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Significant Developments in Canadian Taxation

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1962 TO DATE has either been a particularly good year or a particularly bad year in Canada in so far as significant taxation developments are concerned.

If one is of the view that few developments are desirable, then 1962 has been a good year; if, however, one is of the view there is always room for improvement in taxing statutes, and this would appear to be the more appropriate view, then 1962 has been a particularly bad year.

Before getting into the detail, I propose to describe the procedure by which Canadian taxing statutes are amended. My purpose for doing this is two-fold: firstly, to give you an opportunity to compare the procedure with that in the United States, and secondly, it will make some of my later comments more meaningful.

I will not burden you with the steps employed in the various Governmental Departments' facilitating a pronouncement to the Public, but rather will start at the point where those steps have been completed.

Around April of each year, there is considerable anxiety in Canada while the Budget Speech is awaited. The main purpose of the Budget Speech is to enable the Minister of Finance to present the financial position of the Government and to propose any changes in the tax rates deemed necessary to sustain that financial position. It includes a comprehensive survey of the financial and economic state of the nation and is used frequently as the vehicle for making announcements affecting government financial or economic policy. It sums up the position for the last fiscal year and provides a forecast of the probable position in the year ahead.

To facilitate study by the Committee of Ways and Means, it being a policy that all money bills are considered in Committee before being enacted into law, the tax changes proposed in the Budget Speech are submitted in resolution form. There is a separate resolution for each taxing act to be amended, with the individual paragraphs of the resolution detailing the proposed changes. They do

not necessarily contain every change that the Minister will submit, but as a general rule tax increases and other major changes are set forth. Many items of lesser importance are left to be dealt with in the amending bill introduced after the resolutions are adopted.

The first opportunity for debating the resolutions takes place when the Minister of Finance passes the motion that the resolutions go to Committee of Ways and Means. Generally the members of the Opposition are responsible for most of the debating. A period of several days or weeks is often occupied in intermittent debate on the motion, although the total time spent on it may not exceed eight days under the present rules of the House.

With the passage of the Minister's motion (if it were not passed, the Government would fall for lack of confidence), the opportunity for debating the specific resolutions arises.

When the resolutions have been approved by the Committee of Ways and Means, a report to this effect is made to the House. Introduction of the amending bills then follows with a separate bill being introduced for each taxing Act to be amended. Here again the procedure is designed to give ample opportunity to consider the Government's proposal in that each bill must be read three times. A full discussion may take place on second reading but because the resolutions are usually subjected to extensive debate, further discussion at the 'bill' stage is limited.

After the bill has been given its third reading in the House, it goes to the Senate for its approval. The Senate's approval is usually perfunctory although occasionally minor changes are suggested. The amending bills become an Act of the Parliament of Canada when Royal assent has been given by the Governor General.

With the foregoing as background, the Minister of Finance introduced on April 10, 1962, through his Budget Speech, resolutions affecting income taxes, estate taxes, and excise or sales taxes.

On April 19, 1962, Parliament was dissolved in order to prepare for a general election so there was no opportunity to debate the resolutions. With the return of the former Government to office, it is anticipated they will re-introduce the resolutions; this has not yet been done as Parliament did not re-convene until late September. Since the resolutions are given the effect of law pending their passage, they will probably be effective as of the date originally indicated when finally enacted.

With reference to the resolution affecting income taxes, there

are two parts which can be regarded as being significant. The first part offers a tax reduction as an incentive to increase sales.

The proposed tax reduction is confined to companies whose principal business is manufacturing or processing and is to take the form of a tax credit on the portion of taxable income attributable to increased sales.

Taxable income attributable to increased sales is to be determined by comparing the gross sales of the current year with the average gross sales of a base period. For the first year of the plan, that is the company's first year ending after April 1, 1962, the base will be the gross sales of the previous year. In the following year, the base will be the average sales of the two previous years. After that the base will be the average sales for the three previous years.

The amount by which current sales exceed the average sales for the base period is expressed as a percentage of sales for the current year and this percentage is used to determine the portion of taxable income for the year attributable to increased sales.

