THE SMALL BUSINESS DEDUCTION AND A CANADIAN TAX ON UNREASONABLE ACCUMULATIONS

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ABSTRACT

In its treatment of "small" business at the time of Tax Reform, the government of the day chose not to attempt to achieve the ephemeral goal of strict adherence to concepts such as neutrality and horizontal equity. On the contrary, in implementing the "small business deduction" for Canadian-controlled private corporations its stated intention was to provide "direct assistance to small business" — but only to incorporated small business. Conventional wisdom justifies such a policy of providing assistance to small business on the theory that in the absence of special tax concessions (or other assistance) for small business imperfections in the capital markets, which are alleged to reduce significantly the funding available to small business, would limit the ability of small business to fulfil what is seen by adherents to this theory to be its traditional entrepreneurial role in the Canadian economy.

The thesis proposed herein does not attempt to assess the validity of a policy of providing assistance to small business through fiscal measures (assuming that it does in fact exist) but rather focuses on a potential inefficiency inherent in one aspect of its (apparent) implementation: there is presently no control mechanism to ensure that the funds made available to incorporated small business through the "small business deduction" are used in furtherance of the purported goal of this tax credit, i.e. "direct
assistance to small business." It is suggested in this thesis that the restoration of some form of tax on unreasonable accumulations to replace the departed Part V tax would provide appropriate pressure upon the Canadian-controlled private corporation in terms of guiding the tax deferral benefits available through the small business deduction towards their stated object. Such a tax would, of course, have the complementary function of depriving those corporations which failed to reinvest the deferral benefits of same.

Chapter one of the thesis introduces the topic and defines its basic parameters. As a means of laying a foundation for exploring the suggestion that a tax on unreasonable accumulations may be desirable, chapter two reviews the relevant statutory context into which such a tax would have to be placed. Chapter three considers aspects of the justification for such a tax. In the interest of learning such lessons as history might offer in this realm, chapters four, five and six examine specific variations on such a tax which have already found expression in legislative form: chapter four dealing with Canadian experiences in this area, chapter five looking at the American example and chapter six reviewing its British manifestation. Chapter seven analyses the possibilities as to the form which a tax on unreasonable accumulations might in fact take were it to be instituted in Canada. Finally, chapter eight contains some conclusions.
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THE SMALL BUSINESS DEDUCTION AND A CANADIAN TAX ON UNREASONABLE ACCUMULATIONS

"Once the decision is made to tax a corporation as a separate entity, the virtually insoluble problem of how to achieve total neutrality ... is posed." 1

Chapter 1

Statement of the Problem

In this thesis, the potential problem of "unreasonable accumulation" by a Canadian-controlled private corporation of that portion of its profits taxed at the small business rate will be examined. It will be suggested that in the context of the small business deduction, an accumulation becomes "unreasonable" when it is not reinvested in the business of the corporation.

Reference will be made herein to the very basic concepts of neutrality, horizontal equity and vertical equity. While these terms are obviously capable of carrying varying shades of meaning, for present purposes the meanings ascribed to them in the Report of the Royal Commission on

Taxation\textsuperscript{2} chaired by the late Kenneth LeM. Carter will be used. Thus, a taxation system is said to be neutral when it does not change the allocation of resources in the private sector as compared to the allocation which the forces of the market place would produce in the absence of taxes.\textsuperscript{3}

Neutrality is said to be desirable because:

\textldots the allocation of resources in response to free market forces will in general give in the short run the best utilization of resources, and in the long run the most satisfactory rate of increase in the output of the economy.\textsuperscript{4}

Horizontal equity exists when:

\ldots individuals and families in similar circumstances bear the same taxes.\textsuperscript{5}

Vertical equity exists when:

\ldots those in different circumstances bear appropriately different taxes. \ldots vertical equity is achieved when individuals and families pay taxes that are a constant proportion of their discretionary economic power.\textsuperscript{6}

In the view of the Carter Commission, equity was of fundamental importance - as seen in the following passage from the Commission's Report:

If equity were not of vital concern taxes would be unnecessary. The state could simply commandeer what it needed. \ldots Unless the allocation of the burden is generally accepted as fair, the social and political fabric of a country is weakened and can be destroyed.\textsuperscript{7}

\textsuperscript{2} This paper will follow the common practice of referring to the Commission itself as the Carter Commission and the report of the Commission as the Carter Report.

\textsuperscript{3} Canada, Report of the Royal Commission on Taxation (Ottawa, Queen's Printer, 1966), vol.2, chapter 1, p. 8.

\textsuperscript{4} Loc. cit.


\textsuperscript{7} Loc. cit.
When using the terms "neutrality" and "horizontal equity," in the context of corporate taxation, it is immediately obvious that they are very closely intertwined. If the use of a corporation as an intermediary between an income source and its indirect owner, the shareholder or shareholders of that corporation, provides an advantage insofar as the incidence of tax is concerned when compared to direct ownership of that same income source by an individual or individuals, then horizontal equity does not exist—individuals in essentially "similar circumstances" do not "bear the same taxes." This "inequity" in turn would tend to change the allocation of resources in the private sector as compared to the allocation which the forces of the market place would produce in the absence of taxes by providing a fiscal incentive for incorporating a business; in other words, this "inequity" would result in a taxation system which would not be neutral. Conversely, of course, one manifestation of a policy of neutrality would occur where the use of a corporation as an intermediary between an income source and its indirect owner, the shareholder or shareholders of that corporation, provided neither advantage nor disadvantage insofar as the incidence of tax was concerned when compared to direct ownership of that same income source by an individual or individuals.
In its treatment of "small" business at the time of Tax Reform the government of the day chose not to attempt to achieve the ephemeral goal of strict adherence to concepts such as neutrality and horizontal equity. On the contrary, in implementing the "small business deduction" for Canadian-controlled private corporations its intention was to provide "direct assistance to small business" - but only to incorporated small business. This policy of providing assistance to small business - assuming that it exists not only in public pronouncements but also in substance (as

8. This paper will follow the common practice of referring to the process commencing with the creation of the The Royal Commission on Taxation and terminating with the passage of the Income Tax Act of Canada, S.C. 1970-71-72, c. 63, as Tax Reform.

9. Honourable E.J. Benson, Minister of Finance, Summary of 1971 Tax Reform Legislation, Ottawa, Queen's Printer, 1971, p. 37. This restriction of the small business deduction to incorporated small business was apparently based upon the fact that the finances of the corporation are (or should be) clearly segregated from those of its shareholders whereas those of the sole proprietor would not necessarily be. The advantage from the government's perspective of segregated finances was apparently that this state of affairs would facilitate the use of the cumulative deduction account as a device for targeting the small business deduction to "small" business. (See on this point: Kathleen A. Lahey, "The Small Business Credit: A Tax Expenditure Analysis," Canadian Taxation (Summer, 1979) pp. 29-34 at p. 30.) In his budget speech, the Minister of Finance commented that it had been his "hope that a system might be developed to aid unincorporated as well as incorporated business" but that "all the proposals were found to be unworkable. (See: Canada, Parliament, House of Commons, Official Report of Debates, 3rd Session, 28th Parliament, Ottawa, Queen's Printer, vol. VII, 1971, p. 6897.)
appears to be the case)\textsuperscript{10} – is not a recent development in this country. In announcing the dual rate corporate tax regime which the "small business deduction" replaced, the Honourable D.C. Abbott, Minister of Finance at that time, described its implementation as being motivated by the belief that:

\[\ldots\text{small businesses should be encouraged and}\ldots\]
\[\text{a useful way to do this is to lower the tax and take less out of the funds they need for growth and expansion}.\textsuperscript{11}\]

Conventional wisdom justifies such a policy on the theory that in the absence of special tax concessions (or other assistance) for small business imperfections in the capital markets, i.e. biases towards relatively low risk investment in large established firms and away from greater risk in new and small businesses, which biases are alleged to reduce significantly the funding available to small business, would limit the ability of small business to fulfil what is seen by adherents to this theory to be its traditional entrepreneurial role in the Canadian economy.\textsuperscript{12}

\textsuperscript{10.} See below at pp. 31 – 36 for discussion regarding the evidence, as manifested in the small business deduction, tending to establish that such a policy does, in fact, exist. It should be noted also, however, that the contrary has been asserted by, inter alia, J.E. Hershfield in an article entitled "Is an Unintegrated Corporate Tax Regime a Small Business Subsidy?" which appeared in \textit{Canadian Taxation} (Winter, 1979) at pages 51-53 and Wolfe D. Goodman in an article entitled "The Small Business Credit: A Critique of the Proposed Changes" which appeared in \textit{Canadian Taxation} (Summer, 1979) at pages 38-39.


\textsuperscript{12.} This view is most clearly articulated in the Carter Report, vol. 4, pp. 271-272, but is implicit in the statements of Messrs. Abbott and Benson found above.
The thesis proposed herein does not attempt to assess the validity of the policy of providing assistance to small business through fiscal measures (again, assuming that it does in fact exist) but rather focuses on a potential inefficiency inherent in one aspect of its (apparent) implementation: there is presently no control mechanism to ensure that the funds made available to incorporated small business through the "small business deduction" are used in furtherance of the purported goal of this tax credit, i.e. "direct assistance to small business."

When the small business deduction came into force in 1972, there were two control devices which sought to direct it towards its goal. These were:

1. Part V tax - a refundable tax in respect of ineligible investments; and

2. the "total business limit" which terminated eligibility for the "small business deduction" when "retained earnings"\(^{13}\) reached $400,000.

The Part V tax was repealed shortly after coming into force with its repeal having application retroactively to 1972.\(^{14}\) It was never replaced. The concept of the total business limit remained a part of the small business tax system until 1984. At the time of its disappearance, it had grown in size to $1,000,000.

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13. Retained earnings that is as determined by the formula prescribed by the Income Tax Act of Canada (paragraph 125(6)(b)) defining the content of the "cumulative deduction account". To equate the cumulative deduction account to retained earnings is, of course, to simplify in the extreme, but for present purposes such a definition seems adequate.
It is submitted herein (for reasons which will be explored in chapter three of this thesis) that elimination of the total business limit, in itself, has created a need for the development of an alternate method of guiding the fiscal advantages available through the small business deduction towards their intended target of assisting business— as opposed to providing a potential source of funds for passive investment. It is further submitted that the new exemption from tax of certain capital gains and, if it becomes law, the proposed reduction in corporate tax rates greatly intensify that need. One such method, it is suggested, would be the restoration of some form of tax on unreasonable accumulations to replace the departed Part V tax.

From the inception of the small business deduction, it has been the intention that funds made available to the "small business" corporation through this device be reinvested in the corporation's business. That policy appears to have retained its status as the justification for the small business deduction notwithstanding the elimination of the total business limit. The enactment at this time of a new measure designed to ensure that only businesses

15. Statements to this effect can be found in the two most recent federal budgets. See: Honourable Marc Lalonde, Minister of Finance, Simplifying Taxes For Small Business, Canada, Department of Finance, Ottawa, Queen's Printer, 1984, at p. 1 and The Honourable Michael H. Wilson, Minister of Finance, The Corporate Income Tax System A Direction for Change, Canada, Department of Finance, Ottawa, Queen's Printer, 1985, at p. 25.
fitting within some arbitrary definition of the term "small" be given the right to benefit from the small business deduction might prove to be politically difficult. Whatever its form, in view of the recentness of the repeal of the concept of the total business limit, it could be seen as a mere restoration of this latter device and, thereby, as merely "another" example of a government "retreating" on its policy initiatives - presumably an unpalatable option. On the other hand, no such complaint could be made of a measure designed to ensure that a policy of making funds available for business purposes was successfully implemented. A legislative device designed to encourage attainment of that policy would seem to be in order. As one author has put the matter:

... as the total business limit increased [sic], the application of a low rate of corporate tax becomes less acceptable without further target controls, such a a Part V-type tax.16

If an increase in the total business limit makes the absence of some form of tax on unreasonable accumulations "less acceptable," a fortiori, the absence of any such limit whatsoever makes the case for such a tax very compelling indeed.

16. "Another" in the sense that the government was recently accused of "retreating" when it decided to drop its budget proposal of "de-indexing" pensions. See for example: The Financial Times (Canada), vol. 74, no. 2, July 1, 1985, p. 1. While the elimination of the total business limit was originally suggested in the 1984 Budget of Mr. Lalonde, in the final analysis it was the new Conservative government which actually passed the legislation doing away with it.

As a means of laying a foundation for exploring the suggestion that a tax on unreasonable accumulations may be desirable, chapter two will review the relevant statutory context into which such a tax would have to be placed. Chapter three will consider aspects of the justification for such a tax. In the interest of learning such lessons as history might offer in this realm, chapters four, five and six will examine specific variations on such a tax which have already found expression in legislative form: chapter four dealing with Canadian experiences in this area, chapter five looking at the American example and chapter six reviewing its British manifestation. Chapter seven will analyse the possibilities as to the form which a tax on unreasonable accumulations might in fact take were it to be instituted in Canada. Finally, chapter eight will contain some conclusions.
Chapter 2

The Statutory Context

As a prelude to proposing a legislative amendment, it would seem appropriate, as a means of providing a foundation upon which to build the structure of that amendment, to describe - at least in a summary fashion - the context into which the amendment will be inserted. This chapter constitutes that foundation.

As a result of the activities of the Carter Commission and of the extensive canvassing of public opinion which followed the release of its report, the taxation regime applicable to the Canadian-controlled private corporation was significantly modified when the amendments to the Income Tax Act of Canada¹ resulting from Tax Reform finally came into force on January 1, 1972. As these amendments form the basic framework of our present system for taxing the income of the Canadian-controlled private corporation, this date provides a convenient point of departure for describing the statutory context into which it is proposed that a tax on unreasonable accumulations be placed.

¹. The Income Tax Act of Canada is hereinafter referred to as the "Act."
The taxation scheme applicable to the private corporation which came into effect in 1972 was not an independent code without relation to other provisions of the Act, but rather was supplementary to those provisions. Thus, whatever the income source, it was assessed to tax in the first instance at the full corporate rate\(^2\) (capital gains being, of course, an exception in that only the taxable half thereof was so taxed)\(^3\) - initially pegged at 50% but declining at one per cent each year through to 1976 when it reached its present rate of 46%\(^4\).

At its inception, the "new" legislative scheme envisaged four seemingly distinct "income" sources\(^5\) for the Canadian-controlled private corporation:

1. active business;
2. business other than active business;
3. property; and
4. capital gains.

2. The Act, s. 123.
3. Technically and legally, of course, it is not accurate in the Canadian context to call a capital gain a "source" of "income" but for present purposes the technical and legal distinction between a capital gain and income will be ignored.
4. This thesis will adopt the common practice of assuming the combined federal and provincial tax rate to be equal to the federal rate as it would be were it not for the abatement in respect of taxable income earned in a province provided for in sub-section 124(1) of the Act.
5. As a result of the interaction of sections 125 and 129 of the Act.
In keeping with the principle of neutrality, "integration"\(^6\) of corporate and personal income tax was to be an important feature of this scheme.

In this new system, only the income which the Canadian-controlled private corporation derived from an "active business" would receive the "assistance" (or, more accurately, tax credit) provided by the "small business deduction" which reduced its effective tax rate to 25\%.\(^7\)

The principle of integration was preserved in this situation\(^8\) in that upon distribution of its income by the corporation to its shareholders the total amount of income tax paid by both the corporation and its shareholders was essentially equal to the amount which would have been payable had the business been owned by a sole proprietor rather than a corporation.\(^9\)

As of 1972, the income (other than dividend income) of the Canadian-controlled private corporation from sources other than active business would be taxed at the full

\(^6\) While it is probably unnecessary to do so in light of the extensive use of the term, the purpose of this footnote is to confirm, in the interest of eliminating possible ambiguity, that the term "integration" is used herein in the sense attributed to it in the Carter Report: "... a full credit ... for the underlying corporation tax, the integration of corporation and personal income taxes." (vol. 1, p. 7.)

\(^7\) Subsection 125(1).

\(^8\) The statement that "integration was preserved" overlooks, of course, the potentially significant advantage of deferral about which more will be said in the following chapter.

\(^9\) Assuming – as is the custom in this sort of analysis – that the marginal rate of the sole proprietor in question was 50\%.
corporate rate and, upon payment of dividends, the company would be eligible for refundable dividend tax treatment under Section 129 of the Act. The refundable dividend tax mechanism was designed to prevent deferral or double taxation with respect to income subject to its provisions. Deferral was prevented (in theory) by the fact that the income was taxed upon its receipt by the corporation at the full corporate rate - rather than at the lower small business rate. By refunding to the corporation an amount sufficient to reduce its effective rate of tax to 25% when it paid dividends, the refundable dividend tax system prevented double taxation - the total amount of income tax paid by both the corporation and its shareholders was essentially equal to the amount which would have been paid by the shareholders alone.

10. In fact, of course, given that for the first decade of the existence of the refundable dividend tax system the top marginal rates applicable to individuals exceeded the full corporate rate, the refundable dividend tax did not totally eliminate the deferral advantage during that period. When the 1981 Budget decreased the top marginal rate applicable to individuals to approximately the level of the full corporate rate, the ability of the refundable dividend tax to fulfil its intended role was greatly improved.

11. In fact:

[The basic federal corporate rate ... was 50 per cent in 1972. A refundable tax at 25% of investment income therefore resulted in an effective corporate rate of 25 per cent, and this was fully offset by the dividend tax credit. The federal rate, however, was reduced ... to a 46 per cent rate by 1976. No corresponding reduction was made in the rate at which refundable tax was earned. In theory, overintegration resulted. (Thomas E. McDonnell, "The Taxation of Investment Income of Private Corporations and Personal Services Business Income," Report of Proceedings of the Thirty-Fourth Tax Conference, Toronto, Canadian Tax Foundation, 1982, pp. 103-147 at p. 112.)]
payable had the income source been owned by an individual rather than by a corporation.

Under Part IV of the Act, the dividend income of Canadian-controlled private corporations (other than dividends received from controlled corporations which generally speaking were received tax free) was subjected to a refundable 33 1/3% tax. The effect of this tax was to make the total tax paid (by both the payer and the recipient of the dividend) on the income from which the dividend was derived equivalent to the total tax which would have paid by both payer and recipient had the recipient been an individual taxable at a marginal rate of 50%. This refundable Part IV tax was considered to form part of the refundable dividend tax on hand of the recipient corporation.

