

Report of the

Technical Committee

on **BUSINESS**

TAXATION

Submitted to the
Honourable Paul Martin, P.C., M.P.
Minister of Finance

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Technical Committee
on **BUSINESS**
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The views and recommendations put forward in this report are those of the Technical Committee on Business Taxation, and do not necessarily reflect the views of the Minister or Department of Finance.

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December 1997

The Honourable Paul Martin, P.C., M.P.
Minister of Finance
Government of Canada
Ottawa, Ontario
K1A 0G5

Dear Mr. Martin:

We are pleased to submit to you the report of the Technical Committee on Business Taxation.

We trust that this report will provide a comprehensive base for the public consultations that are to constitute the next stage in consideration of this important subject, and – together with the results of these consultations – will furnish the government with a basis for significant improvement in the business tax system and therefore in Canada's economic performance.

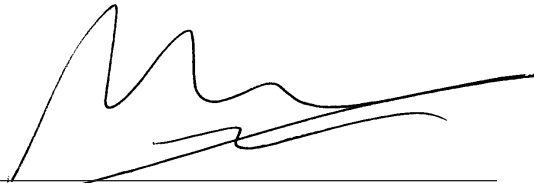
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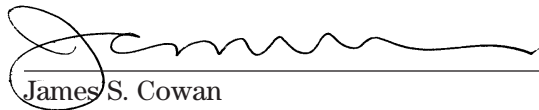
Jack M. Mintz, Chair



Robert D. Brown



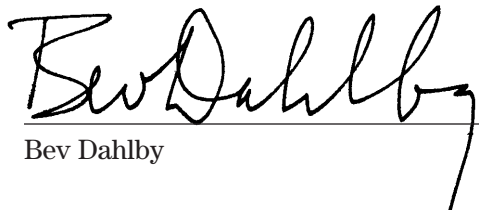
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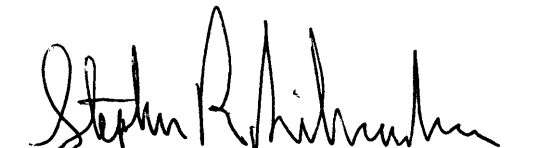
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Chair's Foreword

Business taxation plays a necessary and fundamental role in the lives of Canadians. Taxes paid by business assist with the funding of public expenditures – without these taxes, many public programs of benefit to Canadians would not be provided. Business taxes also have a significant impact on the Canadian economy – they affect the choices made by Canadians to invest in business activities and to create jobs.

In recent years, federal and provincial governments have taken great efforts to control expenditures and improve their fiscal balances after over a decade of running large deficits. As a result, Canadians are now beginning to witness the significant gains that arise from better fiscal management by governments in terms of improved prospects for economic growth and job creation. To bring its finances under control, the federal government focussed on reducing its expenditures. As part of that focus, it reviewed its programs and determined how its expenditures could be made more effective. However, there was not a comparable review of the effectiveness of the tax system in terms of its impact on job creation and economic growth.

On March 6, 1996, the Technical Committee on Business Taxation was appointed by the Minister of Finance to begin a process of reviewing the tax system in Canada. The nine members were asked to assess taxes paid by business, including corporate income, capital and payroll taxes, and personal taxes on income derived from businesses with the following three objectives in mind: creating better prospects for economic growth and job creation in today's global economy; improving fairness so that businesses pay a fair share of the cost of public services provided to them; and reducing compliance and administration costs incurred by taxpayers and governments. The assessment was to take into account the role of both federal and provincial governments in determining the business tax structure and the fiscal constraints faced by governments in meeting their commitments. The Committee's Report was to serve as a basis for consultation with Canadians following its release by the Minister.

The Committee's assessment of the business tax structure follows the tradition of major reviews, including the Carter Report of 1966, leading to the reform of the tax system. These earlier reviews concluded that the business tax structure that best supports economic growth, job creation and fairness is one that includes taxes with broad bases and rates as low as possible. With a broad base and low rates, the tax system would provide a neutral treatment of business activities, implying the same tax burdens on similar investments, so that businesses would seek opportunities for economic growth and job creation without undue influence from the tax system. The tax reforms of 1972 and 1986-87 that followed these reviews moved the tax system toward a more neutral system.

Arguments for a neutral and low-rate business tax system were evaluated by the Committee in light of the substantial change in Canada's business environment during this past decade. Increased global economic integration has provided new opportunities and challenges for Canadians to develop their niche in world markets, especially with the growth of international trade in service industries. Rapid technological change has enabled Canadians to develop new products and processes in today's knowledge-based global economy. New forms of business organization and financial innovations have allowed businesses to pursue more flexible business arrangements in Canada and internationally.

The challenge for Canada's business tax structure is to respond to these new developments so that the tax system facilitates economic growth and job creation in today's global economy. The Committee developed a research program and consulted with experts to assess the current business tax structure. In the course of its work, the Committee concluded that the current business tax structure has several important deficiencies that impede prospects for economic growth and job creation in Canada.

- The Committee regards the current corporate income tax rate for the non-manufacturing sectors as too high by international standards. The combined federal and provincial rate, which averages 43 percent, is well above those of major trading partners including our NAFTA partners – the United States and Mexico – and the United Kingdom. The high corporate income tax rate has created incentives for business to shift income and jobs to countries where tax rates are lower. The high rate of tax has also encouraged business to shift costs, such as interest expense, to Canada, resulting in an eroded corporate income tax base.
- The Committee also found that the business tax structure still provides a non-neutral treatment of business activities by levying corporate income tax rates that vary by industrial activity and by providing accelerated cost deductions and tax credits for certain investments. These non-neutralities impose economic, administrative and compliance burdens on the Canadian economy. The tax structure is especially biased against the service industries, thereby impeding opportunities for economic growth and job creation in these knowledge-based and growing, internationally competitive sectors.
- The Committee has noted the substantial growth in profit-insensitive taxes, such as capital and payroll taxes, levied by the federal, provincial and municipal governments. Although some of these taxes are intended to be a charge for the cost of using of public resources, they operate, in part, as a source of general tax revenue. As a result, some businesses are treated in a non-neutral way, since the payments they make are not aligned with the costs of using these public resources.

The Committee believes that the rationale for past reforms in favour of a more neutral business tax structure with low rates is even more compelling today than it was a decade ago. With the global mobility of business and the need to adopt technologies to improve business performance, creating a neutral business tax structure and bringing corporate income tax rates down to internationally competitive levels would promote economic growth and job creation in an open economy like Canada's. We believe that the business tax structure can be improved in several ways, and our Report provides a comprehensive analysis and recommendations for such improvements, as a basis for review and discussion by Canadians.

The implementation of our proposals would result in a broader-based, more neutral corporate income tax structure with low, internationally competitive rates without increasing or reducing the amount of taxes paid by business. The proposals would also improve neutrality by restructuring two federal profit-insensitive taxes – the federal Employment Insurance employer contributions and the federal excise tax on motive fuels – so that businesses would pay charges more in accordance with the cost of using public resources. Proposals are made to improve compliance with and enforcement of the tax system, so that taxpayers are treated more fairly. Finally, we put forward measures that would facilitate improved harmonization of corporate and capital taxes, reduce the incentive for governments to substitute capital for corporate income taxes as sources of general revenue, and reduce interactions that result in conflicts among governments and lessen their accountability to their electorates.

We believe that our proposals for the business tax structure comprise a balanced package that will provide new opportunities for economic growth and job creation for Canadians, without imposing substantial change in the aggregate amount of taxes paid by industries or regions. Some of our proposals provide a framework for change to the business tax structure for the next several years, while others are responsive to issues of a more immediate nature. We realize that the implementation of our proposals would entail significant change for taxpayers who need, and will have, the opportunity to review and react to our recommendations.

We also stress the need for the federal government to work co-operatively with the provinces to improve the business tax structure in Canada. Our proposed base-broadening measures would provide significant additional revenues to provincial governments – we hope that the provinces would use these revenues to reduce their corporate income tax rates and capital taxes, consistent with the aims of this Report.

This Report would not have been completed without the dedication and hard work of the Committee members. I am very grateful to them for their full and constructive participation in the preparation of this Report. There are many individuals who provided assistance to the Committee and I wish to thank them for their efforts.

While the Committee has benefited greatly from the assistance of officials in the Department of Finance, Revenue Canada and other federal government departments, I wish to stress that the analyses, views and recommendations put forward in this report are solely those of the Committee.

Finally, I would like to thank the Minister of Finance, the Honourable Paul Martin, for giving us the opportunity to provide this assessment of business taxation in the interests of creating better opportunities for economic growth and job creation for Canadians.



Jack M. Mintz
Chair
December 1997

Preface and Acknowledgements

Our Process

The Technical Committee on Business Taxation was established by the Minister of Finance, the Honourable Paul Martin, to review taxes related to investment and business activity. Its terms of reference (reproduced at the end of this Report) were announced with the March 6, 1996 budget. The Minister's news release stated that public consultations would follow the release of the Report. After an exchange of letters with the Chair of the Committee, the Minister of Finance announced on November 5, 1996 that the Committee would be granted an extension to report by the end of 1997.

The Committee has met for one or two days most months since its appointment, to consider the issues before it and to develop its analyses and recommendations. We have been supported by a small secretariat, most of whose members were seconded from the Department of Finance and Revenue Canada. We have also received substantial analytical and data support from these departments.

As noted, the Committee's mandate did not include the undertaking of public consultations. Thus, we did not invite submissions. The Committee's Report will be followed by a process that will involve broad public input and official consultations with provincial governments.

However, to ensure that we had an opportunity to consider a wide range of views and information, we commissioned 29 research studies (listed at the end of this Report).

We had the benefit of hearings held by the House of Commons Finance Committee on economic and compliance costs of the business tax system. We met with provincial tax officials on a bilateral basis, at federal-provincial meetings of tax officials, and in a round table organized by the Committee. We conducted round tables with experts on international tax issues, the taxation of business income, corporate and personal income tax integration, tax simplification, the Committee's statistical studies, federal-provincial corporate tax policy, and, jointly with the Canadian Tax Foundation, on resource taxation. As well, a number of organizations, groups and individuals wrote on their own initiative to the Committee and met with various members of the Committee.

Consensus Underlying our Recommendations

The comments and recommendations of this Report were prepared by the Committee after extensive discussion and debate, involving 39 days of committee meetings as well as substantial further work by individual committee members. All of the Committee members participated in the development of the Report and its conclusions, and hope that the Report will contribute to a better understanding of our business tax system and of the means that should be considered to improve it.

All members of the Committee support the broad conclusions and recommendations of the Report. However, some individual members, with respect to particular recommendations, may have views that are at some variance with those expressed in the Report. Individually, the Committee members do not consider that such a normal difference of personal opinion on such a broad range of issues requires any dissent or qualification from their support for the Report taken as a whole.

Acknowledgements

We have benefited substantially from the research studies prepared for the Committee and from the round tables noted above. We are grateful to those who undertook this work, and who participated in these technical discussions, for the high level of competence and effort that they contributed to our task. We also benefited from the advice of Mr. Robert Couzin and Professor Michael Keen who reviewed draft material for us.

The Committee made numerous requests to the Department of Finance and to Revenue Canada for information. We have received substantial support from officials of these two departments, who provided essential data and prepared estimates and analyses of revenue impacts of options, and of technical and economic issues, at our request. The Committee, however, takes responsibility for the estimates and analytical conclusions contained in the report.

The Committee's functioning was also greatly aided by the fact that we were able to make use of other services of the Department of Finance, in the areas of contracting and financial administration, preparation of material for publication, and the library.

We are grateful to the Committee secretariat for effective support of our deliberations and work. A list of members of the secretariat and of others who worked directly on the preparation of this Report is included at the end of this volume. We particularly acknowledge the assistance of Mr. John Sargent, the executive director of the Committee, for his strong direction of the administrative and research operations of the Committee. Mr. Roy Shultis, on part-time secondment to the Committee from Revenue Canada, provided valuable counsel and liaison with Revenue Canada. Mr. Steve Clark, and subsequently Mr. Steve Dodds, seconded from the Department of Finance, and Mr. Marc Vanasse, and subsequently Mr. Paul Lynch, seconded from Revenue Canada, provided highly competent support for the Committee's deliberations and contributed to the development of the Committee's analyses. Mr. Mario Mansour, who was assigned to assist the Committee on a part-time basis by the Department of Finance, carried out extensive work in the estimation of effective tax rates on marginal investment. We also benefited greatly from the services of several research assistants and administrative staff.

Lastly, we wish to thank all those – federal officials in Environment Canada, Human Resources Development Canada, Industry Canada, and Natural Resources Canada, provincial finance department officials, and outside experts in Canada, London and Washington – who agreed to meet with us and provide information and advice.

Introduction and Summary

1

A fair tax system that encourages economic growth and job creation benefits all Canadians. To help achieve this goal, the Technical Committee on Business Taxation was appointed by the Minister of Finance on March 6, 1996 to review taxes paid by Canadian business and to recommend ways of improving the business tax system. Under our terms of reference, the Committee was asked to assess Canada's business tax structure with the following objectives:

- improving the tax system to promote job creation and economic growth in an open economy;
- simplifying the taxation of business income to facilitate compliance by taxpayers and administration by Revenue Canada; and
- enhancing fairness in the tax system by ensuring that all businesses share the cost of providing government services.

The Committee was asked to review taxes related to business activity, including corporate income, capital and payroll taxes as well as taxes paid by individuals on income derived from investments. Since Canada Pension Plan/Quebec Pension Plan (CPP/QPP) premiums and the harmonization of federal and provincial¹ sales taxes were the subject of separate discussions between the federal and provincial governments, the Committee did not consider these elements of the business tax structure.

The Committee was asked to take into account the fiscal constraints faced by federal and provincial governments. We were also asked to consider the co-ordination of federal and provincial tax policies that apply to business and income derived from business.

As part of our terms of reference, as amended in November of 1996, the Committee was requested to report to the Minister by the end of 1997. The release of the Report by the Minister will provide a basis for consultations with Canadians.

Objectives for Business Taxation

The primary purpose of taxation, including business taxation, is to raise revenue for governments in order to finance public expenditures on goods and services and transfers to individuals. Canadians know that the taxes they pay reduce economic growth and job creation in the private sector. At the same time, however, Canadians also realize that they benefit from government programs and must be prepared to contribute to their cost.

Canadians share a fundamental interest in seeing that our federal and provincial governments deal responsibly with their budgets. Canadians also have the right to expect that, given a certain level of revenue required by governments, the tax system should not unduly retard job creation and economic growth, should operate in a fair manner and should be as easy to comply with as possible. These objectives for the tax system are complex and interrelated and require a fuller discussion.

Economic Efficiency – Economic growth and job creation are fundamentally linked to the notion of economic efficiency, which results when the limited resources of the Canadian economy are put to their best use. The tax system can impair economic efficiency – and

hence job creation and economic growth – by interfering with decisions made by businesses and entrepreneurs in their pursuit of economically profitable opportunities. Market prices and profits operate as the essential signals to determine how best to allocate resources when making these decisions. If taxation distorts these signals, then taxpayers will allocate resources to activities that will reduce their taxes, rather than pursue those economic opportunities that ultimately help Canada grow and prosper. In some limited circumstances market prices and profits will not result in an efficient allocation of resources, so that some form of government intervention may be justified to ensure that resources are put to their best use.

Fairness – Fairness is not easy to define to everyone’s satisfaction but the concept is well rooted in the principles of horizontal and vertical equity. Horizontal equity means that individuals in the same or equivalent circumstances are taxed in a similar way, including a recognition of the benefits received from the use of public resources. Vertical equity connotes a tax system where individuals in different circumstances should bear appropriately different levels of tax. For example, taxes levied on individuals vary according to their ability to pay.

Simplicity – The objective of simplicity in the tax system is primarily related to the goal of reducing as much as possible compliance costs for taxpayers and administrative costs for governments. When compliance and administrative costs are reduced, resources are freed up to be used by business and governments to produce more of the private and public goods desired by Canadians.

The objectives of job creation and economic growth, fairness and simplification in the taxation of business and income derived from business frequently conflict. In pursuit of the best business tax structure for Canada, it is important to find a balance among them.

Balancing these Competing Objectives

Economic Efficiency and Growth with Fairness

Canadians want a tax system that encourages economic growth and opportunities for all Canadians. But it is also important that the tax system be fair – and be perceived to be fair – in its distribution of burdens so as to maintain the integrity of the system. Lower taxes on business and investment can encourage growth and employment in Canada – just as lower taxes on individuals may encourage Canadians to work harder, to save and invest more, or even to remain in Canada. But most Canadians are not willing to give up fairness as one of the several objectives to be sought in the design of our tax system. Economic growth, therefore, must be balanced with fairness, although, perhaps in the long run, the tax system that is fairest is the one that best promotes broad economic growth and job creation that benefits all Canadians.

Fairness with Simplicity

Canadians want a simple tax system. But in a complex society that is part of a world economy, where the form and processes of business activities are increasingly sophisticated, and where the tax system is also used for purposes other than raising revenue, it is unrealistic to expect our tax system to be simple. Moreover, a simple tax system can be unfair – as for example, if all individuals were required to pay the same amount of tax, such as a poll tax. Taxpayers have different capacities to bear taxes and Canadians desire a tax system that recognizes those differences.

Simplicity with Economic Efficiency

Achieving simplicity in the tax system can also run counter to economic efficiency. A tax system could be less complex by following overly simplistic rules to define income rather than trying to measure correctly what each person or business earns. For example, it is simpler to allow businesses to write off some capital spending immediately, rather than provide rules that require the costs to be

written off over the period in which benefits are produced. While such rough approximations may simplify the tax system, they do not recognize the actual circumstances of the taxpayer and can result in distortions and unfairness. If the single-minded pursuit of simplicity results in taxpayers paying higher or lower tax on income earned from certain business activities as compared to others, economic efficiency – and, therefore, job creation and economic growth – can be impaired.

Limits on the Technical Committee's Mandate

Revenue neutrality

Our mandate did not contemplate that the Committee would assess what share of revenues should be raised through taxes on business and income derived from business as opposed to taxes levied directly or indirectly on individuals or the total taxes that should be paid by Canadians. We therefore only considered how taxes paid by business could be improved without materially changing the total amount of such taxes. We also considered the relationship of corporate and personal taxes on income derived from business.

Federal-provincial dimension

The Committee was a federally appointed group which was asked to review taxes on business. While the federal government collects two thirds of corporate income taxes, over 60 percent of total taxes paid by business are levied by provincial and local government bodies, and this percentage has increased over time. Overall, actions to improve the business tax structure require the federal and provincial governments to work co-operatively. Our mandate required us to recognize the roles of both federal and provincial governments in the taxation of business.

The Role of Business Taxes in the Overall System

As set out more fully in this Report, the taxes imposed in Canada largely fall on individuals living in Canada. In economic terms, business does not represent a separate source of tax revenue, divorced from individuals. As pointed out in the Carter Report in 1966,² businesses ultimately do not bear taxes – they simply pass them on to others: to customers in the form of higher prices, to suppliers and labour through lower costs and wages, and to those who supply capital through lower returns. Business taxes are thus borne directly or indirectly by individuals.

But because business organizes so much of our economic activity, there are circumstances that require business to be taxed so that the overall tax system is more efficient, fairer and easier to administer. One of the primary roles of the corporate income tax is to help ensure that all income of individuals is fully taxed, including corporate income accruing to their benefit. Otherwise, individuals could avoid or defer the payment of income tax by leaving income undistributed in corporations in which they are shareholders. It is also appropriate to tax businesses to recognize that they benefit from public goods and services such as infrastructure provided by governments. And, given the importance of foreign ownership of capital in Canada, business taxation ensures that foreign investors also contribute to Canada's public revenue requirements.

Allowing for these economic imperatives, it is nonetheless important when examining the business tax system to recognize the fact that the taxation of business is largely a surrogate for the taxation of individuals. It is the Committee's view that some issues – such as the progressivity of the tax system – are best addressed in the taxes paid directly by individuals.

As this Report does not deal with the personal income tax system, the Committee suggests to the government that our recommendations should be considered along with an assessment of the level and structure of taxes paid by individuals. It is vital to have an appropriate balance in the taxation regimes for businesses and individuals.

Deficiencies in the Current Business Tax Structure

The Committee reviewed the impact of the current business tax structure on economic growth and job creation, fairness and compliance. This review led to the following conclusions about deficiencies in the corporate business tax structure.

High Corporate Income Tax Rates by International Standards: For non-manufacturing corporations, the federal-provincial general corporate income tax rate averages 43 percent, well above rates in many countries, such as 31 percent in the United Kingdom and as low as 35 percent in a number of U.S. states. Manufacturing corporations in Canada are taxed at a rate of about 35 percent which is more consistent with international norms. The implications of the comparatively high corporate income tax rate in Canada are twofold:

- Higher corporate tax rates on income earned by non-manufacturing activities in Canada relative to the United States and other countries have discouraged the location of business operations in Canada, thereby reducing the potential for economic growth and job creation in these internationally competitive sectors.
- As a result of internationally non-competitive tax rates, Canada's corporate income tax base is being eroded. Since the mid-1980s Canada's corporate income tax rates have been higher than those found in many other countries. This has influenced large Canadian-controlled and foreign-controlled non-financial multinationals to increase borrowings in Canada, and therefore interest expense deducted here. The resulting erosion of the Canadian tax base has reduced the potential revenue available from corporations through income taxation. This has resulted in governments levying greater amounts of other taxes, such as capital taxes on corporations, thereby impeding prospects for job creation in Canada.

Impediments to Economic Growth and Job Creation: Although corporate income tax reform in the mid-1980s reduced a number of economic distortions in the tax system, several remain that result in economic inefficiency, unfairness and high compliance costs.

- Tax burdens vary substantially across different types of business activities and these differences result in economic inefficiency, unfairness and greater costs of compliance and administration.
- Taking into account corporate income, capital, payroll, sales and excise taxes on capital inputs levied by federal and provincial governments, we find important industries, especially, communications, utilities, wholesale trade and other services, are taxed more highly than other sectors of the Canadian economy and in comparison to similar activities in the United States. These activities also tend to include the knowledge-based sectors of the economy. High taxes on these sectors reduce the potential for Canadian business to use technologies arising from the research that has been heavily supported by governments through grants and tax incentives.

Growing Reliance on Profit-insensitive Taxes: In 1995, Canadian business paid almost \$85 billion in corporate income, capital, property, sales, excise, payroll and other indirect taxes or fees. Only about 22 percent of this total – \$19 billion – was paid as corporate income taxes. Over the past two decades, profit-insensitive taxes have grown substantially, increasing more quickly than corporate income tax revenues, particularly in the case of provincial and local government taxes. Some of these taxes are directly related to benefits received by the corporation, such as workers' compensation premiums, royalties for the exploitation of resources from public lands and certain property taxes. These taxes can be fair and efficient when they operate as charges for the use of publicly provided services. However, many of the profit-insensitive taxes are unrelated to specific benefits or costs of publicly provided programs, and can result in economic inefficiency and unfairness among businesses. At the federal level, Employment Insurance (EI) premiums paid by business are not closely related to the cost that employers place on the insurance system – some businesses pay more premiums than the costs associated with laying off their workers, while for other businesses, the associated costs are larger than premiums they pay. The federal fuel excise tax is a charge on the use of gasoline and other fuels related to transportation. However, there is no clear linkage between this tax and benefits from the use of highways and roads, which are primarily provided by provincial and municipal governments.

The Committee's Overall Perspective: Neutrality with Internationally Competitive Tax Rates

The Committee sought balance among the objectives of job creation and economic growth, fairness and simplicity in its assessment of the business tax structure. We sought this balance taking account not only of the domestic economy, but also the increasing international dimension of the economy.

We recognized in our work that it is vital that the tax structure be fair, and be perceived to be fair, so as to maintain the credibility and integrity of the entire fiscal system. We took account of the fact that taxes on business are levied by both the federal and provincial governments in Canada, and that it is the aggregate tax burden, not just the federal portion, that affects economic growth and job creation.

As we reviewed each of the business taxes, it became clear to the Committee that the pursuit of one overall principle for business taxation – neutrality together with internationally competitive tax rates – is consistent with the aims of job creation and economic growth, simplification and fairness. With neutrality, the total tax paid on income earned from different business activities is similar, so the decisions of businesses are largely unaffected by the tax system. Tax rates are kept as competitive as possible by being applied to the broadest possible base.

Neutrality encourages businesses and entrepreneurs to pursue profitable opportunities that will make Canada prosper, rather than to waste resources in an effort to reduce taxes. Moreover, with lower and more competitive tax rates, Canada would be a more attractive location for business, thereby creating employment and growth.

There may be special circumstances where, for reasons of economic efficiency or in pursuit of some other public policy goal, non-neutrality may be appropriate; for example, to correct underinvestment by businesses in the training of employees. However, it is the Committee's view that such policy goals may often be better addressed by other government policies such as regulation or public expenditure, rather than through the tax system. For example, while the Committee recognizes the importance of encouraging businesses to hire young workers, it believes that targeted tax credits are far less efficient in achieving this objective than direct public and private expenditures on training and co-operative programs. Non-neutral provisions under the tax system should apply only in special situations, such as to correct underinvestment in research and development due to the inability of firms to capture the full benefits of such investments.

Another key objective is fairness, in particular horizontal equity or the equal treatment of individuals in similar circumstances. This is best achieved when the business tax structure is neutral. A business generates benefits for individuals who derive income from it. For example, it is very difficult to tax a business in a way that fully recognizes differences in the personal position of its owners. If it is desirable to tax individuals at different rates, then this is best accomplished through the personal tax system.

Furthermore, compliance and administrative costs are often significantly reduced when the business tax is neutral so that fewer distinctions are made among different sources of business income or in the overall treatment of sectors and industries. Non-neutrality creates complexity, both for businesses in determining their tax liabilities and for government tax authorities in administering the tax system.

Finally, neutrality also serves the goal of improved co-ordination among federal and provincial governments, both of which are responsible for levying business taxes. A neutral business tax structure used by federal and provincial governments assists the disentangling of tax policies in an economic union by reducing interactions between levels of government and facilitating the free flow of goods, services, capital and labour.

The Evolution of Tax Policy Formation

Our study and its underlying perspective represent a continuation of developments in Canadian tax policy extending back many years – including the Carter Report of 1966 and other reviews of Canada’s tax system. We have continued to build on themes established in these studies and on initiatives of federal and provincial tax policies.

As our predecessors noted, the best business tax structure strives toward fairness and efficiency by means of a broader tax base with the lowest possible rates. We are convinced that the best tax system emphasizes neutrality. Tax incentives, directed at investments, differential tax treatments of industries and sectors, and the proliferation of special rules tend to hinder, not advance, our economic performance.

Economic Issues of the 1990s

The Committee was faced with issues that did not have to be dealt with in the past. These include rapid technological change in a knowledge-based global economy, the growing importance of services, the growth of international flows of capital and trade, and the trend away from producing goods to discovering, disseminating and using knowledge. Canada must take a hard look at where the new jobs are being created in our economy and ensure that the tax system is not biased against the growth in those sectors. The Committee recognizes the importance of these issues in our Report.

The International Dimension

The Canadian economy is one of the most open of the larger developed countries. Almost 40 percent of our Gross Domestic Product (GDP) is derived from exports and about 20 percent of our business capital has been provided by foreign investors. Moreover, Canada has evolved into a significant capital exporting nation as well as a capital importer. The growing size of global trade and investment is a major, but not the only, international influence on our tax system. We live in a world in which international alliances and networks among businesses, shifting locations of production, the mobility of the tax base and the spread of technology and innovation are features of the global economy.

As the world economy becomes more integrated, it is also becoming more competitive. The number of countries acquiring the capital, human skills and technology to produce knowledge-based goods and services continues to grow. Many governments throughout the world are implementing policies to attract capital and jobs. The appropriate business tax strategy for Canada must, therefore, be assessed in relation to the world economy, with particular attention to the United States, with which we carry on about three quarters of our foreign trade.

Another reality of a globalized economy is that some factors of production, particularly human capital and investment capital, are becoming increasingly mobile and transferable, and naturally seek low-cost and low-tax environments. The cost to Canada of imposing high taxes on these mobile factors is increasing.

Canada cannot afford to be insensitive to these international pressures. Our current relative prosperity is linked to the creative talents of Canadians who have been able to innovate, adapt and market products and services globally in a healthy business environment facilitated by governments. Hard experience has taught us that attempts by governments to support activities in which Canada has no comparative advantage fail to achieve lasting job creation and economic growth. Canadians achieve the best results when they specialize in producing those products where there is a comparative advantage. The best government strategy for supporting Canadian initiatives is to assist Canadian businesses to determine their niche in world markets rather than to support inefficient businesses that cannot compete in today’s international economy.

The best business tax structure, therefore, is one that supports the capacity of Canadian entrepreneurship to identify and produce goods and services that are competitive in world markets. Neutrality and internationally competitive tax rates are the essential qualities that the Committee believes should guide us toward efficiency, fairness and ease of compliance in our restructured business tax system.

Basic Thrusts of the Committee's Recommendations

The Committee recommends the following measures to make the tax system more neutral:

- lowering corporate income tax rates for business toward international norms and correspondingly broadening the tax base;
- making certain profit-insensitive taxes fall more heavily on those who derive related benefits from public programs or contribute to costs imposed on Canadians;
- reducing compliance costs and improving enforcement within the tax system; and
- facilitating the co-ordination and disentanglement of federal-provincial corporate tax policies within Canada's economic union.

These proposed changes to the business tax structure, taken as a whole, should achieve an appropriate balance among the three objectives laid out for us in the terms of reference: to improve job creation and economic growth, to improve fairness, and to reduce compliance and administrative burdens. The recommended changes should result in a rebalancing of taxes paid by business, without changing the aggregate amount of such taxes.

As part of its review of business taxation, the Committee considered new taxes that could be used to replace or reduce existing ones; these include taxes on financial transactions, wealth and cash flow. As discussed in the Annex at the end of this Report, the Committee does not favour the adoption of any of these taxes.

A More Neutral Business Income Tax System with Lower Rates and a Broader Base

Overall, we propose a more neutral system whereby the corporate income tax rate for all industries is lowered toward international norms. At the same time we propose a number of base-broadening measures to improve efficiency and fairness. Taken together, our measures should not change the aggregate amount of taxes paid by business.

These lower rates would help to make Canadian business more competitive internationally, and would reduce the incentives to shift income out of Canada and deductions into this country. Further, the lower rates and base-broadening measures would themselves reduce the distortions and inefficiencies in the income tax system.

The Committee believes that the implementation of its recommendations in these areas would provide significant benefits to Canada, leading to job creation and economic growth.

A Modernized Corporate Income Tax

In Canada, and around the world, new jobs are concentrated in the service sectors, including the new knowledge-based industries, while employment is declining in many of the traditional sectors. Furthermore, international trade in services is rapidly expanding, so that large sections of the service industry are now competing in a global environment. Our proposals would provide benefits to the service sector where most new jobs – including many jobs in the high-technology sectors – are being created. These proposals will best achieve their goals with federal-provincial co-operation.

We would broaden the corporate income tax base to make it more neutral and less distorting. We propose some reductions in R&D tax incentives, while still leaving them among the most generous in the world. We recommend replacing the Atlantic Investment Tax Credit with a more cost-effective and broad-based non-tax program. We also recommend that mining and oil and gas industries should be treated in a way more comparable to other industries. We propose a general review of capital cost allowances to ensure that rates are closer to economic depreciation, along with a reduction in the rates for some accelerated classes.

Our proposals would ultimately result in an average federal-provincial corporate income tax rate of 33 percent on large businesses so that all businesses would benefit from internationally competitive corporate income tax rates, not just the manufacturing and processing sector and the resource sector. We recommend a general federal corporate income tax rate of 20 percent. We also suggest that, with the revenues from base-broadening, the provinces could reduce their corporate income tax rates by 1 percentage point to, on average, 13 percent without loss of revenue. Small Canadian-owned businesses would continue to benefit from preferential federal-provincial tax rates ranging from 18 percent on average for those small firms with substantial payrolls to 21 percent on average for firms with no employees. The federal rate would range from 11 percent to 14 percent, and the suggested provincial rate would be reduced by 1 percentage point to an average of 7 percent. The federal corporate income tax surtax would be eliminated for both large and small businesses.

These measures would provide a number of important benefits to Canada, including:

- greater ability to compete in international markets due to a more neutral tax system that encourages business exports of those goods and services in which Canada has a comparative advantage;
- federal and provincial corporate income tax rates that are at or below many foreign corporate income tax rates, including those in the United States, our most important trading partner, so as to prevent an erosion of our tax base;
- improved incentives for the adoption of R&D in Canadian production through lower tax rates, while maintaining Canada's internationally competitive tax treatment of R&D; and
- an enhanced but restructured incentive for small businesses to encourage growth related to the employment of workers.

We also recommend that the federal and provincial governments consider the adoption of a formal mechanism that would allow businesses to transfer losses within a corporate group. This would reduce compliance costs and result in a fairer treatment of business loss deductions.

Our recommendations do not address a number of important tax issues related to financial institutions. While we have been undertaking our review of the tax system, the federal Task Force on the Future of the Financial Services Sector has been examining the regulatory structure affecting financial institutions. This Task Force's Report will follow ours, and a research study on the taxation of financial institutions jointly sponsored by the two groups will be completed after our Report. We believe that the strongest financial sector for Canada is one that is competitive and receives a more neutral treatment under the tax and regulatory systems. We also believe that the net tax burden on this sector should only be changed when the future regulatory regime is clear. Our general recommendations, however, would provide significant benefits to larger institutions. For this reason, we recommend a temporary increase in the capital surtax on financial institutions so that their current tax burden remains the same pending the outcome of this regulatory review.

Modifications to Rules on Taxing Outbound and Inbound Investment

Our economy is increasingly integrated with the global economy, and the tax system must explicitly recognize this fact in the way outbound and inbound investments are treated. Canada, which historically relied on imported capital from other countries, now exports almost as much capital as

it imports. The growing international trade in goods, services and capital is accompanied by rapid growth of such trade and investments between members of multinational corporate groups. For example, about 45 percent of our trade with the United States – exports and imports – is represented by such intrafirm transactions. Such trade is frequently in goods or services for which there are no comparable arm's-length prices, raising difficulties in valuation for the purposes of measuring income, and in the allocation of tax revenue between government jurisdictions.

There are also important international influences that are leading to the erosion of the Canadian tax base. After the mid-1980s when several countries, including the United States and the United Kingdom, reduced their corporate income tax rates significantly below Canada's general corporate rate, multinationals tended to shift income out of, and deductions into; Canada for tax reasons. Moreover, since the late 1980s, new U.S. restrictions on the ability of multinationals to benefit fully from interest deductions in the United States have encouraged U.S. multinationals to shift their interest expenses to other countries, including Canada. The increased aggressiveness of other countries, especially the United States, in ensuring that multinational transfer pricing works to enhance their own corporate tax base has also provided incentives for corporations to shift the tax base out of Canada.

The Committee recognizes that the outbound investments made by our multinationals have been important to the Canadian economy by allowing these companies to grow and prosper in a competitive global environment. Canada has also benefited from inbound investments of foreign multinationals that provide needed capital and managerial talent for Canadian industries.

Tax policies related to inbound and outbound investment are driven by two important objectives: domestic economic growth and job creation on the one hand, and protection of the Canadian revenue base on the other. The Committee believes that if our proposals – lower corporate income tax rates competitive with those of our major competitors, offset by a broader tax base that includes international tax measures where appropriate – were to be adopted, the result would be increased domestic investment and job creation, greater fairness and better protection of Canada's domestic tax base.

Specifically, the Committee proposes the following:

- a modification of our system of taxing income received by Canadian corporations from their foreign affiliates to require a higher ownership threshold to benefit from the system;
- that, with respect to income from transactions between foreign affiliates of the same Canadian taxpayer, the right to repatriate such income free of tax to Canada be limited to those affiliates fully entitled to tax treaty benefits with Canada;
- that Canadian taxpayers should no longer be able to claim a current deduction for interest expense traced to investments in foreign affiliates;
- that interest payable to arm's-length non-residents be exempt from Canadian withholding tax, regardless of the term of the related indebtedness; and
- that the ability of non-residents to shift interest expense to related Canadian business enterprises be more restricted, by reducing the existing thin capitalization ratio of 3 to 1 to 2 to 1, by broadening the thin capitalization rules so that they apply, not only to investments in Canadian corporations, but also to Canadian branches of foreign corporations and to partnerships and trusts, and by repealing the rules related to non-resident owned investment corporations.

We also support the strengthening of our transfer-pricing regime as recommended to the Committee in a research study released in December 1996, and as contained in legislation tabled in 1997, and we suggest certain general principles that should guide the formulation of tax policy in this area.

Measures to Better Integrate Corporate and Personal Taxes

The appropriate structure and level of tax paid by business is, of course, related to that on individuals. The Committee believes it is important to achieve a fairer system of taxing income flows from businesses to individuals.

We favour the continuation of the present dividend tax credit so as to give recognition to individuals receiving dividends from Canadian corporations for the tax already paid by the corporation on its income. But to achieve greater efficiency and fairness, we are recommending that the dividend tax credit be more closely tied to the actual taxes paid by the corporations through the introduction of a joint federal-provincial Corporate Distributions Tax.

We also favour the retention of the present exclusion of one-quarter of capital gains from income so that capital gains and dividends are taxed at roughly the same rate and the double taxation of corporate income is partially relieved. However, we recommend that the lifetime capital gains exemption for farm property and shares of Canadian-controlled private corporations be replaced by a new retirement saving measure that recognizes the difficulties that some farmers and owners of small businesses have in accessing the current system of tax-assisted savings for retirement.

Moving toward the User Pay Principle

Canadians – and Canadian businesses – are liable for several taxes intended to compensate for the costs of certain public goods or services that provide benefits directly consumed by the individual or business. These taxes include EI, CPP/QPP and Workers' Compensation premiums, municipal property taxes, gasoline taxes and highway tolls, airport charges, provincial royalties for the use of resources and environment taxes for the use of air, water and land.

In some cases, such as provincial workers' compensation programs or provincial highway tolls, there is a direct relationship between the benefits arising from a public good or service and the charges paid by the user of the good or service. In other cases, such as the federal EI program, there is only a very general and indirect connection between contributions levied on employers and the costs associated with layoffs.

When there is a mismatch of benefits and charges – paying more or less than the value of the benefits received or costs transferred – the efficient use of public and private resources is impaired. Some businesses pay charges greater than the benefits they receive, making them less competitive in domestic and international markets, and harming both job creation and economic growth. Businesses that are net beneficiaries may overuse a public good or service resulting in higher taxes for all Canadians.

As matters of both efficiency and fairness, we believe that some taxes should be more closely related to the user pay principle. In appropriate cases, businesses should be charged at levels corresponding to the economic benefits they receive from public goods or services, or to the costs that they impose on society. Implementing our recommendations would not result in higher or lower government revenues – instead, there would be a closer matching of benefits received and charges paid by individual businesses. The result would be greater efficiency for the economy and fairness among businesses.

The key measures proposed are as follows.

Experience-rated Employment Insurance Premiums for Employers

We recommend that the employer premiums for EI be restructured so that employers who have fewer layoffs – and hence cause their workers to use the EI system less than others – would pay lower premiums.

The Committee believes that the federal government should continue to move, over time, to set EI premiums at a level that covers the long-run cost of the program. Based on current benefit levels, total employee and employer premiums should decline. On the employer premium side, we recommend that the federal government concentrate these reductions on those businesses that have a superior record in retaining rather than laying off workers. Businesses would thereby be encouraged to reduce employee turnover rates in order to earn a lower contribution rate for employment insurance. We believe that this proposal would significantly promote stable employment and efficiency.

Environmental Taxation

We also recommend that the federal government, after consultation with the provinces, consider restructuring the federal fuel excise tax in order that it more closely corresponds to the user pay principle. The current federal excise tax on fuels is inefficient and unfair in that it levies tax on only one category of product – gasoline and other motive fuels – that affects the environment. Restructuring the federal fuel excise tax in the manner we suggest would raise the same revenue. The restructured tax would include other sources of pollutants and ensure that polluting activities by businesses – and by all Canadians – bear a more appropriate charge for the use of air, water and land.

Compliance and Enforcement

The Committee found that Canadian business faces substantial compliance costs, even though these are lower than the corresponding costs in the United States. The Committee endorses efforts by governments to reduce compliance costs through streamlined processes, joint audits and less paperwork. Lower compliance costs for our businesses would make them more competitive in domestic and international markets. The Committee recommends several measures that we believe would result in improved compliance and enforcement:

- Federal and provincial governments should harmonize the structure and administration of certain business taxes – notably capital taxes – to provide significant reductions in compliance costs.
- New procedures for drafting should be adopted to improve the application and understanding of tax legislation.
- New mechanisms should be introduced to enable Revenue Canada to apply commercial practices to settle disputes and collect taxes owing.
- Civil penalty provisions in the tax legislation should be expanded to apply to advisors and promoters who are grossly negligent.

We further suggest that stronger measures be taken to combat tax evasion.

Improving the Co-ordination of Federal-Provincial Tax Policies

Canada's prosperity has been enhanced by policies that have fostered the free trade of goods and services and mobility of labour and capital within the Canadian economic union. A neutral business tax structure would also contribute to economic growth and job creation by allowing resources to flow to the most profitable economic opportunities in each region. Consequently, the Committee believes that it is vital for federal and provincial governments to do their utmost to ensure that the business tax structure is applied efficiently and fairly across the country. With a shared tax field, the federal and provincial governments should have a common interest in working together to achieve a harmonized and balanced tax system.

Canadians have benefited from the current system of taxing business income whereby the federal and provincial governments use a common corporate income tax base, even in those provinces that collect their own corporate income tax. Compliance and administration costs are further reduced in those provinces that have entered into Tax Collection Agreements. Current substantial co-operation between federal and provincial authorities ensures that the same income is not subject to tax by more than one province.

Compared to some federations, Canada has a high degree of federal-provincial co-operation in the business tax field. With the aim of further encouraging co-operation and disentanglement, the Committee makes the following recommendations:

- Federal and provincial governments should work toward using neutral, common corporate income and capital tax bases. If the federal or a provincial government wishes to adopt a policy that diverges from neutrality, then this should be done in a manner that minimizes the impact on the revenues of other governments.
- Federal and provincial governments should extend the present federal-provincial tax collection agreement to capital taxes, and to all provinces. This would help to minimize compliance costs for taxpayers and administrative costs for governments. The federal government should take active measures to better ensure the proper application of the interprovincial allocation of the corporate income and capital tax bases.
- Capital taxes, which are closely related to income taxes, should not be deductible from the corporate income tax base. This would remove an incentive for one government to expand its capital taxes, since part of the cost of the tax would no longer fall on other governments.

Overall, our recommendations to the federal government would result in base-broadening that would provide additional revenues to provinces that have tax collection agreements with the federal government, and to the other provinces if they adopted parallel changes. We urge the provinces to consider an offsetting reduction in corporate income and capital taxes as this base-broadening takes effect.

Without a substantial level of co-operation by the federal and provincial governments concerning our recommendations, the Report's objectives will not be achieved. For example, unless the provinces also take specific action to reduce their tax rates, the impact of base-broadening would substantially increase taxes on business, and provincial revenues, and thus defeat the thrust of our proposals. We recognize too that the provinces may wish to develop their own responses to some of the proposals we have set out. Therefore, the Committee urges the federal government to consult with the provinces with a view to achieving a common broad approach.

The Impact of our Recommendations

It is important neither to overestimate nor underestimate the scope of our Report. Under the terms of our mandate, we did not undertake a broad review of the entire tax system. Rather, our review was focussed only on business taxation, and there are important tax policy issues that are outside our terms of reference. The task of translating our recommendations into actual statutory language with full consideration of all details of the changes was also clearly beyond our scope.

As well, the changes we are recommending will require appropriate transitional measures, providing adequate notice to taxpayers, and taking account of commitments and investments made under existing legislation. The pace of implementation will have to recognize the fiscal constraints of the governments involved.

No Change in Business Tax Revenues

Under our terms of reference, the Committee was asked to take into account fiscal constraints faced by federal and provincial governments. Accordingly, we have brought forward a balanced package of recommendations for taxing the business sector which we consider could be implemented over a period of time in a fiscally neutral manner. As shown in Table 1.1, our proposals would neither increase nor decrease the level of business taxes at the federal and provincial level in a mature (post-transition) system. If the provinces also agree to implement business tax reductions financed from the revenues obtained from these base-broadening measures, then the overall package would be revenue neutral at both the federal and provincial levels.

Table 1.1
Impact of Recommendations on Federal and Provincial Revenues

	Federal	Provincial	Total
		(\$ millions)	
Corporate Income Tax Rate Reduction			
Large business	-2200	-340	-2540
Small business	-285	-160	-445
Subtotal	-2485	-500	-2985
Base Broadening and Reduced Tax Credits			
International Business Income	400	250	650
Non-deductibility of Capital Taxes	375	200	575
Corporation Distributions Tax	350	175	525
Lifetime Capital Gains Exemption Replacement	275	175	450
Mining, Oil and Gas	215	130	345
Temporary Increase in Financial Institution Surtaxes	300	–	300
Research and Development	200	10	210
Capital Cost Allowance	105	60	165
Atlantic Investment Tax Credit	95	Small	95
Subtotal	2315	1000	3315
Net, before other adjustments	-170	500	330
Other Adjustments			
Savings to governments as employers on EI Contributions	100	190	290
Reductions in Provincial Capital Taxes or Other Adjustments	–	-550	-550
Total	-70	140	70

Notes: Revenues are estimated using a forecast of 1997 corporate income taxes based on the latest corporate tax data available to the Department of Finance. Calculations are made according to a “mature system” assumption: recommended measures are fully implemented after a transition period. Estimates have also been adjusted for changes in behaviour including a reduction in base erosion arising from lower corporate income tax rates.

Increased Neutrality in the Modified Tax Regime

We have examined the impact of our recommendations on various business activities. Our recommendations are revenue-neutral overall, but some activities would be taxed more highly, while others less, compared to the current system. We estimate that the variation in effective tax rates on different activities would be reduced and the system would therefore be more efficient and fair. However, our recommendations, with appropriate transition, would not result in a radical shift in taxes paid by industries, nor would our recommendations result in significant changes to the amount of tax paid in each of the regions of Canada.

Future Review of Aggregate Business Taxes

The Committee's terms of reference required us to bring forward a package of recommendations that would raise approximately the same revenue as the existing system. This precluded us from evaluating the total level of taxes paid by Canadian business in relation to international competitiveness, or the balance between business and other taxes.

The Committee has noted in this Report the fundamental need of Canadian business to be internationally competitive. We also note the trend in a number of other countries to consider shifting taxes away from business.

We recognize that under our proposals to rebalance the business tax burden, some businesses would face higher tax rates on new investment. We are concerned that this might weaken the internationally competitive position of Canadian businesses with mobile capital and labour, such as the manufacturing sector.

We believe that the federal government should carefully monitor the international competitiveness of Canadian business as it implements changes in the tax system. If this review indicates that the total burden of taxes on business impairs its international competitiveness, we believe that the government should consider action to reduce that burden. The objective should be to ensure that business contributes appropriately to economic growth and job creation, even if this results in some reduction in overall taxes raised from businesses.

Conclusion

We believe that our proposals for the business tax structure constitute a balanced package that would provide new opportunities for economic growth and job creation for Canadians. Lowering tax rates toward international norms would provide a greater incentive for business to invest and create jobs here, while also protecting the revenue base. Broader bases with low rates will also make the business tax structure more fair and efficient. We believe that this Report together with the consultations that will follow, will contribute to a better business tax structure that will benefit Canadians.

Endnotes

- ¹ In the balance of this Report, "provinces" refers to both provinces and territories as the context requires.
- ² Canada. Royal Commission on Taxation (1966), vol. 1, p. 7.

Key Features of Business Taxation in Canada

2

Taxes paid by businesses are an important component of total taxation in Canada, and have major effects on business costs and performance. Before considering changes to their structure, it is important to understand key aspects of the business tax system.

Specifically:

- What taxes do businesses pay?
- Why is it desirable to levy some taxes on business, as opposed to collecting all taxes from individuals?
- How have the amounts of tax that businesses pay changed over the last four decades in relation to their profits and the economy?
- How does Canada's taxation of business compare with that of other countries?
- How do the levels of government – federal, provincial and local – share responsibility for the various components of business taxation?

This chapter discusses these questions. This descriptive information, together with the overview analysis of the impact of the tax system on job creation, economic growth, fairness and compliance in Chapter 3, set out what the Committee regards as the essential backdrop to an informed discussion of how to structure the business taxation system in order to maximize overall Canadian prosperity.

What Taxes are Collected from Businesses?

The term “business taxes” initially brings to mind such taxes as corporate income and capital taxes, but in fact also includes property taxes on land and buildings used and/or owned by businesses, payroll taxes collected from business employers, and sales and other taxes on inputs used by businesses. The dividing line between business and “personal” or “other” taxes is not entirely clear, reflecting the facts that:

- As noted in the preceding chapter and discussed further in this chapter, the burden of taxes collected from businesses ultimately falls on individuals in their roles as owners of capital, as suppliers of labour and of other inputs to businesses, and as consumers. This somewhat reduces the significance of the distinction between taxes that are collected from businesses in the first instance, and taxes that are collected directly from individuals. A further complication is the fact that some businesses are owned by non-residents, and some goods and services are sold to foreign markets, and therefore a part of business taxes may ultimately be borne by non-Canadians.
- While business taxes are ultimately borne by individuals in their roles as consumers and suppliers of labour, capital and other inputs, there is a wide range of views as to the proportion of business taxes that are borne as higher costs of consumption versus lower wages or business input costs.
- The profits of a corporation are subject to corporate income tax plus, on distribution, personal income tax. If the business is not incorporated, the business profits are only subject to personal income tax.
- Even personal taxes, however, may influence the terms on which a business can obtain funds from investors or employ labour – especially where these terms are strongly influenced by competition from businesses in other countries.

Nonetheless, some taxes have a closer association with businesses than others, and it is useful to start with an overview of all taxes that might commonly be regarded as business taxes broadly defined, and of their contribution to total government tax revenues. Table 2.1 shows all the major tax revenues of the total government sector in Canada (column 1), the revenues that we have designated as “business taxes” (column 2), and – for each major tax category – the business share (column 3). We have included 100 percent of federal and provincial corporate income and capital taxes; 100 percent of federal withholding taxes on payments to non-residents; the business employer share of payroll taxes; and portions of property, and sales and other taxes and charges that are estimated to be paid on business inputs and operations, as business taxes. With the exceptions of the corporate income and corporate capital taxes, these taxes are paid by both incorporated and unincorporated businesses. Although we have been quite inclusive in what we have considered to be business taxes, we have not included any fraction of personal income taxes even though part of these taxes fall on business income. For the purposes of this Table, we have viewed resource royalties as payments to governments for the use of public resources rather than as taxes; thus, royalties are not included in the Table.

Table 2.1
**Business Taxes as Shares of Total Government Tax Revenues –
All Levels of Government – 1995**

Source of Revenue	Total	Business	Business Share
	(\$Billion)	(\$Billion)	(%)
Personal Income Taxes	104.6	–	0
Corporate Income Taxes ^a	18.8	18.8	100
Withholding Taxes	1.7	1.7	100
Capital Taxes ^b	4.3	4.3	100
Insurance Premium Taxes	0.9	0.9	100
Payroll Taxes ^{c,d}	45.2	22.5	50
Property Taxes ^f	28.8	15.1	52
Sales Taxes ^f	42.6	6.6	15
Fuel Excise Taxes ^f	10.8	4.4	41
Other Indirect Taxes and Fees ^{e, f}	23.4	10.0	43
Total^g	281.2	84.3	30

^a Corporate income tax revenues have been adjusted to exclude revenues from federal capital taxes. Provincial taxes on mining and logging profits (\$239 million) have been included with corporate income taxes.

^b Capital tax revenues consist of the federal capital taxes (large corporations tax and taxes on capital of financial institutions) plus the general capital taxes levied in some provinces and the taxes on paid-up capital of financial institutions other than insurance companies levied in all provinces.

^c In this table, and generally in this report, the term “payroll taxes” is used to cover social insurance contributions, as well as taxes on payrolls that give rise to no entitlement to specific social insurance benefits. (See inset: “What is a “Payroll Tax”.”)

^d Business, public sector and non-profit employers pay 50 percent of Canada and Quebec Pension Plan contributions, 58 percent of Employment Insurance contributions, and 100 percent of provincial workers’ compensation contributions and of the general payroll taxes assessed in some provinces. On average, business employers are estimated to pay 75 percent of all employer payroll taxes.

^e Other indirect taxes and fees include federal excise taxes on alcohol and tobacco, federal import duties, provincial motor vehicle licences, provincial liquor commission profits, and other indirect taxes and fees.

^f Estimates of the portions of property taxes, provincial sales taxes, fuel excise taxes and other indirect taxes levied on business inputs are approximate.

^g Resource royalties are not considered for the above purposes to be a tax, but rather a payment for the use of public resources. Such royalties, to provincial governments, amounted to \$6.2 billion in 1995 (excluding provincial taxes on mining and logging profits).

Note: Components may not sum exactly to totals due to rounding.

Source: Statistics Canada, *National Income and Expenditure Accounts: Annual Estimates 1984-1995*, 13-201-XPB, plus estimates by Committee secretariat.

Overall, about 30 percent of total tax revenues, or about \$85 billion out of \$280 billion in total tax revenues in 1995, is estimated to come from business taxes as defined above. The largest business tax components are payroll taxes on business employers, corporate income taxes and property taxes.

Information on the federal, provincial, local government and Canada/Quebec Pension Plan (CPP/QPP) components of these tax categories is presented in the final section of this Chapter (see Table 2.6). Given our mandate, our primary focus will be on corporate income, capital and payroll taxes at the federal level. This focus notwithstanding, we provide a brief description of the range of taxes paid by businesses.

Corporate Income Taxes

The taxation of corporate income depends on the type of business activity, its location (province or territory) and the form of corporation in which the activity occurs. Both public and private corporations pay corporate income taxes on income as determined by the Canadian *Income Tax Act*. (See inset: “Businesses in Canada: A definition.”) Federal and provincial rates of corporate income tax are shown in Table 2.2. Manufacturing and processing and small business income are taxed at lower rates than other types of business income.

Table 2.2
Corporate Income Tax Statutory Rates by Type of Income and Province, 1997^a

	General	Manufacturing and Processing (M&P)	Canadian-controlled Private Corporations (CCPCs ^b)
	(percentage)		
Federal	29.12	22.12	13.12
Alberta	15.5	14.5	6.0
British Columbia	16.5	16.5	9.0
Manitoba	17.0	17.0	9.0
New Brunswick	17.0	17.0	7.0
Newfoundland	14.0	5.0	5.0
Nova Scotia	16.0	16.0	5.0
Ontario	15.5	13.5	9.5
Prince Edward Island	16.0 ^c	7.5	7.5
Quebec	9.15	9.15	5.91
Saskatchewan	17.0	10.0	8.0
Northwest Territories	14.0	14.0	5.0
Yukon	15.0	2.5	6.0 ^d
Average Combined Federal-Provincial Tax Rate^e	43	35	21

^a The rates shown are those generally applying to active business income. Certain provinces provide tax holidays for a limited number of years to newly incorporated businesses and, in the case of Newfoundland, also to business expansions. Higher rates apply to investment income of CCPCs, and Quebec applies a higher general rate (16.71 percent) to inactive income. Surtaxes are included in the rates shown.

^b The rates shown for CCPCs apply to the first \$200,000 of active business income. The amount of income eligible for the lower rate is reduced for corporations with taxable capital employed in Canada of more than \$10 million and is fully phased out at \$15 million. Ontario has a different approach to clawing back the small business deduction.

^c Rate effective July 1, 1997. A rate of 15 percent applied in respect of the first half of 1997.

^d Note that the Yukon's 2.5 percent rate on M&P income also applies to M&P income of CCPCs.

^e Based on allocation of taxable income by province in 1994. Data provided by the Department of Finance.

Note: The overall rate applicable to taxable income allocated to a province is the sum of the federal and relevant provincial rate.

Source: Price Waterhouse, *Corporate Tax Strategy 1997-1998*, Butterworths, Markham, Ont., 1997, pp 206-10.

Businesses in Canada: A Definition

A business is an economic unit that operates in the expectation of earning profits or net income through commercial activity, and has a substantial degree of management autonomy from other business units. Included in this definition are government-owned businesses (provincial and federal Crown corporations, for example) engaged in commercial activities; and the commercial activities of charities and non-profit organizations (co-operative financial institutions and the Prairie grain pools are two examples).

Business activity in Canada is carried out under two main organizational forms: unincorporated enterprises and corporations.

An unincorporated enterprise is either owned by a single person (sole proprietorship) or by a partnership of two or more individuals who have a claim to the profits and are responsible for the losses of the firm. The profits (or losses) of the business are divided according to the interest of each partner. In the case of a sole proprietorship, all the net income is attributable to the sole owner.

With many unincorporated businesses, liability is unlimited in the sense that the owners are personally responsible for damages or to satisfy any amounts owing to creditors who lend money on account of the business (such as mortgages and trade credit). The most common examples of sole proprietorships and unlimited liability partnerships include professional businesses (medical, legal, accounting and consulting), retailing, farming and fishing.^a

Corporations are owned by shareholders who hold shares in the company. The shares generally convey voting rights and a share in the profits, although some classes of shares may be non-voting in that the owner derives profit but has no right to vote in shareholder meetings. For the purposes of law, corporations are “persons” in that the corporation owns its own assets and is solely responsible for its liabilities in its own name. Shareholders have limited liability in the sense that any damages or amounts owing to creditors can only be claimed against the corporation and not against the owners themselves. Upon wind-up of a corporation, shareholders have a claim to the residual value of assets after amounts owing to secured and unsecured creditors are satisfied.

In turn, there are two types of corporations – public and private companies. For tax purposes, a public corporation is one whose shares are listed for trading on a Canadian stock exchange or otherwise are widely distributed, and a private corporation is one which is closely held, in that shares are not traded in a public market.^b

Since the legal innovation over a century ago of limited liability, the corporation has, over time, become the dominant form of larger business organization. Through the vehicle of limited liability, corporations have been able to obtain equity financing from a much larger pool of potential owners (shareholders) who are not normally involved in their management and who need not be concerned with unlimited personal liability. In 1993, it was estimated that there were about 900,000 businesses with at least one employee in Canada. Of these, slightly less than one half (some 420,000) were corporations, but the corporate sector accounted for almost 80 percent of business employees.^c

^a In recent years, limited partnerships have become popular vehicles to organize firms, whereby some investors who receive profits may be protected from claims by creditors for any losses incurred by the firm beyond their investment in the partnership.

^b In addition to the above sorts of businesses, trusts can hold property and may earn income for immediate or ultimate distribution to beneficiaries. A trust is established by a person who appoints a trustee to hold the assets. Often, trusts are used by individuals to own assets held on behalf of members of the family. In certain circumstances, trusts can engage in business activity and may be widely owned. As the Committee is not examining issues related to the taxation of individuals, it does not consider general issues related to the taxation of family or personal trusts.

^c See Hendricks, Amit, and Whistler (1997), Technical Committee Working Paper 97-11. It may be noted that there are also substantial numbers of businesses, both unincorporated and incorporated, with one or more self-employed owners but no employees.

What is a Tax Rate?

Throughout this Report, we refer to several concepts of tax rates – statutory, effective and marginal tax rates. What do these terms mean, and why do we use them?

Statutory Tax Rate: The statutory tax rate is the legislated rate of tax that applies to the taxable income earned by the business. To illustrate, a business may earn \$1000 in income as defined for tax purposes and be taxed at a statutory rate of 50 percent. The tax paid by the business is therefore \$500. The statutory tax rate may be expressed as a federal, provincial or a combined federal-provincial rate, and it is the basis for determining the amount of tax paid on additional income earned by the firm. For instance, if a firm borrows more money and incurs interest expense, the reduction in tax paid will be governed by the statutory tax rate.

Effective (Average) Tax Rate: The effective (average) tax rate is the total amount of tax paid by the business divided by its financial accounting income or profit, after excluding loss carry-overs and dividends received. The amount of tax paid by the firm is its statutory tax rate, multiplied by its taxable income as determined under the *Income Tax Act*, less any investment or other tax credits or adjustments. As taxable income is not identical to financial accounting income, the effective tax rate may be greater or less than the statutory tax rate. For instance, in a given year, if the business is able to depreciate capital expenditures at a faster rate for tax purposes than that used for determining financial accounting income, taxable income is less than financial accounting income, and the effective tax rate is less than the statutory tax rate. The effective tax rate is a useful measure to determine the burden or level of tax paid by the firm on its income.

Effective Tax Rate on Marginal Investments: The effective tax rate on marginal investments is a measure of the amount of tax paid on income earned by investing in a marginal project (just on the margin of acceptability). The marginal project earns profits, net of taxes, just sufficient to attract funds from investors in the form of equity and bond financing. For example, suppose investors are only willing to invest in a marginal project that earns a rate of return on capital, net of taxes, equal to 5 percent. If the effective tax rate on marginal investment is 50 percent, then the firm must earn a rate of return on capital invested in the project equal to 10 percent to cover its tax payments and to leave a 5 percent rate of return on capital, net of taxes, for its owners. The effective tax rate on marginal investment is therefore an indicator of how taxes affect the incentive for businesses to invest. When the effective tax rate on marginal investment increases (decreases), the incentive to invest decreases (increases).

The base to which these tax rates apply, i.e. taxable income, differs from corporate profits for financial accounting purposes. The calculation of taxable income may be viewed as starting with gross revenues from the sales of goods and services, and financial income. From these revenues, the corporation may deduct expenditures to earn such income, including salaries and wages, purchases of goods and services from other businesses, depreciation of capital assets (as determined by tax rules) and interest. To avoid double taxation of income as it flows through corporations, dividends received from other corporations may be exempt from tax. Three quarters of capital gains from the sale of shares and other assets are also taxed in the hands of the corporations. Chapters 4 and 5 provide an extended discussion of corporate income tax rates and issues associated with the tax base.

As will be discussed in more detail in the section of Chapter 5 on “Small Business,” a number of special rules apply to the corporate income tax paid by Canadian-Controlled Private Corporations (CCPCs).¹ For example, CCPCs are taxed at the reduced rates shown in Table 2.2 on the first \$200,000 of active business income. As they grow larger in size in terms of assets, the income subject to the reduced rate may be clawed back. Also, a CCPC that receives certain forms of investment income must pay taxes on such income according to a special regime to ensure that all types of investment income are taxed at a rate similar to the personal income tax rate.

Capital, Payroll, Property and Other Taxes Collected from Businesses

Businesses pay other sorts of taxes. An incorporated business may pay federal and/or provincial capital taxes,² which include the federal large corporations tax and provincial capital taxes on shareholder equity and certain debt liabilities (British Columbia, Manitoba, New Brunswick, Nova Scotia, Ontario, Quebec and Saskatchewan). Banking and insurance companies are liable to pay a federal capital tax as a form of minimum tax and provincial capital taxes (or premium or other taxes in the case of insurance) in all provinces. Summary information on capital taxes is provided in Table 2.3.

Table 2.3
**Capital Tax Rates and Thresholds
by Type of Corporation and Province, 1997**

	General ^a		Banks, Trust and Loan Corporations
	Rate (%)	Threshold (\$)	Rate (%) ^b
Federal	0.225	10,000,000	1.625
Alberta	n/a	n/a	2.0
British Columbia	0.3	1,500,000	1.0 or 3.0
Manitoba	0.3 to 0.5 ^c	2,000,000	3.0
New Brunswick	0.3 ^d	5,000,000	3.0
Newfoundland	n/a	n/a	4.0
Nova Scotia	0.25 ^d	5,000,000	3.0
Ontario	0.3	1,000,000	0.99 or 1.07
Prince Edward Island	n/a	n/a	3.0
Quebec	0.64	None	1.57
Saskatchewan	0.6	10,000,000	3.25
Northwest Territories	n/a	n/a	n/a
Yukon	n/a	n/a	n/a

^a A number of provinces impose a capital tax on all non-financial corporations with permanent establishments in their jurisdiction, subject to an exemption for capital of the amount indicated under "threshold." The capital tax base varies among jurisdictions. The federal government imposes the large corporations tax which is reduced by the corporate income tax surtax.

^b Rates shown are the combined rates of general capital tax and a specific tax on deposit-taking institutions. Reductions or exemptions may apply below certain thresholds.

^c The 0.5 percent rate in Manitoba applies to capital in excess of a threshold of \$10 million.

^d These are the rates applicable to taxation years starting on or after April 1, 1997.

Source: As for Table 2.2, pp 211-17.

Businesses are also liable for federal Employment Insurance (EI), CPP/QPP and provincial workers' compensation employer contributions, and provincial payroll taxes (as summarized in Table 2.4).

Most businesses are also subject to property taxes imposed by provinces or local governments, fuel excise taxes, and a range of other taxes and charges. Five provinces – British Columbia, Manitoba, Ontario, Prince Edward Island and Saskatchewan – levy retail sales taxes that result in significant amounts of taxes on business inputs (see Table 2.1). Four other provinces – Quebec, New Brunswick, Newfoundland and Nova Scotia – have substantially harmonized their sales taxes with the federal Goods and Services Tax (GST) that relieves most business inputs from tax. Alberta has no sales tax.

What is a “Payroll Tax”?

The report follows a practice common in national and international tax statistics by including under payroll taxes two distinct types of revenue: general taxes on payroll with no direct link to benefits, and required payments by employers and employees to governments where the payment is a condition for entitlement to specific program benefits provided by governments. The latter payments are often referred to as contributions or premiums, rather than as taxes. They reflect at least a partial application of the user pay principle, and as such their economic effects may be quite different from those of general payroll taxes. For example, a payment to government which directly earns a future pension benefit, such as a Canada/Quebec Pension Plan contribution, would not be expected to have the same effects on the labour supply and savings decisions of contributors as the same amount levied in the form of a general payroll tax.