For example, if the average sales of the base period were \$800,000 and current sales were \$1,000,000, one-fifth of the taxable income for the current year would be regarded as attributable to increased sales; this would be so even though profits had not increased. This is deliberate since the objective is to encourage increased production.

Having determined the amount of taxable income attributable to increased sales, the Federal tax on the first \$50,000 of this amount is to be reduced by 50% and the balance by 25%. It is understood that the tax on the taxable income attributable to increased sales is to be determined at marginal rates. In other words, if a company has a total taxable income of \$40,000, of which \$35,000 is subject to tax at the low rate and \$5,000 at the high rate, the tax on the first \$5,000 of taxable income attributable to increased sales will be based at the high corporate rate of tax, rather than at average rates.

The tax subject to the credit is to be based on the net Federal rate, i.e., after deducting the Provincial tax credit. For provinces other than Quebec, these rates are 12% on the first \$35,000 of taxable income and 41% on the balance. For income earned in Quebec, the rates are 11% and 40%.

Based on a December 31st year end, the following illustration will serve to summarize this part:

Sales for the base period—year ended December 31, 1961	\$ 800,000
Sales for the year ended December 31, 1962	<u>1,000,000</u>
Increase in sales	<u>\$ 200,000</u>

Increase in sales expressed as a percentage of sales for the year ended December 31, 1962	20%
Taxable income for the year ended December 31, 1962	\$ 50,000
Taxable income attributable to increased sales—20% of \$50,000	\$ 10,000
Federal tax on last \$10,000 of taxable income @ 41%	\$ 4,100
Tax credit for increased sales—50% of \$4,100	\$ 2,050
Less: Reduction in credit for portion of year prior to April, 1962—	
$\frac{90}{365} \times \$2,050$	505
Amount of credit	<u>\$ 1,545</u>

The second part offers a tax reduction as an incentive to increase expenditure on scientific research.

As of 1961, it became possible to claim as an expense deduction in the year of outlay, current and capital expenditures on account of scientific research. Early in 1962, the Government announced that it would contribute towards applied research and development projects. As a further incentive, it is proposed that to the extent corporations increase their expenditure on scientific research in Canada, such increase will be deductible in the computation of taxable income at 150% of the actual amount of increase. This proposal is to be effective for the year in progress at April 10, 1962, and the following four years.

The 150% deduction will apply to the excess of current and capital expenditures on scientific research in Canada in each of those years over the amount expended in the last year ended before April 10, 1962. Thus, the base against which future expenditures will be measured is fixed rather than a moving average as in the case of the tax credit for increased sales.

There has been no indication as to the specific types of research that will qualify for this treatment; however, programmes which are subsidized by the Government as well as expenditures relating to sales promotion, such as market research and surveys of customer acceptance, have been specifically excluded. It is intended that payments to Universities and approved institutions and associations in Canada to have research carried out will qualify.

The remaining parts of the resolution affecting income taxes are not as significant by comparison as the proposals for production incentive and scientific research in that they do not have as wide an application.

Briefly, these are as follows:

PERSONAL INCOME TAXES

1. Commencing with 1962, the personal exemption for children qualified for family allowance is increased to \$300.00 and for other dependents to \$550.00.

2. Individuals engaged in exploring or drilling for petroleum or natural gas will be entitled to deduct all such expenditures incurred after April 10, 1962, to the extent of income from that source.
3. Contributions into deferred profit sharing plans and registered retirement savings plans are transferable to new plans without incidence of tax.

CORPORATION INCOME TAXES

1. To further encourage the exploitation of Canada's oil, gas and mineral resources, it is proposed that all companies will be entitled after April 10, 1962, to deduct prospecting, exploration and development expenses incurred in searching for minerals, petroleum or natural gas in Canada in amounts not exceeding the income from those sources.

It is further proposed that after April 10, 1962, amounts paid for a right, license or privilege to explore for petroleum or natural gas in Canada shall be classed as drilling or exploration expenses for deduction purposes. On the disposition of such property, the consideration received therefor will be income.

