would tax him accordingly. The donee would be treated as though he had purchased the asset for its fair market value. This is in accordance with the Carter Report. However, the White Paper does not propose that there be a deemed realization at death as did the Carter Report. Instead, the beneficiary is to take the assets at their cost base to the deceased. This cost base is to be increased by the death taxes, presumably both estate tax and succession duty, which are allocable to the capital gain part of the asset. This means that the accrued capital gains tax

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73 Senate Report, p. 25.
74 Commons Report, p. 30.
75 White Paper, p. 42.
76 Ibid.
liability is indefinitely postponable but that, unlike the approach adopted in the United States, there will be no forgiveness of the accruing capital gains liability at death.

In the United States, not only is there no deemed realization on death, for the purpose of assessing tax on the capital gain but the successor takes the property at the current market value as at the death. In regard to assets purchased by the taxpayer, the "lock-in" effect will be less under the White Paper even if the five-year revaluation proposal for widely-held shares is abandoned. Because there is to be no forgiveness of the accruing capital gains tax liability on death, the taxpayer will be more inclined to sell assets instead of retaining them until death as is the case in the United States. However, in regard to assets which have passed on death from one generation to the next, there will eventually be a much greater "lock-in" effect under the White Paper than would exist in the United States because the capital gains tax liability is cumulative from one generation to the next.

According to the White Paper, when a gift of property which has appreciated in value is made, two types of taxes will become payable—a gift tax on the total value of the property given less any exemption and an income tax on the difference between its fair market value and the cost basis to the donor. However, the White Paper wished to avoid the coincidence of an estate tax and an income tax on accrued capital gain and therefore did not propose a deemed realization at death. There is a substantial difference between an inter vivos gift and property which passes on death. The making of a gift is a voluntary act and, in addition, the donor will probably only give a small portion of his property away at any one time. The coincidence of gift tax and income tax on any capital gain is unlikely to be a large burden relative to his total assets. However, at death all property of the deceased passes. A mitigating factor would be that the income tax on the accrued capital gain would reduce the estate tax base but there is little doubt that the coincidence of the two taxes might create problems where the estate consists of illiquid assets.

This problem does not appear to militate in favour of indefinite deferral of the tax on the accrued capital gain as the White Paper proposes but rather of providing reasonable terms under which the capital gains tax liability could be satisfied. The Commons Committee has recommended that there be a deemed realization on death applied to all assets except those passing to a spouse and that a provision similar to section 16A of the Estate Tax Act which permits the liability to be satisfied in up to six equal annual instalments should apply to capital gains tax arising on a deemed realization at death. As a further means of alleviating the problem of the coincidence of a capital gains tax and an estate
tax, the Commons Committee suggested that all estate tax exemptions should be significantly increased, that estates valued at less than $150,000.00 should not pay tax, that the rate brackets be expanded and that the top rate should not be reached until the estate has a value of about $800,000.00. The Senate Committee Report recommends against any deemed realization and in favour of wide roll-over provisions. The Senate Committee states that these suggestions "would go a long way to making the capital gains tax more acceptable in Canada". The Senate Committee appears to feel that the only acceptable capital gains tax is one that is virtually ineffectual. It may be that the Senate Committee has erroneously gauged Canadian public opinion and that the only type of capital gains tax which is acceptable is one which is effective and which prevents indefinite deferral of accrued capital gains liability.

The White Paper and the Carter Report both propose that there be a deemed realization when a taxpayer gives up his Canadian residence. The Carter Report, however, suggested that a taxpayer should have the option of continuing to be taxed as though he were a Canadian resident and thereby to avoid a deemed disposition, provided satisfactory arrangements could be made in regard to the accrued tax liability. The Commons Committee concurs in the Carter approach. It recognizes that there is a basic reticence about the imposition of tax barriers but states that, "just as Canadians are now expected to meet their tax obligations on ordinary income before giving up Canadian residence, so they can reasonably expect the same principle to apply to capital gains". The Senate Committee reacts in a more emotional way and describes the proposed deemed realization on the giving up of Canadian residence as an "intolerable restraint on the liberties of Canadian individuals". The Commons Committee appreciates that there may be problems about double taxation for a person who gives up Canadian residence. He will be taxed on the accrued capital gain when he gives up his Canadian residence and then he may be taxed by his new country of residence when he realizes the gain with the gain measured from actual cost and not simply from market value at the time he gave up his Canadian residence. The Commons Committee suggests that tax treaties should include a provision stipulating that the country of residence at the time of realization would only tax capital gain accruing after taking up residence in that country.

77 Commons Report, p. 33.
78 Senate Report, p. 25.
80 3 Report, p. 377.
81 Commons Report, pp. 34-35.
82 Senate Report, p. 25.
83 Commons Report, p. 35.
A person who takes up residence in Canada will be treated according to the White Paper as though he purchased his assets at their fair market value at that time. If persons temporarily resident in Canada were to be taxed on the accrued value of their world assets while resident in Canada, there are many professional persons who would be reluctant to take up temporary residence in Canada. To solve this problem the Commons Committee has recommended that the rule should be suspended with respect to foreign assets if the person entering Canada remains in Canada for no longer than three years. However, in regard to Canadian assets, the Commons Committee notes that it would be anomalous for a person to acquire a new cost basis by taking up Canadian residence shortly before selling the assets and thereby to avoid Canadian capital gains tax. The Committee recommends that in the absence of reciprocal tax treaties the new cost basis should not be applicable to Canadian assets other than widely-held shares.

The more comprehensive tax base in addition to including capital gains is to include unemployment insurance benefits in income and the contributions paid by the employees are to be deductible. This appears eminently reasonable and will result in persons with the same economic power paying comparable taxes. Fellowships, scholarships, bursaries and research grants are also to be included in income. The White Paper says “that postgraduate students and research workers are professional workers and should pay tax as others. Payments to undergraduates normally fall well within the personal exemptions, after deducting tuition fees. Where they exceed exemptions or where the student has other income, he should pay tax just as other Canadians do”.

The Senate Committee states that it “cannot come to the conclusion that under any circumstances fellowships, scholarships, bursaries and research grants should be made subject to tax”. However, the Commons Committee approves of the addition of these items to the tax base but recommends that they be tax exempt up to an aggregate of $500.00 per year. It would appear difficult to disagree with the approach of the White Paper. If all students had the same amount of income over and above a fellowship or similar grant, the exclusion of these receipts from tax would be an equitable tax subsidy for education. However, students do not have the same income and the exclusion of fellowships and similar grants results in the largest tax subsidy accruing to the student with the largest income. The only equitable approach is to include fellowships and similar grants in income. However,

84 Ibid., pp. 35-36.
85 White Paper, p. 18.
86 Ibid.
87 Senate Report, p. 19.
88 Commons Report, p. 20.
at the same time governments should increase their fellowships and grants so that the student with the average amount of other income will continue to have the same amount of after tax income. Because the provinces provide many of the scholarships and educational grants but their share of the total personal income tax revenue is much smaller than that of the federal government, this proposal will involve a transfer of funds from the provinces to the federal government. The provinces should be compensated in some way for this transfer.

The White Paper states that various fringe benefits received by employees or by the owners of businesses would be included in income for the first time. The examples which are given are the value of a business-owned car or aircraft available for personal use, and employer's contributions to private medical care plans on behalf of an employee. The employer's contribution to medical care plans is a benefit which is presently excluded from income by the exception to section 5(1)(a). There is no indication whether other benefits excluded by the exception to 5(1)(a), for instance, the employer's contribution to group term life insurance up to $25,000.00 and to accident insurance plans will remain tax free. To be consistent, the employer's contribution should be treated as income to the employee. The White Paper does not mention windfalls and gambling gains but the Carter Report believed that such gains should be taxable. The inclusion of gambling gains does present a problem in that if they are included in income, gambling losses should be deductible. But gambling losses could be regarded as merely a consumption or entertainment expenditure which should not be deductible. The solution proposed by the Carter Report was that gambling losses should be allowed as a deduction from gambling gains with no set-off against other income. The Carter Report also suggested a two-year carry-back and an indefinite carry-forward against gambling gains.

The White Paper stated that family allowance payments should remain exempt, pending a review of Canada's system of social security. Social assistance payments to those in need if made under federal or provincial legislation or by a registered charitable organization subject to a needs or means test would also remain exempt. Payments made under the Old Age Security Act would continue to be included in income.

Workmen's compensation benefits received are specifically excluded from tax by section 10(1)(g). The Carter Report recommended that these benefits should be included in income, but the

88 White Paper, pp. 16-17.
89 3 Report, pp. 526-527.
90 White Paper, p. 15.
91 Ibid., p. 18.
92 Ibid., p. 18.
93 3 Report, p. 526.
White Paper is silent on this matter. Damage awards received for personal injury claims are not specifically excluded by the Act, but it appears to be departmental policy not to include them in income either by analogy to section 10(1)(g) or by considering that compensation received for loss of earning capacity is a capital receipt. The Carter Report recommended their inclusion but the White Paper omits mention of them. The Carter Report recommended that strike pay should be included in the tax base and the Commons Committee agrees to the extent that it is paid out of funds which have not been subject to Canadian tax. The Carter Report also advocated that the tax-free allowances for members of parliament and of provincial legislatures be withdrawn. The White Paper and both parliamentary committees are notably silent on this point.

The White Paper thus proposes, if not a comprehensive tax base, at least, a very much broader tax base than the existing one. It is only with a broad tax base that a reasonable degree of horizontal and vertical equity can be achieved—that individuals in similar circumstances and with the same economic power over goods and services such that its exercise would not diminish their net worth should bear the same amount of taxes and that individuals in different circumstances should bear appropriately different taxes. An income tax with a broad base, although not a condition precedent to the introduction of an income maintenance plan or a system of negative income tax, would greatly facilitate the integration of such plans with the positive income tax structure.

As the taxation of capital gain is one of the major reform proposals of the White Paper, it is perhaps pertinent to compare the approach with the United States approach to capital gains. It would appear that the White Paper approach, which is basically to tax capital gain at full progressive rates and to permit the full deduction of capital losses, will avoid many of the definitional problems which have troubled United States tax law. The segregation of gross income into two classes, ordinary income and capital gain, has presented an insoluble definitional problem. Professor Surrey states that “the difficulties inherent in the present approach to the definition of capital gains are formidable almost beyond belief”.