Table 2.4
Payroll Tax Rates and Thresholds – Canada and Provinces, 1997

	Employer Contribution Rate		Maximum Insurable Earnings per Employee
	(%)		(\$)
Federal (Employment Insurance)	4.06		39,000
CPP/QPP	2.925		35,800
	General Payroll Taxes		Workers' Compensation ^a
	Rate	Threshold	Average Rate
	(%)	(\$)	(%)
Alberta	n/a	n/a	1.82
British Columbia	n/a	n/a	2.38
Manitoba	0.00	0 to 750,000	2.19
	4.50	750,000 to 1,500,000	
	2.25	over 1,500,000	
New Brunswick	n/a	n/a	1.75
Newfoundland	0.00	0 to 100,000	3.05
	2.00	over 100,000	
Nova Scotia	n/a	n/a	2.54
Ontario	0.00	0 to 200,000	3.00
	1.101 to 1.829	>200,000 to 400,000	
	1.95	over 400,000	
Prince Edward Island	n/a	n/a	2.03
Quebec	4.26	0	2.52
Saskatchewan	n/a	n/a	1.99
North West Territories	1.00	0	2.33
Yukon	n/a	n/a	1.40

^a The workers' compensation contribution rates shown here are for 1996. The source document notes that average assessment rates provided by the individual provincial Workers' Compensation Boards may not be fully comparable. In addition, differing earnings ceilings apply.

Source for provincial general payroll tax rates: as for Table 2.2, pp. 218-20.

Source for workers' compensation rates: Association of Workers' Compensation Boards, *Workers' Compensation Industry Classification Industry Classifications, Assessment Rates, and Experience Rating Programs in Canada, 1996*, 1996, Table 5.

Companies in the mining and forestry sectors also pay royalties and stumpage fees to provinces for the right to exploit non-renewable and renewable resources, while petroleum producers pay provincial royalties.

Taxes on Capital Income from Corporations

Owners of the capital of corporations who are resident in Canada pay personal income taxes on income derived from the corporation, including dividends, interest and capital gains, although these taxes are not considered to be business taxes. Dividends and capital gains on shares are taxed at the personal level at a reduced rate, since these forms of income already bear tax paid at the corporate level – a point to be further elaborated upon in Chapter 7.

Owners of corporate capital who are resident outside Canada are subject to federal withholding taxes on some distributions of corporate income received from Canada. Depending on their country of residence, these non-residents may also be subject by their country of residence to income taxes on business income that is derived from Canada, and may also be permitted to credit Canadian withholding taxes against tax liabilities owing to the country in which they reside.

Why Collect Taxes from Businesses?

The Committee undertook to study how the current business tax structure affects job creation and economic growth as well as compliance and fairness in the tax system. The results of our assessment are presented in Chapter 3. However, an even more basic issue arises as soon as the subject is considered: Why tax businesses at all?

Businesses, after all, are simply organizations that sell goods and services to consumers, pay wages and salaries to employees, and provide owners with capital income in the form of profits, interest, rents and capital gains. Taxes imposed on businesses are necessarily passed on to individuals in some combination of higher prices for goods and services, and lower wages and capital income. So, if individuals ultimately bear taxes levied on businesses, why not just tax individuals directly and let the businesses be?

In the view of the Committee, there are three good economic reasons for taxing businesses, all of which go to furthering the interlinked goals of efficiency and fairness:³

Administrative Necessity – Backstop to the Personal Income Tax: It is a fundamental principle of tax neutrality that individuals be fully taxed on all sources of income, and it is an inescapable reality that no tax is perfect. One major component of business taxes, the corporate income tax, works to close some of the gaps in the personal income tax system. Individuals are generally subject to tax on all sources of income but not including unrealized capital gains.⁴ In the absence of corporate income tax, Canadian resident shareholders would have strong incentives to defer the payment of personal income taxes by leaving income in the corporation rather than taking it out as taxable distributions. In turn, capital taxes may have a role as a backstop to corporate income taxes, if there are problems in fully taxing that income.

Taxing Income Accruing to Non-residents: About one fifth of Canadian corporate assets are foreign-controlled, so a significant portion of Canadian-source income goes to non-residents. Further, a number of foreign governments permit their taxpayers to credit Canadian corporate income and withholding taxes against the foreign government's taxes that are owing on income repatriated from Canada. In the Committee's view, corporate income taxes are a fair and practical means of obtaining some revenue contribution from foreign-owned businesses that have activities in Canada.⁵ If Canada did not assess corporate income taxes, foreign investors and the treasuries of foreign governments would be among the main beneficiaries. Capital taxes also have a practical role in collecting taxes from foreign shareholders (see further discussion in Chapter 4). Other taxes, of course, generally apply to corporations owned by non-residents.

Paying Taxes for Publicly-provided Benefits: Businesses benefit from the provision of certain public goods, services and infrastructure. There are convincing arguments for collecting some form of payment for those goods and services.⁶ Examples of taxes related to benefits that businesses receive from the provision of public goods and other government activities range across the economy. The most important include:

- payroll taxes that fund the CPP/QPP, EI and workers' compensation are payments for public programs and services. In the absence of these programs, businesses might incur similar private insurance costs on behalf of their employees and/or might have to increase employee wages and salaries;
- property taxes that are, at least in part, payments for municipal services;
- fuel taxes that are assessed by provincial governments as a form of user charge for the use of highways;
- royalty and stumpage fees, levied by provincial governments on income of resource companies (mining, forestry and oil and gas), may be regarded in part as a payment for the privilege of using property owned by governments; and
- environmental taxes may be levied for the right of using land, air and water damaged by pollution.

This “benefit” rationale for taxing business would suggest forms of taxes that would not depend on whether or not a business is incorporated, and in general would not be based on profits. All of the leading examples noted above generally apply to all forms of business, and use a base that has some link to the size of the publicly provided benefit.

To the extent that some services provided by governments are not charged to businesses, businesses can earn greater profits as a result of not paying for the costs of these services. Corporate income and capital taxes may, therefore, be viewed as an imperfect charge to pay for public benefits in this case.

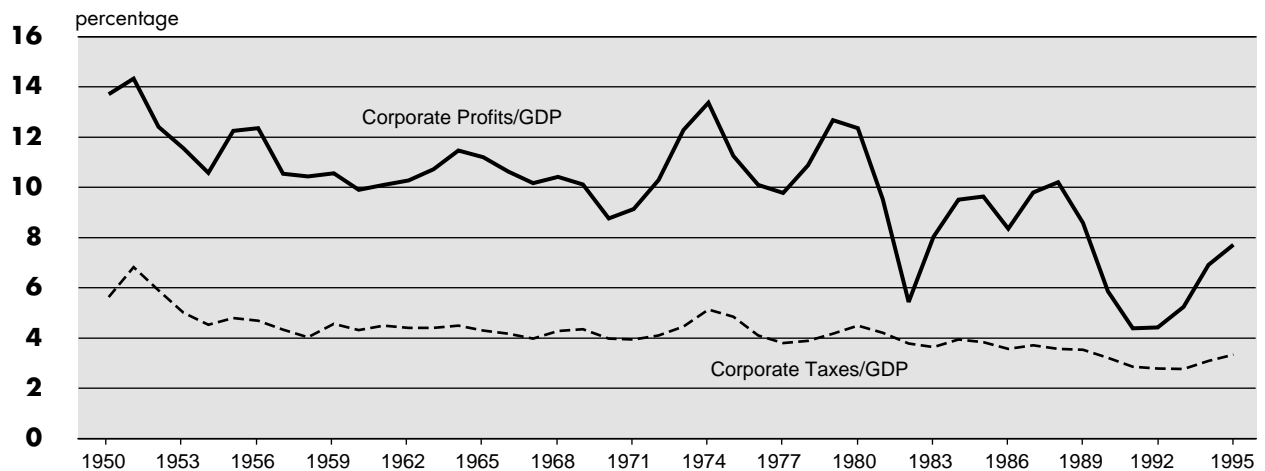
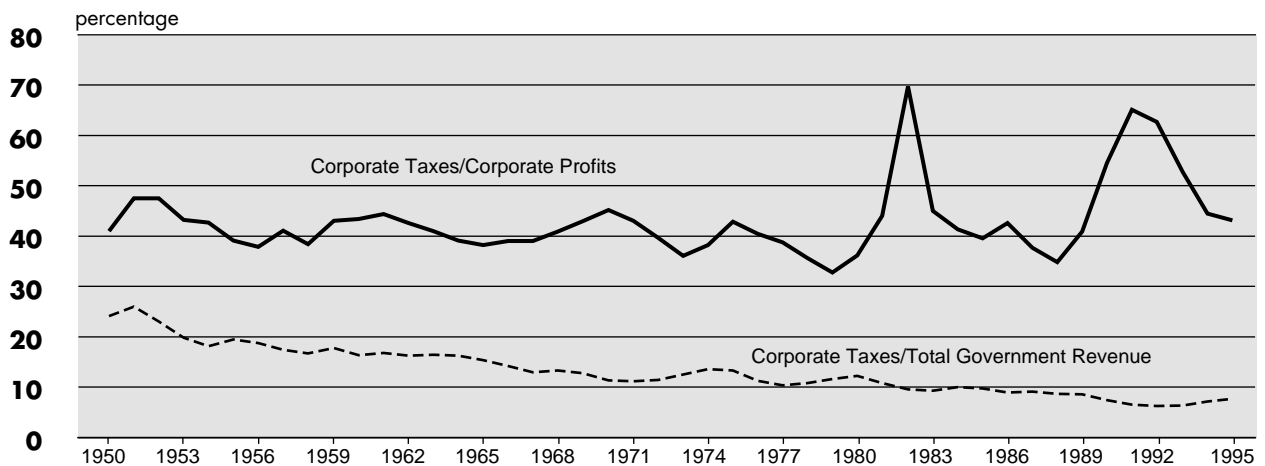
The Committee is well aware that the economic rationale for taxing businesses set out here is significantly at variance with broadly held public opinion. An argument sometimes advanced – explicitly or implicitly – for taxing businesses, and especially for corporate income and capital taxes, is that taxes on businesses are a separate source of government revenue that do not affect individuals. As discussed above, there is no basis for this view: ultimately, business taxes fall on individuals. Another argument is that businesses are owned largely by the wealthy, and therefore should be taxed to ensure that wealthy members of society pay appropriate amounts of taxes. This rationale, while consistent with the view that taxation of corporate income is a necessary part of taxing all income fairly, rests on a fundamental misconception about the way Canada's economy works – that business taxes are paid only by well-off members of society. As discussed in Chapter 3, a part of business taxes may fall on lower-income Canadians, as for example through higher consumer prices or lower wages.

Historical Evolution of Taxes Collected from Businesses – Getting the Facts Straight

Having noted the current broad mix of taxes on business, and the basic rationales for such taxes, we now describe how revenues from business taxes have evolved over the last four decades in Canada. We first look at income and capital taxes, and then turn to the total of all the business taxes covered in Table 2.1. We put the evolution of revenues from the business taxes in context by comparing revenues from a given business tax category with the total size of the economy or GDP, with total government revenues, and, most importantly, with measures of business income that are appropriately related to the taxes in question.

It has often been observed that federal and provincial corporate income taxes as a percentage of GDP and total government revenues have declined since 1950, as shown in Chart 2A. However, it is important to consider why this has happened, and whether – when the broader context is considered – it suggests any case for major change in the overall level of business taxation.

Chart 2A

Corporate Income and Capital Taxes (Total Government)**Notes:**

- Corporate taxes consist of federal and provincial corporate income and capital taxes, federal petroleum and gas revenue tax, federal withholding tax on payments to non-residents, provincial taxes on mining and logging profits, and provincial insurance premium taxes.
- Corporate profits are profits as recorded in the National Accounts adjusted to remove corporate interest payments to non-residents (which are included in corporate profits for national accounts purposes), in order to bring the measure of profits closer to the standard financial accounting profits concept and to the tax base for corporate income taxes. Corporate profits have been further adjusted by adding back provincial capital taxes, in order to express them on a "pre-capital tax" basis.
- Total government revenue is consolidated revenue on the National Accounts basis.
- GDP is gross domestic product measured at market prices in current dollars.

Source: Statistics Canada, *National Income and Expenditure Accounts* and calculations by Committee secretariat.

Corporate Income and Capital Tax as a Percentage of Corporate Profits

One approach to assessing changes in corporate income and capital taxes is to consider trends in the ratio of such taxes to total corporate profits. Chart 2A (upper panel) shows these corporate income and capital taxes (plus withholding taxes on payments to non-residents made largely by corporations) as a percentage of corporate profits over the last 45 years. It shows a pattern quite different from the commonly used ratio of these taxes to GDP (lower panel).

After a gradual downward trend from about 40 percent in the mid-1950s to about 35 percent in the late 1970s, the ratio of these taxes to corporate profits spiked to record-high levels in the deep recessions of the early 1980s and early 1990s, when many firms were experiencing losses – thereby depressing aggregate corporate profits without reducing taxes paid in a fully corresponding manner.⁷ In 1994 and 1995, with the partial economic recovery, these corporate taxes again averaged about 40 percent of profits. Overall then, the share of corporate profits paid in these forms of taxes to governments fell slightly through the 1970s but, following sharp temporary increases in this ratio in 1981-82 and 1990-93, has returned to a level similar to the average for the 1950s and 1960s, and somewhat above the average for the 1970s.

The decline in corporate taxes as a percentage of profits in the 1970s and the subsequent rise to the non-recession years of the late 1980s reflect a number of factors. Among these were policy actions taken during these periods. In the 1970s, a number of tax preferences were introduced, which resulted in an erosion of tax revenues. This erosion was arrested in the mid-1980s, when tax reform resulted in lower rates and broader bases.

Corporate income and capital taxes have declined as a percentage of GDP from 6 percent in 1950 to less than 4 percent in 1995, but this reflects the fact that corporate profits as a percentage of GDP have declined from over 13 percent of GDP to less than 8 percent in 1995 (see Chart 2A, lower panel). Corporate profits were simply smaller in relationship to the overall economy. For further discussion, see inset: “The Decline in Corporate Profits Relative to GDP.”

As shown in the upper panel of Chart 2A, over the past several decades, this measure of corporate taxes has declined even more as a share of government revenues than as a share of GDP. Arithmetically, this reflects the growth in government revenues (more or less corresponding to the growth in government expenditures) relative to GDP. As these corporate taxes already represented a substantial share of corporate profits at the beginning of the period, governments apparently judged that the additional revenues required to finance the increased share of government in the economy should come primarily from other types of taxes for which the effective rates in the 1950s and 1960s were much lower than the effective rates for these corporate taxes. Thus, personal income taxes, as a share of personal income, have increased from an average of 6 percent in the 1950s and 9 percent in the 1960s to more than 15 percent in the first half of the 1990s – an increase of 2 ½ times from the 1950s to the 1990s.

The Committee shares the view that it would have been unwise to attempt to increase corporate taxes, given their already substantial average rates of the 1950s, in order to finance any significant part of the growth in the government share in the economy. For example, if there had been an attempt to increase the ratio of corporate taxes to corporate profits by the same proportion as the increase in personal income taxes to personal income, the ratio of corporate income and capital taxes to profits would have had to approach 100 percent. Any very large increase in corporate tax rates, even to levels well below 100 percent, would have had major adverse effects on economic growth and job creation, and could be expected to have been self-defeating from both the economic and revenue-raising points of view. There is a point where tax rates on a potentially mobile base can become so high that total revenues will begin to decline.

The Decline in Corporate Profits Relative to GDP

It is clear that an important factor explaining the decline in corporate income taxes relative to GDP and to total government revenues is the decrease in corporate pre-tax profits relative to GDP. Why has this shift occurred? Several factors have clearly influenced the course of profits relative to GDP over the last four decades.

- High interest rates in the late 1970s and early 1980s resulted in substantial increases in interest expense (see Chart 2B). As interest rates have declined since 1982, interest expense as a share of total value-added has tracked downward.
- Businesses on the whole increased debt financing throughout the 1970s and early 1980s,^a resulting, everything else being equal, in lower corporate profits relative to the total capital stock.
- The recessionary periods at the beginning of the 1970s, in the early 1980s, and in the early 1990s, resulted in sharply lower corporate profits as a percentage of GDP (Chart 2A). The lowest share of our adjusted measure of corporate profits to GDP was reached in 1991 (under 5 percent of GDP) and tax loss carry-forwards from this recession can be expected to reduce corporate taxes for many years thereafter.
- Nominal corporate profits were higher in the 1970s and 1980s due to inflation, since both depreciation and inventory expenses were understated. Interest expenses were overstated as interest, unadjusted for inflation, compensates lenders for the loss in the purchasing power of their capital due to inflation. On balance, the overall impact of inflation was to overstate corporate profits in the 1970s and 1980s relative to the 1960s and 1990s.^b
- Since the mid-1980s, many countries, including Canada, have reduced corporate income tax rates and broadened tax bases. However, as discussed in Chapter 3, Canada has not reduced its statutory rate on corporations as fast as other countries and now has a higher corporate income tax rate, especially for large non-manufacturing corporations, than the United States, the United Kingdom and several other OECD countries. When Canada has a higher corporate income tax rate than those other countries, there is an incentive to shift costs into Canada and income to other countries, resulting in a decline in recorded corporate profitability in Canada.

^a Debt/equity ratios of Canadian public corporations increased from 1960 to 1982 but have declined somewhat during the later 1980s and early 1990s. For a recent analysis of debt/equity ratios see Suret and l'Her (1997).

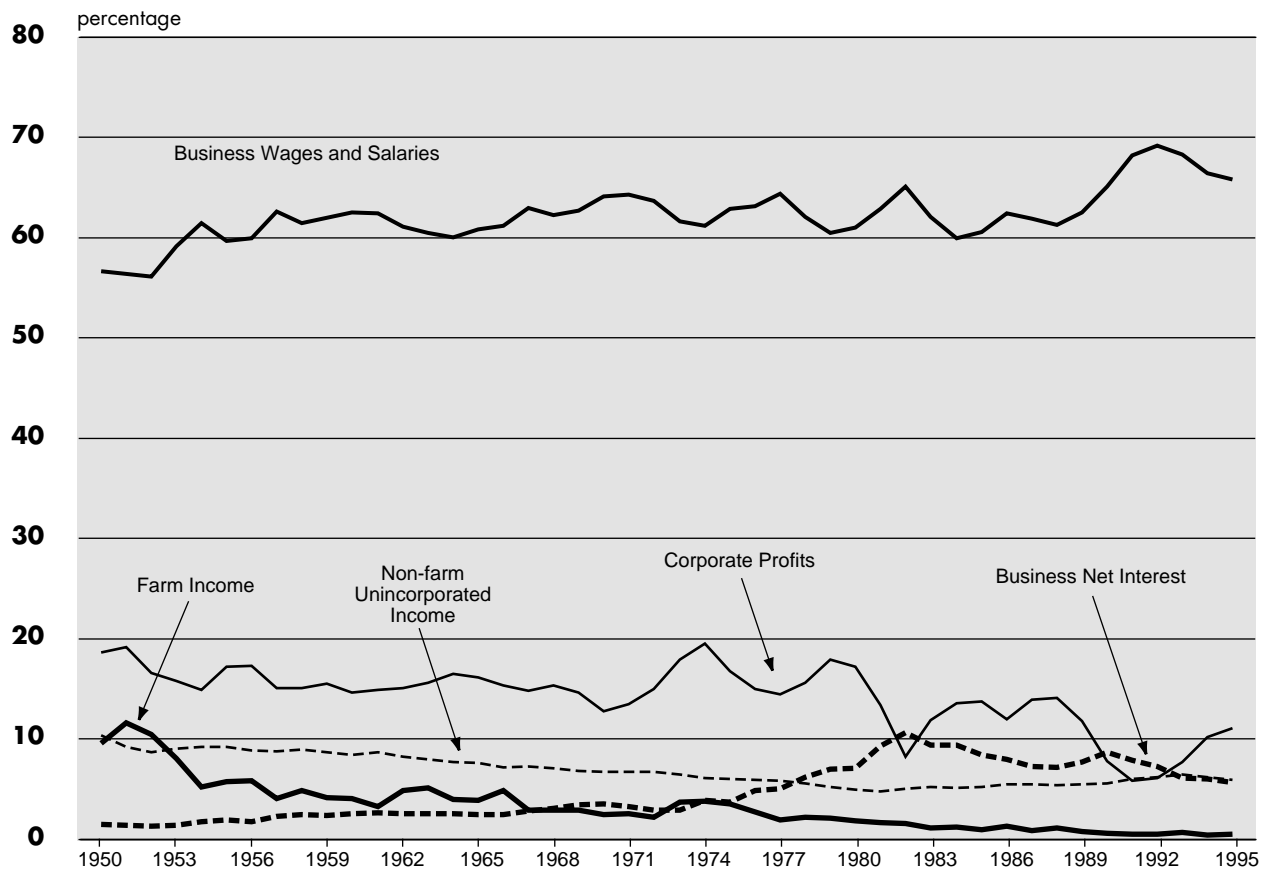
^b St.-Cerny (1993).

A Broader Measure of Business Taxes as a Percentage of Business Net Value-added

As noted at the beginning of this chapter, businesses pay many taxes in addition to corporate income and capital taxes. In the following discussion, we use the same broad measure of business taxes as in Table 2.1 – that is payroll and property taxes paid by business, plus sales taxes, excise taxes and tariffs on business inputs, in addition to corporate taxes. The sum of all these taxes is compared with business net value-added – the sum of labour compensation, corporate profits, interest and rents, and income of farm and non-farm unincorporated business (net of capital depreciation) – in other words, total incomes, rather than just incomes in the form of corporate profits, generated by business activity.⁸

We consider this broad measure of the size of business activity to provide a better basis than would corporate profits for comparison with the broad measure of business taxes.⁹ To provide some background information on this rather unfamiliar concept, Chart 2B shows historical developments in the components of business net value-added. Wages as a percentage of business net value-added have increased from 57 percent in 1950 to 66 percent in 1995. Corporate profits have declined relative to business net value-added from 19 percent in 1950 to 11 percent in 1995. Estimated business net interest costs increased substantially from the 1950s to the early 1980s in part reflecting higher interest rates and increased debt, but subsequently showed some decline through 1995 as interest rates declined substantially.

Chart 2B

Business Net Value-added: Main Components as Shares of Total**Notes:**

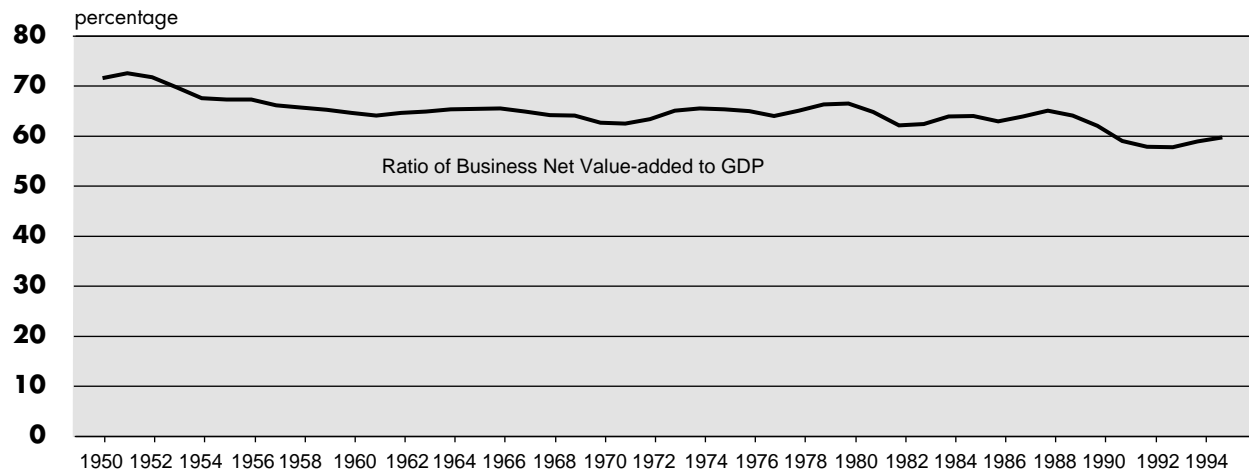
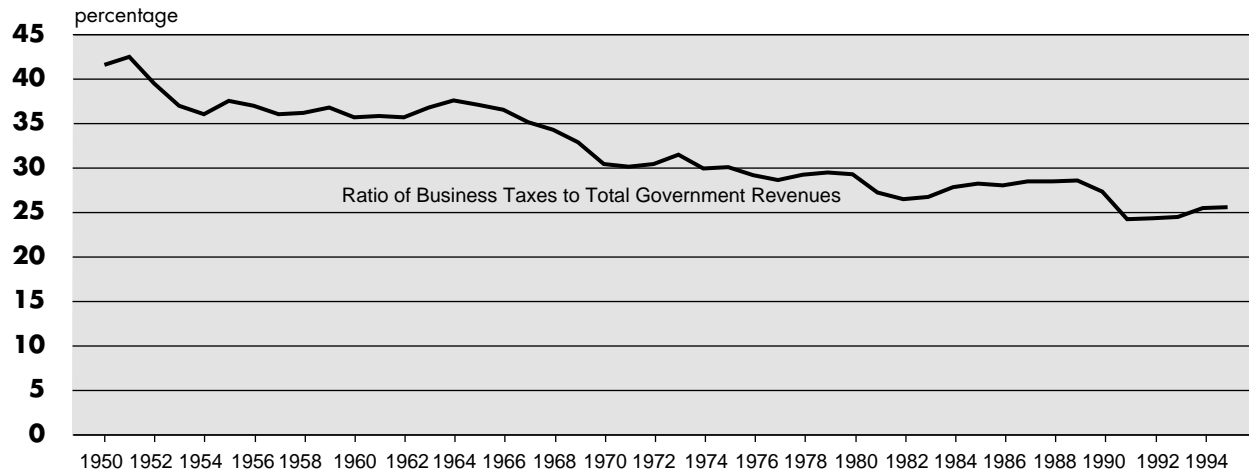
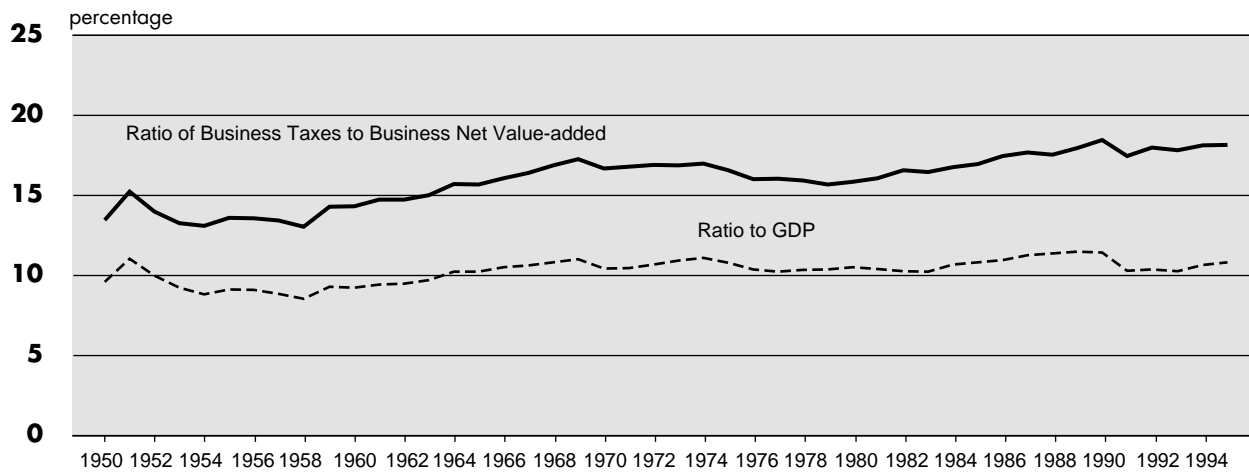
- Corporate profits: as defined in Chart 2A.
- Farm income: accrued net-farm income.
- Non-farm unincorporated income: net income of non-farm unincorporated business excluding residential rent.
- The components shown on the chart sum to less than 100%, as a number of minor components are not shown.

Source: Committee secretariat estimates derived from Statistics Canada, *National Income and Expenditure Accounts*.

Chart 2C shows this broader measure of business taxes expressed as ratios to business net value-added, GDP and total government revenues. This measure of business taxes has increased, as a proportion of business net value-added, from about 13 percent in the 1950s to about 18 percent in the 1990s. This increase primarily reflects growth in payroll taxes relative to business wages and salaries, and relative to total business net value-added. Rates for all the major components of payroll taxes have shown a strong upward trend over the periods that these taxes have been in existence.

One component of business taxes included in the above calculations that has decreased in recent years is sales taxes paid by business on their inputs. As discussed above, the replacement of the manufacturers' sales tax by the Goods and Services Tax in 1991 virtually eliminated federal sales taxes on inputs. However, there still remain provincial retail sales taxes on business capital inputs. There is no retail sales tax in Alberta. Quebec converted to a tax similar to the GST in 1992, and three Atlantic provinces (Nova Scotia, New Brunswick and Newfoundland) harmonized their provincial sales tax with the federal sales tax in 1997. The harmonization will remove provincial sales tax on business inputs in these provinces, and will reduce economic distortions arising from the cascading of taxes on business inputs when goods and services are sold from one business to the other before reaching the consumer.

Chart 2C
Business Taxes (Total Government)



Source: Statistics Canada. *National Income and Expenditure Accounts* and estimates of Committee secretariat.

There has been no decline in this broader measure of businesses taxes to GDP – the ratio has varied between 9 percent and 11 percent. It may be noted (see bottom panel) that the ratio of business net value-added to GDP has decreased moderately, unlike corporate profits whose ratio to GDP has fallen quite sharply. On the other hand, the ratio of business taxes to total government revenues fell from about 40 percent in 1950 to about 25 percent in 1995.

The overall conclusion we draw is that a careful examination of historical trends in business tax revenues provides substantial explanation for the decline in importance, relative to the economy and relative to total government revenues, of corporate income and capital taxes taken together. These corporate income and capital taxes have not declined on average, over the past four decades, relative to corporate profits. Our examination further indicates that there has not been a long-term decline in business taxes broadly defined, but on the contrary, total business taxes have increased relative to a broad measure of business activity.

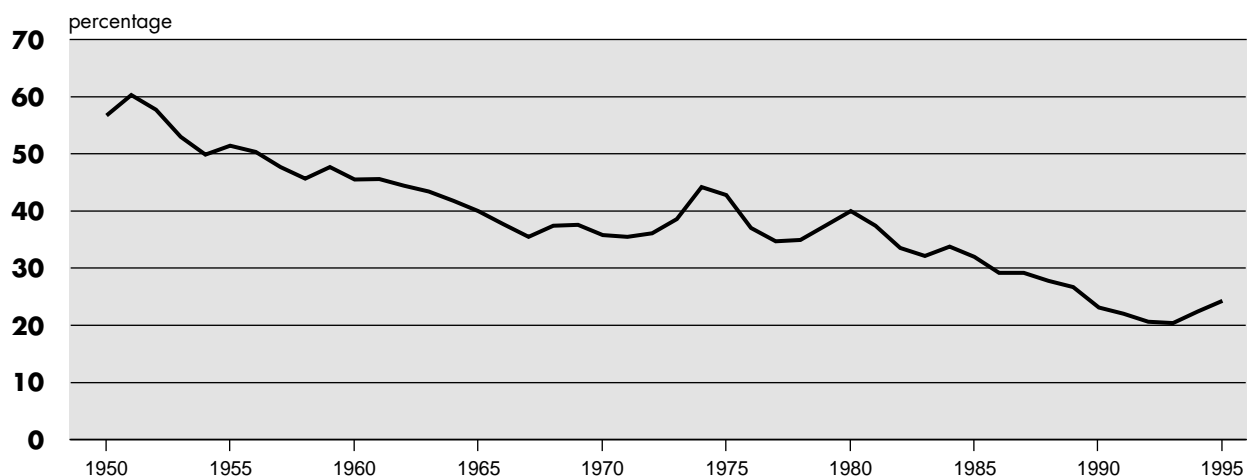
Significant Shifts in the Kinds of Taxes that Businesses Pay

Although total taxes on businesses relative to business net value-added have shown a gradual upward trend over the past 40 years, there has been a significant shift in the mix of taxes paid. As illustrated in Chart 2D, there has been movement over the years from profit-sensitive taxes (corporate income taxes and profit-based resource taxes) to capital, property and payroll taxes, and sales and fuel excise taxes on business inputs. In 1950, just under 60 percent of such business taxes were profit-related but by 1995, this ratio fell to about 25 percent. In part, this shift is due to the decline in corporate profits relative to business net value-added, but it also reflects the increase in rates and the corresponding growth in revenues from these profit-insensitive taxes.

This increase in the relative importance of profit-insensitive taxes, including capital, payroll, and fuel excise taxes, is one reason why the Committee has given considerable attention to these areas. We consider policy issues concerning capital taxes in chapters 4 and 11, and issues concerning the main federal payroll tax – employer contributions to EI – in Chapter 8, and the federal fuel excise tax in Chapter 9.

Chart 2D

Profit-sensitive Business^a Taxes as a Percentage of Total Business Taxes



^a Corporate income tax plus withholding taxes on payments to non-residents.

Canada's Taxes on Business in Comparison to Other Countries

Given the openness of Canada's economy, it is desirable to examine how Canada's tax system compares with those of other countries with whom we trade and compete for investment. Comparison with the United States is especially important, given the closeness of the economic relationship between the two countries. Much discussion of business taxation has centred on comparing rates for major taxes in Canada with those in other countries.

It is useful to compare statutory corporate income tax rates across countries. Although other provisions of the tax system also affect investment, including write-offs for depreciation and inventory costs, the statutory tax rates are especially relevant in determining the incentive for businesses to shift income out of Canada to countries with lower tax rates and shift income from countries with a high tax rate into Canada. As shown in Table 2.5, Canada's general corporate income tax rate of 43 percent is below rates in Germany, Italy and Japan but well above rates in the United States (as low as 35 percent), United Kingdom (31 percent), Mexico (34 percent) and Chile (15 percent).

Table 2.5
**Maximum Corporate Income Tax Rates
for G-7 Countries, Mexico and Chile**

	1983	1990	1997
		(percentage)	
Canada ^a	44.9 – 52.9	35.3 – 45.8	38.1 – 46.1
United States ^a	48.7 – 51.4	34.0 – 41.9	35.0 – 42.5
Chile			15.0
France	50.0	37.0 ^b	41.6 ^c
Germany	56.0 ^b	50.0 ^b	57.4 ^b
Italy	38.8	46.4	53.2
Japan	53.0	52.0	51.6
Mexico			34.0
United Kingdom ^d	52.0	35.0	31.0
Canadian Manufacturing Rate	38.8 – 46.8	32.8 – 43.3	24.6 – 39.1

^a Rates vary by province or state.

^b Tax rates on retained earnings. Rates on profits distributed to stockholders are lower in all cases except France, in 1990, when the rate on dividends was higher, at 42 percent, compared to a 37 percent tax rate on undistributed profits.

^c This will be the new rate, as announced in July 1997. The current rate is 36.6 percent.

^d The U.K. Chancellor has proposed a 30 percent corporate tax rate for 1998.

Sources:

1983 data from *Corporate Taxes, A Worldwide Summary*, Price Waterhouse, 1983.

1990 data from *Corporate Taxes, A Worldwide Summary*, Price Waterhouse, 1990.

1997 data from KPMG *Corporate Tax Rate Survey*, <http://www.kpmg.com>

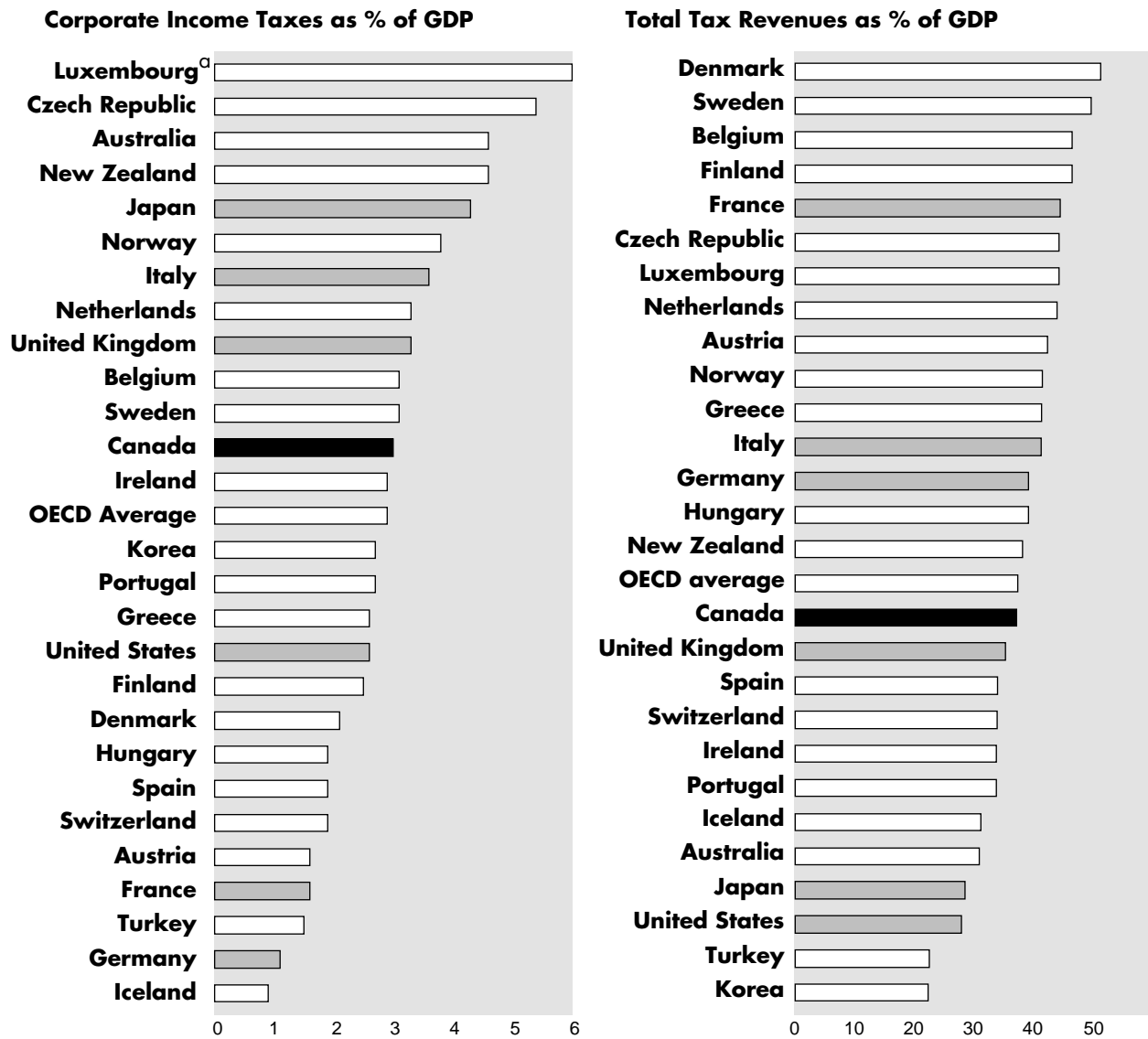
A more broad brush approach, frequently employed in public discussion, is to compare corporate income tax as a percentage of GDP across countries, as in the left-hand side of Chart 2E. Canada's ratio is in the middle of the range, and significantly less than many other countries including Japan. However, as discussed in the context of the historical evolution of corporate taxes in Canada, the ratio of corporate income taxes to GDP is of limited value as an indicator of the relative role of such taxes, and of course provides no recognition of other business taxes that are of major importance in Canada and elsewhere.

A more analytically interesting approach would be to compare corporate income tax revenues as a percentage of aggregate profits. However, there are significant differences among countries in the ways in which profits are measured, and fully comparable data on this ratio are not obtainable.

Unfortunately, it is also difficult to obtain reasonably comparable data on broader measures of business taxes and of business net value-added. The ratio of total taxes (business and all other) to GDP, shown in the right-hand side of Chart 2E, provides a rough indicator of whether a country tends in general to be "high tax" or "low tax." It will be seen that the Canadian ratio is again in the middle of the range, but is substantially higher than the ratio for Canada's most important trading and investment partner, the United States.

A comparison focussing on effective tax rates on marginal investment in Canada relative to other countries is provided in Chapter 3.

Chart 2E

Corporate Income Taxes and Total Taxes, as Percentages of GDP, 1995

^a Corporate income taxes as percentage of GDP for Luxembourg are 7.7 percent.

Note: G-7 countries (other than Canada) are shaded.

Source: OECD, Revenue Statistics 1965-1996, Paris, 1997. Covers all levels of government.

The Federal-provincial-local Mix of Business Taxes

All three levels of government in Canada levy taxes on businesses and these taxes interact. Table 2.6 presents an overview of federal, provincial, local and CPP/QPP shares of the major taxes levied on businesses. This Table is based on the same comprehensive coverage of business taxation as is used in Table 2.1.

The federal government is responsible for about two thirds of corporate income taxes. Other levels of government have larger shares than the federal government in the other major business tax fields. The provinces collect over two thirds of capital and premium taxes. In the case of payroll taxes,⁹ the federal government, the provinces, and the CPP and QPP all have major shares. Property tax, which accounts for almost one fifth of all taxes paid by business, is levied primarily at the local level but also has a small provincial component. Provinces and local governments collect the dominant shares of the portions of sales taxes, fuel excise taxes, and other taxes and charges that are estimated to be paid on business inputs and operations.

The federal government collects about one third of all business taxes, the provinces 40 percent, local governments 21 percent, and the CPP/QPP 6 percent. Thus, provinces and local governments play vital roles in determining the amount of taxes paid by businesses. In a number of instances, federal and provincial governments have taken steps to co-ordinate these policies, especially with respect to income taxes.

Table 2.6
Federal, Provincial, Local and CPP/QPP Taxes on Business - 1995 (\$ Billion)

	Federal	Provincial	Local	CPP/QPP	Total	%
Corporate Income Taxes	12.5	6.3			18.8	22
Capital and Premium Taxes	1.4	3.8			5.2	6
Withholding Taxes	1.7				1.7	2
Payroll Taxes	8.2	9.1		5.2	22.5	27
Property Taxes		1.6	13.5		15.1	18
General Sales Taxes		6.6			6.6	8
Fuel Excise Taxes	1.8	2.6			4.4	5
Other Indirect Taxes and Fees	1.8	3.9	4.3		10	12
Total	27.4	33.9	17.8	5.2	84.3	100
%	33%	40%	21%	6%	100%	

Note: See notes to Table 2.1.

Source: Statistics Canada, *National Income and Expenditure Accounts*, and estimates by the Committee secretariat.

As in other areas of taxation policy, the Committee looked to other countries to determine if there were lessons (positive or otherwise) to be learned about taxing in a federal state. However, practice with respect to allocation of tax fields in federal states varies widely.

Corporate income tax is an example (Table 2.7). In Australia, only the central government levies corporate income tax, whereas German and Swiss central government shares of this tax are smaller than in Canada. The U.S. central government collects a larger share of corporate income taxes than does the Canadian government.

Table 2.7

Distribution of Corporate Income Tax by Level of Government in OECD Federal Countries, 1995

	Central	Province/State (% Share)	Local
Australia	100	0	0
Belgium	80	9	11
Canada	64	36	0
Germany ^a	33	32	35
Switzerland	46	33	21
United States	83	15	1

^a German corporate income taxes are collected by the federal government and shared with states through a revenue-sharing formula. However, local governments in Germany collect their own corporate taxes.

Notes:

- Components may not sum exactly to totals due to rounding.
- Definition of corporate income tax may differ somewhat from definition in Table 2.6.

Source: OECD Revenue Statistics 1965-1996, Paris, 1997.

Furthermore, the share of revenue received is only one dimension of the central government versus provincial/states government role in a tax field. In some cases (e.g. Germany), a single authority may collect all of a given type of tax, at common rates throughout the country, and then distribute a portion to provincial/state governments on a formula basis. Such an arrangement implies substantial centralization of the tax regime even in cases where the tax share of the central government is relatively small. While the Canadian federal government collects a smaller share of corporate income taxes than does its U.S. counterpart, there is greater harmonization of corporate income taxes between the federal and sub-national governments in Canada than in the United States.

Key Points in Chapter

- Taxes on businesses are warranted as an essential administrative means of reinforcing the personal income tax system, as a means of taxing business income accruing to non-residents on Canadian operations, and to ensure that businesses pay for their share of benefits received from public programs and services.
- Income taxes on corporations are now less than one quarter of total taxes on business activity.
- The corporate income tax to GDP ratio is flawed as an indicator of how corporate taxes have evolved over time as GDP is not a good measure of business activity and as businesses pay substantial taxes in addition to corporate income tax.
- Although corporate income and capital taxes as a percentage of profits fell from the 1950s to the 1970s, corporate income and capital taxes have since shown some upward trend while also being subject to very wide cyclical fluctuations.
- Profit-insensitive taxes on business have grown far more quickly than corporate income taxes. This partly results from low growth in corporate profits.
- Total business taxes as a percentage of business value-added have increased over the past four decades.
- Unlike certain federations where corporate income taxation is left to the central government, both federal and provincial governments play an important role in this tax area. Only 33 percent of total business taxes are levied by the federal government. The provinces and local governments receive the largest share of business taxes.

Endnotes

- ¹ A Canadian-controlled private corporation is a private corporation that is not controlled by non-residents or public corporations.
- ² For further details, see the “Capital Tax” section of Chapter IV and the paper entitled *Capital Tax Issues* by McQuillan and Cochrane (1996), Technical Committee Working Paper 96-8.
- ³ See Bird (1996), Technical Committee Working Paper 96-2 for an exploration of these themes.
- ⁴ Under an income tax, individuals are, in principle, subject to taxation on all forms of accrued income – the chosen measure of their ability to pay taxes. However, some forms of income, especially capital gains or losses, are difficult to tax at the time they accrue to the individual. Taxation of capital gains net of losses on an accrual basis would require the periodic valuation of assets to measure the difference between the value of an asset at the beginning and end of the taxpayer’s fiscal year – the tax would be assessed on gains regardless of whether the asset were sold or not, and a refund would be provided for losses whether the asset were sold or not. The taxation of net capital gains on an accrual basis might force individuals to sell assets to meet tax liabilities or result in unfairness when some types of property are difficult to value. One proposal that attempts to overcome these difficulties would impose a tax at the time of sale of an asset at a higher rate, which would reflect the value of deferring taxation. This approach would be difficult to implement, given that, in principle, the value of deferring taxation depends on the time pattern of capital gains accrual and the personal income tax rate bracket the taxpayer faced in each year. See Helliwell (1969), p. 315, Meade (1978), pp. 132-35, 148-49, and Auerbach (1991), pp. 167-78.
- ⁵ Alternative methods of collecting the appropriate taxes all have significant weaknesses. One can levy withholding taxes on income distributed to non-residents. However, only dividends and other remitted payments are subject to withholding tax and these taxes can be deferred by not distributing income to owners. Also, withholding taxes are subject to treaty negotiations and are not easily adjusted. Countries such as the United States, Japan, and the United Kingdom allow Canadian corporate income taxes and non-resident withholding taxes to be credited against tax liabilities on foreign income that are owed by their residents to their governments.
- ⁶ It is also efficient to tax businesses on the income that is earned by having access to public goods and services for which they would not otherwise pay.
- ⁷ Corporate income and capital taxes as a percentage of corporate profits are highly cyclical – the ratio of taxes to profits increases during recessions and falls during booms. The reasons are twofold. First, capital taxes are not sensitive to income, so during recessions the ratio of this component of corporate taxes increases relative to aggregate corporate profits. Second, under the corporate income tax, governments tax profits when corporations earn income but do not apply fully parallel negative taxes (refunds) when corporations are unprofitable. Unused corporate losses for tax purposes can be carried back up to three years to reduce income of those years (allowing corporations to claim a refund of past taxes paid), but they may also be carried forward without interest up to seven years to reduce taxes paid on income earned in the future. Thus, taxes paid by corporations that have taxable income, as a percentage of total profits (net of losses) of all corporations, increase during years when many corporations are unprofitable; the unused pools of losses are carried forward by these loss corporations to reduce tax payments in the future when the corporations become profitable and this has an impact on the ratio of “tax” to profits in these recovery years.
- ⁸ Our measure of business net value-added is gross of indirect taxes. It excludes estimated capital income on residential housing.
- ⁹ Many studies have measured capital and labour taxes as a percentage of profits gross of both taxes. This measure is problematic since, all else being equal, tax rates are higher when businesses are labour-intensive (in the extreme case, a firm without capital income and paying any amount of payroll tax would show a rate of 100 percent). For a more detailed discussion of this point, see McKenzie, Mansour and Brûlé (1997), Technical Committee Working Paper 97-15.
- ¹⁰ The Table shows EI premiums paid by business employers to the federal government, business employer contributions to the CPP and QPP and workers’ compensation employer premiums and other business employer payroll taxes paid to provincial governments.

The Business Tax Structure: An Evaluation

3

The public sector plays important roles in a modern economy and society, including the protection of individuals and property, and the provision of education, health care, a transportation infrastructure and a social safety net. These activities make the private sector more productive and ensure a more equitable distribution of income. To perform these essential functions, the public sector has to finance its expenditures, and while it can do this in a number of ways – through borrowing, expanding the money supply and charging for government services – the primary means is taxation.

Although public expenditures may improve the performance of the economy, taxes themselves withdraw resources from the private sector and may impair its efficient functioning. As the Committee noted at the outset, the fundamental challenge for tax policy is to impose those taxes in a fair manner, while at the same time minimizing the loss of output produced by the private sector. Central then to making sensible proposals for change is understanding how well the existing system meets this challenge and identifying aspects of the system where there appears to be room for improvement.

Challenges for the business tax structure are even more critical in today's economic environment of rapid technological change and growing global economic integration. The adoption of new technologies provides opportunities for businesses to improve their productivity and compete in international markets. Moreover, the internationalization of business production requires Canada to maintain competitive advantages, so that investment and job creation take place here.

The Committee was asked, in its terms of reference, to assess how, in an open economy, corporate income, capital, payroll and other business taxes affect Canada's economic performance – economic growth, job creation, fairness and compliance. This Chapter provides a broad overview of these questions, and of the related issue of the impact of corporate income tax rates on the tax base and revenues. It sets the stage for the consideration of policy design issues in specific tax areas that will occupy the remainder of the Report.

Taxation and Economic Growth in an Open Economy

A growing economy increases employment opportunities as well as growth in income per worker. A fundamental concern of the Committee, therefore, was to understand how the business tax structure can affect economic growth.¹

Canada's business tax regime can affect economic growth in four important ways:

- *Economic efficiency*: Economic growth is encouraged if tax policies result in better economic efficiency. In a market economy, prices and profits operate as a signal to businesses for determining the use of resources. A tax system that does not interfere with the relative prices and returns on investment will generally contribute to a more productive use of existing labour and capital,² thereby improving prospects for economic growth.

- *Investment in capital goods and services:* Economic growth depends on investment by Canadian businesses in machinery, structures, and other capital goods and services that increase the capacity of businesses to hire workers and produce goods now and into the future. The tax system reduces economic growth to the extent that the tax system discourages businesses from investing resources in capital to produce goods and services.
- *Growth in the labour force:* Economic growth depends on the willingness of firms to hire more workers and on the growth in the labour force, which in turn depends on population growth and the willingness of individuals to supply labour.
- *Productivity:* The use by businesses and individuals of new ideas and technologies, so that more can be produced with available resources, is a major determinant of economic growth. Investments in technology, research and development, education and training improve the capacity of Canadian businesses to compete in international markets.³

Economic growth is further affected by the ability of Canadian businesses to compete in a global economy. A tax system that is neutral encourages businesses to pursue economic opportunities according to their comparative advantage in Canada, rather than to minimize amounts of tax that they pay. Taxes that distort costs of production in Canada relative to those in countries with which our industries compete, particularly the United States, can lower our potential for economic growth.

We present our assessment of the overall impact of business taxes on Canadian businesses in terms of four broad areas: business investment; efficiency in the use of resources; productivity growth in a knowledge-based economy with special reference to labour and human capital; and overall cost competitiveness.

Taxation and Investment

When a business invests in machinery, structures, land or inventories, it expects to earn income after paying for financing, depreciation and other costs. The owners of a business must expect to earn income on capital investments at a rate that is at least as good as that on other available investment opportunities, if they are to undertake new investment activities. Taxes can reduce income earned on investments or increase the cost of acquiring and holding capital.⁴ The effect of corporate income and other related taxes on investment has been the subject of considerable research.⁵

Prior to the 1980s, studies based on aggregate investment data suggested that income and other taxes on capital did not affect investment decisions in a substantial way. Other factors, such as growth in the demand for goods and services, were seen to play a more important role in explaining investment behaviour. However, more recent studies based on disaggregated industry or firm-level data suggest a different conclusion.⁶ While other factors are certainly important in influencing investment behaviour, based on the total body of research in this area (including research conducted specifically for the Committee), we are of the view that taxes do have a significant impact on investment decisions made by Canadian businesses.

In analysing the impact of taxes on investment, it is important to take account of more than just the statutory rate of corporate income tax. Allowance should also be made for tax provisions related to capital cost allowances, inventory costs and financing costs; for investment tax credits; and for other taxes on investment – capital taxes and sales taxes on business inputs. A useful summary measure of the impact of the overall tax structure on the incentive to invest is the “effective tax rate on marginal investment,” which expresses the taxes payable as a proportion of income earned on capital invested in “marginal projects” (see Chapter 2 inset “What is a Tax Rate?” for further explanation). Table 3.1 shows estimates of these effective tax rates by industry category and by asset type, for large and small firms in Canada.

Table 3.1
Effective Tax Rates on Marginal Investments, 1997

	Large Businesses	Small Businesses
	(percentage)	
Industries		
Agriculture, Fishing and Trapping	–	7.9
Forestry	28.8	12.6
Mining	8.7	–
Oil and Gas	5.5	–
Manufacturing	17.9	7.6
Construction	37.0	17.5
Transportation	27.9	15.7
Communications	23.9	20.2
Public Utilities	30.3	14.7
Wholesale Trade	32.1	15.5
Retail Trade	33.8	16.4
Other Services	27.6	10.1
Assets		
Structures	24.2	8.3
Machinery	19.6	17.9
Land	25.3	9.2
Inventory	37.6	16.5
Subtotal – Tangible Capital	27.0	13.3
Exploration and Development	0.2	–
Research and Development	-28.0	-39.8
Total – Non-financial Industries and Assets	22.8	12.1

Notes:

- See Table 3.10 for detailed estimates by asset and industry.
- In this Table, effective tax rates on marginal investments are calculated relative to gross-of-tax returns. See further discussions of the effective tax rate on marginal investments, in the inset entitled “What is a Tax Rate?” in Chapter 2.
- Small businesses are Canadian-controlled private corporations subject to the low rate of corporate income tax. Large businesses are corporations subject to the high general rate, or the manufacturing and processing rate. (The rates for each industry are based on the proportion of manufacturing and processing versus other income in the industry.)
- No estimates are shown for large businesses in Agriculture, Fishing and Trapping, or for small businesses in Mining and Oil and Gas, due to the small number of businesses in these categories and the consequent unreliability of underlying data.

Source: Calculations by Committee secretariat with technical assistance from the Department of Finance and K. McKenzie. See McKenzie, Mansour and Brûlé (1997). Technical Committee Working Paper 97-15.

The Committee was struck by the apparent unevenness of the playing field for different investment activities as suggested by the substantial differences in effective tax rates on investment shown in Table 3.1. We concluded that the current structure of business taxes impedes investment for certain industries and causes economic distortions that reduce the potential for economic growth. The impact is in four areas:

- *Distortions and biases between industrial sectors:* In the current system, effective tax rates on capital vary across industries, a factor that tends to reallocate capital to those industries with the most preferred tax treatment rather than to those that may have the best prospects for economic growth. The result is to discourage investments – especially for large corporations in forestry, construction, transport, communications, utilities, trade and services.
- *Distortions among kinds of assets:* Assets are taxed at different rates, so that businesses are given an incentive to choose among different kinds of assets based on minimizing taxes rather than pursuing the best economic opportunity. For example, inventory investment in agriculture receives relatively generous tax treatment, because businesses in the sector may use cash basis

accounting. For other industries, investments in inventories are discouraged, because cost deductions for tax purposes are based on historical prices, so that the nominal income earned from holding inventories is taxed. The effective tax rate is lowest on intangible capital investments – exploration and development (E&D) in the resource sector, and R&D, which is especially important in high technology sectors. A less extreme but more widespread distortion stems from machinery being less highly taxed than structures for large businesses because of more generous capital cost allowances; whereas for small businesses the effective tax rate on machinery is higher than that on structures.

- *Distortions that favour one sort or organizational structure over another:* At the present time, the capital investments of smaller corporations – businesses that qualify for the small business deduction and an exemption from federal and provincial capital taxes – are taxed less highly than large corporations. This differential encourages the growth of small corporations at the expense of large businesses for reasons other than the economic advantages that small enterprises may bring to the economy. In addition, though not shown in Table 3.1, other potential distortions of organizational structure can occur. For example, the tax system may allow structures to be developed that convert what in substance are returns on corporate equity to income streams that are not subject to corporate income tax (see “Bypassing the Corporate Income Tax” section of Chapter 7).
- *Distortions that favour debt financing:* Although not shown in Table 3.1, since interest expense is deductible from a corporation’s income for tax purposes, businesses that use debt financing (bonds and loans) as opposed to equity financing (shares) may be able to reduce overall taxes paid on income.

Taxation and the Efficient Use of Resources

Efficiency refers to a business’s (or country’s) ability to produce the most valued total of goods and services with a given amount of resources. Payments to government in the form of taxes, necessary though they may be, raise overall costs to businesses. In addition, various features of the tax system may result in economic distortion by favouring production of some types of goods and services over others, and by favouring some ways of producing a given good or service over others.

As a starting point for considering the impact of taxes on the use of resources, the Committee has prepared estimates of effective tax rates on costs, by industry, that incorporate the effect of business taxes on capital costs⁷ and on labour costs, and calculate their combined effect relative to a measure of total costs. (See Table 3.2 and, for further discussion, the inset “Effective Tax Rates on Costs for Canadian Businesses.”)

Of particular note in Table 3.2 are the following general patterns:

- Estimated effective tax rates paid by employers on labour costs are quite low: 2.8 percent on average for large firms. This reflects both relatively low statutory rates of employer payroll taxes, and the fact that the estimated tax rates are net of associated costs of the workers’ compensation, Canada and Quebec Pension Plan (CPP and QPP), and Employment Insurance (EI) programs.
- Taxes paid by businesses are heavier on capital than on labour for all industries, thus tending to discourage the use of capital relative to labour. For large firms, the effective tax rate on capital is 33.3 percent, while on labour it is 2.8 percent.⁸
- The variation in effective tax rates of employer taxes on labour results primarily from the EI program under which the rate structure of employer contributions is common to all industries, but the associated costs vary substantially depending on industry layoff patterns. See discussion in Chapter 8 and Table 8.1. Because employment insurance benefits paid to laid-off workers are greater than the premiums paid by employers and employees in the agriculture, fishing, trapping, forestry and construction sectors, businesses in these areas pay significantly lower employer taxes net of associated costs of related government programs than businesses in other sectors. In contrast, firms in the transportation, communications, public utilities and wholesale trade sectors pay the highest employer payroll taxes net of associated costs of related government programs.

Table 3.2
Effective Tax Rates on Input Costs, 1997^a

	Large Businesses			Small CCPCs		
	Capital Costs	Labour Costs	Total ^b	Capital Costs	Labour Costs	Total
	(percentage)					
Agriculture, Fishing and Trapping	–	–	–	8.9	-5.4	1.6
Forestry	45.4	-5.2	0.9	14.5	-5.4	-2.9
Mining	13.3	2.7	5.7	–	–	–
Oil and Gas	8.0	1.4	4.5	–	–	–
Manufacturing	27.0	3.2	8.8	9.8	3.0	4.6
Construction	59.9	-0.6	5.5	21.5	-0.9	1.7
Transportation	39.5	3.2	8.3	19.0	2.9	5.3
Communications	35.2	4.4	15.4	27.3	4.0	10.8
Public Utilities	44.4	4.5	26.9	17.4	4.2	12.0
Wholesale Trade	51.7	3.6	10.4	19.4	3.3	5.7
Retail Trade	53.0	3.0	7.5	20.3	2.6	4.3
Other Services	39.5	2.7	9.7	12.2	2.3	4.3
Total – Non-financial Industries	33.3	2.8	9.4	14.6	2.4	5.1

^a The methodology is described in McKenzie, Mansour and Brûlé (1997). Taxes on capital include federal and provincial corporate income taxes, capital taxes and sales taxes on capital goods. Taxes on labour include federal and provincial employer-paid payroll taxes net of estimated benefits of funded programs. The CPP/QPP and EI contribution rates used are the rates expected to apply shortly after the year 2000 when currently envisaged adjustments to rates are completed.

^b The tax on costs is an average of capital and labour taxes based on the shares of business value-added attributed to each component.

Notes:

- Small businesses are Canadian-controlled private corporations subject to the low rate of corporate income tax. Large businesses are corporations subject to the high general rate, or the manufacturing and processing rate. (The rates for each industry are based on the proportion of manufacturing and processing versus other income in the industry.)
- In this Table, effective tax rates are expressed relative to costs excluding taxes.

Source: Calculations by Committee secretariat with technical assistance from the Department of Finance.

- Considering the combined effective tax rates on capital and labour costs used by business, the most highly taxed businesses overall are the large firms in communications, public utilities, wholesale trade and other services (above average rates). These industries, which are among the knowledge-based sectors of the economy reliant on technological innovations and skilled labour,⁹ face the highest corporate income tax rates and benefit the least from the EI system. Among the least taxed industries are mining and oil and gas, primarily because of accelerated deductions for intangible exploration and development expenditures, and the forestry and construction sectors as a result of the excess of benefits over taxes paid for EI. Also estimated to have a low tax rate on total costs is the agriculture, fishing and trapping sector, as a result both of relatively low taxes on capital costs and an excess of benefits over taxes paid under EI. Overall, the tax system encourages production from the resource, manufacturing and construction sectors relative to most service sectors of the economy.¹⁰
- Small firms, which face a lower corporate income tax and generally have relatively larger expenses for labour, tend to be less highly taxed than large firms.

As discussed above, business taxes affect economic efficiency by distorting decisions made by businesses in terms of putting resources to their best economic uses. A more neutral business tax structure would encourage a more efficient use of resources in the economy and would improve prospects for economic growth and job creation.

A number of studies have been undertaken to measure the impact of Canadian corporate taxes on economic efficiency.¹¹

Studies that have compared the impact of corporate capital and payroll taxes have generally ignored interindustry and interasset distortions by treating the business sector as producing a single product over time using capital and labour as inputs in production. These studies have, therefore, incorporated the impact of taxes on the allocation of resources over time and factor use. Several recent studies have suggested that a payroll tax is less distortive than the corporate income tax, since taxes have less distortive impact on labour compared to investment.¹²

Studies indicate that the corporate income tax reform of 1986 and 1987, which resulted in a broader base and lower rates, improved economic efficiency.¹³ However, an analysis of the post-1987 corporate income tax system suggests that it still creates an efficiency loss equal to 15 percent of annual corporate income taxes, due to interindustry and interasset distortions, compared to a non-distortionary tax.¹⁴

These impacts on efficiency of the corporate tax system suggest that there are important economic gains to be made by lowering rates and broadening the tax base. A more neutral corporate tax system would also improve opportunities for economic growth and facilitate job creation.

Effective Tax Rate on Input Costs for Canadian Businesses

To provide an overall measure that combines taxes on capital and labour, the Committee used a measure that aggregates these taxes by weighting them on the basis of capital and labour inputs as a percentage of costs, excluding taxes paid. This "effective tax rate on costs" is the amount that tax adds to the incremental cost of production. For example, suppose a bicycle costs \$200 to produce using \$100 of labour and \$100 of capital costs without any taxes. If the payroll tax on labour is \$10, and the corporate income and capital tax together total \$40,^a the cost of producing the bicycle rises from \$200 to \$250, and the effective tax rate on costs is 25 percent.^b The higher the effective tax rate on costs, the greater the disincentive effect that taxes have on the business's ability to produce goods and services, all else being equal.

Table 3.2 provides estimates of effective tax rates on costs for large and small businesses, incorporating federal and provincial corporate income taxes, capital taxes, payroll taxes and sales taxes on capital inputs. Payroll taxes are adjusted to reflect anticipated increases in CPP/QPP premiums and are calculated on a basis net of related benefits for those payroll taxes that fund specific programs. Property and fuel taxes are excluded, as well as sales taxes on the final sale of products and services. Resource royalties are treated for this purpose as payment for the use of resource property owned by governments, not as a tax.

^a In this example, corporate income taxes are treated as a cost rather than as a reduction in income. To calculate the effective tax rate on capital costs, taxes are expressed here as percentage of net-of-taxes rates of return on capital, rather than as a percentage of gross rates of return on capital as in Table 3.1.

^b Taxes on inputs may be shifted back as lower prices paid to inputs rather than result in higher costs for businesses. This is particularly important with respect to the taxation of labour since, as argued earlier, payroll taxes can be shifted back as lower wages paid to workers rather than as higher costs faced by businesses. In the calculations below, it is assumed that all taxes paid by businesses increase costs of production. See the paper by McKenzie, Mansour and Brûlé (1997), Technical Committee Working Paper 97-15, that shows sensitivity of results to different assumptions.

Productivity in the Knowledge-based Economy: Taxation and the Provision of Training by Firms

The tax system affects productivity through investment in technology and the training of workers. Business investment in R&D, and in other scientific and technological activities related to innovation, is examined in Chapter 5. In this section, the influence of the tax system on investment in “human capital” by businesses is discussed.

The public sector provides substantial support for education by covering the cost of university, college and school programs. However, while education spending in Canada is high by international standards, some studies have indicated that the private sector in Canada does less training than other countries do.¹⁵ The evidence, however, is not unequivocal. Another recent study¹⁶ found that the percentage of Canadian workers who were reported to be in employer-sponsored training programs is the same as that reported in other OECD countries.¹⁷

A central issue for the Committee was to determine whether employer payroll and corporate income taxes, in general, discourage businesses from training workers. In addressing this question, it is helpful to distinguish between two types of training:

- general training, which provides skills that can be applied in other businesses or industries; and
- firm-specific training, which provides skills that are only used in the business in which training takes place.