It was intended, of course, that only "small" incorporated businesses be eligible for the "assistance" available by virtue of the small business deduction. In this context, "small" was defined by reference to both the annual profits derived by the corporation from active business - its "business limit" - and the total "retained earnings" derived by the corporation from active business - the "total business limit." Initially, the "business

12. As mentioned in chapter one, the actual formula for measuring the "retained earnings" of the corporation, found in the statutory definition of the "cumulative deduction account" was such as to make the term "retained earnings" an inaccurate one in this context. This question will be dealt with below.
limit" of the Canadian-controlled private corporation carrying on an active business was $50,000. Over the intervening years, this amount has gradually been increased; it is currently, $200,000. The "total business limit" was originally $400,000 and had increased to $1,000,000 when the concept disappeared from the Act in 1984.

The decision to limit eligibility for the small business deduction in terms of the "retained earnings" from active business of the corporation necessitated the inclusion in the Act of provisions which would permit the measurement of same. The mechanism adopted was the "cumulative deduction account" which:

... as originally introduced was comparatively simple. The balance in the account was determined as:

the aggregate of:

1. The corporation's taxable income for taxation years commencing after 1971 plus

2. 4/3 of taxable dividends received from Canadian corporations and foreign affiliates, deducted in computing such taxable incomes;

less the aggregate of:

3. 4/3 of taxable dividends paid by the corporation in those years and

13. Subsection 125(2).
15. Subsection 125(2).
17. SC 1984, c. 45, s. 40.
4. 4 times the amount by which the corporation's refundable dividend tax on hand exceeded its dividend refund. 19

In essence the cumulative deduction account, as initially constituted, consisted of the undistributed active business income of the Canadian-controlled private corporation. Dividend payments were deemed to have been made from refundable dividend tax on hand until such time as amounts in this account were exhausted. Thereafter, for every three dollars of dividend payment the cumulative deduction account would be reduced by four. The effect of this procedure was that, where the corporation's earnings derived from active business had not exceeded its business limit in a particular year, the corporation would have sufficient funds after payment of income tax to reduce the cumulative deduction account by an amount equal to its profits derived from active business for that year by paying dividends in an amount equal to its after tax profits. On the other hand, where the corporation's profits derived from active business for that year had exceeded the business limit, the higher tax rate payable on that portion of its earnings which exceeded the business limit would leave it unable to "clean out" its cumulative deduction account completely with respect to that year's profits and thus, a permanent addition to the account would have been made.

Aside from increases to the amounts statutorily defined as "small" found in the concepts of "business limit" and "total business limit," the first significant amendments affecting the small business deduction came in 1977. The most important of these was the enriching of the dividend tax credit from its former thirty-three and one-third per cent to the rate of fifty per cent. In terms of its effect upon the small business deduction, this change produced what is variously referred to as "overintegration" and "superintegration." In other words:

Because of the increased dividend tax credit, taxpayers earning active business income in a Canadian-controlled private corporation were about 8 percentage points ahead after tax on dividends paid to them out of that active business income than they would have been had they earned an equivalent amount of active business income directly.

This change would play a major role in necessitating other changes in later years — each of which would contribute to the complexity of the small business rules.

Two important changes were also made in 1977 to the method of measuring the value of the cumulative deduction account. The first of these changes was:

... intended to encourage substantial minority participation by corporations in Canadian enterprises. To accomplish this, the refundable 25 per cent Part IV tax on dividend income

20. McDonnell, op. cit. at p. 117.
received by corporations was waived for shareholdings in excess of 10 per cent.\textsuperscript{23}

This "waiver" of the Part IV tax when the payer of the dividend was "connected" to the recipient was, however, subject to certain restrictions which, given their very short life-span (as will be discussed below), need not be mentioned here.

The other 1977 amendment affected the method of calculating the amount in the cumulative deduction account. Whereas formerly the determination of the amount in the cumulative deduction account at the end of each taxation year required a fresh calculation by reference back to 1972, after enactment of this amendment:

\[ \text{T}he \text{ closing balance in the account at the end of one year would become the opening balance for the subsequent year and all relevant changes for that year would then be reflected. These amendments, while perhaps intended to simplify the ongoing record keeping for the cumulative deduction account, further complicated the planning considerations for the Canadian-controlled private corporation.} \]

... Where there are timing differences in the recognition of income for accounting and tax purposes ... care has to be taken not to pay out the after-tax accounting income to shareholders before such income is recognized for tax purposes.\textsuperscript{24}

As will be discussed in chapter 3, the mounting complexity of the statutory definition of the term "cumulative deduction account" was cited as a significant contributing factor to the demise of the total business limit.


\textsuperscript{24} Strain, \textit{op. cit.}, pp. 19-20.
By 1978, it had been decided that the restrictions attached to the first of the 1977 amendments were interfering with its ability to achieve its intended goals. Thus, these restrictions on the ability of a corporation to pay a tax free dividend to a recipient corporation with which it was connected were eliminated. In removing these restrictions, however, it was felt to be necessary:

... to prevent such 'exempt' dividends from increasing the amount of business income eligible for the low rate [and so] amendments were also made to prevent the deduction by the payer corporation in determining its [cumulative deduction account] for dividends paid to other non-associated private corporations unless Part IV tax was paid in respect of these dividends. The adoption of this provision permitting only certain so called "qualifying dividends" to reduce the [cumulative deduction account] meant that the concept of the [cumulative deduction account] as a measurement of the retained business earnings of a corporation had been abandoned. .... These provisions raised a whole new set of problems

As the last few words of the above quotation might suggest, these changes were still only the beginning.

By 1978, it had become clear, at least in the government's view, that further changes were necessary to the fiscal regime applicable to small business. Income sources to which it had not been intended to extend the benefits of the small business deduction were nonetheless taking advantage of this tax credit. For example, professionals were incorporating in Alberta and making

extensive use of management companies elsewhere. Others were resigning their positions as salaried employees only to be engaged as the employees of companies which they controlled and which promptly contracted to provide their services to their former employers. Furthermore, the jurisprudence with respect to the meaning of the term "active business" was not evolving in what the Finance Department regarded as the desired fashion as was confirmed by one Minister of Finance, The Honourable J. Chretien, in stating that:

Court rulings have also entitled investment and rental income to this reduced rate. As I have said in my budget speech, it would be unfair to allow such practices to go on ....  \textsuperscript{26}

While Bill C-37, Mr. Chretien's attempt at remedying these problems did not become law, relatively similar amendments were made in 1979 through the passage of Bill C-17. \textsuperscript{27}

Amongst other things, Bill C-17 added to the Act definitions of the terms "active business," "non-qualifying business" and "specified investment business." Given that any business other than a non-qualifying business and a specified investment business was defined as an active business, the latter two of these three definitions were of particular importance. The definition of the non-qualifying business has been paraphrased as follows:

\textsuperscript{27} SC 1979, c. 5.
1) the professional practice of certain defined professionals;

2) the business of providing services if more than 66 2/3[%] of the gross revenue for the year was derived from services provided to one entity ...; and

3) the business of providing managerial and related services to a business connected at any time in the year with the corporation.\textsuperscript{28}

The concept of the non-qualifying business was intended to apply to the professionals and former employees mentioned above. The term "specified investment business" was defined as follows:

... a business ... the principal purpose of which is to derive income from property ....

This definition was intended to encompass those sources of "investment and rental" income referred to by Mr. Chretien.

As was the case prior to the 1979 amendments, following their passage only the income from an "active business" was eligible for the full "small business deduction." Income from a "non-qualifying business" received a lesser "deduction." Income from a "specified investment business" was not eligible for any tax credit although under section 129 of the Act it was eligible for refundable dividend tax treatment.

These new sources of income, taxable at differing rates necessitated further changes in the method of calculating the cumulative deduction account. As a result:

\textsuperscript{28} McDonnell, \textit{loc. cit.}
Keeping track of the [cumulative deduction account] for small business corporations had become a nightmare.

On top of the earlier complexities of segregating qualifying from non-qualifying dividends, a different gross-up function (3/2) was introduced in the calculation of the [cumulative deduction account] to be applied to dividends received and paid by corporations carrying on non-qualifying businesses. .... provisions were also introduced in 1979 to increase the [cumulative deduction account] of non-qualifying business corporations by a factor of 1/8 of the balance in the account at the end of the taxation year prior to the new rules becoming effective. This 'specified addition' was intended to compensate for the larger gross-up. This adjustment was also to be made in circumstances where the status of a corporation changed from active to non-qualifying business.

Should the status of a corporation change from non-qualifying to active business ... a deduction in the [cumulative deduction account] was made at the end of the year in which the corporation ceased to carry on a non-qualifying business equal to 1/9 of the balance in the account at that date.29

The small business tax system in general and the measurement of the cumulative deduction account in particular were becoming increasingly complicated.

With the amendments introduced by the 1981 Budget, the complexity of the fiscal regime within which the incorporated small business operated in Canada reached its apogee. Next would come the demands for simplification. One of the significant changes brought about by the 1981 Budget - the most straightforward - has been mentioned already: the final increase in the total business limit prior to its demise took it to $1,000,000.

The 1981 Budget also brought about the Part II tax. This new tax necessitated insertion of a new definition into the Act: that of the "preferred earnings amount," being income earned after 1982 and taxed at the small business rate. The part II tax is a tax of 12.5 per cent on dividends originating from the preferred earnings amount. This tax was "... designed to eliminate overintegration on distributed income, [but] it continued tax deferral benefits for active business income retained in the business."

A further "housekeeping" amendment resulting from the 1981 Budget was the introduction of the concept of the "personal services business." While the creation of the non-qualifying business in 1979 had deprived the incorporated employee of the full advantage of the small business deduction, it left significant deferral possibilities available to the high income "employee" who chose to offer his services through a corporation. These possibilities were eliminated by defining the "business" of the incorporated employee as a personal services business and taxing the income from such a business at full corporate rates while denying it any deductions other than those normally available to an employee.

The final change resulting from the 1981 Budget was to amend, once again, the method of calculating the cumulative

31. SC 1980-81-82-83, c. 140, subsec. 86(9).
deduction account. This change, in effect, reflected the view that the original taxation scheme for small business created by Tax Reform was flawed. This view appears in documents accompanying the 1981 Budget and is expressed as follows:

The purpose of the [total business limit] is to confine the tax assistance during early years when the business is being established and when it may have difficulty in obtaining debt or equity financing from external sources. Businesses can, however, avoid the cumulative retained earnings limit by paying out dividends. As a result, they can remain eligible for the low corporate rates long after they have ceased to be small and obtain benefits even though the funds are not used for business expansion. In order to retarget the incentive where it is most needed, dividends distributed after December 31, 1981 will no longer be deductible in computing the cumulative deduction limit of a business.  

This amendment was apparently a response to the claim that, in permitting dividend payments to "refresh" the cumulative deduction account, the small business tax system was "encouraging small business to remain small."  

With the amendments to the Act resulting from the 1981 Budget, the provisions relating to small business had reached such a level of complexity that the Canadian Tax Foundation felt it necessary to sponsor a symposium of the topic of simplification. The climate was clearly in favour of making changes to reduce the complexity of the

32. Honourable Allan J. MacEachen, Deputy Prime Minister and Minister of Finance, The Budget in More Detail, Canada, Department of Finance, Ottawa, Queen's Printer, 1981, p. 45.  
33. Shinder, op. cit., p. 20.  
relevant portions of the Act. Thus, a paper accompanying the 1984 Budget stated:

A number of causes of complexity in the small business tax system have been identified. This section puts forward a proposal to simplify that system. ... elements of the proposal are:

- elimination of the $1,000,000 limit on total cumulative income eligible for low tax rate benefits, which eliminates the requirement for the cumulative deduction account;

- elimination of the distinction between non-qualifying business income and active business income subject to the low tax rate, thus reducing the number of types of income receiving different tax treatment; ... 35

Legislation embodying these proposals was passed by the new Conservative government shortly after it assumed office. 36

As was previously mentioned, the legislative scheme of "assistance" to small business first enacted in 1972 also included a refundable tax in respect of ineligible investments which was repealed shortly after coming into force with its repeal having application retroactively to 1972. 37 This tax will be discussed in greater detail below. 38

35. Honourable Marc Lalonde, Minister of Finance, Simplifying Taxes For Small Business, Canada, Department of Finance, Ottawa, Queen's Printer, 1984, p. 15.
36. SC 1984, c. 45.
38. See Chapter 4, The Canadian Experience.
The Rationale for a Tax on Unreasonable Accumulations

To advance the proposition that Canada should impose a tax on the unreasonable accumulations of Canadian-controlled private corporations eligible for the small business deduction is, of course, to suggest that the present fiscal regime applicable to such entities is flawed or incomplete. This suggestion needs to be explored. In order to do so, it would seem appropriate, as a preliminary step, to consider:

1. the purpose which originally motivated the enactment of the small business deduction; and
2. the manner in which it sought to achieve its purpose when first enacted.

Having looked at these matters from an historical perspective, this chapter will then examine the question of whether that purpose and the manner of achieving same continue to be factors in the fiscal legislation which applies to small business. This discussion will be followed in turn by a review of the mechanisms through which the Income Tax Act has attempted to control the "assistance" made possible by the small business deduction in order to ensure that it is made available to its intended beneficiaries only. Finally, this chapter will conclude with an analysis of the rationale for adding a tax on
unreasonable accumulations to the present small business tax regime.

In describing the 1972 version of "assistance to small business," The Honourable E.J. Benson, Minister of Finance, stated that the government sought to:

\[
\text{limit the incentive to smaller private Canadian-controlled corporations that require, and in fact use, the tax savings to invest in their businesses or to pay dividends to shareholders.} 
\]

Although, as the above quotation suggests, in providing a favourable tax rate to incorporated but not to unincorporated small businesses the "small business deduction" was intended to be neither equitable nor neutral, the scheme adopted for its implementation in 1972 appeared, at least upon a superficial examination, to render the resulting inequity or loss of neutrality only temporary; integration of corporate and personal income taxes upon the payment of dividends by the company apparently removed the inequity — returning the situation to one of neutrality (ignoring for the time being the important advantage of deferral) so that, again in the words of Mr. Benson:

"the net effect ... [would be] ... to tax the corporate income at the individual shareholders' rates of tax.  

The two quotations attributed above to The Honourable E.J. Benson would indicate that the small business deduction was created with a view to fulfilling two goals:

1. providing for the integration of the corporate and personal income taxes payable by the shareholder of the Canadian-controlled private corporation carrying on an active business; and

2. providing assistance to small (incorporated) businesses.

No other goals were explicitly articulated by the Minister. Does the small business deduction as originally enacted in 1972 provide any evidence to confirm that it was, in fact, intended to fulfill these goals?

In order to answer this question, it would seem necessary to analyse the practical implications, not only for the corporation eligible for the small business deduction but also for its shareholders, of the legislative scheme which came into force in 1972. Specifically, it would appear helpful to compare the net after tax return available to the shareholder of a Canadian-controlled

2. Honourable E.J. Benson, Minister of Finance, Summary of 1971 Tax Reform Legislation, Ottawa, Queen's Printer, 1971, p. 38. When the deferral advantage is taken into consideration, it readily becomes apparent that the small business deduction is not merely a tool for preventing double taxation. Even ignoring the deferral advantage, it is obvious that the "net effect" referred to by Mr. Benson will only occur where the mechanism through which "integration" is implemented is effective in achieving its purpose. This aspect of the problem will be discussed more fully below at pages 31-35.
private corporation eligible for the small business deduction from an active business carried on by that corporation with the return which would have been received by the shareholder if, as an individual, he had carried on that same business as a sole proprietor. In making this comparison (which appears below), several assumptions will be made to facilitate the analysis; these are:

1. that the combined federal and provincial marginal tax rate of the individual in question is fifty percent;

2. that the combined federal and provincial tax rate for a Canadian-controlled private corporation earning income from an active business and eligible for the small business deduction is twenty-five per cent; and

3. that the after-tax profits of the corporation are distributed in the same calendar year as they are earned.

The first two of these three assumptions introduces a slight element of inaccuracy but it is somewhat of a convention in analysing the Act to make these two assumptions and accept this element of inaccuracy in order to facilitate the analysis. The third assumption will obviously be true in some cases and untrue in others; the effect upon this analysis of the fact that not all companies eligible for the small business deduction pay out all of their profits in the

3. As mentioned in chapter two, this thesis will adopt the common practice of assuming that the combined federal and provincial tax rate is equal to the federal rate as it would be were it not for the abatement in respect of taxable income earned in a province provided for in sub-section 124(1) of the Act.
calendar year in which they are earned will be discussed below. 4

The individual described above would have paid $200 tax on $400 of active business income earned directly by him. In 1972, had that same $400 of active business income been earned by a corporation eligible for the small business deduction and then paid out by way of dividends, the total tax payable by both corporation and shareholder (taking into account the assumptions described above and based upon the dividend tax credit system in force at that time) would also have been $200 – the tax payable by the corporation would have been $100 and that payable by the shareholder would likewise have been $100. In these circumstances, then, the small business deduction would involve no reduction in total tax payable – its only effect would be to provide integration of corporate and shareholder taxes. In the absence of the small business deduction i.e. if the corporation's revenue had been taxed at the full corporate rates, double taxation would have occurred; the use of the corporate form would have resulted in a total tax payable by both corporation and shareholder of $266.67 – obviously in excess of the total tax payable by the sole proprietor described above. These figures would seem to confirm that one of the purposes behind implementation of the small business deduction was to provide for integration of the corporate and personal income taxes of the shareholder of a

4. At pages 31-35.
Canadian-controlled private corporation carrying on an active business.

If, however, the effect of the small business deduction, in the circumstances described in the preceding paragraph, was to integrate corporate and personal income taxes, in what way did this tax credit fulfil the second of the two purposes mentioned above? Did the small business deduction, in fact, provide any assistance to small business? These questions lead back to the third assumption made above: that the after-tax profits of the corporation are distributed as dividends in the same calendar year as they are earned. Under the 1972 scheme of things, to the extent that distribution of after-tax corporate profits took place at any time after the calendar year in which these profits were earned, as it most certainly did in many instances, then payment of a portion of the tax - the portion payable by the shareholder upon receipt of the profits in the form of a dividend - upon those profits was deferred by comparison with the situation of the individual earning the active business income directly rather than through the intermediary of a corporation - the corporation paid in taxes an amount equal to 25% of its profits while the sole proprietor in this example would have paid twice that much. Does the mere deferral of liability to pay tax constitute "assistance?"
Common sense without more would suggest that the deferral is of value to the extent that the funds thus retained, over and above those which the individual carrying on the same business without the use of a corporate intermediary would be able to retain, can be used within the corporation to continue to generate income. In fact, of course, the benefits of deferral are one of the basic goals of tax planning. 5

Work in the area of tax expenditure analysis provides a method of measuring the value of a tax deferral. A tax expenditure is said to occur, of course, when tax revenues are reduced as a result of preferential tax treatment given to some income source or taxpayer. 6 Prior to reaching the conclusion that tax revenues have been foregone, one must first identify the "normal" tax rate; it is only a deviation from this "normal" tax rate which will constitute a tax expenditure. Thus, to determine whether or not the "small business deduction," as originally enacted constituted a tax expenditure, the "normal" rate in force at the time of its enactment must be identified.