The White Paper does propose that only half the gain and half the loss on the sale of shares of widely-held Canadian companies is to be taken into income. This is a very major exception from the full capital gain and loss treatment in that a very large proportion of total capital gains is derived from this source. Gains

95 3 Report, p. 532.
on widely-held shares of Canadian companies, even those realized within six months, will be taxed at a top rate of approximately 25% as compared with a top rate of 70% for short term gain in the United States and up to 35% on long term gain. The distinction between a widely-held and closely-held company will be of great significance. It is a distinction which will not be difficult to draw. All Canadian incorporated companies which were listed on a Canadian stock exchange on November 7th, 1969, the day the White Paper was released, and all companies which subsequently list their shares, are to be classified as widely-held. In addition, corporations which can meet certain tests relating to the number of shareholders and the dispersal of shares may elect to be classified as widely-held. The Minister of National Revenue is to have the power under special conditions to designate corporations as widely-held. All other corporations will be classified as closely-held and gains on the sale of the shares will be taxable in full.97

The preferential treatment to be accorded to gains on shares of widely-held companies will not produce a rush for closely-held companies to go public. The reason is that the shareholders of closely-held companies will be entitled to full credit for all the corporation tax paid while shareholders of a widely-held company will be entitled to credit for only half the corporation tax paid in regard to cash and stock dividends. In addition, the five-year revaluation rule will only be applicable to shares of widely-held Canadian companies. A problem which may be inherent in this proposed treatment is that there may be too great a deterrent to a closely-held company going public. To reduce this deterrent, it might be necessary to exempt from the five-year revaluation rule the shares of companies which become widely held for the first ten or fifteen years after the company has gone public. This is a solution proposed by David Slawson to overcome the reluctance of companies to go public if the unrealized but accrued appreciation of publicly traded stock is taxed as ordinary income.98 Slawson's proposal is much more radical than that of the White Paper in that he proposes to tax as ordinary income the appreciation of shares of public corporations without any provision for the integration of corporation and personal taxation.

The determination of the cost basis of shares will be more complex under the White Paper proposals than is the case in the United States. Stock dividends which are taxable in Canada will have a cost basis equal to the earnings which are capitalized when they are declared. If this cost basis is only to be applicable to the stock which is declared as a dividend, there will be difficulties

97 White Paper, p. 52.
98 Taxing as Ordinary Income the Appreciation of Publicly Held Stock (1967), 76 Yale L.J. 623, at p. 652.
in identifying the stock. If, however, the earnings which are capitalized are to increase the cost basis of the individual's total shareholding, this will involve a considerable amount of bookkeeping. In addition, the distinction between property held for personal use and enjoyment as distinct from property held for a trade or business will give rise to problems. Dealers in such property will be fully taxable on their profit, while others will only be taxable if the proceeds of sale exceed $500.00. In regard to the deduction of losses, the further subdivision of property held for personal use and enjoyment, into property which decreases in value through use and property that does not decrease in value through use will create definitional problems. Although there will be some definitional problems and some complexity in the White Paper's proposals for the taxation of capital gains, the difficulties appear to be far less than under the system that exists in the United States.

Adopting the general approach that capital gains should be taxed in full and admitting only one major but clearly defined exception, one-half the gain on widely-held shares is to be taxed, should help to maintain the integrity of the tax system over time.

If the general principle is that capital gains are to enjoy preferential treatment, this promotes and stimulates pressure for the expansion of this treatment. As Professor Surrey states: "Congress follows the practice of granting relief from high rates of tax through the device of bestowing 'capital gain' status on those taxpapers who are successful in pressing their claims for a tax reduction limited to their situation."

One reason why Canadian tax law does not contain more relief provisions than it does is that the choice has often been between taxing and not taxing instead of between taxing fully and taxing at a preferential rate. It requires a much more persuasive case and much more powerful lobbying to cause full exemption from tax to be granted as compared with permitting a preferential rate of tax to be levied. An instance when "capital gain" status was granted even though this meant no tax would be levied was the 1950 provision, which excluded from income the consideration which a prospector received for a sale of a mining claim provided it was not received in the form of a royalty. The argument made was that this was analogous to a capital gain and yet the sale of mining claims is an integral part of the business of a prospector. If a concession such as this can be granted when the choice is between tax and no tax, it is apparent that such concessions could more easily be granted when the choice is between two recognized categories, ordinary gain and capital gain, with the latter being taxed at a preferential rate.

100 An Act to Amend the Income Tax Act, S.C., 1950, c. 40, s. 28, which is s. 83(2) of the Income Tax Act.
As a result of capital gains not being taxed in Canada, there has been a tendency for the judiciary to construe what constitutes a capital gain more narrowly than in the United States. The development of the law has not been particularly rational. A very few transactions in land, foreign exchange, and commodities will make one a trader and taxable on such gain. However, unless one is a stock broker or registered security dealer, stock market transactions in spite of their frequency do not appear to render one a trader. The courts have at times adopted an objective test which has become known as the "badges of trade" test and at other times they have utilized a subjective test, the intention or even the secondary intention of the taxpayer, to determine whether a gain is profit subject to tax or a capital gain. Perhaps the only consistency in this area is a consistent failure to evolve a rational test of distinguishing between an income gain and a capital gain. A major disadvantage of both the Senate and Commons Reports in regard to capital gains taxation is that they would perpetuate the need for the courts to grapple with this insoluble problem. The stakes in this roulette game would not be as high but the game would continue. Whereas a major advantage of the approach of the Carter Report and that of the White Paper is that it would no longer be necessary to attempt to distinguish the often undistinguishable. Also, to adopt the Commons Committee proposal to include only one-half of capital gains in the tax base might in part be a regressive step in that it might tend to lead to a narrowing of the tax base over time rather than to its broadening if the courts were to construe capital gains more widely than in the past.

If the Senate or Commons Committee Reports in regard to the taxation of capital gains were adopted, Canada would be placing herself in the same position as the United States, where tax reformers have been struggling to remedy the inequities which have resulted from the introduction of the preferential rate for capital gains in 1921. The United States Tax Reform Act of 1969 reduces the distinction between long term capital gains and ordinary income. It eliminates the 25% alternative capital gains rate on long term gains in excess of $50,000.00 so that by 1972, individuals in the highest tax bracket will pay tax at the rate of 35% on gains in excess of $50,000.00. The Tax Reform Act of 1969 also establishes a new top marginal rate of 50% on earned income for taxable years beginning after December 31st, 1971.

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102 Pub. L. No. 91-172, s. 511(a) and (b), adding s. 1222(11) and amending s. 1201 of Int. Rev. Code of 1954.
103 Ibid., s. 804(a), adding s. 1348 to Int. Rev. Code of 1954.
III. Deductions to Determine Net Income.
The major new deduction proposed is the general deduction to be allowed for expenses incurred in earning employment income of 3% of gross employment income up to a maximum of $150.00 per year. This deduction is to be available to anyone with employment income without proving actual expenses. Wage and salaried employees in Canada have long chaffed under a system which discriminates against employment income by taxing it on a gross basis, with only minor exceptions, while taxing business and professional income on a net basis.\(^\text{104}\) The discrimination against employment income is very explicitly stated in the Income Tax Act. Section 5(1) states that: “Income for a taxation year from an office or employment is the salary, wages and other remunerations” minus certain deductions but “without any other deductions whatsoever”. The only general and substantial deductions permitted are pension contributions and union and professional dues.\(^\text{105}\) Whereas, section 4 states that income from a business or property is the profit therefrom.

The treatment of an employee’s expenses is quite different in the United States. An employee under the Internal Revenue Code is considered to be carrying on a trade or business and is entitled under section 162 to the same “ordinary and necessary” business expenses as the self-employed business or professional man. The Carter Report in effect recommended the United States approach. It stated that: \(^\text{106}\)

The most equitable course would be to treat employment income on the same basis as income from a business or profession. Expenses would be deductible if reasonably related to the earning of income. The prohibition against the deduction of personal and living expenses as set out in Section 12(1)(h) of the Income Tax Act would of course, be applicable, as would the provision in Section 12(2) that expenses must be reasonable in the circumstances.

The adoption of such a course would remove the unfair discrimination between the different kinds of income. To cope with the administrative problem arising from the fact that there are about nine times as many employee taxpayers as there are self-employed taxpayers, and the impossibility of checking the expense claims for all employees without an enormous increase in staff, the Carter Report recommended an optional deduction of 3% of gross employment income up to a maximum of $500.00 and any employee whose expenses exceeded the optional deduction

\(^{104}\) The departmental policy of taxing salary and wages on a gross basis appears to have been initially based on In re Salary of Lieutenant-Governors, [1931] Ex. C.R. 232 and subsequently the policy received statutory confirmation. See Stikeman, Taxation Law 1923-1947 (1948), 26 Can. Bar Rev. 308, at p. 316.

\(^{105}\) Income Tax Act, s. 11 (1)(i) and s. 11(10).

\(^{106}\) 3 Report, p. 312.
was to be at liberty to claim the expenses provided they were itemized and substantiated.\textsuperscript{107}

The \textit{White Paper} recommendations thus fall far short of those contained in the Carter \textit{Report}. The \textit{White Paper} limits the deduction of employee expenses to 3\% of gross income with the maximum of $150.00,\textsuperscript{108} not $500.00 as Carter recommended, and makes no provision for employees with greater expenses to itemize. A reason advanced for this is that "claims for expenses on the broad basis suggested by the Commission would either impose record keeping on millions of employees or deny them the ability to submit acceptable claims".\textsuperscript{109} But the Carter \textit{Report} would not impose the obligation of record keeping on millions of employees. Only employees whose employment expenses are likely to exceed 3\% of gross employment income or $500.00 would need to keep records and even those persons whose employment expenses exceed these limits will not have record keeping imposed upon them if they are content with the standard deduction.

The \textit{White Paper} states that "government believes these expenses are not generally as high as implied by the commission. It would be costly, and inequitable to others, to permit substantially more to be deducted by means of a formula than was normal in typical cases".\textsuperscript{110} It may be true that the Carter \textit{Report} over-estimated employment expenses and, if so, it is a justification for lowering the total standard deduction from $500.00 to $150.00. However, employees whose expenses exceed 3\% of gross employment income or $150.00 should be able to itemize. If the government is right and employment expenses are not nearly as high as the Carter \textit{Report} suggested, few employees will itemize and the tax administration will not be burdened. If a very large number of employees itemize, and the burden of checking their returns is too great, this will indicate that the standard employment expense deduction is too low and should be raised. There must necessarily be trade-offs between equity and the facilitation of tax administration. In this instance, facilitating tax administration has probably been given too much attention to the detriment of promoting more equitable treatment between employees and self-employed persons. The Senate Committee, however, concurs in the employment expense deduction proposed in the \textit{White Paper} and does not offer any suggestions for improvement.\textsuperscript{111} The Commons Committee states: "There seems to be no valid reason, however, why those who have higher expenses should not be permitted to itemize and claim them, if properly substantiated."\textsuperscript{112}

\textsuperscript{107}Ibid.
\textsuperscript{108}White Paper, pp. 15-16.
\textsuperscript{109}Ibid., p. 16.
\textsuperscript{110}Ibid.
\textsuperscript{111}Senate Report, p. 12.
\textsuperscript{112}Commons Report, p. 17.
It recommends as soon as revenue needs permit, that employees be given the option to itemize all expenses incurred in gaining or producing income on the same basis as self-employed persons.