A business will regard spending on these types of training differently. Spending on general training will tend to be relatively unattractive to businesses, because employees receiving such training can always leave to work for another business or can command a higher wage that reflects the market value of their increased productivity. Thus, there will be *under-provision* of general training by the private sector.¹⁸ Under such a scenario, tax incentives for such training may appear justified.

However, there are other and, in the view of the Committee, better ways to encourage general training than through the tax system. A training loan scheme (similar to a student loan program) would be a more direct method of dealing with problems related to the financing of training. Moreover, since the provinces are largely responsible for education and labour regulations (for example, minimum wages), it would be preferable if the provinces were primarily responsible for such a scheme.

With respect to employer payroll taxes, some have argued that they create a disincentive for general training, since if a business trains a worker, its payroll tax liability goes up due to the higher wage rate that has to be paid to a trained worker, but its training costs are not deductible from the payroll tax liability. This argument is, however, not conclusive, since if the costs of training are fully shifted to workers through lower earnings during their training, then the costs of training are implicitly deductible from the employer payroll tax.

There are two further reasons, however, why such taxes might affect training. First, if the employer payroll tax is shifted to workers through lower wage rates, then the net wage rate differential between skilled and unskilled workers will decline, and this may cause a reduction in the number of workers who are willing to undertake training. Second, training specific to an individual employee is similar to an investment in physical capital, but with one difference – the capital is embodied in the employee. A trained worker who leaves an employer takes part of the firm’s capital stock with him or her. This gives employers an incentive to reduce employee turnover, by paying a wage above the market wage in order to retain their trained workers and avoid additional training costs. Thus, part of the gains from employer-specific training will accrue to workers in the form of higher wages and part will accrue to employers in the form of higher profits. To the extent that the employer payroll tax is not shifted to workers, the payroll tax will increase the relative cost of skilled workers and will reduce the number of workers who receive employer-specific training.

As for the corporate income tax, training costs are expensed immediately, even though training may increase the business's profits for a number of years. Thus, the corporate income tax directly encourages employer-specific training compared to investments in physical capital.

On balance, there is no clear evidence that taxes either encourage or discourage businesses from training their workers. However, there has been very little research on the effects of business taxes on the provision of training.¹⁹ In the Committee's opinion, future research in this area could usefully address the issue of whether employer payroll taxes – other than those that finance specific program benefits – should provide an allowance for education or training costs, so that they do not discourage investments in training by businesses. We recognize, however, that a problem facing both research and policy design is the difficulty of defining training and measuring associated costs.

Influence of Tax Rates on Overall Cost Competitiveness

Canada's economic growth depends partly on the cost competitiveness of Canadian businesses in international markets. As well, given the openness of the Canadian economy (see insets "International Trade and the Openness of Canadian Industries," and "Foreign Direct Investment and Canadian Direct Investment Abroad"), a "taxation environment" that does not inhibit continued strong export performance is important for maintaining jobs within Canada's borders. A business that finds that its costs, of which taxes are one, are higher than in other locations in the world, might shift production elsewhere or lose market share.

It is important to note, however, that these location-specific costs depend on a multitude of factors: the cost of labour, the cost of capital, the availability and efficiency of skilled and unskilled labour, natural resources and infrastructure, and, finally, taxes. This means that, while Canada must continually be mindful of taxation levels in other countries, waging an international competition for the lowest tax rates, especially on an industry-by-industry basis but also in overall terms, would not be sound public policy. Maximum economic performance is achieved by a tax system that treats businesses neutrally. Canada achieves the greatest economic gains when it exports products in which it has a comparative advantage. This means accepting the consequences that some industries have higher production costs than their foreign competitors, rather than attempting to offset these costs through tax concessions or direct government subsidies.

International Trade and the Openness of Canadian Industries

Historically, Canada has been a trading nation, especially relying on the export of resource and manufactured products to the rest of the world. Today, Canada continues this tradition of relying on exports as a means of encouraging growth and employment. However, in today's world, the openness of the Canadian economy plays an important role not only for the resource and manufacturing industries but also for other sectors in the economy such as business services.

Table 3.3 shows two measures of the openness of industries based on export trade. The first measure shows direct export sales of goods and services (based on 1992 export data) as a percentage of total sales of the industry. The second shows value-added contained in products exported directly, or indirectly through other industries, as a share of total value added of the industry (based on 1990 data, the latest year available). As seen from the second column, the most open sectors in terms of direct and indirect exported value-added as a share of total value-added are forestry (64 percent), fishing (77 percent), mining and mineral fuels (63 percent), followed by manufacturing (41 percent) and transportation (37 percent). Some of the other industries, historically viewed as producers of "non-tradable" goods and services, are also important contributors to export activities: utilities (20 percent), wholesale trade (23 percent) and other services (13 percent).

Table 3.3
Openness of Canadian Industries

	Direct Exports as a Percentage of Industry Sales (1992)	Value-added in Direct and Indirect Exports as a Percentage of Industry Value-added (1990)
Agriculture	23.6	32.9
Forestry	2.1	63.9
Fishing and Trapping	27.0	77.0
Mining and Mineral Fuels	45.1	62.8
Manufacturing	39.4	40.9
Construction	—	2.8
Transportation	10.0	36.6
Communications	2.3	13.3
Utilities	2.6	20.0
Wholesale Trade	12.4	23.3
Retail Trade	—	4.6
Finance	1.4	9.8
Other Services	6.4	13.4
For All Industries	16.6	22.3

Source: Committee secretariat calculation based on Statistics Canada input-output data.

Foreign Direct Investment and Canadian Direct Investment Abroad

Canada has always relied on foreign direct investment, especially from the United States, as a source of capital and managerial talent for Canadian industry. Moreover, in the past several decades, Canadian businesses have increased their involvement in the global economy by investing in other countries. The stock of Canadian direct investment abroad relative to GDP has doubled since 1980, rising from a level equal to 9 percent of GDP in 1980 to 18 percent in 1995. Over the same period, the ratio of the stock of Canadian direct investment abroad to the stock of foreign direct investment in Canada has risen from 42 percent to 85 percent.

The stock of foreign direct investment in Canada as a percentage of assets held by all businesses operating in Canada (see Table 3.4) provides a measure of the degree to which Canadian businesses rely on foreign capital. For all industries, about 20 percent of capital is held by foreigners. The industries most heavily reliant on foreign capital are chemicals, chemical products and textiles (68 percent), electrical and electronic products (61 percent), followed by machinery and equipment (42 percent), transportation equipment (40 percent) and food, beverage and tobacco (34 percent). Service industries, finance, utilities and communications tend to be Canadian-owned.

Canadian direct investment abroad as a percentage of assets held by all businesses in Canada is now 17.5 percent. Certain industries, such as electrical and electronic products (54 percent), chemicals, chemical products and textiles (44 percent), metallic minerals and metal (44 percent), followed by transportation services and communications (28 percent), finance and insurance (22 percent), food, beverage and tobacco (25 percent), have major investments abroad.

Given the size of foreign direct investment in Canada and Canadian direct investment abroad relative to assets held by Canadian businesses, it is evident that cross-border capital flows are significant to many Canadian industries. Similar to the case of trade of goods and services, the relative importance of cross-border flows of capital indicates the important role of Canada's tax system in encouraging the location of business activities in Canada.

Table 3.4

Foreign Direct Investment in Canada and Canadian Direct Investment Abroad

	1994 Foreign Direct Investment in Canada as a Percentage of Industry Assets in Canada	1994 Canadian Direct Investment Abroad as a Percentage of Industry Assets in Canada
Food, Beverage and Tobacco	34	25
Wood and Paper	21	10
Energy	17	10
Chemicals, Chemical Products and Textiles	68	44
Metallic Minerals and Metal	21	44
Machinery and Equipment	42	7
Transport Equipment	40	8
Electrical and Electronic Products	61	54
Construction	5	4
Transportation Services, Communications	8	28
Finance and Insurance	19	22
Consumer Goods and Services	19	8
Other Services	11	8
For All Industries	20.4	17.5

Source: Statistics Canada, *Canada's International Investment Position*, 67-202-XPB, plus calculations by the Committee secretariat.

Effective Tax Rates for Large Businesses: Canada Versus the United States

Canada's most important competitor is the United States. It is thus useful to compare the effective tax rates on costs for large Canadian and U.S. businesses, since these businesses are most sensitive to differences in costs of production across countries.^a As shown in Table 3.5, the effective tax rate on costs is higher in Canada than the United States for most industries especially in the fastest growing industries such as communications, transportation, public utilities, trade and services. Canadian effective tax rates on capital and labour tend to be higher than those in the United States. (However, the total of employee and employer payroll taxes is higher in the United States than in Canada.) The tax advantages for R&D and E&D are greater in Canada compared to the United States.

The Committee also notes that the U.S. tax system provides a favourable tax regime for mining and oil and gas relative to other industries, although the differences in effective tax rates on costs between resource companies and other industries, particularly utilities and communications, are larger in Canada than in the United States.

^a Taxes included in the comparison are federal and provincial/state corporate income taxes, capital taxes, payroll taxes and sales taxes on capital inputs.

Table 3.5
Canada-U.S. Effective Tax Rates on Costs for Large Business

	Canada			United States		
	Labour	Capital	Total	Labour	Capital	Total
	(percentage)					
Forestry	-5.2	45.4	0.9	0.1	25.4	3.5
Mining	2.7	13.3	5.7	-0.3	1.9	0.4
Oil and Gas	1.4	8.0	4.5	-0.3	3.9	1.9
Manufacturing	3.2	27.0	8.8	-0.5	22.5	5.2
Construction	-0.6	59.9	5.5	-0.6	30.1	2.8
Transportation	3.2	39.5	8.3	0.4	14.3	2.5
Communications	4.4	35.2	15.4	0.4	8.3	3.4
Public Utilities	4.5	44.4	26.9	0.4	17.8	10.5
Wholesale Trade	3.6	51.7	10.4	0.3	28.6	4.5
Retail Trade	3.0	53.0	7.5	0.5	27.6	3.1
Other Services	2.7	39.5	9.7	0.4	26.1	5.5
Total – Non-financial Industries	2.8	33.3	9.4	0.2	22.7	5.2

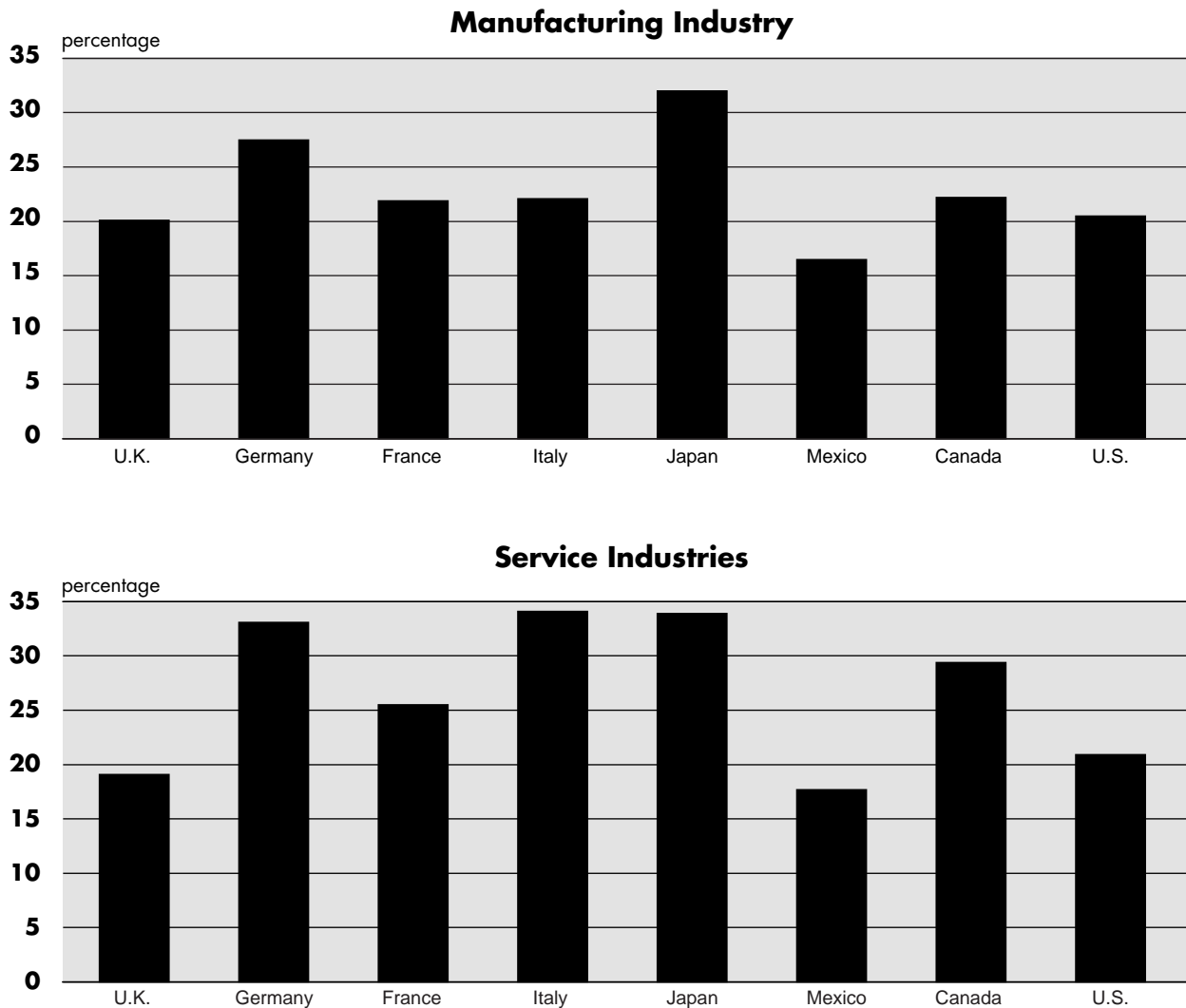
Note: In this Table, effective tax rates are expressed relative to costs excluding taxes.

Source: Calculations by Committee secretariat with technical assistance from the Department of Finance and K. McKenzie. See McKenzie, Mansour and Brûlé (1997).

As shown further in Chart 3A, in 1995 Canada's effective corporate tax rates on marginal investment were below those of Germany and Japan for both manufacturing and service industries, and also below that of Italy for services. However, Canada's effective tax rate on capital was above that in the United States, the United Kingdom and Mexico, especially in services. A more detailed comparison by industry with the United States, which includes taxes on labour, is provided in the inset "Effective Tax Rates for Larger Businesses: Canada Versus the United States."

Chart 3A

**Effective Tax Rates on Marginal Investments
G-7 Countries plus Mexico (1995)**

**Notes:**

- Effective tax rates reflect income and capital taxes on investment in tangible capital for large firms.
- In this Chart, effective tax rates are calculated relative to gross-of-tax rates of return on capital.

Sources: Calculations by the Committee Secretariat with the technical assistance of the Department of Finance and K. McKenzie. See McKenzie, Mansour and Brûlé (1997).

Taxation, Employment and Unemployment: a Complex Interaction

While we view the potential impact of most business taxes on employment as less direct than their impact on productivity and growth, we are very conscious that the first objective set for the Committee in its review of the tax system was to promote job creation. There is little doubt that the emphasis on this objective stems directly from the experience of the last two decades: unemployment rates in Canada in the 1980s averaged 9 percent and thus far in the 1990s have averaged 10 percent, compared with 4 percent in the 1950s, 5 percent in the 1960s, and 7 percent in the 1970s. Why, on average over the past two decades, have employment opportunities not expanded rapidly enough to provide jobs for all Canadians who want to work?

A number of factors have been suggested, including the shifting of production to countries with lower costs, and the replacement of low-skill jobs with high-skill jobs due to technological change.²⁰ It has also been suggested that policies pursued by government, including tax policies, have resulted in less employment. Yet on their own, these factors cannot be the root of the problem; a well-functioning economy makes its own adjustments to these and other pressures.

An underlying factor keeping unemployment high is insufficient flexibility in Canada's labour markets. This may take several forms: first, high and inflexible costs of labour that can cause businesses to substitute machinery for labour, or leave the Canadian labour market altogether; and second, lack of job mobility and mismatches in numbers of available workers in a particular region with the skill sets demanded by the available employment. The well-known situation of Canadian high-tech firms being forced to go beyond Canada's borders to find sufficient numbers of employees with suitable engineering and computer skills – while Canadians lacking such skills go without jobs – is a classic illustration of labour market mismatching.

Revising the business tax system cannot by itself mend the flaws in labour markets that are rooted deeply in social and economic history. The Committee is nonetheless concerned that Canada's business tax system should maximize opportunities for firms to create good jobs and for workers to gain the skills necessary to fill them. Below, we consider in detail the most important influences that the business tax system has on employment.

How Taxes on Employers Affect the Cost of Labour

The burden of personal income taxes and payroll taxes levied on employees is generally considered to be borne by the employee; most economists agree that these taxes are reflected in lower after-tax earnings for workers, not in higher costs of labour. Individual workers, by and large, do not have the power to set their own wage rates.²¹ More importantly, since hours of work provided by employees are relatively unresponsive to changes in net after-tax wage rates, personal tax increases generally do not create labour shortages that would lead to higher wage rates.

Many are concerned that employer-paid payroll taxes have raised the cost of labour and contributed to the adverse labour market conditions that we have experienced over the last decade. If the tax system drives up labour costs, it weakens the competitive position of Canadian industry, and reduces employment opportunities. In addition, higher labour costs may cause businesses to substitute machinery and equipment for labour in production processes.

If the costs of employer taxes are completely shifted to workers through lower earnings, then employer taxes will have no impact on the cost of, and thus the demand for, labour. The Committee agrees with the view that, in the longer run, such tax shifting occurs to a substantial degree. Most, but by no means all, of the theoretical and econometric studies support the notion that a significant amount of the employer payroll tax is shifted back on to workers in the form of lower earnings after several years of adjustment.²²

Profile of Employment in the Canadian Business Sector

The demand for labour by businesses is an important determinant of jobs in Canada. Many factors influence employment decisions by businesses, including the domestic and international demand for their products, productivity, the cost of labour, the cost of capital, labour market regulations and taxes.

Table 3.6 shows selected employment characteristics of the main industrial sectors in Canada. From this Table, we note the following:

- During the period 1985-95, tertiary industries (from construction through finance, insurance and real estate in the Table)^a had positive annual rates of employment growth, while resource and manufacturing industries experienced declines in employment. Direct employment, however, is only one part of the demand that businesses create for labour. Businesses can also indirectly employ labour by contracting out non-core activities to others, thereby maintaining the same level of overall employment demand. Thus, trends in employment by industry may partly reflect outsourcing by businesses. For example, a manufacturer might reduce office employees in favour of contracting out services from commercial businesses in the service sector. The benefits that can accrue to a business contracting out are improved flexibility and reduced costs through better efficiency. However, businesses will prefer employment rather than contracting out if a long-term relationship with the employee is preferable for maintaining employer-specific human capital (experience and skills) acquired by the employee and for reducing staff turnover costs.
- At times, many individuals find that they have to accept part-time employment even though they would prefer full-time employment. As shown in Table 3.6 (column 2), the ratio of involuntary part-time employment to total employment was highest in the retail trade and other services (excluding government) sectors.
- Some sectors tend to rely more on workers who are paid relatively low wage rates (less than \$7.70 per hour) – close to provincial minimum wages. As shown in column 3, agriculture, fishing and forestry, retail trade, and other services, tend to hire a greater percentage of their work force at low-wage rate levels.
- Some industries also tend to rely on workers with a shorter duration of employment with the business. As shown in column 4, employees in construction, wholesale trade and retail trade tend to have relative short periods of tenure with the employer.
- Characteristically, industries that have involuntary part-time employment, employees paid at low wages and, to some extent, shorter tenure are also industries that tend to have a greater portion of employment in small employers. As shown in column 5, agriculture, fishing, and forestry, construction, wholesale trade, retail trade and other service industries tend to have a relatively large percentage of employment by employers that have less than 20 employees.

^a Other services include household and business services and exclude government administration.

Table 3.6
Profile of Canadian Business Sector Employment

Industry	1985-95 Annual Growth in Employment	1995	1989 % of	1995 Average Job Tenure (Months)	1993	
		Involuntary Part-time Employment as % of Total	Employment with Wages Less than \$7.70		Percentage of Employment by Business Size	<20
Agriculture						
Fishing and Forestry	-0.34	2.7	52.1	156	70.7	3.8
Mining	-1.08	n/a	5.2	115	13.0	53.7
Mineral/Fuels	-0.77	n/a	6.7	93	4.8	70.9
Manufacturing	-0.20	1.2	14.2	107	10.9	45.4
Construction	1.17	4.3	11.8	82	56.3	5.0
Transportation and Storage	0.80	3.4	12.1	111	20.5	45.7
Communications	1.43	4.8	7.9	123	4.1	86.3
Utilities	1.50	1.3	4.5	141	3.2	84.9
Wholesale Trade	0.34	2.1	17.5	84	30.6	20.3
Retail Trade	0.76	10.0	43.8	70	32.8	36.8
Other Services (excluding gov't)	3.75	8.0	28.7	161	21.7	41.2
Finance, Insurance and Real Estate	1.78	3.9	14.4	98	18.4	59.1
Total – All Industries	1.23	5.8	22.7	92	24.3	41.4

Source: Special tabulations by Statistics Canada for the Committee.

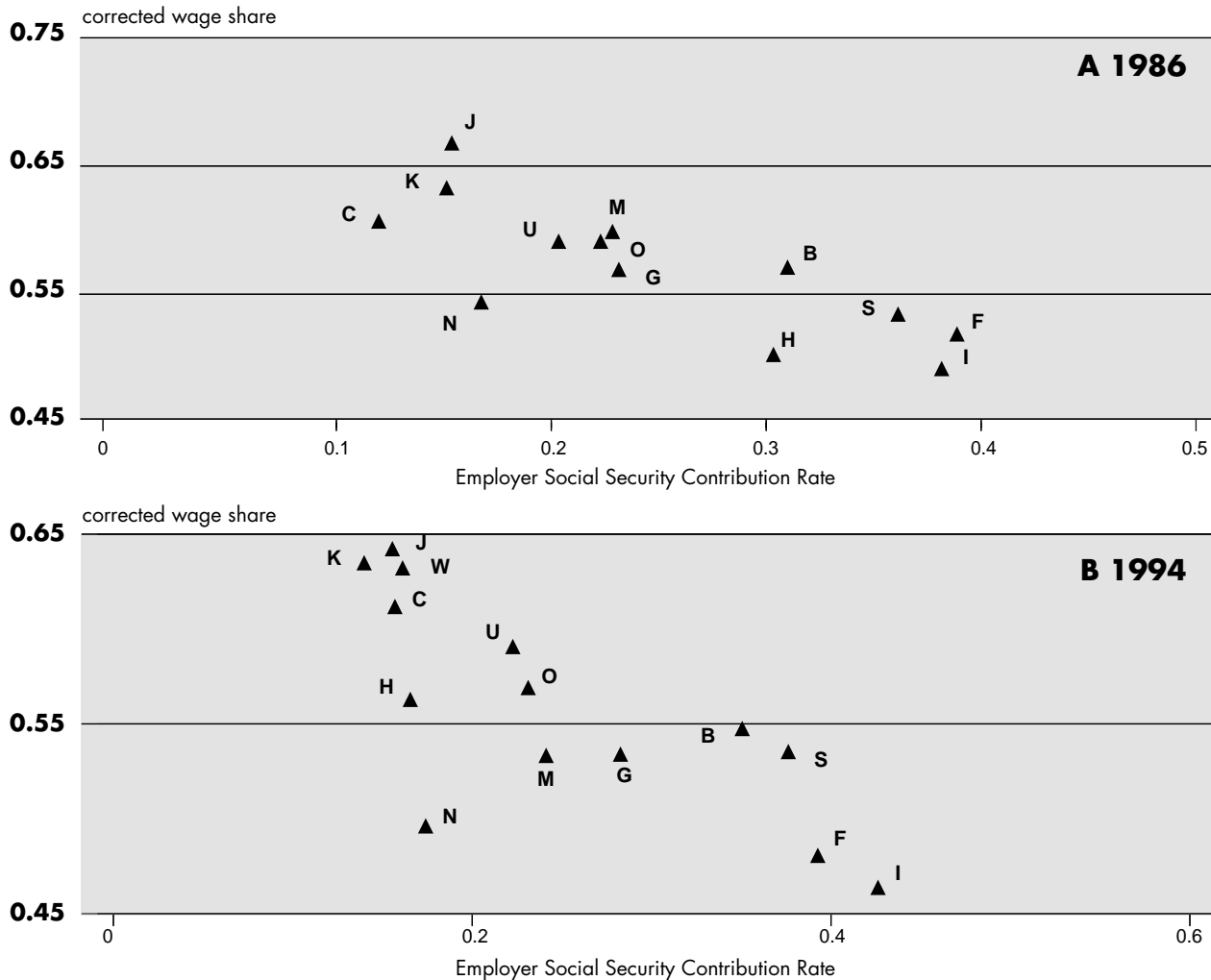
Some caveats about the shifting of employers payroll taxes need to be stressed:

- *Lags*: It may take several years before labour markets fully adjust to changes in the employer payroll tax rate, in part because wages are set by multi-year labour contracts. Therefore, in the short run, an increase in an employer payroll tax can raise the cost of employing workers and can lead to layoffs or reduced employment growth.
- *Not all workers are affected equally*: Most of the evidence for the shifting of the employer payroll tax is based on highly aggregate data and is not specific to sectors of the economy or types of employment. It is highly unlikely that the employer payroll tax is shifted back in lower wages for all workers. For example, workers who are represented by a strong union may be able to negotiate wage contracts that prevent employers from shifting the employer payroll taxes to them.²³
- *Significant impact on employment of low-wage workers*: The adverse effects of higher employer payroll taxes might be particularly important where minimum wages or social assistance benefits create a legal or de facto floor for wages. The employer payroll tax may not be shifted to minimum wage workers, because their employers are unable to offset increases in such taxes by paying lower wage rates. Thus, increases in employer payroll taxes would be expected to raise the cost of hiring minimum wage workers, and as a result, to reduce their employment, even in the longer run. This is particularly important in industries with significant numbers of employees with low wages: agriculture, fishing and forestry; wholesale and retail trades; and other services.²⁴
- *Taxes that finance specific benefits should be viewed differently*: Some payroll taxes such as EI, CPP/QPP and workers compensation premiums, pay for an insurance program provided by government. In the absence of these public programs, the employers may provide similar programs or pay higher wage rates, and therefore, the net effect on employment is reduced.²⁵

Tax Cost Shifting, Employers to Employees

Some of the evidence for the shifting of employer payroll taxes to workers is illustrated in Chart 3B. Panels A and B show employees' shares of GDP plotted against employers' social security contribution rates in 14 OECD countries in 1986 and 1994. These figures indicate that the share of wages in total output is lower in countries with higher employer social security contribution rates. This negative relationship is consistent with the notion that employer payroll taxes are largely shifted to workers over time through some combination of higher prices for the goods and services purchased by workers or declines in their nominal wage rates.

Chart 3B
The Wage Share and the Employer Social Security Contribution Rate in OECD Countries^a



O=Austria J=Japan B=Belgium H=Netherlands C=Canada N=Norway M=Finland S=Sweden
 F=France K=United Kingdom G=Germany U=United States I=Italy W=Switzerland (1994 only)

^a The wage share is the ratio of wages and salaries to GDP divided by the ratio of dependent (employee) employment to total employment. The employer social security contribution rate is the ratio of total employer compulsory social security contributions and voluntary pension contributions to total wages and salaries.

To summarize, the Committee concludes that, in general, payroll taxes on employers are largely shifted to employees in the longer run, such that the impact over the long term on the cost of hiring is mitigated. However, an increase in employer taxes can have short-run effects because of economic lags. As well, these taxes may exacerbate the impact of already existing rigidities in the labour market, and they may have a disproportionate impact on low-wage employment.

Other Links from Taxes to Unemployment

The direct evidence of a link between overall levels of taxation and unemployment rates is equivocal. A number of recent studies in Canada have employed a variety of methodologies, and there is considerable variation in their conclusions about the magnitude of these effects. There is some consensus that the increases in payroll taxes in the 1990-93 period, mainly in the form of unemployment insurance premiums, had a significant negative impact on employment.²⁶ However, international comparisons indicate that there is little direct linkage between taxation levels and unemployment rates.²⁷

One Canadian study of interest to the Committee linked unemployment not to taxes, but rather to three other factors: higher real interest rates, the increase in the female labour force participation rate and the overall rise in the generosity of the unemployment insurance system.²⁸ Of these, the last has a link to the business tax system, and was thus considered further by the Committee.

Employer contributions to Employment Insurance:

Would linking contribution rates to lay-offs help reduce unemployment?

Canadian studies of the labour market impacts of EI, including the study noted above, have tended to concentrate on the impact of the benefit structure on the behaviour of those seeking work. But the taxes used to finance EI also affect labour market rigidities and distortions.

As will be discussed more fully in Chapter 8, the current EI system – which levies an employer contribution at a common rate for all employers and an employee contribution at a common rate for all employees – results in large, persistent net payments (benefits in excess of employer and employee contributions) to employees associated with some businesses, and the reverse situation for others.

An EI system with this financing structure will influence both the cost situation of employers and their behaviour, which will result in higher employment by businesses with unstable employment patterns, since these businesses can hire workers for wages that are lower than they would be in a neutral system.

Further, since employers do not face anything approaching the full cost to the EI system of instability in their employment patterns, they have insufficient incentive to reduce such instability through rescheduling production in order to smooth out seasonal peaks or make greater use of short-time work patterns during periods of low demand.

The link between employer contributions and lay-off practices is considered in Chapter 8. Establishing a linkage would create incentives for more stable employment patterns, and would make the EI system somewhat more neutral across unstable and stable businesses.

The Impact of Taxes on the Kinds of Employees that Businesses Hire

When engaging workers, employers confront a set of choices as to the nature of the engagement and the skill level of the individual hired. Specifically, businesses choose between (a) part-time or full-time workers; (b) skilled or unskilled workers; and (c) independent contractors or employees.

Part-time Versus Full-time Workers: In general, the deduction of wages from the corporate income tax results in corporate income taxes having little impact on the type of worker hired by a business. However, payroll taxes that include a ceiling on an individual employee's earnings that are subject to the employer tax can introduce undesirable distortions in the choices of part-time versus full-time labour by making part-time workers relatively costlier for business. This would especially be the case if such ceilings applied to general payroll taxes. When the payroll tax is linked to a benefit that is also subject to the ceiling, the distortion may be less significant.²⁹

The Committee has found few studies that have assessed the impact of payroll taxes with earning limits on the choice between full-time and part-time work, so the extent of the impact remains unknown.

Skilled Versus Unskilled Workers: Skilled workers are paid more than unskilled workers at least in part because skilled workers must incur the cost of training. The tax system's treatment of such costs was discussed earlier in this Chapter. However, the employment of skilled and unskilled workers will be affected by the tax system in other ways besides the tax treatment of training costs.

As many Canadian employers have witnessed, retention of skilled workers in Canada – and especially relocation of such workers to Canada – is discouraged by higher personal income, payroll and sales taxes, although these effects are partially offset by the benefits of the public programs financed by the higher taxes. While a number of Canadian studies suggest that migration flows are affected by differences in net fiscal burdens (taxes less benefits) across provincial boundaries,³⁰ few have been undertaken to see if impacts can be observed across the Canada-U.S. border.

Canada puts a generally higher tax burden on skilled labour than does the United States, because Canada relies more on personal income taxes and has a more progressive system. Some have suggested that commercial projects that depend on skilled labour have been located in the United States because of this disincentive.

The payroll tax system also affects businesses' choice of unskilled versus skilled labour. As discussed earlier, employer payroll taxes are less likely to be shifted back in the form of lower wages when wage rates are close to the minimum wage. Given that many unskilled workers are paid wages close to the minimum rate, employer payroll taxes may discourage employment of these workers.

Independent Contractors Versus Employees: Self-employed workers who operate on a contractual rather than on an employee basis with businesses comprise a growing proportion of the economy. (See inset "Forms of Employment: Evolution since the Second World War.") Although there are many reasons for the shift from employees to independent contractors that have nothing to do with the tax system, the Committee believes that taxes do play a role.

Payroll taxes that only apply to employee wages may cause firms to substitute independent contractors for employees. Counteracting this pressure, however, is the potential for workers who lose the benefits of public programs funded by payroll taxes to require higher remuneration, thus eliminating businesses' cost savings. At the federal level, the EI payroll contributions are currently greater than the related costs – the total contributed is greater than the amount paid out (although in certain sectors, notably agriculture, fishing, forestry and construction, the reverse is true). Considered in the aggregate, therefore, the current level of EI payroll taxes may, on average, encourage independent contracting, though the magnitude of the impact may not be significant, especially if, as expected, contributions return to approximate balance with benefits over the next few years.

Viewed from the perspective of the worker who is subject to the personal income tax system, independent contractors are, in general, able to deduct costs more readily than employees, which provides an incentive to independent contracting.³¹ On the other hand, many employees have a number of benefits provided by employers, including company pension, disability and health plans. Employer contributions on behalf of an employee are deductible against corporate income, and certain benefits, such as health and disability insurance, are exempt from personal income tax in the hands of the employee. Independent contractors cannot fully deduct the cost of health plan contributions (only medical expenses in excess of a minimum receive a tax credit) although the independent contractor can use the incentives for retirement savings through RRSPs.

The decision to engage as an independent contractor rather than as an employee may be influenced by the corporate income tax as well. An independent contractor may establish a CCPC, which has special tax advantages under the corporate and personal income tax system, including the small business deduction and higher tax credits for R&D investments.

Given the tax advantages provided to the self-employed and to CCPCs, firms may face lower costs when engaging the services of a private corporation operated by independent contractors rather than hiring employees.

Forms of Employment: Evolution Since the Second World War

The relative importance of self-employment in the total labour force has gone through two very distinct phases since the Second World War. For the first three decades after the War, self-employment declined sharply as a percentage of all those with jobs, from 24 percent in 1946 to about 9 percent in 1975. While the most dramatic change was the decline in the percentage of self-employed agricultural workers, from 15 percent to less than 3 percent of those with jobs in the total economy, the proportion of self-employed in the non-agriculture sector also fell (from 13 percent to 7 percent of those with jobs in the non-agriculture sector, or from 9 percent to 7 percent of total employment).

Starting in the mid-1970s, the trend reversed and self-employment began to increase relative to total employment. As well, starting in 1976, Statistics Canada revised the categories used for labour force statistics, and began to provide estimates of the number of owner-managers of incorporated companies. People in this category may be considered more comparable to the self-employed than to employees with whom they are often included in labour force statistics. (We refer to this group as the "incorporated self-employed" in what follows.)

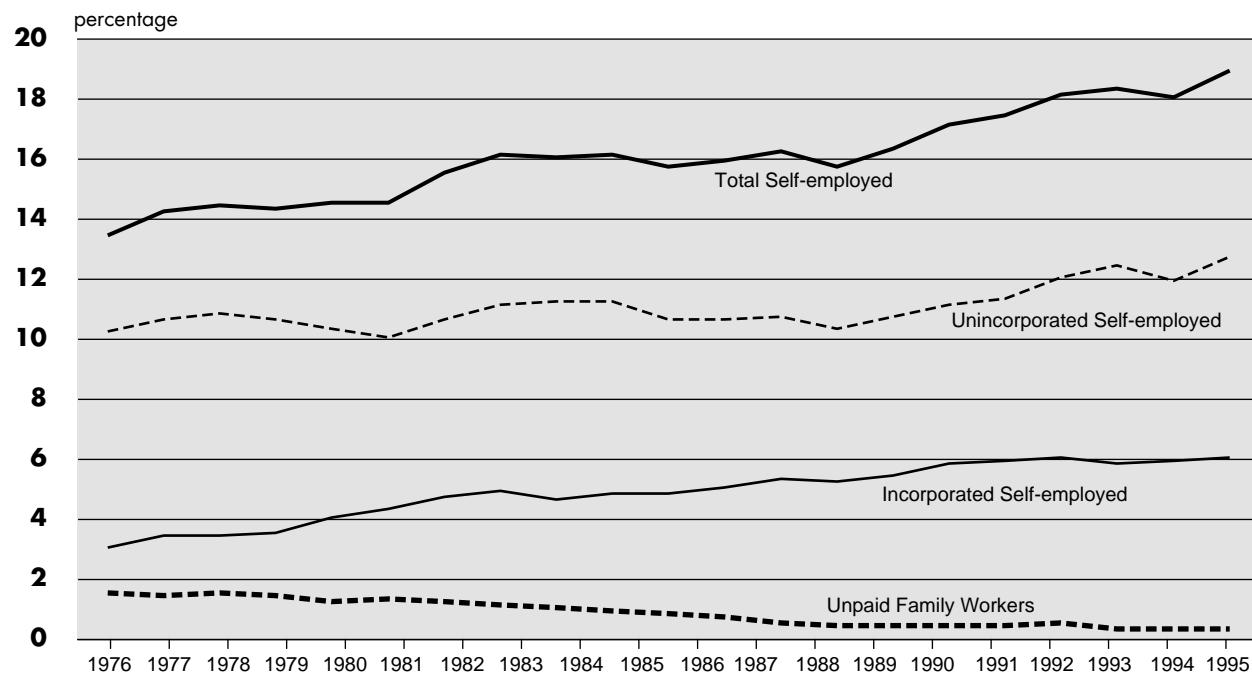
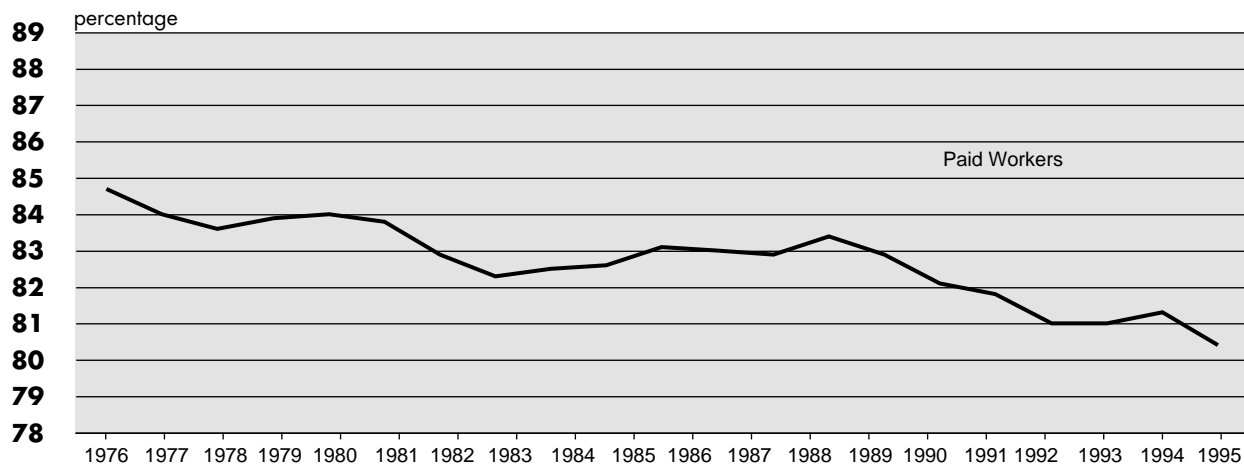
Chart 3C provides data on the composition of private sector employment from 1976 to 1996. The share of all self-employed (that is self-employed who work in unincorporated businesses plus owner-managers of incorporated businesses) has increased from less than 14 percent in 1976 (the first year for which data on this basis are available) to just over 19 percent in 1996. The growth in the incorporated self-employed has been substantially faster than the growth in other self-employed, though from a much smaller base. As the mirror image of the increasing share of the self-employed, the share of paid workers in private sector employment has declined from just under 85 percent in 1976 to just over 80 percent in 1996.

Neither the reasons for the increase in self-employment, nor the potential changes in the characteristics of the self-employed, are fully understood. Especially during the recession of the early 1990s, there was a suspicion that some of the increase in self-employment represented disguised underemployment, a possibility given credence by data suggesting that low-income self-employment had grown strongly, while the number of self-employed individuals with gross incomes over \$30,000 had remained flat.^a But growth in self-employment has continued to be strong during the subsequent economic recovery, when more job opportunities for employees have been available.

^a Salley and Heath (1996).

Chart 3C

Total Private Sector: Types of Worker as a Percentage of Total Private Sector Employment (1976-96)



Notes:

- Paid workers: Total paid workers, excluding incorporated self-employed.
- Total self-employed: Total self-employment, i.e. self-employed (in incorporated sector) plus incorporated self-employed.
- Unincorporated self-employed: Self-employed individuals plus employers in the unincorporated sector.
- Incorporated self-employed: Principal owner-managers of incorporated businesses.

Source: Canada, Statistics Canada. *Historical Labour Force Statistics* (Various)

The Question of Fairness in the Business Tax Structure

A frequently expressed view, in Canada and elsewhere, is that taxing businesses is fair since owners of businesses can afford to pay. As noted in Chapter 1, assessing the relationship of business taxes to fairness is not straightforward. Ultimately any tax imposed on a business must be paid by individuals in society either through higher prices for products, lower wages for workers, lower returns to lenders or lower profits for owners of the business. This raises the issue of “incidence” of a tax – namely, who bears the tax. Ascertaining the incidence of business taxes, to the extent this is possible, can help us to understand how taxes paid by businesses ultimately affect the real incomes of Canadians.

Corporate Income and Capital Taxes

Economic studies on the incidence of the corporate income and capital taxes are not very conclusive. Studies suggest that the corporate income tax is partly shifted forward through higher prices to consumers of businesses’ products and partly shifted back either to workers as lower wages or to capital in general, including owners of equity in corporations, as lower returns to owners and investors.³² If corporate income and capital taxes are shifted primarily to consumers, the taxes would tend to fall more heavily on lower-income individuals, since consumption is a larger portion of their income. However, if the corporate income and capital taxes fall primarily on owners of capital, the taxes would, on average, be progressive, as they would tend to fall more heavily on higher income individuals who receive a greater proportion of their income from capital.

A number of economists have argued recently that the global integration of financial markets implies that corporate income and capital taxes will fall more heavily on earnings of workers. In an open economy like Canada’s, after-tax rates of return on capital are often viewed as primarily determined by international markets independently of Canadian ownership of equity,³³ and product prices are heavily influenced by international markets. One might thus expect the corporate income and capital taxes on large corporations to be substantially shifted to immobile factors – labour and, to a lesser extent, land. Given this argument, the corporate income and capital taxes would likely fall proportionately more on lower-income individuals.³⁴

However, there are a number of factors that affect these lines of argument:³⁵

- Studies have shown that there is some segmentation in equity capital markets internationally³⁶ – prices of equity securities of Canadian businesses are somewhat sensitive to developments in both foreign and Canadian markets. The implication of these studies is that the rate of return on capital is affected to some degree by the supply of Canadian savings so that the corporate income tax can be shifted back in part to owners of capital.
- Corporate income tax paid by foreign-owned corporations operating in Canada may in part be credited against foreign taxes owing to foreign governments. As discussed in Chapter 2, certain countries, including the United States, the United Kingdom and Japan, allow corporations to credit tax paid in Canada by their subsidiaries against the home country taxes on income remitted from Canada. If Canada were to eliminate the corporate income tax altogether, the parent corporation would have fewer foreign tax credits and therefore might pay more tax to the government of its country of residence. Thus, the incidence of the corporate tax paid by foreign multinationals in Canada may be partly on foreign governments rather than on Canadians.
- Small businesses have less access to international markets compared to large businesses. Part of the corporate income tax paid by small businesses may therefore fall on the owners of capital.

- Individuals often use holding corporations as conduits for investment income. Thus, the corporate income tax on investment income may largely fall on the owner.
- Shares in corporations are owned by pension plans and stock savings plans held by workers and managers. Therefore, a portion of the corporate income tax paid by corporations lowers the after-tax return on pension savings of employees.

An examination of the income of the corporate sector, by type of corporation, can help in assessing the importance of these factors. Table 3.7 provides a decomposition of corporate taxable income for 1994 according to four sources: income of Canadian-controlled public corporations, foreign-controlled corporations and CCPCs (large and small). Income is further decomposed into active business and investment income for private corporations.

Table 3.7
Components of Corporate Taxable Income (1994)

	(\$ Billion)	(%)
Canadian-controlled (Large Public)	18.7	33.0
Foreign-controlled	12.2	22.0
Canadian-controlled (Large Private)	5.8	10.5
(Active)	(4.5)	(8.1)
(Investment)	(1.3)	(2.3)
Canadian-controlled (Small Private)	19.2	34.6
(Active)	(16.1)	(29.0)
(Investment)	(3.1)	(5.6)
Total	55.5	100

Notes:

- Investment income: includes capital gains.
- Components may not sum exactly to totals due to rounding.
- In this Table, small private corporations are CCPCs with assets less than \$15 million.

Source: Department of Finance.

In 1994, the largest share of corporate taxable income was earned by small CCPCs – 34.6 percent. Large Canadian-controlled public corporations accounted for 33 percent, foreign-controlled corporations 22 percent, and large CCPCs 10.5 percent of corporate taxable income. Investment income earned by large and small CCPCs was 2.3 percent and 5.6 percent of total corporate taxable income respectively.

The Committee noted the significant amount of corporate income earned by small private corporations and that the tax on such income may be significantly shifted back to the owners. The lack of information about the crediting of taxes in foreign countries and our limited understanding of the competitive relationship of small to large businesses, create further difficulties in attempting to ascertain the incidence of Canadian corporate income and capital taxes.

Because there is a great deal of uncertainty regarding the incidence of the corporate income tax, and because individuals at the same income levels can have different patterns of consumption, savings and capital ownership, the Committee concludes that business taxes should not be used as a means of pursuing one important aspect of fairness – vertical equity – that is, that individuals in different circumstances should bear appropriately different levels of tax. Rather, in the Committee's view, the prime tax instrument for achieving vertical equity should be the personal tax system.

Fairness and the Appearance of Fairness – Why Do Some Corporations Not Pay Corporate Income Taxes?

In any one year, a number of corporations may pay little or no corporate income tax, even though they may be earning profits for financial accounting purposes. In 1994, 28 percent of all profitable corporations, accounting for 21 percent of profits (excluding intercorporate dividends), did not pay federal corporate income tax.³⁷ Although these corporations may still be paying other taxes such as federal or provincial capital, property and payroll taxes, many Canadians are often puzzled that profitable corporations may pay little or no corporate income tax³⁸ in a particular year.

To understand why profitable corporations may pay little or no corporate income tax in any year, the following differences between financial accounting profit and taxable income should be noted:

- *Dividends from other corporations:* For financial accounting purposes, dividends received from other corporations are included in profits. However, for tax purposes, dividends from other corporations are exempt to avoid double taxation of income flowing between corporations. Thus, taxable income is reported at a lower amount than financial accounting income for this reason.
- *Prior years' losses:* Unlike income that is taxed in the year that it is earned, a corporation that incurs an operating loss for tax purposes in a year is not provided an immediate refund of the tax value of the loss. Instead, it may carry the loss back three years or forward seven years to reduce income subject to tax in those years. Although a corporation can obtain an immediate refund for losses when carried back to past profits, the corporation must wait to obtain a refund in respect of losses when carrying them forward to future years. Thus, a profitable corporation in a particular year may pay little or no corporate tax after the application of unused prior years' losses.
- *Differences in the deduction of costs for financial accounting and tax purposes:* For financial accounting purposes, cost deductions for assets, including depreciation of fixed assets and depletion of non-renewable assets, are based on estimated lives. For tax purposes, assets may be written off at rates faster or slower than those used for financial accounting purposes. Also, the base on which assets are recorded may differ for financial accounting and tax purposes. For example, when one corporation acquires another, the assets of the acquired corporation are often revalued from historical cost to fair market value for financial accounting purposes, but not generally for tax purposes.
- *Other components of financial accounting profits not included in taxable income:* For financial accounting purposes, corporate profits include net capital gains from the sale of assets. For tax purposes, corporate income includes only three quarters of net capital gains.

There are further important differences between the reported income of corporations and their taxable income arising from the use of particular accounting conventions such as consolidated and equity accounting. All of these make it difficult to fully reconcile reported financial accounting income with taxable income for the business sector as a whole.

Table 3.8 provides a comparison of income for tax purposes and financial accounting profits, reduced by dividends received from other corporations, for corporations in the period 1982-94. Taxable income as a percentage of adjusted financial accounting profits is sensitive to the use of prior years' losses. For example, in the recession years of 1990-92, total adjusted book profits of both profitable and all corporations were very low. Taxable income as a percentage of adjusted financial accounting income for profitable corporations was about 72 percent in these years and taxable income was almost four times adjusted financial accounting income for both profitable and non-profitable corporations. In years when corporate profits rose, as in 1993 and 1994, taxable income as a percentage of adjusted financial accounting income declined as corporations were able to use prior years' losses.

Table 3.8

**Calculation of Ratio of Taxable Income to
Adjusted Financial Accounting Income, 1982-94 – (\$ millions)**

	Adjusted Financial Accounting Income		Taxable Income of Profitable Corporations	Taxable Income as a Percentage of Adjusted Financial Income of Profitable Corporations
	All Companies	Profitable Only		(percentage)
1982	20,236	40,360	25,969	64.3
1983	29,649	48,493	31,795	65.6
1984	38,594	55,021	38,321	69.6
1985	36,492	59,355	40,901	68.9
1986	36,876	59,138	38,549	65.2
1987	51,121	73,081	43,946	60.1
1988	63,325	82,708	50,336	60.9
1989	61,482	85,456	57,638	67.4
1990	31,119	67,931	49,220	72.5
1991	7,292	58,364	45,302	77.6
1992	- 2,467	60,576	39,658	65.5
1993	27,619	72,536	45,793	63.1
1994	43,101	79,936	54,618	68.3

Note: Adjusted Financial Accounting Income is net income for financial accounting purposes adjusted to add back current and deferred income taxes, to exclude dividends received, and to add back charitable donations. Taxable income is as initially reported, i.e. it is net of loss carry-forwards but has not been retrospectively adjusted for loss carry-backs subsequently claimed.

Source: Revenue Canada, Statistical Files, 1982-94.

Profitable corporations may not pay taxes in a particular year primarily as a result of three factors: the partial or full exemption of certain sources of income for tax purposes (especially inter-corporate dividends); the application of prior years' losses; and the cost measurement differences between book profits and taxable income.

In Chapters 4 and 5, we consider a number of base-broadening measures that would have the effect of lessening the difference between income for tax and financial accounting purposes, and would reduce the number of profitable corporations that pay no tax. However, it will always be the case that, in a given year, a substantial number of profitable corporations will properly pay no income tax.

Incidence of Other Taxes

Businesses pay substantial other taxes, including employer payroll taxes, property taxes and resource taxes. The incidence of these taxes is briefly reviewed.

Employer payroll taxes, and their incidence, were discussed in detail earlier in this Chapter. We concluded that in the long run, a majority of employer payroll taxes, net of any related benefits of programs funded by payroll taxes, are borne by workers in terms of lower wages. In the short run, and on a longer-term basis in certain situations, employer payroll taxes may increase business costs, but this tends to result in less employment.

The incidence of property taxes, while probably not as complex as that of the corporate income tax, is also subject to considerable uncertainty. Some property taxes imposed by provinces or local governments are payments for public services. The incidence of the property tax, net of the benefits, would then be expected to fall on the owners of property or be passed forward as higher rents to the tenants. Property taxes on land are expected to reduce net of tax rental payments to the

landowners, and hence to reduce property values. Property taxes on structures may be borne by the owner through lower property values or as higher costs to owners, who may eventually pass these on to tenants.

The incidence of resource royalties is expected to primarily fall on the owners of the resource property that is relatively fixed in supply. Given that provincial governments are largely the owners of resource properties, the royalties serve in good part as a payment by businesses for the exploitation of the resource.

Costs to Business of Complying with the Tax System

The process of reporting and paying taxes inevitably creates costs for businesses and individuals in addition to the amount of taxes remitted. The costs to taxpayers include researching the tax laws, keeping records, completing and filing tax returns, and participating in audits, appeals and litigation.

The sums involved are not trivial. In a report prepared for the Committee, the compliance cost to the 500 largest non-financial Canadian businesses of complying with federal and provincial corporate income and capital tax laws was estimated to be \$250 million in 1995, an amount that represents roughly 5 percent of the taxes they paid.³⁹ However, the compliance burden was not evenly distributed among these corporations. Compliance costs tended to increase with the number of foreign affiliates and, after adjusting for business size and other characteristics, were found to be 85 percent higher within the mining, oil, and gas sectors. Asked to identify the most significant sources of high federal compliance costs, the causes receiving the most frequent mention were the complexity of legislation, the frequency of legislative changes, participation in audits and appeals, and coping with foreign reporting rules.⁴⁰

Although estimates of the corporate tax compliance burden for smaller Canadian businesses are not available, it has generally been found in other countries that the compliance cost per dollar of revenue collected tends to be greater among such businesses. Moreover, newer businesses tend to experience higher costs in complying with the tax laws than more established businesses. Small business in particular tends to rely heavily on outside assistance to deal with corporate income tax issues and compliance.⁴¹

Minimizing compliance costs is important, because they represent resources that might otherwise be employed by the private sector in the production of socially beneficial goods and services. Eliminating as many unnecessary complexities as possible should be an ongoing concern of the taxing authorities. However, such simplification is not in itself a simple task. The Committee sought to find the right balance among sometimes contradictory objectives of creating a tax system that is at one and the same time, simple, fair and efficient.

In a tax system that applies to millions of diverse businesses and individuals, substantial numbers of which operate in a highly complex business environment, some degree of complexity is inevitable to ensure that each taxpayer pays a fair share and that economic activity is not unduly distorted. Frequent amendments to the tax laws also are required if the tax system is to keep up with the continually changing business and financial environment that pervades modern society, but such changes add to compliance costs.

Of course, efficiency, fairness and simplicity do not always represent conflicting objectives in the design of a tax system. For example, it is argued in Chapter 4 and elsewhere in this Report that, when high tax rates are applied to narrow tax bases, both efficiency and fairness tend to be compromised. Such a policy is also antithetical to simplicity, as it tends to foster excessive tax-planning activities.

It is also important to recognize that some of the compliance burden experienced by taxpayers is discretionary. For example, businesses of all sizes commonly engage in tax-planning activities to reduce their overall tax liabilities. Many of these activities not only result in a tax savings for the business, they also serve to promote economic activities, such as R&D, which the government wants to encourage. Nonetheless, since real resources are used up in complying with the rules associated with tax incentives, it is important to structure them so that compliance costs will be as low as possible while still achieving the desired objectives. We consider specific measures that might facilitate compliance and reduce compliance costs in Chapter 10.

The Interaction of Corporate Tax Revenues and Rates

At the outset of this Report, we identified “rate lowering” and “base broadening” as among the main policy thrusts meant to guide our specific recommendations. A basic impetus for this theme stems from a conclusion that the Committee reached early in its deliberations: one of the significant problems in the current business tax system is the relatively high corporate income tax rate.

When corporate statutory income tax rates are above international norms, multinational businesses with Canadian operations are less willing to allocate income to Canada and are more willing to deduct costs (such as interest expense) in Canada. The resulting loss in corporate income tax revenue requires governments to seek other sources of revenue (such as capital taxes and payroll taxes) to maintain public expenditures, thereby impairing the efficiency and competitiveness of the Canadian business tax structure, and further eroding the overall tax base. Over time, there is simply less business activity to generate tax revenues.

In considering the policy options that arise from this observation, the Committee examined the impact of reducing corporate income tax rates on revenues received by governments. A study for the Committee⁴² examined the expected impact of a reduction in corporation income tax rates on the economy. It found that, due to the economic expansion induced by the tax reduction, the net impact was 83 percent of the direct revenue loss that would be expected in the absence of any behavioural impact.

The same study found that, in addition, the corporate tax base is sensitive to the difference between the U.S. and Canadian corporate income tax rates: the higher the rate in Canada relative to the United States, the less income that is reported in Canada. The Committee undertook further investigation of this area through a study that examined the amount of debt used to finance Canadian assets by Canadian and foreign multinationals operating in Canada. Summary results are shown in Table 3.9.⁴³

As the federal general corporate income tax rate dropped by eight points following 1986-87 tax reform in Canada, one might normally have expected businesses to reduce debt financing since the tax savings from deductibility of interest had become smaller. Canadian-controlled corporations without multinational operations did reduce their debt-financing ratios. Corporate income tax rates in Canada, however, fell less than in other countries. For example, the United States dropped the federal corporate income tax rates from 46 percent to 34 percent in 1986 and subsequently raised the rate to the current level of 35 percent. As of 1995, for non-manufacturing corporations, combined federal-provincial corporate income tax rates in Canada varied from 38 percent to 46 percent by province (average of 43 percent). U.S. combined federal and state rates varied from 35 percent to 43 percent by state (on average 39 percent). As seen from Table 3.9, Canadian multinationals increased debt ratios after 1987, even through corporate income tax rates dropped.

Furthermore, the United States in 1986 introduced revised interest allocation rules that resulted in substantial amounts of interest expense being allocated between foreign and domestic operations for the purpose of computing foreign source income. These rules effectively encouraged U.S. corporations to reduce debt at home in favour of increased debt financing by U.S. subsidiaries abroad.⁴⁴

Table 3.9
**Debt-asset Ratios of Canadian and Foreign Companies
Operating in Canada – Various Years**

	Canadian-controlled with no Foreign Affiliates	Canadian-controlled with Foreign Affiliates	Foreign-controlled
		(percentage)	
1986	33.7	35.5	20.1
1987	33.0	37.2	20.8
1988	33.6	34.7	17.8
1989	34.2	36.8	25.9
1990	35.9	39.3	25.8
1991	30.4	48.2	26.7
1992	30.4	47.7	25.1
1993	35.6	42.2	26.7
1994	30.3	39.4	24.7
Average:			
1986-88	33.4	35.8	19.6
1992-94	32.1	43.1	25.5

Source: Based on Revenue Canada longitudinal data analyzed by the Department of Finance. Excludes financial companies. Debt includes short-term and long-term debt except accounts payable. Assets include financial assets net of accounts payable.

As a result of revised U.S. interest allocation rules and of having a higher corporate income rate in Canada relative to the United States, foreign multinationals in Canada (most of which are U.S.-owned companies) have tended to increase debt financing of Canadian subsidiaries after 1987. Thus, Canada has become an attractive location for interest deductions, given its current relatively high corporate income tax rate.

It is clear that corporate rate reductions offer no “free lunch” – reductions in rates of tax are not fully compensated for by increases in income earned except in extreme circumstances that do not seem to apply here. However, our analysis does suggest that rate reductions will lead to some increase in the tax base, thus partially offsetting the revenue loss from the rate reduction and lessening the extent of other tax measures required to achieve overall revenue neutrality in the face of the rate reduction.

Our analysis in this Chapter suggests that the business tax structure could be improved by lowering the top corporate income tax rate to improve efficiency and reduce base erosion. Moreover, a number of base-broadening changes would reduce the dispersion in effective tax rates. These changes – which are set out in detail in the remainder of this Report – would alter the taxation structure to achieve greater neutrality and improved overall efficiency in the economy.

Key Points in Chapter

- Business taxes on capital in Canada (the corporate income and capital taxes, plus sales taxes on capital goods) are substantially uneven across industries and types of assets. The existing tax structure provides favourable treatment for investment in non-renewable resources and manufacturing relative to investment in construction, transportation, communications, utilities, trade and other services. As well, the existing tax structure supports investment in R&D, exploration and development, and some forms of machinery, and provides less favourable treatment for investment in structures, inventory and land. Finally, on average, the system favours investment by small businesses over investment by large businesses. Distortion in investment patterns can be expected to impede economic growth and job creation.
- Including business taxes on labour costs net of the benefits of government programs associated with some of these labour taxes, we find that combined taxes on capital and labour are also substantially uneven. Resource industries and construction are taxed relatively lightly, while communications, utilities, wholesale trade and other services are taxed relatively heavily. The more heavily taxed sectors tend to be those that have shown the greatest potential for employment growth and that contain many important knowledge-based industries.
- Business taxes do not appear to discourage investment in human capital by businesses.
- Relative to other countries, and in particular to the United States, the Canadian business tax system has similar or somewhat higher effective rates in the manufacturing sector, but tends to have substantially higher rates in several of the service sectors.
- Taxes can affect unemployment through their impact on the cost of labour. While payroll taxes on employers are largely shifted to employees in the longer run, substantially mitigating the impact on labour costs, increases in such taxes can still have adverse effects on employment in the shorter run and may have a disproportionate impact on low-wage employment.
- Currently, an individual employer's contributions for employment insurance are not linked to its layoffs. The introduction of such a linkage, in accordance with the user pay principle, offers the prospect of improving the stability of employment and reducing unemployment.
- Business tax systems should be evaluated on the criterion of fairness, as well as in terms of their impact on employment creation and economic growth. In applying this criterion, it is important to recognize that, ultimately, business taxes are borne by individuals through some combination of lower returns to owners of the business and other suppliers of capital, higher prices for consumers of what the business produces, and lower wages for employees and payments to suppliers of other inputs. It is difficult to draw general conclusions about the ultimate incidence of the various business taxes, but there is no reason to expect corporate income and capital taxes to be borne mainly by the wealthy.
- Tax system compliance costs for large businesses in Canada are significant but not as high as those found for similar businesses in the United States. Features of the tax system that increase compliance and administrative costs should be scrutinized and improvements made where possible. However, a trade-off is often encountered among the tax system objectives of simplicity and low compliance costs, versus fairness and economic growth and job creation.
- As corporate tax rates are pushed above international norms, multinational businesses will have an increasing incentive to structure operations, so that income is assigned to other countries and costs are assigned to Canada. This would appear to be particularly true with respect to interest costs. High rates thus have the potential to erode the tax base, and there is evidence that the Canadian corporate income tax base has experienced such erosion in the last decade.

Table 3.10
Effective Tax Rates in Marginal Investments

	Tangible Capital				Total	E&D	R&D	Total
	Structure	Machinery	Land	Inventory				
	(percentage)							
Large Firms								
Agriculture, Fishing and Trapping	–	–	–	–	–	–	–	–
Forestry	30.3	13.1	24.7	38.7	31.7		-31.8	28.8
Mining	0.1	15.5	20.7	35.0	17.8	0.1	-29.7	8.7
Oil and Gas	10.9	20.3	23.9	38.6	24.7	0.3	-35.3	5.5
Manufacturing	23.2	8.6	22.4	35.3	22.3		-27.4	17.9
Construction	36.4	31.0	25.9	40.4	37.4		-24.9	37.0
Transportation	25.8	26.9	26.2	40.7	28.2		-33.8	27.9
Communication	26.3	35.3	26.2	40.6	28.5		-27.7	23.9
Public Utilities	27.9	29.7	26.2	40.7	30.4		-31.1	30.3
Wholesale Trade	23.5	26.5	25.3	39.5	34.8		-29.9	32.1
Retail Trade	13.2	34.7	26.0	40.4	33.5		-30.0	33.3
Other Service Industries	25.0	35.7	25.9	40.2	28.2		-30.1	27.6
Total	24.2	19.6	25.3	37.6	27.0	0.2	-28.0	22.8
Small Firms								
Agriculture, Fishing and Trapping	5.8	7.6	9.2	9.3	8.5		-42.7	7.9
Forestry	11.8	12.7	9.2	16.9	12.8		-49.7	12.6
Mining	–	–	–	–	–		–	–
Oil and Gas	–	–	–	–	–		–	–
Manufacturing	7.1	5.2	9.2	16.9	10.4		-39.0	7.6
Construction	14.3	23.8	9.2	16.9	17.6		-41.8	17.5
Transportation	7.9	17.9	9.2	16.9	15.9		-41.3	15.7
Communication	7.7	25.1	9.2	16.9	21.8		-44.4	20.2
Public Utilities	8.9	15.5	9.2	16.9	15.0		-26.0	14.7
Wholesale Trade	5.6	23.0	9.2	16.9	16.7		-40.5	15.5
Retail Trade	3.9	26.0	9.2	16.9	16.4		-42.3	16.4
Other Service Industries	8.6	22.7	9.2	16.9	11.4		-39.8	10.1
Total	8.3	17.9	9.2	16.5	13.3		-39.8	12.1
Large and Small Firms								
Agriculture, Fishing and Trapping	5.8	7.6	9.2	9.3	8.5		-42.7	7.9
Forestry	22.6	12.7	11.0	30.6	17.2		-35.0	16.3
Mining	0.1	15.5	20.7	35.0	17.8	0.1	-29.7	8.8
Oil and Gas	10.9	20.3	23.9	38.6	24.7	0.3	-35.3	5.5
Manufacturing	21.3	8.1	19.2	32.5	20.5		-29.1	16.5
Construction	27.6	24.7	16.0	26.0	25.5		-38.6	25.3
Transportation	21.0	24.2	16.7	37.9	24.6		-35.8	24.4
Communication	26.3	34.9	25.7	39.4	28.5		-27.7	23.6
Public Utilities	27.8	26.5	24.4	40.4	29.5		-30.3	29.4
Wholesale Trade	16.8	24.8	18.6	28.4	26.2		-33.1	24.3
Retail Trade	8.1	30.5	14.7	24.9	23.3		-39.0	23.2
Other Service Industries	16.6	28.3	15.9	29.9	19.3		-36.9	18.2
Total	18.9	19.0	15.6	29.0	21.8	0.2	-30.9	19.0

Notes:

- This Table is included in order to provide greater detail, by asset type and industry, than is provided in Table 3.1.
- Taxes on capital include federal and provincial corporate income and capital taxes, and sales taxes on capital goods.
- No estimates are shown for large businesses in Agriculture, Fishing and Trapping, or for small businesses in Mining and Oil and Gas, due to the small number of businesses in these categories and the consequent unreliability of underlying data.
- See also notes to Table 3.1.

Source: Calculations by Committee secretariat with technical assistance from Department of Finance and K. McKenzie. See McKenzie, Mansour and Brûlé (1997).