2. Two of the more significant developments in 1961, which I dealt with last year, pertained to accelerated depreciation.

You may recall that there are two separate situations under which depreciation acceleration is available:

- (i) Assets that are acquired to manufacture products new to Canada or new to designated surplus man-power areas.
- (ii) Asset additions in excess of a prescribed base; this latter provision is known as the re-equipment and modernization allowance.

Both of these provisions were introduced for a limited period expiring as of the end of 1962 and March 31, 1963, respectively; the period of application for both has been extended one additional year.

Turning to developments outside the proposals contained in the Budget Speech, the following may be of interest:

FEDERAL-PROVINCIAL RELATIONSHIPS

Under Canada's Constitution, namely the British North America Act of 1867, the Provinces of Canada were given certain powers including the right to impose direct taxes within the Province.

For the period 1957 to the end of 1961, each of the Provinces with the exception of Ontario and Quebec rented their rights to impose income taxes and Succession Duties to the Federal Government. Ontario retained its right to impose corporation income taxes. As rental consideration, the Provinces received a share of the amounts collected by the Federal Government.

Because the Provinces put up such a continual clamour for a larger share of the amounts collected by the Federal Government, the Federal Government decided that the Provinces should be given the opportunity to impose their own taxes. Accordingly the rental agreements were not extended, with the result each of the Provinces, as of 1962, have re-entered the taxation fields previously rented to the Federal Government.

This has not complicated the Canadian taxing scene as much as one might expect in that simultaneously with the expiry of the Federal-Provincial rental agreements, the Federal Government entered into new agreements with all Provinces, again with the exception of Ontario and Quebec, whereby the Federal Government acts as collecting agent for the Provincial taxes. One of the significant terms of these agreements is that the Federal and Provincial tax bases will be identical.

This means that as of January 1, 1962, the Federal corporation tax return serves as the Provincial return for all provinces other than Ontario and Quebec. A revised form has been made available for this purpose.

The rates of Provincial tax are 9% with the exception of Manitoba and Saskatchewan at 10%, Ontario at 11% and Quebec at 12%. The Federal credit for Provincial taxes is 9% except for Quebec at 10%.

The rules relative to income allocation remain unchanged in that a permanent establishment must exist in a jurisdiction before income is allocable thereto. To determine the amount of income allocable to a particular permanent establishment, a formula calculation based on sales and wages is applied.

Similarly as of January 1, 1962, the Federal individual tax return will be a joint Federal-Provincial return for all provinces with the exception of Quebec.

Except for Manitoba and Saskatchewan, there will be no increase in the rates of personal tax as a result of the Provinces re-entering the field. The Provincial tax is a certain percentage of the Federal tax, commencing at 16% in 1962 and increasing 1% per year to 20% by 1966. The Federal percentage will decrease by an amount equal to the Provincial increase. In Manitoba and Saskatchewan there is a 6% over-all increase in personal rates.

Quebec continues to impose and collect its own personal income taxes.

ROYAL COMMISSION ON TAXATION

A recent development of major significance undertaken by the Federal Government has been the establishment of a Royal Commission on Taxation. The Commission consists of six members, two of whom, including the chairman, are chartered accountants.

Among other things, the Commission is to consider and report on the distribution of burdens among taxpayers; the effect of the tax system on employment, living standards, investments, industrial productivity and economic growth; anomalies or inequities of the tax system and tax avoidance devices; the effect of taxes on income and investment flow affecting balance of international payments and economic relations with other countries; means of formulating the tax laws so as to encourage Canadian ownership of industry; changes to be made in order to achieve clarity, simplicity and effectiveness in the tax laws.

The taxes to be investigated are not only the income taxes (both individual and corporation taxes) but also the estate taxes, and sales and excise taxes.

Based on this scope, Canadian representatives at this meeting in years to come should have a rather easy time in bringing you developments of interest.

CANADA'S AUSTERITY PROGRAMME

I should like to preface my comments on this subject by inserting that I am no economist and my remarks are based strictly on my understanding of the situation.