It must, however, be recognized that the employment expense deduction is not the only way in which the White Paper has attempted to redress the balance between employees and self-employed persons. The White Paper recommends a frontal assault on expense account living. The White Paper states: "The costs of attending conventions and belonging to clubs would no longer be permitted as a charge in determining business income. The cost of yachts, hunting and fishing lodges or camps, amounts spent for tickets for games and performances, and costs of entertainment would be excluded." At present if an expense is not related to the earning of income or is unreasonable, it will be disallowed to the business and if it is a benefit to an employee, it will be added to his income. There are, however, many expenditures which constitute a hybrid mix—in part a legitimate business expense and in part a significant benefit to the self-employed or senior employee. For instance, the country club dues, which a trust company pays for their branch managers, is in part a legitimate business expense incurred to attract more business, but there is little doubt that in part it is a personal benefit conferred on its branch manager, which is being subsidized by the general body of taxpayers. It is this hybrid mix of expenditure with which every tax system finds difficulty.

In the White Paper, the government is in effect saying that in this area, it is impossible to determine what part of the expenditure is a legitimate business expense and what part constitutes personal benefit to the self-employed or senior employee. The government is saying to businesses, "you police these benefits; we cannot". If a significant part of the payment of club dues, convention expenses or entertainment is a mode of remunerating senior employees, this form of indirect remuneration would cease, in that an equal increase in salary would be cheaper for the business. For self-employed persons, making convention and entertainment expenses non-deductible will automatically increase their taxable income.

This solution to the expense-personal benefit hybrid of entertainment, convention expenses and club dues will help to redress the tax balance between average employees and self-employed and senior employees. The White Paper proposal was probably inspired by the United Kingdom Finance Act 1965 which, in section 15(5), stated that business entertainment provided by a per-

113 White Paper, p. 16.

114 Such dues were held to be deductible as a business expense in Royal Trust Co. v. M.N.R. (1957), 57 D.T.C. 1055 (Ex. Ct).
son carrying on business or by a member of his staff shall be dis-
allowed as a deduction in computing profit. There is an exception
for the entertainment of an overseas customer.

Businessmen have long complained of the so-called “nothings”
—items which are not currently deductible as an expense nor de-
ductible over time through a capital cost allowance. The White
Paper would create a new type of “nothing”—entertainment, con-
vention expenses and club dues. This new type of nothing might
not give rise to any particular concern if it were to have an equal
impact on all businesses. However, it appears that entertaining ex-
penses may have a materially different significance from one busi-
ness to another. Entertainment may not be nearly as important if
you are selling steel ingots rather than personal services. It may,
therefore, not be very equitable to require entertainment expenses
to come out of after-tax dollars.

It should also be borne in mind that these expenses which are
deductible under the existing Income Tax Act have led to the
growth of an infrastructure committed to serve the purposes of
those deductions. If the deduction is to be eliminated, it should
probably be done gradually so as to cushion its immediate impact
on the hotel, resort, and convention business. The Carter Report,
which could not be described as enamoured with expense account
living, stated that: “Disallowance of the expense to the employer
would be both inequitable and under some circumstances ineffect-
tual.” The Report stated that it would be ineffectual where the
employer was a tax-exempt organization. Both the Commons and
Senate Committees were opposed to making these expenses non-
deductible. They regarded the proposal as unfair in that it would
penalize all businessmen because of the excesses of some.

A new deduction which is to be permitted is the expense in-
volved from moving from one residence to another in connection
with a new job, provided that the taxpayer moves to a location
at least ten miles closer to his new job. This is subject to a
limitation that the deduction is only to apply against income
earned from working in the new locality. If this limitation is in-
tended to prevent the tax subsidization of a retirement move, it
does not appear to be very effective. As a result the Commons
Committee has suggested that the deduction should be subject to
a condition that “a certain length of time must be spent working
at the new location during the first year after the move”. The
scope of the deduction was clarified by government witnesses be-
fore the Committees. It will be available where there is a change
of job location even though there is no change in the employer.
It is also to be made available to the self-employed. Both Commit-
tees recommend that there be a carry-forward of one year for this

deduction in order that a person who moves near the end of a taxation year will not lose the advantage of the deduction.\textsuperscript{118}

Since 1964, section 217 of the Internal Revenue Code has permitted the deduction of the expenses of moving household goods and personal effects from the former residence to the new residence and the cost of travelling, including meals and lodging, provided that the new place of work is at least twenty miles further from his former residence than was his old place of work and that he works for at least thirty-nine weeks in the new location. By the United States Tax Reform Act of 1969, the twenty mile condition was increased to fifty miles but three additional types of moving expenses were permitted: 1) travel, meals and lodging for pre-move house-hunting trips; 2) expenses for meals and lodging in the general location of the new job location for a period of up to thirty days after obtaining employment—these two items limited to $1,000.00; 3) expenses incident to the sale of a residence or a settlement of a lease at the old job location or to purchase of a residence or the acquisition of a lease with an overall limit of $2,500.00 on the three items. It also extended the moving expense deduction to self-employed persons but they must be fully employed for a period of seventy-eight weeks at the new location rather than thirty-nine weeks for employees.\textsuperscript{119}

The proposed moving expense deduction, like all deductions, benefits only taxpayers and the extent of the benefit varies in accordance with the taxpayer's marginal rate of tax. An employee who incurs moving expenses but whose income is below his personal exemption does not obtain any benefit. A pertinent question is whether a moving expense deduction is a subsidy or tax expenditure inequitably cast for the purpose of inducing labour mobility. Professor Surrey, the former assistant secretary to the United States Treasury, considers a tax expenditure as any special deduction, exclusion or exemption which is included in the tax law, not for the purpose of more accurately calculating net income in accordance with generally accepted definitions of income and standards of business accounting, but in order to achieve a desired end other than the measurement of net income. Professor Surrey concludes that a moving expense deduction is at the frontier of the positive income tax structure and that it is probably legitimate to regard it as a proper and necessary deduction for the accurate measurement of net income.\textsuperscript{120} The introduction of a moving expense deduction is not an inequitable subsidy or tax

\textsuperscript{118} Senate Report, p. 53 and Commons Report, p. 18.

\textsuperscript{119} Pub. L. No. 91-172, s. 231, amending Int. Rev. Code of 1954, s. 217 and adding s. 82.

expenditure, but represents the removal of an imperfection in the definition of net income.

Another new deduction which is to be permitted is the deduction of the expenses of caring for children when both parents are working or where there is only one parent and he or she is working. The costs which may be deducted are baby-sitting expenses, day nursery care, and up to $15.00 a week lodging paid at boarding schools and camps. The limitation on the deduction is $500.00 per child under fourteen years, with a maximum of $2,000.00 per family.121

The deduction is also to be limited to no more than two-thirds of the earned income of the parent with the lower earned income and there is to be no deduction for payments made to a relative who is claimed as a dependent. The Carter Report, on the other hand recommended not a deduction but a tax credit of $80.00 for a working mother with school-age children and $200.00 for a working mother with pre-school children.122 The child care expenditure incurred by working parents should be regarded as a legitimate expense of earning income and be deductible in arriving at net income. Admittedly, tax credits have the virtue of having the same significance to all taxpayers who can utilize the full credit and do not depend on the taxpayer's marginal tax rate; however, if it is a real expense of earning income, it should be allowed as a deduction. The low income taxpayer should be helped in other ways and not by converting an expense of earning income into a tax credit. Both parliamentary committees endorse the child care expense deduction. The Commons Committee thought it should be made clear that the deduction would be allowed only to the parent with the lower earned income while the Senate Committee considered that it should be available to either spouse.123

The White Paper states that existing deductions for charitable donations are to continue and that national amateur athletic associations are to be added to the list of eligible charitable organizations.124 The Carter Report, after recommending some administrative safeguards, recommended that the limit on charitable gifts should be increased from 10 to 15% of income for individuals and that the limit of 10% for corporations should be retained.125 The White Paper retains the limits of 10% for both the individual and the corporation. Both parliamentary committees recommended that ambit of section 27(1)(b) of the Income Tax Act, which permits the deduction of gifts to Canada or a province, should be expanded to include institutions which hold works of art, manu-

121 White Paper, p. 15.
123 Commons Report, p. 15 and Senate Report, p. 53.
124 White Paper, p. 17.
125 3 Report, pp. 223-224.
scripts and scientific collections for exhibition and research in order to encourage the gifting of such objects to public institutions. The Commons Committee also recommended that there should be no deemed realization with respect to such gifts. However, if there is to be no deemed realization at the time of the making of the gift, it would seem that only the cost basis to the taxpayer should be deductible and not the current market value. As most persons make charitable donations out of income which has been subject to tax, the person who possesses property which has appreciated in value should be restricted in claiming a deduction to his cost basis because without a deemed realization he will not pay tax on the capital gain.

The encouragement of charitable giving is a socially desirable objective but the charitable deduction appears to be irrationally structured. It is clearly a tax subsidy or expenditure. It represents revenue foregone for the purpose of stimulating charitable giving. Since it is a tax expenditure, it is instructive to consider how one would construct a direct expenditure programme which would achieve the same result. First, you would say that charitable donations would no longer be deductible for tax purposes. Then you would tell every charitable donor to reduce his charitable donation by the amount of his donation, multiplied by his marginal tax rate. After he has made this reduced donation, you might instruct him to send his receipt and evidence of his marginal tax rate to the Minister of National Health and Welfare and the department would send the appropriate amount to the charity selected by the individual, such that the charity would continue to receive the same total amount. If, for instance an 80% bracket taxpayer gave $10,000.00 to Queen's University last year and he wished to do the same this year, but donations are no longer deductible for tax purposes, he would reduce his contribution by $8,000.00, send $2,000.00 to Queen's and forward the receipt to Ottawa and Ottawa, because he is an 80% bracket taxpayer, would forward $8,000.00 to Queen's. A 25% bracket taxpayer who gave $1,000.00 to the United Appeal, would reduce his contribution by $250.00 and contribute $750.00. He would send his receipt to Ottawa and Ottawa would forward $250.00 to the United Appeal. A direct expenditure programme such as this would never be proposed or passed by Parliament.