Endnotes

- ¹ See Engen and Skinner (1996) for a comprehensive survey on taxes and growth. They conclude that higher taxes result in a somewhat lower growth rate for the economy, although the effect depends on the structure of taxes and the public services provided by governments.
- ² As discussed in the Introduction, the Committee is of the view that departure from neutrality is warranted only in certain situations where market prices do not provide appropriate signals for resource allocation.
- ³ Recent literature on economic growth suggests that countries that encourage investments in human capital and technology will best improve prospects for economic growth. See De Long and Summers (1991), Romer (1990) and Perroni (1997).
- ⁴ Those taxes that directly reduce income earned on capital include federal and provincial corporate income taxes, while federal and provincial capital taxes, provincial sales taxes on capital goods, and provincial and municipal property taxes increase the cost of using capital. Provincial mining and oil and gas royalties, and forestry stumpage fees also affect capital investments, although these “taxes” can be regarded as payments for the benefit derived from exploiting non-renewable and renewable resources owned by the government.
- ⁵ See recent surveys by Chirinko (1994), Mintz (1995) and Shah (1995).
- ⁶ See, for example, Bernstein and Shah (1994), Chirinko (1995), Cummins and Hassett (1994), Cummins, Hassett, and Hubbard (1996), Ng and Schaller (1996). One study based on industry-wide data prepared for the Committee, McKenzie and Thompson (1997), Technical Committee Working Paper 97-3, finds that tax differences between Canada and the United States influence investment in machinery and equipment; the effects are statistically significant but not large. Two firm-level studies on U.S. and Canadian multinational investment, by Altshuler and Cummins (1997), Technical Committee Working Paper 97-4, and Cummins (1996), Technical Committee Working Paper 96-4, show that taxes have substantial negative impacts on investment.
- ⁷ The effect of taxes on capital costs shown in Table 3.2 is an aggregate measure of taxes on structures, machinery, inventories, land and intangible capital as provided in Table 3.1. Note, however, that taxes in Table 3.2 are expressed as a percentage of costs excluding taxes rather than as a percentage of gross of tax rates of return on capital as in Table 3.1; hence, this measure shows higher estimates of effective tax rates.
- ⁸ These tax rates do not reflect personal taxes paid by residents and non-residents deriving income from Canadian businesses.
- ⁹ A recent Industry Canada study identified the first three of these sectors as high or medium knowledge-based. The other services sector also includes high and medium knowledge-based subsectors. See Gera (1997).
- ¹⁰ In the calculations, resource royalties are treated as costs. If they are treated as taxes, which the Committee views as less generally appropriate, the effective tax rate on costs for large firms in mining is 17.7 percent and for large firms in oil and gas is 18.2 percent.
- ¹¹ These studies measure the impact that the corporate tax system has on factor use, and interasset, interindustry and intertemporal distortions as discussed above. Some studies have accounted for the impact of corporate taxes on the international location of investment and output, and others allow for the crediting of Canadian corporate income taxes against foreign taxes by multinationals operating here. Few studies have considered other distortions related to the corporate income tax, such as financing arrangements and the choice of organizational form for businesses. Nor have many incorporated the effects that the corporate income tax system would have on growth arising from the use of technology in the business sector. There have also been studies that have examined the impact of EI on economic efficiency. These are discussed later in this chapter and in Chapter 8. See Whalley (1997b), Technical Committee Working Paper 97-8, for a review of studies on the impact of corporate income taxes on economic efficiency.

- ¹² See, for example, Dahlby(1994) and Organization for Economic Co-operation and Development (1997a). The latter reference reports estimates that the costs of corporate income taxes are much higher than the costs of personal income, payroll or sales taxes, when impacts on economic growth are taken into account.
- ¹³ See Hamilton and Whalley (1989).
- ¹⁴ See Hamilton, Mintz and Whalley (1991).
- ¹⁵ For example, one study “found that Canadian expenditures [on employer-based training] as a percentage of GDP are only 40 percent of those in the United States, 18 percent of those in Japan and 13 percent of those in West Germany. A recent OECD study found that only 31 percent of Canadian enterprises reported some training activity compared with 55.8 percent in France, 73.8 percent in Japan and 80 percent in Great Britain.” See Hum and Simpson (1996).
- ¹⁶ See Kapsalis (1993).
- ¹⁷ The lower level of training activity in Canada that has been reported in other studies may be due to difference in the definition of employer-based training across countries.
- ¹⁸ Minimum wage laws may also discourage firms from providing general training if the minimum wage prevents the cost of training from being shifted from the business to the worker.
- ¹⁹ See Driffill and Rosen (1983), Davies and Whalley (1991), Trostel (1993) and Dupor et al. (1996).
- ²⁰ See Nickel and Bell (1996) for a discussion of the relative importance of these factors in the growth of unemployment in OECD countries. See also Fortin, Keil and Symons (1995) for discussion of a wider range of potential factors than considered in this section.
- ²¹ Changes in personal taxes may have some impact on wage determination in collective bargaining situations.
- ²² For recent surveys of the economic effects of payroll taxes, see Dahlby (1992), Hammermesh and Biddle (1993), Marchildon, Sargent and Ruggeri (1996), Baran (1996), Organization for Economic Co-operation and Development (1996c) and Kesselman (1997). Recent studies of the effects of Canadian payroll taxes on aggregate employment include Prescott and Wilton (1996) and Abbott and Beach (1997). Prescott and Wilton find, for union contracts in the period 1979 to 1992, that income tax and employee payroll tax increases did not lead to higher wage rates, that about one-half of a sales tax increase was reflected in higher wage rates, and that higher employer payroll taxes were associated with higher wage settlements. Abbott and Beach estimated the effects of employer payroll taxes on employment and wage rates in the 10 provinces over the period 1970-93. Their study indicates that employer payroll taxes have strong negative effects on employment and wages. However, some caution must be expressed about these results, since data on earnings and effective payroll taxes are not easily estimated, as Abbott and Beach point out.
- ²³ There is some indication that Canada itself might be a special case. Most of the research on the incidence of the payroll tax has been conducted using international cross-section data or time series data for other countries. Canadian labour market conditions and institutions might produce quite different responses to changes in employer payroll taxes.
- ²⁴ The degree of wage rigidity caused by minimum wages has diminished since the mid-1970s, because minimum wages have declined as a percentage of average manufacturing wages from 49 percent in the mid-1970s to 35 percent in the 1990s. See Fortin, Keil and Symons (1995).
- ²⁵ See Gruber (1995), who shows that the switch from an employer-funded pay-as-you-go pension program to a mandatory contribution program by employees had no discernible employment effects in Chile.
- ²⁶ Estimates of the job losses range from 100,000 (Crosier and Mang (1994)) to 316,000 (Archambault and Hostland (1996)).
- ²⁷ See Zee (1997).
- ²⁸ See Fortin, Keil and Symons (1995). They also found that a five percentage point increase in the tax rate on labour income would raise the aggregate unemployment rate by about 0.4 percentage points in the short run but did not affect the unemployment rate in the long run.

- ²⁹ Many employer payroll taxes, such as CPP/QPP contributions, EI premiums and provincial worker's compensation, are based on maximum earning limits, similar to earning limits for determining benefits. When the payroll taxes capture the true insurance cost of the benefits paid to workers, then one would not expect payroll taxes with earning limits to affect the choice between full-time and part-time workers. However, in certain circumstances, the programs are not fully based on insurance principles so the contributions operate as a tax on employment. In these circumstances, part-time hiring will be discouraged. As noted in Canada, Advisory Group on Working Time and the Distribution of Work (1994), payroll taxes with maximum earning limits can discourage the use of part-time workers, since fewer payroll taxes are paid when overtime and full-time workers are hired instead. On the other hand, a minimum threshold that exempts earnings from payroll tax can encourage part-time employment. Recent changes to the EI program, which require contributions and benefits to be based on annual rather than weekly earnings, help to reduce the impact that payroll taxes have on the choice between full-time, overtime and part-time work. However, payroll taxes based on earning limits per employee remain a tax on part-time employment hired on an annual basis.
- ³⁰ See Day and Winer (1994), for a comprehensive survey.
- ³¹ Under the personal income tax, individuals with self-employed earnings are allowed to deduct, as business costs, expenses incurred for the purposes of earning income including qualifying automobile expenses, meals and entertainment costs (50 percent of costs are eligible for deduction) and home office expenses (which are not deductible if they create an operating loss). Employees are able to deduct limited costs incurred to earn a living, including sales persons' expenses, certain expenses incurred by employees in forestry, transportation and the arts, and qualifying travelling expenses, automobile expenses and meals, incurred in the conduct of business, that are not covered by the employer.
- ³² The original study of Musgrave and Krzyzaniak (1963) suggests that the U.S. corporate income tax is fully shifted forward to consumers through higher prices, while Harberger (1962) suggests that the corporate income tax is largely borne by capital owners through lower rates of return on capital. See Whalley (1997a), Technical Committee Working Paper 97-7 for a review of tax incidence studies, as well as recent papers by Vermaeten, Gillespie and Vermaeten (1994) and Block and Shillington (1994), who assume that part of the corporation tax is shifted forward to consumers and part back to owners of the corporations.
- ³³ This view is taken by Boadway and Bruce (1992) who argued that the Canadian economy is a small open economy and that foreign markets largely influence the rate of return on capital earned by corporations in Canada. Devereux and Freeman (1995) provide a different view in that the corporate taxes can reduce income received by domestic shareholders to the extent that the domestic owners hold corporate assets. Burgess (1988) suggests that the corporate income tax is shifted back on to shareholders to some extent, since Canada is not a small open economy in export markets.
- ³⁴ A Department of Finance model uses the small open economy assumption for capital markets to determine how corporate income and capital taxes affects the real income of groups. It finds that a 5 percentage point increase in corporate income tax rates reduces the real income of lowest-income Canadians (up to \$20,000 in income) by about 1 percent. The real income of the highest-income individuals, with income over \$150,000, is reduced by 0.7 percent. See Beauséjour (1997).
- ³⁵ Further discussion is provided in Whalley (1997a).
- ³⁶ See McKenzie and Thompson (1996), Technical Committee Working Paper 96-7, and Mitoo (1997).
- ³⁷ This refers to Part I tax, for which income is the base.
- ³⁸ Further discussion of this issue can be found in papers appearing in Clarkson Gordon Foundation (1993) and Ontario, Fair Tax Commission (1992b).
- ³⁹ Erard (1997a), Technical Committee Working Paper 97-2.
- ⁴⁰ Very few studies of the tax compliance burden for large corporations have been performed in other countries. However, results from a recent U.S. study indicate that the U.S. federal-state corporate income tax structure tends to create significantly higher compliance costs for large businesses than the Canadian tax structure. Much of the difference may be attributed to relatively less complex tax rules in this country as well as the smaller number of jurisdictions to which large corporations must report and pay taxes. See Erard (1997a) and Slemrod and Blumenthal (1996).

- ⁴¹ In a study of small and medium sized businesses (Erard (1997c), Technical Committee Working Paper 97-12), businesses were asked to identify the most significant sources of high corporate tax compliance costs. The sources receiving the most frequent mention were record-keeping requirements, the cost of professional services, and the complexity of the information required. Preparation fees tend to be about 50 percent higher for small businesses located in Alberta, Ontario or Quebec, reflecting the additional work required to comply with the provincial corporate taxes administered by these jurisdictions. See also Plamondon & Associates (1996), Technical Committee Working Paper 96-9.
- ⁴² See the paper prepared by Dungan, Murphy and Wilson (1997), Technical Committee Working Paper 97-1. The sensitivity of corporate tax revenues to rate changes depends also on how governments accommodate fiscal policy changes with monetary policy.
- ⁴³ Based on the study prepared for the Committee by Jog and Tang (1997), Technical Committee Working Paper 97-14.
- ⁴⁴ See Froot and Hines (1995) and Altshuler and Mintz (1995).

Modernizing the Corporate Income Tax – Provisions of General Application

4

Introduction

Canadian businesses currently pay about \$25 billion in corporate income and capital taxes to federal and provincial governments. But this is only about one quarter of total taxes paid by businesses to government, and approximately 8 percent of all government tax revenues. The corporate income tax is nevertheless a key component of Canada's broader tax system, as it is arguably the single most influential tax on business income and activity.

As discussed in Chapter 2, the corporate income tax serves three important functions. It is a backstop to the personal income tax helping to ensure that income is subject to current taxation. It ensures that foreign investors pay a Canadian tax on corporate income earned in Canada. It may serve as an imperfect mechanism to ensure that corporations pay for the benefits derived by them from services provided by governments.

In this Chapter, we consider options for the reform of the corporate income tax with respect to the rates of tax and the general measurement of taxable income. Building on the notion of neutrality as set out in Chapter 1, we begin with a discussion of a uniform federal corporate income tax. We then consider issues related to general provisions of the corporate income tax:

- the general rates of corporate income tax;
- capital cost allowances;
- the recognition of losses for tax purposes; and
- capital taxes.

Chapters that follow take up more specialized tax corporate income issues: Chapter 5 reviews a number of specific provisions of the present system that offer special treatment to certain sectors and regions of the economy – small business, R&D costs, the resource industries, the Atlantic Investment Tax Credit and financial institutions. The application of corporate income tax to outbound and inbound international investment is dealt with in Chapter 6, and the integration of the corporate and personal income tax system is discussed in Chapter 7.

Starting Point: A More Neutral Corporate Income Tax

As the Committee noted in its evaluation of the Canadian tax system in Chapter 3 – and as is further illustrated below – the present tax system shows a remarkable divergence of effective corporate tax rates on investments of industry sectors, activities and businesses. We believe, however, that lower and more uniform rates of tax, and a broader and more neutral tax base, would serve to reduce the differences in tax burdens between various business activities and sectors, thereby encouraging business to maximize economic opportunities rather than minimize taxes. With a more neutral tax system and rates that are internationally competitive, Canadians would benefit significantly from the greater fairness and efficiency that resulted.

In the existing tax system, it is Canada's service industries – ranging from communications to personal and business services – which bear relatively high rates of tax. And yet it is these same industries that are important components of the new knowledge-based economy, and have demonstrated the greatest capacity for growth and new job creation. As global competition spreads from goods-producing industries to services, the present sharp differences in effective tax rates become more and more difficult to justify. Moreover, because our present corporate income tax rates on non-manufacturing income are higher than those of many of our trading partners – especially the United States – our corporate income tax base is being eroded and Canadian service firms are being placed at a competitive disadvantage. Governments are losing revenue, firms are foregoing profits, and Canadians are missing out on jobs.

The Unacceptably Large Variation in Effective Tax Rates

As shown in Table 4.1, effective federal corporate income and capital taxes relative to pre-tax financial accounting profits differ quite widely by industry and size of firm, varying from 6 percent of income in mining to 26 percent for large deposit-taking institutions and public utilities.¹ There are other taxes paid by firms, including corresponding provincial corporate income and capital taxes, property and payroll taxes, but the large differences in federal corporate income taxes paid as a percentage of profits across industries are quite striking.

Table 4.1

Average Federal Effective Corporate Tax Rates and Amounts of Tax, by Industry and Size of Corporation for the Years 1993 and 1994

Industries	Average Tax Rate (%) ^a (Federal Income and Capital Tax only)			Amounts of Tax (\$ million)		
	Overall	Large	Small ^b	Overall	Large	Small ^b
		Corporations	Corporations		Corporations	Corporations
Agriculture, Forestry and Fishing	8	12	7	133	42	91
Mining	6	6	n/a	112	112	n/a
Oil and Gas	16	16	n/a	724	724	n/a
Manufacturing	16	17	13	2,599	2,270	329
Construction	14	20	12	385	146	239
Transportation and Storage	14	15	10	294	225	69
Communications	17	17	n/a	455	455	n/a
Public Utilities	26	26	n/a	359	359	n/a
Wholesale Trade	20	24	14	1,036	704	332
Retail Trade	16	20	14	451	181	270
Deposit-taking Institutions	26	26	n/a	1,161	1,161	n/a
Other Finance	15	14	19	2,118	1,276	841
Other Services	16	21	14	1,054	458	596
Total - All Industries	16	17	14	10,881	8,112	2,768

^a Average effective tax rates are calculated as ratios (%) of federal income and capital taxes to adjusted financial accounting income of profitable companies.

- Federal income and capital tax (corporate tax) includes Part I tax, the LCT, and Part VI tax on the capital of financial institutions, gross of any foreign tax credits.
- Adjusted financial accounting income is adjusted to remove intercorporate dividends and to reflect loss carry-overs.
- Tax rates are averages for the two years, 1993 and 1994, as are amounts of tax. No amounts of tax are shown, and no average rates are calculated, for sectors with very small amounts of tax and income.

^b Small businesses are those eligible for the small business deduction. Additional taxes levied to achieve corporate-personal tax integration on investment income received by CCPCs are included in calculations.

Note: Components may not sum exactly to totals due to rounding.

Source: Data and technical assistance made available by the Department of Finance.

While recognizing the need to consider special circumstances – such as the special position of small business – the Committee regards the current variation in effective federal tax rates shown above as unacceptably large. The federal corporate income tax has significant impact on the overall efficiency of the tax system, and we believe the range of rates shown above is causing a misallocation of resources in the business sector and a less than optimum economic performance – including in the important goal of job creation.

Moving Toward a Neutral Corporate Tax

Given the virtues of lower rates and broader tax bases, the Committee undertook, strictly as an exercise, to consider the implications of a **uniform federal corporate income tax**, which would raise the same revenue as the current federal corporate income tax (with no changes in capital taxes). This hypothetical uniform federal corporate income tax would have the following features:

- a uniform tax rate on all corporations at a federal rate of 18 percent and a combined federal-provincial rate of roughly 30 percent on average;
- capital cost allowances reduced to values closer to economic depreciation rates for most assets;
- the current deduction of unsuccessful exploration costs and the amortization of successful exploration costs over the lifetime of the project;
- the deduction of resource royalties from profits and the elimination of the resource allowance; and
- the repeal of the Research and Development (R&D) and Atlantic Investment Tax credits.

A uniform corporate income tax would have certain advantages:

- The tax system would be more neutral in that differences in effective tax rates on capital across industries and assets would be reduced. There would be substantial efficiency gains resulting from more neutrality.²
- The combined federal and provincial general corporate tax rate of 30 percent on average would be well below those of the United States and many other OECD countries. The result would be that Canada would be more attractive as a place to earn income, and there would be less erosion of the Canadian base as a result of transfer pricing and debt placement by international firms.
- The elimination of many special deductions and allowances would simplify the tax system thereby reducing compliance costs and providing administrative savings for taxpayers and governments.

It is clear that a move to neutrality of the kind described here would result in substantially higher tax rates for certain business activities as existing preferences are eliminated. However, given the important advantages of a more uniform corporate income tax, the Committee believes that there are significant gains to be had for the Canadian economy from some base broadening and lower, more uniform, rates.

Neutrality Still the Goal with Recognition for Special Situations

While this theoretical uniform federal rate of 18 percent has many advantages, it has the significant drawback of not recognizing a limited number of situations where non-neutralities in our tax system are justified. The external benefits resulting from scientific research and exploration for resources, and the special position of small businesses are two examples. However, our analysis shows that one could achieve most of the economic advantages of the lower uniform rate – while retaining an appropriate treatment for a limited number of special circumstances – by using a modified approach. Such a system would result in a combined general federal and provincial rate of 33 percent, in contrast to the 30 percent rate under the uniform system. The modified approach would also involve the retention of the capital taxes, although it is hoped that these will decline over time.

As a general principle, the Committee believes that the corporate tax (indeed, most business taxes) should tend toward neutrality and simplicity, rather than contain special preferences for particular activities. The Committee is of the view, however, that situations in which non-neutrality is justified include those where individual decisions in markets are not sufficient to ensure that resources are being put to their best economic use. Compelling evidence exists to show that these conditions for special treatment are met in two main areas: small businesses require assistance in financing capital since they currently have less access to equity capital markets, and research and exploration incentives are needed because they involve activities that benefit many businesses in an industry and society generally, not just the entrepreneur who develops a new idea.

To address such special cases, governments have two instruments at hand – grants and tax incentives. Of the two, for several reasons we regard grants as the preferable option in most instances. Costs are more easily controlled with grants as compared to tax incentives, which are usually open-ended. Providing incentives through government expenditures facilitates periodic review by Parliament and makes governments more accountable for their actions. And finally, grants are available to all businesses, while tax incentives can be used only by those with tax liabilities (unless the tax incentive is made refundable for businesses with insufficient current tax liabilities).

The Committee does recognize that grants have their limitations in certain circumstances. By the nature of their open-endedness, tax incentives are readily available to all qualifying businesses, and with less front-end bureaucratic review. Tax incentives also are more likely to be available on a uniform and defined basis, providing more certainty to businesses regarding the rules of the game.

Conclusion

As set out more fully in the following sections and chapters, the Committee favours a substantial broadening of the tax base and a reduction, with appropriate transition, in a number of existing tax preferences. Equally, the Committee recognizes the need to keep some limited and revised special treatment and tax incentives to achieve fairness and efficiency. We are convinced that this approach will yield major benefits for Canadians.

The General Corporate Income Tax Rate

The amount of tax that a corporation pays is determined by two main variables: the income base upon which the tax is levied, and the rate at which it is applied. Even before turning its attention to issues regarding the tax base, the Committee noted that current statutory rates vary across a broad range. The current general rate for the federal corporate income tax is 38 percent, reduced by 10 percentage points to 28 percent for income earned in a province. Manufacturing and processing firms are provided an additional reduction in the rate to 21 percent at the federal level. A federal corporate income surtax increases rates for all corporations by 1.12 percentage points, bringing the overall rates to 29.12 percent and 22.12 percent respectively. With average provincial taxes, the combined federal and provincial corporate rates for larger corporations are in the range of 43 percent for non-manufacturing and 35 percent for manufacturing. (Provincial income tax rates vary by province and type of activity – see Table 2.2 in Chapter 2).

Small Canadian-controlled private corporations are afforded preferential rates by the federal government and by the provinces. The effective federal corporate rate on the first \$200,000 of active business income is reduced to 13.12 percent (including surtax) for both manufacturing and non-manufacturing businesses. Provincial corporate income tax rates are an additional 8 percent on average, thereby resulting in a combined federal and provincial rate of about 21 percent on average. As a broad generalization, federal and provincial statutory corporate income tax rates for large manufacturing corporations are within the range imposed by other industrialized countries.³

R E C O M M E N D A T I O N

The Committee believes that these variations in rates reflect a corporate income tax system that is less neutral than desirable, adding to a relatively complicated tax regime with considerable scope for complex tax planning. Furthermore, Canada's combined federal and provincial corporate income tax rates, for non-manufacturing in particular, are high by international standards, especially when compared to U.S. rates.

The Committee proposes that the general federal and provincial corporate income tax rates be lowered, after a transitional period, to 33 percent on average. We recommend a general federal rate of 20 percent, and we suggest that provincial rates could be reduced on average by one point to 13 percent from the revenues generated from base-broadening. The Committee also recommends that the federal corporate income surtax for both large and small businesses be repealed.⁴

As discussed in Chapter 1, the loss in revenue arising from rate reductions set out here would be balanced by our base-broadening and other measures, so that the same amount of tax in total would be collected from the corporate sector. However, the rate reduction and base-broadening measures together would result in a more neutral corporate income tax system at internationally competitive rates.⁵ The general base-broadening measures in our Report would result in substantial revenue increases to the provinces, which tend to parallel the federal definition of taxable income. The Committee believes that, with this revenue, the provinces can and should provide a one percentage point reduction in their corporate income tax rates as well as some lessening of provincial capital taxes, without affecting their total revenues from the corporate sector. As an integral part of this recommendation, the manufacturing and processing tax reduction would be phased out as the general lower rates become effective.⁶

The aggregate impact of this recommendation would be to set the statutory corporate income tax rate to which all corporations, including manufacturing and processing, would be subject at a competitive rate below that of the United States and many of our trading partners. The current statutory federal corporate income tax rate is 22.12 percent on manufacturing and processing income, although the actual average rate on large manufacturing corporations is 23.3 percent as some income earned by manufacturers is taxed at the general rate. As noted, the combined average federal-provincial statutory tax rate on manufacturing and processing income is 35 percent. Under the Committee's proposals, an average federal and provincial rate of 33 percent would apply to the manufacturing sector after a transitional period.

The overall impact of our proposals would be to moderately increase the effective tax rate on marginal investments of the manufacturing sector; these rates are already somewhat above comparable U.S. rates. Similar situations may apply in a limited number of other sectors with internationally mobile businesses.

It is impossible to evaluate the final position of each sector at this time. We have suggested that the provinces use approximately \$550 million of the annual revenues that they are expected to derive from base broadening to reduce capital and other taxes on business. If the provinces use the revenue in this way, the increases in effective tax rate on marginal investment will be moderated.

Including the impact of repealing the federal corporate income surtax, federal and provincial tax rates on small business income are recommended to be reduced on average by 1.5 percentage points. Federal rates would vary from 11 percent to 14 percent with the maximum reduction in rates benefiting small businesses that create and maintain employment (see Chapter 5). We suggest that provincial small business tax rates be reduced on average from 8 percent to 7 percent.

The Committee recognizes that our package of recommendations would take several years to implement. Base broadening and other reform measures can only be implemented after appropriate transition, and corporate income tax rates would be reduced in steps as the base broadening becomes effective. We propose that the net statutory rates of tax on manufacturing and processing be maintained during this transition period so that manufacturing and processing statutory tax rate not be increased at any time.

Capital Cost Allowances

Background

Businesses are required to write off the cost of depreciable capital assets – such as buildings, machinery and equipment – over a number of years in determining their income for tax purposes. Canada has a relatively simple and stable system of capital cost recovery for businesses, largely based on allowing taxpayers to claim deductions annually that are not in excess of a maximum rate applied to a declining balance of unrecovered capital costs. The system also contains mechanisms to correct over- or under-deductions of previous years when assets are sold or scrapped.

In concept, capital cost allowances should allow a taxpayer to write off the cost of capital property for income tax purposes in some reasonable manner over its useful life. There are economic and financial accounting approaches to setting appropriate depreciation rates, and both involve judgement and estimation. However, if the rates at which taxpayers are allowed to depreciate assets differ significantly from their economic lives, taxpayers may be penalized or receive undue benefits. If the allowance in one year is less than the portion of the capital cost that might be regarded as consumed in that year, income is being overstated, and the taxpayer is being forced, in effect, to prepay future taxes. Equally, if the annual allowance is more than the portion of the asset consumed in that year, then the taxpayer secures an advantage in writing off the cost of assets more quickly than the asset is being consumed.

From the viewpoint of economic analysis, the portion of an asset's cost that is consumed in a year is usually taken as the decrease in the inflation-adjusted value of the asset in the year – an amount that is frequently difficult to determine because of a lack of an active market for used assets. For accounting purposes, the depreciation of a capital asset in any one year is the result of applying reasonable and consistent depreciation methods designed to spread the net cost of the asset – acquisition cost less residual value – in a rational way over its useful life to the enterprise.

How Fast Should Assets be Written Off?

For most depreciable property, an asset acquired for a certain capital cost will be used in the business to produce income over a period of years, and its value will be reduced – in many cases – to an almost nominal amount at the end of its useful life.⁷ The difficulty is in determining what portion of the economic cost might reasonably be allocated to a particular taxation year.

The determination of such an appropriate annual consumption of capital costs is dependent on a number of factors:

- the actual period of time during which the assets can be profitably used in a business – a period that obviously varies according to circumstances such as the character of the asset, and the amount of use made of it.
- the relative contribution that the asset will make to the income of the business in each of the years that it is employed: for some assets, the contribution that the asset makes to the enterprise may remain relatively constant over a period of years, and hence, a reasonable annual depreciation may be a constant percentage of its original cost – as provided under the straight-line depreciation approach. For other assets – and perhaps an increasing portion of total assets owned by businesses

generally – the asset may be most useful (and contribute most to the profitability of the business) when it is relatively new. This annual contribution to profitability may decline in subsequent years, even though the asset may still be used, because it is no longer the most current or productive model, and higher repair and maintenance costs may be necessary to keep it functioning.

- the residual value, if any, of the asset at the end of its useful life to the enterprise.

With regard to the length of time that an asset contributes to a business, there is evidence that the useful lives of plant, machinery and equipment are shortening because of the influence of rapidly advancing technology. For example, the useful life assumptions used by Statistics Canada for purposes of calculating industry capital stocks have been reduced from 1946 to 1994, such that the corresponding economic depreciation rates on a declining balance basis have increased on average for structures from 4 to 6 percent, and for machinery from 10 to 21 percent.⁸ Increasingly, capital assets are becoming economically obsolete – in the sense that they cannot make a net contribution to the enterprise – long before they physically wear out. The appropriate portion of an asset's cost to be assigned to any one year is therefore not simply a technical function – based on how long the asset will last – but rather a complex question involving the economic as well as the technical life of the equipment, and the contribution to profitability that the asset makes year by year over the period that it is employed.

Straight-line Versus Declining Balance Methods

For accounting purposes, many companies record depreciation expense on a straight-line basis – a method that assigns equal amounts of cost in each of the years during which an asset may be used. The amount of capital cost allowance determined under a declining balance basis⁹ will naturally be greater, for most businesses, during the initial years of an asset's life, and lesser in the latter years of that life, than the corresponding annual accounting depreciation as determined on a straight-line basis. In a growing economy, businesses will add an increasing amount of new assets year by year, and thus the annual amounts available to Canadian businesses for capital cost allowances for tax purposes can be larger than the amount of depreciation expense recorded for financial accounting purposes.

Why Accounting – Tax Conformity is Undesirable

The actual useful lives of assets and the depreciation rates employed by Canadian businesses to record them for accounting purposes vary significantly from business to business, depending on their individual circumstances and individual firms' perceptions of the usage of the capital over time. For income tax purposes, however, it is necessary to specify a uniform method of calculating capital allowances on a simple, stable and understandable basis, which can be uniformly applied to all taxpayers and which reduces detailed record-keeping and complexities to the minimum for both the tax administration and for taxpayers.

Some have argued that the amount of depreciation recorded in accounting records by businesses should be identical to the depreciation expense claimed for income tax purposes. In the view of the Committee, the adoption of such a provision – a system once used in Canada – would be a retrograde step because it would serve mainly to advantage certain kinds of businesses over others. Capital cost allowances permitted for income tax purposes should be based on a uniform and simple system, applicable to all taxpayers, and not dependent on varying accounting approaches to depreciation used by individual businesses. Privately held corporations and most Canadian subsidiaries of foreign corporations would in this case benefit, since publicly held and traded firms rely on audited and publicly reported earnings statements for shareholder evaluation. Introducing such a requirement could lead enterprises that are not so restricted and that wished to claim more capital cost allowances for tax purposes to simply record additional depreciation in their own internal and unaudited accounts.

Current Canadian Capital Cost Allowance System

For income tax purposes, the cost of most depreciable capital assets is allocated, depending on the nature of the asset, to one of 33 classes of capital cost (11 additional classes remain for assets purchased in earlier years for which classes have been discontinued). Each year, the undepreciated balance of each class is increased by the cost of additions, and decreased by the proceeds of disposals (but not any proceeds in excess of the asset's original cost). A taxpayer may claim any amounts as an allowance for the year up to a maximum, generally determined as a defined percentage of the net undepreciated balance of the class.^a The amount of capital cost allowance claimed reduces this undepreciated balance. If the net balance in the class becomes negative, this amount – representing excess allowances – is recaptured and added to income, and conversely, if the class still has a positive balance after the last asset has been disposed of, then the taxpayer can claim this amount as a terminal loss. The result is that, over a period of years, the taxpayer will be able to claim the net cost (unadjusted for inflation) of the assets in the class (the original cost less applicable proceeds of disposal).

The classes of capital cost allowance include not only classes that are based on the nature of the asset, (such as buildings – Class 1), but also those that are based on the purpose of the asset (Classes 24 and 27, pollution control equipment) or the nature of its use (various classes for certain resource and manufacturing assets).

There are a few types of assets (for example, leasehold improvements in Class 13) for which allowances are provided at a uniform rate of the original capital cost (straight-line method) instead of under the usual declining balance basis. There are also special and more complex rules relating to certain resource and other capital expenditures.

In recent years, total capital cost allowance earned by corporations for tax purposes has been moving closer to financial accounting depreciation. In 1993, the total of capital cost allowances earned by Canadian corporations was about \$56 billion (“earned” being the maximum amount that could be claimed, the actual amount claimed being less since the allowance is a discretionary deduction), and was still somewhat larger than amounts of depreciation recorded for financial accounting purposes.^b These numbers have been affected by the slow down in investment during the early 1990s when older assets with straight-line accounting depreciation rates were proportionally more important, and the fact that these older assets had already been written off more quickly prior to the 1990s under the capital cost allowance system based on the declining balance method. They also reflect – perhaps more importantly – the 1987 tax reform measures that resulted in many capital cost allowance rates being revised downward to match better estimated economic depreciation rates.

^a In general, only half the normal allowance can be claimed in the year that the asset is acquired and first used.

^b Capital cost allowance claimed was less than financial depreciation from 1989 to 1994. For example, in 1993 capital cost allowance claimed was about \$41 billion compared with about \$46 billion in depreciation for financial accounting purposes (and about \$56 billion in capital cost allowance earned). See further our discussion in the following section on losses in this chapter.

Why Capital Cost Allowances are Sometimes Higher than Accounting Depreciation Expenses?

In the past, governments have permitted taxpayers to write off assets at accelerated rates under the tax system for a variety of reasons. In some cases, a government has simply wanted to encourage businesses to invest in particular assets such as water and air pollution control equipment or manufacturing equipment by providing capital cost allowances well in excess of economic depreciation costs. The acceleration of deductions for tax purposes reduces income for tax purposes in early years and results in smaller deductions, and greater income, in future years relative to the true economic cost of depreciation for the asset. In this way, accelerated capital cost allowances provide a financial advantage to businesses that invest in depreciable assets, since they have more cash flow, net of taxes, to finance their investments during early years.

Thus, the fact that capital cost allowance claims by businesses under our present tax system are sometimes in excess of the depreciation expense recorded in the books of those same businesses needs to be considered carefully in relation to the following:

- There is evidence that, in an era of increasing technological change, the contribution that capital assets can make to the productive process is higher in their initial years of use than it is in later years when the asset is no longer the newest or most efficient model. This argues for a method that grants larger allowances in these initial years to account for greater economic depreciation and the risk of obsolescence.
- The simplicity of our present capital cost allowance system is based on applying up to a maximum percentage write-off rate to the balance of undepreciated costs in a class of assets. Calculating the maximum annual allowance on a pool of assets on a declining balance basis inevitably “front ends” the depreciation claims for tax purposes, in the sense that the annual allowance – as determined by applying a rate to a balance of unrecovered capital costs – will be higher for any one asset in its initial years of use. The front ending of deductions can be justified as a by-product of the simplicity and ease of application of the Canadian system, which avoids both the requirement to keep detailed records for each individual asset. It may also be more consistent with the facts of modern technological circumstances than straight-line methods.
- Capital cost allowances are based on the historical cost of the asset, without allowance for inflation. To the extent that there is inflation present in the system – and inflation is clearly still an appreciable factor over a period that represents the useful life of many long-lived assets – then deducting allowances based on this historic cost over a long period of time in the current dollars of each year will not recover to the business the true inflation-adjusted cost of the asset. In the presence of inflation, capital cost allowance rates that are set close to book depreciation rates are often inadequate to fully cover the true cost of replacing assets. The effects of inflation on the cost of replacing assets, however, can be partly offset by the deductibility of interest expense, unadjusted for inflation, from income.

Other Timing Differences that may be Disadvantageous to Business

When assessing the appropriateness of certain accelerated deductions, it should be remembered that there are a number of other significant deductions, which, while recognized for financial accounting purposes, can only be deducted later – perhaps many years later – for tax purposes. These rules may more than offset the advantages accruing to businesses that are able to claim capital cost deductions more rapidly than they depreciate them in their own records.¹⁰

There are tax policy reasons why certain costs should not be deductible for tax purposes until the amounts involved are determined. It is nevertheless clear that timing differences between the calculation of income for tax purpose and income for accounting purposes do not all go one way.

Comparisons with Other Countries

While the Committee did not undertake a detailed comparison of the Canadian capital cost allowance system with those of other countries, we note that, on average, Canadian write-off rates are not out of line with those of many other developed countries (see Table 4.2 for estimated average declining balance or straight-line depreciation rates for manufacturing and services for 1995). We noted especially that, while the Canadian capital cost allowance system is roughly comparable in terms of the speed of write-offs to that of the United States, it is vastly simpler in design and involves substantially less effort by taxpayers and tax administrators alike. There are some significant differences in the treatment of certain kinds of assets – for example, Canadian structures are depreciated at rates somewhat less than in France and Mexico, while machinery can be written off somewhat more quickly than in Mexico and Japan.

Table 4.2

Average Capital Cost Allowance Rates on a Declining Balance (DB) and Straight-line (SL) Basis^a for Structures and Machinery – Major Trading Partners, 1995

	Manufacturing		Services	
	Structures	Machinery	Structures	Machinery
	(percentage)			
Canada	5 DB	39 DB	5 DB	29 DB
France	5 SL	15 SL	5 SL	15 SL
Germany	4 SL	15 SL	4 SL	15 SL
Italy	3 SL	13 SL	3 SL	13 SL
Japan	4 SL	10 SL	4 SL	10 SL
Mexico	5 SL	10 SL	5 SL	10 SL
United Kingdom	4 SL	25 DB	4 SL	25 DB
United States	6 DB	32 DB	7 DB	34 DB

^a Calculations based on estimated average depreciation rates for structures and machinery assets. U.S. rates are converted to equivalent declining balance rates.

Source: McKenzie, Mansour and Brûlé (1997), Technical Committee Working Paper 97-15.

Conclusion

The Committee concludes that the present capital cost allowance system works relatively well. We believe that in both concept and application, it is superior to more elaborate and substantially more complex tax depreciation methods used by some other countries.

Encouraging a Neutral Capital Cost Allowance System

It is the Committee's view that the guiding principle for the capital cost allowance regime should be "neutrality"—capital cost allowance rates should correspond roughly to the economic depreciation. This is consistent with our overall view that lower corporate tax rates are more efficient as an incentive than highly accelerated depreciation rates. Furthermore, to more accurately reflect actual experience, the calculation of the economic costs of replacing assets that depreciate should include the factors that have an impact on the economic contribution of the asset to earning income for its owner. These factors would include a recognition of estimated useful life of an asset and anticipated changes in capital values that arise from the effects of technological change.

The Committee also believes that, as a matter of general principle, the capital cost allowance system should not be used to deliver special incentives for business to invest in particular assets. Such incentives tend to work against achieving an income tax system with a broad and neutral base, and low compliance and administration costs. To the limited extent that incentives to acquire particular assets are regarded as necessary and are required to be provided by the tax system, for the following reasons, we suggest that they should be delivered through the investment tax credits rather than accelerated capital cost allowances:

- Investment tax credits – reductions in tax in the year that the asset was acquired – are generally a more efficient incentive than accelerated allowances, because the benefit is provided up front where it can assist in financing the cost of the asset, rather than over some period of years.
- The use of investment tax credits makes the incentive more visible and therefore imposes accountability as well as avoiding distorting the income tax base.
- The use of federal investment tax credits instead of accelerated allowances minimizes the entanglement of federal and provincial tax systems. The cost of a federal initiative is thus borne by the federal government and not shifted in part to the provinces (through alterations in the common

tax base), thus preserving the integrity of the taxable income base for both levels of government. (The issue of disentangling federal-provincial tax policies is discussed in detail in Chapter 11 of this Report.)

R E C O M M E N D A T I O N S

We recommend that special incentive rates of capital cost allowances – rates that appear to be substantially in excess of economic depreciation – be phased out or reduced over a transitional period. Specifically, we suggest that the neutrality and allocative efficiency of the system would be enhanced by the following measures:

- **The capital cost allowance write-off rates applied to class 38 and 43 (including earth-moving equipment and manufacturing and processing assets) be reduced from 30 percent to 25 percent.¹¹**
- **The items included in class 12 (including tools, library books, and computer software) be reviewed, and those items with a significant cost and a useful life of four years or more should be moved into a new class with a 50 percent annual rate instead of the present 100 percent rate applied to class 12.**
- **The generous write-off rates on Canadian-built and other vessels should be reviewed.**

In Chapter 5, we make recommendations for a reduction in the capital cost allowance rates on certain resource assets and for a modification of the immediate write off of equipment and structures used in research.

The Committee's recommendations for some restriction on capital cost allowance rates should be viewed in context with our proposals for a significant reduction in corporate income tax rates. Taken together, we believe that our recommendations would result in a fairer, and more neutral and efficient system with positive economic results.

A Detailed Review of Asset Classification and Rates of Allowance

The Committee notes that the present rates of capital cost allowances for most classes have remained substantially unchanged for some years, as has the system for segregating assets into separate classes. A detailed review of the classification and write-off rates of individual assets for tax purposes is beyond the scope of the Committee's mandate.

We recommend that the government review the classification and rates of allowance for capital assets for income tax purposes to ensure that they take into account economic lives.

This review should take into consideration the following factors:

- The evidence that the useful lives of many capital assets are shortening should be considered, in relation both to the assigned maximum allowance rates and the present classification of assets.¹²
- There is some evidence to suggest that capital cost allowance rates on certain assets, particularly those subject to high technological obsolescence, are not adequate. As just one example, the possibility that rates of allowance on coaxial cable for utilities might be too low is suggested both by

knowledge about the anticipated useful life of such assets, and by the fact that the Canadian rate is less than half of the average write-off rate allowed in eight other industrialized countries. Research indicates that the write-off rates on various other classes of assets – including rail cars and some computer systems – may also be less than adequate.

Losses for Tax Purposes

Background

Although a business expects to earn profits, the fact that it may incur losses is recognized and addressed within the income tax system. Losses for tax purposes generally arise for two reasons. First, a business may suffer economic losses whereby its revenues from the sale of goods and services and financial income are insufficient to cover wages and salary costs, materials, interest on borrowed money and appropriate depreciation of capital. Second, losses for tax purposes may arise when some forms of income are not subject to taxation, or when costs are written off more generously for tax purposes compared to economic costs. For example, certain costs measured for tax purposes may be greater than those recorded for financial accounting purposes, such as in the case when governments permit firms to write off capital expenses on an accelerated basis rather than at a depreciation rate that reflects their true economic cost.

When losses are incurred by businesses, government must determine how such losses should be treated in the tax system. This is an important issue: in each year from 1965 to 1985 at least 45 percent of corporations reported zero taxable income or a loss. Moreover, as shown in Table 4.3, the cumulative amount of unused tax losses of corporations in Canada has grown from \$68.5 billion in 1985 to \$115 billion in 1993, while total unused investment tax credits have increased from \$3.4 billion in 1985 to \$4.4 billion in 1993. It can take a significant amount of time for losses to be used. For example, only \$13 billion of losses were applied to reduce taxable income of corporations in 1994, which is about 10 percent of the 1993 total carry-forward of unused deductions. Not all loss carry-forwards are able to be claimed by businesses in the carry-over period.

Table 4.3

Stock of Unused Allowances, Deductions and Credits

1985 to 1993 Taxation Years

Year	Deductions				Total of Unused Deductions	Credits
	Stock of Unused Non- capital Losses	Unused Capital Cost Allowance ^a	Stock of Unused Earned Depletion	Unused Resource- related Expenses		Stock of Unused Investment Tax Credits
	(\$ millions)					
1985	35,580.4	18,599.5	8,219.7	6,106.6	68,506.2	3,350.7
1986	35,798.0	18,537.7	6,339.2	4,438.6	65,113.5	2,771.9
1987	32,282.5	16,377.6	6,398.1	6,008.9	61,067.1	2,158.5
1988	42,010.8	15,638.3	7,371.4	6,476.2	71,496.7	2,750.4
1989	44,924.7	16,937.3	6,082.7	5,947.5	73,892.2	3,043.3
1990	60,858.0	17,033.7	6,316.0	6,565.2	90,772.9	3,556.7
1991	75,052.6	17,758.3	4,872.5	7,207.8	104,891.2	3,677.8
1992	87,576.9	16,996.8	4,801.2	6,995.8	116,370.7	4,052.4
1993	87,522.4	15,525.0	4,356.6	7,895.0	115,299.0	4,375.7

^a Unused capital cost allowance refers to the difference between what could have been claimed (earned amounts) and the actual amount claimed in a year.

Note: Components may not sum exactly to totals due to rounding.

Source: Data and technical assistance provided by the Department of Finance.

Further, as shown in Table 4.4, the accumulated federal tax value of unused losses, deductions and credits was \$31.3 billion in 1993¹³ – about three times larger than federal corporate income taxes collected in 1993. The size of the federal tax value of accumulated unused losses, deductions and credits is related in part to the recession of the early 1990s, and in part to past and continuing tax preferences for certain business activities. Some tax preferences, such as earned depletion, were discontinued by the late 1980s, yet as indicated by the figure for 1993, significant amounts of earned depletion still remain to be used.

Table 4.4
**1993 Summary of Federal Tax Values
of Unused Losses, Deductions and Credits**

	Federal Tax Value of Unused Non- capital Losses	Federal Tax Value of Unused Capital Cost Allowance	Federal Tax Value of Stock of Unused Earned Depletion	Federal Tax Value of Unused Resource- related Expenses	Federal Tax Value of Stock of Unused Investment Tax Credits ^a	1993 Total Federal Tax Value	1993 Federal Corporate Income Taxes Paid
	(\$ millions)						
Agriculture, Forestry and Fishing	117.3	31.5	0.0	0.0	98.3	247.1	102.7
Mining	602.0	362.7	792.1	858.6	170.1	2,785.5	57.5
Oil and Gas	737.8	168.2	423.6	1,258.2	281.5	2,869.2	643.6
Manufacturing	4,020.2	1,562.2	73.0	1.2	1,983.4	7,640.0	2,251.5
Construction	1,085.8	68.1	53.7	4.0	37.6	1,249.3	402.5
Transportation and Storage	826.8	288.8	4.0	3.6	221.4	1,344.6	237.9
Communications	652.5	164.9	0.0	0.0	35.6	853.1	422.1
Public Utilities	77.3	151.4	1.1	2.1	4.0	235.9	347.2
Wholesale Trade	1,099.4	151.9	1.1	2.6	124.0	1,378.9	848.7
Retail Trade	843.2	42.4	1.3	0.0	4.5	891.4	411.6
Deposit-taking Institutions	2,054.3	77.0	0.0	0.6	71.6	2,203.6	890.5
Other Finance	7,235.4	279.2	48.6	139.3	85.2	7,787.7	2,151.4
Other Services	1,280.0	162.6	2.1	4.1	274.0	1,722.8	1,034.8
Other	61.9	30.9	2.8	2.7	5.6	103.9	39.1
Total	20,693.9	3,541.8	1,403.4	2,276.9	3,396.9	31,312.9	9,841.0

^a The 'federal tax value of unused ITCs' reflects the amount of unused ITCs (shown in Table 4.3) adjusted for the impact of the reduction in capital cost or the income inclusion in the year following the use of the credit.

Note: Components may not sum exactly to totals due to rounding.

Source: Data and technical assistance provided by the Department of Finance.

The treatment of losses in the tax system is a long-standing issue that has been subject to considerable study in the past.¹⁴ As noted earlier in the Report, corporate income tax reforms of the mid- to late 1980s were in part a response to the accumulation of losses for tax purposes by corporations throughout the 1970s and early 1980s. In particular, the base-broadening measures of 1986 and 1987 were intended, among other objectives, to reduce the accumulation of losses for tax purposes. Moreover, since 1987, the federal government has placed additional restrictions on the use of tax losses by imposing further limitations on the transfer of tax losses from one taxpayer to another, along with special rules on after-tax financing, leasing and tax shelters.

A significant issue for governments is to determine the extent and manner in which accumulated losses for tax purposes can be effectively claimed to reduce tax liabilities or refunded.

What is Meant by the Refundability of Losses?

Full refundability of losses under the tax system implies that, when a loss is incurred, that is when income is negative, the government will provide a refund or offset equivalent to the tax value of the loss, thus treating annual losses and profits symmetrically. The strongest argument in favour of refundability of losses is that it treats businesses more fairly and improves neutrality in the tax system. Full refundability of tax losses would ensure that the tax system does not discriminate against businesses facing risk in markets and against sectors that inherently have more volatility in earnings. It also allows growing firms that experience economic losses incurred in early years to compete on the same basis as established firms with a steady or increasing level of income over time.

Refundability also may improve competitiveness and market efficiency by allowing firms to enter more easily into, as well as exit from, industries.¹⁵ It permits businesses to organize themselves in corporate groups of separate companies for regulatory and business-related reasons without being penalized for tax reasons. Moreover, with refundability, firms that incur losses for tax purposes can immediately use tax incentives such as accelerated depreciation and investment tax credits, just as profitable firms can do under the present provisions.

Alternative mechanisms for allowing full or partial refunds or offsets include:

- a cash refund paid to the firm equal to the tax value of the loss (full refundability);
- permitting firms to flow out deductions to the owners to reduce personal taxes owing on their personal income. (The value of the loss deduction to the owner is equivalent to that taken by the business only if the corporate income tax rate is equal to the tax rate faced by the shareholder);
- allowing operating income and losses from different sources within a business to be offset for tax purposes (almost universally followed);
- the carry-back of losses against previous years' income allowing for a refund up to the amount of past taxes paid by the business;
- the carry-forward of losses to reduce future years' income, and therefore the amount of tax payable on such income. (If the losses carried forward were to be increased by a rate of interest, the present value of future tax savings would be equivalent to an immediate refund);
- allowing firms in a corporate group under common control to consolidate profits and losses of the members for tax purposes, thereby allowing the losses of one corporation to be offset against the income of another; and
- permitting losses incurred by a business that is liquidated, merged or acquired to be transferred to the purchaser or successor to reduce its income.

The last five methods above are the most widely used approaches in most countries – and have been employed in the Canadian system at one time or another – but these alternative approaches raise an issue fundamental to the notion of refundability: Who should be regarded as the “owner” of undeducted losses for these purposes? Does the loss “belong” to the business that incurred the loss, to the corporation that owns the business, or to the shareholders who own the corporation? And as a separate point, should the owner have the right to obtain the value of the loss by selling it to others?

- If a loss is considered to “belong”, in some sense, to the business, then the loss should follow the business if it is transferred from one owner to another.
- If it “belongs” to the corporation, then the loss should not be transferable to other corporations or to individuals.
- If it “belongs” to the shareholders or to the corporate group of which the company is a part, then there should be some provision for the loss to be transferred from the loss corporation to another taxpayer within the group or to its shareholders.

The present Canadian tax system has elements of all three of the above approaches for corporations. It is also noteworthy that for individuals, losses effectively belong to the individual – they cannot be transferred to another individual even upon death.

The Effect of Refundability on Businesses

Despite the theoretical arguments in favour of refundability, tax systems around the world have uniformly rejected the full refundability of losses for tax purposes, generally permitting only limited means for using losses. Several reasons are advanced for restricting the use of losses in this manner:

- to reduce the availability of tax incentives to inefficient businesses that are more likely to earn a low economic rate of return on their investments compared to efficient businesses;
- to reduce the scope for tax evasion that arises when businesses report claims for refunds without actually suffering the losses for which claims are made;
- to preserve the business tax base and to prevent a substantial revenue loss to governments. Given the importance of multinational business, full refundability in Canada would attract losses into the country, without necessarily improving the climate for investment. For example, businesses would be further encouraged to finance international operations with debt issued in Canada. The Committee is especially concerned that refundability in a world with increased international economic integration would result in a substantial loss in revenues that would need to be offset by higher tax rates in Canada; and
- to reduce the volatility of corporate income tax revenues and resulting spill-over effects into other parts of the tax system. The full and immediate refundability of losses would substantially reduce or virtually eliminate corporate income tax revenues for several years. With reduced taxes on businesses, governments would need to increase business taxes by other means such as increasing the capital tax. Other arguments aside, this final point must be a major practical consideration in forming government policy on loss refundability and transfers.

The Committee is thus of the view that the only appropriate approach is one that, as under the present system, allows for the refund or transfer of losses on a strictly controlled basis. Provisions that allow refunds in respect of the tax value of losses in some circumstances are necessary to treat risky and growing firms in a more equitable manner, and to improve fairness. We believe, however, that unrestrained refundability would result in an unacceptable loss of revenue to government. A balance must be struck between the desire to provide the full neutrality benefits of refundability, and the need to maintain government revenues.

Current Canadian Tax Treatment of Business Losses

The existing Canadian income tax system effectively provides partial refundability in respect of losses, but subject to complex limitations designed to restrict the ability to transfer losses among taxpayers.

Non-capital losses – that is, losses that result from business operations – incurred in a taxation year may be carried back by a taxpayer to reduce taxable income of the immediately preceding three years, and may be carried forward to reduce income in the following seven years. Losses are not adjusted by an interest factor relating to the time difference between when the loss was incurred and when it was used.

Capital losses incurred in a taxation year may be carried back to reduce net capital gains of the preceding three years, and may be carried forward to reduce net capital gains in any subsequent year.

To prevent the effective transfer of losses to other taxpayers, the *Income Tax Act* contains a number of restrictions of the carry-forward of losses by a corporation. For example, if control of the corporation changes, non-capital losses otherwise available to the corporation may not be carried forward to a subsequent period, unless the corporation continues to carry on the business in which the loss was

sustained and the loss may only be used to reduce income from that or a similar business. Also, on a change of control of a corporation its unused capital losses are eliminated. These limitations restrict the ability of the owners of a corporation, with accumulated business losses, to realize some return for those losses by transferring control of the corporation to new owners who could use the losses.

The *Income Tax Act* also provides flexibility to taxpayers who earn, but who are unable to immediately use, certain tax credits. Investment tax credits (ITCs) earned but not utilized by a corporation to reduce tax payable in a taxation year may be carried back to reduce tax payable of the immediately preceding three years, and may be carried forward to reduce tax payable in the immediately following 10 years.

The Canadian tax system also provides limited opportunities for cash refunds to firms with unused tax credits and losses. For example, refunds equal to 40 percent of unused R&D tax credits are payable to most firms, with 100 percent being available in some cases (see further discussion in Chapter 5 on R&D).

An issue that has raised difficulties for many years is the appropriate treatment of losses (and other potential tax benefits) in individual corporations within a corporate group under common ownership or control. Many taxpayers are obliged to carry on business in a number of separate corporations for business reasons, and are of the view that when losses are incurred by one corporation in the group, those losses should be allowed to be transferred to a corporation in the group.

Unlike a number of other countries, Canada has no specific rules that permit such transfers. The United States permits a corporate group with 80 percent ownership to file consolidated tax returns, with a full offset of deductions, losses and credits within the group, while in the United Kingdom, corporations with 75 percent common ownership are allowed to transfer losses to each other by use of subvention payments.

The Canadian tax rules deal with a number of particular situations. Losses may be transferred within corporate groups, subject to important limitations, for example, on the liquidation of a subsidiary into a parent corporation, or on an amalgamation of corporations. As well, losses incurred by corporations within a group with over 50 percent common control sometimes may, by rather complex means, be transferred to other corporations within the group.

It can be argued that, as in the United Kingdom and the United States, loss transferability to another corporation should be largely restricted to those situations where there is a high degree of continuing common ownership of the transferor and transferee, perhaps 75 percent or 80 percent. This would deny the economic benefit of the transfer of losses to the owners of some businesses. If a formal system of restricted loss transferability were introduced, it would be necessary to consider whether loss transfers that can now be accomplished within a corporate group by other means would also require this higher degree of continuing common ownership.

If a high threshold for continuing ownership was introduced as part of a formal mechanism for loss transfer, the question would arise as to whether provisions relating to loss carry forwards (which affect the ability to transfer losses within a corporate group) should also be modified. This would require a major restructuring of long-established rules in a number of areas, with potentially broad effects on corporate taxpayers.

For these reasons, there is substantial difficulty in determining the degree of common ownership or control that might be required in a rationalized loss-transfer system, including all related provisions.

The Committee nonetheless suggests that the government undertake a review of loss transferability and the restrictions on loss carry-overs, to see if the rules could be changed to reduce administration and compliance costs. In particular, the Committee is of the view that the tax system should provide a more straightforward means of transferring losses within a group of companies with common ownership.

Flexibility in Loss Recognition

The *Income Tax Act* also provides flexibility to taxpayers who may wish to limit the amount of their reported losses for income tax purposes. Corporations and other taxpayers can claim less than the maximum permissible amount of certain discretionary deductions in a particular year, thereby preserving deductions for subsequent years. These unclaimed discretionary deductions are similar to losses, in that they are carried forward and deducted in subsequent years to reduce income that would otherwise be subject to tax but, unlike these losses, never expire.

Among such discretionary deductions are capital cost allowance. If less than the maximum permissible capital cost allowance claim is made, the balance available for deductions in future years is increased. Other discretionary deductions that can be the equivalent of losses include certain R&D expenses and various resource exploration and development (E&D) costs. Taxpayers are allowed to accumulate such expenses in pools from which they are permitted to deduct a portion of the balance (varying from 10 percent to 100 percent) each year against income. Some of these deductions cannot be used to create or increase losses, but they are generally available for an indefinite carry-forward subject to certain restrictions.

The effect of all these measures is to provide taxpayers with substantial flexibility to extend the carry-over of losses beyond the generally applicable statutory period. These effects vary depending on the circumstances. In some situations – assets related to resource projects, for example – such flexibility is warranted, since the taxpayer may need to wait many years until sufficient income is earned on capital investment to absorb losses. In other cases, however, the flexibility simply provides an advantage to some taxpayers, with particular types of investments (for example, those with accelerated capital cost allowances) or with certain kinds of reserves, over other taxpayers who, owing to the nature of their business activity, do not have similar opportunities to extend the period in which losses may be used.

In limited cases, the current system also allows certain losses or deductions of corporations to flow out to shareholders. Oil and gas and mining corporations are permitted to renounce various non-renewable resource-based E&D expenses – which, because of accumulated losses, cannot be claimed immediately by the corporation – and, in effect, transfer them to investors using special “flow-through” shares. Similar provisions that allow companies to flow out certain intangible development costs to investors have been made available to encourage investment in renewable energy and energy conservation projects. The Committee suggests that the amount of such deductions flowed out to investors be adjusted to recognize the difference between effective corporate income tax and personal tax rates, so that benefits are limited to investors in those non-taxpaying corporations who cannot themselves use these expenses immediately for tax purposes.

Since partnerships are not treated as separate legal entities for tax purposes, losses incurred by general or limited partnerships may be used by the individual partner-owners to reduce taxable income. The provisions for partnership losses have, however, allowed for the development of tax shelters, whereby certain losses or tax credits are flowed out to investors to reduce personal income taxes. In recent years, the federal government has limited the use of losses claimed by limited partners by such means as the “at risk” rules and other provisions related specifically to tax shelter investments.

R E C O M M E N D A T I O N S

The Committee believes that, in general, the existing system of loss carry-overs, transfers and refundability represents a reasonable compromise between competing policy objectives. However, we make the following recommendations:

The federal government should consider, in consultation with the provinces, a formal system for transferring losses between members of the same corporate group, starting with a review of the 1985 federal discussion paper.

A formal loss-transfer system would permit the transfer of losses within a corporate group that has a defined common ownership. While such transfers are now available to many taxpayers able to undertake complex transactions, a formal loss-transfer system would permit such transfers to occur at lower cost, and would make the procedure available to taxpayers now prevented by non-tax reasons from undertaking such transactions.

The federal government should review the right of taxpayers to claim various deductions on a discretionary basis, with a view to moving toward a better measure of annual income for tax purposes and eliminating inappropriate advantages provided to some taxpayers.

This review should consider making some deductions mandatory, in whole or in part, such that the effective carry-over of deductions or allowances is more limited. At the same time, consideration should be given to an extension of the general corporate loss carry-forward period.

Given the Committee's proposed reductions in corporate income tax rates, adjustments should be made to flow-through share rules to reflect the new relationship between corporate and personal income tax rates.

Corporate Capital Tax

Background

The federal government levied \$1.4 billion in capital taxes, and the provinces levied a further \$2.9 billion in annual taxes on the capital of corporations in 1995. In Alberta, Newfoundland and Prince Edward Island, capital taxes are limited to large financial institutions, while other provinces levy capital taxes on both non-financial and financial businesses. In the case of the federal government, capital taxes are levied on both financial institutions and large corporations.

Taxes on the capital of corporations are levied in a number of countries, and often at relatively low rates. In some cases, the tax functions almost as a nominal licence fee for the privilege of incorporation. In Canada, corporate capital taxes tend to be more substantial, levied not just on corporate equity (which might be taken as the aggregate shown for shareholders equity on a balance sheet) but on a base that includes a large part of the company's debt.

Why Tax Corporate Capital?

Justifications for the taxation of a corporation's capital fall into a number of categories, most of which, in the Committee's view, are not persuasive. It has been argued that capital taxes are:

- The equivalent of an annual wealth tax at the corporate level. In Canada, such a justification for the tax makes little sense, since Canada has no general wealth tax on individuals (although there is a tax on property), and in any event, the wealth of a corporation is not necessarily connected to the wealth of its individual shareholders. A large corporation can be owned by many small shareholders, while a more modest-sized corporation can be owned entirely by a single, wealthy individual.
- A presumptive income tax regarded as possessing two virtues. It is relatively easy to assess, because corporate capital is easily identified, and corporate capital is related, if very imperfectly, to corporate income. Canada already has a comprehensive system for taxing corporate income, so it seems inappropriate to employ a less perfect measure of that income – corporate capital – in favour of the more accurate corporate income tax base. In situations where income has been understated the capital tax has served as a presumptive tax for this purpose.
- A form of minimum tax on corporations. It has been argued that a minimum corporate tax is justified because it requires corporations, regardless of their profitability, to pay at least some tax. It is the Committee's view, however, that by making the current corporate income tax more fair and neutral (as set out in proposed measures elsewhere in this Report) the need to introduce a separate general corporate minimum tax for all corporations – with all its attendant complexities and distortions – can be avoided. The Committee does recognize that there are special circumstances that require a minimum tax to correct for past imperfections in the tax system, such as the development of after-tax financing in the 1970s and 1980s to transfer losses from non-financial to financial corporations.
- A charge or levy by the public sector for the privilege of incorporation. This rationale is not persuasive because capital taxes are based neither on the cost nor the value of incorporation, and are levied by jurisdictions other than that which granted the incorporation.
- A levy related to the benefits of public services received by corporations – essentially a user charge for public services. In this regard, the Committee notes that some property taxes, such as development fees, are already intended to operate as a user charge for municipal infrastructure and services. A justification for capital taxes as a charge for benefits is a weak rationale, because the tax is not linked to the use of specific public resources.
- A way to improve the efficiency of the corporate tax system generally. By having a capital tax, corporate income tax rates are kept lower than they would otherwise be, while the level of total tax revenues collected from the corporate sector is maintained. As discussed earlier, a lower corporate income tax rate in itself offers important advantages, since:
 - it increases the return to successful entrepreneurs and more efficient business;
 - it can improve neutrality in the tax system by reducing differences in effective tax rates across business organizations; and
 - it preserves the Canadian corporate tax base by lessening incentives to move revenues out of Canada and deductions into Canada through transfer pricing and debt placement.

Ultimately, the Committee is most convinced by this last, very practical argument. Canada already has important corporate capital taxes in its tax system, and we are concerned that simply abolishing the federal and provincial capital taxes would require corporate income tax rates to be raised substantially – perhaps by almost 9 percentage points (3 points federal and 6 points provincial) – if taxes on corporations were increased to make up for the lost revenue. Such an increase in corporate income tax rates would be detrimental to the overall efficiency of the tax system and could result in significant erosion of the tax base because of global rate competition. The Committee therefore accepts the necessity of federal and provincial corporate capital taxes in Canada's system,

although in a supplementary role and hopefully at lower rates in the future. Under our recommendations, the provinces will obtain substantial new revenues from base-broadening that would exceed the amount needed to reduce provincial corporate income tax rates by one percentage point. We suggest that the provinces use this excess to significantly reduce their capital taxes. In the future, if governments have the ability to cut business taxes while maintaining corporate income tax rates below international rates, it is the Committee's view that the capital tax should be further reduced.

Corporate Capital Tax Bases

For non-financial corporations, corporate capital taxes in Canada are usually levied on a base that includes equity and most debt, while for financial institutions the tax is applied primarily on equity and long-term debt, with an exclusion for deposits. Thus the tax is on the financial capital (roughly measured) used by a corporation rather than on the corporation's equity. The corporate capital tax base is reduced by an investment allowance to recognize situations where one corporation owns shares in another, thus avoiding double taxation of the same base.

Difference in Concept Between Federal and Provincial Corporate Tax Levies

The general federal capital tax is the large corporations tax paid by corporations at a rate of 0.225 percent on the amount by which the value of shareholders' equity plus most liabilities used in Canada, determined for financial accounting purposes, (less an investment allowance to avoid double counting of corporate capital) exceeds \$10 million. The corporate income surtax (generally 1.12 percent of taxable income) can be credited against the large corporations tax.

An additional, specific federal capital tax is levied on the capital of financial institutions (net of the investment allowance) at a rate of 1 percent of capital between \$200 and \$300 million and 1.25 percent of capital in excess of \$300 million. Capital for this purpose includes shareholders' equity and long-term debt. Corporate income tax paid by financial institutions can be credited against capital tax payments. Temporary surtaxes are also levied on capital of deposit-taking institutions and insurance companies but the surtax cannot be reduced by corporate income tax liabilities in the case of deposit-taking institutions.¹⁶

The provincial capital tax rates vary by province,¹⁷ but all provinces (not just those with general capital taxes) tax the capital of financial institutions, and at rates substantially higher than the average rates on other companies (see the description of rates and thresholds in Chapter 2). Some provinces have levied capital taxes on not only large but also smaller businesses with less than \$10 million in assets (Quebec, Ontario, British Columbia and Manitoba). General rates are highest in Quebec (0.64 percent) and Saskatchewan (0.60 percent).

The bases for provincial capital taxes differ from the federal base, and the provincial bases differ from one another. Provincial capital taxes are levied on capital measured according to a combination of tax rules and financial accounting. Further, investment allowances for provincial purposes are either generally less generous than under the federal rules or are not provided at all.

There is another important difference between federal and provincial capital taxes: provincial capital taxes are generally deductible in computing taxable income for both federal and provincial income tax purposes, while federal capital taxes are not.¹⁸ The fairly rapid increase in provincial capital taxes in recent years has, therefore, resulted in an erosion of the corporate income tax base (see further discussion in Chapter 11).