Canada has incurred a deficit in its balance of international payments for the last nine consecutive years and has incurred Federal budgetary deficits for the last five consecutive years. This combined

deficit of some eleven billion dollars has in the main been offset by a large inflow of foreign capital.

Around the middle of 1961, the inflow of foreign capital began to diminish with the result the deficiency in the balance of payments was no longer being covered by capital inflows. Canadian importers began to cover their foreign exchange needs for longer periods while exporters deferred the conversion of their sales proceeds with the result a net withdrawal of capital began. European and especially British investors pressed sales of investments in Canada, converting their proceeds into other currencies. United States investors began to withdraw some capital but on a modest scale in relation to their total investments. The accumulation of capital withdrawals, added to the current payments deficit, finally assumed the proportions of a run on the Canadian dollar.

According to official figures, Canada's foreign exchange reserves declined by almost one billion dollars between December 31, 1961 and June 24, 1962, the date the Government announced its austerity programme.

The first measure in the austerity programme was to impose a surcharge on certain classes of imports covering approximately one-half of Canada's total imports. The imports exempt from surtax consist in the main of basic foodstuffs, raw materials, industrial components and agricultural machinery which either enter directly into the costs of Canadian production or are highly essential for other reasons, or enter directly into the cost of living of the average Canadian.

The classes of imports subject to a surcharge of 5% or 10% consist of imports of a less essential nature or for which surplus capacity exists in Canada or for which alternative Canadian products are available.

The class of import subject to a surcharge of 15% consists of luxury items.

The surcharge applies to imports from all countries except a few countries to which the general tariff rates already apply. The trade with these latter countries is stated to be very small.

The second measure in the austerity programme relates to the tourist exemption under which Canadians travelling abroad are allowed to bring items into Canada duty free. The exemptions have been lowered to \$25.00 three times a year in the case of purchases in United States and in the case of overseas visitors, \$100.00 once a year.

The third and final measure in the austerity programme relates to decreased Governmental spending.

It is hoped that the combined effect of the foregoing measures will reduce the current deficit by \$450,000,000 and reduce the deficit in international payments by \$300,000,000.

The Prime Minister in his pronouncement stated that the Government is determined to defend the foreign exchange value of the Canadian dollar at 92½ cents U.S. He further stated that it is the Government's intention to continue to maintain a climate in Canada hospitable to foreign investment, that the Government will not be imposing any exchange controls and that the measures described above are temporary and will be removed as soon as circumstances permit. In this latter regard, the Government announced last week the removal of the surcharge on certain items.

As at the end of September, 1962, Canada's foreign exchange reserves have increased from the low point of \$1.1 billion in June, 1962, to a figure in excess of \$2.4 billion. Of this increase, approximately one-half represents financial assistance received from the International Monetary Fund. The normal range of the foreign exchange fund in the past has been between \$1.8 billion and \$1.9 billion.

THE CORPORATIONS AND LABOUR UNION RETURNS ACT

This Act, which is yet to be proclaimed in force, was enacted in April, 1962.

Its purpose is to provide the Dominion Statistician with financial and other statistical information relating to the affairs of corporations and labour unions carrying on business in Canada.

The Act is stated to have application to all corporations authorized to carry on business in Canada, but as usual, there are exceptions to its application. The exceptions include banks, insurance companies, loan companies and companies whose gross revenue and assets within Canada do not exceed certain amounts. The Act would appear to have application to foreign incorporated companies that are authorized to carry on business in Canada.

The information required of corporations is divided into two sections. Section A includes all the basic statutory information such as corporate name, jurisdiction of incorporation, details of capital stock, names of directors, etc. This information is available to the Public for a nominal inspection fee. Section B includes complete

financial information including a copy of the auditors' report. This latter information is not to be available to the Public under any circumstances.

Although stipulated to have application to 1962 fiscal periods, the fact that the Act has not yet been proclaimed in force makes it uncertain when the initial filing will take place.

To conclude I reiterate, on behalf of all the Canadian offices of D. P. H. & S., the invitation to be of assistance to you in any Canadian tax problems that arise in your practise.