If such a direct expenditure programme would be unacceptable, it seems to follow that the present tax expenditure programme should also be rejected. A tax credit equal to perhaps 30% of charitable donations in excess of the lesser of $100.00 or 1% of net income with some upper limit would be a more egalitarian mode of encouraging charitable giving. However, with

a reduction of the top marginal tax rate to about 50% as proposed by the *White Paper*, tax expenditure through the charitable deduction will be reduced. Elitist charities such as art galleries, museums and perhaps universities may be detrimentally affected by the reduction in the top marginal rate to 50% and the broadening of the tax base, which will tend to increase the effective tax rate applicable to many wealthy persons. Both the price effect and the income effect will operate to reduce the charitable giving of wealthy persons. As the rate reduction is to take place over a period of five years and the amount of capital gain subject to tax will only gradually increase over time, it is unlikely that the elitist charities will encounter any real difficulty. Their receipts may not grow as rapidly as they would have done in the absence of tax reform, but there is unlikely to be any absolute reduction in donations.

The medical expense deduction is to be reformed in accordance with the *Carter Report* and has received the endorsement of both parliamentary committees. Only medical expenses not recoverable from either public or private plans are to be deductible to the extent that they exceed 3% of the taxpayer's income. Premiums or contributions to plans other than government plans will be considered to be deductible medical expenses.\(^{127}\) The reason that contributions to government medical plans are not to be deductible is that some provinces have financed their plans out of general revenue, while others have levied premiums. Therefore, if premiums paid to government plans were deductible, there would be discrimination against the residents of those provinces where the plan is financed out of increased taxation rather than through charging a specific premium.

As the medical expense deduction is included not in order to measure net income, but to provide some assistance to the taxpayer who encounters extraordinary medical expenses, a more equitable way of providing this assistance would be in the form of a refundable tax credit equal to say 30% of all medical expenses in excess of 3% of income. This would provide the same level of assistance to taxpayers with extraordinary medical expenses, instead of providing relatively greater assistance to those persons with higher marginal tax rates.

The optional standard deduction of $100.00 in lieu of claiming either medical expenses or charitable contributions is to continue. There does not appear to be any valid reason for having the optional standard deduction applicable to items as disparate as medical expenses and charitable contributions. The *Carter Report* recommended that the standard deduction be reduced and applied only to charitable donations.\(^{128}\)

\(^{127}\) *White Paper*, p. 17.

\(^{128}\) *3 Report*, p. 224.
The White Paper indicates that the government wishes to change the basis of the deduction for contributions to registered retirement savings plans. Instead of a limitation on the amount which can be paid in, which is $1,500.00 under sections 11(1) (g) and 11(1) (i) for the employer and the employee and $2,500.00 under section 79B for the self-employed person, the White Paper wishes deductibility to be limited by a maximum to be set with reference to the benefits which will be provided at retirement. The White Paper does not state what the level of the retirement benefit maximum is to be for a contribution to qualify as a deduction. The Carter Report suggested that for a married person the benefit limit should be the equivalent to a joint and survivorship annuity of $12,000.00 per year commencing at age sixty-five, with a guaranteed term of ten years. The White Paper says that a benefit limit would be difficult to work out. With the growing complexity of benefit formulas of modern pension plans, this is probably an understatement. The White Paper also says that the removal of the contribution limit would be quite expensive and revenue considerations prohibit a switch at this time. If this is the case, the government may be thinking of a benefit limit quite different than that proposed by the Carter Report. If a person aged thirty-five is earning $10,000.00 and is contributing 6% of his salary less the Canada Pension Plan contribution and this is matched by an equal contribution by his employer and it is assumed that his salary increases by 4% per year, the pension purchasable at age sixty-five is approximately $23,000.00 per year, assuming a rate of return of 8%. If a benefit limit of $12,000.00 is adopted, his tax deductible contributions would be substantially reduced. The benefit limit is, of course, more generous to older individuals who have not accumulated pension rights than is an annual limitation on contributions. The benefit limit also permits an individual to utilize pension contributions as an averaging device to a greater extent than if there were an annual limit to contributions. In any case, the White Paper proposes that the present limits be retained except for unspecified lump sum payments into registered plans and that plans primarily for shareholders are to be denied registration until the benefit limit is adopted.

Registered retirement funds will continue to be exempt from tax on earnings and now capital gains but, of course, when funds are paid out, they will be fully taxable. Therefore, to the extent that a payment out is derived from the gain on widely-held shares, this gain will be taxable in full, whereas, if the gain had been realized by the individual directly, only one-half will be taxable.

130 3 Report, p. 423.
The potentially great tax deferment available through registered pension plans will tend to offset this factor. The Carter Report advocated that a pension fund should be entitled to a credit for the corporate tax paid. This is rejected by the White Paper. The White Paper also proposed that no more than 10% of the assets of a registered fund should be invested in foreign securities. The present requirement is that no more than 10% of the income is to be from foreign sources. Thus, pension funds by investing in high growth low dividend paying stocks such as International Business Machines and Xerox were able to invest substantially more than 10% of their assets in foreign securities. This will no longer be possible. The White Paper adopted the Carter proposal that a withholding tax be levied on pension payments. Carter proposed a rate of 30%; the White Paper 25%, but with a provision for higher or lower rates according to the circumstances of the recipient. Presently, a retired person who becomes a non-resident pays no Canadian tax on the Canadian pension he receives even though the payments in were deductible from his income. The withholding tax will insure that even if he becomes a non-resident at retirement the Canadian tax will be paid on payments out of the pension fund. The Reports of the parliamentary committees were generally favourable to the proposals relating to pensions. However, the White Paper had advocated that all special averaging provisions except section 42 be replaced with one general averaging formula. Sections 35 and 36 accord special treatment to lump sum payments out of a pension plan. Under section 36 a taxpayer had the option of excluding the lump sum payment from his income and paying tax on the lump sum at his average rate of tax for the three years immediately preceding the taxation year. Section 36 under most circumstances would be considerably more favourable to the taxpayer than would the proposed general averaging formula. The Commons Committee states: We are concerned about people who have participated in plans for which this special treatment was available, and we feel there should be alleviation of the retroactive effect which the White Paper proposals would have. The Committee feels that past contributions to and earning of such plans should be taxed according to the present law, and that future contributions and earnings should be subject to any new legislation that may be enacted.

The Commons Committee appears to take the view that participants in pension plans have acquired a vested right in the continuance of the special tax treatment of lump sum payments pro-

131 4 Report, p. 31.
133 Ibid., p. 22.
134 Income Tax Act, s. 62(1)(q).
135 3 Report, p. 440.
vided by sections 35 and 36 in regard to past contributions. Making pension contributions deductible is an incentive to foster retirement savings but to provide generous terms under which a lump sum received from a pension fund will be taxed when one terminates employment with one employer and accepts employment with another works against this incentive. A person should be encouraged to transfer the funds to another registered pension plan. There seems little reason to regard pension contributors as having acquired a vested right to the continuance of sections 35 and 36. However, the Senate Committee has proposed even more favourable tax treatment for lump sum payments from a pension plan. It proposes "a tax equal to the lesser of a flat rate of tax such as 15% to 20% or the average rate of tax paid by the taxpayer for the previous five or preferably ten years".  

IV. Personal Exemptions and Allowances Used to Calculate Taxable Income. 

The White Paper recommends that personal exemptions for a single person be increased from $1,000.00 to $1,400.00 and for married taxpayers from $2,000.00 to $2,800.00. The level of personal exemptions has not been changed since 1949. If 1949 were still being used as the base year for the consumer price index, it would now stand at 169 instead of 130.5 based on 1961. Therefore, merely to exclude from tax the same amount of real income today as was excluded in 1949 would require a personal exemption of $1,690.00 for a single person and $3,380.00 for a married person. When consideration is given to the fact that prices have increased 69% since 1949, an increase of 40% in the personal exemptions does not appear particularly generous.

It is perhaps relevant to inquire what the function of a personal exemption is. The Carter Report recommended maintaining the present exemptions at roughly the present levels through the adoption of zero brackets of $1,000.00 for individuals and $2,100.00 for married persons. The Carter Report stated:

The idea that income taxes should not reduce income below "subsistence" is laudable in its intention but we believe misconceived. Subsistence has no absolute meaning. It is the relative positions of individuals and families that are important. Furthermore, neither exemptions from tax nor credits against tax can ensure that every Canadian has a minimum income. This objective can only be achieved through

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138 Senate Report, p. 21.
141 3 Report, p. 21.
increased government transfer payments including, for example, refundable credits against taxes. The income tax system cannot be used to help people without income — those who most need help.

I think that is very callous nonsense. Granted that subsistence can have no absolute meaning, but everyone knows that $1,000.00 will not support a single individual and $2,100.00 will not support a married couple. Granted a positive tax system can do nothing for those below the exemption level; however, a tax system surely does not have to exacerbate the problems of those in poverty through unreasonably low personal exemptions.

Lawrence Seltzer states that:

"Two views of the primary purpose of personal exemptions have long been held. One regards them as aimed at excluding from tax those persons whose incomes are only equal to or less than the minimum amounts needed for a tolerable standard of living, family responsibilities considered. The other regards them as designed to exclude from tax that portion of all incomes required for this need. In the first view exemptions are limited to the poor; in the second they are extended to all.

In Canada and the United States the second view has been followed. It is not possible to say that the Canadian experience with personal exemptions has been very successful, if we grant that the primary purpose of the personal exemption is to exclude from tax those whose incomes are equal only to the amount necessary for a tolerable standard of living. Personal exemptions have not been increased during the last twenty years in spite of rapidly rising prices which have eroded the real income represented by the personal exemptions. This is primarily because of the concern about the revenue loss. When a reduction in taxes has been called for to stimulate the economy, the rates of tax have been decreased in preference to reducing the tax revenue through increasing the personal exemptions. This appears to stem from the feeling that it is politically more difficult to reduce personal exemptions once they have been increased than it is to increase tax rates. It also stems from the realization that after the personal exemptions have been increased, a larger increase in tax rates will be necessary to yield the same increase in government revenue as would have been obtainable with the former lower personal exemptions.