As noted above, the present federal capital taxes on financial institutions may be reduced by a corporation's "mainstream" income taxes (except for the capital surtax on large deposit-taking institutions), and the large corporations tax may be reduced by corporate income surtaxes.

In this way, therefore, federal capital taxes are effectively minimum taxes – though not minimum income taxes. They are only payable to the extent that the corporation does not have sufficient income tax or surtax within a carry-over period to offset the corporate capital tax.

The provinces' capital taxes, on the other hand, are additional or supplementary taxes, payable over and above any corporate income tax. The fact that the provincial capital taxes are deductible from income for federal and provincial corporate income tax purposes is discussed further in Chapter 11.

Features of Corporate Capital Taxes

Because the levels of corporate capital vary little over the economic cycle as compared to the levels of corporate profits, revenue from corporate capital taxes tends to be more stable than that from corporate income taxes. It should be noted, however, that the stability of the corporate capital tax revenues simply represents the fact that risk has been shifted from the government to the corporate sector. Corporate capital taxes are relatively fixed, in that they do not vary substantially from year to year, and any sort of tax that is fixed in amount, as a replacement for income tax, does have the positive feature of allowing efficient firms to generate additional profits without paying additional taxes, and thereby adds an incentive effect.

It is also important to remember that such profit-insensitive taxes add to the losses incurred by business during downturns in the business cycle, and impose greater burdens on firms with inadequate profits or with economic losses.¹⁹ In this way, capital taxes, and other profit-insensitive taxes, exacerbate the effects of cyclical downturns in the economy – an important consideration given Canada's relatively large export and resource sectors, and consequent exposure to unstable world prices. A heavy reliance on profit-insensitive taxes worsens the economic cycle by imposing a heavy burden at precisely the point where corporations can least afford it.

An additional factor to weigh when assessing capital taxes is international tax harmonization. Corporate income tax systems in some countries provide relief in respect of corporate income and withholding taxes on income remitted to the parent, up to the amount of their own corporate income tax. There is no foreign tax credit available, however, for capital taxes. To the extent that corporate income taxes are credited against foreign taxes, a switch from corporate income taxes to capital taxes can result in less corporate tax being credited against foreign taxes and can reduce the efficiency of the corporate tax in Canada.²⁰

As already noted, however, there are international competitive pressures on corporate income tax rates, and it can be argued that any country could be better served by keeping its corporate income tax rates low and supplementing its revenues by a corporate capital tax. However, as corporate capital taxes increase beyond modest levels, their impact will be taken into account in determining the cost of capital employed, and hence will have their own influence on businesses' evaluations of the competitiveness of the tax system.

One of the few advantages of a capital tax, in the Committee's view, is to allow lower corporate income tax rates. Corporate capital taxes must in the end be regarded as an imperfect surrogate for corporate income taxes. Their continuation as a component of Canada's tax system would appear to be more of a matter of fiscal necessity rather than a permanent feature of a well-designed and integrated tax system with less need for revenue.

Variations and Inconsistencies Among Tax Bases

As discussed above, the imposition of capital taxes in Canada by both the federal and provincial governments involves a number of different jurisdictions imposing capital taxes, with different thresholds and rates, using different methods of calculation, and on different industry sectors. The federal government alone imposes several capital taxes with somewhat differing bases, and the bases for provincial capital taxes differ from the federal and from each other. The result is that the calculation of corporate capital taxes impose unnecessary compliance costs.

In a federal state such as Canada, it is important to keep some distinction between the federal and provincial jurisdictions in the responsibility and accountability for the imposition of taxes. Corporate capital taxes have no separate justification other than as a rather partial substitute for corporate income taxes, and as a means of keeping the corporate income tax rate as low as possible. Federal and provincial governments need to treat the capital taxes that they impose as part of the overall corporate tax system. Viewed from this perspective, however, the lack of harmonization of the bases makes the tax costly to collect and comply with, and at the provincial level especially, encourages tax planning.

R E C O M M E N D A T I O N

We recommend that federal and provincial governments harmonize their capital tax bases to reduce compliance and administration costs.

Governments would retain the right to select and vary the rate of capital taxes, and thus would continue to have control and responsibility for their own revenues. Businesses would benefit from simplified calculations and more clarity in application of taxes arising from a harmonized base. Federal and provincial governments would also significantly benefit from a tax that would be easier to administer and more certain in application. A uniform base would make it feasible to have a joint collection mechanism for all provincial and federal capital taxes, and, as we suggest in Chapter 11 on federal-provincial issues, would offer a significant reduction in compliance and collection costs.

As set out elsewhere in our recommendations, we propose that the present corporate income surtax be integrated with the general corporate income tax rate and not levied separately. This implies that there would no longer be a partial offset of corporate income taxes against the large corporations tax, meaning that this latter tax would raise more revenue. However, since the corporation always pays the greater of either capital tax liabilities or the corporate income surtax, Canadian corporations would pay as a whole less corporate income and capital tax with the removal of the surtax. The effective increase in the burden of the large corporations tax through the removal of the offset could mean that the foreign parent companies of Canadian corporations would find a reduction in their ability to claim foreign tax credits. Some minimal adverse impact on their investment in Canada could result.

The proposal to eliminate the corporate income surtax is primarily a practical one. As the Committee stated earlier, we believe that there are significant benefits to Canada in reducing the general corporate income tax rate as much as possible in the interest of improving the efficiency of its tax system and minimizing base erosion. The role of the large corporations tax is solely to supplement federal corporate revenues – its role should be limited by fiscal necessity, and it and the other federal capital taxes should be reduced as fiscal conditions permit. When a capital tax is offset by corporate income taxes, the capital tax operates as a minimum tax. We see no need, however, for a general minimum tax on corporations as a permanent part of our system.

Endnotes

- ¹ As provincial income taxes are largely imposed on the same base, total variation in federal and provincial rates would show an even wider range than indicated above.
- ² See Whalley (1997b), Technical Committee Working Paper 97-8, for a discussion of various estimates of the efficiency gains from a more neutral corporate income tax system.
- ³ The international comparison of the real effective burdens of total taxation on corporations is a complex task. As just one point, while income tax rates on manufacturing companies in Canada may be roughly in line with those imposed on our major trading partners, the overall impact of taxes on manufacturing investments depends on detailed corporate tax rules relating to depreciation and other deductions, and the level of other taxes, including capital, property and sales taxes on capital inputs. As indicated in Chapter 3, effective tax rates on marginal investments in manufacturing are somewhat higher than those in the United States.
- ⁴ The surtax is discussed further in the section below on capital taxes.
- ⁵ The Canadian combined federal and provincial general rate of 33 percent would be lower than the minimum U.S. rate of 35 percent that is available in several states (the average U.S. rate is about 39 percent). With the 5 percent withholding tax on dividends paid to non-residents, the Canadian effective corporate income and withholding tax rate on income remitted to U.S. taxpayers would be about 36.5 percent. Although the Canadian corporate income tax rate would be well below a number of OECD countries, including Japan, Germany, France and Italy, it would still be higher than, for example, the United Kingdom (31 percent but proposed to be reduced to 30 percent), and Sweden (28 percent).
- ⁶ The manufacturing and processing reduction was provided beginning in 1973 in reaction to the introduction of the Domestic International Sales Corporation provision in the United States that allowed U.S. companies to be taxed at low rates on income earned from exports.
- ⁷ Buildings, structures and some other assets may have substantial value at the end of their assumed useful lives to a particular enterprise.
- ⁸ Source: Canada, Statistics Canada (1984) and (1994), and calculations by the Committee secretariat.
- ⁹ Declining and straight line methods can be equivalent in value for the firm. Equivalency is established when the present value of depreciation costs under the declining balance method is equal to that under the straight-line method. Equivalency can be approximated for a declining balance rate by multiplying the straight-line depreciation by a factor of two.
- ¹⁰ These rules include:
 - provisions for the best estimate of legal claims. For accounting purposes, a company must accrue its best estimate of outstanding claims, but in general, these can only be deducted for income tax purposes when actually determined or paid.
 - provisions for obsolescence and for the decline in value in certain capital assets. While these may be required for accounting purposes, in a number of circumstances they will not be recognized for tax purposes either until actually incurred or until the disposal of the last asset in a class of similar assets.
 - provision for a post-retirement benefit for retired employees. Under current accounting proposals, these costs must be accrued, for accounting purposes, over the working lives of the individuals, so as to match these costs with the contribution that the employees make to the generation of revenue. For tax purposes, however, the costs can only be deducted as incurred.
- ¹¹ As discussed, there may be some concern regarding the international competitiveness of new investment in manufacturing under our proposal. Any incentive should be provided by way of an investment tax credit.
- ¹² One limited solution to the possible uncertainties with respect to obsolescence and therefore useful lives in the rates of some capital cost allowance classes would be to allow taxpayers to elect to create more subclasses in respect of individual assets, so as to be eligible to claim terminal losses on the disposal of specific items. This would, however, complicate the overall system.

- ¹³ These data are the latest available. They do not include certain unused deductions related to financial and other reserves.
- ¹⁴ For a recent discussion, see the papers appearing in the Clarkson Gordon Foundation (1993) and Canada, Department of Finance (1985).
- ¹⁵ See Poitevin (1997), Technical Committee Working Paper 97-13.
- ¹⁶ The capital surtax on deposit-taking institutions is 0.15 percent of capital in excess of \$400 million. The capital surtax on life insurance varies from 0.5 percent to 1.0 percent of taxable capital employed in Canada between \$10 million and \$300 million and 0.25 percent over \$300 million.
- ¹⁷ For a comprehensive list of variations in the base for capital taxes on non-financial corporations, see McQuillan and Cochrane (1996), Technical Committee Working Paper 96-8.
- ¹⁸ As noted above, some federal capital taxes can be offset by federal corporate income taxes.
- ¹⁹ Capital taxes that operate as a minimum tax, such as the tax on financial institutions, allow for past corporate income taxes in excess of capital tax payments, to be carried forward to reduce future payments of capital taxes – this reduces the impact of capital taxes when firms are in a recession. Also, Quebec allows companies to exchange the corporate income tax value of losses to reduce capital tax payments.
- ²⁰ However, when Canadian corporate income taxes are high relative to foreign taxes, not all Canadian corporate income taxes will be credited against foreign taxes. In this situation, a modest switch from corporate income taxes to capital taxes will have a limited impact on the ability of foreign corporations to credit Canadian corporate taxes against foreign taxes.

Modernizing the Corporate Income Tax – Specific Provisions

5

Introduction

The existing tax regime contains special rules for certain industries and activities, as well as some significant incentives for particular businesses and sectors. While the Committee is committed to a more neutral system that would have the effect of reducing the number of incentives and special treatments, we recognize that some of these provisions are vital to important sectors of the economy. They deserve specific discussion and review in the context of the Committee's overall goal of ensuring that our tax system is structured to maximize the performance of the Canadian economy.

In the following pages, we consider five areas in which the corporate income tax contains special provisions and incentives:

- small business;
- research and development;
- resource industries;
- the Atlantic Investment Tax Credit; and
- financial institutions.

In each case, we assess the existing tax rules in relation to the Committee's core principle of neutrality, especially in relation to economic efficiency and fairness. We recommend the retention of important incentives for small business, research, exploration and some other areas, and propose modifications to the current provisions that would, we believe, bring these incentives into line with the central thrusts of the Committee's Report.

Small Business

Small and medium-sized enterprises play a vital role in the Canadian economy, providing valuable goods and services to consumers and other businesses, and making important contributions to employment, innovation and wealth generation. Small business¹ also benefits from a variety of preferential tax measures, which represent a notable departure from a neutral tax system, and give Canadian-owned smaller corporations one of the most favoured income tax regimes in the world relative to the general tax system.

The traditional rationale for the preferential treatment has been that small businesses face special difficulties not encountered by larger enterprises, and that they make a singular contribution to the economy and our social fabric. For example, it is suggested that small businesses are particularly adept at creating employment; that they experience special difficulties in obtaining financing and complying with regulations and taxes; and that they are obliged to bear significant taxes unrelated to profitability.

Small Business, Jobs, and Job Creation

Over 40 percent of all Canadians in the private sector are either self-employed or work in businesses with less than 50 employees. Self-employment alone accounts for 19 percent of private sector employment in 1996, up from 15 percent in 1981 (see further discussion in Chapter 3).

In terms of employees, as shown in Table 5.1,² 22 percent of 1993 private sector employment was in unincorporated business, 51 percent in Canadian-controlled private corporations (CCPCs¹) regardless of size, and 26 percent in public corporations (primarily large public and foreign-owned corporations).

In discussing the role of small business in promoting employment growth, it is important to note that not all small businesses create jobs equally. In the decade to 1989, for example, some 4 percent of small businesses accounted for 70 percent of total employment growth.³ The small business population is extremely heterogeneous, and is subject to considerable churning as enterprises start up or are shut down.

As shown in Table 5.1, new business entrants, mostly unincorporated businesses and CCPCs, hired an average of 365,000 employees per year in the period 1984-93. However, once established as a business, only 'other corporations' increased employment levels in these years – by a modest 16,000 employees per year – while unincorporated businesses lost an average of 194,000 employees per year and CCPCs dropped 68,000 employees per year.

Table 5.2 provides information that further illuminates these employment trends by examining how the status of CCPCs established in the year 1984 (the '1984 cohort') had evolved by 1992. Of the 46.9 percent of corporations in this cohort operating in 1985 that had no taxable income, 54 percent had exited by 1992, while 26 percent remained with no income and 18 percent grew in income but remained as a private corporation, and less than one percent became a public or a foreign controlled business. Turning to CCPCs in the cohort with taxable income of more than \$200,000 in 1985 (less than 0.8 percent of such businesses in 1985), 29 percent had exited by 1992, 45 percent declined in income and 21 percent remained with taxable income over \$200,000.

Table 5.2 also shows that 76 percent of CCPCs established in 1984 had fewer than five employees in 1985, and that by 1992, most of these businesses had either declined in size (47 percent) or remained stable (40 percent) in terms of employment. About 12 percent grew by 1992 to 5 to 19.9 employees and only 1 percent grew to more than 20 employees.

The essential conclusion to draw from these figures is that most of the net employment gains attributable to small business consistently come from either a few businesses, or the entry of new businesses. Relatively little employment growth arose from small businesses established for two or more years. In total, many more small businesses have declined in employment after establishment than have increased employment.

We also note the significant changes in the nature of employment itself. In light of recent corporate labour shedding and the dramatic increase in contracting out, the clear rise in self-employment numbers requires further scrutiny. While difficult to quantify, some preliminary research suggests that around half the decrease in employment in the business services sector may be accounted for by the increase in businesses contracting out work⁴ to self-employed individuals or other small businesses.

Table 5.1

Employment Dynamics – The Contribution of Business Entry and Net Growth of Existing Businesses, by Business Type, 1984-93

Employment Shares, by type of Business ^a	1984		1993		Total Change in Employment (,000 ALU)	Change in Share (% points)
	(,000 ALU)	Share (%)	(,000 ALU)	Share (%)		
Unincorporated businesses ^b	2,276	30	1,942	22	-334	-7.6
CCPCs	3,535	47	4,440	51	905	4.6
Other Corporations ^c	1,745	23	2,253	26	508	3.0
Total	7,557	100.0	8,635	100.0	1,078	0.0

Annual Average Change (,000 ALU) and Component Growth Rates (%)

Contributions to Employment Growth ^a	1984-88		1988-93		1984-93	
	(,000 ALU)	%	(,000 ALU)	%	(,000 ALU)	%
New Entrants ^d						
Unincorporated Businesses	177		141		157	
CCPCs	179		159		168	
Other Corporations	54		29		40	
Total	410		329		365	
Businesses over Two Years Old						
Unincorporated Businesses	-231		-164		-194	
CCPCs	141		-234		-68	
Other Corporations	123		-69		16	
Total	33		-468		-245	
All Businesses						
Unincorporated Businesses	-51	-2.3	-24	-1.2	-36	-1.7
CCPCs	319	8.0	-75	-1.6	101	2.6
Other Corporations	177	8.9	-40	-1.7	56	2.9
Total	443	5.4	-139	-1.5	120	1.5

^a Employment figures are based on **Average Labour Units (ALUs)**, representing standardized full-time employees, and are calculated by dividing the annual payroll of each enterprise by the average annual income for workers in the relevant province, industry (by 3-digit SIC code), and enterprise size class. This generally does not include self-employed individuals and primary owners of incorporated small business.

^b Excluding the public sector.

^c Includes public corporations, foreign-controlled corporations and taxable Crown corporations.

^d The employment impact of new enterprises is measured as the standardized employment in their birth year (the first year a payroll deduction account is registered with Revenue Canada) and the next calendar year.

Notes:

- The estimates shown above for total employment for different types of business are not official and may be subject to certain biases. They are included to provide an indication of overall characteristics of this special data base.
- Components may not sum exactly to totals due to rounding.

Source: Calculated from Hendricks, Amit and Whistler, Technical Committee Working Paper 97-11, Tables 2.2B, 2.3 and 2.4.

Table 5.2
Change in Size and Status of Employer CCPC Businesses, 1984 Cohort

Status in 1985		Change in Income, 1985-92				Status in 1992				
Taxable Income	Share of all Firms	Declined	Same Income Class	Grown ^{a,b}	Exit	CCPC with no Taxable Income	CCPC with Taxable Income	Public	Foreign	Other
(\$)	(%)		(%)						(%)	
0	46.9	n/a	26	18	54	26	18	0.3	0.2	1.4
1 - 200,000	52.3	24	38	1	34	24	39	0.1	0.1	1.9
> 200,000	0.8	45	21	n/a	29	18	48	0.0	2.3	3.2
Total	100.0	13	32	9	44	25	29	0.2	0.2	1.7

Status in 1985		Change in Employment 1985-92				Employment Level in 1992					Other Status
Number of Employees	Share of all Firms	Declined	Same Employment Class	Grown ^a	Dramatic growth ^b	0	0.1-4.9	5-19.9	20-49.9	>50	Other
	(%)		(%)					(%)			(%)
< 5	76.3	47	40	12	1	47	40	12	1	0.1	0.3
5 - 19.9	18.9	51	37	10	2	33	18	37	10	2	0.5
20 - 49.9	3.6	54	32	11	3	33	5	16	32	14	0.9
50 - 99.9	0.8	56	30	12	n/a	30	3	6	16	42	2.0
> 100	0.4	43	54	n/a	n/a	24	0	0	7	67	2.6
Total	100.0	48	39	11	1	43	34	17	4	2	0.4

^a Interpreted as moving up one size category.

^b Interpreted as moving up more than one size category.

Note: The 1984 cohort is defined as those CCPCs registering a payroll deduction account in that year.

Source: Calculated from Hendricks, Amit and Whistler (1997), Technical Committee Working Paper 97-11, Tables 4.6A and 4.6B.

Small Business: Special Circumstances and Constraints

This mixed pattern of small business growth might be explained, at least in part, by a number of obstacles reported by small business. The impediments to small business growth most often highlighted are restricted access to adequate financing, the compliance burden imposed by government taxes and regulations, and the financial difficulties that may arise from taxes that are not related to profitability such as payroll and property taxes.

Access to Financing: Access to financing can be a critical issue for small businesses, particularly for businesses in their early years without an established credit history, or in some knowledge-based sectors, where investments are concentrated in intangible assets. Initial risk capital for a new enterprise frequently comes from the owner, or from family and friends. Once these sources are exhausted, the difficulty of accessing external financing can cause many entrepreneurs to rely primarily on earnings accumulated in the business to finance future growth.

Smaller businesses are subject to more volatile performance and higher failure rates than larger businesses. In part, this arises because larger businesses typically have a broader range of products and locations, and greater internal capital resources (in relation to sales) than smaller enterprises. The resulting higher volatility and failure rate for small business translates into a higher cost of capital,⁵ in the form of higher interest rates on loans and a lower share price for new capital issues.

Information problems peculiar to small businesses can also affect decisions on financing. Better information is usually available for and about larger businesses – particularly public companies – so that lenders and investors are more able to accurately assess the risk associated with lending to a particular venture. Lacking information of similar quality, suppliers of funds have a reduced ability to analyse the average small business in order to determine the risk associated with a particular business or project. To put it another way, the cost of obtaining reliable credit information is relatively higher in respect of a smaller enterprise than for larger businesses intending to carry out the same activity.

The relative contribution of these information problems to the overall risk premium for small business is not clear, however. Nor is it clear that these information asymmetries result in a generalized small-business premium. What seems more likely is that relatively low-risk small businesses cross-subsidize higher-risk small businesses. The Committee notes that many financial institutions have improved their expertise in assessing and financing small business activity in recent years, suggesting that information biases – and the resulting costs to small businesses – may be less significant in the future.

Compliance Costs: The cost of complying with the large number of different regulations, taxes and other levies imposed by government often creates an onerous burden for small businesses. Unlike most large businesses, small businesses generally do not have the internal expertise to deal with tax issues, audit requirements, labour law and other regulations. As a result, they often must rely on outside assistance, which is relatively expensive per dollar of sales or assets.⁶ In any event, natural economies of scale dictate that the costs of such compliance for small enterprises are often larger, as a percentage of sales or assets, than for large businesses.

Profit-insensitive Taxes: As noted in Chapter 2, the largest part of the total taxes borne by business are not income taxes, but rather various levies not related to profits. For small businesses, the most important profit-insensitive taxes include property taxes, payroll levies, and sales and excise taxes on business inputs. These profit-insensitive taxes have been increasing faster than taxes on income,⁷ and can have a disproportionate impact on smaller businesses. Small businesses are inherently riskier than larger enterprises that generally have more adequate capital resources. For small businesses incurring losses, profit-insensitive taxes can exacerbate financial difficulties.

Also worth special note is the potential burden of payroll taxes on small business. They make up a significant proportion of all taxes paid by corporations and, like other profit-insensitive taxes, have risen in recent years. As pointed out in Chapter 3, there is evidence that a significant portion of payroll taxes is in the long run passed on to employees through lower wages, rather than being fully borne by the employer. It is also clear, however, that some small business employers may be less able to pass on these costs than larger firms, since their employees earn, on average, lower wages and are more apt to be working at or near the minimum wage.⁸

Current Policy Responses to the Needs of Small Business

There are a range of different types of policy responses that may be employed to assist small businesses in overcoming the difficulties outlined above. They include targeted government services (such as information and business support), small business financing, grant programs and specific tax incentives. All levels of government in Canada have, over the years, adopted policies to assist small and medium business, including a special system for the taxation of CCPCs. The incentives include:

- the small business deduction (SBD), which reduces the federal corporate income tax rate for CCPCs by 16 percentage points to 13.12 percent (with surtax) on the first \$200,000 of active business income. Provinces also have lower rates for CCPCs. Total federal and provincial rates vary from 18.12 percent in Newfoundland, Nova Scotia and the Northwest Territories to 22.62 percent in Ontario (see Chapter 2 for rates by province). These lower rates of tax on such income contrasts with the general federal corporate rate of 29.12 percent, and combined federal and provincial rates of 38.27 percent (in Quebec) to 46.12 percent (in Manitoba, Saskatchewan and New Brunswick). The deduction is reduced when companies become larger than \$10 million in taxable capital, and the \$200,000 limit must be shared among member corporations if there is an associated group;
- the ability for shareholder-managers of CCPCs to maximize the use of the small business limit and to reduce unintegrated tax. This can be achieved by the payment of bonuses to principal shareholder-managers to maintain taxable income at the \$200,000 threshold; the funds so paid are subject to personal tax only, and can be loaned back to the company if required in the business;
- a deferral of tax on stock options issued by small businesses to their employees when exercised;
- an enhanced scientific research and experimental development tax credit (see the following section in this Chapter);
- a \$500,000 lifetime capital gains exemption on gains on investments in the shares of large and small CCPCs and farm property (see Chapter 7);
- an enhanced treatment for investors in labour-sponsored venture capital corporations so that 150 percent of amounts invested in small business count towards the 60 percent business investment requirement for these venture capital funds;
- more generous treatment of capital losses incurred on the disposition of investments in smaller businesses;
- measures that reduce the tax compliance burden on small corporations, such as not requiring corporate income tax instalments unless federal taxes owing for the current and previous years exceed \$1,000, allowing CCPCs an extra month to remit any income tax owing, quarterly instalments for payroll tax remittances and deferring the payment of taxes in dispute until settled; and
- an exemption for the first \$10 million of assets under the large corporations tax that effectively eliminates federal capital taxes for small businesses. Most of the provinces also exempt or assess lower rates of capital tax on assets below a certain threshold, thereby providing relief to small businesses.

Small Business, Canadian-controlled Private Corporations and Tax Integration: An important effect of the lower rate for small business is that owners benefit from having their corporate and individual income taxes more fully integrated than do shareholders in larger businesses. For CCPCs, the combination of the lower rate of federal and provincial income tax of 21 percent, on average, on the first \$200,000 of active business income and the special regime of taxing income from property, along with the general dividend tax credit, means that the corporate and personal taxes on such profits are roughly integrated. A shareholder is expected to pay about the same total income tax (corporate and personal) on distributed profits as though he or she had earned the income directly. This favourable regime contrasts with the treatment of other income in the corporate sector, where

there is a substantial amount of unintegrated corporate income tax, and the total taxes on distributed corporate income is normally well above that payable if the income had been earned directly by individuals (see Chapter 7 for further discussion of this issue).

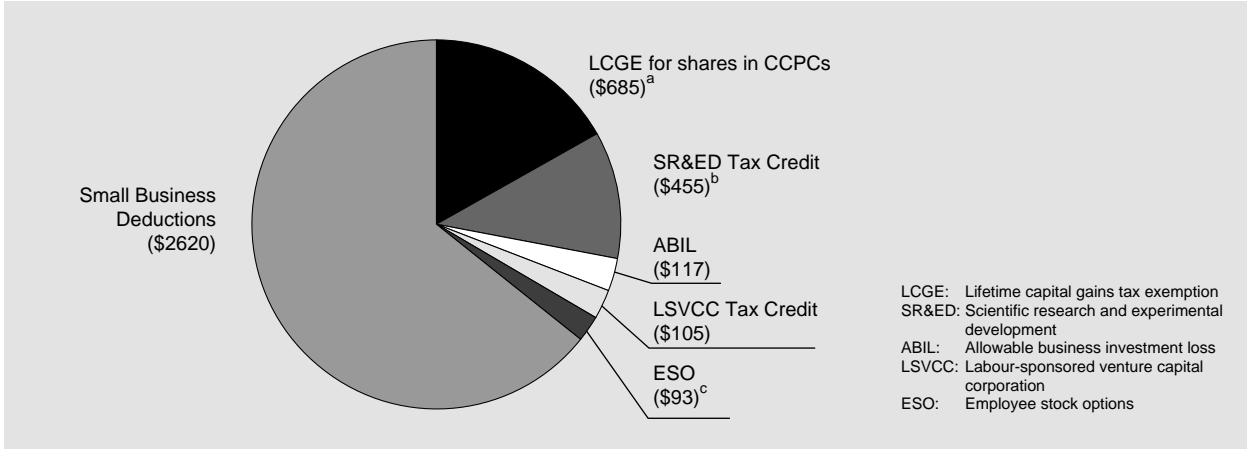
The benefits of this integration of corporate and personal income taxes are limited to Canadian-controlled, rather than foreign-controlled, private corporations. The intent of such integration is to ensure that Canadian residents receive the same after-tax return on business income (up to a limit) or investment income, whether received directly or through such a corporation. Non-residents operate under much different rules. Similar benefits of a low corporate income tax rate provided to foreign-controlled private corporations in Canada would be clawed back by taxes on foreign-source income earned by investors resident in countries that provide a foreign tax credit and would result in a significant erosion of the Canadian tax base.

A Favourable Tax Environment for Small Business Corporations

Added together, these provisions result in Canada’s income tax treatment of small business being among the most generous in the world. Measured both in terms of providing assistance to small businesses, and in terms of the total of foregone revenues to government, the small business deduction is the most important single item of assistance to small business (as shown in Chart 5A)

Chart 5A
Small Business Tax Support, 1997

(\$ million)



^a The LCGE exempts up to \$500,000 in lifetime capital gains per person on shares in one or more CCPCs, regardless of size.
^b Estimates represent amounts used by small business to reduce income taxes otherwise payable, plus credits refunded during the year.
^c This measure benefits both CCPCs and public companies.

Source: Canada, Department of Finance (1997) and Department of Finance estimates.

Most of the measures described here are intended to provide broad support for employment and wealth creation by small businesses, although some (such as the enhanced tax credit for R&D) represent the small business component of a broader set of policy measures. The Committee believes it is important to assess the effectiveness of existing measures in achieving their intended aims.

Access to Financing and the Small Business Deduction: To assist smaller Canadian-owned corporations that are having difficulty gaining access to external financing, the current tax system provides a preferential corporate income tax rate on the first \$200,000 of active business income, thereby increasing the proportion of business profits that can be retained for expansion and

investment. The overall impact of the measure is to reduce the aggregate federal tax burden of close to 300,000 corporations by over \$2.5 billion per annum, and to allow each profitable CCPC to benefit from this tax measure by up to \$32,000 each year. As discussed above, several provinces also provide lower corporate income tax rates to these same businesses providing additional benefits (see Chapter 2 for rates).

As noted earlier, Canada extends a high degree of tax support to small businesses. Approximately one third of OECD member countries have a reduced corporate income tax rate for small corporations, but in nearly all cases, the reduction in the general rate is less than that provided for in Canada. For example, the U.S. progressive corporate tax rate structure levies a reduced federal rate of 15 percent on the first US\$50,000, and 25 percent on the next US\$25,000, with provisions that recover the benefit of this reduced small business tax rate as income rises.

In addition, the U.S. government, for income tax purposes, has created a form of business entity known as the Sub-chapter S-corporation, which has the advantage of operating as a corporation with limited liability and ease of ownership transfer, but is treated as a partnership for income tax purposes. Sub-chapter S-corporations are generally not subject to corporate income tax, and income generated by their activities is allocated to shareholders and subject to personal income tax.⁹

Some Issues Related to the Small Business Deduction: While the Committee recognizes the role that the small business deduction plays in providing small business with greater cash flow to finance growing investment and employment, the small business deduction raises some issues.

While the federal small business deduction and lower provincial corporate income tax rates allow CCPCs to retain more of their taxable income, there is no requirement that the additional funds be invested in active business operations. As a result, the additional funds derived from the concessional tax rate may be used to acquire passive investments rather than being invested in active job-creating operations. When a CCPC retains business profits in the form of passive investment, this has the effect of deferring the additional personal tax on amounts invested that would otherwise have been paid upon distribution of the earnings. This confers a benefit on the individual shareholder who defers personal tax – not necessarily the intended goal of the tax preference.

It has been suggested that the income limit for the small business tax rate and higher R&D tax credit be increased.¹⁰ Advocates for raising the \$200,000 income ceiling maintain that, since income over the limit is effectively taxed at a higher rate, the current limit acts as an incentive to businesses to keep taxable income below \$200,000. The Committee notes, however, that the vast majority of CCPCs have business income well below the present limit; raising the limit would thus be of benefit only to a relatively few businesses. Moreover, in the view of the Committee, the fairness of such a change would be questionable. Many small corporations with \$200,000 or more of annual business profits are owned by wealthy individuals; an increase in the limit would provide this particular set of owners with significant new benefits without providing assistance to owners of smaller businesses. Finally, increasing the small business limit would introduce additional non-neutralities and distortions into the system. The Committee suggests that a higher-income threshold would not be consistent with the focus on assisting truly small businesses, which, as noted, do face high financing, compliance and other costs.

Instead, it may be more appropriate to reduce the general corporate tax rate (and thus the differential between the effective general and small business rates) rather than increasing the amount of income to which reduced federal and provincial rates apply. This change would provide a more favourable treatment to small businesses whose earnings exceed \$200,000, as well as to all other corporations. It would both reduce existing distortions and incentives for tax planning associated with the small business deduction and improve incentives to invest in business generally.

It is sometimes argued that the small business deduction, and the enhanced R&D tax credit, may deter some small businesses from “going public,” since many of the tax preferences intended for small businesses are provided only to CCPCs.¹¹ This is particularly relevant to small fast-growing

businesses, which may benefit from the additional equity funds that an initial public offering would provide. Against this, it seems likely that for many businesses considering public distribution of shares, the loss of this tax support will not be a significant factor, because the amounts of tax relief are modest in relation to the advantages. It should also be noted that a reduction in the top corporate tax rate to a level much closer to the small business tax rate would reduce any tax barriers to going public.

The Committee reviewed alternative means of providing tax support to small business corporations. For example, a targeted investment tax credit for capital purchases, or for investments in small business corporation share capital could be considered. Such incentives would, however, involve new complexities – such as means of limiting them to long-term commitments – and could introduce new distortions.

Table 5.3 sets out the distribution of the \$2.11 billion federal tax value of the small business deduction among eligible small businesses cross-classified by level of taxable business income and the amount of wages paid. For those businesses reporting salaries and wages, 30 percent of the small business deduction was claimed by businesses paying out less than \$100,000 in wages and salaries. A further 29 percent of the small business deduction was claimed by eligible businesses with wage costs between \$100,000 and \$300,000. Small businesses with payroll expenditures of over \$300,000 account for over 40 percent of the small business deduction. It is useful to note that over 80 percent of small businesses earn less than \$100,000 in income.

Table 5.3
Distribution of Small Business Deduction (SBD), 1993 (\$ millions)
by Business Income and Salary and Wage Costs

	Business Income (\$000)				Total	Percent
	Below 50	50 to 100	100 to 200	Over 200		
Wages (\$000)						
Less than 50	145	89	78	3	315	16.2
50 to 100	113	62	87	6	268	13.8
100 to 300	92	141	301	22	556	28.6
300 to 500	21	46	167	30	264	13.6
Over 500	21	43	344	133	541	27.8
	392	381	977	194	1944	100.0
No salaries reported	59	41	65	18	183	
Total SBD claimed	451	422	1042	212	2127	
% of SBD claimed	21.2	19.8	49.0	10.0	100.0	
Share of eligible firms	67.7	14.1	15.5	2.7	100.0	

Note: Components may not sum exactly to totals due to rounding.

Source: Data and technical assistance provided by the Department of Finance.

Conclusions and Recommendation

The information provided in Tables 5.1, 5.2 and 5.3 indicate that the current small business deduction provides assistance to many employment-providing companies, some of which have had significant growth. However, it is equally clear that many recipients of the small business deduction provide little or no employment, or have not grown despite the availability of the small business deduction. The Committee is of the view, therefore, that while it is appropriate to use the small business deduction to encourage businesses to accumulate earnings for business investment purposes – where the aim is to create opportunities for economic growth and employment – there is less reason to give these same advantages to investors for the purpose of financing passive investments and deferrals of personal income tax.

The Committee supports maintaining and even improving the lower rates of tax applicable to small business corporations. We believe, however, that the existing support should be modestly restructured to direct a greater share of this relief to small businesses with larger levels of employment and less to businesses that represent incorporated self-employment or otherwise have low levels of employment relative to business income.

R E C O M M E N D A T I O N

The Committee recommends that, as the general rate of corporate income tax is reduced, the federal corporate income tax on income eligible for the small business deduction should also be reduced. This reduction should be concentrated on those small businesses that create and maintain jobs. Specifically, the Committee recommends that the federal income tax rate applied to small businesses should range from 11 percent to 14 percent (with an expected average of about 12.5 percent instead of the current rate of 13.12 percent including surtax), and that the rate should vary with each corporation's level of employment. We also suggest that the provinces should reduce their small business tax rates by one percentage point, on average. This revenue loss would be offset by the additional revenues received from base broadening.

The Committee proposes that the net federal tax rate be set at 14 percent for eligible business income, and that a CCPC be allowed to credit 20 percent of its employment insurance employer payroll tax against its corporate income tax liability, so as to achieve a reduction in the rate down to a minimum of 11 percentage points.¹² With an average provincial rate of 7 percent, our proposal would result in a combined average federal-provincial rate down to 18 percent, compared to the existing average of 21 percent.

Our proposal would reduce corporate income tax rates for most small businesses. Moreover, restructuring the existing regime in the manner suggested, would provide a greater incentive for companies to increase employment, and would give additional assistance to businesses that wish to use retained earnings to expand business activities and employment levels. Small businesses would be rewarded more directly for their contribution to employment creation.

Tax Incentives to Promote Investment in Research and Development

The goal of research is to produce technological innovation, provide new insights and build intellectual capital: a body of knowledge that can be used to enhance productivity and create wealth. It is well established that the capacity to create and use new ideas and technologies is a key determinant of the long-term growth of a modern economy. However, it is the actual use of these new ideas and techniques in production, rather than their initial discovery, that ultimately provides benefit to a knowledge-based society.

Governments give assistance to R&D activities in the belief that the benefits of such activities spill over beyond the individual performers to other businesses and sectors of the economy, and so the total value of these benefits – the social value – is not fully captured by the businesses engaged in the R&D activity. Because of “spillover benefits” – benefits to persons or businesses other than those paying for the research – businesses are likely to perform less R&D than is desirable from the economy’s perspective in the absence of government support.

Considered in a global context, R&D raises additional issues. Acting on the knowledge that economies showing the greatest ability to discover and then use new innovations are the economies that tend to show the greatest growth and opportunities for their people, governments support R&D with the aim of attracting research capital and efforts, and thus promoting high quality, knowledge-based jobs and overall economic growth. However, two points must be kept in mind in a world in which technology and innovation are spreading more broadly and more rapidly than ever before:

- While the spillover benefits of research are global, it is only the benefits that accrue within a country’s borders and to its own people that directly justify the provision of tax incentives or other subsidies for domestic R&D.
- It is the widespread adoption of innovations within a domestic economy, and not their initial discovery, that provides the greatest benefits to that economy. Examples include the widespread adoption of new drilling techniques in the petroleum industry and the rapid spread of new processes and equipment in computers – each leapfrogging on previous advances.

Empirical Evidence of Spillovers Benefits

Many empirical studies, focussing mainly on the manufacturing and high-tech industries, have been undertaken to determine the magnitude of R&D spillovers to the economy, and to calculate private and social rates of return from R&D investments (the difference between private and social rates of return indicates the magnitude of the spillover). Generally, the evidence indicates that spillover benefits exist between projects, businesses, sectors and countries. Some of the results of this empirical literature can be summarized as follows:¹³

- Social rates of return from R&D investment are at least twice private rates of return.
- Social rates of return on R&D spending range from 20 percent to 150 percent and vary significantly among industries and activities; while not all R&D provides major benefits to the economy, it is very difficult to determine in advance which projects or activities will deliver the largest benefits.
- Social rates of return on basic R&D – research on development of fundamental or primary knowledge – are higher than those on applied R&D.
- Private rates of return for R&D investments are generally higher than private rates of return for other capital investments; on the other hand, government-provided R&D yields lower rates of return than private R&D.
- R&D spillovers improve productivity, increase the demand for skilled labour and result in an expansion of output.

The Committee's view is that special recognition and encouragement of R&D in Canada by governments is justified and supportable, but that such encouragement is more appropriate if the innovations that result are adopted in the wider domestic economy. The reduction in corporate income taxes that we propose in this Report would encourage many businesses to adopt innovations in Canada.

R&D Tax Credits in Context: Federal Support for Innovative Activity

The R&D tax credit is one of several incentives intended to support innovative activity. Total federal support for R&D equalled about \$5.0 billion in 1996-97. Of this amount, \$1.6 billion (forecast for 1996) was in the form of investment income tax credits for SR&ED while the remaining \$3.4 billion consisted of various forms of non-tax assistance – primarily in the form of subsidies to particular research projects. Total federal support for the broader category of all scientific and technological activity¹⁴ was over \$7 billion in 1996-97. Non-tax funding was \$5.7 billion, of which \$2.3 billion was for scientific activities related to R&D and \$3.4 billion was for R&D per se. It is evident then, that the R&D tax credit and other federal assistance support only one element – albeit an important one – of innovative activity. Innovative activity includes not only R&D activity, but also other activities related to the transformation of an idea into a new or improved product.

Federal Research and Development Tax Incentives

The Current System

The federal government has provided income tax incentives in various forms for R&D since 1944. Delivery mechanisms have included accelerated and incremental bonus deductions and investment tax credits, and special incentives for small business and investment in particular regions. The basic structure of the current federal income tax regime for research – referred to as SR&ED (Scientific Research and Experimental Development) – was put in place between 1983 and 1985, and has continued to evolve.

The definition of SR&ED for tax purposes is generally consistent with the internationally accepted definition of R&D used by the OECD.^a Spending eligible for Canadian SR&ED tax incentives falls into three broad categories: basic research, applied research and experimental development.^b

Current and capital R&D expenditures in Canada, performed by, or on behalf of, a taxpayer, are generally eligible for the SR&ED tax incentives. However, capital expenditures for the acquisition of land or buildings (other than certain special purpose buildings), and current expenditures for related rental or leasehold payments are not allowable SR&ED expenditures. Both eligible current and capital SR&ED expenditures may be claimed as an expense for tax purposes as incurred. SR&ED expenditures that are not deducted in a year can be carried forward indefinitely.

There are currently two rates of investment tax credit for SR&ED in Canada: a general rate of 20 percent of eligible spending, and an enhanced rate of 35 percent for certain CCPCs.^c These credits are claimable as a reduction of current federal income tax, but reduce the allowable deduction for eligible SR&ED spending in the following year. Thus, part of the credit is recaptured for tax purposes by reducing deductible costs.

Investment tax credits may be deducted from federal taxes otherwise payable. Unused tax credits (not claimable in the year they were earned because of insufficient tax) can be carried back three or carried forward 10 years to a tax period where there is sufficient tax to absorb the credit. Generally, up to 40 percent of SR&ED credits for both capital and current spending can be claimed as a direct payment from the government by those taxpayers who are unable, because of inadequate income, to use them to reduce tax. However SR&ED tax credits on current spending that are accrued at the 35 percent rate (the higher rate of credit applicable to small business) are fully refundable. Unincorporated business can also obtain a refund at a rate of 40 percent of unused credits earned in a year. (Refundability is discussed in Chapter 4.)

(Cont'd on next page)

Federal Research and Development Tax Incentives (Cont'd)

Basic SR&ED Statistics

In 1992, the value of actual claims for SR&ED tax credits amounted to \$1.25 billion, calculated with respect to total eligible spending of \$6.9 billion. Small businesses (CCPCs eligible for the enhanced rate of tax credit) accounted for about 30 percent of this total and represented over three quarters of claimants. The manufacturing and processing sector accounted for 48 percent of the value of all claims for SR&ED tax credits. Information technology SR&ED – the use and development of communications technology and computer software and hardware to collect, process, store or disseminate information – comprised about 35 percent of the value of all claims.

Eligible SR&ED may be conducted in-house or by a third party on behalf of a taxpayer. About 75 percent of allowable expenditures claimed is for in house research carried out directly by the taxpayer, with the balance being claims in respect of subcontracted spending. Over 40 percent of claimants subcontracted some portion of their R&D.

A 1996 study of a sample of 51 SR&ED claimants conducted for Industry Canada revealed that the average compliance cost associated with the SR&ED tax credits was quite low: 0.7 percent of the value of credits claimed. Based on this finding, the study concluded that the perceived low level of R&D activity in Canada cannot be a result of high compliance costs. However, almost 20 percent of the total number of claims in 1992 were in respect of allowable expenditures of less than \$20,000; and these claims in total accounted for only 0.4 percent of the value of SR&ED tax credits claimed in that year. Smaller claims involve relatively high compliance costs for claimants and administration expenses for government.^d

^a See Organization for Economic Co-operation and Development (1993).

^b Eligible activities consist of work in respect of engineering, design, operations research, mathematical analysis, computer programming, data collection, testing and psychological research. Certain types of work that are not eligible for the credit include market research and sales promotion; quality control or routine testing; research in the social sciences or humanities; commercial production of new or improved products or processes; and prospecting, exploring and drilling for oil, gas and minerals.

^c Generally, CCPCs with prior-year taxable income under \$400,000 and prior-year capital employed in Canada under \$15 million. The amount of R&D expenses eligible for the higher rate of credit is generally limited to \$2 million for CCPCs with prior-year taxable income of \$200,000 or less. This is reduced under a formula where prior-year taxable income is between \$200,000 and \$400,000 or taxable capital employed is between \$10 and \$15 million.

^d The cost of compliance per dollar of small claims may be as high as 15 percent. See Gunz, MacNaughton and Wensley (1996).

Provincial Income Tax Incentives

Provincial governments generally follow federal rules in respect of the deductibility of current and capital expenditures on SR&ED in the province.¹⁵ Under those rules, the deduction from corporate taxable income for SR&ED spending is generally based on qualifying expenditures less government or non-government assistance receivable in a taxation year and federal SR&ED tax credits claimed in the preceding taxation year. The provinces of Manitoba, New Brunswick, Newfoundland, Nova Scotia, Ontario and Quebec also offer various types of special income tax incentives for R&D conducted within their borders. These special provincial incentives, primarily investment tax credits and bonus deductions are summarized in Table 5.4. Eligible expenditures are also generally reduced by the amount of any government or non-government assistance.¹⁶ Provincial tax credits are considered to be government assistance, and they reduce the amount of expenditures available for the deduction (and federal tax credits) in the year in which the provincial credits are earned. The Committee suggests that federal and provincial credits should receive similar treatment, and should be applied against spending in the following year.

Table 5.4
Summary of Provincial R&D Tax Incentives

Province	Additional Tax Tax Deduction ^a	Deduction	Tax Credit
Manitoba	100%; SR&ED current and capital expenditures	Not applicable	<i>Research and Development Tax Credit</i> rate: 15% Non-refundable, seven-year carry-forward/three-year carry-back
New Brunswick	100%; SR&ED current and capital expenditures	Not applicable	<i>Research and Development Tax Credit</i> rate: 10% Non-refundable, seven-year carry-forward/three-year carry-back
Newfoundland	100%; SR&ED current and capital expenditures	Not applicable	<i>Scientific Research and Experimental Development Tax Credit</i> rate: 15% Fully refundable
Nova Scotia	100%; SR&ED current and capital expenditures	Not applicable	<i>Research and Development Tax Credit</i> rate: 15% Fully refundable
Ontario	100%; SR&ED current and capital expenditures	<i>R&D Super Allowance</i> rates: non-CCPCs – 25% up to base amount and 37.5% on incremental R&D spending; CCPCs – 35% up to base amount and 52.5% on incremental R&D spending Base amount: average spending of previous three years Mandatory deduction	<i>Ontario Innovation Tax Credit</i> available to CCPCs with prior-year taxable income under \$400,000 and prior-year taxable capital employed in Canada under \$15 million Annual expenditure limit: SR&ED expenditures up to \$2 Rate: 10% Refundable: 100% of eligible expenditures; no carry-over of unused/unrefunded credits
Quebec	100%; SR&ED current and capital expenditures	Not applicable	Base: R&D salaries and eligible expenditures under various types of research contracts Rates for corporations: 40% for small businesses (assets under \$25 million) on R&D salaries up to \$2 million; 40% to 20% for medium businesses (assets between \$25 and \$50 million) on R&D salaries up to \$2 million; 20% for large businesses (assets over \$50 million) and R&D salaries over \$2 million Rates for contract R&D: 20%-40% for eligible expenditures Refundable: 100% of eligible expenditures Two-year exemption for foreign researchers
Other Provinces	100%; SR&ED current and capital expenditures	Not applicable	Not applicable

^a Essentially following federal rules. See Table 5.5 for the federal description.

Government Incentives for R&D: International Comparisons

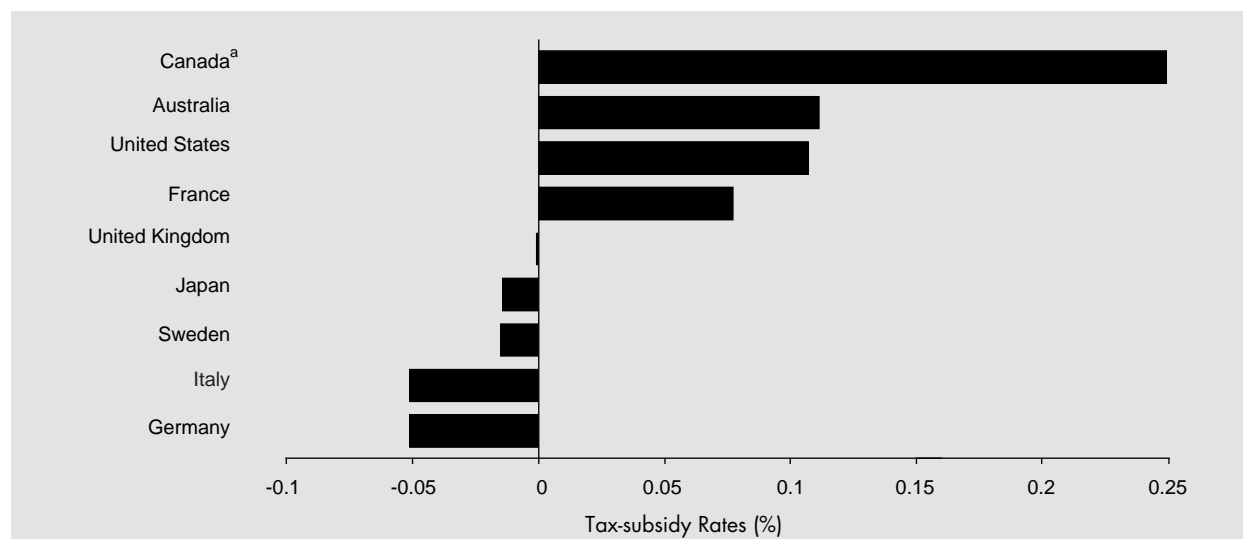
Many countries provide both tax and non-tax incentives to encourage R&D activities within their borders, with specific incentives within these general categories taking many different forms. Table 5.5 highlights the differences in the income tax treatment of R&D in the G-7 countries, plus Australia and Sweden. The Committee notes that the Canadian system of income tax incentives for SR&ED provides one of the most favourable investment climates for R&D in the world.¹⁷

Countries are ranked in Chart 5B by comparing the effective tax-subsidy rates inherent in a country's income tax treatment of large manufacturing businesses. Specifically, the tax-subsidy rate measures the extent to which the cost of R&D is reduced by the value of incentives including tax credits, investment allowances, financing deductions and accelerated write-offs relative to the economic cost of the investment.¹⁸ For example, if an R&D project costs \$100 in economic terms and the tax-subsidy rate is 10 percent, then the cost of the R&D project for the investor is \$90. The greater the tax-subsidy rate, the more that R&D is encouraged.

The Chart shows that, after taking account of both federal and provincial incentives, Canada has the most favourable income tax treatment for R&D investments of the countries compared. Australia, which provides a bonus income tax deduction (but which recently reduced this incentive from 150 percent to 125 percent of eligible current and capital spending on R&D), is second. Germany and Italy, which along with Sweden do not offer special incentives for R&D, are lowest; R&D activity bears some tax since capital expenditures for R&D are depreciated rather than expensed. Each of the other countries provides some form of income tax assistance for R&D.

Chart 5B

R&D Tax-subsidy in the G-7 Countries, Australia and Sweden, for Manufacturing



^a For an R&D investment averaged across provinces. Tax-subsidy rates are calculated as the difference between economic cost of the investment and the net cost, including the present value of taxes, expressed as a percentage of the economic cost of investment.

Source: Warda (1997) and, for Canada, data from Revenue Canada and Department of Finance Canada. Data and technical assistance provided by the Department of Finance.

Table 5.5
R&D Tax Treatment in the G-7 Countries, Australia and Sweden

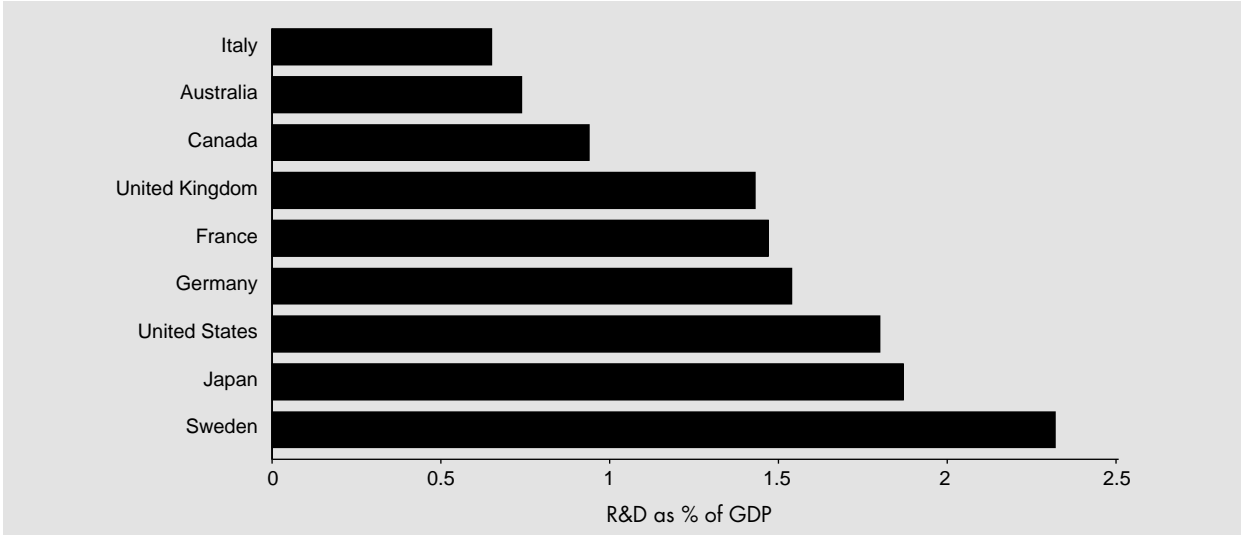
Country	Income Tax Deduction	Income Tax Credit
Canada	Current expenditures: 100% Capital expenditures other than land and buildings: 100%	Base: all expenditures Rates: 20% generally; 35% for certain CCPCs; additional credits in provinces (Table 5.4) Refundable for CCPCs (100% or 40%) Three-year carry back; 10-year carry-forward Taxable: reduces base for deduction (plus some provincial incentives)
Australia	Minimum threshold: A\$20,000 Current expenditures: 125% Capital expenditures: 125% over three years on a straight-line basis	Not applicable
France	Current expenditures: 100% Capital expenditures: straight-line or declining balance; some acceleration for R&D	Base: incremental R&D spending compared to previous two years; positive or negative Rates: 50% Refundable for new businesses; three-year carry-forward/refundability for other firms Annual limits on tax credit use
Germany	Current expenditures: 100% Capital expenditures: straight-line or declining balance	Not applicable
Italy	Current expenditures: 100% (or over five years on a straight-line basis) Capital expenditures: straight-line generally; some acceleration for R&D	Not applicable
Japan	Current expenditures: 100% (or over five years) Capital expenditures: ordinary (straight-line, declining balance or any other approved method), initial or accelerated depreciation; some acceleration for R&D	Three tax credits; one for incremental R&D spending Base for incremental credit: R&D spending in a year in excess of largest annual R&D spending since 1966 Rates: 20% general credit 6% credit for small or medium-sized enterprises (SMEs) Annual limit on tax credit use No carry over of unused credits
Sweden	Current expenditures: 100% Capital expenditures: declining balance	Not applicable
United Kingdom	Current expenditures: 100% Capital expenditures: 100%	Not applicable
United States	Current expenditures: 100% (or over five years on a straight-line basis) Capital expenditures: modified accelerated cost-recovery system; some acceleration for R&D	Temporary Base: R&D spending in excess of the product of the ratio of R&D spending to gross receipts for the period 1984-88 and the average of the taxpayer's gross receipts for the four preceding years Rate: 20% Annual limits on tax credit earned Three-year carry back; 15-year carry-forward Taxable: reduces base for current deduction

Private-sector Spending on R&D: International Comparisons

While the results of international comparisons indicate that among the countries reviewed Canada provides the most favourable income tax treatment for R&D investments, Canada’s private sector still lags behind many other developed countries in terms of its relative spending on R&D (as shown on Chart 5C) – a fact that indicates that factors other than tax incentives are at work in determining a nation’s level of R&D spending. Besides taxation, aggregate R&D activity in a given jurisdiction is also influenced by a number of other factors, including:

- the availability, costs and quality of human capital (scientists and other skilled workers) and knowledge infrastructure (such as universities and research organizations);
- the cost of financing and other expenditures incurred through R&D processes;
- the availability, cost and quality of physical infrastructure (such as telecommunications and airports);
- proximity and access to markets, industrial structure, and level of demand for product and process innovations;
- the state of competition in markets; and
- government policies including patent regulation, procurement policies, and grant programs.

Chart 5C
R&D to GDP Ratios in the G-7 Countries, Australia and Sweden^a



^a The data generally relates to 1994; for Sweden, they are based on 1993 estimates.

Source: Organization for Economic Co-operation and Development (1996b)

A recent survey found that a skilled work force, the quality of life and the reputation of a local university were the dominant factors in influencing development of “clusters” of knowledge-based industries, while tax incentives played a less critical role.¹⁹ While the differences in R&D spending levels between countries can be attributed to factors other than specific tax incentives, they can also be traced to more general tax policies that lie within governments’ purview. As noted elsewhere in our Report, Canada imposes corporate taxes on service industries that are high compared to those of our global competitors, thus discouraging the broader adoption of the results of R&D in Canada and the development of knowledge-based industry clusters. Moreover, high personal tax rates relative to other countries make it more costly to attract and retain the skilled labour that is needed for knowledge-based industries in Canada.

The Committee is therefore of the view that the R&D tax regime provides valuable support for research in Canada, but that support is high by international standards and focussed on only the scientific research portion of the innovation process. The Committee believes that it would be appropriate to rebalance incentives, to put more weight on lower corporate income tax rates as a means to encourage the Canadian adoption of innovations that result from the research process.

R E C O M M E N D A T I O N

Current and Capital Expenditures: Normally, expenditures on fixed assets are capitalized for income tax purposes and written off over their useful life. However, under Canadian tax rules, qualifying capital expenditures on SR&ED machinery and equipment can be claimed immediately, a benefit in addition to an already generous system for R&D capital spending. The provision creates distortions in that it favours research projects that are capital-intensive against those that are not.

The Committee recommends that the immediate deductibility of SR&ED capital assets be phased out. As a result, SR&ED capital assets that are not specially designed or adapted for research purposes, such as furniture, transportation equipment, or non-specialized computers, would be included in the capital cost allowance class in which they would normally fall. Specialized research equipment and other assets, including special purpose structures, should be placed in a new class with a 35 percent declining balance rate.

This proposed treatment of R&D capital assets would bring Canada more in line with the general treatment of R&D assets in G-7 countries, as well as with our present tax treatment of non-special purpose buildings used in research. The suggested write-off rate for special purpose R&D assets is sufficiently generous to take account of the short useful lives of many of such assets.

Incentives Based on Incremental rather than Total Spending: The effectiveness of the SR&ED tax credit in encouraging Canadian research measured against the cost to government revenues suggests to the Committee that the current system requires some review. An alternative design used in many countries is to provide an incentive determined by the amount of R&D spending in excess of some specified base. The advantage is that an incentive for R&D based on incremental rather than total spending could lower the cost of the program, while still providing significant incentive to businesses to increase research spending.

The conceptual attractiveness of such targeted measures is offset, however, by considerable practical difficulties. Determining incremental R&D necessitates arriving at some measure of a business's base amount of required R&D expenditures. The base amount could range from the amount of expenditures incurred in a previous taxation year, to a moving average of a business's spending levels over a number of years, to a percentage of sales or profits.

None of the instruments available to determine this amount are particularly attractive. Incremental incentives based on prior years' spending levels offer no support for businesses to consistently maintain a high level of R&D spending. Further, a one-time large increase in R&D spending may also make a business ineligible for further incentives for a number of years, despite an overall upward trend in its R&D spending. Incentives based on R&D spending in excess of a set percentage of sales or profits are essentially arbitrary, would provide less support for successful innovators compared to less successful ones, and would not take account of normal differences in R&D costs in different industries. In addition, the efficiency of incremental incentives can be undermined by a variety of tax-planning techniques, and the rules governing incremental incentives are therefore necessarily complex. This latter difficulty was perhaps the most common criticism of the 50 percent bonus deduction for increased R&D spending provided by the federal government between 1978 and 1983.

On balance, therefore, the Committee favours continuing to base the Canadian R&D tax incentive on total R&D spending.

Differences in the Rate of Tax Credit: The enhanced rate of 35 percent for the SR&ED tax credit currently available to qualifying CCPCs – in contrast to the general rate of 20 percent – is particularly generous. A comparison of tax-subsidy rates for CCPCs and non-CCPCs performing SR&ED in different provinces is provided in Table 5.6. The comparison includes each of the six provinces that provide special incentives for R&D. Also included is a weighted-average calculation for Canada based on the share of SR&ED spending in all ten provinces.

Table 5.6 shows that the tax-subsidy for CCPCs eligible for the enhanced rate of SR&ED tax credit is substantially higher than that for large manufacturing companies across all provinces and for Canada as a whole. Furthermore, those CCPCs with low corporate income tax rates would remain advantaged relative to large manufacturing companies, even if the rate of SR&ED tax credit were reduced to the general rate of 20 percent (as shown by comparing the third column of Table 5.6 with the first), although the advantage is only substantial in Ontario and Quebec.

Table 5.6

A Comparison of Tax-subsidy Rates by Province for R&D

	Large Manufacturing Companies ^a	CCPCs @ 35% ^b	CCPCs @ 20% ^c
		(percentage)	
Canada (average)	23	42	29
Man.	28	42	29
N.B.	24	39	26
Nfld.	29	42	30
N.S.	28	42	30
Ont. ^d	21	41	29
Que.	27	48	37

^a Eligible for the manufacturing and processing tax credit.

^b CCPCs eligible for 35% SR&ED investment tax credit.

^c CCPCs eligible for 20% SR&ED investment tax credit.

^d The calculations for Ontario assume non-incremental expenditures only and exclude the Business Research Institute Tax Credit.

Source: Data and technical assistance provided by the Department of Finance.

As discussed above, there are two rates of SR&ED tax credit: a general rate of 20 percent and an enhanced rate of 35 percent for qualifying CCPCs. The Committee is concerned that the differential in tax credit rates may encourage situations in which taxpayers decide to enter certain kinds of contractual arrangements with other corporations based on maximizing the value of the SR&ED tax credit claim rather than finding the most efficient and effective manner of having the R&D work carried out.

For example, a taxpayer that is not eligible for the higher rate of tax credit granted to CCPCs of 35 percent could contract with a qualifying CCPC to have it perform the research that the taxpayer would have conducted in any event. The company could even spin off existing SR&ED personnel into an unrelated CCPC. Both parties could potentially gain: the qualifying CCPC by doing the work and being able to access the higher rate of tax credit, and the original taxpayer by paying a reduced price for the work through a sharing of the additional tax credit earned by the qualifying CCPC. While no additional SR&ED would have been performed, the cost to the revenue authorities of the SR&ED tax incentives would have been increased.

The contracting out of SR&ED work is growing. Currently, almost 25 percent of total SR&ED spending is in respect of SR&ED carried out by others on behalf of the claiming corporation, while in 1988, the figure was 18 percent. However, it is difficult in practice to distinguish between the type of situation in which SR&ED is diverted to a CCPC for tax reasons and one in which SR&ED is performed for others by a CCPC that possesses some relative economic advantage, for example in know-how relating to the work. Even in situations where a company spins off a separate entity and, at first, remains its primary customer for research, this entity may grow and develop into a successful company in its own right.

In examining this issue, the Committee considered the option of providing a single SR&ED credit tax rate of 20 percent to both large and small Canadian companies. Although this option would have some clear advantages – the elimination of tax-planning opportunities, reduced compliance costs and lower distortions – the existing enhanced SR&ED tax credit for small business does serve as a significant source of financing for enterprises that have limited access to equity markets. Moreover, it is argued that R&D spending involves more risk to small enterprises than larger ones because of reduced opportunities to spread the risk over several projects.

We conclude, therefore, that an enhanced rate of tax credit should continue to be available for CCPCs.

The Overall Level of Tax Support for R&D: The Committee is committed to maintaining a generous treatment of R&D in Canada. However, we question whether compensating for the spillover effects requires a level of tax support as high as at present. Specifically, the spillover benefits to Canada from R&D are not realized primarily from carrying out the research itself but from the adoption of innovations in improving Canadian productivity. Moreover, the R&D tax credit is directed at only one part of the innovation process – particular forms of scientific research – and does not provide assistance for many other activities that also contribute to knowledge.

R E C O M M E N D A T I O N S

The continued development of Canada's knowledge-based economy rests on its overall level of economic performance, which in turn can be impaired by effective tax rates on knowledge-based industries that are high, relative to international norms. Consistent with the Committee's recommendations in other areas of Canada's business tax system, we believe that lower overall corporate tax rates can be important in encouraging economic activity and increased employment, including that flowing from the adoption of innovations. Lower corporate tax rates, combined with a slightly reduced level of SR&ED tax credits, would redirect some of the current incentive away from *finding* innovations toward *using* them. The result, we believe, would be a more efficient business tax environment.

We are, therefore, proposing a moderate reduction in the rate of SR&ED credits. This proposal should not be viewed in isolation, but instead as part of a balanced package that uses the lower revenue cost of the revised SR&ED system to contribute to lowering general corporate income tax rates with the consequent incentive effects that the change would create. This change would still leave Canada with a more competitive regime (including provincial incentives) than virtually all other major countries, including the United States. Canadian research activities would thus not suffer any competitive disadvantage that would lead to a significant decline in R&D efforts.

The Committee recommends that the general SR&ED tax credit be reduced for large companies, after a transition, to 15 percent from 20 percent, and that the enhanced rate for small business be reduced by a similar proportion, to 27 percent from 35 percent. The reduction in the credit should be phased in over a period of years concurrent with the reduction in corporate income tax rates.

Under this option, eligible CCPCs would continue to have access to a higher rate of tax credit in addition to the refundability features of the current regime. Since a large credit rate differential would continue to exist, our proposal would not fully address concerns that some SR&ED is being performed under contract with eligible CCPCs solely to maximize the value of the tax credit claim. However, the narrowing of the difference in tax credit rates between CCPCs and others would reduce somewhat the distortions present in the current tax regime.