In the circumstances described above, the "norm" chosen as the basis of comparison was the tax rate of an individual

6. This definition of the concept of a "tax expenditure" is taken from Roger S. Smith, Tax Expenditures: An Examination of Tax Incentives and Tax Preferences in the Canadian Federal Income Tax System (Toronto, Canadian Tax Foundation, 1979) at pp. 1-6.
carrying on an active business as a sole proprietor. The conclusion drawn was that by comparison with the sole proprietor the shareholder of the Canadian-controlled private corporation carrying on an active business (and, ideally — in terms of the stated goals of the small business deduction — its active business) benefitted to the extent of the deferral advantage available through the small business deduction. Is this deferral advantage a tax expenditure?

Professor Surrey in his seminal work on the topic of tax expenditures, Pathways to Tax Reform, is of the opinion that it is, as is Professor Smith who has attempted to apply the tax expenditure analysis to the Canadian context. If the deferral advantage is a tax expenditure, how does one measure its value?

In theory, the value of the tax deferral is equal to the present value of the interest cost avoided by the corporation over the period of the deferral by reason of the fact that it was able to avoid borrowing altogether or reduce its borrowing by making use of the moneys which might otherwise have been paid out in taxes — taking into account in calculating the cost of the interest thus avoided that a reduction in the income tax otherwise payable would follow upon setting off the interest expense against the revenue.

derived from the funds. An example from Professor Surrey illustrates this phenomenon:

Suppose an individual, A, in the 60 percent tax bracket, invests $100 in an asset. Assume that business, accounting and normal tax rules would require the cost of the asset to be capitalized, but that a tax expenditure provision permits the cost to be expensed in the year of acquisition, thus deferring tax liability on the amount of income offset by the special deduction. ....

The immediate deduction of $100 gives A an immediate tax saving of $60. The $60 tax will be postponed until the asset is sold. One way to describe the result is to say that the Government has made a loan of $60 to A without asking for interest, collateral, or a definite time for payment of the loan, since it will wait until A decides to sell the asset. The higher A's tax bracket, the larger the interest-free loan.

What is this loan worth to A? Assume that borrowing $60 from a bank would cost him 10 percent interest. A thus saves paying 10 percent a year on $60 - or $6 - less the benefit of the income tax deduction of $6 interest a year, or a net saving of $2.40 per year, for a total of $6 interest a year, or a net saving of $2.40 per year, for a total of $24 if he sells in ten years. The saving from deducting the cost of the asset in the first year instead of the tenth year, expressed in terms of the present value of money, would be worth $19.46 to A (using an after-tax discount rate of 4 percent if A can freely borrow at a 10 percent before-tax rate). ....

While this valuation technique suggests a method for determining the value of the deferral which the small business deduction makes possible, proponents of the small business deduction would argue that it is misleading to attempt to place a value on the deferral in this way in that it overlooks the possibility that financing may be unavailable at any cost to the type of corporation which is

eligible for the small business deduction. Viewed from this perspective, one would see the deferral advantage as being invaluable and irreplaceable.

In any event, it can be seen that, at the time of its inception in 1972, the small business deduction did constitute "assistance" to small business - to the extent that it allowed for deferral. Has it continued to do so?

Notwithstanding changes in the Act which have affected the taxation regime faced by the Canadian-controlled private corporation eligible for the small business deduction and its shareholders, the deferral advantage has remained a constant feature of the small business deduction down to the present day. The small business tax rate has remained constant at 25% while the top marginal rate payable by an individual has dropped from approximately 60% to approximately 50% but has come no closer to 25% than that. Additionally, of course, as mentioned in chapter two during the period 1978-1981 inclusive, the combination of the small business deduction and an enriched dividend tax credit went beyond integration to produce "overintegration" or "superintegration." In respect of the active business income of a Canadian-controlled private corporation eligible for the small business deduction, this change in the dividend tax credit produced a situation whereby the $400 of

10. See, for example, the discussion on small business financing found in the Carter Report, vol. 4, pp. 271-272.
11. See subsection 117(5.2) of the Act added by SC 1980-81-82-83, c. 140, subsec. 75(2).
income used as the basis of comparison above would attract only $175 of combined corporate and individual tax as compared to the $200 of tax on that same income earned directly by an individual. "Superintegration" did not, however, increase the amount of assistance available to the incorporated small business; the tax rate of the corporation remained essentially constant during this period and with the implementation of the Part II tax as a result of the 1981 Budget "superintegration" itself disappeared leaving the deferral advantage discussed above as the only significant method through which the small business deduction provided a tax advantage to those who chose to avail themselves of its provisions.

The small business deduction, then, constituted at its inception, and continues to constitute, a form of assistance to the incorporated small business through the mechanism of deferral. Does the small business deduction provide assistance in any other way? A review of the legislation would suggest that it does not - as is confirmed in the literature.12 The favourable tax rate is the sole form of "assistance" and constitutes assistance only to the extent that the shareholder or shareholders of the Canadian-controlled private corporation eligible to avail itself of this favourable tax rate can afford to leave its profits within the corporation.

The fact that implementation of the oft-stated goal of providing assistance to small business relies solely upon deferral to achieve that end confirms the value of this device. The size of the resulting tax expenditure strongly suggests that there is a need to limit the benefits of deferral to its intended beneficiaries - in 1980, according to the 1985 federal Budget the most recent year for which such figures are available, the amount of tax thus deferred was estimated at $1,305,000,000.\textsuperscript{13} It seems unlikely that an "assistance" program of this size - implemented by way of direct grants rather than as a tax expenditure - would be created without including within its structure some form of control to ensure that the aims of the program were being met.

The question then arises: what mechanisms ensure that this assistance - the tax deferral available to the owner of the small business who uses the corporate form as an intermediary between himself and that business - is not diverted from its stated purpose of assisting small business to fulfil its traditional entrepreneurial role in the Canadian economy? What mechanism ensures that the funds thus accumulated in the corporation - a sum which, as the analysis found above suggests, would exceed by approximately

\textsuperscript{13} The Honourable Michael H. Wilson, Minister of Finance, The Corporate Income Tax System A Direction for Change. Canada, Department of Finance, Ottawa, Queen's Printer, 1985, pp. 7-8.
fifty per cent the after tax proceeds available to the sole proprietor from his active business - are not simply left there to shelter them from immediate taxation while being invested in so-called "passive" investments?

In 1972, when the decision was made to depart from neutrality by providing a fiscal advantage to incorporated businesses, certain criteria were indeed established as the preconditions for eligibility for the small business deduction. These criteria were that these businesses:

1. be small; and either
2. reinvest the tax savings; or
3. use the tax savings to pay dividends.

Given that, in this system (as discussed above at pages 28-31), where tax savings were used to pay dividends, integration appeared to restore equity, and thus neutrality (ignoring the important advantage of deferral discussed above), the policy seemed to involve a departure from the principles of neutrality and equity only insofar as the tax savings which it provided remained in the hands of the corporation and even then there were two further criteria to be satisfied: the first and second of the three conditions

14. Of the profits of $400 described in the example found above at pp. 28-31, there would be $300 left after payment of tax in the corporate coffers of the Canadian-controlled private corporation as opposed to only $200 remaining in the hands of the sole proprietor from the same level of profit.
15. As is suggested by the quotation taken from Honourable E.J. Benson, Minister of Finance, Summary of 1971 Tax Reform Legislation, Ottawa, Queen's Printer, 1971, p. 37 which is found at p. 27 above and confirmed in the discussion below on pp. 37-41.
mentioned above. It becomes relevant therefore to enquire as the nature of the mechanisms through which adherence to these two conditions was to be ensured.

The first of the prerequisites to "assistance" was that the corporation's business be small. This restriction was justified on the basis of the perceived imperfections in the capital markets mentioned above. One of the important tools for ensuring that only "small" business benefitted from the small business deduction was the concept of the "total business limit" which, as originally enacted, terminated eligibility for the "small business deduction" when "retained earnings"\(^{16}\) derived from active business reached a defined threshold figure - $400,000 for taxation years 1972 and 1973, $500,000 for taxation years 1974 and 1975, $750,000 for taxation years 1976 to 1981 inclusive, $1,000,000 for taxation years 1982 to 1984 inclusive.\(^{20}\)

Legislation resulting from the 1984 Budget did away with the restriction embodied in the concept of the total

\(^{16}\) As determined by the formula prescribed by the Income Tax Act of Canada (paragraph 125(6)(b)) defining the content of the "cumulative deduction account". To equate the cumulative deduction account to retained earnings is, of course, to simplify in the extreme - especially, in view of the amendments to the Act stemming from the 1981 Budget which put an end to the possibility of "refreshing" the cumulative deduction account by paying out dividends - but for the present such a definition seems adequate.

\(^{17}\) Para. 125(2)(b) of the Income Tax Act.


\(^{19}\) Para. 125(2)(b) of the Income Tax Act as amended by SC 1976-77, c. 4, subsec. 49(1).

business limit\textsuperscript{21} and did away as well with its companion piece, the cumulative deduction account.\textsuperscript{22} The goal of providing assistance to small business had not changed - the "small business deduction" is described in the 1984 Budget as a "small business tax incentive"\textsuperscript{23} - but a new policy had come to the fore: "simplification." In the words of the Honourable Marc Lalonde, speaking as Minister of Finance:

\begin{quote}
... the mechanics of computing the corporation's cumulative income, as well as the legislation required to define it, have become increasingly complicated. The cumulative deduction account is now one of the most complex parts of the small business tax system ...\textsuperscript{24}

... the additional precision achieved by the cumulative income limit is not justified in light of the complexity it creates.\textsuperscript{25}
\end{quote}

The other criterion for entitlement to the small business deduction, as originally enacted, was that the resulting tax savings be reinvested in the corporation's business. At the time of passage of the Tax Reform legislation, Part V tax - a refundable tax in respect of ineligible investments - was to be the control mechanism which ensured that:

the incentive [was limited] to smaller private Canadian controlled corporations that require, and if fact use, the tax savings to invest in their businesses...\textsuperscript{26}

\textsuperscript{21} SC 1984, c. 45, section 40.
\textsuperscript{22} Loc. cit.
\textsuperscript{23} Honourable Marc Lalonde, Minister of Finance, Simplifying Taxes For Small Business, Canada, Department of Finance, Ottawa, Queen's Printer, 1984, p. 1.
\textsuperscript{24} \textit{op. cit.}, p. 15.
\textsuperscript{25} \textit{op. cit.}, p. 16.
\textsuperscript{26} Honourable E.J. Benson, Minister of Finance, \textit{Summary of 1971 Tax Reform Legislation}, Ottawa, Queen's Printer, p. 37.
This tax, however, was repealed shortly after coming into force with its repeal having application retroactively to 1972.27 It was never replaced. The Part V tax was not, apparently, withdrawn on the basis of a deliberate policy change but, quite simply, because it was feared to be too complex. In the words of The Honourable John N. Turner, Minister of Finance:

I believe that the policy which gave rise to the ineligible investment test was correct, but I have come to the conclusion that it is too complicated.28

It can be seen then that the legislation embodying the small business deduction was originally accompanied by measures designed to ensure that its benefits were indeed restricted in their availability to a definite target group - the "small" businesses which used the "tax savings to invest in their businesses." Equally apparent, of course, is the fact that both of the control devices originally built into the small business deduction have now been eliminated. In this context, the potential rationale for a tax on unreasonable accumulations in Canada begins to take shape and will now be explored.

It has been demonstrated that the advantage accruing to the shareholder or shareholders of the Canadian-controlled private corporation by reason of the "small business deduction" when compared to the situation of the sole proprietor is the possibility of deferral. Assuming equal rates of return, the revenue which may be earned by the Canadian-controlled private corporation eligible for the small business deduction on its reinvested profits will be approximately fifty per cent greater than that available to the sole proprietor from his reinvested profits - given that, due to the deferral factor, the sum available to the corporation for investment would itself be fifty per cent greater (as the example discussed at pages 28 to 31 illustrates). Thus, whether it is used as was intended or abused as was feared, the small business deduction clearly represents a departure from the twin principles of horizontal equity and neutrality. The inequity lies in the fact that the advantage of deferral is available to the indirect owner of the incorporated small business, its shareholder, but not to the sole proprietor. There is a lack of neutrality in that such a situation means, of course, that fiscal concerns rather than considerations of a business nature may provide the sole motivation for incorporation.

Insofar as the funds left within the corporation as a result of the operation of the small business deduction are reinvested in its active business, the departure from the
principles of equity and neutrality would be rationalised by the proponents of the small business deduction as being justified by the resulting contribution to the economic development of the country which the small business deduction is claimed to provide. When such reinvestment does not occur, that explanation does not justify permitting the corporation, and, through it, its shareholder or shareholders, to benefit from this tax expenditure. In such circumstances, the corporation, in effect, constitutes a tax shelter.

In terms of policy, that the benefit available through the small business deduction accrue to those who do not reinvest the tax savings in the active business from which the funds originated appears to be unintentional - as mentioned above, the Part V tax was intended to be the mechanism for ensuring that the tax savings resulting from the small business deduction would only remain in the hands of the recipient corporation if reinvested in the business from which the funds originated. As the quotation with which this thesis begins suggests, the problem of achieving total neutrality is virtually insoluble. In fact, with the small business deduction Canada has deliberately chosen to depart from neutrality. Where such a choice is made upon policy grounds, and where the total amount of tax revenue
deferred is as large as it is in this instance, then steps should be taken to ensure the successful attainment of the important policy goals - in this case, of course, providing funds for reinvestment in the corporation's business - by which the departure from fundamental principles was justified. This would indicate that a control mechanism is needed. The total business limit was, of course, such a mechanism, but, following the repeal of the Part V tax, it was the only restrictive factor inherent in the legislative framework of the small business deduction and at that its utility as a control device was limited to placing a ceiling on the potential value of the deferral advantage. Notwithstanding the existence of the total business limit, it remained possible when the total business limit was $1,000,000 for the corporation to have in its coffers up to $750,000 of after-tax retained earnings - whereas the sole proprietor having earned a similar amount of income would retain only two-thirds as much - and yet, the total business limit in no way ensured that these retained earnings would be reinvested in the business. Thus, given that a control device would seem to be necessary and that the total business limit, at best a faulty tool, is now gone, a new control device would seem preferable. A form of tax on unreasonable accumulations would seem to be an appropriate

29. As discussed at page 37 above, the value of the tax revenue deferred was placed at $1,305,000,000 in the Honourable Michael H. Wilson, Minister of Finance, The Corporate Income Tax System A Direction for Change. Canada, Department of Finance, Ottawa, Queen's Printer, 1985, pp. 7-8.
device. If appropriately structured, such a tax would leave the benefits available through the small business deduction (now limited only in terms of their annual increment rather than their total amount) in the hands of the corporation when used in accordance with the requirements of the corporation's business—thus, fulfilling the goals of the small business deduction—while withdrawing the funds where they were diverted from the corporation's active business—thus, restoring equity in circumstances where the justification for a departure from same did not exist. The precise form which such a tax could take will be discussed in chapter seven.

In addition to alleviating the potential for abuse of the small business deduction as described above, a tax on unreasonable accumulations, if implemented, could conceivably, in and of itself, be viewed as a more satisfactory method of dealing with the types of small business which formerly fell into the category of the "non-qualifying business" than were the provisions specifically inserted into section 125 of the Income Tax Act to deal with the "non-qualifying business." It would appear that one of the reasons which led the government to conclude that the forms of professional income affected by the non-qualifying business provisions were unworthy of the full benefit of the small business deduction was their allegedly lesser need of internally generated capital. This conclusion may be drawn, for example, from the budget speech wherein the Honourable
J. Chretien introduced the concept of the non-qualifying business as originally conceived. In that speech, after stating that:

we are justified ... in favouring small business ... to get the necessary capital for growth ...

Mr. Chretien went on to assert that the:

financial situation of professional classes is not the same as that of the small business.

Insofar as it may be true that professionals have a lesser need for internally generated capital, it would seem to follow that, in many instances, they will not find it necessary to reinvest their profits (or those of their management companies) in the "small business" which generated those profits. If a tax on unreasonable accumulations were a part of the small business tax regime and if those profits were neither reinvested nor distributed to the shareholders of the corporation which generated them, the effect of the tax on unreasonable accumulations would essentially be to eliminate the deferral advantage for the non-qualifying business and ipso facto to remove the theoretical basis which, in the eyes of Mr. Chretien, justified the special tax treatment of the non-qualifying business to which his budget led. Thus, even in the absence of special measures targeted at this class of "business," it

30. In Bill C-37. This bill was not, however, the legislation which eventually gave the force of law to the concept of the non-qualifying business. Rather, Bill C-17, a somewhat modified version of Bill C-37, effected this result when it received Royal Assent on December 6, 1979.

would be possible, through a tax on unreasonable accumulations, to deal with at least one source of inequity wherein the fiscal system has been alleged to favour the "professional."

In the preceding pages, it is argued that in the absence of the Part V tax, the elimination of the concept of the total business limit has provided justification for a tax on unreasonable accumulations and that such a tax could be viewed as a replacement for the non-qualifying business provisions which were repealed at the same time as those pertaining to the total business limit. Following closely upon the elimination of the total business limit and the non-qualifying business has come the 1985 Budget creating an exemption from taxation for the first $500,000 of capital gains earned by an individual during his lifetime. This move provides a further incentive for the shareholders of the incorporated small business to cause their corporation to retain its profits. That incentive is found in the possibility that retained earnings may be converted to capital gains which in many cases would be tax free. Those who are able to accomplish this manoeuvre successfully will have gained a very significant advantage indeed. They will have not merely deferred tax on these "capitalized" retained earnings - already a benefit not available to the sole proprietor, they will have avoided it altogether. In such

32. The Honourable Michael H. Wilson, Minister of Finance, Budget Papers, Canada, Department of Finance, Ottawa, Queen's Printer, 1985, p. 3.
circumstances, the unjustifiable violation of basic tax principles which occurs where the Canadian-controlled private corporation benefitting from the small business deduction fails to reinvest its retained earnings in its active business would, of course, be greatly exacerbated.