The 40% increase in the personal exemption for single and married persons results in a revenue loss of about one billion dollars. It will free an additional 750,000 Canadians from income tax. If these 750,000 Canadians, who are freed from income tax, were previously paying an average of $100.00, a very liberal estimate, these 750,000 Canadians will save in tax $75 mil-

142 The Personal Exemption in the Income Tax (1968), pp. 5-6.
143 White Paper, p. 95.
144 Ibid., p. 9.
lion. That is, at the most only 7.5% of the benefit of the increased personal exemption accrues to the 750,000 lowest taxpaying Canadians. An increase in the personal exemption applicable to all taxpayers is a very inefficient mode of benefiting the poorest taxpayers. In addition, an exemption for each taxpayer is essentially illusory. What every taxpayer appears to gain from an equal allowance must be made up by higher tax rates on the remaining portion of his taxable income. This is explicitly recognized in the White Paper, which states that: "The benefits which larger exemptions would otherwise give to those with higher incomes would be offset by higher rates of tax."\(^{145}\)

If a higher marginal tax rate does exert a disincentive to work and to invest, productivity of the economy is diminished. It would appear preferable to adopt a vanishing exemption for a single person. For example, you might exempt all single persons whose income is less than $1,500.00 and for persons whose income exceeds $1,500.00, the exemption might be reduced by one dollar for every three dollars of income in excess of $1,500.00. This would mean that the personal exemption would vanish at $6,000.00. Tax rates could be adjusted downward. The major advantage of such an exemption would be that it would be easier to increase such a personal exemption in response to rising prices in that the revenue loss, and thus the need for an increase in tax rates would be far less than an increase in the personal exemptions for all persons.

It is far more likely that such an exemption would more adequately perform its primary function over time of excluding from tax those who have only a subsistence amount of income. A difference in family size could be recognized through tax credits. A married man would have his own individual but vanishing exemption and, in addition, a tax credit for his wife and tax credits for his children. The Carter Report recommended that exemptions for children be replaced with tax credits. It recommended a tax credit of $100.00 for the first child and $60.00 for each additional child.\(^{146}\) The revenue loss that would be involved in insuring that a system of an individual vanishing exemption combined with tax credits protected from tax a subsistence amount of income as prices increased would be considerably less than a system which relies on continuing exemptions. It would thus lessen the upward revision in tax rates which would be necessary to compensate for the revenue loss. It is regrettable that the White Paper proposed to adhere to the system of continuing personal exemptions—a system which has proven in the past to be unresponsive to the protection of a subsistence amount of income from tax.


\(^{146}\) 3 Report, p. 181.
An individual vanishing exemption combined with tax credits to recognize a difference in family size is not a very radical proposal. Richard Goode would be prepared to have a vanishing exemption even for dependents. He states:147

While it seems clear that the principle of ability to pay requires differentiation of tax liability by family size at income levels close to the socially acceptable minimum, it is not obvious how far up the income scale this differentiation should be carried. In my opinion, the ability-to-pay principle does not require differentiation by family size at high income levels and vanishing exemptions are justifiable.

The Commons Committee recognized that the tax credit mechanism of providing relief to low income persons has much to commend it in that it can be increased without need for restructuring the rate schedule to prevent high-income taxpayers obtaining a greater tax benefit. However, it recommended the exemption approach should be continued because taxpayers have become accustomed to it and that the proposed exemption level be adopted. It does urge that the question of credits versus exemptions should be reviewed when the family unit is considered.148 The Senate Committee has recommended the increased personal exemptions should only be given to single persons whose income does not exceed $3,000.00 and to married persons whose income does not exceed $8,500.00 with an appropriate notch provision for persons just over these limits.149 The cut-off for the additional personal exemption with a notch provision which the Senate Committee has proposed might closely resemble the vanishing exemption which has been advocated in this article. However, the Senate Committee does not provide any detail about the notch provision. A difficulty with the notch provision is that it will probably produce significant discontinuity in marginal rates above the cut-off point. If marginal rates of tax do have a significant impact on work incentive, a discontinuity in marginal rates should be avoided. The vanishing exemption rather than the cut-off exemption would appear preferable.

The White Paper proposes that the additional exemption of $1,400.00 for a married man is to be reduced by one dollar for every dollar that his wife’s income exceeds $100.00.150 Thus, the amount of income that a wife can have without affecting the husband’s marital deduction will be reduced from $250.00 to $100.00. The deduction for children is to remain at its current level of $300.00 for children under sixteen and $550.00 for children sixteen and over.151 At the present time, a child is a de-

149 Senate Report, p. 17.
150 White Paper, p. 17.
151 Ibid., p. 15.
dependent if his income does not exceed $950.00. If it is $951.00 all the deduction is lost. This unreasonable discontinuity is to be eliminated. Where the deduction is $300.00 it is to be reduced by one dollar for every two dollars in income of the child in excess of $900.00. For children sixteen or over, the $550.00 deduction is to be reduced one dollar for every one dollar that the dependent’s income exceeds $950.00. The exemption for the wife or child will in each case fall to zero when the wife or dependent becomes taxable on his or her own income.

The additional personal allowance of $500.00 for those over seventy and for those who are blind or confined to bed or a wheelchair are to be continued. The White Paper noted that the Carter Report recommended that they be cancelled, but the White Paper proposed to continue them on “compassionate grounds”. It stated that “it can be argued that this is not the best way to assist the incapacitated or the elderly but most of the incapacitated benefiting from this provision have relatively small incomes and taxpayers’ needs tend to increase with age”.

It is submitted that not only can it be argued that this is not the best way to assist these people, but that it is patently obvious that this is not the best way to assist these people. Surely, it would be more rational and much more compassionate to determine what the revenue loss of these additional personal allowances are and then structure a tax credit which would result in the same loss of revenue. Then all taxpayers who are aged or incapacitated would receive the same benefit regardless of their marginal rate of tax. It would be preferable if it were a refundable tax credit so that those aged and incapacitated persons who need it most, the ones who do not have taxable incomes, would also benefit. It would then represent a small tentative step toward a negative income tax. However, retaining this extra personal allowance in its present form might be properly classified as misguided compassion.

Table I compares the amount of income exempt from tax presently under the White Paper proposals with the income exempt from tax in the United States prior to and under the Tax Reform Act of 1969. It can be seen that the married person with no children or the married person with one child has a greater amount of income exempt from tax in Canada as compared with the United States. The single person fares better in the United States as does the married man with two or more children. As a result of the United States system of an equal per capita personal exemption, the amount of income exempt from tax grows greater as the size of the family increases relative to the amount of income exempt from tax in Canada.

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152 Ibid., p. 17.
153 Ibid.
### TABLE 1

**Amount of Income which will be Exempt from Income Tax in Canada and the United States**

<table>
<thead>
<tr>
<th></th>
<th>CANADA</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Single</td>
<td>Married</td>
<td>M+1</td>
<td>M+2</td>
<td>M+3</td>
<td>M+4</td>
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<tr>
<td>Existing Canadian</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(where all dependents are under 16 years)</td>
<td></td>
<td>1100</td>
<td>2100</td>
<td>2400</td>
<td>2700</td>
<td>3000</td>
<td>3300</td>
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<tr>
<td>Existing Canadian</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(where all dependents are 16 or over)</td>
<td></td>
<td>1100</td>
<td>2100</td>
<td>2650</td>
<td>3200</td>
<td>3750</td>
<td>4300</td>
</tr>
<tr>
<td>Proposed by White Paper</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(where all dependents are under 16 years)</td>
<td></td>
<td>1500</td>
<td>2900</td>
<td>3200</td>
<td>3500</td>
<td>3800</td>
<td>4100</td>
</tr>
<tr>
<td>Proposed by White Paper</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(where all dependents are 16 or over)</td>
<td></td>
<td>1500</td>
<td>2900</td>
<td>3450</td>
<td>4000</td>
<td>4550</td>
<td>5100</td>
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<tr>
<td>Proposed by White Paper</td>
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<td></td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(where all dependents are under 16 years and income is all employment income)</td>
<td></td>
<td>1545</td>
<td>2987</td>
<td>3296</td>
<td>3605</td>
<td>3914</td>
<td>4223</td>
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<tr>
<td>Proposed by White Paper</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(where all dependents are 16 or over and income is all employment income)</td>
<td></td>
<td>1545</td>
<td>2987</td>
<td>3553.50</td>
<td>4120</td>
<td>4686.50</td>
<td>5250</td>
</tr>
</tbody>
</table>

|                      | UNITED STATES |                  |                  |                  |                  |                  |                  |
|                      | (In United States Dollars) |                  |                  |                  |                  |                  |                  |
| U.S. 1969¹           |                  | 900              | 1600             | 2300             | 3000             | 3700             | 4400             | 5100             |
| U.S. 1970²           |                  | 1725             | 2350             | 2975             | 3600             | 4225             | 4825             | 5475             |
| U.S. 1971³           |                  | 1700             | 2350             | 3000             | 3650             | 4300             | 4950             | 5600             |
| U.S. 1972²           |                  | 1700             | 2400             | 3100             | 3800             | 4500             | 5200             | 5900             |
| U.S. 1973³ and thereafter |              | 1750             | 2500             | 3250             | 4000             | 4750             | 5500             | 6250             |

¹ This includes the personal exemptions and the minimum standard deductions.
² These include the personal exemption and the low income allowance. The benefit of the low income allowance of $1,100.00 in 1970 and $1,050.00 in 1971 is phased out as adjusted gross income increases.
To assess which system of exemptions is more appropriate, that of the United States or that of Canada, it is necessary to compare the exemptions for various family sizes with the pattern of living costs.

**Table II**

<table>
<thead>
<tr>
<th>Canada White Paper (1)</th>
<th>U.S. in 1973 (2)</th>
<th>Ratio of exemptions in Canada (3)</th>
<th>Ratio of exemptions in U.S. (4)</th>
<th>Ratio of living costs (5)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single person</td>
<td>1500</td>
<td>1750</td>
<td>52</td>
<td>70</td>
</tr>
<tr>
<td>Husband and wife</td>
<td>2900</td>
<td>2500</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Husband, wife, one child</td>
<td>3200</td>
<td>3250</td>
<td>110</td>
<td>129</td>
</tr>
<tr>
<td>Husband, wife, two children</td>
<td>3500</td>
<td>4000</td>
<td>121</td>
<td>160</td>
</tr>
<tr>
<td>Husband, wife, three children</td>
<td>3800</td>
<td>4750</td>
<td>131</td>
<td>190</td>
</tr>
<tr>
<td>Husband, wife, four children</td>
<td>4100</td>
<td>5500</td>
<td>141</td>
<td>210</td>
</tr>
</tbody>
</table>

The United States Treasury has determined that if a married couple with no children have living costs equal to 100, the ratio of living costs are 70 for a single person, 128 for a married couple with one dependent, 152.5 where there are two dependents, 171 where there are three dependents, and 194.5 where there are four dependents.\(^{154}\) The ratio of exemptions in Canada and the United States appears in columns 3 and 4 of Table II. If a comparison is made between the ratio of exemptions with the ratio of living costs in column 5, the United States exemptions must be given a much higher score than the Canadian. For a single person, a married person without dependents, and a married person with one dependent, the exemption ratio behaves in accordance with the ratio of the pattern of living costs. However, for larger families the per capita exemption of the United States does produce disproportionate benefit.