Refundability: The Committee proposes no fundamental changes in the refundability rules for unused SR&ED credits. Under these provisions, corporations unable to make use of SR&ED credits to offset federal income tax because of insufficient income or losses, can obtain a refund of up to 40 percent of the credit. For certain small enterprises, the refund can be 100 percent of the credit associated with current SR&ED spending for the first \$2,000,000 in current expenditures.

We recommend that qualifying smaller enterprises be able to obtain a full refund of the SR&ED credit not only for current spending but also for capital spending, within the same overall limit, to assist the financing of such assets.

Minimum Expenditure Threshold: The Committee is concerned that the cost of administering very small claims is disproportionately high. Almost 20 percent of SR&ED claimants spend less than \$20,000 each year and account for just 0.4 percent of the total value of SR&ED tax credit claims. The Committee considered whether a new eligibility requirement should be introduced in the form of a minimum expenditure threshold for expenditures to qualify for the SR&ED tax incentives.

The Committee concluded, however, that it would be inappropriate to reject SR&ED credit claims simply because they were small, except for those below a *de minimis* level of, say, \$500. A number of small claims result from situations where a trade association or other body carries out research activities and then allocates the cost to its members to enable them to make individual claims. With the aim of reducing administrative and compliance costs for small claims, the Committee suggests that the government explore an alternative program of providing incentive grants directly to certain associations carrying out such research.

Information Technology: The Committee notes that about 35 percent of current R&D expenditures relate to information technology and a large part of this is the cost of writing new computer programs. There is no reason why spending on information technology should not qualify as scientific research in appropriate circumstances; however, business now operates in a technological environment where virtually all major corporations are obliged to spend major amounts each year to revise their computerized information systems. Recurring costs of this sort, when appropriately analysed, do not, we believe, represent scientific research of general benefit to Canada. Specifically, the spillover benefit from the development of proprietary software exclusively for the internal use of a taxpayer may be relatively modest, particularly where the programming is not widely available for sale to others or does not result in substantial and innovative enhancements to productivity in the economy.

The Committee, therefore, does not support tax assistance for routine in-house, software development, a principle consistent with government policy. Revenue Canada, after consultation with affected taxpayers, has recently issued a comprehensive new information circular on the SR&ED credit, including a discussion on qualifying software.²⁰ We suggest that the government should continue to monitor SR&ED credit claims, especially with respect to software, and if on further consideration it undertakes additional delineation of qualifying activities, it should ensure that only software development that supports innovations with significant spillovers is provided assistance.

Resource Industries

Introduction

Canada's resource industries, including mining, oil and gas, forestry, agriculture, fishing and trapping, have long made a significant contribution to Canada's economic development and trade. The continued success of these industries is important to Canada's overall economic activity and employment. These industries provide broad support through their purchases of goods and services for other sectors of the Canadian economy, and are particularly important to a number of remote regions. They have also been a source of technological innovation. We do not recommend any specific changes to the taxation of agriculture, fishing, trapping or forestry, although our proposed reduction in general corporate income tax rates provides benefits to these industries.

Non-renewable Resources – Mining, Oil and Gas Production

The non-renewable resource sector – mining, and oil and gas – conducts its activities in an environment that has given rise to special or differential tax treatment:

- This sector frequently engages in activities that involve large elements of risk: some projects require that very large amounts of capital spending be committed to exploration, development and equipment, but may earn only an uncertain stream of future revenues dependent on volatile world prices.
- The significant economic risks that the industry faces give rise – in some circumstances – to situations where the income from profitable projects will be taxed, but losses from unsuccessful ventures by other corporations will not be effectively deducted because these other companies lack sufficient income to absorb them.
- Mining operations are subject to a variety of provincial mining taxes and royalties, and oil and gas production also bears substantial provincial royalties and levies.²¹ These provincial charges, which are in addition to the federal and provincial income taxes that all corporations bear, are in part, compensation for the use of provincial resources but may also represent an additional tax on the industry, to the extent that the charges are more than the value of the benefits received.

Current Income Tax Treatment of Non-renewable Resources Sector Activities

For tax purposes, income from non-renewable resource production includes that arising from extracting, concentrating, smelting and refining of minerals to the prime metal stage, and from the production and initial processing of natural gas and crude petroleum. Income derived from transportation and marketing, and from the further processing of natural gas, is, in general, not regarded as resource revenue and not subject to provincial resource levies. Refining crude petroleum and fabricating metal are regarded as manufacturing and processing activities, and thus are separately eligible for the manufacturing and processing tax credit.

For tax purposes, treatment that is specific to the non-renewable resource sector includes:

- The deduction of a special resource allowance, in computing taxable income, calculated at 25 percent of net resource profits.^a This allowance is provided in lieu of the deductibility of provincial oil and gas royalties and mining taxes.
- Accelerated write-off rates for certain types of Canadian capital expenditures, as, for example:
 - Canadian exploration expenses (defined as any expense to determine the existence, location, extent or quality of a non-renewable resource) can be fully deducted against available income. Any unused exploration expenditures may be carried forward indefinitely and fully deducted at any time.
 - Pre-production development expenses for new mines are treated as “grass-roots” exploration expenses and can be fully deducted against available income or carried forward indefinitely and deducted at any time.
 - Canadian development expenditures are deductible at a rate of 30 percent per year (declining balance), but can also be carried forward indefinitely.
 - Expenditures on structures and equipment with respect to a new or major mine expansion may be written off to the full extent of income from that mine.
- Resource property purchases are deductible at a rate of 10 percent per year for oil and gas properties, and at a rate of 30 percent per year for mining properties as purchases of the latter are treated as Canadian development expenditures.
- Flow-through shares which enable investors to claim deductions for exploration and development expenses incurred and renounced by the companies in which they have acquired shares. (This subject is discussed in Chapter 4 on losses.)

Comparing Tax Treatment of Mining Versus Oil and Gas

The tax treatment of income varies between the mining and petroleum sectors, and in addition, oil sands projects receive a different tax treatment than conventional petroleum production. The key differences between mining and oil and gas are the following:

- All pre-production development costs for new mines have been entitled to a 100 percent deduction as exploration expenses, while similar types of expenditures for the intangible costs of production and injection wells in the oil and gas sector have been treated as development expenses, and are written off at a maximum rate of 30 percent.
- An accelerated capital cost allowance in respect of the cost of new mines and mine expansions is provided. Capital expenditures for structures and equipment in respect of a new mine (incurred prior to the commencement of production in commercial quantities) or a major mine expansion,^b may be claimed to the full extent of resource income from that project.^c
- Eligible property costs related to the acquisition of mining property are claimable at a rate of 30 percent per year. In contrast, property costs in the oil and gas industry are written off at a maximum rate of 10 percent per year.

All *in situ* oil sands projects are now treated as mines. (Previously, *in situ* oil-extraction projects were treated as oil wells, whereas projects using mining methods were treated in the same manner as conventional hard rock mines.)

^a Before deducting interest, E&D costs.

^b A major mine expansion includes expansion of capacity by 25 percent. It also includes, as recently announced, those capital costs incurred in a year in excess of 5 percent of mine gross revenue.

^c This provision in combination with 100 percent deduction of all exploration and pre-production development costs has the result that no corporate income tax is payable by new mines until all capital costs have been deducted.

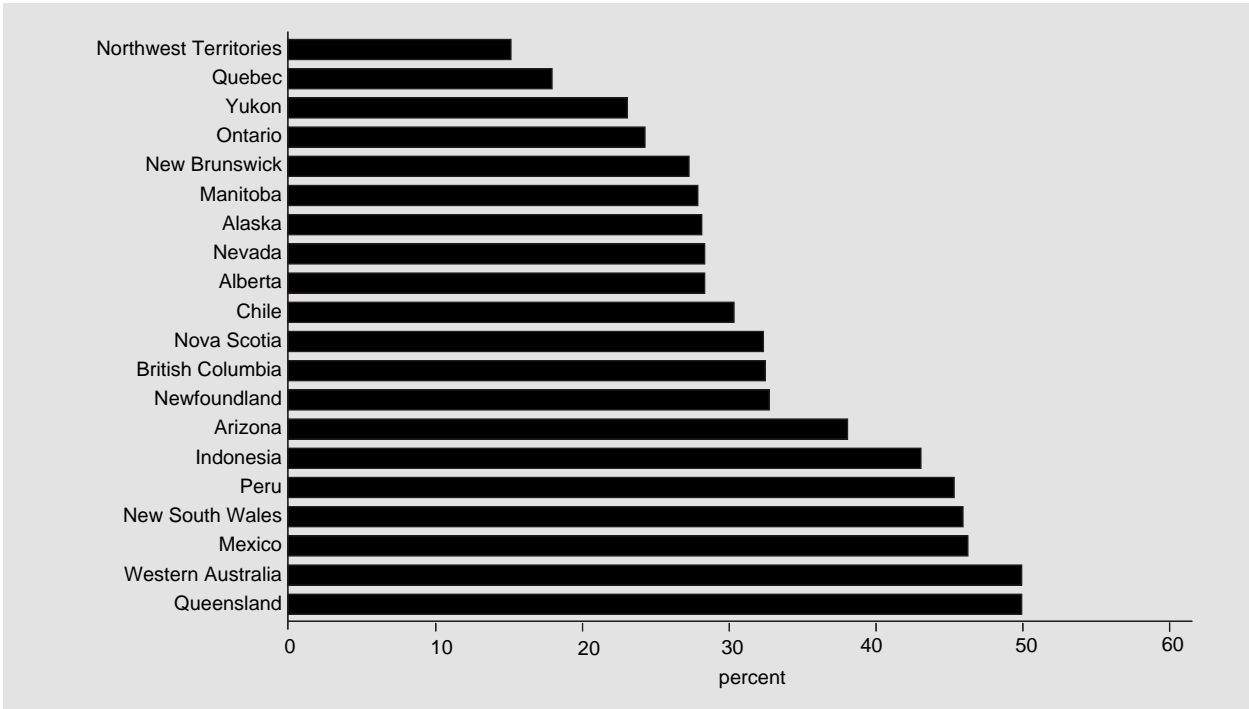
International Comparisons of Non-renewable Resource Taxation

As pointed out in Chapter 3, non-renewable resource industries in Canada receive favourable tax treatment relative to other sectors in the economy, taking into account provisions of corporate income, capital and sales taxes on capital inputs, and payroll taxes. In the United States and in many other countries, a similar preferential tax treatment is provided to non-renewable industries in relation to other sectors.

A recent study of mining shows that Canada’s corporate income and mining taxes for investments, with a 10 percent pre-tax inflation-adjusted internal rate of return on capital, are below those of many countries as shown in Chart 5D.²²

The main features of specific mining, oil and gas provisions in Canada and the United States are summarized in Table 5.7.

Chart 5D
Average Effective Tax Rates for Base-metal Operations (10% Internal Rate of Return), Latest Available Data



Notes:
This analysis is based on work done at Natural Resources Canada (NRCan). NRCan uses a model that calculates tax payments that would be incurred by a typical mine during its entire life. This model includes federal and provincial corporate income taxes, the large corporations tax, as well as mining taxes and royalties. An average effective tax rate is defined as a net present value of all taxes divided by the net present value of accounting income, expressed as a percentage. Financial accounting income is defined as operating revenue, less pre-production capital cost, amortized on a straight-line basis over the production life of the mine. A discount rate of 7.5 percent is used to reflect the average cost of capital.

Source: 1997 data provided by Natural Resources Canada. Brewer, Bergevin and Arseneau (1997). Brewer, Bergevin and Kitts (1993).

Table 5.7
Summary of Specific Mining and Oil and Gas Tax Provisions in Canada and the United States

	Canadian Mining	Canadian Oil and Gas	U.S. Mining, and Oil and Gas
Property Costs	Claimable at 30%	Claimable at 10%	Unsuccessful land costs may be expensed in the year incurred whereas successful land costs must be depleted on a production rate basis or through percentage depletion.
Exploration Expenses	Fully claimable in the year	Same as mining	Mining companies may claim domestic exploration expenses in the year incurred, provided these amounts are included in income once the mine goes into production. Oil and gas companies may elect to deduct exploration expenses in the current year, or charge them to capital.
Development Expenses	Claimable at 30%	Claimable at 30%, includes all development and drilling intangibles	For mining companies only, expenses can be deducted currently, unless the taxpayer elects to treat them as deferred expenses and deduct them, as the ore or mineral is sold. For oil, see 2 nd and 3 rd notes below.
Depletion	No longer applicable	Same as mining	Deductions for depletion available on a cost or percentage basis.
Royalties paid to Governments	Not deductible (resource allowances provided in lieu)	Similar to mining	Deductible
Resource Allowances	25% of net income (before interest, and write-off of exploration and development costs)	Same as mining	Not available
Depreciation	Most mining assets eligible for deduction at rate of 25%	Most oil and gas upstream assets are eligible for deduction at rate of 25%	Mining, and oil lease and well equipment, can be depreciated over seven years (approximately equivalent to 30% declining balance rate)
Accelerated Depreciation	Eligible capital expenditures on new mines or mine expansions on capital costs in excess of 5% of gross project income may be deducted to the extent of income from the mine	Available only for oil sands mines and <i>in-situ</i> oil sands projects	Not available
Pass-through of Investment Other Taxpayers	Flow-through shares available for E&D expenses	Similar treatment	Generally not available to corporations

Notes:

- Unlike Canada, the U.S. fiscal system distinguishes among companies depending on whether they are vertically integrated operations (i.e. whether a company is both a producer and a refiner, or only a producer) and on the amount of production (i.e., more generous tax allowances are provided for small companies). Also in the United States, the alternative minimum tax (AMT) was introduced at the corporate level, to ensure that the corporations that are profitable but that can use allowable tax preferences to reduce their tax liability, still pay tax. The AMT rate is 20 percent.
- In the United States, all unsuccessful drilling costs are fully deductible when incurred. Independent companies can fully deduct successful drilling costs as well. In contrast, integrated companies may expense only 70 percent of their successful drilling costs and must capitalize the remaining 30 percent over five years on a straight line basis.
- The U.S. system allows only unsuccessful geological and geophysical (G&G) costs to be fully expensed. Successful G&G costs must be recovered over the life of the project.

Reviewing the Special Treatment Provisions

Resource Allowance: The resource allowance, introduced in 1976, provides a deduction from taxable income of 25 percent of net resource production profits in lieu of the deductibility of mining, and oil and gas royalties.²³ However, these net resource production profits are determined before the write-off of E&D expenses and interest charges, so that in practice, the allowance is larger than 25 percent of the actual net resource income (before considering the non-deductibility of provincial charges).

Effectively, the resource allowance means that income from mining, and oil and gas production faces federal and provincial corporate income tax rates that are 25 percent below those applicable to other corporations (for example, a combined federal and provincial rate of 44 percent is reduced to 33 percent), again before considering the non-deductibility of provincial charges and the fact that interest and resource write-offs are not deducted in calculating the resource allowance.²⁴ Thus, industry's exploration, development and interest expenses are effectively deductible at the general corporate income tax rate, providing a more advantageous treatment for these expenditures than for direct production costs.²⁵ Resource income is, however, subject to another level of "tax" in the form of provincial Crown royalties and mining taxes.²⁶

The requirement to measure resource income and to draw the distinction between income derived from production – and so eligible for the resource allowance – and that derived from refining, distribution and other activities (and therefore not eligible for the allowance), results in complexities and uncertainties. For example, a 1992 court decision involving the interpretation of the calculation of production profits resulted in a substantial one-time loss of federal and provincial tax revenues. In an effort to address the technical uncertainties and tax-planning opportunities inherent in the treatment of non-renewable resources, the federal government has put forward a number of tax amendments over the last two decades, some of which are related to the transfer of deductions to other businesses.²⁷

In addition, the structure of the resource allowance was discussed extensively with provincial governments and industry in 1995 and 1996. Several different alternative structures were analysed in detail, including allowances based on gross royalties, a manufacturing and processing regime, a return to royalty deductibility, as well as modifications to the resource allowance. Both provinces and industry recognized the benefits of having a resource allowance structure that disentangles the federal and provincial governments' tax and royalty regimes, permitting provincial governments to adjust their royalty regimes for particular activities and types of companies without having an impact on federal revenues or revenues of other provinces. (See further discussion in Chapter 11.)

For its part, the industry was concerned that changes to the resource allowance implemented in isolation would simply raise revenues from the sector, and indicated that any changes being considered should occur as part of a broader review. While making some technical changes to the resource allowance structure, (the symmetric treatment of resource profits and losses, for example) the federal government asked the Committee to undertake a review of the resource allowance as part of its overall assessment of the business tax structure.

In examining the special treatment of non-renewable resource income, as in all the other areas we reviewed, the Committee believed that the principles of neutrality and fairness ought generally to prevail. The non-renewable resource sector is subject to substantial non-deductible provincial resource levies not imposed on other industries, and it is necessary to take into account the nature and amount of those levies in assessing the level of income tax paid by the non-renewable resource industries compared to those in other sectors.

Provincial resource levies constitute a charge for the use by the industry of non-renewable resources owned by or under the jurisdiction of, the province. While this has been the historical justification for such levies, most of the provincial petroleum and mining charges apply to production from privately owned as well as publicly owned resources, and the level of such charges has been changed by the provinces as resource prices, and therefore, profits have fluctuated.

Constitutionally, these resources are the responsibility of the provinces. The history, structure and level of the provincial charges make it apparent that they are being used by provinces, at least in part, to extract a larger share of the income flowing from the use of these resources, and to help ensure that they are gaining what they regard as an appropriate portion of the non-renewable sector's economic rent – the higher than normal profits accruing to enterprises from the use of provincial resources.

For a number of reasons, the Committee believes that the provincial charges represent an imperfect means of obtaining such rent. If the provincial levies represent a charge for the use of resources determined as a share of their economic rent, then the levies should be considered as a cost that would be deductible from income. On the other hand, to the extent that provincial resource royalties and charges may be regarded as the equivalent of, or a substitute for, income taxes – and therefore represent a diversion of a higher share of the total income tax revenue from the industry to the provinces – then it is arguable that they constitute more a form of income tax than a production expense, and should not therefore be an allowable deduction in the calculation of taxable income. The issue is further complicated by the contention that, if the latter interpretation is the correct one, then the federal tax should be reduced by a credit to recognize the enhanced provincial share of tax.

In practice, however, it is not possible to draw a distinction between provincial resource levies that might be regarded as deductible costs, and those that should be treated as the equivalent of an income tax.

In accordance with current rules, in the case of oil and gas production, provincial oil and gas royalties have not been deductible for federal income tax purposes since 1974. The granting of a resource allowance – a deduction of 25 percent of resource profits – is an offset for the non-deductibility of royalties that, in part, may represent a legitimate cost of production. Not all provinces – in particular, Alberta, British Columbia and Saskatchewan – fully follow the federal resource allowance. Instead, they provide rebates or extra charges that effectively simulate royalty deductibility in the calculation of provincial corporate income taxes.

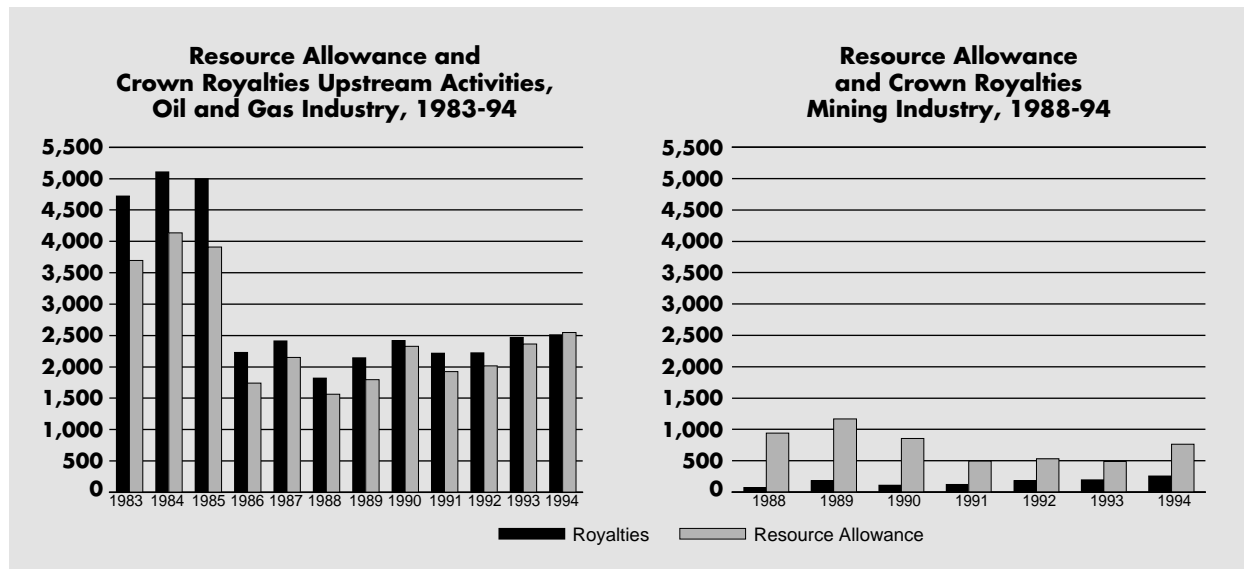
Chart 5E shows the relationship between the resource allowance and royalties in recent years for the oil and gas, and mining sectors. For the oil and gas industry as a whole, the benefits obtained from the resource allowance deduction have been a rough offset for the tax costs arising from the disallowance of provincial royalty deductions. However, the relationship between royalties and resource allowance differs greatly from one corporation to another. Some corporations deduct substantially more under the resource allowance compared to the disallowed provincial royalties, while for others, the resource allowance is inadequate compensation for this non-deductibility. Aggregate oil and gas royalties could decline over time as production from existing conventional fields declines. Royalties from new offshore production and from higher cost areas tend to be lower than those applied to older conventional reserves.

The position with respect to mining is somewhat different. Provincial mining royalties are also non-deductible for income tax purposes. The mining industry receives a resource allowance deduction similar to the oil and gas sector, but in the mining sector the aggregate of the tax value of the resource allowance to the industry is greater than the value of the disallowance of provincial mining royalties (see Chart 5E). This difference has been argued to provide, at least in part, treatment somewhat similar to that provided by the manufacturing and processing deduction for processing activities to the prime metal stage.

It is the Committee’s view that it would be inappropriate for the federal government to remove the resource allowance, and to allow the deduction of provincial royalties and other charges without limit. The deductibility of provincial levies would provide an incentive to the provincial governments to expand their revenue base at the expense of the federal treasury, precisely the issue that led to the initial introduction of the non-deductibility of provincial charges in 1974 (a further discussion of this point is provided in Chapter 11 on federal-provincial issues). The provinces support the flexibility provided by the resource allowance regime, since any adjustments to their royalty structures have no impact on corporate income taxes paid by the sector. The question, therefore, is whether some restructuring of the resource allowance could provide better economic effects while still treating the industry in a fair manner.

Chart 5E
Resource Allowance Versus Royalties

\$ Millions



Note: Does not include results of the Gulf case.

Source: Canada, National Resources Canada (various).

Note: Does not include results of the Gulf case.

Source: Data provided by Department of Finance.

Rebalancing the Non-renewable Resources Tax Regime

It is the Committee's view that there are substantial arguments in favour of a rebalancing of the tax provisions affecting the non-renewable resource sector in order to levy income taxes on a more neutral and less distorting basis. The Committee believes that the industry's tax regime should be adjusted, so that, while continuing to recognize the sector's special characteristics, the tax rules are brought more in line with those of other industries with respect to the timing of deductions and the structure of determining taxable income and tax.

A Revised Resource Allowance: As discussed above, we believe it is appropriate to continue to disallow the deduction of provincial resource levies, and provide a resource allowance in lieu of this deductibility. However, the current structure of the resource allowance could be improved, and, to this end, the Committee considered two broad proposals: a resource allowance based on gross revenues from production, and a second option based on resource income after the deduction of all related expenses and allowances.

A resource allowance based on gross revenues has one major benefit: it avoids the difficulties inherent in attempting to allocate costs between resource and non-resource activities. However, the allowance based on gross revenues takes no account of different cost levels and thus, the profitability of different producers. Such an allowance, in our view, would be unfair and distorting.

The second alternative reviewed would restructure the present resource allowance, so that it was computed as a percentage of resource profits after the deduction of all associated costs, including related exploration, development and interest expenses. Effectively, the restructured allowance would be calculated at the current rate of 25 percent but on a narrower base. The change would be significant – along with the lower general federal-provincial corporate income tax rate of 33 percent on average that we propose elsewhere in our Report, the corporate income tax rate on resource profits, net of the allowance applied at both levels of government, would be 24.75 percent (15 percent federal and an average provincial rate of 9.75 percent), one of the lowest corporate income tax rates for resource income among major producing countries. We estimate that our package of proposals will not increase the aggregate of federal taxes to be paid by the oil and gas sector.

The advantage of this proposal is that a resource allowance based on actual net profits would reduce economic distortions inherent in the current system by treating all resource income and costs uniformly. The Committee recognizes that income from resource activities would be taxed at a lower rate than other income, a result that appears to be inconsistent with our view of encouraging a single rate of corporate income tax. However, the disparity in rates for resource and non-resource income has a valid basis in the need – discussed earlier – to limit deductibility of provincial levies. Fairness and efficiency would be improved across the range of producers.

The Committee also recognizes that, under this alternative system, interest and E&D expenses incurred by resource companies would be deducted against income effectively taxed at lower rates.²⁸ Accordingly, there would be an incentive to transfer such costs, so that they would be deducted against non-resource profits taxed at higher rates, if claimable by non-resource corporations against other fully taxable income.

A restructuring of the tax regime along the lines set out above would inevitably create winners and losers among existing enterprises and for prospective new activities. Nevertheless, the changes that we propose in the resource allowance, and other recommended modifications to the tax regime for the sector, should be considered in the light of the major corporate income tax rate reductions that are also recommended. All are put forward by the Committee as part of the overall effort to achieve a less distorting and more neutral tax system.

R E C O M M E N D A T I O N S

The Committee recommends that the federal government consider, after consultation with the provinces, the restructuring of the resource allowance to base it on income from resource activities, net of all deductions, at the current rate of 25 percent.

As the issues involved were subject to recent discussions that led to some changes announced in the 1996 Budget, full consultation among the federal and provincial governments and the industry on the resource allowance is appropriate before action is taken.

We recommend that any changes along the foregoing lines should occur only after an appropriate transition of at least five years.

This would provide time for the industry to adjust and minimize the present value of benefits and disadvantages to individual corporations flowing from the shift in tax burdens. This would also reduce the disruption that would result from a major change in the structure of the resource allowance and the accompanying shifting of tax burdens.

We also recommend that the gradual lowering of the general corporate tax rate recommended in this Report should not apply to resource income until such consultations have been carried out, and the interrelation between the base broadening and general rate reduction proposals as applied to this industry and the restructuring of the resource allowance have been fully reviewed.²⁹

Deductibility of Capital and Intangible Expenditures: The rate at which capital expenditures in the non-renewable resource sector can be written off for tax purposes also provides benefits to the industry, including opportunities to defer taxes on current accounting income. Generally, exploration costs can be immediately deducted against income, while development expenditures can be generally claimed at rates of 30 percent per annum on a declining balance basis.³⁰ Further, certain capital expenditures on a new mine or a major expansion of an existing mine can be claimed to the extent of income from the mine, meaning that the production will not bear income taxes until these costs have been fully written off. Allowances for the write-off of equipment and other capital assets (generally at 25 percent) have also been provided on a relatively generous basis, although arguably somewhat less accelerated than on many assets used in manufacturing activities (30 percent).

Given the variability of resource prices and the uncertainties in determining the extent of reserves in place, parts of the industry face risks about the future profitability of their initial investments; this creates a case for the continued expensing (100 percent write-off) of certain exploration costs. In many instances, the success of exploration efforts cannot be guaranteed, and hence, the deferral of such costs would be inappropriate. Alternatively, it could be argued that unsuccessful exploration costs should clearly be expensed, and costs on successful efforts should be capitalized and written-off over the lifetime of the discovered resource.

However, in reviewing the issue, the Committee noted that research costs and certain exploration expenditures have similar attributes; both relate to obtaining new and valuable knowledge, the discovery of which is uncertain, and thus, both are deserving of special consideration. For other

non-exploration types of capital expenditures, including development and resource production assets, the present accelerated write-offs may create economic distortions, and unfairness among producers and industries.

The Committee's view is that exploration expenses should continue to be fully deductible by taxpayers as incurred, to recognize the essentially uncertain results of exploration efforts, and also because of the externalities – benefits that may go beyond the business making the expenditure – generated by new discoveries.

The costs of the development of oil, gas and mining projects are of a different character. Such costs, which are incurred after the existence of the resources have been established, are primarily related to placing the property in a position so that production can commence, and hence, may be regarded as capital, and are included in development costs for tax purposes. The line between exploration and pre-production development is not easy to define in some cases.

The Committee notes that there appears to be a significant difference in the treatment of pre-production development costs in the oil and gas industry – which are generally treated as development costs subject to a maximum 30 percent annual write-off rate – and somewhat similar pre-production costs for new mines, which are generally treated as exploration costs, subject to a write-off rate of up to one to 100 percent. We suggest that the government review the tax treatment of the pre-production costs of new mines, and consider whether the components of such costs that are not analogous to exploration or operating costs should be treated as development costs.

R E C O M M E N D A T I O N S

We recommend that the maximum rate of write-off on development costs in both mining and oil and gas should be reduced from 30 percent to 25 percent of the declining balance for expenses incurred after a three-year period of advance notice.

We recommend that capital costs³¹ incurred in connection with new mines or major expansions of existing mines should not be immediately claimable in full against the income from the project. Rather, such costs should be placed in a new class and only be deductible up to a maximum of 25 percent of the declining balance. The recommendation would only apply after a five-year period of advance notice.

With respect to the second recommendation above, operators would continue to have the current option of including each project in a separate class, so as to be able to claim a terminal loss on abandonment. We suggest an unusually lengthy transition to provide fairness to mining and oil sands projects that have been planned or started under the present income tax rules. If the federal government wishes to provide further assistance for investments in new mines through the tax system, such assistance should be provided as an investment tax credit.

We recommend that the cost of acquiring new mining properties should, as in the case of oil and gas, be treated as a capital cost, deductible at a 10 percent annual rate after transition.

Atlantic Canada Investment Tax Credit (AIRC)

The Atlantic Canada Investment Tax Credit (AIRC) was introduced in March 1977. The objective of the measure was to promote economic development in the Atlantic provinces and the Gaspé region. Investments eligible for the AIRC are qualifying buildings, machinery and equipment used or leased by the taxpayer for the purpose of farming, fishing, logging, mining, oil and gas, or manufacturing and processing.³²

The credit was initially set at a rate of 10 percent while the general investment tax credit was available for other regions at a rate of 7 percent. The AIRC rate was subsequently increased to 20 percent in 1978. In 1989, the rate was lowered to 15 percent in conjunction with lower tax rates that resulted from tax reform. The general investment tax credit of 7 percent for other regions was eliminated in 1986 as part of the first phase of corporate tax reform. The AIRC was further reduced to 10 percent in the February 1994 Budget, effective as of 1995.

The AIRC is the only regional investment tax credit that remains in the federal tax system and provides about \$125 million in annual support, of which about 50 percent went to manufacturing, and 25 percent to mining, oil and gas projects during the period 1989-94. In 1994, however, oil and gas, primarily related to offshore developments, accounted for about 45 percent of the AIRC.

In examining the various specific provisions of Canada's corporate tax regime, the Committee noted that evaluations of regional investment tax credits have concluded that they do not generally achieve the intended effects. Relative to their cost, such measures have had only limited effectiveness in attracting incremental investments to designated regions, reducing economic disparity or creating additional jobs.³³ Investment tax credits are associated with additional problems, in that they are subject to abuse and in the words of one report, "run the risk of encouraging clients to acquire higher levels of capital assets than needed and to undertake more long-term financial obligations than their enterprise can easily maintain."³⁴

While the latter concerns apply with much greater strength to very high rate investment tax credits, such as the former Cape Breton Investment Tax Credit (tax credit rate of 60 percent), the AIRC does suffer from a key defect: sectors of the economy with substantial growth potential in the region – service industries generally including tourism, call centres, trade, communications, utilities and support functions – are ineligible for the credit. As the Committee has stated a number of times throughout this Report, a tax credit directed at only certain selected types of investment creates distortions and results in a poorer allocation of resources.

The Committee recognizes that the AIRC is only one of several federal programs used to assist economic development and small businesses in the Atlantic region. Others include loans, loan guarantees, grants and conditionally repayable contributions administered by the Atlantic Canada Opportunities Agency. It is the Committee's view that an array of support of this kind often provides a more flexible means of assisting job creation without complicating the tax system. The replacement of the Atlantic Investment Tax Credit by a non-tax-related program would be consistent with the reduction or elimination of selective tax preferences. The Committee favours moving the tax system in this direction, in conjunction with reduction in corporate income tax rates – a measure that we believe would be of significant benefit to the Atlantic region.

R E C O M M E N D A T I O N

The Committee recommends that the Atlantic Canada Investment Tax Credit be phased out and replaced by a broad-based, cost-effective program of development assistance for the Atlantic region that would not involve the tax system.

Financial Institutions

The financial sector – including chartered banks, trust companies, credit unions and *caisses populaires*, investment companies and mutual funds, investment dealers and brokers, general and casualty insurance companies and life insurance companies – is a large and growing part of our economy. Its expansion in recent years has been accompanied by an overall growth of employment within the sector, and the payment of substantial taxes by financial institutions to federal, provincial and municipal governments.³⁵

In considering the impact of the current tax system on the financial sectors, the Committee notes that federal and provincial taxes tend to be higher for this sector than for any other, and that substantive distortions on financial transactions are a result. These taxes create non-neutralities among financial service providers, and between the finance sector and other sectors of the economy.

The Rapidly Evolving Financial Sector

After years of relatively modest change, the industry as a whole has, for the last few years, been undergoing a period of rapid growth, adaptation and consolidation. The larger part of the industry used to be referred to as the “four pillars” – chartered banks, trust companies, investment dealers and insurance companies – each with separate functions and powers, and each with a distinct and defined role to play in the economy.

Important segments of the financial sector are still defined for regulatory, tax and other purposes according to the statutes governing incorporation. A chartered bank, for example, faces special tax rules because it is incorporated under the Bank Act, and not because it carries on certain activities. However, in recent years, the combined impact of heightened competition (domestic and global), partial deregulation, and large changes in technology and management techniques, have led to a substantial blurring of the separate responsibilities of different portions of the industry. Competition has led all players in the sector to respond to the new imperatives of improved efficiency in operations and closer adaptation to markets.

In recent years, the financial services sector has experienced the following developments:

- a general trend toward “disintermediation” has affected lending institutions – increasing numbers of businesses access financial markets directly rather than through intermediate financial institutions, as occurs, for example, in the case of securitization of assets;
- increased consolidation, not only within industry lines but across the traditional four pillars. For example, the chartered banks now own the bulk of the investment dealer sector, as well as a number of trust companies – and the banks are now branching out into general insurance;
- the growth of new financial companies which, while not formally part of the industry (in the sense of being incorporated as specialized institutions), perform certain functions carried on by financial institutions and compete with them;
- reorganization and restructuring, aided by technology and induced by competition, with various parts of the industry branching out into products and services that they have not previously handled; and
- growth in the proportion of business carried on abroad in some segments (for example, banks and life insurance), accompanied by a corresponding increase in the activities of some foreign institutions in Canada; the Canadian industry is now more exposed to international markets.

However, despite the growth of competitive forces in the sector as a whole, and the major changes in structure that have occurred, important parts of the industry are still subject to restrictions and regulations that are not faced by other enterprises. Some of these, such as the regulation of banking institutions by the Office of the Superintendent of Financial Institutions, naturally reflect public interest in the stability and solvency of deposit-taking institutions. However, there are other significant restrictions that have an impact on competition in the financial sector generally, including important rules restricting the transfer of ownership of the major chartered banks and federal and provincial regulation of other aspects of individual lines of business.

Taxation of Financial Institutions

The financial services industry is taxed at general corporate income rates, but is also subject to a significant number of special provisions, which reflect what were considered at the time of implementation to be special circumstances. The special rules include but are not limited to the following:

- Credit unions and *caisses populaires* have the bulk of their income taxed at the lower rate of corporate income tax (normally reserved for the first \$200,000 of small business income) as a special concession to the sector.
- The life insurance industry is subject to several special provisions. First, the taxation of income from life insurance policies is subject to detailed rules relating to the calculation of allowable reserves; these have been changed significantly over the years as the government has sought to have the industry contribute appropriately and currently on its profits. Second, investment income earned by life insurance companies attributable to policy-holder accounts is taxed at a flat rate of 15 percent on a current basis, with the mortality gains from such reserves generally paid out to policy holders tax free. Third, in recognition of the fact that the Canadian life insurance companies may have to operate abroad through branches – rather than through foreign subsidiaries – with these foreign branches being taxed and regulated under different rules by foreign taxation and regulatory authorities, the foreign branch income of life insurance companies is not subject to tax in Canada.
- Large financial institutions, like other large enterprises, are subject to the federal large corporations tax. In addition, however, large deposit-taking institutions and life insurance companies pay a further special capital tax (Part VI Tax). Regular (Part I) income taxes are creditable against the tax, so that, in some cases, it can be regarded as a minimum tax. Further, these companies are subject to another temporary tax (Part VI Surtax), which, in the case of deposit-taking institutions, cannot be offset by income tax payments. Federal capital taxes raised about \$100 million from banks and life insurance companies in 1995.
- Financial service businesses generally cannot obtain a refund of or an offset for the GST paid on inputs; as well, many of the charges for their services are not subject to GST.
- Life and casualty insurers are subject to substantial provincial insurance premium taxes (\$636 million in 1994).
- Financial institutions may be subject to provincial capital taxes at rates several times higher than other companies. The total amount of provincial capital taxes on financial institutions was \$429 million in 1994.
- There are special income tax rules applicable to certain financial institutions relating, for example, to the claiming of bad debt provisions by chartered banks and the “mark to market” rule for trading securities. The latter rule results in a significant acceleration in the recognition of unrealized income and losses in many cases.
- Deposit-taking institutions have to pay deposit insurance premiums to the Canada Deposit Insurance Corporation or other entities. When the premiums are greater or lesser than a reasonable current charge for the deposit guarantee provided, these amounts constitute, at least in part, a tax or subsidy for the institution.

Some of the measures described above represented efforts to correct past anomalies and attempts to ensure that financial institutions paid their fair share of taxes. However, it is the view of the Committee that these measures have gone beyond whatever original purpose they may have had, and that, considered together, have resulted in the imposition of a level of taxation on large parts of the financial sector that is substantially heavier than that faced by other sectors of the economy. (See Chapter 4, Table 4.1) Moreover taxes on banks have grown faster than taxes on other industries: from 1987 to 1994, federal and provincial corporate and capital taxes paid by the six largest banks increased from less than \$500 million to almost \$2.4 billion, while corporate income and capital taxes paid by all sectors only grew from \$18.4 to \$20.0 billion. All financial institutions paid about 15 percent of total federal corporate income and capital taxes revenue in 1995.

Financial Services: A Long-term View

A core theme of this Report is that in the absence of a compelling rationale, all business sectors of the Canadian economy should be subject to similar levels of tax. The Committee favours a neutral tax system, one that allows Canadians to make their own best choices with respect to the employment of their resources. Consistent with this view, we believe that, in the long run, a competitive and largely deregulated financial services sector should pay rates of corporate income tax and capital tax similar to other sectors of the economy, and bear an equivalent burden of other federal and provincial taxes. It is the view of the Committee that no single sector of the economy – in this case, a growing sector operating in an increasingly competitive and international environment – should permanently face substantially higher taxes. As businesses within the sector adapt to broader and more intense competition, such that the public interest in its efficiency is well-served, we believe that there will be little to justify special levies that have the effect of raising the financial sector's tax level well above those of other sectors.

The Minister of Finance has appointed a Task Force on the Future of the Canadian Financial Services Sector, with broad responsibilities to review and report on regulatory, competitive and other public interest issues relating to this important industry. This group's report is expected to be submitted to the government in 1998, and we anticipate that it, along with the actions that the government may take in response, will have important implications for the regulation and competitiveness of the entire sector.

The Financial Services Sector Task Force and this Committee have a common interest in the overall financial and competitive position of financial institutions. Accordingly, the Task Force and this Committee have jointly commissioned a study on the taxation of the financial services sector.³⁶ The research and the final study will not be completed until after the completion of our Report. We anticipate that the Task Force, and then the government, will find this study useful in their respective consideration of the taxation of financial institutions.

Conclusions Concerning Taxation of the Financial Services Sector

The mandate of this Committee is to put forward recommendations for the improvement of our present system of business tax, within the overall restriction that the system, with our modifications, should generate revenue in an amount roughly similar to that produced by the present tax regime. The Committee also supports a regulatory and taxation environment that results in a more neutral and fair treatment of all components of the financial services sector. In light of these two underlying themes, it is the Committee's view that, as long as the financial services sector is under broad review by the Task Force and by the government, we should make no recommendations nor suggest any policies that would significantly alter the level of tax revenues currently derived from the financial sector under the existing tax regime.

This does not mean our other, broader recommendations would have no impact on the financial sector. It, along with other sectors of the economy, would benefit from the lower general corporate tax rates recommended in this Report. The sector would also be subject to the general base-broadening measures that we propose, including the disallowance of capital taxes as a deductible tax as discussed in Chapter 11.

R E C O M M E N D A T I O N

The Committee recommends that, to the extent that our proposals in total result in a decrease in the amount of tax paid by the industry, the government should impose a temporary increase in the federal capital surtax on deposit-taking institutions and insurance companies to make up the difference. This surtax should be removed at the time that the government, following the review of our Report and that of the Task Force, implements a long-term and integrated package of changes in the regulation and taxation of the industry.

As noted, the Committee believes that coincident with the government developing its response to the Task Force on the Future of the Financial Services Sector, it should also review the tax position of the industry. Subject to the report of the Task Force, and within the overall restraints imposed by budgetary needs, and also with due regard to changes in regulation and organization of the industry, the government should move toward equalizing the tax burden of companies in this industry with the general corporate sector. More specifically, we suggest that capital and income taxes on financial institutions be adjusted over time to be comparable with those imposed on other large corporations in other industries.

In the view of the Committee, the Canadian financial services sector – assuming it is operating within competitive markets – should, over the longer run, face a level playing field in regard to taxation, in order to enable it to effectively compete at home and abroad, and to continue to provide major benefits to the Canadian economy.

Endnotes

- ¹ As used in this section, small business refers to all smaller enterprises, incorporated or unincorporated. However, many special tax measures for small business apply to Canadian-controlled private corporations (CCPCs), which may be large or small, while some special preferences, such as the small business deduction, are available to Canadian-controlled private corporations of less than a certain asset size or with less than a certain level of business income. (As noted in Chapter 2, a CCPC is a private corporation not controlled by non-residents or public corporations.)
- ² Data in the table do not include self employment, and are derived from Hendricks, Amit and Whistler (1997), Technical Committee Working Paper 97-11.
- ³ Canada. Industry Canada (1994).
- ⁴ Salley and Heath (1996).
- ⁵ The risk associated with venture-capital businesses is documented in Amit, Brander and Zott (1997).
- ⁶ Plamondon & Associates Inc. (1996), Technical Committee Working Paper 96-9. In Erard (1997c), Technical Committee Working Paper 97-12, the cost of small business compliance was related most strongly to the number of filings done and the paper burden. See also Canada, Industry Canada, Small Business Working Committee (1994).

- ⁷ Although, as discussed in Chapter 2, some of these levies are related to benefits provided to businesses, they are a source of revenue when the levies are more than the benefits of public programs provided to businesses.
- ⁸ Three of four provinces imposing payroll taxes also offer some relief to small businesses.
- ⁹ The U.S. provision creates a fully integrated tax regime for Sub-chapter S corporations similar to the Canadian treatment of distributed income at the corporate and personal level for small business, but is not as favourable as the Canadian system since it does not provide any deferral of tax on earnings retained in the small business.
- ¹⁰ In Canada, Industry Canada, Small Business Working Committee (1994), for example, the Small Business Working Committee recommended an increase in the small business limit up to \$400,000 with a progressive federal corporate income tax rate structure.
- ¹¹ For a discussion of recent initial public offerings of smaller businesses, see Jog (1997).
- ¹² In the case of associated groups of CCPCs, the employment tax credit could be allocated as desired among companies in the group.
- ¹³ See McFetridge (1995), Bernstein (1994) and Mohnen (1992).
- ¹⁴ Scientific and technological activity includes R&D, scientific and technical education, and scientific and technological services.
- ¹⁵ However, in Quebec, expenditures eligible for the 100 percent deduction are not reduced by the amount of federal or provincial tax credits. Furthermore, the amount of federal SR&ED tax credits claimed are included in a taxpayer's income for Quebec purposes in the year after they are claimed.
- ¹⁶ Except for provincial tax credit purposes in Newfoundland and Nova Scotia.
- ¹⁷ See Warda (1997).
- ¹⁸ Note that if economic costs of the R&D project are fully deducted in determining income, then the tax subsidy rate would be zero.
- ¹⁹ See Zieminski and Warda (1997).
- ²⁰ Canada, Revenue Canada (1997b).
- ²¹ Federal levies are also assessed for production from federal lands.
- ²² See Brewer, Bergevin and Arseneau (1997). The above estimates for average effective tax rates are based on a representative project. The calculations do not correspond to the effective tax rates on marginal investment provided in Chapter 3.
- ²³ The resource allowance replaced a 10-point (oil and gas) and a 15-point (mining) corporate income tax abatement that served the same purpose.
- ²⁴ Most provinces parallel the federal rules, but British Columbia, Alberta and Saskatchewan offer more generous treatment in some instances.
- ²⁵ The June 1975 budget stated that "exploration and development expenditures and the depletion they earn will be deductible against a net federal tax rate of 36 percent rather than the present lower rate of 25 percent. This will augment appreciably the incentive already contained in the present system such as earned depletion and the immediate write-off of exploration expenses." Canada. Minister of Finance (1975).
- ²⁶ The resource allowance is not generally available to the processing of imported ores in Canada. Starting in 1990, these activities have been entitled to the manufacturing and processing deduction on a phased-in basis that will be completed in 1999.
- ²⁷ One example is the special rules for "carved out" property. Another is successor rules that limit deductions to income from properties owned at the time of change in control or acquisition.
- ²⁸ See also the discussion on flow-through shares in the losses section in Chapter 4.
- ²⁹ If the lower general tax rates suggested in this Report were made available to the industry along with the continuation of the present resource allowance, the industry would gain a significant net benefit.

- ³⁰ Some development costs can be deducted at 100 percent. For example, development costs in some circumstances can be “flowed through” to shareholders and are deductible at 100 percent for purchasers of new equity.
- ³¹ The additional incentive allowance provided under the *Income Tax Regulation 1100(1)(w)* in regard to Class 41(a) assets.
- ³² Eligible activities for the AITC are broader than was the case with the Special Investment Tax Credit (SITC) that was also used by the federal government to promote regional economic development until it was eliminated in the 1994 budget. The eligibility criteria for the SITC was designed only to provide an incentive for “foot-loose” industries, i.e. industries like manufacturing that would be relatively free to locate anywhere in Canada. The primary processing of natural resources was specifically excluded from qualifying for the SITC.
- ³³ See, for example, May and Rowlands (1993) and Canada, Department of Finance (1990).
- ³⁴ See Canada, Atlantic Canada Opportunities Agency (1991).
- ³⁵ In 1996, financial institutions (deposit-taking institutions, insurance companies and ancillary financial services subsidiaries) paid \$8.3 billion in federal, provincial and municipal taxes on corporate income, capital, insurance premiums, property and payroll, plus sales taxes on business inputs. See Birkbeck and Vanasse (1997). Other data in this section are provided by the Department of Finance.
- ³⁶ The study is being undertaken by Kevin Dancey of Coopers & Lybrand and Kenneth J. McKenzie of the University of Calgary.

International Taxation

6

Introduction

International taxation is, by its very nature, one of the most complex and difficult areas in any business tax regime – for policy makers, tax administrators and taxpayers alike. A business carrying on activity in multiple jurisdictions is subject to a myriad of taxes and other levies on its various sources of income, and tax rules related to international income – both in design and application – are extraordinarily complex in many jurisdictions. This is a particular concern when, increasingly, small and medium-sized businesses, often lacking internal tax expertise, are expanding into foreign markets and must comply with the rules. The challenge for policy makers is that Canadian tax rules must take account of disparate rules across many jurisdictions, having regard to the significant potential impact that Canadian rules can have on domestic economic growth, job creation and protection of the tax base.

The issue is not a new one; historically, Canada has been a large capital importer and has placed a relatively heavy reliance on foreign investment. However, as noted in Chapter 3, Canada is now a significant capital exporter as well. The stock of foreign direct investment into Canada is substantial, and amounted to approximately \$170 billion in 1995 or 20 percent of assets held by Canadian businesses.¹ However, the stock of outbound foreign direct investment by Canadians is also significant (approximately \$140 billion in 1995 or 18 percent of total assets held by Canadian businesses), and is rising faster than inbound investment.

Today's global economy is characterized by the ongoing liberalization of trade policies and increasing transborder flows of goods, services, capital and technology. As the world economy becomes ever more integrated, and as business becomes increasingly mobile, the requirement that Canadian tax rules keep pace with international trends increases in importance.

In this Chapter, we provide an outline of some fundamental concepts of international taxation, and an examination of the major policy issues in this area, with a prime focus on foreign direct investment.

Competing Objectives for International Tax Policy

Tax policies related to inbound and outbound investment are driven by two important objectives: domestic economic growth and job creation on the one hand, and protection of the Canadian revenue base on the other. The Committee recognizes that there are often tensions between these two objectives, and there are many situations where there are no obvious “right” or “wrong” answers. A major constraint is the need to balance domestic considerations against international realities over which Canada has little control. For example, Canadian tax policies that are more onerous than those of other countries can have the effect of discouraging Canadian business activity and, as a result, can dampen domestic economic growth and job creation. Another constraint when examining Canada's

international tax policy is a pragmatic one: experience under the tax systems of other countries indicates that relatively little domestic tax revenue is raised from outbound foreign direct investment, irrespective of the nature and scope of the particular tax regime that is in place.

Against this background, this Chapter sets out concepts of international taxation that are fundamental to understanding the issues, examines the major policy issues related to inbound and outbound investment, and finally, details its conclusions. Throughout the discussion, a major theme prevails: it is the Committee's view that as a matter of general principle, Canadian tax rules should strike a balance between facilitating international trade and investment, and protecting the Canadian domestic tax base.

Canada derives considerable benefit from the presence of Canadian-based multinationals, and we believe that Canada's tax policy should accommodate the expansion of such companies, and their foreign investments, but on terms that are fair to Canada. It is also important that Canada continues to attract foreign investment, with foreign and domestic investors being placed on a similar footing. The Committee believes that if our proposals – to lower corporate income tax rates to make them competitive with those of our major competitors, offset by a broader tax base, which includes international tax measures where appropriate – were to be adopted, the result would be increased domestic investment and job creation, greater fairness and better protection of Canada's domestic tax base.

Fundamental Concepts for the Taxation of International Income

Multinational businesses are important to the Canadian economy. Many Canadian businesses operate throughout the world by investing in foreign operations; similarly, foreign enterprises operate here. Also, investment outbound from Canada can contribute to economic growth and job creation at home.² For example, Canadian-owned multinationals often rely on domestic sources of supply, and Canadian managerial talent and operational efficiency, to develop export markets for Canadian products and services.

Investment outside Canada by Canadian multinational businesses can therefore have significant spinoff effects, which contribute directly and indirectly to increased economic activities here. Further, as international trade in goods, services, capital and technology grows, and as both foreign and domestic markets open up to international competition, many Canadian businesses have found that they must expand abroad in order to achieve the necessary size to be efficient in production. In a number of industries, only large multinational enterprises have the ability to be truly competitive in global markets.

As for inbound investment, foreign multinationals operating in Canada provide capital, management and expertise for the development of key sectors of the economy, thereby also contributing to Canada's economic well-being. Inbound investment can also provide important spin-offs for Canadian-owned businesses that supply products and services to foreign multinationals operating here. Foreign companies also have access to financial markets in their home countries, often providing pools of cheaper capital for Canada.

The tax system of the host country where the business is carried on can have an important impact on both domestically owned and foreign-owned multinational operations. Although taxes are not the only factor that influence business decisions, the evidence is clear that they affect decisions of multinationals to invest at home and abroad.³ In examining Canada's tax system, the Committee concluded that taxation of investment in Canada has had a significant impact in discouraging investments from being made in Canada by both Canadian-owned and U.S. companies.⁴

Canadian tax rules also influence the way in which investments are structured and whether the Canadian domestic tax revenue base is adequately protected. For example, as pointed out in Chapter 3, there has been a tendency for multinational businesses to shift debt financing and associated interest expense into Canada, thereby eroding the tax base.⁵ The contrast between multinational and domestic-only businesses in this regard is striking: Canadian multinational businesses have increased their debt as a proportion of assets from 36 percent in the period 1986 to 1988, to 43 percent in the period 1992 to 1994, and foreign-controlled businesses have increased their debt as a proportion of assets from 20 percent to 26 percent in these same periods. In comparison, Canadian-controlled businesses without foreign affiliates slightly reduced their debt financing as a proportion of assets from 33 percent to 32 percent for these periods.

The growth and size of inbound and outbound investments thus raise two important tax policy issues for Canada: the need to strive for a tax system that is neutral for all businesses, foreign or domestically owned; and the requirement that governments protect their tax revenue base in order to support public-sector activities.

Neutrality in Tax Treatment for Businesses in Canada

Neutrality – the equal treatment of businesses in similar circumstances – results in both economic efficiency and fairness. It fosters international commerce and the flow of capital, by not interfering with the decisions of multinational businesses, and it contributes to economic growth and job creation by permitting businesses to seek economic opportunities for investments without being unduly influenced by taxation. As a principle, neutrality, in its fullest sense, implies that:

- Canadian businesses bear similar amounts of taxes on domestic and foreign investments;
- Canadian businesses operating in foreign jurisdictions bear similar amounts of taxes on their foreign investments as competitors operating in those jurisdictions; and
- foreign-owned businesses operating in Canada bear similar amounts of tax as Canadian-owned businesses operating in Canada.

As a practical matter, however, neutrality is a difficult principle to apply at the international level, since different jurisdictions choose taxes with varying rates and bases. The result is that all three conditions described above cannot be achieved simultaneously. For example, if foreign tax burdens are less than Canada's, payment by Canadian multinationals of taxes at the Canadian rate on their foreign investments may ensure tax neutrality between domestic and foreign investments, but at the same time, cause Canadian businesses to be more highly taxed than companies operating in foreign jurisdictions. Neutrality in the international context, therefore, can never be absolute. The best possible policy objective for Canada is to minimize economic distortions as much as possible.

Neutrality at the International Level

Varying concepts of neutrality are employed when assessing issues of international taxation. Several of the most important include the following:

Global Versus National Neutrality

Global neutrality implies that businesses should pay similar rates of Canadian and foreign tax on income derived from investments in Canada or abroad and regardless of the nationality of the owner operating in Canada. Under global neutrality, foreign taxes paid by businesses would be credited against Canadian taxes owing, so that the total rate of foreign and Canadian tax on income paid on foreign investments is no greater or less than on domestic investments. Similarly, foreign governments would allow their resident multinationals to credit Canadian taxes against the foreign governments' taxes owing on income derived from Canada.

The concept of global neutrality can be contrasted with national neutrality. National neutrality implies that domestic taxes should apply at the statutory rates of the investor country, irrespective of the geographic source of the income, and that foreign income taxes should only be deductible, in the investor country, as an expense of doing business in another country, rather than being treated as a credit against taxes. With deductibility, however, there is an element of double taxation that results in higher taxes on foreign compared to domestic operations. This can impede the efficiency of Canadian multinational businesses.

Most countries have accepted the concept of global neutrality, in that they allow foreign income taxes to be credited against domestic taxes on income earned abroad, or by exempting foreign income from further taxation in the home country when profits are repatriated in the form of dividends. Given Canada's desire to foster trade in international markets, the Committee believes that global neutrality for Canadian businesses is a more appropriate principle to follow.

Capital Export Neutrality

Capital export neutrality is achieved when foreign-source income is subject to the same effective rate as Canadian domestic income. This leaves Canadian multinationals indifferent, from a tax perspective, as to whether they invest in the Canadian domestic market or in foreign markets. In theory, capital export neutrality implies that Canadian tax would be paid on income taxed at lower rates abroad or, alternatively, result in the provision of refundable Canadian credits to bring down foreign taxes to the level of Canadian tax.

Capital Import Neutrality

Under capital import neutrality, a foreign investor is subject to tax at the same level as domestic companies in the country in which the business is carried on, contributing to international competitiveness by ensuring that foreign-source income is taxed in a particular country at the same rate as income earned by businesses owned by residents of that jurisdiction. From a Canadian perspective, capital import neutrality also implies that Canadian taxes on inbound investment should be similar to those on domestic-owned businesses – there should be no discrimination between foreign and domestic businesses.

Conflicting Demands of Neutrality

These various "neutralities" can conflict with each other. In particular, international competitiveness for Canadian businesses operating abroad can conflict with capital export neutrality, since it implies that domestic and foreign investments of Canadian multinationals may be taxed at different rates. The Committee recognizes that there are conflicts between capital export and capital import neutrality when foreign taxes are less than Canadian tax on income earned from abroad. An appropriate balance must be achieved. Canada derives benefits from the operation of multinationals here. The full application of capital export neutrality could impair their competitiveness abroad or, even worse, discourage companies from operating here. On the other hand, if Canadian businesses earn income that bears little or no tax in foreign jurisdictions, multinationals may be encouraged to locate production in foreign jurisdictions.

Fairness and Revenue Protection

The unavoidable outcome of taxing multinational businesses is that Canada is obliged to share the tax revenue raised from their activities with other national governments. Taxes paid by multinationals to Canadian governments contribute to meeting the cost of public activities that benefit all of us, including Canadian and foreign-owned businesses operating here. It is in Canada's interest, therefore, to protect its share of the tax base of income earned by Canadian and foreign multinationals from operations in Canada.

The sharing of tax revenues among national governments raises the issue of fairness – jurisdictions, either of source (where the production or delivery of goods and services takes place) or of fiscal domicile (where the business enterprise is resident or incorporated), are both entitled to tax the income earned by the enterprise. The country of source taxes the income earned in its jurisdiction to ensure that foreign businesses operating there share in the cost of public goods and services. The country of domicile may also choose to tax the foreign-source income of its residents to ensure that they pay a similar level of tax on all sources of income, domestic or foreign, in the interests of efficiency and fairness. In this event, and consistent with neutrality, a credit for foreign income taxes is often provided to recognize that such income has borne tax elsewhere and should not be subject to double taxation.

Challenges in Implementing the Principles of Neutrality and Revenue Protection

While the Committee regards both neutrality for Canadian businesses and revenue protection as crucial to economic growth and job creation, we are also aware of the difficulties inherent in implementing policies that will achieve these goals. National governments have varying revenue requirements and different views on what constitutes an appropriate sharing of business taxes. Every government chooses its own tax levels and tax mix, as well as the rules for defining what income is subject to tax. In the absence of worldwide uniform corporate taxation, full neutrality for all businesses operating in all countries is impossible to achieve. What Canada can do, however, is be fully aware of the impact its system has on international business, and take measures to ensure that Canada and Canadians benefit to the greatest extent possible from these economic activities.

For example, high levels of tax (relative to other jurisdictions) on foreign and domestic investments can affect the competitiveness of Canadian multinationals, and can reduce the economic benefits that Canadians derive from the Canadian multinational's activities. Similarly, high levels of Canadian tax on foreign businesses operating in Canada can discourage investments here. Also, international tax structures that result in the erosion of the Canadian tax base – for example, a tendency to borrow in Canada for foreign direct investment, rather than in the foreign country in which the investment is being made – can result in the need to increase taxes on other taxpayers or reduce public expenditures.

As noted, Canada has historically been reliant on significant levels of foreign direct investment from other countries. While high levels of Canadian tax can impair the flow of capital to Canada, low levels of Canadian tax on Canadian income may be offset by higher taxes paid by foreign parent corporations to their foreign governments where the foreign country applies the credit system, as do the United States, the United Kingdom and Japan. The interaction of the Canadian tax system with those of other countries is thus an important factor to keep in mind when developing Canadian policies for the taxation of inbound investment.

Despite recognition that neutrality is, in theory, a desirable objective, most, if not all, countries have elements within their tax systems that create economic distortions. As well, every government seeks to protect what it regards as its rightful share of the revenue base. In this regard, Canada is faced with the same constraints as its neighbours and trading partners: the Canadian tax regime must balance the goals of neutrality and revenue protection while being neither overly generous nor restrictive vis-à-vis the tax systems of other countries.

What Income is Liable to Canadian Federal Income Taxation?

Canadian federal income tax is generally levied on the worldwide income of persons resident in Canada (subject to credit or deduction for foreign taxes in respect of foreign-source income), and on certain Canadian-source income of non-resident persons. However, a Canadian corporate shareholder is generally not taxable on dividend income received as a result of foreign direct investment in countries with which Canada has entered into a tax treaty.

As discussed in Chapter 2, business and investment income may be earned by corporations, individuals, trusts or partnerships. A corporation is generally considered to be resident in Canada if it is incorporated in Canada, or if its central management and control is located here. The residence of an individual is a question of fact, but includes an individual who is living in Canada on a permanent basis. The residence of a trust is generally determined by the residence status of its trustees. Finally, a partnership is an entity that flows through its income to its partners, rather than a taxpayer itself.

A non-resident of Canada is subject to tax on certain Canadian-source income, under one of two regimes. First, a non-resident who is employed in Canada, carries on business in Canada or disposes of certain types of Canadian property, is subject to tax on net income from these sources, based on the general Canadian tax rates. Second, non-residents may be subject to withholding tax at a flat rate with respect to certain types of income, generally of a passive nature, such as interest, dividends, rents and royalties that are paid or credited by persons resident in Canada. The rate of tax on such income is 25 percent, generally on the gross amount paid or credited. As discussed further below, this rate is often reduced under tax treaties, and such treaties may also reduce the tax liabilities of non-residents carrying on business in Canada or deriving other taxable income from this country.

These Canadian rules establishing liability for tax are generally consistent with those followed by other major countries, although the detailed rules do, of course, vary considerably across countries.

The Role of International Tax Treaties

The bilateral income tax conventions (usually referred to as tax treaties) that Canada has entered into with other countries play an important part in facilitating cross-border trade, income and capital flows, and generally result in a more globally neutral tax regime for investment and business transactions between Canada and its treaty partners. Canada has one of the most extensive tax treaty networks in the world, with about 60 treaties in force, and a number of others under negotiation.

Tax treaties modify the taxation of cross-border income in a number of significant ways, primarily to reduce double taxation. For example, a resident of a treaty country is generally not taxable on income from a business carried on in the other country, unless the business is carried on through a fixed place of business. To minimize the potential for double taxation, countries may agree to either provide a credit for foreign income taxes, or an exemption for dividends received from foreign direct investment in the other country.⁶ Also, under most treaties, capital gains realized by residents of one country from assets in the other are generally exempt from tax in that other country, except for real property interests and certain other assets. Most treaties provide for significant bilateral reductions in the rate of withholding tax applicable to income such as interest, dividends, rents and royalties that are paid to residents of the other country. Tax treaties also provide for an exchange of information between the revenue authorities of the two countries to assist in administration and enforcement, as well as dispute-resolution procedures to resolve issues of double taxation, including cross-border transfer pricing issues.

While Canada has tax treaties with almost all of our important trading and investment partners, we have generally not negotiated treaties with tax havens (generally those countries without significant domestic income taxes). However, a number of countries with which we have treaties have domestic systems that do not tax some sources of income, or do permit some types of income or entities to be taxed more favourably than the domestic norm.

Taxation of Foreign Income of Canadian Investors

In this section, we review and examine the alternatives for taxation of foreign-source income earned by Canadian-based multinational businesses from foreign direct investment. Such income is generally subject to tax in the foreign country; however, the home country of the investor will often also assert a right to tax the same income. The difficult policy issues to be addressed include the extent to which double taxation is to be avoided, as well as whether, and to what extent, restrictions should be placed on deductions incurred in the investor's home country that relate to business activities carried on abroad. After an analysis of these issues, we then turn to the taxation of passive income from foreign investment.

Accrual, Deferral and Exemption Methods

There are various alternatives for the recognition of income earned in an investor's home country from foreign direct investment. For example, active business income earned by a foreign subsidiary of a parent company could be taxed on a current basis in the home country (the **accrual** method). As a second alternative, income could be recognized as it is distributed as dividends to the parent company and subject to tax in the home country at that time. This approach, referred to as the **deferral** method, results in the recognition of taxable income in the home country being deferred as long as profits are retained or reinvested abroad. A third alternative is to **exempt** income earned abroad from home taxation, meaning that income will only bear foreign tax. The tax systems of many countries incorporate elements of all three methods, adopting the approach considered most appropriate to the particular nature of different sources of income.

To avoid double taxation of income, countries have generally followed either the deferral method with a credit, or the exemption method. Under the deferral method with credit, which is consistent with capital export neutrality, countries such as the United States, the United Kingdom and Japan tax business income from foreign direct investment, and then provide credit for qualifying foreign taxes up to the amount of their domestic tax liabilities. Under this method, such income is, in theory, ultimately subject to tax at the greater of the statutory rates of the foreign jurisdiction(s) and that of the home country of the investor. Under the exemption method, income derived from foreign direct investment is exempt from taxation in the home country and thus only subject to tax in the country where the investment takes place. The exemption method can be viewed as proxy for the deferral method with credit, on the assumption that the income in question has been subject to foreign tax at a rate comparable to that which would have applied in the home country. Alternatively, the exemption method can be viewed as encouraging international competitiveness, by ensuring that home country investors operating in foreign jurisdictions bear similar tax to businesses owned by residents of that jurisdiction, consistent with capital import neutrality.