If the principles of equity and neutrality are violated by the small business deduction (as the analysis found above at page 42 indicates they are - in a departure from principle which is said to be justified by the economic benefits flowing from the encouragement of small business), a fortiori is this the case when the added advantage of completely escaping liability to personal income tax occurs. If a tax on unreasonable accumulations is warranted in the absence of the projected capital gains exemption, the imminent enactment of such an exemption would appear to lend further support to arguments in favour of such a tax. If it becomes possible for the shareholder of a Canadian-controlled private corporation through careful planning to avoid personal income tax on the profits which his corporation makes, then at the very least it would be desirable that some control be exerted over those funds which have remained at the corporate level to ensure that they are used in a manner which is consistent with the aims of the small business deduction.

Also in the 1985 Budget is the proposal to decrease corporate tax rates - thereby, if it becomes law, allowing the Canadian-controlled private corporation to retain for
re-investment a greater portion of its profits. Even if it is assumed that implementation of this proposal would be accompanied by other changes to ensure that the ultimate tax burden borne by the shareholder, upon distribution by the corporation of its profits as dividends, would equal the taxes payable by the individual whose income came from another source - thereby maintaining integration - this proposal certainly has the potential for significantly increasing the value of the deferral advantage - and the resulting potential for inequity - available through the small business deduction. In fact, given that the full corporate rate as proposed in the 1985 Budget would be 39%, the possibility of a deferral would exist even where the corporation's income was taxed at the full corporate rate. Thus, it is not inconceivable that the controlling shareholder or shareholders of either private or public corporations might, in some circumstances, prefer to allow the corporation's profits to accumulate within the corporate coffers rather than to expose them to the higher marginal rates of personal income taxation. By greatly increasing the potential for the use of the corporation as a tax shelter, this proposal, if it should become law, would add much weight to the arguments put forth above which favour implementation of a tax on unreasonable accumulations.

33. The Honourable Michael H. Wilson, Minister of Finance, The Corporate Income Tax System A Direction for Change. Canada, Department of Finance, Ottawa, Queen's Printer, 1985, p. 31.
34. As seems to be the intention. See op. cit., pp. 40-41.
35. op. cit., p. 31.
Based upon the foregoing analysis, it is submitted that the several legislative changes and proposed changes described above represent a progression, each tending to increase the potential for inequity and, as a consequence, non-neutrality in the Canadian small business tax system. A tax on unreasonable accumulations could redress the balance and permit the small business deduction to provide the Canadian economy with the benefits which have often been attributed to this fiscal measure while significantly reducing the possibility for abuse of this "incentive."
Chapter 4

The Canadian Experience

Canada has had two forms of tax on unreasonable accumulations in its fiscal history. The first was found in Canada's first federal income tax statute, the Income War Tax Act, enacted in 1917. The second was that mentioned in previous chapters, the refundable tax in respect of ineligible investments or Part V tax, which came into force as part of Tax Reform. Unfortunately, neither is of much assistance in providing a model upon which to base any future such tax: the 1917 provisions granted ministerial discretion to determine that there had been an unreasonable accumulation — and, as with any provision in a taxing statute which grants ministerial discretion, must be considered to be objectionable on that basis alone, while the 1972 example was so seriously flawed (as will be discussed below) as to necessitate a repeal effective retroactively to the date upon which it originally came into force.

Canada's original tax on unreasonable accumulations was expressed in the following terms:

For the purpose of the supertax only, the income of a taxpayer shall include the share to which he would be entitled of the undivided or
undistributed gains and profits made by any corporation ..., if such gains and profits were divided or distributed, unless the Minister is of opinion that the accumulation of such undistributed or undivided gains and profits is not made for the purpose of evading the tax, and is not in excess of what is reasonably require for the purposes of the business.

In 1919, this provision was repealed and replaced by slightly modified version which was said to demonstrate:

... a changing attitude towards corporation income, the corporation being thought of more and more as a separate entity ....

Section 3(4) as re-enacted in 1919 read as follows:

'The share of a taxpayer in the undivided or undistributed gains and profits of a corporation shall not be deemed to be taxable income of the taxpayer, unless the Minister is of opinion that the accumulation of such undivided or undistributed gains and profits is made for the purpose of evading the tax, and is in excess of what is reasonably required for the purposes of the business.'

While the original section considered as income to the shareholder his proportionate share of the earnings of the company, unless distribution was withheld for some good reason, the section substituted in 1919 provided that the income of the corporation should NOT be considered income of the shareholders unless distribution was withheld for the purpose of evading tax.

In spite of the evolving attitudes towards the corporation commented upon in the above quotation, there is one common thread to both of these provisions which may recall the various ministerial pronouncements regarding the

1. Income War Tax Act, subsection 3(4) as found in Canada, Report of the Royal Commission on The Taxation of Annuities and Family Corporations, Ottawa, Queen's Printer, 1945 at p. 53.
2. loc. cit.
small business deduction and certainly provides a concept of value for future application: the question of an accumulation being justified where "reasonably required for the purposes of the business." In discussing the possible meaning of this expression, it was said:

No attempt can be made ... to enumerate all the ways in which the gains and profits of a corporation may be accumulated for the reasonable needs of the business. Undistributed income is properly accumulated if invested in increased inventories or additions to plant reasonably needed by the business. It is properly accumulated if retained for working capital required by the business, or in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation.3

It may be worthy of note as well that in both of its manifestations in the Income War Tax Act this Canadian tax on unreasonable accumulations required the Minister to be of the opinion, before the tax could be imposed, that the accumulation was for the purpose of evading tax.

Although the original Canadian tax on unreasonable accumulations remained on the books until 1948,4 it was apparently not enforced after the early years of its

existence. This may explain why there are no reported decisions in which it is at issue.

After a lengthy period without such a tax, in 1972 Canada made a second attempt. The Part V tax was brought in as part of an "incentive package" for small business which was said to have been "extracted from the government with the greatest reluctance." Such reluctance is perhaps understandable in light of the many criticisms levelled at the dual rate structure (which the small business deduction replaced) by the Carter Commission. In the Budget speech wherein the Tax Reform bill was presented, the Minister of Finance after echoing some of those criticisms went on to say:

However, with these deficiencies eliminated, a low rate can be an effective way of encouraging initiative by helping small corporations to accumulate capital for business expansion. ....

If a corporation employs the tax savings that result from the low rate for non-business purposes, such as portfolio investments, a special refundable tax will be imposed to recover the low-rate benefit.

The Part V tax was, of course, that tax. Thus, a special tax was included in the Tax Reform package in an attempt to

ensure that the tax savings resulting from the small
business deduction would in fact be used by the corporation
to finance its business operations.

The Part V tax did not, however, last long.

In February 1973, the government gave up on the
proposal .... Concluding that the provisions
required to distinguish business from non-business
investments would be just too complicated, the tax
on ineligible investments was dropped, retroactive
to the beginning of 1972. 10

The description of the Part V tax as "too complicated"
contained in the above quotation is a recurring theme in a
great many of the articles which refer to it. In one of the
few published attempts which appears to have been made to
analyse the provisions of Part V, the author states that
"the convoluted provisions of Part V are numbing in their
initial impact." 11 In view of the fact that the complexity
of the Part V tax is so very frequently cited as the cause
of its demise, its potential utility as a model for a future
Canadian tax on unreasonable accumulations seems extremely
limited indeed – particularly at a time when simplicity has
become the watchword. This being so, it would seem
pointless to engage in a detailed analysis of its provisions
herein. At the same time, however, the flaws which were so
quickly fatal to the Part V tax may provide guidance as to

and Total Business Limits and the Cumulative Deduction
Account," text of a paper delivered at a Symposium on the
Simplification of the Small Business Provisions of the
Income Tax Act held in Toronto, Ontario on July 11-13, 1983
sponsored by the Canadian Tax Foundation.
Chartered Accountant, December, 1972, pp. 62-65 at p. 64.
pitfalls to avoid. Thus, the examination of the Part V tax which follows will describe the manner in which the tax was intended to function only to the extent necessary to provide a framework for reviewing the criticisms which were levelled at it.

The focus of the Part V tax was the "ineligible investment" made by the Canadian-controlled private corporation eligible for the small business deduction. In the language of the statute, an "ineligible investment" was:

... a property that was not acquired for the purpose of gaining or producing income from an active business of the particular corporation, except ...\textsuperscript{12}

There followed a lengthy list of "investments" which would not be considered to be "ineligible investments." In essence, these permitted "investments" consisted of money (whether on deposit in a financial institution or otherwise) short-term debt securities and shares or debt obligations of private corporations controlled by the taxpayer. The exemption from the category of ineligible investments of money and short-term debt securities was made so that:

... a corporation which finds itself temporarily with idle funds is not precluded from using them to earn a return until such time as these funds are required by the business.\textsuperscript{13}

The exemption with respect to shares or debt obligations of private corporations controlled by the taxpayer was

\textsuperscript{12} The Income Tax Act of Canada, paragraph 189(4)(b).
\textsuperscript{13} Spindler, \textit{op. cit.}, p. 64.
withdrawn where the controlled corporation itself made ineligible investments.

In circumstances where the corporation did in fact make an ineligible investment, the resulting tax was "equal to 25% of the lesser of:

(a) 2 times the cost of ineligible investments acquired after 1971 and owned at the end of year, and

(b) The corporation's preferred-rate amount at the end of the year.\textsuperscript{14}

The "preferred-rate amount" was:

... income taxed at the low rate [which] goes into a separate pool of funds ... which is then decreased by dividends paid. The pool of funds is increased by dividends from subsidiaries to the extent that the payer's preferred rate amount is reduced by the dividend. In other words, so long as dividends paid equal the sum of the income taxed at the low rate, plus certain dividends received, the pool will be zero and no tax on ineligible investment will be payable. If the annual dividend rate is lower, then any purchases of ineligible investment will be presumed to be out this pool and the tax will be payable ...\textsuperscript{15}

This "recaptured" tax saving could, itself, be recovered by the corporation from the government where:

... a corporation sells some or all of the investments on hand at the end of the year, or the corporation pays sufficient dividends to reduce its preferred-rate amount or the preferred-rate amount is reduced by a non-capital loss carry-back.\textsuperscript{16}

\textsuperscript{14.} Canada, National Revenue, Taxation, Corporate Tax Guide - tax reform and you, p.34.
\textsuperscript{15.} Analysis of the Canadian Tax Reform Bill 1971, Toronto, CCH Canadian Limited, 1972, pp. 75-76.
\textsuperscript{16.} Spindler, \textit{op. cit.}, p. 64.
It was in this sense that the tax was "refundable." Eligibility to receive a refund of the tax was lost, however, if application for the refund was not made within four years of the tax's payment.

Aside from the question of complexity, one of the common complaints about the Part V tax was that the meaning of the pivotal concept - the "ineligible investment" - was itself unclear. It was felt to be:

... broad enough to include many items which might not normally be considered to fall into this category: e.g., cars, yachts and club memberships acquired solely for a shareholder's personal benefit. In view of this, many corporations could encounter difficulty in identifying all ineligible investment on hand at any particular time.\(^7\)

A further source of difficulty was the requirement that the:

... the company must invest all its funds and not just the income subject to tax at the low rate in its active business. A Canadian-controlled private corporation which invests all of its income in its business but borrows money or sells ineligible investments acquired prior to 1972 and uses the fund to acquire ineligible investments would still pay the tax under Part V to recapture the low rate.\(^8\)

As unfair as the problems described in the foregoing quotation may seem, there was worse - the consequences described above could flow even where the corporation had no

preferred-rate amount at the time of acquisition of the ineligible investment. Assuming that the corporation retained the ineligible investment and that it remained "ineligible" (i.e., was not converted to use in an active business), liability for Part V tax would commence at such time as the corporation acquired a preferred-rate amount. This led one author to suggest that:

future tax planning may tend to avoid using one corporation to both carry on business and make investments.19

In the preceding paragraph, the matter of the ineligible investment remaining "ineligible" is mentioned. Whether it was possible for the asset to change its status from "eligible" to "ineligible" or vice versa was in fact another issue to resolve. The definition of "ineligible investment" found in the Act seemed to focus on the "purpose" of the acquisition. Thus, in one article it was hypothesized that:

Where control of a Canadian-controlled private corporation is acquired as a result of several transactions extending over a period of time, all shares acquired prior to the particular transaction which gave the purchasing corporation control of the other will fall into the category of ineligible investment. The fact that control was ultimately acquired will not remove the taint attached to earlier share purchases.20

19. Spindler, op. cit., p. 64.
20. Litman and Wright, op. cit., p. 44.
All of these complaints notwithstanding, the Part V tax has been described as "fundamentally sound in conception." Such a statement suggests that perhaps the route was the correct one but the vehicle was not. The question of the appropriate vehicle, if any, will be explored in chapter seven.

In the United States, fiscal legislation has long recognized the possibility of use of the corporation to avoid or defer the income tax imposed on individuals. An early manifestation of this recognition was found in the Revenue Act of 1913 which dealt with the problem of income accumulations by corporations for the purpose of escaping the individual income tax by deeming the shareholders of such corporations to have received a ratable share of the corporate income whether or not it was distributed.¹

Concern as to the constitutionality of levying such a tax upon the shareholder soon caused the focus to shift to the corporation (where it has remained to this day).² Thus, in 1921, legislation was enacted providing for a penalty tax to be levied upon the corporation itself in such circumstances. This tax has been described as the "principal limitation" on the "full utilization of the

². Loc. cit.
[corporation as a] device of accumulating income subject only to the corporate tax rates."³

The essence of the legislative scheme with respect to "unreasonable accumulations" presently in force in the United States is found in the following portions of the Internal Revenue Code ⁴ of that country:

Section 531 - In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in section 535) of every corporation described in section 532, an accumulated earnings tax equal to the sum of -

(1) 27 1/2 percent of the accumulated taxable income not in excess of $100,000, plus

(2) 38 1/2 percent of the accumulated taxable income in excess of $100,000.

Section 532(a) GENERAL RULE - the accumulated earnings tax imposed by section 531 shall apply to every corporation (other than those described in subsection (b)) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

As the introductory words to section 531 suggest and as befits a tax which is intended to constitute a "penalty," this tax is an additional tax payable by the corporation over and above its normal tax load. While the value of the corporation's retained earnings over its lifetime is a relevant factor in determining whether the corporation has

⁴ In this thesis, the American Internal Revenue Code is sometimes referred to as the "Code."
retained an "excessive" amount of its earnings from a particular taxable year (as will be discussed below), the tax is imposed with respect to the corporation's earnings from a particular year or years. In other words, it is not a tax on the corporation's retained earnings generally but on its "unnecessary" retention of the income from a particular taxable year.

To appreciate the full import of these provisions, the meaning of some of the terminology found therein must be examined. Obvious questions are:

1. What is the "accumulated taxable income" of a corporation?

2. When can it be said that a corporation has been "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders?"

3. With respect to which of its shareholders must the purpose of avoiding tax have been present in order for the corporation to be subjected to the accumulated earnings tax?

4. What corporations are exempted from the tax by reason of the fact that they are "described in subsection (b)" of section 532?

Each of these questions will now be considered in turn in order to provide an analysis of the manner in which the accumulated earnings tax functions in the United States.

1. What is the "accumulated taxable income" of a corporation?

In practical terms, the "accumulated taxable income" of a corporation is that portion of a particular taxable year's profits which the corporation is considered to have
"unreasonably" accumulated and upon which, therefore, the penalty tax will be levied. Essentially, the calculation of this amount with respect to a particular "taxable year" of a corporation requires a determination of the portion of its profits for that taxable year which is actually available to the corporation for distribution to the shareholders as dividends after taking into account its business needs. The actual definition found in subsection 535(a) of the Code states:

... the term "accumulated taxable income" means the taxable income, adjusted in the manner provided in subsection (b), minus the sum of the dividends paid deduction (as defined in section 561) and the accumulated earnings credit as defined in subsection (c)).

Briefly, then the accumulated taxable income of the corporation is its taxable income subjected to three separate "adjustments."

The first such adjustment, made pursuant to subsection 535(b), allows the corporation in calculating its accumulated taxable income to deduct from taxable income amounts previously paid out, whether by way of, inter alia, taxes, net capital losses or disallowed charitable contributions. This adjustment also allows the corporation to exclude from its calculation of taxable income capital gains net of taxes paid on same.

The next "adjustment," the "dividends paid deduction" if translated into the Canadian context would consist primarily of dividends actually paid during the taxation
year and within two and one-half months thereafter. Also included within the parameters of this definition is a concept which has no Canadian equivalent, the "consent dividend," an amount reported as income by the shareholder but not actually paid out by the corporation.5

Both the adjustment provided for in subsection 535(b) and the dividends-paid deduction deal essentially (although not entirely) with funds which the corporation has already disbursed. The third "adjustment," the "accumulated earnings credit," however, in recognition of the fact that good business practice would not necessarily permit the corporation to distribute each year its annual profit for the year, allows amounts retained in a "taxable year" for the purpose of meeting the business needs of the corporation to be excluded from the amount subject to the penalty tax. This provision is found in paragraph 535(c)(1) of the Code which defines the accumulated earnings credit as:

... an amount equal to such part of the earnings and profits for the taxable year as are retained for the reasonable needs of the business6

In effect, then, as a result of this subsection, a corporation will not be subject to the accumulated earnings tax on that portion of its earnings and profits from a taxable year which is retained to meet the "reasonable needs

Thus, the question of the reasonableness of the corporation's "accumulations" is very important. The importance of this factor is magnified by the statutory presumption (to be discussed below at page 71) that an accumulation which exceeds the reasonable needs of the corporation has been made for the purpose of avoiding tax. It should be noted here as well that the term "earnings and profits" is not a term which is defined in the statute, but rather, is used in a non-technical sense as being equivalent to its income (including capital gains) from all sources.  

Further analysis of the circumstances which might indicate that a corporation's accumulations are "reasonable" in light of its needs will take place below in the context of discussion of the "purpose" factor. It should be mentioned at this point, however, that the Code contains what could well be described as a relieving rule relating to the reasonableness of accumulations of the corporation during its existence which provides that:

(A) IN GENERAL - The credit allowable under paragraph (1) shall in no case be less than the amount by which $250,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.