If the Canadian exemption for a married couple without children is appropriate, it appears that inadequate relief is provided to single persons and married persons with dependents. One reason why relief provided for the single person is inadequate as compared with the relief for a married person is that it is solely through the personal exemptions that differences in tax-paying ability between single and married persons are recognized. The maximum difference in tax liability between a single person and a married couple with one wage earner with the same salary as the single person is the additional exemption times the highest marginal tax rate. Even with the married person receiving an

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additional exemption equal to the single person's exemption, the difference in tax liability produced is not very great. The additional personal exemption cannot be relied upon to provide appropriately different tax liability for the single as compared with the married person. This can only be achieved through two different rate schedules. With two different rate schedules, it would then be easier to shield from tax a subsistence standard of living for the single person, which is about 70% of the amount necessary for a subsistence standard for a married person.

The Canadian personal exemptions for dependents appear very inadequate as compared with those of the United States or with the pattern of living costs of families. It must, however, be recognized that in Canada there are family allowance payments made to the parents of all children under sixteen years of age—$6.00 per month per child under ten years and $8.00 per month per child between ten and under sixteen years of age. It does not appear very rational to have a system of family allowance payments co-existing with a system of fixed exemptions for children. The family allowance system produces a fixed grant per child, regardless of the parents' income and is thus analogous to a refundable tax credit of the same amount per child. The fixed exemption per child, however, is analogous to a system of family allowances under which the high income parent receives a larger grant per child than a low income parent receives.

V. Drawing up the Appropriate Rate Structure.

The rate schedule proposed by the White Paper involves a considerable measure of simplification. The old-age security tax, the social development tax, the current surtax and the reduction under section 33(4) is to be welded into the basic rate schedule. This one federal tax rate schedule will not include any provision for provincial tax and, therefore, there will be no abatement, which is presently 28% for provinces other than Quebec. The provinces would be free to impose a tax at whatever rate they chose, but it is to be expressed as a percentage of the federal tax. The White Paper assumes, and it will be assumed in the tax comparisons which are made, that the provinces will levy a tax at 28% of the federal tax.

A minor part of the simplification of the rate structure is the elimination of section 32(3), which levies a surtax on foreign

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158 However, in 1970 only British Columbia, Nova Scotia, Ontario and Prince Edward Island levied tax at 28% of the federal tax. Alberta, Newfoundland and Saskatchewan levied tax at 33% and in New Brunswick the rate is 38% and in Manitoba 39%.
investment income in excess of $2,400.00 at a rate of 4%. It was obviously thought that this minor deterrent to foreign portfolio investment was no longer justified in view of the integration proposal which will increase the attractiveness of Canadian equities to Canadian residents.

Presently, the marginal tax rates vary from 14.8% on the lowest taxable incomes to 82.4% on taxable incomes of $400,000.00 a range of progression on taxable incomes of 67.6%. This large degree of progressivity is to a considerable extent and for a considerable number of taxpayers, window dressing in that many relatively well-to-do taxpayers have been able to arrange their affairs so as to have capital gains. Henry Simons, an early advocate of tax reform in the United States, wrote:

One senses here a grand scheme of deception whereby enormous surtaxes are voted in exchange for promises that they will not be made effective. These politicians may point with pride to the rates, while quietly reminding their wealthy constituents of the loopholes. If we had a more moderate sort of progression—a scale of rate which responsible leaders really approved—it would be less difficult to obtain the urgently necessary changes in the basis of levy. It is high time for Congress to quit this ludicrous business of dipping deeply into great incomes with a sieve.

This advice has been accepted by the Carter Report and the White Paper. Both reject an artificially narrow tax base with extravagantly high tax rates and advocate a broad base tax with realistic and effective tax rates. Carter’s recommended rate schedule varied from a marginal tax of 12% up to 50%. The White Paper’s proposed range is from 21.76% to 51.20%, at the end of five years, assuming a provincial income tax levy at 28% of the federal tax, a range of progression or taxable income of considerably less than half the present range of marginal taxes.

It is relevant to inquire why the rate of 50% was adopted by the Carter Report. The Carter Report states:

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

158 White Paper, p. 20.
159 Ibid., p. 24.
162 White Paper, p. 25.
The Carter Report is so committed to a rate of approximately 50% that it advocates that if a more progressive system is desired it should be attained through a net wealth tax on individuals with more than $1 million in net assets rather than through the imposition of a top marginal rate much above 50%. Yet in another volume the Carter Report states: "What evidence there is suggests that taxes have little impact on the size, skill and industriousness of the work force." This statement cannot be easily rationalized with the Carter Report's insistence on the importance of a top rate of 50%. Also if one consults the study made by Professor Barlow for the Commission on The Effects of Income Taxation on Work Choices, one learns that there is no convincing evidence for the proposition that progressive income taxation has any significant disincentive effect on the supply of work effort at least up to marginal tax rates of about 70%. An increase in taxation results in two conflicting effects. The income effect will lead to more work effort when the average rate of income tax is increased as the individual may attempt to achieve his previous level of disposable income and standard of living through working longer or harder. The substitution effect will lead to less work effort when the marginal rate of tax has increased because at the margin, leisure is now relatively more attractive in that the after tax reward for an additional hour of work has diminished. There is therefore a tendency for these conflicting effects to offset one another. The validity of the disincentive argument is further weakened by recognizing that work effort is not motivated solely by monetary gain. There are many individuals who work because they enjoy their job, or the social status which is derived from the job or the sense of power which is obtained from directing a business. The psychic income derived from work is probably greatest among those whose tax rates are highest and thus ameliorates the disincentive effect of progressive taxation. Professor Barlow reviewed the empirical studies which have attempted to assess the impact of taxation on work incentives and stated that: "The unanimous conclusion is that in general the income tax does not deter work effort to any significant degree. . . . There has not been a single study known to the writer which has demonstrated the existence of a strong and widespread disincentive effect." Since the empirical studies fail to provide any evidence about any significant disincentive effect from taxation at least up to tax rates of about 70%, it is perhaps pertinent to inquire about why

164 Ibid., pp. 28-29.
165 5 Report, p. 78.
166 Barlow, Studies of the Royal Commission on Taxation, #4, The Effects of Income Tax on Work Choices (Ottawa, Queen's Printer, 1966), p. 15.
the Carter Commission was so insistent on achieving a top rate of 50%. One reason might be that the Carter Commission did not have confidence in the empirical studies or that it considered the validity of the empirical studies were restricted to a tax system which lacks a comprehensive tax base. It might have thought that the disincentive effect of high progressive income taxation may not be experienced in a tax system which has loopholes but would be felt more fully if a comprehensive tax base were adopted. However, the adherence to a top rate of 50% was probably in the main an attempt to make the taxation of capital gains at full income tax rates more palatable. A subsidiary reason might have been to achieve a symmetrical system which would eliminate the problem of corporate surplus stripping. With full integration of corporate and personal taxation and a top marginal rate of tax equal to the corporate rate, the corporate surplus stripping problem evaporates. There is no second level of taxation for persons to attempt to avoid. But the major reason for the 50% rate must have been to make the taxation of capital gains at full income tax rates more acceptable.

The Senate Committee seized on the proposal that the top marginal rate should be approximately 50% with alacrity and thought that it should be "enacted without any time phasing procedure". The Senate Committee stated that it was mindful that the proposed rate was based on the premise that capital gains would in general be taxed fully as income but it states that it "feels that its conclusion as to a lower rate of tax on capital gains does not militate against the general proposition, supported by the Royal Commission on Taxation . . . that the interests of the economy demand a maximum marginal rate of 50 per cent". The Commons Committee thought that a top rate of 50% was too low and suggested a top rate of 60% commencing at $60,000.00 with the 50% bracket commencing at a taxable income of $30,000.00 rather than $24,000.00 as proposed in the White Paper. It also recommended that the new rate schedule should be adopted in one step rather than being phased in over a period of five years as suggested in the White Paper.

When one compares the tax rates proposed by Carter with those of the White Paper, two very significant facts emerge: first, the lowest marginal rate proposed by the White Paper is 21.76%, which is 80% higher than the lowest rate of 12% proposed by Carter and secondly, the top rate of 51.2% proposed by the White Paper is to be applicable to taxable incomes in excess of $24,000.00, whereas Carter's top rate of 50% was to be applicable only to taxable incomes in excess of $100,000.00. The mar-

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167 Senate Report, p. 11.
168 Ibid., p. 12.
ginal tax rate proposed by Carter on taxable income of between $24,000.00 and $25,000.00 was 35% for single persons and 31% for married persons. The proposed marginal rate of the White Paper for taxable income of between $24,000.00 and $25,000.00 is thus 46% and 65% higher than that of Carter.

What is the explanation for this great difference in the rates proposed by the White Paper and Carter? Firstly, Carter did not propose any increase in the personal exemptions. The White Paper proposes a 40% increase in the personal exemptions with a resulting revenue loss of about one billion dollars. Secondly, as indicated by the White Paper, the rates proposed in the Carter Report were based on assumptions about revenue requirements in 1964 and these assumptions are no longer valid. Thirdly, the tax structure proposed by Carter was after a transition period to produce the same amount of revenue while the White Paper proposal would after the elapse of five years produce an additional $630 million in tax revenue on the basis of 1969 incomes or $1.3 billion according to the estimates made by the Ontario government. The government has undertaken that the legislation will provide for tax cuts in the first five years sufficient to offset any additional tax revenue generated by the new structure. The Minister of Finance has indicated the tax reduction will take the form of tax benefits to small businesses and an adjustment in the personal tax rates.

One reason that the Carter Report did not propose any increase in the basic personal exemptions was that it was “concerned with reducing Canadian taxes on skilled workers and professionals to the point where there are no major tax incentives for emigration to the United States”. For the single person, Carter would provide tax relief only for persons earning over $10,000.00 who did not have their tax base increased. The rate schedule proposed by Carter for married persons would result in some tax reduction at all levels, but the reduction in tax was most substantial for married persons with incomes in excess of $10,000.00 who did not have their tax base increased. The authors of the Carter Report thought the proposed rate schedules would eliminate most of the unfavourable tax differential between Canada and the United States.