An Overview of the Present Canadian System⁷

The Canadian system, consistent with most countries, contains elements of all of the three methods described above. Foreign branch income is taxed on an accrual basis, as is "foreign accrual property income" (FAPI), both with relief for foreign taxes. In the case of the earnings of foreign branches of Canadian companies, accrual taxation is consistent with the basic principle that the world income

of Canadian residents should be taxed in Canada. In the case of FAPI – which, as described below, includes passive investment income of foreign affiliates – accrual taxation serves to protect the Canadian tax base, by preventing Canadians from shifting mobile passive income to low tax jurisdictions. On the other hand, dividends received by a Canadian corporate shareholder out of active business income of a foreign affiliate are only subject to recognition in Canada as received, and Canada uses both the exemption and deferral methods in this regard.

A foreign affiliate is generally defined to be a foreign corporation in which the Canadian taxpayer owns, directly or indirectly, at least 10 percent of any class of shares (or more specifically, at least 1 percent of any class of shares, provided the taxpayer, together with related persons, owns, directly or indirectly, at least 10 percent of any class). Active business income earned by a foreign affiliate in a treaty country is included in what is called exempt surplus, and dividends out of exempt surplus paid to a Canadian corporate shareholder are deductible in computing its taxable income, irrespective of the foreign tax burden that has been incurred. Active business income earned by a foreign affiliate in a non-treaty country is included in taxable surplus and, where a dividend is received by a Canadian corporation out of taxable surplus, deductions (adjusted so as to be equivalent to a credit) are available with respect to both the underlying foreign tax applicable to the earnings being distributed, as well as any foreign withholding tax applicable to the dividend.

Canada's approach is consistent with those of other major investor countries. Japan, the United States and the United Kingdom have opted for the deferral method with a credit in respect of income remitted from foreign subsidiaries. However, many other countries, particularly in Europe, use the exemption method. Certain countries, such as Australia and Germany, operate both systems, as does Canada. Canada provides exemption in the case of dividends received by foreign affiliates in treaty countries, and uses the deferral method with the equivalent of a credit in the case of dividends from foreign affiliates in non-treaty countries.

Alternatives for Consideration

In common with other countries, Canada generally recognizes the active business income of foreign affiliates when it is received as dividends. An alternative would be for Canada to adopt the accrual system, whereby income from all foreign direct investment (whether earned by foreign affiliates or by foreign branches) would be taxable in Canada on a current basis, with credit given for any applicable foreign tax. While this would ensure that domestic and foreign-source income was taxed currently at comparable rates, it would put Canadian business enterprises at a major competitive disadvantage vis-à-vis all of Canada's major trading competitors, none of which has adopted this approach. For this and other reasons, it is the view of the Committee that accrual taxation of all sources of income is not a viable option.

Other methods that might be considered as alternatives to the existing Canadian regime are described below.

The Full Exemption Method: Canada could implement a full exemption system, under which all dividends received by a Canadian corporate shareholder out of the active business income of a foreign affiliate would qualify for exemption, irrespective of whether the business operations were carried on in a treaty or non-treaty country. Such a change might be based, in part, on the fact that Canada has a very extensive tax treaty network, which includes virtually all of our major trading and investment partners. With the exception of industries that operate primarily in developing countries, a very significant portion of active business income of foreign affiliates already constitutes exempt surplus. Also, dividends are rarely paid to Canadian corporate shareholders out of taxable surplus, if this would result in additional Canadian tax. Implementing a full exemption system should accordingly result in little loss of Canadian tax revenue, while significantly reducing administrative and compliance costs, by eliminating the requirement to maintain detailed computations of exempt and taxable surplus balances.

One significant problem, however, is related to capital gains. If Canada were to adopt a complete exemption system, under which both dividends from foreign affiliates, and capital gains from the disposition of shares of foreign affiliates, were exempt from tax in Canada, there would be an incentive to seek opportunities for investments in foreign markets with potential for capital appreciation, to the detriment of similar investment opportunities in the Canadian domestic market. If, on the other hand, capital gains from the disposition of shares of foreign affiliates did not qualify for exemption, there would be a continuing requirement to maintain detailed computations of surplus balances of foreign affiliates (or to enact complex anti-surplus stripping provisions to prevent capital gains from being turned into exempt dividends), which would eliminate much of the simplification that would otherwise be achieved by full exemption. Finally, it might be argued that a complete exemption system, even for dividends, is overly generous, when compared with the regimes of many of Canada's major trading and treaty partners.

The Deferral Method with Crediting: As an alternative to the exemption approach, Canada could follow a full deferral method with crediting, under which all active business income earned by foreign affiliates would be included in taxable surplus. All dividends would be taxable when received by Canadian corporate shareholders, with relief in respect of applicable underlying foreign taxes and withholding taxes. Under the deferral method, relief for foreign taxes might be computed on a global basis; alternatively, more detailed rules could be put in place requiring separate calculations for specific sources of income.

It can be argued that converting to a full deferral system would not add significant additional complexity to the Canadian tax system. Canadian corporate taxpayers have been required, since 1972, to maintain computations of surplus account balances. Accordingly, and after a transitional period, all active business earnings might flow solely into the taxable surplus account. However, experience in other countries that operate under the deferral with credit method has proven that the rules do, invariably, become extraordinarily complex, resulting in a significant increase in administrative and compliance costs.⁸ While it is true that Canadian rules for the computation of taxable surplus have been in place for many years, taxable surplus dividends are rarely paid to Canada and, if Canada implemented a full deferral with credit method, the rules would have to be considerably more intricate and sophisticated than they are at present, including dealing with important differences in the timing of the recognition of income in foreign countries and Canada.

It is unlikely that the implementation of a deferral with credit method would, by itself, result in any significant revenue gain to the Canadian treasury. Experience under the tax systems of other countries, notably the United States, indicates that relatively little domestic tax is raised with respect to active business income from foreign direct investment under the deferral systems.⁹ Corporations simply tend not to repatriate foreign earnings if the action involves significant domestic tax, or implement planning measures to maximize the availability of foreign tax credits. Finally, entitlement to benefits under the exempt surplus system is embedded in Canada's tax treaty network, and abandoning the system in favour of the deferral with credit method might require either a renegotiation of many of Canada's tax treaties, a process that would take many years, or a change to Canadian domestic legislation, which would effectively override Canada's existing treaty obligations.

The High-tax Method: An additional alternative is a hybrid of the deferral and exemption approaches which would maintain the existing distinction between active business income earned in treaty and non-treaty countries, but would add an additional requirement that income earned in a treaty country would only be included in exempt surplus if the income met a "high-tax" requirement. For example, there might be a requirement that the income bear an effective tax rate equal to a certain, prescribed amount, or a rate equal to a certain percentage of the Canadian corporate income tax rate.

Under the hybrid approach, the nominal or statutory rate in the foreign country should presumably not be relevant, as this would not reflect the actual tax burden that the income in question has borne. Rather, what would be important is the effective tax rate (taxes divided by income) that each particular foreign affiliate is actually paying on its various sources of income. As a result, and similar

to the deferral with credit method, complex rules would be required for purposes of determining both the income base (either under Canadian tax rules, foreign tax rules, or some combination) and the amount of taxes being paid. These rules would have to deal with various issues such as the impact of loss carry-overs, whether computations are to be done on a company-by-company or on a group basis, the impact of tax credits and other foreign tax incentives, and foreign exchange issues. Perhaps most importantly, a high-tax approach limits the ability of Canadian taxpayers to aggregate taxes paid on all sources of foreign business income, as is the case under a deferral with credit method with a global tax credit. This would place Canadian companies at a disadvantage relative to competitors from countries such as Japan, the United States and the United Kingdom, which allow more flexibility for companies to average low- and high-taxed sources of income.

In summary, with only modest anticipated revenue gains to the Canadian treasury, the high-tax method could put Canadian multinationals at a competitive disadvantage and could result in substantial additional complexity.

Conclusions and Recommendations

On balance, it is the Committee's view that the existing regime – providing exemption in the case of active business income earned by foreign affiliates in treaty countries, deferral with credit in the case of such income earned in non-treaty countries, and accrual with credit or current taxation with respect to income earned by foreign branches and FAPI – is fundamentally sound and should be maintained. The alternatives in the form of a total deferral system or a hybrid, high-tax system, would introduce significant new complexity and would discourage some foreign direct investment by Canadian multinationals, with little anticipated revenue gain for Canada. At the same time, however, the Committee believes that there are certain elements of the existing system that weaken its integrity and should be addressed.

R E C O M M E N D A T I O N

It is the Committee's view that the ownership threshold for access to the exempt and taxable surplus system (generally, direct or indirect ownership of at least 10 percent of any class of shares of the foreign affiliate by the Canadian taxpayer and/or by related parties) is low, both in absolute terms and by international standards. For example (and subject to the possible application of a specific anti-avoidance provision), the ownership of at least 10 percent of a special class of preferred shares, even if *de minimis* in amount, is sufficient to allow access to the system. This may allow certain tax avoidance arrangements, where taxpayers can invest in preferred shares and can access the exempt surplus of otherwise unrelated taxpayers.

We recommend that the present definition relating to foreign affiliates be strengthened, so that only foreign companies in which Canadian corporations have a significant equity interest can be considered as foreign affiliates.

For example, the ownership threshold might be increased to require the ownership (either directly or indirectly, and by the Canadian taxpayer and/or by related parties) of at least (i) 10 percent of shares having full voting rights under all circumstances, and (ii) 10 percent by value of all outstanding shares. At the present time, there is an interrelationship between the rules defining foreign affiliates, and those defining controlled foreign affiliates that are subject to the FAPI rules. The Committee does not consider it appropriate to loosen the scope of the FAPI rules. We suggest, therefore, that the present definition related to controlled foreign affiliates be maintained.

A second weakness in the current regime concerns the manner in which income from foreign affiliates is treated. The exemption method can be argued to act as a proxy for the more complex credit method, on the assumption that the income of the foreign affiliate has borne foreign taxes at rates roughly equivalent to the Canadian rate (although the exemption method can also be viewed as encouraging international competitiveness under the principle of capital import neutrality). However, with the increasing expansion of the Canadian tax treaty network, more and more situations are arising – typically in the context of interaffiliate transactions involving the receipt of passive income such as interest, rents and royalties – where income earned in treaty countries is subject to low effective tax rates under special rules applicable to such income. It is the Committee’s view that permitting exempt surplus treatment for such income tends to encourage tax-planning mechanisms that erode the Canadian tax base. Accordingly, we recommend later in this Chapter that interaffiliate income earned by certain low-tax entities in treaty countries be included in taxable surplus.

Interest Expense Related to Foreign Investment of Canadian Investors

Background

Prior to the tax reform of 1972, interest on funds borrowed by Canadian corporations to invest in both Canadian and foreign subsidiaries was non-deductible. Taxpayers used tax-planning techniques to avoid the application of the rule (for example, “cash damming,” with cash from operations being accumulated in a separate account and ultimately being used to make investments in Canadian or foreign subsidiaries, and with borrowed funds being used to pay day-to-day operating expenses). At times, such planning was effective, although the rule did have the effect of reducing borrowings in Canada.

Since the 1972 reform, interest has been deductible by Canadian companies on funds borrowed to invest in both domestic companies and foreign affiliates. At the time, it was argued that this modification to the rules would put Canadian companies in the same position as foreign corporations in claiming interest deductions to invest in other companies. While interest deductibility resulted in a significant reduction in the Canadian tax revenue base, it also resulted in a significant decrease in the after-tax cost of such borrowing, and allowed Canadian corporations to be more competitive in making investments, both in Canada and abroad.

Other Countries’ Approaches

There is no international norm with respect to deductibility of interest on funds borrowed for foreign direct investment. Some countries (such as Canada) provide for full interest deductibility, while others have direct or indirect limitations. For example, Australia and the Netherlands deny interest deductibility on funds traceable to foreign direct investment, if the dividends from the investment qualify for the exemption method. In certain European jurisdictions, interest expense is effectively denied in a particular year, but only to the extent of exempt dividends received in that year. Finally, some countries, such as the United States, require the apportionment of interest expense between domestic and foreign-source income using a formula approach, where the amount of interest expense allocable to foreign-source income, while still deductible, serves to reduce the entitlement to foreign tax credits.

Alternatives for Consideration

As discussed earlier, while Canada uses both the exemption and deferral methods (exempt and taxable surplus) in respect of foreign direct investment by Canadian corporate shareholders, in practice, dividends are rarely received out of taxable surplus; thus the exemption system is the norm.

Under the exemption system, income repatriated as dividends to Canada bears no domestic tax, meaning that such income is only subject to foreign tax. Against this background, it is arguable that, as a general proposition, the tax system of the foreign country in which the business activities are carried on (and not the home country from which the investment is made) should bear the preponderance of the cost of financing the foreign business activities.

On the other hand, it can be argued that by restricting the exemption system to tax treaty countries (and assuming that Canada would only negotiate tax treaties with countries that impose a reasonable level of taxation), the exemption system serves as a proxy for foreign taxes that have been paid, and is also consistent with capital import neutrality. This suggests that interest deductibility in Canada should not be objectionable from the viewpoint of global neutrality. Furthermore, exempt surplus may be ultimately taxed in Canada when it is distributed as dividends to individuals or realized as capital gains.

Why Businesses Shift their Borrowing Costs to Canada

In addressing the clear differences between these two views on interest deductibility, it must be kept in mind that Canadian corporations frequently have a choice as to whether to borrow funds in Canada for foreign investment, resulting in interest deductions to the Canadian corporation itself, or to cause the foreign affiliate to borrow the required funds. Financing choices are influenced by a number of non-tax considerations; however, tax issues are often critical to the decision as to whether the funds should be borrowed by the parent company or by the foreign affiliate. As noted above, in recent years, and for a number of reasons, it appears that a disproportionate amount of borrowed funds has been incurred in Canada rather than abroad, resulting in a significant reduction of the Canadian domestic revenue base. As discussed earlier in this Chapter and Chapter 3, Canadian multinationals have significantly increased their borrowings of debt in Canada since the period 1986 to 1988. The Committee sees a number of factors leading to this trend.

First, and as discussed in Chapters 2 and 3, the combined federal and provincial corporate income tax rate for non-manufacturing activities in Canada is above the corresponding tax rate in a number of other countries. This creates an incentive for Canadian corporations to incur interest expense in Canada, where a current deduction may be obtained against income taxed at relatively high rates, leading to an increase in debt financing of multinational operations in Canada.

Second, many tax treaty countries provide domestic tax incentives that can often significantly reduce the tax burden in the foreign country. As the amount by which the Canadian rate exceeds those of other countries' increases, so does the incentive to claim interest deductions in Canada.

Third, tax changes introduced by other countries in recent years, most notably the United States, have tended to restrict the deduction of interest costs relating to foreign investment, inducing U.S. and other foreign corporations to shift such costs to their subsidiaries in other jurisdictions such as Canada.

Finally, funds may be borrowed in Canada to invest in a foreign affiliate in situations where losses are expected in the affiliate, such that the foreign affiliate will not be in a position to obtain an immediate deduction for the interest expense.

Weighing Alternatives – Factors to be Considered

In considering possible solutions to tax base erosion, the Committee is fully aware of the potential adverse impact on the amount of foreign direct investment by Canadian companies that could result from a restriction of interest deductibility. We pointed earlier to a number of studies that suggest that foreign direct investment has a beneficial effect on the investor country. It can be legitimately argued that interest deductibility is a reasonable price for Canada to pay to allow Canadian multinationals to continue to expand and compete in the global marketplace. A case can also be made, however, for

the view that a restriction of interest deductibility would affect, for the most part, the manner in which foreign investment is financed, rather than its absolute amount. For example, in most cases, funds that might otherwise have been borrowed by a Canadian parent corporation could be borrowed directly by its foreign affiliates (supported, if necessary, by a parent company guarantee).

The Committee weighed the arguments, and evidence for and against interest deductibility on funds borrowed to invest in foreign affiliates. It is our view that the current rules have resulted in a substantial erosion of the Canadian domestic revenue base, and that other Canadian taxpayers are paying more tax to make good on the shortfall. We are convinced that lower corporate income tax rates, offset by a broader tax base, including measures relating to the taxation of foreign-source income, where appropriate, will encourage domestic investment in job creation, improve fairness, and protect the Canadian domestic revenue base. A restriction of interest deductibility on funds borrowed to invest in foreign affiliates would be one such international tax measure. We also believe that, generally, the tax system of the foreign country in which the business is being carried on should bear the preponderance of the cost of financing the foreign business activities.

For these reasons, the Committee later recommends that interest expense be restricted on borrowed funds related, directly or indirectly, to investments in foreign affiliates. We appreciate that such a rule could, in certain circumstances, penalize small start-up companies, which will only be able to obtain financing directly in Canada, and we accordingly also recommend an exemption for up to \$10 million of borrowings related to investments in foreign affiliates, to be shared among members of an associated group.

In arriving at its conclusion that interest expense should be restricted, the Committee considered an alternative approach of continuing to allow full interest deductibility on all borrowed funds used to invest in foreign affiliates and, at the same time, converting to a total taxable surplus regime (the deferral with credit method), described further above. Under such an approach, it would be most appropriate for interest expense to be allocated between foreign and domestic-source income for purposes of computing foreign tax deductions available in Canada, consistent with the system used in the United States. However, this alternative would, of necessity, involve a long and difficult transitional period, and would result in a regime for the taxation of foreign-source income that would be both exceedingly complex, and could act as a severe impediment to taxpayers seeking to invest and expand in foreign markets.

Restricting Interest Expense Deductibility: Methods of Allocation

If, as we propose, rules are introduced to restrict interest expense on funds borrowed in Canada to invest in foreign affiliates, an important issue to be resolved is the method to be used for determining the amount of expense attributable to foreign (as opposed to domestic) investment. The Committee examined four alternative approaches: tracing; a Canadian domestic allocation formula; a modified domestic allocation formula incorporating a “safe-haven” for up to a certain amount of Canadian borrowings; and a worldwide allocation formula. Each, together with its perceived advantages and disadvantages, is set out below.

Tracing

Under tracing, any Canadian taxpayer borrowing to invest in foreign affiliates, whether directly or indirectly through one or more Canadian subsidiaries or affiliates, would be subject to a restriction of the related interest expense. This method would be consistent with general Canadian income tax principles, and avoids many of the arbitrary results, distortions and complexities that can arise under the various allocation methods.

The rule would be broadly drafted, and would include borrowings that can reasonably be considered, having regard to all of the circumstances, to have been used to assist, directly or indirectly, another person to make the foreign direct investment. Additional anti-avoidance provisions would be required to deal with tax-planning techniques that sought to avoid the rule, such as cash damming.

One disadvantage of tracing is that past experience with the enforcement of rules governing the disallowance of interest indicates that taxpayers will seek to construct mechanisms aimed at making borrowings that relate to a direct or indirect investment in a foreign affiliate, appear to be traceable to an investment for which the interest expense is deductible. Also, under tracing, it will be difficult – even with elaborate anti-avoidance rules – to overturn arrangements whereby a Canadian taxpayer borrows to invest in Canadian domestic operations and, in separate transactions, uses existing equity to finance foreign direct investment.

In practice, a tracing rule would be most effective in the context of Canadian business enterprises that have significant investments in foreign affiliates in relation to their Canadian operations, or where the company's financing arrangements are such that applying the tracing method is fairly obvious. By contrast, one can expect that larger multinationals, with complex financing structures and substantial operations both in Canada and abroad may, in some circumstances, be able to avoid the full application of the tracing rule.

Bearing in mind these limitations, it is nonetheless the Committee's view that the tracing approach would reduce the amount of funds borrowed in Canada to invest in foreign affiliates, and would induce taxpayers to locate a greater amount of indebtedness in foreign affiliates rather than in Canada.

Canadian Domestic Allocation Formula

Under a Canadian domestic allocation approach, the amount of a Canadian corporation's indebtedness that is considered to support foreign direct investment, is based on the ratio of foreign assets to total assets. For example, if a Canadian corporate taxpayer has \$50 of Canadian assets and \$50 of foreign direct investment (total assets of \$100), supported by \$70 of third-party debt and \$30 of equity, 50 percent of the debt would, under an allocation formula, be considered to support the foreign direct investment. Accordingly, interest on indebtedness of \$35 would be subject to restriction.

Formula allocation is based on the argument that money is fungible, and that all funds borrowed by a business enterprise should be regarded as effectively supporting its total assets at any point in time. There are, however, a number of major disadvantages to employing such a system, including the following:

- The domestic allocation approach ignores the extent to which foreign operations have themselves been capitalized through third-party borrowings.
- In common with any formula allocation, the domestic allocation approach will inevitably lead to undesirable economic results. For example, consider a Canadian business enterprise with 50 percent of its assets invested in Canada and 50 percent invested in foreign affiliates. If the enterprise decides to borrow to make a new investment in Canada, approximately 50 percent of the related interest expense would, under the allocation method, be restricted. Such a rule could accordingly discourage borrowings for Canadian domestic investment, where a Canadian business enterprise already has a significant proportion of its assets invested in foreign affiliates. On the other hand, if the same enterprise decides to borrow to invest in a foreign affiliate, approximately 50 percent of the interest expense would be allowed in Canada and, to this extent, the Canadian tax system would continue to provide a benefit in the form of partial deductibility of interest expense on funds borrowed to invest in foreign affiliates.
- To be effective, the formula method must be employed on the basis of a corporate group (and not on a taxpayer-by-taxpayer basis), and would require a compulsory consolidation for purposes of calculating all of the assets and borrowings of the corporate group, as defined. In the absence of

such consolidation, the formula method would be largely ineffective, and, with appropriate tax planning, little if any interest expense would ever be subject to disallowance. For example, if a Canadian parent company borrowed funds and invested in share capital of its 100 percent-owned Canadian subsidiary, with the Canadian subsidiary then investing in a foreign affiliate, the Canadian parent company would have used the funds for a qualifying purpose (to invest in another Canadian corporation), and the interest expense would be fully deductible.

- The consolidation rules that would be required under the formula allocation approach would, without question, add a significant amount of complexity to the Canadian tax system, with the attendant increase in administrative and compliance costs. In addition, defining the ownership threshold of the corporate group would itself lead to anomalous results. If the ownership threshold is relatively high, there would be situations where the rules would not apply. For example, assume that the defined ownership threshold is 90 percent, and assume further that a Canadian corporation borrows to invest in an 80 percent-owned subsidiary, with the subsidiary using the funds to invest in a foreign affiliate. As a result of the fact that the subsidiary does not form part of the corporate group as defined, none of the interest expense would be restricted. This contrasts with the tracing method, where the borrowings would have been considered to have been used, directly or indirectly, to assist another person to invest in a foreign affiliate, resulting in a restriction of all of the interest expense. To address this situation, one could set the threshold level for purposes of defining a corporate group relatively low. However, this option has its own shortcomings. In particular, under any corporate group approach, the borrowing and investment decisions of one member of the group might have an adverse impact on the interest deductions available to another; and, the lower the ownership threshold, the greater the possibility that the interests of minority shareholders could be adversely affected.
- The basis on which Canadian domestic assets and foreign assets would be measured must also be defined – does the system employ accounting values, tax values or fair market values? The use of accounting values is the simplest approach but could yield anomalous results. In the United States, interest allocation rules include an election to prepare calculations based on current fair market value, but the result is even further complexity.

For all of the reasons described above, the Committee is of the view that, in addition to introducing additional complexity to the Canadian tax system, a domestic allocation formula would inevitably produce results that are both uncertain and arbitrary, and would, in some circumstances, unduly increase the cost of both foreign and domestic investment by Canadian multinationals. We do not believe that a domestic allocation formula is a viable alternative, particularly in the context of a regime such as Canada's, which relies, to a great extent, on the exemption method, and where disqualified interest would be non-deductible (unlike the United States, where the deferral method is used, and where disqualified interest remains deductible but serves to potentially reduce foreign tax credits otherwise available).

Modified Domestic Allocation Formula

In order to address certain of the anomalies that might result from the domestic allocation method, a modified allocation formula could be devised. Such a formula might have two parts. First, a Canadian corporate group would be allowed to deduct interest on borrowing up to a certain prescribed amount of its total Canadian domestic assets. For example, using a 2-to-1 debt/equity ratio as a hypothetical "safe harbour," interest on indebtedness of a Canadian corporate group would be allowed under all circumstances, up to 66⅔ percent of the amount or value of Canadian domestic assets. Second, any interest expense incurred by the Canadian corporate group in excess of the original base would be subject to the domestic allocation method described above, taking into account both the indebtedness already allowed in Canada and the Canadian domestic assets financed by such borrowings,

both of which would be excluded from the calculation. The overall impact is that indebtedness up to a percentage of Canadian domestic assets would be allowed in full, while any excess indebtedness would be subject to the application of the formula allocation method.

The main advantage to this modified approach is that the safe harbour would permit full deduction of interest up to a reasonable amount, so that for corporate groups falling within the safe harbour range, there would be no adverse economic effect of incurring additional indebtedness to finance new Canadian investment. Its major disadvantage is a level of complexity in design and application similar to that which would likely result from the general domestic allocation method. The modified approach gives rise to two additional concerns. First, there would still be an inducement for Canadian corporate groups that fall below the safe harbour limit to put more borrowings in Canada. Second, for corporate groups operating in business sectors that generally require higher amounts of financial leverage (real estate and certain other industries), there might be difficulty in meeting the safe harbour exception, and consideration would have to be given to industry-specific exceptions, introducing yet more complexities.

Worldwide Allocation Formula

Under worldwide consolidated allocation, the corporate group would be defined with reference to both Canadian domestic taxpayers and foreign affiliates, and worldwide debt would be considered to support foreign assets, based on the ratio of worldwide foreign assets to worldwide total assets. The formula would produce an amount of consolidated debt considered to support foreign assets and, to the extent that foreign affiliates of the consolidated group had third-party borrowings equal to or in excess of this amount, there would be no restriction in Canada. However, to the extent that the amount of debt considered to support foreign assets under the worldwide allocation formula exceeded the amount of third-party borrowing incurred by foreign affiliates, any excess would be considered to have been borrowed in Canada to support foreign investments, and the interest on such excess would be restricted.

From the theoretical perspective, the worldwide formula allocation method is clearly better than the domestic allocation methods described above, in that it recognizes the extent to which debt has been incurred by foreign affiliates. However, the method appears to be so extraordinarily complex that, for all practical purposes, it is virtually unworkable. For example, the existing ownership threshold for foreign affiliate status is, in general terms, the direct or indirect ownership interest of at least 10 percent of any class of shares. The Committee has concluded that in such a context, there would be many circumstances in which any attempt to prepare consolidated worldwide calculations would be effectively impossible.

Restricting Interest Deductibility: Alternative Tax Treatments

Once a method is adopted to identify borrowings related to investments in foreign affiliates, the next step is to decide what treatment should apply to interest expense on such indebtedness. Again, the Committee examined different approaches. For example, any such interest expense could be unconditionally denied, or denied only to the extent of exempt surplus dividends received in the particular year or within a prescribed carry-over period (an approach that would obviously have a negative implication on repatriation). Another approach would be to restrict the interest expense, with deductibility being initially denied, but then being reinstated if the investment in the foreign affiliate results in taxable income in that year, or in a prescribed carry-over period.

As is usual in international taxation, no perfect solution emerges, especially in the context of Canada's current tax regime which employs elements of the accrual, exemption and deferral methods. Any rules that sought to allocate interest expense between "qualifying" and "non-qualifying" foreign

affiliates (for example, foreign affiliates in treaty versus non-treaty countries) would be complex, arbitrary, and unworkable in many situations, particularly given that foreign affiliates can earn varying amounts of exempt and taxable surplus from different sources and different jurisdictions on a year-to-year basis.

On balance, however, an initial denial of interest deductibility appears to the Committee to be appropriate in the context of Canada's broad exemption system, where dividends from foreign affiliates to Canadian corporate shareholders are predominantly paid out of exempt surplus, and where taxation is accordingly restricted to income taxes paid in the foreign jurisdiction in which the business activities are carried on. To the extent that taxable surplus dividends are ultimately received by the Canadian corporation, we believe that it is appropriate to then allow an amount of interest to be deducted, equal to the net inclusion in taxable income (in other words, net of deductions in respect of foreign taxes), on the basis that the interest expense should then be regarded as having been incurred to earn income subject to tax in Canada.

A refinement to this alternative would be to limit the amount of deductions in respect of foreign taxes, by incorporating into the formula for foreign-source income, an allocation of all or a portion of the restricted interest now being allowed as a deduction. However, such an approach would introduce its own set of complex allocation problems, with little anticipated revenue gain to the Canadian treasury.

Under our approach, we suggest that any disallowed interest in respect of an investment by a Canadian corporation in the shares of a directly held foreign affiliate be disallowed and added to the tax basis of those shares. The disallowed interest would also be accumulated and be eligible for carry-over, to be offset against any net taxable dividends received on the shares of that affiliate (and would then be deducted from the tax basis of the shares). The Committee considered other approaches, including the alternative of allowing an offset for disallowed interest against net taxable dividends received from, or capital gains realized on, the shares of any foreign affiliate. However, we concluded that this option would be overly generous.

It is the Committee's view that FAPI, in contrast, requires a different approach than does other taxable surplus. The FAPI rules are primarily anti-avoidance provisions, which include in taxable income, investment or passive income that could have been earned in Canada rather than abroad or which otherwise erodes the Canadian revenue base. It is arguable that interest expense should not be allowable in respect of income which is subject to this type of anti-avoidance provision. While double taxation could arise if a Canadian taxpayer borrowed to invest in foreign affiliates that earned FAPI, the behavioural response should be for the income to be earned directly in Canada. Also, if the cumulative disallowed interest expense balance was available for offset against FAPI, there would be a significant incentive for any Canadian taxpayer who had such balances to establish foreign affiliates for the express purpose of earning FAPI. The FAPI inclusion would simply be offset by the release of a corresponding amount of disallowed interest.

Summary and Recommendations

As set out above, there are a number of competing, and often contradictory, policy objectives and technical issues related to interest expense on funds borrowed to invest in foreign affiliates. These include economic efficiency, international competitiveness, complexity and protection of the Canadian domestic revenue base. As stated earlier, however, the Committee believes that lower corporate income tax rates proposed in our Report, supported by base broadening measures (including international tax measures, where appropriate) will produce a net benefit to Canada. Further, and as a general rule, we believe that the tax system of the foreign country in which the business activities are carried on (and not that of the home country from which the investment is made) should bear the preponderance of the cost of financing the foreign business activities.

With these overall principles in mind:

R E C O M M E N D A T I O N S

The Committee recommends that interest expense of Canadian taxpayers on indebtedness incurred to invest in foreign affiliates should be disallowed.

This disallowance should also apply to individuals, to the extent that funds are borrowed to invest in foreign affiliates of the individual through Canadian corporations.

The tracing method should be used for purposes of identifying the amount of indebtedness allocable to investments in foreign affiliates.

This should include interest on funds borrowed by a taxpayer, which can reasonably be considered to have been used, directly or indirectly, to assist another person to make an investment in a foreign affiliate of the taxpayer; other anti-avoidance provisions should be incorporated as discussed above.

Interest expense that is disallowed should be added to the tax basis of the shares of the relevant foreign affiliate, and accumulated in a “disallowed interest account.”

To the extent that dividends are received on those shares out of taxable surplus, an amount equal to the lesser of the accumulated balance in the disallowed interest account, and the net inclusion in taxable income should be allowed as a deduction (and deducted from the tax basis of the shares). Accumulated balances in the disallowed interest account should not be available, however, for offset against FAPI.

To prevent small start-up businesses that must resort to borrowing in Canada from being penalized, and also to address the administrative and compliance burden on small and medium-sized business, we recommend an exemption for up to \$10 million of accumulated indebtedness related to investments in foreign affiliates (with the exemption to be shared among members of a an associated group).

Indebtedness incurred or committed to under existing rules should be exempted from the new regime or be eligible for a generous transition period.

Grandfathering or transitional provisions are particularly significant in this area, having regard to the fact that taxpayers have made significant borrowing and investment commitments based on existing rules.

Deductibility of Other Expenses Related to Foreign Direct Investment

While the single, major expense incurred in Canada in respect of investments in foreign affiliates is, in most circumstances, interest expense, there are other costs incurred by Canadian business enterprises that relate to foreign direct investment. These include the costs of Canadian management personnel, certain accounting and legal costs, and support services. To the extent that such costs and expenses are custodial in nature (and thus properly the costs of the Canadian taxpayer rather than its foreign affiliate), it is arguable that such costs should be subject to the same general restriction as might apply to interest expense incurred for foreign direct investment.

On the other hand, custodial expenses are fundamentally different from interest expense. If they were to be disallowed, taxpayers might be induced to relocate management personnel out of Canada and into foreign markets. Moreover, disallowing custodial expenses incurred in Canada would result in double taxation, given that such expenses would not be deductible in the foreign country. Finally, the Canadian economy benefits from inbound foreign direct investment, and from the associated custodial expenses incurred outside of Canada by foreign parent companies.

It is the Committee's view, therefore, that while Revenue Canada should continue to be vigilant in ensuring that all costs borne in Canada for services incurred for the benefit of a foreign affiliate are charged to it, there is no compelling reason to change the Canadian tax law related to other expenses that are custodial in nature.

Foreign Accrual Property Income

Any Canadian taxpayer, individual or business, that has an interest in a "controlled foreign affiliate," may be taxed on an accrual basis where such affiliates earn certain types of income, including passive income such as interest and portfolio dividends, as well as prescribed amounts where the corresponding deduction erodes the Canadian tax base. These are the FAPI rules. As an anti-avoidance regime, the FAPI rules are intended to be prophylactic, and as such, they safeguard the Canadian tax base by preventing taxpayers from diverting income abroad. As a result, the FAPI regime can be said to be most effective when little if any FAPI is, in fact, being earned by foreign affiliates of Canadian taxpayers.

Countries vary in their approaches to this type of income; the United States, for example has extremely detailed and complex rules while certain other countries have rules that are extremely limited in scope. Tax policy considerations in this area accordingly involve difficult issues as to the appropriate nature and scope of such rules. Income to be attributed needs to be defined broadly enough to protect the domestic revenue base, but without casting too wide a net, such that the rules hamper the ability of Canadian multinational businesses to compete in the international marketplace.

Background

A controlled foreign affiliate of a taxpayer resident in Canada is defined, in general terms, as a foreign affiliate of the taxpayer that is controlled by the taxpayer (alone or with persons with whom the taxpayer does not deal at arm's length), or by the taxpayer and/or not more than four other persons resident in Canada (whether or not related to the taxpayer). To be defined as a controlled foreign affiliate, a foreign company must first be a foreign affiliate of the Canadian taxpayer. Earlier in this Chapter, the Committee recommends that the ownership threshold to qualify as a foreign affiliate be increased, to require a more significant equity interest in the relevant foreign affiliate for access to the exempt and taxable surplus system. However, the Committee also recommends that the existing (and lower) threshold continue to apply for purposes of the definition of controlled foreign affiliate, to prevent an erosion in the amount of income, potentially subject to the FAPI rules, that would otherwise result.

Taxpayers resident in Canada must include their proportionate amount of any FAPI earned by a controlled foreign affiliate in income on a current basis (subject to deductions equivalent to credits in respect of underlying foreign tax), whether or not the income is distributed by the affiliate as dividend payments. These rules apply to Canadian-resident individuals as well as corporations, and to affiliates in treaty as well as non-treaty countries. The allocable amount is based on the taxpayer's participating percentage (as defined) in the foreign affiliate, determined at the end of each taxation year of the affiliate. FAPI includes an affiliate's income from property and businesses other than active businesses, and taxable capital gains from dispositions of certain property (generally, a property that is not used or held for the purpose of gaining or producing income from an active business).

The definition of FAPI was substantially expanded in scope by the 1995 foreign affiliate amendments, and there are various sources of active business income that are, in fact, characterized as FAPI. In addition to property income, which is purely of a passive nature, FAPI includes income from an investment business unless the affiliate employs more than five employees (or their equivalent) full-time in the active conduct of the business, as well as specified types of income earned by a foreign affiliate, where the corresponding deduction erodes the Canadian tax base. There are also certain relieving provisions, which provide specific exceptions in the case of income that would otherwise be characterized as FAPI, but which arise from payments and other transactions between different foreign affiliates of the same Canadian taxpayer (generally referred to as "interaffiliate transactions").

Interaffiliate Transactions

As noted above, the 1995 amendments to the foreign affiliate rules significantly expanded the scope and definition of FAPI. The Committee is aware, however, of some suggestions that the FAPI provisions be even further expanded, by repealing or severely restricting the exemption provided by the rules related to interaffiliate transactions. We examine the issues relating to interaffiliate transactions below.

Background

Under the FAPI rules, income received by a foreign affiliate of a Canadian taxpayer, and paid by another foreign affiliate of the taxpayer (or by a related, non-resident corporation), is treated as active business income (rather than FAPI), provided the amount reduces active business income of the payor (and other prescribed tests are met).¹⁰ In addition to being exempt from FAPI, income from such interaffiliate transactions is included in exempt surplus provided, in general terms, that the payments reduce exempt surplus of the payor, and are received by an affiliate in a tax treaty country. The rules, accordingly, characterize such income, which would otherwise often be considered passive in nature, both as active business income and, in many circumstances, as exempt surplus.

Exempt Versus Taxable Surplus Characterization

As discussed earlier in this chapter, the exemption method for active business income earned by foreign affiliates in treaty countries can be argued to be based, in part, on the assumption that the income of the foreign affiliate has borne taxes somewhat equivalent to the Canadian tax rate. However, many countries with which Canada has negotiated tax treaties provide rules that allow certain activities or entities to be taxed at rates well below domestic norms. Under Canadian rules, such income qualifies for exempt surplus treatment, even if the entity in question is specifically denied benefits under the treaty.

For example, Canada has a tax treaty with Barbados, a country that has a general corporate income tax rate of 40 percent. Special-status entities such as Barbados international business corporations (IBCs), which are taxed in Barbados at preferential rates of 1 percent to 2½ percent, are specifically

denied treaty benefits, but remain eligible for exempt surplus treatment. This is equally true of certain tax-favoured entities in other jurisdictions, including Cyprus, Israel, Jamaica and Luxembourg. Most typically, income earned by such entities arises in the context of interaffiliate transactions involving offshore financing and similar arrangements, and where the income is passive in nature. It can be argued that this tends to encourage tax-planning mechanisms that erode the Canadian tax base, particularly where the interaffiliate payments relate to amounts that are deductible in Canada. For example, many finance structures involve borrowing in Canada to invest in an offshore, captive finance company, with the finance company, in turn, lending to another foreign affiliate in a higher-tax jurisdiction.

As a general principle, the Committee believes that Canada should not unilaterally seek to claw back general incentives implemented by its treaty partners, involving active business activities carried on in their jurisdictions. However, income from interaffiliate transactions often involves minimal, if any, direct job creation in the foreign country.

For these reasons, the Committee recommends below that the government revise the rule that extends exempt surplus characterization on interaffiliate payments, for income earned by entities that are expressly denied benefits under Canadian tax treaties. Such income would accordingly be included in taxable surplus of the recipient affiliate (even if the payment reduces exempt surplus of the payor affiliate), consistent with the treatment that applies with respect to such income earned by affiliates in non-treaty countries. We also urge the government to aggressively pursue a policy of renegotiating its existing treaties, to ensure that other tax-privileged entities in treaty countries are denied access to the exemption system with respect to interaffiliate transactions that would otherwise be passive in nature.

Exemption from FAPI

It has been suggested that the exemption from FAPI for interaffiliate payments (where the corresponding deduction reduces active business income of the payor affiliate) should be repealed altogether, on the basis that, as discussed above, the exemption tends to encourage tax-planning arrangements which erode the Canadian tax base. On the other hand, the interaffiliate exemption, in and of itself, simply ensures that the active business of one foreign affiliate of a Canadian taxpayer is not, as a result of deductible payments (such as interest, rents and royalties) characterized as FAPI in the hands of the recipient affiliate. The exemption from FAPI therefore facilitates interaffiliate payments, where consolidation of the income of a foreign affiliate group might not otherwise be possible. There are, for example, many situations in which multi-tier structures are required for regulatory and other non-tax reasons (for example within the United States and the European Union).

In addition, there are many situations involving interaffiliate payments such as royalties, interest and various other running expenses, where any fundamental change to the provision would be singularly inappropriate. We also recognize that the exemption allows Canadian businesses to compete more effectively in the global marketplace with the multinationals of certain other countries that can often benefit from similar provisions.

The Committee's recommendation (discussed earlier in this Chapter) with respect to the restriction of interest expense on funds borrowed to invest in foreign affiliates will help to protect the Canadian domestic base erosion from financing transactions. If in addition to this measure, and to the recommendation to repeal the rule that extends exempt surplus status to interaffiliate payments earned by entities denied treaty benefits, the exemption from FAPI for income from interaffiliate transactions were to be eliminated, the cumulative impact of these changes could significantly impair the international competitiveness of Canadian businesses.

Conclusions and Recommendations

In the Committee's view, the FAPI regime – including the extent and scope of the definition of FAPI – is generally sound, and since the expansion of the FAPI rules as part of the 1995 foreign affiliate amendments, operates effectively to protect the Canadian revenue base. However, there are still certain areas in which the system should be tightened.

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We recommend that the FAPI exemption for interaffiliate transactions be maintained, but that such payments be included in taxable surplus where the income is received by an entity that, while located in a tax treaty jurisdiction, is expressly denied benefits under that treaty.

As a result, such income would be treated in the same manner as income from interaffiliate transactions earned by entities in tax havens, which do not have tax treaties with Canada.

We recommend that the government actively renegotiate its existing tax treaties, to ensure that all tax-privileged entities in treaty countries are denied access to the exemption system with respect to income from interaffiliate transactions.

In addition to the FAPI exemption for interaffiliate payments, exemption from FAPI applies in respect of income received by a foreign affiliate of a Canadian taxpayer, where it is paid by a non-resident corporation that is not a foreign affiliate of the Canadian taxpayer, provided the payor is a non-resident corporation to which the particular affiliate and the Canadian taxpayer are related. This provision has encouraged the implementation of a number of so-called “second-tier” financing transactions, which may erode the Canadian domestic tax base, in situations where a foreign parent company controls the Canadian corporation, and where the Canadian corporation has little if any economic interest in the foreign operations being financed.

The Committee recommends that the provision that provides FAPI exemption for payments from related non-resident corporations that are not foreign affiliates of the Canadian taxpayer, be revised to exclude situations in which related party status arises solely as a result of share ownership by foreign parent companies outside Canada.

Finally, the Committee is concerned by reports that significant amounts of Canadian assets are being invested in a variety of foreign trust structures, and in circumstances where positions are being taken by Canadian taxpayers and their advisors that income earned by the foreign trusts fall outside the ambit of the Canadian FAPI provisions. These transactions undermine the integrity of (and confidence in) the Canadian tax system. The new foreign reporting requirements should assist Revenue Canada to identify situations in which these transactions are taking place.

The Committee recommends that foreign trust structures identified by Revenue Canada be challenged in the courts, in circumstances in which the trust income may be subject to the FAPI rules, and that, if such challenges prove to be unsuccessful, appropriate amendments be made to the tax legislation.

Later on in our Report (Chapter 10), the Committee also recommends the introduction of expanded civil penalties on gross negligence of tax advisors and promoters – penalties that we believe should also apply in the foreign trust area.

Offshore Investment Funds

As noted, the FAPI rules only apply in respect of controlled foreign affiliates of a Canadian shareholder. As a result, and consistent with the approach that has been adopted in certain other countries that have adopted anti-avoidance provisions similar to the FAPI rules, they do not apply to shares of foreign entities that are widely held by residents of Canada, such as offshore mutual funds and unit trusts or in other foreign entities. Accordingly, the offshore investment fund rules (which were introduced in 1984) serve as a backstop in these situations.

Offshore investment fund rules address situations in which Canadian taxpayer has an interest in a foreign entity that does not qualify as a controlled foreign affiliate, where the interest in the foreign entity derives its value primarily from portfolio investments, and where one of the main reasons for the taxpayer acquiring or holding the interest in the property is to reduce Canadian tax. If the rule applies, the Canadian taxpayer must include in income a notional amount equal to the designated cost of the investment (as defined) multiplied by a prescribed rate. This prescribed rate may of course be greater or less than the actual income earned by the foreign entity and attributable to the interest of the Canadian taxpayer. The rule is arbitrary and, where it applies, can result in a significant penalty to the Canadian taxpayer. However, as an anti-avoidance provision, this result is not necessarily inappropriate. While the offshore investment fund rules could be revised, so that they would operate on a more specific and targeted basis, such changes would not necessarily provide any additional protection to the Canadian domestic tax base.

There appears to be little income being reported by taxpayers or assessed by Revenue Canada under the offshore investment fund rules. This could result from the fact that the rules have had their desired effect, and that offending, portfolio investments are not being made. However, the Committee is concerned that certain transactions are occurring that may fall within the ambit of the rules, but where the income is neither being reported nor assessed. We suggest that Revenue Canada review investments in foreign entities and aggressively apply the offshore investment fund provisions as appropriate.

Taxation of Income of Non-resident Investors

Introduction

As noted earlier in this Chapter (see inset entitled “What Income is Liable to Canadian Federal Income Taxation?”), non-residents are taxable in Canada on Canadian-source employment and business income, on the disposition of certain types of Canadian property, and on the receipt of specified property income (including dividends, interest, rents and royalties) paid or credited by persons resident in Canada. International tax treaties modify these rules on a bilateral basis, generally restricting the right of one country to tax income earned by a resident of the other, so as to facilitate trade and investment, and reduce the potential for double taxation. Also, treaties generally provide for significant reductions in the rate of withholding tax applicable to income such as dividends, interest, rents and royalties, paid to residents of the other country.

With respect to inbound investment, it is the Committee's view that tax policy in this area should work toward two goals: that foreign investors in Canada should, to the extent practical, be on an equal footing with Canadian domestic investors operating in the Canadian marketplace; and that the Canadian treasury obtain its fair share of tax revenue derived from businesses carried on in Canada. Achieving a fair balance between the two includes determining an acceptable level of rates of withholding taxes applied on property income paid to non-residents of Canada, and an appropriate scope of the thin capitalization provisions.

In this section of the Report, after commenting on tax policy objectives related to inbound investment, the Committee reviews the issues noted above, as well as the exemption for interest payments on arm's-length indebtedness and the status of non-resident-owned investment corporations.

Finding a Balance Between Attracting Foreign Capital and Protecting the Revenue Base

As discussed earlier, there are a number of sometimes competing tax policy objectives related to inbound investment. Primary among these are the need to attract foreign capital and know-how to Canada, so as to benefit our economy, and the simultaneous requirement to prevent erosion of Canada's tax revenue base. The conflicting pressures are not easily resolved.

One means of protecting the revenue base is to impose high rates of withholding tax on interest and other deductible amounts paid to non-resident investors. However, such taxes may impede cross-border income and capital flows, and act as a tariff on the importation of capital or knowledge, contrary to neutrality principles. This is particularly the case when such taxes are not fully creditable in the home country of the non-resident. Such situations often arise, since Canadian withholding tax generally applies to gross income (and without reference to related, deductible expenses), but with tax being computed in the home country based on net income after expenses. Withholding taxes can be shifted onto Canadians, to the ultimate detriment of the national economy. For example, withholding taxes on interest are frequently shifted to the borrower, thereby increasing the cost of foreign capital to domestic business enterprises. Similarly, with respect to royalties, withholding tax can increase the cost to domestic business enterprises of accessing foreign technology, representing a tariff on knowledge.

Pulling in the other direction, however, are some equally compelling realities. Withholding taxes on deductible payments such as interest, rents and royalties are an important element in protecting the Canadian domestic revenue base, and represent significant revenue to the Canadian treasury – almost \$1.7 billion in 1995.

Foreign Portfolio Versus Foreign Direct Investment

In reviewing the treatment of inbound investment, the Committee remained cognizant of the need to differentiate between foreign portfolio investment and foreign direct investment, particularly with respect to withholding taxes and thin capitalization provisions. Foreign direct investment is generally regarded as an investment by a person with an equity ownership in a business enterprise of at least 10 percent. In practice, this level of ownership interest will often be sufficient to allow the non-resident investor to have influence on the borrowing and investment decisions of the business entity. A foreign direct investor often looks to the rate of return of the business enterprise itself, with a view to deriving income, either in the form of dividend payments, or by capital appreciation realized on an ultimate divestment of the ownership interest. A foreign portfolio investor, on the other hand, will generally have little, if any, control over the borrowing and investment decisions of the business enterprise, and is primarily interested in the return on the shares or indebtedness owned, rather than the underlying performance of the business enterprise itself.

Withholding Taxes

Background

While the general withholding rate is 25 percent under Canadian domestic tax law, under our bilateral tax conventions this rate is almost always reduced. Canada has historically been, and continues to be, a significant importer of capital – both foreign direct and portfolio investment – and has in the past, accordingly, tended to seek higher rates of withholding rates in its tax treaties than many of our major trading and treaty partners.

The OECD Model Tax Convention sets out a uniform basis of withholding tax rates in respect of different sources of income. The Model Convention is intended to act as guidance to member countries in negotiating bilateral tax treaties, but is not binding. The Model Convention suggests a 5 percent dividend withholding rate in the case of foreign direct investment, 15 percent for dividends on foreign portfolio investment, 10 percent on interest and no tax on royalties. In the past, Canada generally sought higher rates in its treaties than suggested in the Model Convention – often 15 percent for dividends (whether direct or portfolio), 15 percent for interest, and 10 percent for royalties.

More recently, however, Canada has taken a different approach in its treaty negotiations, and Canada's position with respect to treaty withholding rates now conforms more closely to the OECD Model Tax Convention. The 1992 and 1993 federal budgets announced Canada's willingness, in its tax treaty negotiations, to reduce the withholding tax rate on direct dividends to 5 percent, and to eliminate withholding tax for royalty payments made for the use of computer software and in respect of rights to use certain patented information or information concerning scientific experience. Canada has now negotiated a number of new treaties, or protocols to existing treaties, which incorporate these reduced rates, as well as a 10 percent withholding tax rate for interest payments.

It is the Committee's view that the present Canadian position with respect to the level of withholding taxes under bilateral tax treaties is consistent with international norms, strikes an acceptable balance between the competing goals of global neutrality and protection of the Canadian revenue base, and, accordingly, requires no modification at the present time.

Exemption for Interest Payable on Arm's-length Indebtedness

Under Canadian domestic tax law, interest payable by a corporation resident in Canada to a non-resident person with whom the corporation is dealing at arm's length is exempt from withholding tax, if certain conditions are met. The exemption generally applies if, under the terms of the obligation, the Canadian corporate borrower may not be obliged to pay more than 25 percent of the principal amount of the obligation within five years from the date of issue of the indebtedness, except in the event of a failure or default under the terms of the agreement. This exemption was introduced as a temporary measure in 1975, to allow Canadian corporate borrowers increased access to international capital markets. The exemption was extended on several occasions, until it became a permanent feature of the Canadian tax system in the 1988 federal budget.

As noted earlier, withholding taxes on interest payments tend to be shifted to the borrower, thereby increasing the cost of capital. The exemption for interest payable on arm's-length indebtedness provides Canadian businesses with increased access to global financial markets at competitive interest rates. The Committee supports the exemption, but has two recommended changes.

R E C O M M E N D A T I O N S

The Committee recommends that the withholding tax exemption for interest payments to arm's-length non-resident lenders be extended to all indebtedness, regardless of its term.

We see little compelling rationale for limiting the exemption to longer-term debt. While it can be argued that restricting the exemption in this manner may provide some degree of control over monetary conditions or may facilitate the regulation of Canadian financial institutions, in today's global environment, such arguments have little validity.

We also recommend that the exemption be denied in circumstances involving back-to-back transactions and similar financial support arrangements, in the same manner as discussed below under the thin capitalization provisions.

At present, there is no provision in the income tax rules that specifically denies the exemption in situations involving back-to-back loan arrangements by non-resident investors through third-party, financial intermediaries, or similar arrangements. While the exemption does require that the Canadian borrower and the financial institution deal at arm's length, at present the issue of whether otherwise unrelated parties are dealing at arm's length with respect to a particular transaction has to be determined in each case, thereby introducing uncertainty and complexity.

Rules Applying to Thinly Capitalized Businesses

Background

A business is said to be thinly capitalized when it is financed with a relatively high proportion of debt in relation to its equity base. In the absence of legislative restrictions, foreign investors seeking to minimize taxes associated with an investment in Canada would tend to invest a disproportionate amount of debt (as opposed to equity) in Canada. The interest expense reduces income otherwise subject to tax in Canada. By thinly capitalizing a Canadian business enterprise, a foreign investor can receive a greater proportion of its return in the form of deductible interest payments (generally subject to a 10 percent treaty withholding rate), rather than dividend payments out of after-tax income. The purpose of thin capitalization rules is to prevent this type of erosion of the domestic tax base in the country in which the business enterprise is being carried on.

Canada was one of the first countries to introduce thin capitalization rules, under which interest payable on indebtedness owing to certain non-residents is disallowed, to the extent that the amount of such indebtedness exceeds three times equity.¹¹ These rules were introduced in 1972 and, with minor modifications, have remained in place since that time. After describing the Canadian rules as well as international comparisons, this portion of the chapter reviews the efficacy of the rules and possible alternative approaches.

Canadian Thin Capitalization Rules – An Overview

Canada has a statutory thin capitalization rule of 3 to 1. This rule disallows interest that would otherwise be deductible, and that is paid by a corporation resident in Canada to a specified non-resident, as defined, where such indebtedness exceeds three times equity. For this purpose,

a specified non-resident includes a non-resident shareholder who, either alone or together with other persons with whom it does not deal at arm's length, owns 25 percent or more (votes or value) of the shares of the Canadian corporation; a specified non-resident also includes any other non-resident persons that deal at non-arm's length with such shareholders.

For purposes of applying the 3 to 1 debt/equity ratio, equity is generally defined to be the aggregate of: (i) the retained earnings of the Canadian corporation on an unconsolidated basis, (ii) the amount of surplus contributed by specified non-resident shareholders of the corporation; and (iii) the corporation's paid-up capital, to the extent that the capital stock is owned by specified non-resident shareholders. Indebtedness is generally defined as the greatest amount of interest-bearing debt owing to specified non-residents at any time in the year.

For example, if a Canadian corporation had \$100 of equity and interest-bearing indebtedness of \$400 owing to specified non-residents, \$100 of the \$400 of debt will be treated as being in excess of the allowable limits, and therefore, 25 percent of interest paid for the year to specified non-residents would be disallowed. On the other hand, if the greatest amount of interest-bearing indebtedness to specified non-residents at any time in the year is restricted to an amount of \$300, there will be no disallowance.

To the extent that interest expense is disallowed as a result of the thin capitalization formula, double taxation will often result. The interest remains subject to Canadian withholding tax, and will often also be taxable in the home country of the foreign investor. The rules are therefore prophylactic in nature, and are intended to apply to financing that is provided by non-resident shareholders in closely held situations. Canadian corporations in these situations generally carefully monitor their debt/equity ratios to ensure that there is no disallowed interest expense.

Other Countries' Approaches

There is no single, common standard with respect to the application of thin capitalization rules, and the approaches of different countries vary widely, both in concept and in detail. As noted, Canada introduced a thin capitalization rule in 1972, and was one of the first countries to do so. Increasingly, other countries have implemented thin capitalization rules, particularly since the late 1980s. Many countries follow the same type of objective formula approach as does Canada, with the majority using the same statutory debt/equity ratio of 3 to 1 as Canada. More recently, however, lower debt/equity ratios of 2 to 1 are being adopted.

Some countries use a more subjective approach. For example, in the United Kingdom, amounts paid to non-resident investors are generally recharacterized as dividend distributions, and not deductible interest, where (i) the borrower is a 75 percent-owned subsidiary of the lender, or both the borrower and lender are 75 percent-owned subsidiaries of a third company, and (ii) all or any part of the payment would not have been made had the parties been dealing at arm's length. When applying this rule, the U.K. revenue authorities generally consider both the debt/equity ratio, and the amount of "interest coverage" (defined as the extent to which projected earnings or cash flow would be sufficient to satisfy interest expense obligations).

The United States has a unique approach that includes both subjective and objective elements. Under the U.S. legislation, debt may be reclassified as equity in thinly capitalized situations. In addition, the United States adopted an objective test in 1989 referred to as the "earnings stripping rule," which generally applies to a corporate group that has a debt/equity ratio in excess of a safe harbour amount of 1.5 to 1. Subject to this safe harbour, interest on related-party loans is defined to be "disqualified interest," if the recipient of the interest is not subject to U.S. tax, or is subject to tax at less than the U.S. non-treaty rate of 30 percent. The regulation applies whether the recipient is a foreign or domestic investor (for example, a U.S. domestic, tax-exempt entity, which is related to the payor). Disqualified interest is disallowed to the extent that the U.S. corporate group has excess interest expense as defined, and any disallowed interest may generally be carried forward indefinitely.

Certain other countries adopt a substance over form principle, whereby loan capital provided by a shareholder can, under certain circumstances, be considered as equity (for example, where there are no fixed provisions for repayment, or payment of interest is dependent on profits). In other countries, excessive loan financing of a subsidiary company may be subject to general abuse of law concepts (although, in such countries, there appears to have been little significant practical application of the concept in thin capitalization situations). Finally, certain countries have no restrictions whatever.

Canadian Thin Capitalization Rules – An Assessment and Alternatives

Objective Versus Subjective Approaches: The Canadian objective approach, which uses a fixed debt/equity ratio, is, of course, inflexible and somewhat arbitrary. For example, it does not account for different debt/equity ratios that apply in certain industries or between businesses in the same industry. The advantages to the objective approach, however, are significant: the rules are simple to understand and apply, and are generally effective in protecting the domestic revenue base. Subjective approaches tend to increase uncertainty, as well as administrative and compliance costs.

Earnings-based Methods: Another alternative would be to maintain an objective calculation with an income or profits-based test instead of one using a fixed debt/equity ratio – similar to that which applies in the United States under the earnings stripping rule. However, unless the Canadian approach is modified so that the rules apply to interest (and possibly other non-deductible expenses) paid to a broader category of taxpayers such as Canadian domestic investors (as discussed in Chapter 7 of this Report), we do not favour adopting an earnings-based approach. Earnings-based methods, such as the U.S. earnings-stripping rule, are considerably more complex than thin capitalization rules based on a fixed, debt/equity ratio. In addition to a significant increase in administrative and compliance costs, this complexity can also lead to uncertainty in determining the acceptable level of indebtedness, and the extent to which interest expense may be disallowed in any particular year.

Possible Application of Thin Capitalization Provisions to Non-corporate Borrowers: The Canadian thin capitalization rules only apply to corporations that are resident in Canada, and not to other forms of business enterprises, such as Canadian branches of foreign corporations, or to partnerships or trusts. This creates an opportunity for domestic base erosion through the use of such entities. On the other hand, the extension of the thin capitalization rules to Canadian businesses other than Canadian-resident corporations would result in legislative complexity. Rules would be required to define the non-resident stakeholder to which the rules apply, as well as the allocation of equity to such stakeholders, and it is likely that separate rules would be required for each category (Canadian branches of foreign corporations, partnerships and trusts). With respect to discretionary trusts, it may be difficult or impossible to determine amounts attributable to particular beneficiaries.

Back-to-back Arrangements and Guaranteed Debt: A non-resident investor can lend to a Canadian business directly or indirectly using third-party financial institutions or other intermediaries. For example, in the extreme situation (and in the absence of any countervailing rules in the tax legislation), a non-resident investor might make a loan to a third party, with the same amount then being lent by the third party to the Canadian business. In other back-to-back arrangements, the tracing may be less direct. For example, the non-resident investor may undertake, as part of its commercial relationships with a third party (often a financial institution) to leave certain amounts on deposit with it, which may or may not correspond with the amount of the loan that the third party makes to the Canadian business. As another example, the non-resident investor may guarantee the

loan made from a third party to the Canadian business, with the guarantee being supported by a pledge of assets or other security, or possibly simply by the credit rating of the non-resident investor. There is, therefore, a continuum of foreign investor support that could apply, some of which are clearly tax-motivated and seek to avoid the application of the thin capitalization provisions, and others that may be entered into primarily for commercial reasons.

Again, the approach to back-to-back arrangements, and to guaranteed debt, varies among countries. The Canadian thin capitalization provisions deal with the most egregious type of tax planning. In general terms, they provide that where a loan has been made by a specified non-resident shareholder to another person, on condition that a second loan be made by any person to a corporation resident in Canada, the lesser of the amount of the first and second loan is deemed to be subject to the thin capitalization provisions. This rule does not appear to apply, however, in situations where a specified non-resident places funds on deposit with a third party, and where the third party makes a loan to the Canadian business in a different amount, and subject to different terms and conditions. Finally, third-party debt that is only guaranteed by a specified non-resident is clearly outside the application of the Canadian thin capitalization rules.

While it is clear, from a tax policy viewpoint, that back-to-back financing should be addressed by thin capitalization rules, the treatment of guaranteed debt is not as evident. Debt guarantees by related foreign parties can be regarded as a means of circumventing thin capitalization rules, and a number of countries have included such guaranteed debt in the thin capitalization provisions. On the other hand, the inclusion of guaranteed debt might often disrupt normal commercial financing arrangements. For example, there may be situations where a Canadian business enterprise does have sufficient borrowing capacity, or where a lender will nonetheless request a parent company guarantee (normally, a lender will seek the greatest amount of security possible). There are also a large number of circumstances where a Canadian borrower and related foreign parties will enter into joint financing arrangements, which could include, for example, cross-guarantees by each party of the other's indebtedness.

Conclusions and Recommendations

In general, the Committee is of the view that the thin capitalization rules are working well, and are not a major impediment with respect to the day-to-day operations of Canadian businesses. The rules are simple and effective, and the paucity of jurisprudence with respect to the rules suggests that disputes with the Canadian revenue authorities have been rare, notwithstanding the fact that the rules have been in place for more than 25 years. The Committee would not favour technical revisions to create a system that is purer from a theoretical viewpoint, but that adds complexity to the tax legislation with little benefit to either taxpayers or the tax administration. Accordingly, the Committee favours the fixed, debt/equity ratio approach, in lieu of subjective or earnings-based methods. The Committee also sees little merit in technical modifications to the rules dealing with the definitions of equity and indebtedness (such as a global debt/equity ratio that might focus on the total borrowing capacity of the Canadian business enterprise, or on the measurement of equity or debt attributable to the specified non-resident).

R E C O M M E N D A T I O N S

The Committee is of the view, however, that the existing rules should be strengthened in certain areas, following appropriate transitional notice, to provide further protection of the domestic revenue base, generally without undue interference with ordinary, commercial transactions.

The Committee recommends that the existing ratio of 3-to-1 should be revised to 2-to-1, as a closer proxy for financing that would generally be available in an arm's-length context.

While some countries allow somewhat higher debt/equity ratios for companies operating in specific industry sectors (financial institutions, for example), these exceptions have not applied to date in Canada, and there is little evidence that higher industry averages are in fact required.

The thin capitalization rules should be revised so that they apply, not only to investments in Canadian corporations, but also to Canadian branches of foreign corporations, and to partnerships and trusts.

While this will result in additional complexity, it is important that the domestic revenue base be protected. In situations involving discretionary trusts where the relevant beneficial interest of each beneficiary cannot be determined, the thin capitalization rule could apply to all debt attributable, directly or indirectly, to non-resident beneficiaries.

The existing provisions with respect to back-to-back arrangements using third-party intermediaries should be strengthened to include all indebtedness (such as amounts on deposit) between a specified non-resident and a third party, where all or a portion of the amount may reasonably be considered to have been loaned or transferred, directly or indirectly, by the third party to a Canadian business.

The rationale for the possible inclusion of third-party debt guaranteed by a “specified non-resident” is, in the Committee’s view, not as compelling. On balance, we propose that guaranteed debt not be included in the thin capitalization provisions at this time, but suggest that the issue be reviewed periodically by the government to identify possible abuses.

Non-resident-owned Investment Corporations

Introduction

A non-resident-owned investment corporation (NRO) is a special-purpose vehicle, eligible for special tax treatment. The NRO regime is a holdover from the 1948 *Income Tax Act*, and seems to have been originally introduced to provide non-resident investors (whether direct or portfolio) with the same Canadian tax result, whether they invested in Canada directly, or through a Canadian subsidiary company. In recent years, however, it appears that NROs have often been used primarily for tax-planning purposes.

Analysis of Current NRO Rules

An NRO is, in general terms, a company incorporated in Canada that elects to be taxed as an NRO, and complies with various conditions, including the following:

- All of its issued shares and indebtedness are owned by non-residents of Canada.
- Its income for each taxation year is derived from prescribed sources, including interest, rents and royalties.
- Not more than 10 percent of its gross revenue for each taxation year is derived from rents.
- Its principal business is not the making of loans or trading or dealing in bonds, shares, debentures, mortgages, notes or similar property.

Various special rules apply for purposes of computing the income of an NRO, and it is then taxed at a flat rate of 25 percent on such income. The 25 percent tax is refunded when the income is distributed as dividends to non-residents and, at that time, Canadian dividend withholding tax applies. This means that, ultimately, the final tax payable on most income earned by an NRO is the Canadian dividend withholding tax.

In recent years, it appears that NROs have often been used for tax-planning purposes. For example, if a foreign investor decides to establish or acquire a Canadian corporation, it could form an NRO to provide part of the required capital. An NRO is treated as a non-resident person for purposes of the Canadian thin capitalization provisions discussed above. Assuming, therefore, an investment of \$100, the foreign investor might, for example, invest in \$25 of equity of the Canadian company and \$75 of equity of the NRO, with the NRO using the \$75 to acquire indebtedness of the Canadian subsidiary. In this manner, the existing 3-to-1 debt/equity ratio in the thin capitalization provisions have been respected. Interest payments from the Canadian company to the NRO are deductible by it at ordinary corporate rates, and subject to tax at a rate of 25 percent to the NRO. On an ultimate payment of dividends, the 25 percent is refunded to the NRO, and Canadian withholding tax applies.