(B) CERTAIN SERVICE CORPORATIONS - In the case of a corporation the principal function of which is the performance of services in the field of

7. The term "reasonable needs of the business" is also used as part of the test for evaluating whether or not the corporation has been used for a tax avoidance purpose and will be discussed below at pp. 70-75 in the context of this aspect of the American legislation.

8. See for example on this point: Ted Bates & Co., Inc. 24 T.C.M. 1346 (1965) at p. 1357.
health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, subparagraph (A) shall be applied by substituting "$150,000" for "$250,000". 9

To illustrate this provision, a brief example follows. In its first year of operation, the corporation obviously has no accumulated earnings and profits from a "preceding taxable year." Thus, assuming that the corporation is not a service corporation of the type described in subparagraph 535(c)(2)(B), the application of subparagraph 535(c)(2)(A) would lead to the conclusion that an accumulation of ($250,000 - nil =) $250,000 could not be considered unreasonable. If during that first year of operation the corporation in fact earned and retained $150,000, then in its second year of operation an accumulation not exceeding ($250,000 - $150,000 =) $100,000 could not be considered unreasonable. Assuming, however, that this corporation earned and retained $150,000 in its first year of operation and $100,000 in its second year of operation, then in practical terms the statutorily prescribed minimum "reasonable accumulation" of $250,000 would be of no further relevance. The application of the "formula" found in paragraph 535(c)(2) would indicate that for future years the "minimum" reasonable accumulated earnings credit allowed under that paragraph would be ($250,000 - $250,000 =) nil. In such circumstances, the corporation would in effect have to justify all further

retentions of its retained earnings and profits as being reasonable in order to escape imposition of the tax with respect to its accumulated taxable income for that particular taxable year.

By building into the accumulated earnings credit the concept of a "minimum" reasonable accumulated earnings credit and relating that concept to the "earnings and profits" of the corporation over its lifetime, the American fiscal authorities have clearly indicated that, in spite of the fact that the accumulated earnings tax is an annual tax, the appropriateness of levyng it in a particular taxable year cannot be evaluated purely on the basis of the corporation's earnings for that year. Indeed, one comment made in Congress about the tax was:

In determining the portion, if any, of the earnings and profits for a taxable year which may be retained for the reasonable needs of the business, the amount of the earnings and profits accumulated in prior years shall, of course, be taken into account.10

It seems logical to suppose, and the American jurisprudence confirms, that, if the accumulations from previous years are sufficient to meet the corporation's needs, then there can be no need for the corporation to retain its earnings from the particular taxable year in question. The Regulations to the Code also support this view in providing as follows:

In determining whether any amount of the earnings and profits of the taxable year has been retained for the reasonable needs of the business, the

accumulated earnings and profits of prior years will be taken into consideration. Thus, for example, if such accumulated earnings and profits of prior years are sufficient for the reasonable needs of the business, then any earnings and profits of the current taxable year which are retained will not be considered to be retained for the reasonable needs of the business.\textsuperscript{11}

The definition of the term "accumulated taxable income" found in the Code and the provisions ancillary thereto can be described as the statutory "formula" for calculating the "unreasonable accumulation" which will be subjected to the accumulated earnings tax. In addition to applying this formula, however, the courts give considerable attention to determining the amount of money actually available to the corporation for the purpose of paying dividends.\textsuperscript{12} The following statement for example was cited with approval by the courts:

\begin{quote}
The question is primarily one of determining whether the taxpayer has enough liquid assets (not surplus) to meet estimated needs, including demands for working capital, plant expansion and all reasonable contingencies.\textsuperscript{13}
\end{quote}

This approach has led the courts to look very pragmatically at the corporation's "cash, liquid assets and other investment assets" as being indicia of its ability to distribute earnings to shareholders.\textsuperscript{14} Thus, one finds, for example, that in calculating its accumulated taxable income the corporation is permitted to deduct the value of its

\begin{itemize}
\item \textsuperscript{11} Regulation 1.535-3(b)(1)(ii).
\item \textsuperscript{12} Koch v. Vinal 228 F. Supp. 782 (D. Neb 1964).
\item \textsuperscript{14} Weithorn, p. 50.
\end{itemize}
capital gains in the relevant taxable year and yet, at the same time:

since the general issue in accumulated earnings tax cases, whether there has, in fact, been an unreasonable accumulation of income, requires an evaluation of the corporation's accumulated earnings and profits in the light of its present and future business needs, retained capital gains (because they increase earnings and profits) may support the Commissioner's contention that the accumulated earnings tax is applicable. 15

2. When can it be said that a corporation has been "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders?"

The tax on accumulated earnings is imposed on any corporation (with certain exceptions which will be discussed below), "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders...." 16

Prima facie, it might be supposed that an enquiry which has as its goal the determination of the "purpose" for which a corporation is "formed or availed of" would concern itself to a significant extent with the question of the subjective intent of those who "formed" or later came to "avail" themselves of the corporation. In practice, however, locating actual evidence of the existence of this "purpose" would not appear to be the principal focus of enquiry. How then does one determine that the "forbidden" purpose was present?

As might be expected, the legislation provides some clues, the most important of which is a presumption that where:

"the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business [this] shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary." 17

The existence of this presumption, coupled with the fact that the accumulated earnings credit described above results in no penalty tax being payable on accumulations which do not exceed the reasonable needs of the corporation, tends to cause inquiries into the possible existence of "unreasonable" accumulations to focus on a factual determination of whether the accumulated earnings exceed the reasonable needs of the business. 18

The obvious question is, then: how is one to determine the "reasonable needs of the business?" In exploring this question, it should first be recalled that (as discussed above) the legislation in effect provides for a minimum "reasonable" amount of retained earnings of $250,000 for corporations other than certain service corporations and $150,000 for this latter group. Recalling the Canadian requirement for associated corporations to share the

17. Internal Revenue Code of 1954, Public Law 591 - Chapter 736, s. 533(a).
"business limit" for a taxation year, this statutorily defined "reasonable" amount must be shared amongst the corporate group in the case of a group of corporations controlled by the same person or persons. Strangely enough (at least as viewed from the Canadian perspective), it would appear that each of the corporations in a parent-subsidiary chain can avail itself of its own minimum accumulated earnings credit.

In addition to the provisions deeming $250,000 (or $150,000, as the case may be) to be a "reasonable accumulation," the regulations to the Code indicate that accumulations may be found to be reasonable when intended to provide funds, inter alia:

1. for additional working capital;
2. for additions to plant and equipment;
3. to meet maturing obligations; and
4. to meet the cash-flow requirements of a business cycle.

As well, judicial interpretation of the phrase "reasonable needs" has given it the broad meaning which one might expect

19. Subsections 125(3) and 125(4) of the Act.
such words to have. Thus, the American Internal Service takes the view that:

Where a corporation can show that all of the capital and surplus on hand would be required for the proper conduct of the business the tax will not be incurred. The Bureau will take into consideration every fact and prospect that a prudent businessman would consider in determining what surplus is reasonably needed for any enterprise.

In assessing the reasonableness of the corporation's judgment as to its need, the following general factors will be considered:

(1) The earnings are being accumulated for a particular purpose or contingency.

(2) The purpose is a legitimate activity of the corporation, or the contingency is a real risk to the corporation.

(3) The current accumulation is not excessive when considered in relation to the probable time it would take for the purpose to be effected or for the contingency to ripen.

(4) The total amount accumulated is not excessive for the purpose or contingency for which the accumulation is made.

What if the corporation has no immediate need for the funds but has plans for expansion? Prior to amendment in 1954, this was one of the problem areas in the American legislation. At that time, there was no provision for "anticipated need" and the so-called "immediacy" test prevailed. In one case, for example, it was stated that:

23. op. cit., p. 9-14.
24. From a November, 1946 speech by Deputy Commissioner E.J. McLarney as quoted in Weithorn at pp. 48-49.
25. Weithorn, p. 49.
[t]he statute ... contemplates immediate need, need associated with business in hand ....26

Currently, however, "need" includes "reasonably anticipated" need.27 "Need" in this context is a concept of sufficient breadth to include a planned expansion into a new field of endeavour not previously engaged in by the corporation — provided, of course, that the new endeavour be of a business nature as opposed to one which would be more aptly described as a passive investment.28

What, then, if the accumulated earnings do exceed the reasonable needs of the business? As mentioned above, an enquiry into "purpose" is an enquiry which might be expected to concern itself with subjective intent. Subsection 533(a) recognizes this factor in providing that, notwithstanding the fact that "the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business," it is possible that "the corporation by the preponderance of the evidence shall prove to the contrary," i.e. shall prove that the accumulation was reasonable. In the final analysis, then, a determination that the accumulated earnings exceed the reasonable needs of the business does not necessarily preclude a finding that, notwithstanding the presumption, the necessary purpose of tax avoidance by the corporation's shareholders was absent.

26. McCutchin Drilling Co. v. Commissioner 143 F. 2d 480 (5th Cir. 1944) at p. 482.
27. Internal Revenue Code of 1954, Public Law 591 - Chapter 736, s. 537.
28. Regulation No. 1.537-3(a).
For example, the shareholder(s) might not have been taxable or might have been subject to relatively little tax or, perhaps, two shareholders, each holding 50% of the issued shares in the corporation are unable to agree as to disposition of the corporation's earnings (as happened in one case\textsuperscript{29}). The jurisprudence has established, however, that:

\[\text{the taxpayer must establish by the preponderance of the evidence that tax avoidance with respect to shareholders was not 'one of the purposes' for the accumulation of earnings beyond the reasonable needs of the business.}\textsuperscript{30}\]

Another aspect of the "purpose question" is found in subsection 533(b) of the Code which states:

\[
\text{The fact that any corporation is a mere holding or investment company shall be prima facie evidence of the purpose to avoid the income tax with respect to shareholders.}\textsuperscript{31}
\]

A "mere holding company" is one having "... practically no activities except holding and collecting the income" from its holdings.\textsuperscript{32} A "mere investment company" does the above and additionally, buys and sells stocks, securities, real estate or other investment property. The adjective "mere" is important in this context; a corporation which actively participates in the management of companies in which it has invested, or which is not "merely" but only "primarily" a holding or investment company does not fall within the

\textsuperscript{29.} Casey v. Commissioner 267 F.2d 26 (2d Cir. 1959).
\textsuperscript{31.} Internal Revenue Code of 1954, Public Law 591 - Chapter 736, s. 533(b).
\textsuperscript{32.} Regulation No. 1.533-1(c).
provisions of subsection 533(b).\textsuperscript{33} This narrow judicial interpretation of the circumstances wherein the accumulated earnings tax might apply to holding and investment companies and other problems with the tax led to the creation in 1934 of a special charging provision with respect to the "personal holding company" (discussed below at pages 78 to 80) and the exemption from the accumulated earnings tax of the personal holding company. This change has greatly diminished the potential application of subsection 533(b). Thus, it has been stated that the "rule in the case of mere holding and investment companies probably affects few corporations, other than passive ... real estate holding companies.\textsuperscript{34}

3. With respect to which of its shareholders must the purpose of avoiding tax have been present in order for the corporation to be subjected to the accumulated earnings tax?

It would appear that the proscribed purpose of tax avoidance need not be present in all of the corporation's shareholders in order for the tax to apply. The jurisprudence suggests that liability may exist where only one of the shareholders intended to avoid tax - even if that shareholder was not a majority shareholder - if the accumulation took place at his instigation.\textsuperscript{35}

\textsuperscript{33} Weithorn, page 46.  
\textsuperscript{34} Weithorn, p. 47.  
\textsuperscript{35} Atlantic Properties, Inc. v. C.I.R. 519 F.2d 1233 (1st Cir 1975).
In the case of a shareholder which is itself a corporation, one would not ordinarily expect the tax to apply - given that it seeks to prevent the use of the corporation as a tax shelter by individuals who might control it - and, in fact, the Regulations to the Code "require that the avoidance be of the individual income tax." At the same time, however, the Code recognizes that in a parent-subsidiary relationship the subsidiary could be used to avoid tax with respect to the individuals who ultimately control the parent. Thus, the statute provides that if the corporation is being used to avoid the income tax "with respect to its shareholders or the shareholders of any other corporation," then the corporation may be obliged to pay the accumulated earnings tax. Vis-a-vis its subsidiary, of course, the parent would be an "other corporation." Where the subsidiary was being used to avoid the income tax of the shareholders of the parent, therefore, the subsidiary could be subjected to the accumulated earnings tax. In this regard, however, it should be noted that, as mentioned above, both parent and subsidiary would be eligible to claim a minimum accumulated earnings credit of $250,000 (or $150,000 in the case of certain service corporations).

36. Regulation 1.532-1(a).
4. What corporations are exempted from the tax by reason of the fact that they are "described in subsection (b)" of section 532?

Subsection (b) of section 532 states:

EXCEPTIONS - The accumulated earnings tax imposed by section 531 shall not apply to -

(1) a personal holding company (as defined in section 542),

(2) a foreign personal holding company (as defined in section 552), or

(3) a corporation exempt from tax under subchapter F (section 501 and following).

The corporation exempt from tax under subchapter F is of little significance to this discussion in that it is one which is not ordinarily operated to profit any shareholder.37

The "personal holding company" becomes such as a function of its income sources. Thus, to understand the statutory definition of the term "personal holding company," one must know that the statutorily defined term "adjusted ordinary gross income" means:

... basically the gross income of the corporation less capital gains and with adjustments relating to income from rents, mineral, oil and gas properties, and interest.38

A personal holding company is one which has more than fifty per cent of the value of its corporate stock held by five or

38. op. cit., p. 9-21.
fewer individuals and which receives at least sixty per cent of its "adjusted ordinary gross income" from:

(a) investments such as rents, dividends, interest, annuities and certain copyright royalties or

(b) the personal services of its "star" (where the person with whom the corporation has contracted for the services of its star has the right to designate that the "star" is the one who must perform the services contracted for and the individual who must or did perform the services owns 25 per cent or more of the stock in the corporation). 39

As a critical reading of this definition may suggest, a corporation meeting the "five or fewer individuals" et cetera ownership criterion which had previously carried on an active business could be transformed into a personal holding company by terminating that business and diverting its assets to "passive" investments.

A foreign personal holding company is, in essence, a personal holding company controlled by persons who are not American citizens. There are, of course, other nuances to the statutory definition but, as they are not germane to the topic at hand, further description of same would be superfluous.

The provisions in the Code dealing with the personal holding company owe their existence to deficiencies in the accumulated earnings tax as originally constituted and are intended to deal with two particular forms of tax avoidance.

which formerly could potentially have been subjected to the accumulated earnings tax: the so-called "star company" and the so-called "incorporated wallet." As Mr. Justice Marshall put the matter in a 1969 case:

In 1934, Congress dealt with one of the more flagrant examples of that ineffectiveness, the personal holding company. ... The reason for the change was that, '[b]y making partial distributions of profits and by showing some need for the accumulation of the remaining profits, the taxpayer makes it difficult to prove a purpose to avoid taxes.'

As this quotation would suggest:

the 'accumulated earnings tax' and the personal holding company tax have the same general purpose: to compel corporations to distribute their earnings as dividends taxable to their stockholders.41

The motivation which "compels" the corporation to distribute its income to its shareholders in these instances is provided by taxing its income at the top marginal rate imposed upon individuals rather than at the somewhat lower corporate tax rate. In the case of the personal holding company, the purpose of the accumulation and its reasonableness are immaterial insofar as liability for the tax is concerned.42

The foregoing examination of the four questions set forth above provides a basic analysis of the legislative and jurisprudential framework within which the accumulated earnings tax functions in the United States. The remainder of this chapter deals with other aspects of this tax.

It is interesting to note that there were changes made in 1954 which were intended to limit the scope and impact of the accumulated earnings tax. There was apparently concern that it was being imposed arbitrarily and forcing corporations to distribute funds which were in fact needed in the business. One of the changes made at that time was the creation of the accumulated earnings credit as a deduction from the amount subject to the accumulated earnings tax. Prior to this change, there was a significant potential for inequity in circumstances where the fiscal authorities sought to levy the tax in that, in the absence of the credit, if the corporation could not justify the retention of its entire accumulation from a particular taxable year, then the tax would be levied upon its entire undistributed net income.

One of the difficult aspects of the accumulated earnings tax from the taxpayer's point of view is that the tax presents a real potential for, in a sense, being cumulative notwithstanding the fact that it is levied with respect to the earnings of only one taxable year rather than

43. see Weithorn, p. 18.
with respect to the retained earnings of the corporation generally. This result occurs in that, if the accumulation was unreasonable in one year, then, barring new circumstances constituting reasonable grounds for the accumulations in subsequent years, it is most likely that any accumulations in following years were unreasonable as well. To a certain extent, this is a hidden cost of the tax.

The accumulated earnings tax has been described as "costly and difficult to enforce" because of its "partial dependence on subjective factors and the corporation's funds not needed in its business." As mentioned above, for example, it was the "ineffectiveness" of the accumulated earnings tax as then constituted which is said to have prompted Congress to enact the provisions of the Code applicable to the personal holding company. At the same time, however, it is certainly arguable that difficulties which may be encountered in enforcing the tax in individual cases may be disregarded in attempting to evaluate the effectiveness of the tax as presently constituted. If taxpayer concern regarding the tax prompts a high level of compliance, then surely the tax is effective notwithstanding the problems which the fiscal authorities may have in prosecuting those who choose not to comply. In this regard, the comments of Rudick are instructive:

44. Weithorn, p. 13.
45. See above at pages 73 and 74.
... the tax ... was not primarily designed to raise money but to deter tax avoidance and it has to a considerable — but probably not to a sufficient — extent achieved this purpose. There can be no doubt that the fear of imposition of the penalty tax has spurred the payment of many dividends that would otherwise not have been declared.46

Looking at the matter from this perspective, it is undoubtedly worthy of note that the same authors who describe the accumulated earnings tax as "costly and difficult to enforce" tacitly recognise that it must be effective to a certain extent in referring to research results showing that:

... the constant threat of the accumulated earnings tax, and the expenditure of time and effort involved in warding off challenges with respect thereto, were important factors inducing some closely held corporations to sell stock to the public or to sell out to public corporations.47

Thus, the American accumulated earnings tax would appear, on the whole to achieve a certain degree of success in deterring the use of the corporation as a tax shelter. The relative longevity of the tax and the fact that its basic structure is relatively unchanged since its original enactment in 1921 are also suggestive of its effectiveness.