The White Paper does not place any emphasis on reducing the tax incentive to emigration to the United States. Immediate tax decreases would go to single persons with incomes up to about

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171 Ibid., pp. 95-96.
174 3 Report, p. 158.
$3,400.00 and to married persons up to an income of about $9,100.00. At the other end of the income scale, tax decreases will go to single persons whose income is in excess of about $44,800.00 and to married persons whose income is in excess of about $41,100.00, provided that their tax base is not increased. It will be five years, however, before the tax decreases at the upper end of the income scale become fully effective as only in years two, three, four and five will the rates in excess of 51.2% be reduced by one-quarter of the excess each year, assuming that the provinces tax at a rate of 28% of the federal tax.175

The proposed tax rate schedule will, when the plan is in its fifth year, result in tax increases for single persons with incomes of between $3,400.00 and $44,800.00 and for married persons whose income is between $9,100.00, and $41,100.00, provided that the individual’s tax base remains the same. The greatest percentage increase in tax for the single person is about 11.2% at an income of about $10,000.00 and the greatest percentage increase in tax for a married taxpayer is about 6.5% at an income of about $11,000.00. The tax rates under the White Paper proposal were not arranged to reduce the tax incentive to emigration. Only the very skilled and the very successful professional person whose income is in excess of $40,000.00 will eventually get a tax decrease provided his tax base remains the same. According to the most recent income tax statistics, those for 1968, only 57,491 persons had incomes in excess of $25,000.00, which is .7 of 1% of the total persons filing tax returns and only 10,592 persons had income in excess of $50,000.00 or .13 of 1% of the total person filing.176 The great bulk of the skilled or professional persons will experience tax increases. However, the modest increase in taxation brought about through change in the rate schedule will not significantly increase the tax incentive to emigrate. It is the broadening of the tax base which may be more significant.

A pertinent question is whether the Carter Report was right when it attempted to reduce the tax incentive to a brain drain to the United States or whether the government is right when it has concentrated the tax relief on low income persons rather than on middle and upper income taxpayers. This is a value judgment. The lower income taxpayer is probably in greatest need of relief particularly when account is taken of the regressive nature of sales and property taxes. In addition, it is unlikely that a tax differential, unless it is very large, is an important factor in determining whether a person remains in Canada or emigrates to the United States. In addition, merely looking at the tax differential is looking at only one side of the coin. It is surely necessary to

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175 White Paper, p. 25.
176 Taxation Statistics (Ottawa, Queen’s Printer, 1970), pp. 34-35.
look at the benefits which are derived from government service provided by the tax dollars. In the field of health, in the field of education, the social benefit derived is probably significantly higher in Canada than in the United States. It is necessary to do a cost benefit analysis and not merely to look at tax cost. The two parliamentary committees disagree about the impact which the White Paper would have on emigration. The Commons Committee states that it “questions the validity of contentions that any changes resulting from the proposals would contribute significantly to emigration”. The Senate states: “The increased tax rates applicable to middle income groups ... would have the inevitable effect of contributing to the gradual emigration of skilled workers and those with executive talent from Canada”.

VI. Providing Tax Credits which can be Used to Reduce Tax Payable.

Aside from foreign tax credits, which will not be considered, the White Paper did not advocate the use of tax credits except for the credit to be given to Canadian resident shareholders of Canadian companies. The Carter Report, on the other hand, advocated the use of tax credits rather than deductions to take into account the size of a family. It suggested a tax credit of $100.00 for the first child and $60.00 for each additional child. It also suggested a tax credit for working mothers. In addition, the Carter Report suggested that the deduction for tuition fees be replaced by a tax credit equal to 25% of tuition fees for post-secondary education and a credit of up to $300.00 for living costs of a student. In addition, any educational tax credits which were not used in a tax year were to be carried forward to reduce future tax liability. Carter also proposed that consideration should be given to a 25% tax credit for political donations up to $50.00. The White Paper did not accept any of these proposed tax credits.

Although tax credits have not been used to any significant extent in Canada, there are instances when tax credits and perhaps refundable tax credits would be more appropriate than deductions. If the deduction is not related to the determination of net income and yet it is still decided that relief should be given through the tax system, there is much to recommend tax credits over deductions and exemptions.

VII. Averaging to Mitigate the Tax Penalty on Fluctuating Income.

It has long been recognized that with a progressive tax structure
and an income period as short as a year, fluctuations in income can involve the imposition of substantially heavier taxes than if income is received in a steady stable flow.\textsuperscript{181} It is also generally conceded that there is no justification for imposing substantially heavier taxes on those with fluctuating incomes in that there is nothing sacrosanct about a one-year accounting period and the selection of a longer period would not have this effect. There is, however, no consensus as to the appropriate time horizon over which income should be averaged in order to reduce the tax penalty involved in income fluctuations. Lifetime averaging has been suggested.\textsuperscript{182} The Royal Commission cursorily rejected this as a suitable temporal dimension, stating: "We are not convinced, however, that equity demands income smoothing over a taxpayer's lifetime."\textsuperscript{183} The maximum number of years which the Commission selected was five, but there was no real analysis as to why this is the maximum appropriate time period.\textsuperscript{184} It was presumably selected with regard to the increasing administrative problems which a longer period would entail. The Commission was perhaps also influenced by the fact that the most significant averaging provision of the existing Act, that for farmers and fishermen,\textsuperscript{185} stipulates a five-year period.

The \textit{White Paper} accepts the proposition that a general averaging provision should be available to all taxpayers and that the introduction of a capital gains tax makes the need even greater.\textsuperscript{186} The Royal Commission considered the three standard forms of income averaging—simple or block averaging, moving averaging, and progressive averaging. The Royal Commission recommended a five-year simple or block averaging system similar to that presently available to farmers and fishermen. At the end of the block of five years, you calculate what your average income has been over the period. You then calculate the tax that would have been payable in each of the five years if the average income had been received in each year and the sum for the five years equals the total tax which is to be paid for that period. To determine the tax payable in the fifth year, you subtract the sum of the actual taxes paid in the preceding four years from the total tax for the five-

\textsuperscript{181} For an excellent assessment of the whole problem, a discussion of the views of the principal writers and the legislative responses both in Canada and abroad, see John Willis, The Mitigation of the Tax Penalty on Fluctuating or Irregular Incomes (Canadian Tax Papers No. 2, Canadian Tax Foundation, 1951).

\textsuperscript{182} William Vickrey, Agenda for Progressive Taxation (1947); Bravman, Equalization of Tax on All Individuals with Same Aggregate Income over Same Number of Years (1950), 50 Col. L. Rev. 1; and Anthoine, Tax Reduction and Reform: A Lawyer's View (1963), 63 Col. L. Rev. 808.

\textsuperscript{183} 3 Report, p. 241.

\textsuperscript{184} \textit{Ibid.}, p. 263.

\textsuperscript{185} Income Tax Act, s. 42.

\textsuperscript{186} White Paper, p. 23.
year period.\textsuperscript{187} The only restrictions which the Commission recom-
mended were that the lowest income in the period must be less
than 75\% of the highest income in the period and that any tax
saving produced by the averaging would be reduced by $50.00.\textsuperscript{188}

The government, however, has decided to adopt in a modified
form the relief provided for fluctuating incomes first introduced
in the United States in 1964.\textsuperscript{189} It is debatable whether the formula
proposed should be dignified with the title of income averaging.
It is simply bracket-stretching for a certain top slice of income.
Relief will only be provided if the income of the current year
exceeds 133\%\textsuperscript{1/3} of the average income of the preceding four
years. If this condition is met, the slice of income of the fifth
year in excess of 133\%\textsuperscript{1/3} of the average income of the preceding
four years is taxed "as though it were subject to a graduated rate
schedule in which the income brackets to which each rate applied
were five times as wide as normal".\textsuperscript{190}

The proposal contained in the \textit{White Paper} has several defects
as compared with the averaging recommendation made by the
Commission. The \textit{White Paper} proposal solves only half the prob-
lem (when income increases) and ignores the other side of the
problem (when income falls). A person whose income falls sub-
stantially because of an accident or illness is surely just as entitled
to some tax relief as someone who realizes a large capital gain.
The fall in income may be the result of rapid technological change,
which renders a man's job obsolete and compels him to accept
less remunerative work. It can be argued that the man whose
income falls is more likely to need tax relief because he has be-
come accustomed to a higher standard of living and will suffer
more from the downward fluctuation. The amount of relief which
can be given through averaging is limited but it seems inequitable
to exclude a taxpayer whose income falls from any relief.

The inclusion of capital gain in the income tax base has made
the need for a general income averaging scheme more necessary.
However, it must be recognized that with the great reduction in
marginal rates and with a top rate of 51.20\% to commence at a
taxable income of $24,000.00, the additional tax burden arising

\textsuperscript{187} The Commission recommended a simplified method of calculation
making use of a special averaging rate, 3 Report, pp. 264-265.

\textsuperscript{188} \textit{Ibid.}, p. 264.

\textsuperscript{189} Int. Rev. Code of 1954, ss 1301-5, as amended by Pub. L. No. 88-272,
1964. It has been further amended by the Tax Reform Act of 1969, Pub.
L. No. 91-172, s. 311. The amount that is subject to the relief provision
has been increased by lowering from 133\%\textsuperscript{1/3} to 120\% the amount of the
base period income to be deducted from income of the computation year.
The condition precedent for averaging has been reduced from 133\%\textsuperscript{1/3}
of base period income +$3,000.00 to 120\% of base period income
+$3,000.00. The provision has been greatly simplified and now includes
capital gains.

\textsuperscript{190} \textit{White Paper}, p. 23.
through an upward fluctuation of income has been much reduced. There will obviously be no additional tax burden on fluctuating incomes if the fluctuation occurs entirely above the level of $24,000.00 of taxable income. There has been no similar limitation on the additional tax burden arising from a downward fluctuation of income.

Another serious defect is that there is no provision for the carry-over or carry-back of unused personal exemptions. In the low income groups, the most serious tax penalty imposed on fluctuating incomes occurs if the fluctuation takes place above and below the personal exemption through the wastage of the personal exemption in the low income years. The Carter Report’s method of averaging would, however, have permitted the carry-over and carry-back of personal exemptions within the five-year block averaging period.\textsuperscript{191} Another defect of the White Paper method of averaging is that it does not produce very generous relief even for upward fluctuations of income. It does not produce any relief for persons whose average taxable income for the preceding four years is $18,000.00 or more. This is because the White Paper only provides for bracket-stretching for income in excess of 133\(\frac{1}{3}\)\% of the average income in the four preceding years. If average taxable income is $18,000.00, the “threshold” income is $24,000.00 and since the top marginal rate according to the White Paper is to occur at $24,000.00 of taxable income, no advantage is to be obtained from bracket-stretching of an already infinitely large bracket. The Commons Committee felt that a threshold amount of 133\(\frac{1}{3}\)\% of the average income in the preceding four years was too high but because of concern about the loss of revenue did not advocate a lower level.\textsuperscript{192}

The Carter Report recognized that the United States’ approach had some administrative advantages over its own block averaging proposal, but it considered the United States’ approach to be unsatisfactory unless it were modified to provide relief when income changed in either direction.\textsuperscript{193} This modification has not been made. The White Paper would permit farmers and fishermen to choose either the White Paper formula or section 42.\textsuperscript{194} As the Carter Report states: “The relief available to farmers, fishermen . . . should either be withdrawn or made available to all.”\textsuperscript{195} The Senate Committee has recommended that the averaging formula of section 42 for farmers and fishermen should be made available to all taxpayers.\textsuperscript{196}

\begin{footnotes}
\footnotetext[191]{3 Report, p. 258.}
\footnotetext[192]{Commons Report, pp. 23-24.}
\footnotetext[193]{3 Report, p. 269.}
\footnotetext[194]{White Paper, p. 23.}
\footnotetext[195]{3 Report, p. 246.}
\footnotetext[196]{Senate Report, pp. 55-56.}
\end{footnotes}
The Carter Report recommended a novel approach to the problem of fluctuating incomes which would permit forward averaging. It recommended a system of income adjustment accounts which would be available to all taxpayers on an optional basis. Deposits made into income adjustment accounts would be deductible from income for that year and withdrawals from these accounts would be taxable income in the year of withdrawal. Thus, forward averaging for an indefinite number of years would be permitted. These accounts would be non-transferable, non-negotiable, and non-interest-bearing accounts held and administered by the government. As the taxpayer would pay a price for tax postponement through the loss of interest on the after-tax income represented by his deposit, it was considered that the system would be self-policing. These income adjustment accounts would only have appeal to relatively affluent taxpayers and only to those who receive large non-recurring items of income or to those who can foresee a sharp decrease in future income.

There appears to be some inconsistency in the Carter Report in regard to its approach to income averaging. It rejected the idea of lifetime averaging in a very categorical way and yet, through the income adjustment account, it would permit forward averaging for an indefinite number of years. These apparently conflicting approaches to income averaging are perhaps reconcilable in that the forward averaging would involve a price—the loss of interest on the after-tax income. Probably the major reason for the Carter Report suggesting the income adjustment accounts was to make its proposed treatment of gifts and successions as income more palatable. The Carter Report's approach to gifts and successions proved too unpopular to be implemented and it appears that the income adjustment account was an indirect casualty of the rejection of gifts and successions as part of the income tax base. Perhaps the merits of the income adjustment account should be assessed independently after a decision has been reached as to the optimum time period over which income averaging should be permitted.

Conclusion

Perhaps as important as the substantive tax proposals contained in the White Paper is the approach to tax reform which has been adopted in Canada within the last decade. Previously, tax laws were formulated in secret and announced by the Minister of Finance in his budget speech. The government would swiftly introduce a bill in the Commons, embodying the proposed changes

which usually passed without prolonged debate.198

There is the notable exception in regard to the Income Tax Act passed in 1948 to replace the Income War Tax Act. On July 12th, 1947, Mr. Abbott introduced Bill 454 towards the close of the session. He stated that:199

... it is not the intention of the government to press this bill for enactment at the present session. ... It is hoped that this bill will receive wide circulation in the hands of the public. Various organizations throughout the country, such as the Canadian Bar Association, the Dominion Association of Chartered Accountants, and the Canadian Tax Foundation are well equipped from the technical point of view to render a useful service to the country through an exhaustive analysis of this legislation. I can assure all interested groups that suggestions for improvement in the statute will be welcomed and given careful study by the government.

This, however, was essentially housekeeping reform intended to make the legislation more coherent and logical. The Bill introduced in 1947 was essentially a consolidation, a rearrangement and a clarification of existing law.200 It was not intended to initiate debate about fundamental tax reform. For this reason, Mr. Abbott could say: "A bill of this kind is, of course, definitely non-political."201 A revised version of the bill was passed almost one year later.

Only during the last eight years has fundamental tax reform in Canada been undertaken in an open, comprehensive, and logical way. It was initiated on September 25th, 1962, when the Royal Commission on Taxation was appointed, whose terms of reference were so broad that no aspect of federal taxation was outside its purview.202 The Commission afforded every opportunity to all who wished to present their views about taxation. It received over 300 briefs and heard approximately 700 witnesses in 99 days of public hearings conducted in twelve cities across Canada.203 The Commission assembled a large and competent research staff. After more than four years of intensive study, the Commissioners submitted their six-volume report to the government and it was tabled and released to the public on February 24th, 1967. This was followed by a period of active public debate. Economists and other academics were generally favorably disposed towards the Report, while many practising tax lawyers and accountants were inclined to be more critical, and some were very hostile.

198 On February 19th, 1968, Bill C-193 which was to impose a 5% surtax with a ceiling of $600.00 was defeated. House of Commons Debates, Feb. 19th, 1968, VI, p. 6896.
199 House of Commons Debates, 12th July, 1947, VI, p. 5504.
201 supra, footnote 199.
202 Order in Council P.C. 1962-1334 (25th Sept., 1962) which is reproduced in 1 Report V-VI.
203 1 Report XIII.
The government invited interested parties to submit briefs relating to the Carter Report. The government indicated that it would formulate its proposals for tax reform after studying the Carter Report and the briefs submitted to it. The assault on the Carter Report by some influential lawyers, accountants and businessmen was so vigorous that during 1968, a rather prevalent opinion was that much of the Carter Report would not be implemented. However, in his budget speech of October 22nd, 1968, Mr. Benson announced changes which would tax the life insurance industry in a manner as consistent as possible with other businesses and which would also tax investment income earned on life insurance policies. These amendments to the Income Tax Act were consistent in principle to the recommendations contained in the Carter Report. It was evident that the Carter Report was not destined to gather dust among the ranks of many Royal Commission Reports which remain unimplemented.

It was intended that the government's proposals for tax reform would be embodied in a draft bill. Mr. Benson said: "It is this draft, suitably revised and explained which will be placed before the house, provincial ministers, and the public for detailed study and discussion early in the new year." The Minister was overly optimistic about the speed at which tax legislation could be drafted. Thus, instead of a draft bill emerging early in 1969, a White Paper was published late in 1969. The White Paper described in a lucid but general way the government's proposals for tax reform. The government endeavored to distribute the White Paper as widely as possible.

On November 18th, 1969, the Senate authorized its Standing Committee on Banking, Trade and Commerce to examine and report upon the White Paper and on December 18th, 1969 the House of Commons referred the White Paper to its Standing Committee on Finance, Trade and Economic Affairs. The public was invited to submit briefs and appear before both of these committees. Mr. Benson was the first person to appear before the House Committee. He stated that: "We are being completely open with respect to making changes in tax reform. We are willing to change any proposals that are in the White Paper if the government can be convinced. Largely, I would think it would come through the work of the committee that proposals should be changed." The Senate Committee in thirty-one meetings heard 118 briefs

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205 Ibid., p. 1685.
from companies, organizations and individuals and received 225 additional briefs in which no appearance was made before the Committee.\textsuperscript{207} The Commons Committee held a total of 146 meetings and heard 211 briefs presented by 820 individuals.\textsuperscript{208} A subcommittee of the Commons Committee travelled to the Atlantic and the Western provinces to hear submissions. The Committee also received 313 briefs in which no appearance was made and in addition 1,093 letters and other submissions. The \textit{Reports} of the Senate and the Commons Committee were tabled in September and October, 1970 respectively. The recommendations of the two Committees differ markedly. The Commons Committee recognized that "no tax proposal is exempt from valid criticism in a complex society with multiple objectives"\textsuperscript{209} and for that reason it confined its recommendations to the basic framework of the \textit{White Paper} proposals. The Senate Committee, however, rejected much of the \textit{White Paper} framework and stated that: "Equity and justice do not necessarily require undue experimentation and utopian dalliance."\textsuperscript{210}

The Senate Committee evolved different proposals based on the premise that there should not be fundamental reform but rather the amending of the present Income Tax Act. If there had been no Carter \textit{Report} and no ensuing public debate about tax policy, the Senate Committee's \textit{Report} might have been an influential document, but time has passed it by and only the Commons \textit{Report} is likely to have much impact in determining government policy. The Minister of Finance, Mr. Benson, has stated that he hopes to have the tax reform bill completed and ready to present to the House of Commons in the spring of 1971. He also hopes that the bill will be passed before Parliament adjourns for the summer recess. The Minister believes that this will afford the provinces sufficient time to amend their income tax Acts so that the new system can be made effective beginning January 1st, 1972.\textsuperscript{211}

The Canadian approach to the formulation of tax policy has undergone a remarkable change. Formerly, tax policy was the sole and secret preserve of the Minister of Finance, his cabinet colleagues, and the senior officials of the Department of Finance. However, since the appointment of the Royal Commission in 1962, Canadians have been invited and encouraged to participate in the formulation of tax policy to a greater extent than in probably any other country in the world. The emphasis which has been placed on participatory democracy in an area as complex as taxation does

\textsuperscript{207} Senate Report, p. 9.  
\textsuperscript{208} Commons Report, p. 5.  
\textsuperscript{209} \textit{Ibid.}, p. 8.  
\textsuperscript{210} Senate Report, p. 49.  
\textsuperscript{211} Dept. of Finance News Release, Oct. 28th, 1970, at pp. 4-5.
involve certain risks. Vocal minorities through misleading statements and irrational criticism can engender powerful political pressure. The Minister of Finance and members of Parliament have become the target of national advertising campaigns against the White Paper. It remains to be seen what impact this will have on the government.

The new approach to tax reform does appear admirable. This approach is grounded on two basic elements: firstly, a detailed and fundamental study of the tax law which produces a coherent and consistent set of recommendations for reform; and secondly, full public participation in both the initial study and in the assessment of the recommendations for reform. The result will not be a perfect tax system but it should be a much more equitable and rational system than the system which we now have.