This being the case, it may offer some guidance as to the

47. Weithorn, p. 16 at footnote 5 attributes this conclusion to the following research: Hall, The Taxation of Corporate Surplus Accumulations, Study Prepared for the Joint Committee on the Economic Report, 82nd Cong., 2d Sess. 75, 187; Butters, Linner & Cary, Effects of Taxation on Corporate Mergers 101-04 (1950), see "Economic Effects of Section 102" (1951), at xv, xvi, published by the Tax Institute, Princeton, New Jersey.
route which Canada could take if it were to adopt a form of tax on unreasonable accumulations.
The Canadian and American fiscal authorities were not alone in their early realisation of the potential for tax avoidance inherent in the separate legal personality of the corporation. In England, the first legislative measures dealing with "shortfalls\(^1\) came into existence in 1922.\(^2\) At that time, England did not have a separate statute dealing specifically with corporations as it does now and income tax was assessed against corporations in much the same manner as against individuals. One significant difference, however, led to the implementation of the anti-avoidance measures of the day - a surtax (or, more accurately in the words of the statute, a "super-tax") was levied against individuals but not against corporations. Thus, a special statutory provision was deemed necessary:

1. From 1966 to 1972, the term "shortfall" was actually used in the relevant statute to describe the portion of the corporation's income which was considered to constitute an "unreasonable accumulation." (See: Finance Act, 1965, section 77.) The term has apparently remained in common usage although its application in the context of the present legislation is described in Simon's Taxes, Income Tax, Corporation Tax, Capital Gains Tax, Revised Third Edition, London, Butterworths, 1983 (at page 584) as "conceptually inept."

[w]ith a view to preventing the avoidance of the payment of super-tax through the withholding from distribution of income of a company which would otherwise by distributed .... 3

The technique used in England to attack this "evil" took the form of a "notional apportionment of some or all of the income of a 'close company' among its 'participators'." 4 For present purposes, "participator" is adequately defined as being equivalent to shareholder – the other aspects of the statutory definition of this term not being relevant to the Canadian system of taxing the income of corporations. The English concept of apportionment will be discussed in more detail below but, in essence, apportionment is the process of treating, for taxation purposes, the undistributed income of a corporation as if it had, in fact, been distributed to the shareholders of that corporation.

A complete examination of all of the shades of meaning of the very complex statutory definition of the term "close company" would not be warranted in terms of the topic at hand and the following summary will suffice in lieu thereof:

Basically, the definition implies ownership or control by a small number of persons .... Major public companies whose names are household words can be and are close companies in circumstances where, although the shares are widely held by the public, the control of the company has remained in the hands of a small family group. 5

4. R. Bramwell and John Dick, Taxation of Companies, London, Sweet & Maxwell, 1979 at page 127. While the terms "close company" and "participators" did not actually appear in the legislation until 1965, this description of the tax is essentially accurate.
Given that the above definition of "close company" may well convey the impression that it applies to any corporate body whatever its income source or sources (which, if this is the impression conveyed, is as it should be in that the definition does apply to any such corporate body), it should be mentioned at this point that this chapter will focus principally upon the form of close company which, in the British legislation, meets the statutory definition of "trading company." It is felt that this focus is consistent with the topic under consideration in this thesis. A "trading company" is:

... any company which exists wholly or mainly for the purpose of carrying on a trade, and any other company whose income does not consist wholly or mainly of investment income ....

This definition of trading company, encompassing as it does "any ... company whose income does not consist wholly or mainly of investment income" might suggest to the reader familiar with Canadian income tax law that the trading company is one which earns the greater part of its income from the carrying on of an active business. For present purposes, that impression is sufficiently precise. Thus, in the context of an analysis of the potential application of a tax on unreasonable accumulations to the Canadian-controlled private corporation which "benefits" from the provisions of the small business deduction, the English trading company provides the most appropriate comparison.

In terms of the subject matter of this thesis, it seems appropriate to mention at an early stage in this chapter that in 1980 the scope of the English shortfall tax was very significantly reduced. Previously, this tax had potential application to all close companies in respect of their income from all sources. Thus, prior to 1980, the unreasonable accumulation of its "active business income" by a trading company could be expected to result in a shortfall assessment. In 1980, this income source was removed from the categories of income source which could form the subject matter of a shortfall assessment for a trading company. In presenting the Budget which led to this change, the Chancellor of the Exchequer explained its goal as being to provide an incentive for:

... the generation of capital from the inside, in the form of profits which are retained in the business. The tax system has now contained for more than 50 years a series of provisions under which a close company may be required to justify the amount of profits which it wished to retain in the business, undistributed. ... I now propose important changes, including the abolition of the apportionment of trading income ... of close trading companies .... These changes will cut out a thicket of complex tax provisions which are time-consuming for the small trading business, and a real impediment to growth.

A review of the legislative provisions referred to by the Chancellor of the Exchequer should suffice to convince

7. The term "active business income" is not, in fact, used in the English statute but is used here simply to facilitate the comparative analysis.
the skeptic that they do indeed qualify as "complex" - and the literature confirms the difficulty of the calculations required by the shortfall legislation.  

The passage from the Chancellor of the Exchequer's Budget speech quoted above is somewhat ambiguous in that it does not permit the reader to ascertain whether it is the complexity of the tax or its mere existence which is seen as the "impediment to growth." If, the complexity, then the conceptual validity of the tax is not necessarily in question and the removal of the tax as impediment could be achieved by "going back to the drawing boards" in an attempt to design less complicated provisions rather than by removing the active business income of a trading company from the ambit of its application. If, on the other hand, it is claimed that the tax itself is an impediment to growth in that it limits the ability of the company to retain funds for the purpose of financing its growth internally, then the assertion must be challenged. As the Chancellor of the Exchequer mentions in his speech, from the outset of the shortfall tax it was always possible for the company to justify the retention of its earnings - the justification being that the moneys retained be for the requirements of the business. As will be discussed more fully below, the legislation mandated an interpretation of the term "requirements" which was sufficiently broad to permit the

9. See for example: R. Bramwell and John Dick, Taxation of Companies, London, Sweet & Maxwell, 1979 at page 127. See also the discussion below at pages 102-106.
Be that as it may, in terms of this thesis the present version of the English shortfall tax is less useful for comparative purposes than its predecessors. This fact and the fact that other significant amendments to the shortfall tax as initially enacted in 1922 came into force in 1966 have dictated that the description of the British experience which follows should involve an examination of the evolution of the tax rather than merely its present state. Thus, the description which follows of the "notional apportionment" mentioned above and its consequences traces their development from the inception of the tax in 1922 to the present day.

There are, in fact, four important dates in the evolution of the shortfall tax:

1. 1922 - when apportionment first came into being;
2. 1966 - when the first separate taxing statute applying to corporations came into force in England;
3. 1972 - when the "imputation" tax system came into force in England; and
4. 1980 - for the reason described above.

The system originally introduced in 1922 was very different from its successors in that it did not lay down extensive statutory formulae for measurement of the "shortfall." This being so, it is worthy of independent examination. Given that the basic framework established in 1972 essentially remains intact (aside, of course, from the 1980 amendment
mentioned above which, although extremely significant in its effect, was accomplished with a relatively simple change to the language of the statute), the shortfall system which came into effect in that year will also be examined. While the system which came into force in 1966 marked a significant change in style from its predecessor, in its essence it is not sufficiently different from its successor to warrant an extensive description of its provisions and, for this reason, it will be reviewed only insofar as it differs significantly from both the 1922 and the 1972 enactments.

The matters to be examined in the following pages include:

1. the process for determining the portion of the corporation's income which may be so apportioned;
2. the person(s) to whom it is apportioned; and
3. the income tax consequences of this apportionment.

Later in this chapter, other aspects of the tax will be analysed. Each of the "preliminary" matters enumerated above will now be considered in turn.

1. the process for determining the portion of the corporation's income which may be so apportioned

As might be expected, the process of determining the amount, if any, which may be apportioned to the company's shareholder or shareholders in respect of a particular
fiscal year is, in essence, the process of calculating the company's "unreasonable accumulation" in respect of that year. It is this aspect, in particular, of the shortfall tax which involves the greatest complexity, has created the greatest number of problems and, presumably as a consequence, has changed the most significantly over the past twenty years or so.

Given that the English legislation under review here seeks to fulfil, very broadly speaking, the same function as the American accumulated earnings tax, one would anticipate finding some conceptual similarities in the systems of the two countries and, to a certain extent, this occurs. In both countries, the fiscal legislation is concerned with assessing the funds available to the corporate body for distribution to its shareholders. In both countries, as well, liability to tax is assessed against amounts retained from the earnings of a particular fiscal year rather than on the retained earnings of the corporation generally. Thus, in both systems where the year's earnings have been fully distributed by the corporation to its shareholders, there can be no further talk of "unreasonable accumulations" (as sub-paragraph (a) of sub-paragraph 1(2) of Schedule 16 of the Finance Act, 1972 which appears below at page 102 demonstrates).

Notwithstanding the presence of some similarities between the two systems, however, the English scheme, in the
details of its implementation, has historically been and remains quite different from its American counterpart. In fact, recent developments have served to accentuate the differences. The legislative "formula" permitting measurement of the amount available for "apportionment" in the English procedure exemplifies the distinctions. Whereas in the American context, the question of the "business needs" of the corporation is the central focus of the enquiry - as indeed it once was in England - this factor, while not insignificant, is merely one of many factors to be considered in the British scheme of things.

As mentioned above, the shortfall tax has found expression in several different legislative formats during its lifetime. At the same time, however, throughout its history certain elements have remained constant features of the tax. These common elements will now be examined as a prelude to a review of the various legislative provisions of which these elements have formed and continue to form a part.

The most important of the "common elements" present since the inception of the shortfall tax has been the ability of the company to justify its decision not to distribute its profits if its motivation in so deciding was its intended use of the funds for the "requirements of the company's business." Portions of the language of the
statute on this point are unchanged since 1922 in specifying that regard be had:

... not only to the current requirements of the company's business but also to such other requirements as may be necessary or advisable for the maintenance and development of that business ....

It clearly would be possible to construe the words "that business" in the foregoing passage as restricting the justification for retention of its profits by the company to circumstances where the "business requirements" in question were those of the particular business or businesses which the company actually carried on in the relevant taxation year. A relatively recent decision of the House of Lords, however, has rejected this interpretation. The better view concerning the nature of the business requirements which the court will recognise as a legitimate defence to a shortfall assessment would appear to be that "... whatever is genuinely in the contemplation of the taxpayer at the relevant date ... to enable the taxpayer company to generate further profits ...." will suffice.

Reaction to the shortfall measures which came into effect in 1966 led the Association of British Chambers of Commerce and the Confederation of British Industry to enter into discussions with the Inland Revenue with respect to the

10. Now found in sub-paragraph 8(2)(a) of Schedule 16 of the Finance Act, 1972, these words can be traced back to subsection 21(1) of the Finance Act of 1922.
12. loc. cit.
application of the legislation. As a result of these discussions, the Association of British Chambers of Commerce and the Confederation of British Industry produced a memorandum which dealt, inter alia, with the meaning to be given to the term "business requirements" under the new legislation. Given that portions of that memorandum are said to "remain relevant to the current legislation," it may be helpful at this point to quote from the memorandum:

6. ... It is only companies which have accumulated cash and liquid resources in excess of their requirements ... whose distribution policy can be called in question.

7. While ... companies with large cash and liquid resources must expect their accounts to be critically examined, it does not follow that higher dividends can necessarily be paid. ....

8. It will be necessary to make some comparison between the future maintenance and development expenditure on the one hand and resources available to meet it on the other. .... The company's expenditure plans must be genuine but cannot be precise. A company may intend to build new business premises if it can find land in an appropriate location and obtain planning permission. In such circumstances there is no absolute certainty that the premises can be built within a specified period of time but this would not necessarily invalidate the company's claim to retain funds for the purpose.

....

10. If a company has no cash or investments, and finances its trading operations by the use of borrowed money such as overdrafts, there would seem to be little ground for any shortfall assessment in the normal case.14

From the foregoing, it appears that as a general rule only where the company has liquid assets available to it for distribution will the question of justifying the retention of those assets on the basis of business requirements become an issue. On the other hand, where the company's illiquidity is self-induced, resulting from the use of its profits for a non-business purpose - to make loans to a shareholder, for example - then its illiquidity alone would not save it from an apportionment.

When the business requirements of the company are considered, relevant factors will be, inter alia:

... the need for and advisability of maintaining and developing the company's fixed assets and equipment, such as factories, plant, warehouses, showrooms and offices; 15

Another example of circumstances adjudged to justify a company's failure to distribute its profits on the basis of business requirements is found in the Fattorini case where the company had agreed with its bank that all income from certain assets purchased from the proceeds of a bank loan would be paid to the bank until the loan had been repaid. 16

As is the case in the American situation, for the purpose of the British shortfall tax, the funds which are considered to be available to the company to meet its

requirements include not only the profits from the current year but also its accumulated retained earnings. 17

Given that the business requirements of the company are, in a sense, the ultimate (but as suggested above, and more fully discussed below, far from the only) justification for the retention of profits, it is entirely comprehensible that almost since the inception of apportionment the winding up of the corporation or of its business has had special consequences. The present provisions trace their origins back to a 1927 amendment 18 to the Finance Act of 1922 (which originally created apportionment) and provide that the amount subject to apportionment:

... for any accounting period in which that event occurs, or which ends in or within the twelve months before that event comprises 100 per cent. of its distributable income. 19

In assessing the adequacy of the company's distributions, certain sums already expended by the company were, from 1922 down to 1978, treated as if still available for distribution and not having been applied to the company's business requirements. These sums were (and, in fact, continue to be) described in the legislation as being:

(a) any sum expended ...

(i) in or towards payment for the business, undertaking or property which the company was formed to acquire or which was the first

17. Bramwell, p. 137.
18. Sub-section 31(4) of the Finance Act, 1927.
business, undertaking or property ... in fact acquired by the company; or

(ii) in redemption or repayment of any share or loan capital or debt ... issued or incurred in or towards payment for any such business, undertaking or property, or issued or incurred for the purpose of raising money applied or to be applied in or towards payment therefor; or

(iii) in meeting any obligations of the company in respect of the acquisition of any such business, undertaking or property; or

(iv) in redemption or repayment of any share or loan capital or debt ... issued or incurred otherwise than for adequate consideration; and

(b) any sum expended or applied, or intended to be expended or applied, in pursuance or in consequence of any fictitious or artificial transaction ....20

Sub-paragraph (b) above bears some resemblance to sub-section 245(1) of the Income Tax Act of Canada; the necessity for such a rule seems beyond dispute. The provisions of sub-paragraph (a), however, have the effect of treating "income applied for or towards the acquisition of a company's first business ... as income available for distribution ...,"21 and have been described as provisions "in which it has not been found possible to discern any rational philosophy.22 While sub-paragraph (a) remains in

20. Currently found in paragraph 12(1) of Schedule 16 of the Finance Act, 1972, the language of these provisions is unchanged since 1922.
the shortfall legislation, new provisions added in 1978 would appear to have rendered it nugatory (except insofar as transactions between associated companies are concerned), as the following comment confirms:

... it is hard to see what scope there is at all for the present provision having regard to the 1978 changes on the one hand and the rules relating to property investment companies on the other.

Turning now to those aspects of the shortfall tax which have not remained constant throughout the history of the tax, one finds that, at its inception in 1922, and for the first 44 years of its existence, the British shortfall tax was expressed in essentially the following terms:

... where it appears ... that any company ... has not, within a reasonable time after the end of any year or other period for which accounts have been made up, distributed to its members ... a reasonable part of its actual income ..., the Commissioners may ... direct that ... the said income of the company shall ... be deemed to be the income of the members, and the amount thereof shall be apportioned among the members.

In assessing the reasonableness of the company's distributions, the Special Commissioners were instructed by statute to have regard to the factor mentioned above: the requirements of the company's business.

The test of reasonableness to be applied to the assessment made by the directors as to the company's ability

23. Finance Act, 1972, paragraph 8(3), added to the statute by Finance Act, 1978, section 36(2) and Schedule 5, paragraph 1.
to distribute its profits is based, as might be expected, on "the actual conditions known [to the directors] at the time for decision." In its original incarnation, the shortfall tax was considered to be "highly penal" with the result that it was held that:

... the onus is originally and remains on the Revenue to show that the company acted unreasonably in withholding part of its income from distribution. At the same, however, it was held to be:

... clear that for the purposes of the section it is to be considered unreasonable not to distribute income when there is no reason, or no sufficient reason, relevant to the needs, present or future, certain or contingent, of the company's business which makes its retention necessary or expedient in the interests of the company's business.

In assessing the company's reasonableness in not distributing some portion of its profits, proof by the Revenue of the presence of an intention to avoid payment of the surtax would eliminate any possibility of the company's proving that it has been reasonable in not distributing its profits. On the other hand, it has never been necessary for the Revenue to prove an intention on the part of the shareholders to avoid tax and, in fact, the reference (quoted above at page 86) to "preventing the avoidance of

27. loc. cit.
28. loc. cit.
the payment of" tax originally found in the preamble to the shortfall legislation no longer appear in the statute.

Effective in April of 1966, a separate statute dealing only with the taxation of corporate bodies came into force in England replacing the former scheme. Anti-avoidance measures continued to be a part of the legislative framework and provisions substantially similar in intent to the legislation originally enacted in 1922 were included in the new statute to permit apportionment of a company's unreasonable accumulations amongst its shareholders. At the same time, however, one very significant change was made in the method of calculating the amount of a company's income which would be subject to apportionment. Effective with the coming into force in 1966 of the 1965 legislation, a distribution by a company of 60% of its net trading profits (or, in other words, its active business income) would render it immune to a shortfall assessment. In effect, the retention by the company of 40% of its net trading profits had been declared to be "reasonable." In commenting upon the legislation, the Chief Secretary to the Treasury said the following:

... the 60 per cent. is a method of eliminating from discussion a whole host of cases. No longer will it be necessary, as it is today, for a company to satisfy the Revenue that it has made a reasonable distribution if it has distributed 60 per cent. of its net profits .... it is a relaxation - that is the whole purpose. A vast number of companies that might otherwise have been put to the trouble of, perhaps, no more than

writing a letter to the inspector of taxes explaining the position - or having an interview with him - will no longer have that trouble.\textsuperscript{33}

Obviously, even as early as 1965, there was perceived to be a need for a "relaxation."

In 1972, the corporate tax system in England underwent a significant revision with the introduction of the so-called "imputation" system which remains in force at present. This "new" system:

[t]o a great extent ... reproduced those parts of the earlier legislation dealing with the apportionment to shareholders of a close company's income in the event of a shortfall in distributions.\textsuperscript{34}

Thus, while the "new" system changed the mechanics of the shortfall tax, it did not greatly affect its substance with the exception of an increase to 50 per cent in the percentage of its active business income which the company could safely retain without fear of being subjected to a shortfall assessment.\textsuperscript{35}

In this "new" system, the statutory "formula" by which the amount subject to apportionment was to be determined during the period 1972 to 1980 was in essence as follows:

(a) an apportionment shall not be made under this paragraph unless the relevant income of the company for the accounting period exceeds its distributions for that period; and

\textsuperscript{34} Simon's Taxes, Revised Third Edition, page 504.
\textsuperscript{35} Finance Act, 1972, Schedule 16, paragraph 9(1).
(b) the amount apportioned shall be the amount of that excess ... 36

A brief review of some of the statutory definitions with which the close company had to contend in order to apply this "formula" to its own circumstances may serve to demonstrate the complexity (alluded to above) of the shortfall legislation.

Perhaps the most straight-forward definition from amongst the many upon which the above "formula" depends is that of distributions, defined as consisting of:

(a) any dividends which are declared in respect of the period and are paid during the period or within a reasonable period thereafter, and

(b) all distributions made in the period except dividends which, in relation to any previous period, would fall under paragraph (a) above .... 37

Essentially, the term "distributions" refers to dividends but even this interpretation must be used with care - when the imputation system came into force in 1972, certain payments made to or on behalf of directors (such as some interest payments 38 and certain living or entertainment expenses 39) fell within the definition of distributions. Furthermore, the definition raises several questions as to the time of payment of the dividends which may qualify as distributions.

37. Finance Act, 1972, Schedule 16, paragraph 10(1).
A very important part of the meaning of the above "formula" hinges upon the statutory definition of the term "relevant income" and this definition in turn is given content by statutory definitions of several terms used therein. As of 1972, "relevant income" was defined as being:

... in the case of a company which is a trading company ... so much of its distributable income for that period as can be distributed without prejudice to the requirements of the company's business;40

The "distributable income" of a company during this period (and today) was:

... the amount of its distributable profits for the period exclusive of the part attributable to chargeable gains .... 41

The term "chargeable gains" means that portion of the company's capital gains for the relevant period which is taxable.

The "distributable profits" of a company were (and are):

(i) the amount of any profits on which corporation tax falls finally to be borne, less the amount of that tax .... 42

One of the implications of measuring "distributable profits" in terms of "profits on which corporation tax falls finally to be borne" is that:

... this does not restrict the calculation to the results of the year, but allows for the offset of

41. Finance Act, 1972, Schedule 16, paragraph 10(2).
42. Finance Act, 1972, Schedule 16, sub-paragraph 10(2)(a).
past losses, etc. which are deducted from the profits of the year before arriving at the amount on which corporation tax falls finally to be borne.43

Having worked its way through this multitude of definitions and applied same to its income sources, the close company was not yet able to calculate the portion (if any) of its income which could be subjected to apportionment. Still to be considered were the rule mentioned above permitting the company to disregard in calculating its relevant income 50 per cent of its active business income and a further relieving provision for the small trading company. This provision allowed the small trading company when calculating its relevant income to disregard all of its active business income if less than £5,000 and, where such income exceeded £5,000 but was no greater than £15,000, to disregard one-half of the amount by which the active business income fell short of £15,000.44

The process of calculating the portion of the close company's income subject to apportionment pursuant to the provisions just described is described by Bramwell in the following terms:

The quantification process is made difficult by reason of the fact that it involves several stages and is given expression by the use of a number of

44. Finance Act, 1972, paragraphs 9(2) and 9(2). In 1978, these amounts were increased to, in the case of the lower amount of £5,000, £25,000 and, in the case of the higher amount of £15,000, £75,000 by Finance Act, 1978, s. 35.
defined terms of which some have no obvious meaning, for example, "relevant income." The foregoing, in fact, gives only a hint of the true complexity of the shortfall legislation during the relevant period in that it omits those parts thereof not pertaining to trading companies. Forms of corporation not falling within the scope of the definition of trading company were (and are) also potentially liable to be assessed to shortfall tax. The rules pertaining to these other forms of corporation add a considerable volume of material to the relevant legislation.

The change to the shortfall tax effected by the 1980 Budget was implemented by amending the definition of "relevant income" found above through the insertion of the words "other than trading income." "Relevant income" of a trading company is now defined as being:

... in the case of a company which is a trading company ... so much of its distributable income, other than trading income, for that period as can be distributed without prejudice to the requirements of the company's business; 46

As mentioned above, these words effectively remove the trading (or active business) income of a trading company from potential liability to the shortfall tax. The income other than trading income of the trading company can also be retained by it without fear of shortfall tax only if that other income is needed in the company's active business.

45. Bramwell, p. 127.
2. the person to whom it is apportioned

As a rule, the income subject to apportionment is "apportioned" to the corporation's "participators" or shareholders. In the case of a corporate "participator," however, sub-apportionments may be made to the participators of that company, and, where necessary, this process may be repeated through a chain of companies until an apportionment to human shareholders is made. 47

3. the income tax consequences of this apportionment

Apportionment has ramifications for both the company and for its "participators." In considering those ramifications, it must be borne in mind that the procedure for calculating the amount of the tax is slightly misleading insofar as the question of liability to pay the tax so calculated is concerned.

From the inception of apportionment in 1922 to the present, the income "unreasonably accumulated," and as a result "apportioned," has, for the purpose of calculating the tax payable, been treated as if it had, in fact, been distributed to the shareholders in accordance with their 47. Finance Act, 1972, Schedule 16, paragraph 1(4).
respective interests in the company. Based upon this notional distribution, the surtax appropriate to the income level of the "recipient" of this income can be calculated.

Insofar as payment of the sum apportioned is concerned, however, the shareholder has never been the sole target. If he so wishes, the shareholder can elect to pay the tax. In the event that the shareholder fails to do so, the Revenue may look to the company for payment. At the same time, ultimate liability for payment of this tax falls back upon the shareholder where the company neglects to attend to the matter.

Up until 1966, apportionment involved a single tax which could, in the manner described in the preceding paragraph, be collected from either shareholder or company. In either event, there was only one level of tax exigible.

In 1966, with the advent of the new corporate tax statute came a new tax to be levied upon the company in respect of its distributions to its shareholders and to be in addition to the tax previously payable by the shareholder upon dividends received. It was at this time that the term "shortfall" actually became a part of the legislation with the introduction of the so-called "shortfall" assessment procedure as a mechanism for measuring the amount of any "unreasonable accumulation" or "shortfall."

corporation and the shareholder, an "unreasonable accumulation" obviously has the potential to cause a revenue loss to the government at two levels rather than merely at one. Thus, the new fiscal regime of 1966 calculated the tax on unreasonable accumulations at two levels - at the corporate level, through the shortfall tax, and at the shareholder level, through apportionment. The question of tax liability with respect to amounts apportioned is dealt with in a preceding paragraph; responsibility for payment of the shortfall tax was solely that of the company.

The "imputation" system initiated in England in 1972 in effect continues the practice instituted in 1966 of levying a tax on the company when it pays dividends to its shareholders as well as taxing the shareholders themselves upon dividends received. The tax payable by the company is now known as the "advance corporation tax" and may be set off by the company against its corporation tax for the period in which the relevant distribution was made by the company. In this "new" system, when an apportionment is made, the company becomes liable to pay to the Revenue an amount which is equal to the advance corporation tax which would have been payable if the amount apportioned had actually been distributed by the company. The shareholder, however, receives a tax credit in recognition of this payment by the company whose income was apportioned to him.
The examination of the three "preliminary" matters set forth above constitutes a basic description of the "tax on unreasonable accumulations" both as it presently exists in England and as it existed in that country in the recent past. In the course of describing this tax above, some of the problems which it has created have, of course, been discussed. The remainder of this chapter deals with other issues which have arisen in connection with the English shortfall tax and which could be relevant to an attempt to institute such a tax in Canada.

In chapter five, the accumulated earnings tax imposed in the United States was reviewed. As was discussed therein, that tax is very definitely penal in nature. It was mentioned earlier in this chapter that the English shortfall tax has been referred to as being not merely penal but "highly penal." What is the nature of the penalty involved?

Consideration of the penal aspect of the shortfall tax reveals another area where the British legislation has followed a similar path to that traced in the United States. During the first 44 years of existence of this tax, a finding that there had been a "shortfall" in the company's distributions would result in what was then known as a "surtax direction." It was possible to appeal or (as will be discussed below) compromise a surtax direction but in the event that this did not take place, the ultimate consequence
of such a direction was the apportionment amongst the shareholders of all of the company's income not previously distributed. In other words, notwithstanding the fact that some or even the greatest portion of the company's income might be required to meet the company's business requirements, if there was a shortfall in the company's distributions, all of the company's income — including that portion thereof which was needed to meet its business requirements — would be apportioned. In this regard, then, there is a basic similarity with the American situation wherein, in the early years of the accumulated earnings tax, the retention of any amount over and above that needed for the business needs of the corporation would result in the accumulated earnings tax being levied on all of the corporation's profits for the relevant taxable year.

During this period, to temper the severity of the penalty a practice developed whereby the Inspector of Taxes would conduct an annual review during which he and the company would attempt to reach agreement as to the appropriate level of distributions for the year in question. As a result of this practice, it would appear that the legal consequences of inadequate distribution by the company of its profits:

... i.e., a direction and apportionment of 100 per cent. of the profits, was rarely enforced once the practice grew ....

49. Talbot and Wheatcroft, p. 241.
Effective with the coming into force in 1966 of a tax statute applicable only to corporate bodies, the American practice of assessing the tax only with respect to the amount which was considered to constitute an unreasonable accumulation was adopted in England. With this change, the shortfall tax ceased to be penal in nature—except to the extent that what some might regard as "prepayment" of the tax can be regarded as penal. Notwithstanding this move away from a penalty tax, the practice of annual agreements as to the appropriate level of distributions was continued. With the move in 1972 to the "imputation" system of taxation for corporations, this procedure was modified and, in the absence of requests for clearance (the procedure described in the following paragraph), the current practice involves reviews by the Revenue at three year intervals rather than the former annual review. 50

To a certain extent, the practice of annual agreements with respect to the portion of the company's earnings to be distributed to its shareholders referred to above is recognised and, perhaps, encouraged by the taxing statute. The relevant provisions allow the company to submit to the Inspector of Taxes on an annual basis its accounts, directors' report and such other material as the company deems appropriate and, in submitting this material, request that the Inspector of Taxes decide whether or not the

company's distributions for the year have been adequate. Upon receipt of such a request, the Inspector has three months (which can, under certain circumstances be extended for a further three months) within which to make an apportionment. His failure to do so within this time will act as a bar to any future apportionment with respect to the period in question. A decision that an apportionment should be made in these circumstances allows the company to make a further distribution and thus avoid the apportionment.

In terms of evaluating the possible effects of a tax on unreasonable accumulations, it is interesting to note that it has traditionally been considered sound practice for a close company to make use of the procedure described in the previous paragraph. This recommendation has been based upon the potential disadvantages of not doing so. Wheatcroft, for example, writes:

Little, if any advantage is gained by not bringing the question to a head quickly, while, if this is not done, and a company is left with a possible liability for directions for six previous years, the shares in that company are difficult to sell or to use to raise money and the uncertainty as to what may be heavy outstanding liability is bound to hamper future development plans. Curiously, the American literature does not seem to mention similar concerns.

One of the problems potentially created by a system which taxes corporate profits which have not in fact been

52. Wheatcroft, 1962, pp. 1621-1622.
distributed on the basis of a notional distribution is that of double taxation. In many cases, of course, the corporation will eventually distribute these profits to its shareholders. The result could be taxation at the time of the notional distribution and taxation once again at the time of the actual distribution. The English legislation contains provisions which are intended to deal with the problem. The (attempted) solution consists of a provision pursuant to which, in circumstances where a subsequent distribution exceeds the company's relevant income for the relevant period, the shareholder's income is deemed not to include a portion of the subsequent distribution which, in theory, corresponds to the portion upon which tax has previously been paid.  

The comments of Bramwell with regard to this "solution," however, are instructive:

... no relief is due, for example, where interests in a close company change hands between the apportionment and the later distribution. ... Furthermore, the provision is defective in that it gives no indication of how an amount that is subsequently distributed is to be identified with the income of an earlier accounting period.  

As will be discussed in the next chapter, the problem is not a simple one.

54. Bramwell, p. 149.
Chapter 7

A Tax on Unreasonable Accumulations for Canada: The Form It Might Take

It has been suggested in earlier chapters of this thesis that, taken together, the elimination of the concept of the "total business limit" from the legislative scheme which embodies the small business deduction, the new capital gains exemption and the proposed reduction in corporate tax rates create a case for the implementation of a tax on unreasonable accumulations. This chapter will consider the manner in which such a tax could be structured.

The cumulative history of Canada, the United States and England in the realm of taxing unreasonable accumulations suggests that simplicity of design and administration must be considered in attempting to impose such a tax. In this regard, the advice of Professor Surrey may be worth heeding:

... some slippage between goals and results can be tolerated if other factors such as simplicity of administration are important enough.¹

An attempt to solve "the virtually insoluble problem of how to achieve total neutrality" would, of course, be mere repetition of ancient error if it achieved technical "perfection" in a system which was virtually incomprehensible to the taxpayer and his advisers. If a tax on unreasonable accumulations is to be instituted, then, it must be structured so as to fulfil its purpose without adding unduly to the complexity of the Act.

The significance of the complexity issue is illustrated by the fact that the American example of this tax clearly does not have the level of complexity which was such an important feature of its Canadian and British manifestations and of it alone can it truly be said that it has survived the test of time - the Canadian examples of this form of tax have long since been repealed, its most recent British manifestation has been very severely reduced in scope and yet, the accumulated earnings tax continues to be a viable aspect of the American income tax system. By contrast with the situation which pertained to its Canadian and British counterparts when they constituted significant elements of their respective tax systems, complaints as to the complexity of the American accumulated earnings tax seem to be the exception rather than the rule. The few complaints which do surface in the American literature with respect to the accumulated earnings tax focus on the fact that it is not always possible to predict how a court will respond to a corporation's attempt to justify its retention of funds as
being necessitated by the "reasonable needs" of the business. For example, one article refers to the "complex business reasons that can justify an accumulation." Concerns such as this must be taken note of as problem areas to consider if such a tax is to be created in Canada. At the same time, however, it is possible that they are more accurately attributable to resentment of the tax than to problems with it - the accumulated earnings tax in essentially its present format has survived for sixty-five years. If the problem of interpreting the "business needs" of the corporation was truly significant, one might have expected to see more in the way of amendment than has occurred.

In very general terms, there are essentially four issues to confront in attempting to design a tax on unreasonable accumulations for the Canadian context. These are:

4. Bittker and Eustice observe that the "corporate penalty tax on unreasonable accumulation is not popular with the business community, as it involves a hindsight verdict on management's business judgment." Boris I. Bittker and James S. Eustice, Federal Income Tax of Corporations and Shareholders, Boston, Warren, Gorham & Lamont, Inc., 1979 at p.8-5.
1. At which level should the tax be imposed: that of the corporation or that of the shareholder?

Which taxpayer should be subjected to the tax on unreasonable accumulations - the shareholder or his corporation? While the measuring device to determine whether the accumulation was excessive would presumably be the same in either case, the calculation of the tax itself would not necessarily be so. Naturally, neither choice would be free from difficulty.

The most serious potential injustice in this situation, however, would seem to be that faced by the individual shareholder where a notional apportionment such as that seen in the British system imposed liability to tax on that shareholder. How would he finance the payment of tax on funds not actually received? Would he ever receive the money upon which he had paid tax? The shareholder who found himself in this situation could, conceivably, bring an action against the directors of the corporation for their
negligence in causing the tax to be imposed. (In the United States where the accumulated earnings tax is levied at the corporate rather than the shareholder level, the possibility of a derivative action being instigated by minority shareholders of a corporation subjected to the accumulated earnings tax is viewed as a very real one.)\textsuperscript{5} To suggest litigation as a solution, however, would rarely be practical advice - in addition to the inconvenience and expense which it entails, it is generally accepted that in the close corporation maintaining the personal relationships amongst the shareholders is very often indispensable.

A further potential problem with the levying of the tax at the shareholder level would be that of double taxation on an eventual distribution of retained earnings by the corporation - the taxpayer, having already been taxed on a "deemed," but not actual, distribution, could conceivably face liability to tax a second time when the actual distribution took place. Insofar as the corporation was being used to avoid tax, double taxation could, of course, be seen as merely constituting a portion of the penalty. If, however, the system was not intended to be penal in nature, then it would seem to follow that it should be designed so as to allow shareholders to avoid double taxation in such circumstances. As was described in chapter

six, the British shortfall legislation could most accurately be described as unsuccessful in its attempt to avoid this potential inequity.

When the problems left unanswered by the British attempt to avoid double taxation are analysed, one is left with the impression that efforts to improve upon that attempt would likely result in extremely complex legislation and, in the final analysis, could well prove fruitless. One might consider, for example, the situation of shareholder A, holding 25% of the common shares of company Z, who has apportioned to him in year 1 $10,000. In year 4, shareholder A receives a dividend of $10,000. Does that distribution represent the income of year 1, 2, 3 or 4? If we assume for a moment that a corporate resolution passed by company Z is to be deemed determinative of that question, how is the company itself to keep track of which distributions relate to the earnings of which fiscal periods? What if shareholder A's interest in the corporation has changed since year 1? There seems to be little likelihood of satisfactorily resolving all of the potential problems inherent in the double taxation aspect of apportionment.

Looking to the alternate possibility of taxing the corporation rather than the shareholder, one finds a

6. As was suggested by Richard Bramwell and John Dick in Taxation of Companies, London, Sweet & Maxwell, 1979 at p. 149.
potential problem in that such a tax could (indirectly, of course) cost the "innocent" minority shareholder (whose marginal tax rate was relatively low and who wished the corporation to distribute its profits) more in taxes than would a notional distribution and taxation of the amount deemed to have been distributed. If a tax on unreasonable accumulations implemented in Canada had the effect of raising the effective corporate rate on income subjected to its provisions to 50% (as would the scheme suggested below), the result effectively would be that the taxpayer/shareholder whose marginal rate was less than 50% would pay a greater amount of tax on the relevant income than would the individual receiving that same amount of income directly. This aspect of the situation would constitute a lack of horizontal equity. As for the majority fellow shareholder or shareholders with whom the unfortunate "innocent" shared ownership of the corporation, depending on the method of implementation chosen for a Canadian tax on unreasonable accumulations, it is conceivable that its ultimate effect (taking into consideration both corporate and personal income tax) upon him or them would be no different than if the income had in fact been distributed by the corporation as dividends. In effect, then, the tax on unreasonable accumulations levied at the corporate level, by affecting the value of each common share in the same way regardless of the financial circumstances of its owner, would bring into the Canadian taxation system a certain lack
of vertical equity — where the "innocent" shareholder with his low marginal rate paid (notionally) the same absolute amount of tax as fellow shareholders whose marginal rates were higher, persons in different circumstances would not "bear appropriately different taxes." \(^7\)

To put the potential inequities described in the preceding paragraph into perspective, however, other aspects of the situation must be explored. Specifically, it must be recalled that the small business deduction represents a potentially significant advantage to the shareholders of the Canadian-controlled private corporation in terms of its possibilities for tax deferral. Those minority shareholders who might be adversely affected in the circumstances described above have available to them two methods of retaining the tax deferral advantage while avoiding the inherent risks. First, prior to their purchase of the shares, the opportunity would exist for them to insist upon appropriate contractual protection in a shareholders' agreement. Second, is the possibility, albeit, as discussed above, not necessarily an attractive one, of instigating derivative proceedings on behalf of the corporation against the directors for so acting as to cause the tax on unreasonable accumulations to be imposed. Taking these elements into consideration, one may contrast the situation of these minority shareholders, who would voluntarily assume

the risk just described in the hope of availing themselves of the potential benefits and whose risks are in themselves accompanied by potential legal remedies, with that of those whose income does not come through a corporate intermediary and who may not, by virtue of the vagaries of a tax system lacking in neutrality, avail themselves of the potential benefits which accompany the use of the corporate form. One may also recall that, by definition, these risks are incurred only by the minority of the shareholders of the Canadian-controlled private corporation. The seriousness of the potential lack of horizontal and vertical equity inherent in a tax on unreasonable accumulations which is imposed at the corporate level must be assessed in light of these factors.

The foregoing reviews advantages and disadvantages of the two choices as to the appropriate level (corporate or shareholder) to which a tax on unreasonable accumulations might be targeted; the relative merits of the two choices must now be compared. A tax on unreasonable accumulations which embodied a form of apportionment would be flawed not only in terms of the injustice of imposing a tax on income not actually received but also in terms of the complexity which would be necessary to avoid double taxation. By comparison with a system of apportionment, a factor which favours the levying of a tax on unreasonable accumulations at the corporate level is that the entity upon which the tax would be imposed would be the entity which had received the
income which gave rise to the tax and which would therefore be in a better financial position to pay same. The potential for such a system to produce circumstances wherein horizontal and vertical equity would be absent is undoubtedly a drawback but, it is submitted, is a less serious problem than the potential abuse of the deferral advantage inherent in the present small business taxation system. In view of the relatively serious problems which might accompany an apportionment system and the relatively lesser problems which would appear to be associated with a tax imposed at the corporate level, on balance, it would appear that levying the tax at the corporate level should be the preferred method.

2. How is it to be decided that there has been an unreasonable accumulation?

As a preliminary comment regarding the question posed in the above sub-title, it should be stressed that the matter of deciding that there has been an unreasonable accumulation will be dealt with herein independently of that of deciding upon the portion of the unreasonable accumulation which should form the basis of an assessment to tax.

The most straightforward approach to the question posed above would appear to consist of a policy which provided that, with respect to any given taxation year, a corporation
would be deemed to have unreasonably accumulated moneys where it had retained more of its profits derived from active business in that year than were needed in terms of the business requirements of its active business. In terms of the alleged lacuna in the present provisions creating a small business tax credit in the Canadian income tax system which is the subject matter of this thesis, this focus seems entirely appropriate. If the purpose of the credit is to provide funds for the small business, then the business requirements of that small business should be extremely pertinent to any enquiry into the continuing eligibility of the corporation to shelter from tax that portion of its retained earnings which represent the credit. Within these broad parameters, there are, of course, a number of elements to consider.

The question of interpreting the term "business requirements" would perhaps cause some uncertainty - as the complaints referred to in the opening pages of this chapter would suggest has occurred in some instances in the United States. At the same time, however, it must be noted that while in general the legislation embodying the British shortfall tax was seriously flawed in terms of its complexity, there would seem to have been, based upon the lack of reference to same in the literature, relatively few problems in interpreting the expression "business requirements." Certainly, there is a wealth of jurisprudential and administrative experience available in
the United States and England upon which Canada could draw for assistance in putting content into this expression. It may be as well that the significant problems experienced in this country in the late 1970's in attempting to define the term "active business" have led to the creation of a jurisprudential and legislative base which would facilitate the implementation of a tax on unreasonable accumulations. With the term "active business" having been subjected to the scrutiny of the courts and defined by statute, it may be that examining the business requirements of that active business and determining whether funds have been retained for use in connection with same could prove to be less difficult than might otherwise be the case. In the final analysis, determining the business requirements of a corporation would essentially be a question of fact and, as with all such questions, would inevitably involve difficult analyses from time to time. The occurrence of such problems, however, would not seem to detract from the inherent simplicity of the concept itself.

One aspect of assessing the "reasonableness" of the corporation's accumulations is the question of defining "retained." In this context, "retained" would mean not distributed within the year or a grace period of, for example, three months thereafter - the grace period giving the corporation some time within which to prepare its final accounts for the year.
It would seem important to assess the reasonableness of accumulations by reference to individual taxation years in the manner adopted in both the United States and England. In other words, if challenged by the Revenue, the corporation would be subject to a tax on unreasonable accumulations with respect to no more of its unreasonable accumulation than was actually earned in the particular year or years under review. The purpose in thus limiting the scope of the Revenue's enquiry would be to attempt to minimise the number of on-going accounts which the company would have to define in its financial records for no other purpose than to permit the assessment of tax.

The preceding portions of this section of the chapter lay a foundation for dealing with the central issue: how to determine whether an accumulation was unreasonable in terms of the business requirements of the corporation. In the interests of simplicity a tax on unreasonable accumulations should, as a general rule, require the corporation to justify its retention of any asset which is not invested in an active business carried on by the corporation. This general rule being too broad to stand alone, however, the following factors (to be discussed in more detail in the next few pages) should also be considered:

1. an exemption in respect of the non-taxable half of capital gain;

2. a form of accumulated earnings credit; and
3. the comments under sub-title 3 below as to the calculation of the specific amount by reference to which tax would be levied.

Both the American and the British examples would suggest that, in practice, enquiries into the reasonableness of the corporation in retaining its profits will obtain considerable guidance through the application of the "liquid assets" test, viz. the presence of cash or near-cash assets of a significant value will tend to show that an unreasonable accumulation has been made. In considering this matter, the assets available would be the assets of the corporation generally without regard to the manner in which they may have been earned – borrowing from the essentially similar American approach.

In recognition of the fact that only one-half of a capital gain is taxable, the non-taxable half of a capital gain could be disregarded for purposes of the assessment of the reasonableness of an accumulation in the year in which it was earned. To extend this exemption beyond that year, however, would appear to introduce an element of complexity - that of the role of the capital dividend account as a part of the retained earnings available to the corporation to meet its business requirements. It would be with a view to eliminating such potential complications that the exemption with respect to the non-taxable half of a capital gain would be limited to the year in which the capital gain was made.
The American approach of providing that a certain threshold level of accumulation over the life-time of the corporation (a specific amount below which the accumulated earnings credit cannot fall) is essentially deemed to be reasonable has much to recommend it as does the British method of allowing a modest credit each year in respect of the earnings of the corporation from that year. Virtually any business requires a minimum level of working capital and this should be recognised. Additionally, designating a particular amount as "reasonable" both in terms of a basic threshold amount and in terms of an annual amount may have the virtue of relieving the tax-collector of the temptation to make nuisance assessments. It was this latter factor which led both the Americans and the English to enact their respective "credit" provisions.

It could be argued that accumulations which had been used in a fashion consistent with the purposes of the small business deduction would become "unreasonable" when the corporation ceased to carry on its active business and should, in such circumstances, be taxed to the extent of the deferral benefit inherent therein. There is, however, a counter argument which seems more convincing. This argument recognises that if a form of tax on unreasonable accumulations was made a part of the fiscal regime constituted by the small business deduction, then, assuming it to be effective, it would ensure that the tax savings created by the small business deduction were used in the
appropriate fashion. This being the case, then it could justifiably be argued that a form of recapture which became effective upon the winding up by the corporation of its active business would, in effect, be no more than a penalty for ceasing to carry on business - the portion of tax "deferred" in the functioning of the small business deduction would have already served its purpose of contributing to the economy through that business.

3. Upon what amount should the tax on unreasonable accumulations be assessed?

The tax should be imposed by reference to the lesser of:

(a) the amount by which the moneys available to the corporation in the particular taxation year exceed its business requirements; and

(b) its profit from active business in the particular taxation year.

When moneys accumulated in previous taxation years are taken into account, the corporation may have considerably more liquid capital than is needed by it in its business. For the reasons discussed above, however, the tax is to be imposed by reference only to the profits from active business in the particular taxation year under review.
4. Should the tax be penal or otherwise?

The purpose of the tax would be essentially to withdraw the benefit of the small business deduction from a corporation which was not making use of same for business purposes. In this regard, a Canadian tax on unreasonable accumulations could be contrasted with the American accumulated earnings tax which is exigible only where, inter alia, the:

\[ \text{corporation ... [was] ... formed or availed of for the purpose of avoiding the income tax with respect to its shareholders ...} \]

In view of the more limited function of the proposed tax on unreasonable accumulations in the Canadian context, there would appear to be no reason for the tax to be penal except to the extent necessary to recover the benefit which originally accrued to it by virtue of the small business deduction and, thus, no reason for the tax on unreasonable accumulations to be restricted to circumstances where the Revenue was able to prove a tax avoidance purpose. Thus, the corporation could be given the opportunity of voluntarily paying the tax whatever form it took and only upon failure to do so would the normal penalties imposed in such circumstances be imposed.

In considering the tax itself, there would appear in essence to be two choices:

8. From Section 532(a) of the American Internal Revenue Code.
(a) an irrevocable "recapture" equivalent to the amount of the tax saving; or

(b) a form of refundable dividend tax on hand.

Each, of course, would have its own advantages.

The recapture provision would have the very significant advantage of simplicity. As will be discussed below, there would seem to be significant opportunities for complexity in a refundable dividend tax on hand format in this context. The recapture, on the other hand, could be designed so as to lead to the same result as if the small business deduction had not been available to the corporation in the first place, which, if the corporation had been unable to justify its retention of the funds on the basis of business requirements, would seem to be an appropriate result. In order to mitigate the possibility that the recapture would also be, in effect, a "penalty" and enable this tax to fulfil an "integration" function, it would seem possible to regard the relevant portion of the corporation's profit from active business remaining after payment of the recapture (an amount which would, at current tax rates, be approximately twice the amount of the recaptured tax) as a tax paid undistributed surplus which could be distributed by the corporation as tax free dividends.

The alternative to the recapture is to regard the amount payable as a tax on unreasonable accumulations as refundable dividend tax on hand. This was the solution opted for as part of the Part V tax. The problem with this
approach is that it potentially raises very difficult questions as to the conditions under which the refundable dividend tax on hand may be refunded. Can it be refunded if the corporation owns investment assets (as opposed to assets used in an active business carried on by it)? Surely not, for the ownership of such assets would indicate that the corporation has funds available to it which are not being used in its active business. How then are we to define investment assets for this purpose? The obvious (and unacceptable) solution is to borrow the very difficult concept of ineligible investments from the Part V tax. The significant uncertainty inherent in this latter concept would suggest that use of a mechanism such as a refundable dividend tax on hand in these circumstances would be fraught with difficulty and, in terms of a desire to avoid complexity in the Act, undesirable.

Another possibility which would be in addition to rather than in substitution for a tax in these circumstances would be to adopt the English approach of having the Revenue and the taxpayer agree on an annual, biannual or triannual basis on the level of distributions which would be reasonable for the taxation year in question. This would have the significant advantage of avoiding the uncertainty and resulting problems mentioned above which accrue in the case where a tax on unreasonable accumulations exists and which focus on the question of whether or not there may be a potential "shortfall" assessment thus casting a shadow over
the corporation and affecting its potential sale value. On the other hand, it would greatly increase the workload of Revenue Canada and could lead to the situation where the taxpayer was in essence asking Revenue Canada to sit in judgment on its business decisions. It would seem more appropriate that the onus rest with the taxpayer in this situation to make its own considered decision as to its business requirements. Furthermore, while the English practice may have been very necessary when it first developed due to the severe penal consequences of the English tax as it then was, the less severe consequences involved in the case of the taxes proposed above would provide far less justification for such a practice.

To sum up, then, it would appear that if a tax on unreasonable accumulations were to be implemented in Canada, it should embody the following features:

1. It should be imposed at the corporate rather than the shareholder level subject to:
   
   (a) an exemption for the non-taxable half of a capital gain in the year in which it occurs; and
   
   (b) a dual accumulated earnings credit consisting of both a basic threshold and an annual amount.

2. It should be levied only where the corporation's accumulations from the income of a particular taxation year exceed its business requirements for that year.

3. It should be imposed by reference to the lesser of:
(a) the amount by which the moneys available to the corporation in the particular taxation year exceed its business requirements; and

(b) its profit from active business in the particular taxation year.

4. It should be designed to recapture from the corporation the amount of tax which the corporation would have paid with respect to its unreasonable accumulation had it not availed itself of the small business deduction in the first place.

A tax on unreasonable accumulations structured along these lines could provide the control device presently lacking in the small business tax system and, by doing so, increase the likelihood that the tax deferral available through this system fulfil the function which justifies the existence of the small business deduction.
The concept of a tax on unreasonable accumulations is far from new — whether in Canada or elsewhere. In fact, viewed from an historical perspective, it must be observed that, whatever merit the suggestion that such a tax be reimposed in Canada may have, it is clearly not a step to be taken without some trepidation. Taken together the Canadian and British experiences in this realm must be interpreted as a warning that it would be all too easy to fall into the trap of complexity.

In light of the Canadian experience with the tax on unreasonable accumulations as created at the time of Tax Reform, the absence of such a tax in the current Canadian context is perfectly understandable — but, nonetheless, undesirable. The slippage between the goals of neutrality and horizontal equity and the reality of a small business tax system which has allowed for significant deferral based merely upon the manner of birth (i.e. "delivery" by Registrar of Companies as opposed to by medical doctor) of the direct owner of a business has been considerable. The elimination of the total business limit and the exemption from tax (announced in the last Budget) of certain
capital gains render that potential for slippage all the greater. The proposed lowering of corporate tax rates, if carried out, would further magnify the problem. A tax on unreasonable accumulations in the Canadian context would now seem to be appropriate. In this regard, the suggestions contained in the preceding chapter attempt to distill from the various examples of this tax reviewed in earlier chapters some lessons for future Canadian use.

It must be recognised that a tax on unreasonable accumulations would produce some inconvenience. For example, the advice referred to in chapter four of this thesis that owners of Canadian-controlled private corporations consider the use of one company for investment purposes and another for active business would probably be very sound advice were such a tax to return. The only forceful response to the complaint which such inconvenience would bring is a reminder that it could be regarded as the price of a privilege: the advantageous rate of tax for the Canadian-controlled private corporation carrying on an active business which gives its owner the opportunity of deferral and which is not available to others. One might also (but with less force) remind the complainant that it may be more prudent to take full advantage of limited liability by not mixing the more secure "passive" investments with the risk normally associated with small business. Finally (and with still less force), one might point out that it is a complaint made possible only
due to the good fortune which permits the complainant to have the problems associated with accumulated wealth.

In the English and American literature regarding the taxes on unreasonable accumulations which have been enacted in those countries, suggestions that the directors of the company create documentary evidence to justify their level of distributions or lack thereof are a frequent feature. A typical example is the suggestion that directors should make a statement in their annual report that the company has made no provision for shortfall tax for certain reasons which should then be specified.\footnote{1 B.D. Easlick, "Shortfalls: How to Avoid and Why," Accountant, vol. 158 (February, 1968), pp. 138-139 at p. 139.} If a Canadian tax on unreasonable accumulations were re-enacted and if, the tax permitted accumulations to be justified on the basis of business requirements - as clearly it should - it is presumably inevitable that prudent business practice in future consist of the preparation of such evidence of the existence of specific corporate plans. In both England and the United States, only plans which seem to be backed with a serious intention to bring them to fruition will satisfy a court. If a subsidiary result of the implementation of a tax on unreasonable accumulations were that it provided additional motivation to small business to give serious consideration to the planning process, it is difficult to see the harm which might be caused thereby. One would not attempt to borrow funds from a bank without presenting a
business plan to that bank. If one applied for a direct
grant from government, one would expect to provide evidence
as to one's intentions and, perhaps at a later date, proof
that those intentions have been carried to fruition. The
suggestion that documentary evidence of plans be available
does not seem unreasonable when the potential for deferral
available through the small business deduction is
considered.

A frequent complaint with the form of tax under
discussion herein is that it acts as a spur to corporate
distributions which would not otherwise be made. Yet the
complaint rings hollow whether made with respect to the
English shortfall tax or the American accumulated earnings
tax when it is recalled that in both those countries the
business requirements of the corporation constitute
justification for the retention of funds. If, in the
absence of such business requirements, the corporation feels
threatened and compelled to declare a dividend, then that is
as it should be - that is the very purpose of the tax. It
is a price to pay - but, as suggested above, it would appear
to be the price of a privilege. To quote from Professor
Surrey's hypothetical attempt to find a method of explaining
the benefits of deferral of tax to an American congressman:

Do you ask the Congressman if he would like to
know a bank that would lend him money without
interest charge and without any collateral? Do
you then say to the Congressman that some
taxpayers are aware of such a bank - they call it the U.S. Treasury?2

There would seem to be no justification for an assertion that the small business deduction should be an unconditional deferral.

Given the current absence of a tax on unreasonable accumulations from the Canadian setting, the following comment from an American writer is interesting.

The penalty tax on corporations improperly accumulating earnings must be kept in the statute. Its complete abolition, suggested by some, would provide a gateway to wholesale tax avoidance and is simply not thinkable.3

It is submitted that the recent and anticipated evolution of the small business corporate tax regime make the assertion found in the above quotation increasingly applicable to the Canadian context.

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