For the investor, there are a number of potential tax benefits to the type of structure described above. First, the effective Canadian tax rate can, to the extent of deductible interest and royalty payments to the NRO, be reduced from ordinary rates to the special refundable rate of 25 percent, even though the income remains in Canada. This rate will likely be reduced even further, to the applicable dividend treaty rate, when the income is distributed. Second, and depending on the tax regime applicable in the home country of the foreign investor, the investor may be able to defer or eliminate home country taxation. For example, in certain jurisdictions (such as the United States), the payment of a stock dividend is generally not a taxable event. In such circumstances, it may be possible for the NRO to pay stock dividends and reduce the effective tax rate in the NRO from 25 percent, to the dividend withholding rate applicable to NROs under the relevant tax treaty, without any income inclusion in the investor country. Of particular concern to the Committee is the fact that these types of planning alternatives may encourage non-resident investors to transfer indebtedness to their Canadian subsidiaries, in circumstances where this might not have otherwise occurred.

R E C O M M E N D A T I O N

The Committee recommends the repeal of the NRO provision, subject to a transitional period.

While the NRO could be viewed as a vehicle that encourages both direct and portfolio investment by non-residents in Canadian corporations – thus creating employment and growth in the Canadian economy – the Committee is of the view that the benefits are limited. In the first place, it is not widely used: in 1994, there were less than 100 NROs in existence. Also, it is unclear whether NROs function to attract additional capital to Canada, or whether, in fact, NRO tax planning structures are more often put in place once an investment decision has been made. The existence of NROs may be acting as an incentive to non-resident investors to thinly capitalize their Canadian subsidiaries.

Transfer Pricing

Introduction

Transfer pricing is a term used to describe the price at which goods, services and capital are exchanged between related parties operating in different tax jurisdictions. The design and application of Canadian transfer pricing rules, and their potential impact on the domestic revenue base, is significant. For example, for 1993, related-party, cross-border transactions of \$248 billion were reported to Revenue Canada by taxpayers, \$166 billion of which was between related parties in Canada and the United States. Considering that Canada raised close to \$20 billion in federal and provincial corporate income tax in 1996, even relatively small percentage shifts in income allocable to Canada from related-party transactions have the potential to cause a significant erosion of (or enhancement to) the domestic revenue base.

The Statutory and Administrative Framework for Transfer Pricing

Prior to the February 1997 federal budget, Canadian legislation required that transactions between a Canadian taxpayer and a related non-resident take place at the amount that would have been reasonable in the circumstances had the parties been dealing at arm's length. The 1997 budget announced that the legislation would be revised to more closely reflect the OECD guidelines, and new legislation has been proposed to achieve this change. At the time of the writing of this Report, this legislation has not been enacted.

In response to legislative and administrative pressure from the United States (described immediately below) and other countries, the February 1997 federal budget also proposed that taxpayers be required to provide contemporaneous documentation supporting the transfer pricing methodology used, and the imposition of penalties where these documentation requirements were not met or where the taxpayer did not act diligently in establishing transfer prices in conformity with the arm's-length principle. These requirements for contemporaneous documentation, and penalty provisions, are also included in the proposed legislation.

Statutory and Administrative Approach in the United States

The approach is somewhat different in the United States. While the United States endorses the OECD guidelines, U.S. authorities have also legislated detailed and complex transfer pricing regulations, which, for example, authorize the use of the "comparable profits method." Under this method, the profit performance of a particular related party is, in general terms, compared with the profit performance of arm's-length companies performing similar functions.

In recent years, the United States, from both legislative and administrative viewpoints, has adopted a more vigorous approach than most other countries in the area of transfer pricing. In the statutory area, the U.S. transfer pricing regulations require that contemporaneous documentation be available at the time of filing of a U.S. corporate tax return, to support the transfer pricing methodology used;

otherwise, any transfer pricing adjustments that are ultimately sustained may attract penalties of either 20 percent or 40 percent of the amount of the tax adjustment (depending on the amount of tax at issue). From the standpoint of administration, U.S. revenue authorities devote significant resources in reviewing and pursuing transfer pricing issues, often with teams that include, in addition to international tax agents, economists and industrial engineers.

The Committee is aware of concerns that, because of the statutory and administrative framework in the United States, there has been a tendency for businesses to establish transfer pricing practices that result in a greater proportion of income being recorded in the United States than would otherwise be the case. Further, many taxpayers are tending to rely, in whole or in part, on the comparable profits method when developing their transfer pricing policies, in a manner that may not be entirely consistent with OECD guidelines. These phenomena are of special concern to Canada because of the very significant volume of related-party transactions between the two countries and the potential for serious erosion of the tax base.

Conclusions

The existence of penalty provisions and documentation requirements in certain other countries (most particularly the United States), combined with aggressive transfer pricing audit procedures in those jurisdictions, poses a threat to the Canadian tax base. In particular, many businesses may, in the past, have sought to “overcomply” with tax rules in those foreign jurisdictions, to the detriment of the Canadian revenue base. On the other hand, when other countries respond with their own administrative, enforcement and penalty initiatives, taxpayers face the threat of double taxation and an escalating compliance burden.

While it is important that a balance be struck between protection of the domestic revenue base on the one hand, and the compliance cost and potential for double taxation imposed on taxpayers on the other, the Committee is of the view that, having regard to the volume of cross-border transactions with related parties (particularly in the United States) the threat to the Canadian revenue base is significant, and that Canadian legislation and enforcement should ensure that Canada obtains its fair share of the income from related-party, cross-border transactions. A research study on transfer pricing prepared for the Committee and released in December 1996, recommended that Canada introduce penalties for the underreporting of income stemming from transfer pricing manipulation, and that such penalties differentiate between taxpayers who act in good faith as evidenced by contemporaneous documentation, and those who do not.¹² The Committee supports these recommendations, and also endorses the principles that taxpayers should be required to have adequate documentation on a timely basis supporting the transfer pricing methodology used, and that penalties should be imposed if such documentation requirements are not met.

Further, it is the Committee’s view that Canadian transfer pricing legislation should incorporate the following elements:

- The level of penalties should reflect the fact that, unlike in certain other countries, interest on taxes is not deductible in Canada.
- Penalties should not apply if the taxpayer provides adequate contemporaneous documentation.
- The penalty should only apply to any net adjustment against the taxpayer, where a taxpayer has both upward and downward adjustments.
- If a taxpayer is in a loss position, the penalty should apply to reduce the taxpayer’s loss, rather than require the immediate payment of cash penalties.
- Canadian law relating to transfer pricing should be consistent with the OECD guidelines.

- In other than exceptional circumstances, the actual nature of transactions entered into by taxpayers should not be disregarded or other transactions substituted for them. Such a rule would be arbitrary, and would also lead to double taxation if the tax administration of the other country does not share the same view as to how the transaction should be restructured. The existing general anti-avoidance rule should be sufficient to deal with those exceptional circumstances where it is appropriate to disregard the structure adopted by the taxpayer.

Transactions between Canadian taxpayers and related parties located in low-tax jurisdictions offer particular opportunities to reduce Canadian taxes through aggressive transfer pricing methodologies. The Committee accordingly urges the Canadian revenue authorities to be especially vigilant in reviewing these types of transactions.

Emerging Issues in the Global Marketplace

Owing to their implications for taxation generally, the emerging issues of electronic commerce and international tax competition in the global marketplace are of special interest to the Committee.

Electronic Commerce

The rapid growth of electronic commerce is challenging many of the traditional concepts of income taxation. For example, when goods or services are provided over the Internet, traditional principles and rules may not be sufficient to determine which jurisdiction should have the right to tax all or a portion of the related income.

As noted earlier, a resident of Canada is generally taxed on worldwide income, and a non-resident is taxable on certain types of Canadian-source income, including income from a business carried on in Canada. Income from services is generally sourced to the country in which the services are rendered. However, it can be difficult to determine the source of income where services are offered electronically. Also, the right to tax business income is generally modified by tax treaty, such that a person resident in a country with which Canada has a tax treaty is generally not taxable on income from a business carried on in Canada, unless the business is carried on through a permanent establishment. In the Canada-United States Income Tax Convention, for example, a permanent establishment includes a fixed place of business such as a place of management, a branch or an office. The nature of electronic commerce is such that, in many instances, a traditional physical presence at the point of delivery or sale need not, and in fact does not, exist.

The electronic delivery of information also blurs the definition of what product is being bought or sold, since the traditional product in tangible form may not be present. Frequently, the nature of a transaction will determine its classification for tax purposes, especially with regard to the taxation of royalties. A sale of a tangible good such as a compact disk by a non-resident into a certain country may not give rise to a liability for income tax in that country, but the payment for that tangible good delivered in electronic format might be considered a royalty to use a copyright, and would thereby subject that transaction to tax in that particular country. The U.S. Treasury has proposed guidelines in this area relating to the classification of income involving computer programs.¹³

In addition to tax policy issues created by electronic commerce, the technology also poses challenges to tax administration at the level of compliance and enforcement. Frequently, the audit trail of electronic transactions is difficult for third parties – including tax authorities – to follow. Although electronic records may exist, they are subject to alteration without detection, and third-party paper records to substantiate transactions often are not available. The development of electronic money or payment systems could challenge tax administrations in the same manner as cash transactions, although electronic systems can be designed so as to establish trails and account for the use of such money in a manner similar to credit card transactions. The nature of the technology, however, points to the need for international co-operation on compliance and enforcement.

Governments and their fiscal agents must continue to monitor the potential impacts of global commerce on tax revenues. The challenge for tax authorities is to devise a means of sourcing such transactions to a particular location, either by extending existing principles to encompass electronic commerce or by creating new rules. Alternatively, source-based taxation may become less relevant, and residence-based taxation could become the standard charging provision for income arising from electronic commerce.

The issues of taxation and electronic commerce have an impact on both governments and businesses – the former confront the risk of tax base erosion, and the latter face uncertainty as to taxation of their operations. Several countries are actively studying these issues, work is being undertaken by the OECD, and a task force dedicated to this issue has been formed in Canada. While the potential risks are well identified, the technology continues to evolve and solutions remain elusive. The Committee favours continued debate and analysis of these issues in Canada, within the OECD, and by businesses undertaking electronic commerce.

Tax Competition

As the pace of economic integration in the global economy accelerates, countries have become increasingly aware of their economic interdependence. Governments have learned that business taxation affects investment and jobs, especially when the taxes levied are higher than those found in competing jurisdictions. However, they are also aware that taxes finance public expenditures on goods and services such as education and transportation – important factors that businesses take into consideration when choosing a jurisdiction in which to locate. Given that different countries have varying preferences for addressing these challenges, it is neither expected nor, we believe, desirable that all countries choose the same level of taxes and public expenditures in the face of global economic integration.

However, knowing the sensitivity of investment and jobs to taxes, a number of capital-importing countries have engaged in “tax competition” by establishing special preferences or low-tax entities to attract capital and jobs to their country from other competing jurisdictions. The most common forms of tax competition include tax holidays, tax-free zones and other tax preferences, such as low statutory income tax rates for designated activities, investment allowances, investment tax credits and accelerated depreciation. Capital-exporting countries have found that, as a result, they are losing more than jobs and investment. Relatively low corporate income tax rates also encourage businesses to shift taxable profits from high to low tax-rate jurisdictions, thereby eroding tax bases of those countries that are trying to maintain the integrity of their own corporate income tax regimes.

Aggressive competition by capital-importing countries to attract jobs and capital tends to encourage capital-exporting countries to retaliate by introducing their own tax preferences. The result is a race to the bottom – a short-term strategy for jobs and investments that results in retaliation by other governments to protect their own interests. In the end, each country chooses an inefficient tax structure. For these reasons, some experts have made the case that governments should strengthen co-operation at the international level, in order to curtail the most harmful effects of tax competition.¹⁴ The Committee encourages the government to involve Canada in these international efforts.

Endnotes

- ¹ Foreign direct investment is generally defined, for this purpose, as investment by a person with an ownership interest of at least 10 percent.
- ² In two recent and extensive surveys, Lipsey (1995) argues that foreign activities of Swedish multinationals have resulted in more domestic activity and job creation, while Feldstein (1995) has argued that each dollar of foreign investment has resulted in one dollar less of domestic investment by U.S. multinationals. Brean (1997) suggests that there is substantial complementarity between foreign and domestic activities of Canadian multinationals. In work done for the Committee, Altshuler and Cummins have found that foreign and domestic capital investments are substitutes, ignoring scale impacts and competitive conditions in an industry (Altshuler and Cummins (1997), Technical Committee Working Paper 97-4). In our view, there is some complementarity between foreign and direct activities for Canadian businesses.
- ³ See Hines (1996).
- ⁴ See Cummins (1996), Technical Committee Working Paper 96-4, for an analysis of U.S. multinational investments in Canada and the United States, and Altshuler and Cummins (1997), Technical Committee Working Paper 97-4 for Canadian multinational investment in the United States and Canada.
- ⁵ See, for example, Jog and Tang (1997), Technical Committee Working Paper 97-14.
- ⁶ This relief from double taxation is often provided unilaterally under domestic tax legislation in addition to tax treaty provisions.
- ⁷ For a further description of the current Canadian tax treatment of foreign source income, and comparison with treatment in several other countries, see the working paper prepared for the Committee by Arnold, Li and Sandler (1996), Technical Committee Working Paper 96-1.
- ⁸ On the cost of compliance with the U.S. foreign tax credit regime, see Blumenthal and Slemrod (1995).
- ⁹ Grubert and Mutti (1995) estimate that the United States has even lost revenue from the taxation of foreign source income under the deferral method.
- ¹⁰ The exemption from FAPI for interaffiliate payments and other transactions includes payments received by certain partnerships; certain payments by foreign affiliate holding companies in jurisdictions that have consolidated or combined tax reporting for members of a corporate group; and income derived by a particular affiliate from factoring of accounts receivable, or from loans or lending assets, provided that the accounts receivable, loans or lending assets were acquired by the affiliate from a related non-resident corporation, and other prescribed tests are met.
- ¹¹ For a detailed discussion, see Williamson and Garland (1996), Technical Committee Working Paper 96-12.
- ¹² See Turner (1996), Technical Committee Working Paper 96-10.
- ¹³ Proposed Treasury Regulation 1.861-18, 61 Fed. Reg. 58, 152 (November 13, 1996).
- ¹⁴ See, for example, Tanzi (1995). The European Council of Finance Ministers also recently agreed to a package of measures to address perceived “harmful tax” competition.

The Relationship of the Corporate and Personal Income Tax

7

Introduction

As noted in Chapter 2, the corporate income tax has two primary functions. First, it serves as a withholding mechanism to ensure that tax is collected on income accruing to shareholders, thereby preventing deferral of tax. Second, it also ensures that a certain level of tax is collected on income accruing to owners who are not subject to personal income tax, such as non-residents¹ and tax-exempt entities. With regard to the second function, when all corporations and their owners pay similar amounts of tax on income, economic efficiency and competitiveness in the corporate sector is enhanced. Furthermore, if there are some general benefits provided by public programs to businesses that are not subject to user charges, the corporate income tax operates to recover some of the costs of these benefits. At present, the corporate income tax serves as an important source of revenue for Canadian governments.

These two disparate functions for corporate income taxation imply that the relationship of the corporate income tax system to the personal income tax system is not a simple one. In particular, this relationship reflects two distinct and often inconsistent themes. The first theme is the reduction or elimination of the potential for the corporate and personal income tax systems to result in double taxation. In its function as a withholding mechanism to support the personal income tax, the corporate income tax may represent an extra level of taxation of business income earned by shareholders through corporations. Income that is earned by a corporation is taxed first at the corporate level and then taxed again at the personal level when distributed as dividends to shareholders.

There are different ways in which the personal income tax system could react to such double taxation. In a “classical” tax system, such as that in the United States, the corporation is treated as an entity separate from its shareholders, and no recognition is provided at the personal shareholder level for corporate income tax. Even the U.S. income tax system, however, diverges substantially from a purely classical approach by providing special rules to allow certain closely held corporations or hybrid entities to be treated as flow-through vehicles for their shareholders so that their income is taxed only once at the shareholder level. An alternative and more common approach found in many income tax systems around the world, including countries of the European Union,² as well as Australia and New Zealand, is a system of “imputation.” Under an imputation system, a corporation is recognized as a representative of its shareholders and some relief is provided from full taxation of corporate income at both the corporate and shareholder levels by imputing corporate income and tax to shareholders. The Canadian tax system currently provides partial relief from taxation of income at both the corporate and shareholder levels, primarily by means of a dividend tax credit that is available to individual shareholders and is determined as a fixed percentage of taxable dividends received from Canadian resident corporations (other than those exempt from tax). This process of reducing double taxation of corporate income is often referred to as “integration.”

The second theme reflected in the relationship of the corporate and personal income tax is maintenance of a certain amount of tax revenue at the corporate income tax level to preserve a level playing field in the corporate sector and to provide a source of revenue for the public sector. Given this motivation, the corporate income tax requires some protection against erosion of its taxable income base into the personal income tax system, or beyond. For example, payments by corporations of amounts such as interest, rents or royalties, which are deductible for corporate income tax purposes, normally result in income that is taxable to the recipient, but this income bypasses the corporate income tax. Where recipients of this type of income are not residents of Canada, the equivalent of full personal income tax will not generally be captured by the Canadian tax system; where the recipients are residents of Canada, income in such form may be subject to tax at lower rates than the corporate income tax rate (for example, a rate of zero, where the recipient is exempt from tax). Moreover, even where such income is subject to tax at the personal level at a rate equivalent to or higher than the corporate tax rate, there still will be a loss of some or all of the extra tax revenue that would result if this income is a substitute for dividends that represent income that would be taxed at both the corporate and personal levels.

Full integration would, in theory, encompass a reduction in personal tax on income paid to shareholders;³ the provision of integration measures for non-resident shareholders; and the refundability of corporate income tax to all shareholders, including those individuals paying little or no personal income tax, tax-exempt entities and non-resident shareholders.

It is the Committee's view that full integration, though consistent with the withholding function of the corporate income tax, would compromise the desire to ensure that a certain level of tax is collected on income earned by corporations. Still, the Committee believes that it is appropriate to consider measures that would link the amount of integration available to domestic owners to amounts of corporate income tax paid by corporations. However, the provision of integration benefits to non-residents would be offset by foreign regimes that may provide no similar treatment. Moreover, the refundability of corporate taxes would result in a significant erosion of Canadian revenue and would impair competitiveness within the corporate sector by providing advantages to businesses whose owners are subject to little or no Canadian tax.

The Committee has concluded that the integration of corporate and personal income tax can only be partial, if a proper balance of these conflicting functions for the corporate income tax is to be achieved. With this background, the following sections of this Chapter will explore three important aspects of the relationship of the corporate and personal income tax systems: integration of the corporate income tax; bypassing of the corporate income tax; and the taxation of income from capital gains.

Integration of the Corporate Income Tax

Benefits of Integration

Integration of corporate and personal income tax is, in principle, designed to ensure that different forms of income – dividends, capital gains, interest, and wages and salaries – earned by owners of a business are provided neutral treatment (taxed at approximately the same rate) under the tax system, regardless of whether the income is earned directly or through one or more corporations. In the absence of integration, income accruing to owners of equity capital invested in the corporate sector could be subject to double taxation at both the corporate and shareholder level. This, in turn, leads to particular patterns of behaviour as businesses seek ways to avoid the additional “unintegrated” tax paid on equity income. These include the following:

- Capital requirements would tend to be financed with debt, since interest is deductible from corporate income for tax purposes, while the return on equity capital in the form of dividends is subject to some level of double taxation.

- Compensation paid to managers and workers, particularly in closely held situations, would tend to be in the form of wages and salaries that are deductible from corporate income for tax purposes, rather than profit distributions that would not receive similar treatment.
- The lack of integration would function as an incentive for businesses, particularly small businesses, to avoid incorporation and remain as unincorporated enterprises. (see Table 7.1 for a comparison of after-tax returns in an unintegrated system).

Table 7.1

Comparison of After-tax Return on Capital Employed in Incorporated Business and Unincorporated Business in the Absence of Integration

	Incorporated Business	Unincorporated Business
	(\$)	
Gross Revenues	100	100
Wages	(30)	(30)
Interest	(10)	(10)
Depreciation	(10)	(10)
Taxable Income	50	50
Corporate Income Tax (@20%)	(10)	–
After-corporate Tax Income	40	–
Distributed Income	40	–
Personal Income Tax (@50%)	(20)	(25)
Net Income	20	25

It is evident, then, that the integration of corporate and personal income tax is consistent with the principle of neutrality, contributing to a more efficient and fairer tax system. Even the partial integration provided for in the Canadian tax system generates important economic benefits for Canadians in four distinct ways:

Investment: Equity finance is critical for financing capital expenditures. The owners share the profits – and the risk – of the enterprise and to some degree may participate in the governance of the business. With many business investments (knowledge-based intangible assets, for example), equity is an important source of financing, since investors have more control over the development of the business.⁴ When equity finance is discouraged by the tax system, businesses are over-capitalized with debt and face a greater possibility of insolvency or bankruptcy,⁵ resulting in higher investment risks and less investment overall. Thus, partial integration of corporate and personal income taxes in Canada has the economic benefit of encouraging capital investment and improving prospects for economic growth.

Increased Efficiency: With integration, the tax system is more neutral with respect to the decisions made by businesses in financing their capital, compensating managers and workers for their efforts, and choosing different organizational forms for business. The current partial integration of the corporate and personal income tax in Canada, while not entirely avoiding economic distortions, does reduce them with undoubted efficiency gains for the Canadian business sector.

Reduced Compliance and Administration Costs: With integration, there is less need for businesses to concern themselves with particular tax-planning structures aimed at reducing the impact of multiple taxes on equity income. Ultimately, this reduces compliance costs for businesses.

Integration also makes it easier for the government to manage the tax system with less reliance on rules, such as those related to surplus or dividend stripping, that create additional complexity for everyone involved. Again, Canada's partially integrated system reduces, but does not eliminate, such complexities.

Fairness: Integration improves fairness in the tax system. To the extent that corporate income tax, which reduces the amount of dividends and capital gains received by shareholders, is recognized as prepayment for tax on shareholders' income, incorporated and unincorporated businesses are treated similarly. The Canadian tax system provides full recognition for corporate income tax paid by small businesses at the low small business deduction rate and partial recognition for corporate income tax paid on other income of small businesses and on income of large businesses.

Limitations of Integration

The economic benefits of integration of corporate and personal income become more limited in relation to the role of international markets in financing Canadian businesses. Foreign investors generally do not receive a dividend tax credit to recognize the payment of Canadian corporate income taxes either from Canada or their country of residence for dividends received from Canada. In some countries, such as the United States, integration of corporate and personal income tax is not provided, except in limited cases. Moreover, in practical terms, Canada's unilaterally extending integration relief to foreign investors may have little effect, since foreign governments may negate such benefits by the manner in which they are taxed under their domestic tax systems.

The benefit of partial integration provided in the Canadian tax system is limited, in that it is available to Canadian resident owners and generally not to foreign shareholders for dividends received from Canadian resident corporations. To the extent that businesses rely on international markets for their financing, the dividend tax credit and other aspects of our integration system may have little effect in mitigating the impact of the double taxation of corporate income on investments.⁶ For this reason, it has been argued that integration benefits should be limited to small businesses. However, the evidence strongly suggests that the availability of equity capital derived from Canadian investors reduces the cost of equity financing for Canadian businesses.⁷ Although Canadian businesses have considerable access to international markets for equity finance, they may be able to issue shares at better terms in Canadian markets, thus making them more competitive.

As described above, the Canadian tax system provides only partial integration of corporate and personal income tax for income derived from large businesses, and for income over a certain limit earned by small businesses: the dividend tax credit is set at a rate that is roughly equal to the small business deduction income tax rate, which is substantially less than the general corporate income tax rate. Integration benefits are thus less for large businesses than for small ones.

It is the Committee's view, however, that this partial integration of corporate and personal income taxes still provides important economic benefits for Canadian businesses. Moreover, it is the Committee's view that the level of relief provided under the partial integration system in Canada is appropriate at this time. While expanding integration could offer substantial economic benefits, the revenue costs to governments would be large, and the heavy reliance of the Canadian economy on foreign capital would blunt some of the positive effects. Nevertheless, the Committee believes that, over time, and as circumstances permit, some consideration should be given to increasing the level of integration of corporate and personal income tax in Canada.

The Dividend Tax Credit on Foreign Sources of Income

As noted above, an element of Canada's system of integration is that individual Canadian taxpayers receive a dividend tax credit for dividends paid by Canadian resident corporations. While no such credit is available for dividends paid directly to Canadian investors from foreign corporations, dividends paid by Canadian corporations to individuals qualify for the dividend tax credit regardless of whether the dividends are derived from domestic or foreign sources of income.⁸

As discussed in the previous Chapter, dividends received by Canadian corporations from foreign affiliates are either exempt from Canadian tax or taxable with relief in respect of foreign corporate income and withholding taxes.⁹ In this way, the dividend tax credit recognizes both foreign and domestic corporate income and withholding taxes on foreign-source income remitted to Canada as dividends on foreign direct investment of Canadian resident corporations. The Committee is of the view that the availability of the dividend tax credit for dividends paid by Canadian corporations out of foreign direct investment is consistent with the principle of neutrality between foreign and domestic activity. Moreover, as currently structured, the tax credit recognizes the benefits of foreign direct investments that are undertaken by Canadian multinationals in terms of investment and job creation in Canada.

Integration Features of the Canadian Tax System

The Canadian income tax system provides for specific measures to integrate corporate level and personal shareholder level taxation in two areas. First, it contains provisions that reduce multiple levels of taxation of business income earned by Canadian resident corporations – those relating to the dividend tax credit; three-quarters taxation of capital gains on shares; and tax-free payment of dividends by one Canadian resident corporation to another. Second, it allows resident individuals to make investments using CCPCs with no greater income tax burden on income arising from such investments than if such investments were made directly by the individual by means of the special provisions relating to the refundable taxes on investment income and dividends, and the capital dividend account, as well as the dividend tax credit.

Dividend Tax Credit

Individual shareholders are provided with a dividend tax credit in respect of taxable dividends received from Canadian resident corporations. The credit reduces income tax otherwise payable by the shareholder, but to the extent that the full credit cannot be used against tax payable, the balance is not provided as a refund. The dividend tax credit is not available to non-resident shareholders. The dividend tax credit is intended to provide some relief to resident shareholders from double taxation in respect of income subject to tax at the corporate level. It has also been viewed as an incentive to Canadian residents to invest in the ownership of Canadian corporations.

The amount of the dividend tax credit is based on a combined federal and provincial corporate income tax rate of 20 percent. Because this is the assumed combined rate of federal and provincial income tax on the first \$200,000 of active business income earned by CCPCs, the measure fully integrates such income.

A taxpayer claiming a dividend tax credit is required to include in taxable income the actual amount of dividends received plus a “gross-up” amount based upon the corporate income tax that notionally has been imposed on the pre-tax income from which the dividend has been paid – currently 25 percent of the actual amount of the dividend.¹⁰ The actual dividend plus the gross-up is meant to represent the pre-corporate-tax income from which the dividend is paid; however, the gross-up is based on a “notional” amount of tax, in the sense that it may not reflect the actual amount of corporate income tax paid.

The dividend tax credit may understate the actual corporate tax paid if the dividend is paid out of income that has been taxed at an effective corporate tax rate greater than 20 percent (the combined federal and provincial statutory corporate income tax rate, which varies across provinces, can be in excess of 45 percent). However, the credit may overstate actual corporate tax if, due to differences between economic and taxable income – including the effects of tax incentives or preferences – the dividend is paid out of income that has been taxed at a corporate rate of less than 20 percent or not taxed at all.

Having included the grossed-up dividends in taxable income, the individual is entitled to claim a dividend tax credit to reduce the personal income tax that is otherwise payable in recognition of the corporate income tax that is notionally imposed on the dividend income out of which the dividend is paid. The combined federal-provincial value of the credit is approximately the same as the gross-up – 25 percent of the actual amount of the dividend.

Table 7.2 shows the impact of the dividend tax credit (simplified for purposes of illustration) in a range of typical cases. The first two columns (Cases A and B) consider the situation in which the corporation distributing earnings is taxable at a rate of 20 per cent, the third column illustrates the case when a corporation is taxed at a rate of 40 per cent, while the fourth column (Case D) considers the case in which the income distributed has not borne Canadian tax.

Table 7.2

Comparison of After-tax Returns, With and Without Integration (Dividend Tax Credit), for Taxpaying and Non-taxpaying Corporations

	Case A	Case B	Case C	Case D
	Taxpaying Corporation, No DTC, Low Rate	Taxpaying Corporation, DTC Available, Low Rate	Taxpaying Corporation, DTC Available, High Rate	Non-taxpaying Corporation, DTC Available, High Rate
	(\$)			
Corporate-level Taxation				
Gross Revenues	100	100	100	100
Wages, Interest, Depreciation	(50)	(50)	(50)	(50)
Taxable Income	50	50	50	50
Basic Corporate Income Tax (@ 20%) (@ 40%)	(10)	(10)	(20)	(20)
Investment Tax Credit	–	–	–	20
Net Corporate Income Tax	(10)	(10)	(20)	(0)
After-corporate Tax Income	40	40	30	50
Distributed Income	40	40	30	50
Personal-level Taxation				
Taxable Income	40	50	37.5	62.5
Personal Income Tax (@ 50%)	(20)	(25)	(18.75)	(31.25)
Dividend Tax Credit	–	10	7.5	12.5
Net Personal Income Tax	(20)	(15)	(11.25)	(18.75)
Corporate Plus Personal Tax	(30)	(25)	(31.25)	(18.75)
Net Income	20	25	18.75	31.25

The first column (Case A) illustrates a shareholder's after-tax return on the distribution of \$40 of after-tax income in the absence of a dividend tax credit. The example corresponds to that shown for corporate distributions in Table 7.1.

The second column (Case B) assumes that the shareholder is able to claim a dividend tax credit in respect of \$40 of dividend income. Assuming a corporate rate of 20 percent, the dividends of \$40 are first grossed-up by a factor of 25 percent to a taxable amount of \$50, which would be the amount of income received if the corporate tax were refunded to the shareholder. The personal tax is determined as 50 percent (\$25) of the taxable dividends less the dividend tax credit which is

20 percent (\$10) of the taxable dividends. In this example, the notional corporate income tax represented by the dividend tax credit equals the actual corporate income tax paid, as the example assumes that the corporation's income is taxed at a 20 percent tax rate. The net result of the operation of the dividend tax credit is that the corporate-level tax is offset, and the pre-tax amount of distributed income of \$50 is taxed at the applicable personal income tax rate after recognizing that the corporate tax is assumed to have been already paid. A comparison of this case and the unincorporated business case in Table 7.1 shows that the individual taxpayer's net income of \$25 is the same in both instances.

The third column (Case C) shows what happens when the corporation is subject to tax at a corporate income tax rate of 40 percent – substantially higher than the rate of 20 percent upon which the dividend tax credit is based. With the 40 percent corporate income tax rate, the corporation is able to distribute \$30 in dividends. The dividends received are grossed-up by a factor of 25 percent (reflecting the assumed corporate tax rate of 20 per cent) to \$37.50. The personal tax liability at 50 percent is \$18.75 and, net of the dividend tax credit of \$7.50, results in a net personal income tax of \$11.25. The total tax paid at the corporate and personal level in this case is \$31.25, leaving only \$18.75 left for the investor. That the dividend tax credit provides only partial relief for corporate taxes paid at a rate 40 percent is illustrated by the fact that the total tax paid by investor is greater than the case in which the corporation is taxed at the low rate.

Column four (Case D) presents the situation of a corporation that is subject to a high rate of tax, where, due to certain factors such as the availability of tax incentives to the corporation, it pays no corporate income tax but still has income to distribute. Because the shareholder is provided with a dividend tax credit irrespective of whether or not the dividend is paid out of income that has been subject to corporate income tax, the shareholder can still claim a dividend tax credit in this circumstance. The result is that the pre-tax income of \$50 is subject to an effective tax rate of only 37.5 percent, rather than 62.5 percent as in Case C, where the corporation was taxable.

Three Quarters Taxation of Capital Gains

While there are several reasons (as discussed later in this Chapter) for not taxing capital gains at full marginal income tax rates, the partial exclusion from income of capital gains on shares of resident Canadian corporations serves the specific additional function of partially integrating corporate and shareholder level taxation. If capital gains were taxed at full rates, then no relief would be provided to a selling shareholder with respect to tax already paid by the corporation on retained earnings to the extent that such earnings are reflected in the share price. Where share gains are taxed at a rate lower than dividends, this results in “dividend stripping” or “surplus stripping,” whereby taxpayers seek to convert corporate surplus (potential dividends) into sale proceeds of shares. These sorts of activities can, to some extent, be dealt with by complex anti-avoidance rules. However, the experience in Canada over a lengthy period of time leading up to the tax reform of 1972 suggests that such approaches are complex, costly, and not wholly effective.

Conversely, where capital gains taxation is imposed at a higher rate than the rate of tax on dividends, taxpayers seek to convert potential capital gains into dividends. That this also leads to difficulties in the tax system is evidenced by the current special treatment in the Canadian corporate tax system of certain inter-corporate dividends under “capital gains stripping” anti-avoidance provisions.

In light of these factors, it is clear that there are significant benefits in terms of economic efficiency, fairness and cost of compliance, in having the general rate of tax payable by individuals on capital gains approximate the rate of tax payable by individuals on dividends received from resident corporations (taking into account the dividend tax credit). Assuming a combined current federal and provincial top marginal tax rate of 50 percent on the income of individuals, it can be seen from Table 7.3 that the tax rates for capital gains on shares and on dividends received from Canadian resident corporations are currently equal.

Table 7.3

Comparison of After-tax Return on Dividends, and Capital Gains on Shares, With Integration (Dividend Tax Credit, Three Quarters Inclusion)

	Dividend	Capital Gain
	(\$)	
Receipt by Individual	100	100
Taxable Income	125	75
Personal Income Tax (@50%)	(62.5)	(37.5)
Dividend Tax Credit	25	–
Net Personal Income Tax	(37.5)	(37.5)
Net Income	62.5	62.5

The Inter-corporate Dividend Deduction

The inter-corporate dividend deduction is intended to limit the imposition of multiple levels of corporate taxation on business income distributed from one corporation to another. Where one Canadian resident corporation receives a dividend on shares of another Canadian resident corporation, the dividend is generally received on a tax-free basis.¹¹

While this measure is predicated on the assumption that the corporation that first generated the income has already paid corporate income tax on that income, there is no general mechanism in place to ensure that such income has, in fact, been subject to tax at the corporate level. There are, however, complex and extensive provisions in the tax system to deny the benefit of the inter-corporate dividend deduction with respect to certain preferred share dividends received by financial institutions, or in other circumstances, where preferred shares do not carry all the usual attributes of equity. There are, in addition, complex special provisions to ensure that certain amounts of corporate income tax have been paid by a corporation paying dividends on preferred shares in order to justify the tax-advantaged receipt of the dividends by shareholders. There are also special anti-avoidance provisions to prevent the tax-free distribution of retained earnings to corporate shareholders in the form of dividends, where such earnings have not borne corporate income tax and such distribution is a substitute for a sale of the shares at a higher price which would be subject to tax as a capital gain.

Investment Income of Canadian-controlled Private Corporations

The Canadian income tax system contains provisions that allow individuals to make investments through CCPCs and to earn investment income without paying more tax (taking account of both corporate-level income tax and shareholder-level income tax) than the individual would pay if making the investment directly, while preventing the individual from obtaining any tax-deferral benefit as a result of potentially lower tax rates at the corporate level. This is accomplished by use of special refundable taxes on investment income, including dividends, as well as a mechanism for distributing the untaxed one quarter of capital gains through the capital dividend account, together with the dividend tax credit.

It is the Committee's view that this part of the corporate tax system achieves integration in an appropriate manner for this type of income, is well understood and generally functions satisfactorily. Accordingly, the Committee concludes that these provisions should remain unchanged.

Improving Integration

The Committee generally supports the integration of corporate and personal level taxation because of the benefits described above. However, it also recognizes that a system of full integration of all business income would be undesirable at present for the reasons set out above in this Chapter. In particular, the Committee does not favour extending this system by refunding to shareholders “unused” dividend tax credits, both because of the cost in terms of forgone revenue, and the other difficult issues that such a refund would raise with respect to non-resident and tax-exempt shareholders. The Committee, therefore, supports the current approach to integration using a dividend gross-up and tax credit regime, which provides partial integration for individual shareholders resident in Canada.

By comparison, an alternative approach to integration – that of allowing corporations to deduct dividends paid to shareholders for tax purposes as an expense, as interest is deducted, in computing income subject to tax and fully taxing dividends at the personal level – is rife with problems. The dividend deduction system may be simpler, and treats debt and equity investment on a more neutral basis at the corporate level. However, such a system would lead to a serious erosion of income tax revenue, with a large proportion of corporate business income bypassing the corporate income tax, such as where dividends are paid to non-residents. This would amplify the various difficulties discussed in the next section of this Chapter. In the final analysis, a system of dividend deductions almost certainly would be too costly in terms of revenue loss, and would lead to undesirable results.

Options for Revising the Dividend Tax Credit System

While the Committee proposes the retention of the current non-refundable dividend gross-up and tax credit system at the current rate of 25 percent (reflecting the credit for underlying corporate taxes paid at a rate of 20 percent), the Committee has serious concerns about one important element of the existing system. As noted above, the dividend tax credit is currently available to individual shareholders without reference to whether corporate tax has been paid on the corporation’s income out of which dividends are distributed. Accordingly, in considering these issues, the Committee surveyed the corporate income tax imputation systems of a number of other countries.

While the aim of each of the systems that we examined is to provide full or partial relief from the imposition of tax on corporate income at both the corporate and individual shareholder levels, they differ significantly in approach.

Variable Dividend Credit System: Some jurisdictions, notably Australia, use a variable dividend credit system whereby the dividend tax credit available to individual shareholders in respect of a particular dividend received from a resident corporation depends on the amount of corporate tax that has actually been paid by the corporation on the income out of which the dividend is paid. In cases where the dividend is paid out of fully taxed income, the dividend tax credit and gross-up are based on the corporate income tax at the full rate. If instead, the dividend is paid out of income that has not generated corporate income tax, no dividend tax credit is available. In such a system, it is possible that only a portion of any particular dividend would be considered to be paid out of tax-paid income, thus adjusting the amount of dividend tax credit available with respect to the dividend.

The net result of the variable credit system is that distributed income is subject to only one level of tax. To the extent that the distribution is out of a corporation’s non-tax-paid income, then that amount of income is subject to tax at the shareholder’s marginal personal income tax rate. To the extent that the distribution is out of the corporation’s tax-paid income, then that amount of income is subject to tax at the shareholder’s marginal rate less the corporate income tax rate. If the corporate tax rate exceeds the shareholder rate, excess credit relief is not available, and such tax-paid income is taxed once at the corporate rate.

The variable credit type of system does not appear to work well with multiple corporate income tax rates, such as those in Canada. Another disadvantage is that it shifts the complexities of computing varying effective rates of tax to the individual shareholder level instead of dealing with them at the corporate level, where the necessary calculations and adjustments can be more readily dealt with. Such a system is also subject to structural pressure, in that corporations will attempt to “stream” their dividend payments, so that tax-paid dividends are paid to resident taxable shareholders, while non-tax-paid dividends are paid to non-taxable and non-resident shareholders. For these reasons, the Committee does not favour the implementation of a variable dividend tax credit system in Canada.

A Corporate Distribution Tax System: A better approach, in the Committee’s view, is one that retains the fixed dividend tax credit and gross-up mechanism, and at the same time, ensures that the dividend tax credit is “funded” by payment of corporate tax at least equal to the amount of the credit available to shareholders. The equalization tax regimes of many European countries (such as France, Germany and Italy) and the advance corporation tax system of the United Kingdom currently adopt this approach.¹²

Under an advance corporation tax system, generally all distributions of domestic-source income to shareholders are subject to a distribution tax at the time the distribution in the form of a dividend is made. This is a corporate-level tax levied at a rate consistent with the effective credit provided to individual shareholders. Corporations are allowed to credit their distribution tax liability against their regular corporate income tax liability, with one unit of distribution tax offsetting one unit of regular corporate income tax. The result is that the corporation effectively pays the greater of the distribution tax and its regular corporate income tax liability. If the corporation has no corporate income tax liability against which the distribution tax can be credited, a net distribution tax liability remains. Comparing this treatment to that provided under equalization tax systems, the distribution tax acts like an equalization tax on a distribution of untaxed or partially taxed pools of income. If the distribution tax can be fully credited against regular corporate income tax, then no net tax liability is imposed. This result is akin to a distribution from a fully taxed pool of income for which there is no equalization tax.

A tax on distributions, such as an equalization or advance corporation tax, confers important economic advantages. It makes the existing dividend tax credit a more neutral and fairer way of recognizing the interrelationship of corporate- and personal-level tax on corporate income. This improvement will, of course, only be realized to the extent that the effective corporate income tax rate on income being distributed by a corporation is less than the distribution tax rate. This lower effective rate of tax on distributed corporate income is often the result of the availability of tax preferences and other non-uniformities in the corporate income tax base. For example, if the corporate income tax were levied at a combined federal and provincial rate of at least 20 percent on a comprehensive and uniform base, no special mechanism would be required to ensure that the amount of dividend tax credit provided to shareholders is not greater than actual corporate income tax paid. The Committee observes, however, that as discussed in Chapter 4, there will always be some non-neutralities or lack of uniformity in the corporate tax.

A tax on distributions would have no effect on the availability of corporate tax preferences or on other non-uniformities to the extent that they result in increased after-tax corporate income retained in the business; but it would have the effect of taxing back some of the benefits of such reduced corporate income tax when that income is distributed to shareholders. The effect, therefore, is that any incentives provided by government to businesses through the corporate income tax would tend to assist the financing of their growth rather than possibly funding greater dividend distributions to their shareholders. As discussed in Chapter 4, the Committee believes that it is important to encourage governments to use grants and other policies outside of the tax system to accomplish economic objectives. Accordingly, the taxing back of incentives with a distribution tax would not be inappropriate.

R E C O M M E N D A T I O N

The Committee recommends the adoption of a system of corporation distribution tax (CDT) and dividend tax credit.

This system would have the following basic attributes:

- Individual shareholders who receive a taxable dividend from a resident corporation would continue to be entitled to a dividend gross-up and tax credit at the current rate of 25 percent of the actual amount of the dividend;¹³ the tax credit would reduce tax otherwise payable, but any excess credit not usable in this way would not be refunded to the shareholder.
- The CDT is proposed to be a joint federal-provincial tax on distributions. It would be charged at the rate of 25 percent of taxable dividends paid by a resident corporation. This would include all such dividends whether paid to residents or non-residents.
- Ordinary federal and provincial corporate income tax in the year would be fully creditable to reduce CDT that is payable for the year; and any excess CDT would be refunded to the extent that the corporation pays ordinary corporate income tax that was not otherwise credited against CDT in the prior 3 years or following 10 years.
- A corporation would have a tax-paid dividend account, from which dividends would be considered to be paid first; there would be no liability for CDT on dividends from the tax-paid dividend account, but in all other respects, such a dividend would be treated for tax purposes in the same manner as any other taxable dividend, thus generally requiring no special identification to shareholders.
- Dividends paid by one resident corporation to another resident corporation (except those that are paid free of CDT as described below) would be added to the recipient's tax-paid dividend account.
- Dividends received by a resident corporation from a foreign affiliate would go into the recipient's tax-paid dividend account to the extent that the amount of the dividend is deductible in computing the recipient's taxable income (that is, that it is paid from exempt surplus or taxable surplus carrying sufficient underlying foreign tax); foreign-branch income not taxed by Canada because of the application of a foreign business income tax credit would also go into the corporation's tax-paid dividend account. These sources of income would be given this treatment, as they have already been subject to foreign tax or have been assumed to be subject to such tax (as described in the discussion of foreign-source income in the previous Chapter).
- Dividends paid by one resident corporation to another resident corporation would not be subject to CDT payable by the payor and would not be added to the tax-paid dividend account of the recipient, where the recipient is related to the payor or has a requisite ownership interest in the payor, measured by votes and value,¹⁴ and both parties elect to treat the dividend in this manner. Where one corporation is related to another, or one has the requisite ownership interest in the other, these corporations may jointly elect to transfer the ability to offset income tax liability from one to the other, to the extent that this can be used to reduce otherwise unusable CDT liability of the transferee for the year. However, special anti-avoidance rules would be required to prevent other trading in CDT and in corporate tax liability.
- Existing taxes under Parts IV.1 and VI.1 of the *Income Tax Act* on certain preferred share dividends would be eliminated; but "term preferred share" and "guaranteed share" rules would be retained and revised to minimize any opportunities for inappropriate after-tax financing using preferred shares.

- Special rules would be required to deal with CDT effects and continuity on corporate reorganizations (including share redemptions).
- An appropriate transition to the new CDT system would be required. While distribution of all existing surplus free of CDT could be justified on considerations of fairness, the complexity and longevity of such a transition mechanism may not be warranted. A preferable transition approach may be to allow for the carry-forward of the offset of corporate income tax for, say, five years prior to implementation against CDT liability. The difficulties of transition issues, including the taxation of major distributions of previously earned income on corporate liquidations or reorganizations, will require further study.

Implications of a Corporate Distribution Tax

Two examples of the manner in which the CDT would operate are shown in Table 7.4. In Case E, the corporation is assumed to be subject to a tax rate of 40 percent on its taxable income of \$50, thereby paying \$20 in basic corporate income tax; on a distribution of \$30 of income, the taxpaying corporation is liable for a CDT of \$7.50. The CDT is reduced by the amount of basic corporate income tax (\$20), thereby resulting in a net payment of CDT equal to zero. The tax paid at the corporate level is \$20.

In the second column (Case F), the corporation is assumed to be non-taxpaying as a result of an existing non-neutrality in the tax system (in this example, an investment tax credit). The non-taxpaying corporation has \$50 of income and is liable for a CDT payment of \$10 (25 percent of dividends paid) on a distribution of \$40. As there is no basic corporate income tax to credit against the CDT, the corporation has a net tax payment of \$10.

A comparison of Table 7.4 and Table 7.2, demonstrates how a CDT would reduce the difference in corporate and personal tax paid on income received from the taxpaying and non-tax paying corporations. Without the CDT, shareholders bear \$18.75 in total taxes on \$50 of corporate pre-tax income in the case of a corporation that does not pay basic corporate income tax, and \$31.25 in the case of the same amount of income received from a taxpaying corporation. (See Cases C and D, in Table 7.2.) With the CDT, the shareholder bears \$25 in total tax on \$50 of corporate pre-tax income received from the non-taxpaying corporation, which is closer to, but still less than, the amount of tax on income in the taxpaying case. The CDT, however, results in the same amount of tax paid on income received from a taxpaying corporation if it were taxed at the rate of 20 percent (as seen from the second columns in Tables 7.2 and 7.4).¹⁵

The Committee recognizes that the introduction of a CDT would increase the complexity of the corporate income tax system. However, this must be weighed against the greater fairness and neutrality that can be achieved. It should be noted that the Committee also has given considerable weight to the fact that the overall increase in complexity caused by a CDT system would be lessened by implementation of the Committee's recommendation to eliminate existing special preference share dividend taxes as a result, and to the fact that the CDT should make it less attractive for the tax system to be used for special incentives that create complexity. On balance, the Committee believes that the benefits of a corporate distribution tax system as recommended would outweigh any detriment in terms of increased complexity.

Furthermore, the Committee would not favour a CDT-type of regime without the treatment that it proposes for foreign-source income, that is, maintaining the current situation whereby dividends paid by Canadian corporations out of foreign-source business earnings would flow through to Canadian resident individual shareholders with the benefit of the dividend tax credit, and without imposition of additional corporate-level tax. This maintains a measure of neutrality as between domestic and foreign investment by Canadian-based corporations, and is consistent with the concept that the exemption of foreign-source income is, in large measure, a proxy for the recognition of foreign tax,

as discussed in Chapter 6. It would also permit foreign-based corporations to use Canada as a base for foreign investment without being inappropriately penalized. Moreover, this treatment of foreign-source income under the CDT regime relieves pressure in the tax system for domestic multinational corporations with excess CDT to find ways to obtain value for this CDT.¹⁶

Table 7.4

Comparison of After-tax Returns with Integration (Dividend Tax Credit) and with Corporation Distribution Tax (CDT) – Taxpaying and Non-taxpaying^a

	Case E	Case F
	Taxpaying Corporation High Rate Tax	Non-taxpaying Corporation High Rate Tax
	(\$)	
Corporate-level Taxation		
Gross Revenues	100	100
Wages, Interest, Depreciation	(50)	(50)
Taxable Income	50	50
Basic Corporate Income Tax (@40%)	(20)	(20)
Investment Tax Credit	–	20
Net Corporate Income Tax	(20)	(0)
After-corporate Tax Income	30	50
Dividend Distributed	30	40
CDT (@25%)	(7.5)	(10)
Reduction in CDT for Income Tax	7.5	0
Net CDT	(0)	(10)
Total Corporate Tax	(20)	(10)
Personal-level Taxation		
Taxable Income	37.5	50
Personal Income Tax (@50%)	(18.75)	(25)
Dividend Tax Credit	7.5	10
Net Personal Income tax	(11.25)	(15)
Corporate Plus Personal Tax	(31.25)	(25)
Net Income	18.75	25

^a Cases E and F may be directly compared to the results obtained under the current tax system as indicated in Cases C and D, respectively, in Table 7.2 above.

Certain of Canada's tax treaty partners may attempt to negotiate CDT refund provisions in tax treaties for their resident shareholders (or a credit for CDT against Canadian dividend withholding taxes) as is the case with a number of U.K. and French tax treaties. The fact that the CDT, unlike the historical situation with some similar European taxes, would not be refundable to any domestic shareholder should be helpful in resisting such pressure for refunds. While not providing relief for CDT to foreign shareholders of Canadian corporations could leave such shareholders bearing the cost of net CDT paid by the corporation, it is our view that in such cases the CDT serves to ensure that corporate distributions from Canadian-source income have borne some Canadian tax at the corporate level.

Finally, the Committee notes that, in some circumstances, a corporate distribution tax system could effectively increase the taxation of dividends relative to capital gains, and could therefore provide a setting for surplus stripping activities. For example, shareholders of a corporation that has retained

earnings and that has not paid sufficient corporate income tax to offset any CDT liability that would result from payment of those earnings as dividends could, in certain situations, arrange to sell their shares and pay tax at the rate applicable to capital gains, instead of the higher combined rate of CDT plus the tax on dividends that would apply if the corporation were to distribute those earnings to them. Nevertheless, the Committee is of the view that an attempt to prevent such surplus stripping activities by reintroducing specific anti-avoidance rules would be a mistake. Historically, they have proven to be complex, they impose substantial compliance burdens, and they are of questionable effectiveness. Moreover, the broadly worded, general anti-avoidance rule added to the tax system as part of the 1987 tax reform should be useful in limiting surplus stripping.

Bypassing the Corporate Income Tax

Tax Policy Issues

At its current level, the dividend tax credit can result in a substantial amount of corporate-level income tax for which shareholders receive no credit on distributions – an amount referred to as unintegrated tax. In addition, the dividend tax credit is not refunded to pension plans, charities and other exempt entities when they receive dividends from Canadian corporations. The combination of these two factors quite naturally creates incentives for affected shareholders to attempt to reduce or avoid corporate-level income taxes for which they will receive only partial credit or no credit at all. Moreover, there is an incentive to organize businesses in forms other than as corporations, so as to allow owners to directly obtain the benefits of net tax deductions (such as capital cost allowance) for tax purposes.

The rapid growth in public issues of interests in income and royalty trusts¹⁷ is an illustration of the impact of newer financing techniques¹⁸ to achieve these types of objectives. There are a number of other, well established approaches to avoiding unintegrated tax:

- the use of salaries and other deductible payments to shareholders to prevent a CCPC from having taxable business income over \$200,000;
- the acquisition by pension funds of direct interests in rental investment properties; and
- the more general use of business trusts and partnerships.

Another important change in the financing of the business sector is the growing role of tax exempt investors. The size and breadth of the participation in Canadian capital markets by tax-exempt investors is such that their investment activities can have a significant impact on the financial costs faced by corporate borrowers.¹⁹ Generally, deferred income plans organized pursuant to specific provisions of the *Income Tax Act* – in particular, registered pension plans, registered retirement savings plans, registered retirement income funds and deferred profit sharing plans – are exempt from federal income tax, as are registered charities. Also exempted from income tax are municipalities and similar public bodies, corporations owned by provincial or municipal governments, and certain pension arrangements organized under provincial laws.²⁰

The rationale behind each of these exemptions varies, although in general tax policy terms, they can be justified on the basis that these entities all perform special economic functions that deserve to be supported by the public as a whole. Pension and other retirement-related tax arrangements encourage individuals to save for their retirement;²¹ government bodies provide public goods and services to the community; charities conduct beneficial non-commercial activities such as education, and care for the poor and the sick. While these justifications for exemptions may be open to analysis and scrutiny, this is not within the Committee's mandate.

Although tax-exempts are not taxed directly on their investment income, they indirectly do bear tax at the corporate level on income derived from taxable business corporations in which they invest.

This is likely to be a factor in the manner in which tax-exempts invest in Canadian capital markets. It might, for example, bias tax-exempts to prefer investment in debt instruments that pay interest rather than comparable risk-adjusted equity investments that pay dividends. Returns in the form of interest payments – which are deductible for income tax purposes to a taxable corporate payor, but are generally subject to full income taxation for recipients (other than tax exempts) – will be higher on a before-tax basis than comparable returns in the form of dividends or capital gains on equity, which result in no corporate-level tax deduction but which carry beneficial tax treatment for taxable recipients.

The recent large growth in public income and royalty trust arrangements in Canada may have the effect of increasing the proportion of business income flowing through the corporate sector that is not taxed at this level. Such trusts can reduce aggregate tax revenues because:²²

- they can reduce the unintegrated corporate tax that would otherwise be payable on income flowing through the corporate sector to shareholders;
- they permit tax exempts to receive a broader range of what would otherwise be corporate income without paying corporate taxes;
- they can permit the effective transfer of certain corporate losses and deductions to unit holders; and
- trust arrangements are generally not subject to capital taxes.

These developments are not radically new approaches to structuring business investment. Instead, they represent a broader use of existing approaches. However, the increasingly varied and growing use of them to bypass the corporate income tax raises what the Committee believes are two important tax policy issues.

Tax Base Erosion and Revenue Loss

First, the bypassing of the corporate income tax could result in a large and increasing erosion of the corporate income tax base, and thus a reduction of tax paid by Canadian corporations. This has serious implications in terms of loss of revenue for governments; it also raises issues related to the extent to which such corporations should be paying some income tax as a contribution in respect of benefits they receive from public goods and services. Arrangements that bypass the corporate income tax can have this adverse impact on the corporate income tax revenue base as a result of investment by taxable, as well as non-taxable investors, because the corporate income tax system only partially eliminates double taxation of corporate-level business income distributed to individual shareholders as dividends. An example is the reduction of corporate level income tax by substitution of interest-bearing debt for equity. While taxable shareholders pay full personal income tax at progressive rates on returns such as interest, the corporate payor, if currently subject to income tax, obtains the benefit of a full tax deduction. Accordingly, unintegrated corporate-level tax is reduced or eliminated.

In some situations, tax exempt investors who invest in corporate-level debt that provides tax free returns would be entitled to invest in the underlying assets or business directly without paying income tax on such income. Thus, to the extent that such an investor is exempt from tax for accepted policy reasons, bypassing corporate-level tax only prevents the imposition of an inappropriate tax on its income. Nevertheless, the Committee is concerned that this approach used on a large scale contributes to a significant reduction of the government revenues from the corporate income tax.²³

Level Playing Field in the Business Sector

The second concern goes directly to the issues of fairness and efficiency. This relates to the question of whether businesses financed by tax-exempt investors obtain the benefits of reduced costs of capital as compared to similar businesses owned and financed by persons subject to income tax.

To the extent that such tax-exempts benefit from transactions that result in higher rates of return on savings, then the borrower does not face a lower cost of financing, nor does it gain any advantage over other businesses that are not financed by tax-exempts. However, to the extent that businesses themselves are able to obtain the advantage of financing at tax-favourable terms, they will be able to price their products and services below their competitors, thereby leading to inefficiency and unfairness among businesses.

There is no clear evidence as yet that gains from financing by tax-exempts benefit the businesses that borrow and lead to an unlevel playing field among businesses. It has been suggested that corporate borrowers have benefited from more favourable financing terms associated with income or royalty unit trusts.²⁴ However, it is unclear whether this has arisen from tax effects or from other factors affecting pricing.²⁵ Further research and analysis are required before conclusions can be reached about the complex policy issues discussed above.

A Framework for Further Inquiry

The choice of measures that might be taken with respect to bypassing the corporate income tax depends, to a large extent, on gaining a more complete understanding than is currently available of both the magnitude of tax base erosion and the extent to which competition is compromised. The Committee would suggest the following framework for additional examination of the problem.²⁶

If it is determined that corporate income tax base erosion is a significant problem, then a number of responses are possible at both investor and corporate levels. Analysis may yield the conclusion that the source of the problem lies in the fact that a taxable corporation's ability to deduct expenses, such as interest, is generally unrestricted regardless of the size of its equity base or whether the interest (or other expense) is paid to a tax-exempt or a taxable investor. On the other hand, if the analysis points more toward concerns about unfair competition, then the status of tax exempt investors becomes a focus for potential modifications of the system.

Investor-level Solutions

A response at the investor level in the form of a new tax on certain types of direct investment income would involve the fundamental problem of defining which sources of income should be included – a process that could prove very difficult. A similar issue could arise with respect to any limitation on tax-exempt status. For example, interests in Canadian resource and real estate properties are recognized as appropriate investments for tax-exempts, as allowed by tax and pension benefits legislation. In the United States, tax-exempt entities may be taxed on “unrelated business income,” which includes interest and other deductible amounts received from entities that are 80 percent or more controlled. This tax has been criticized on the basis that it is conceptually inconsistent and hard to administer in practice. In structural and administrative terms, if tax-exempts were to be taxed, it might be simpler to do so with a low-rate tax on the income from the debt component of a tax-exempt's investment portfolio (probably excepting items such as government debt). While relatively simple mechanically, this approach would be a substantial departure from the existing policy of full exemption on investment income of exempt entities, particularly retirement savings arrangements; would be arbitrary in its effect; and could produce significant distortions in investment of funds by tax-exempts.

In addition, any attempt to tax at the investor level would need to take into account the possibility that certain pension funds are, or could be, considered to be government agencies exempt from tax by other levels of government. Based on all of these considerations, the Committee is of the view that issues raised in this area should not be dealt with by any new tax at the investor level, nor by any limitation on current tax rules determining exempt status.

There are alternative approaches that would focus on the tax characterization of publicly traded trusts or limited partnerships carrying on business activities, treating them more like a corporation, and on the direct investments of tax-exempts and certain others in business ventures.

Corporate-level Solutions

Solutions that could be considered at the corporate level include limiting or denying the deduction of some otherwise deductible amounts, such as interest, based on an earnings stripping or thin capitalization type of test. There would, of course, be significant technical and practical difficulties with such an approach. In addition to the problem of identifying which payments would be subject to limitation of deduction, it would be necessary to have tracking rules to deal with amounts flowing to investors through intermediaries. The latter would add administrative complexity and could be difficult to manage in cases where the intermediary was widely held.

There is the question of whether the payor should be denied a deduction on all interest, and other deductible expenses paid to certain investors, or only the amount determined by the application of some thin capitalization approach using a debt/equity-based or earnings-based test. The earnings stripping rules in the United States are an example of the latter approach applied to a specified group of investors; these rules include a related-party test as well as a thin capitalization element. Limiting a new rule to situations in which investors have a particular relationship to the payor would be practical to administer, but such a rule would not apply to many situations where the business vehicle is widely held by the public.

Another approach would be to apply an earnings stripping or thin capitalization rule of general application to interest and certain other deductible amounts paid by corporations. Such a measure would shift the focus from the status of the recipient to the circumstances of the payor. Many questions would need to be answered in connection with this approach. For example, would there be different debt/equity ratios or earnings tests for corporations in different industry sectors or business circumstances, and how would the acceptable base be defined?

Conclusion

Tax changes in this area would likely have far-reaching implications and would require careful consideration. The Committee has concluded that additional research and analysis are required on these matters. The complexities and interrelationship of the issues means that it is difficult to determine whether a legislative response is required and, if so, what the nature and scope of that response should be. It may well be that ultimately the appropriate response would involve a combination of certain of the alternatives outlined above, and possibly of others not yet identified. As well, the Committee believes that a broad government consultation with the business community and the tax-exempt sector is highly desirable before taking any policy decisions.

Capital Gains Taxation

In the Committee's view, there are a number of reasons why it is appropriate to retain the current three quarter recognition of capital gains and capital losses for income tax purposes. First, as discussed above, this partial taxation of capital gains is consistent with the partial integration of taxation of income at the corporate and shareholder levels. Second, in a system that provides no adjustment for the effect of inflation on taxation, it is appropriate to exclude a portion of capital gains from inclusion in income. And third, it is important to the proper functioning of the tax system to maintain an approximate balance between the individual income tax rates on dividends from resident corporations and those from capital gains.

An additional consideration is the fact that the taxation of capital gains at full income tax rates would not simplify the tax system to any significant degree. This is because capital gains and losses would still be determined on a realization basis, which necessitates restricting the use of capital losses, so as not to reduce income other than capital gains. So long as such a restriction remains part of the income tax system, capital gains must still be identified separately from other income, and capital losses must still be identified separately from other losses, even though taxed at the same rate,

because capital losses would be limited in their use (as compared to other losses), while capital gains could be reduced by capital losses (while other income cannot). Thus, taxpayers and the tax authorities would retain distinct and opposite interests in the characterization of capital gains and losses as compared to income gains and losses.

While the Committee favours the retention of the present approach of taxing three quarters of capital gains, as discussed above, it does not favour differential taxation of capital gains based on the nature of particular assets. Such differential taxation is contrary to the principle of neutrality. In this regard, the Committee endorses the elimination of the general lifetime capital gains exemption in 1994. However, that change to the tax system did leave in place an enhanced lifetime capital gains exemption of \$500,000 for capital gains on farm property and certain shares of “small business corporations.”²⁷ These measures, first introduced in 1985, have been explained in the past as being necessary to meet the special retirement needs of farmers and owners of small businesses, and also as encouraging investment and risk taking. Nevertheless, there appears to be little evidence to indicate that the lifetime capital gains exemption has had any measurable positive impact on investment and risk taking.²⁸ However, there is some evidence to the effect that farmers and lower-income small business owners do not derive as much benefit of the RRSP system as others. The Committee believes that, if there are issues of unfairness relating to the ability to save for retirement as between one group of taxpayers and others, it would be more appropriate to deal with these by adjustments to the tax-assisted retirement savings system itself, rather than by the wholesale exemption of certain types of property from income taxation when disposed of at a profit. A measure such as the lifetime capital gains exemptions provides too much benefit to some who do not need it and not enough to those who do.

R E C O M M E N D A T I O N S

The Committee recommends elimination of the enhanced lifetime capital gains exemption for farm property and qualifying shares of small business corporations, with transitional relief for all gains accrued to the date of the change (to be obtained by election similar to that used for the 1994 repeal of the general lifetime capital gains exemption).

The Committee also recommends that the exemption be replaced by an enhanced RRSP contribution system that would allow taxpayers to use taxable capital gains on farm property and qualifying small business shares that are earned in a year to increase their RRSP contribution room for previous years, up to the maximum room that would be available if they had had sufficient earned income.

This would assist those farmers and owners of small business corporations whose employment incomes are, on average, below the RRSP deduction limits. If they have sufficient capital gains on such property, the proposal would effectively provide them total RRSP contribution room equal to that available to a taxpayer who is in a position to contribute at the maximum annual limit each year, subject to a cumulative limit related to the amount of the current lifetime capital gains exemption. In effect, the measure would allow qualifying capital gains to be treated as earned income for purposes of the RRSP contribution deduction.

Specifically, we propose that the amount of taxable capital gains realized in a year on qualifying farm property or qualifying small business shares would be transferable on a tax-deductible basis into an RRSP in the year realized, subject to the lesser of the following two limits:

- the maximum annual RRSP deduction limit (currently \$13,500) multiplied by the number of years the property was held since 1991²⁹ (the year when the RRSP carry-over provisions first went into effect, allowing for tracking of contribution limits on a cumulative basis) minus the taxpayer's regular RRSP room earned during those years (on the basis of earned income) and minus any previous use of lifetime capital gains RRSP roll-overs for those years; and
- a cumulative limit equivalent to \$375,000 (the amount of the current lifetime taxable capital gains deduction); amounts to be counted against this limit would include, in addition to amounts claimed under this new measure, any amounts claimed against the current lifetime capital gains exemption (including those created by election on its elimination).

The impact of this recommendation, if adopted, would be to provide benefits to farmers and small business owners who sell their businesses for a gain but have not been able to fully access the tax-assisted retirement savings system because of insufficient earned income while operating the business. It would target benefits better than the existing lifetime capital gains exemption and would help to level the playing field between individual taxpayers, particularly wage earners, and owners of qualifying property and shares.

In addition, in order to recognize the benefits of maintaining family-owned small businesses in the absence of the lifetime capital gains exemption, the Committee suggests that the intergenerational tax-deferred roll-overs, formerly provided in the income tax system for shares of small business corporations, be reintroduced in substantially the same form in which they existed when repealed upon the introduction of the lifetime capital gains exemption.³⁰

Endnotes

- ¹ In addition, corporate income taxes in Canada are credited against foreign tax in certain jurisdictions, including the United States, the United Kingdom and Japan. The elimination of the corporate income tax would result in a transfer of revenue from the Canadian treasury to foreign treasuries in these situations.
- ² Devereux (1996), Technical Committee Working Paper 96-5.
- ³ As recognized in the Carter Report (Canada, Royal Commission on Taxation (1966)), full integration would not only include the provision of a dividend tax credit for distributed earnings but also a recognition that corporate income tax on undistributed earnings reduces capital gains that may be subject to personal income tax.
- ⁴ See Johnson, Baldwin and Hinchley (1997).
- ⁵ When governments integrate corporate and personal income taxes by providing a dividend tax credit or exempting part of capital gains under the personal income tax, the effect on investment will depend on the extent to which these personal tax reductions result in a lower cost of capital for the business. For a more detailed discussion of various financial issues, see McKenzie and Thompson (1996), Technical Committee Working Paper 96-7.
- ⁶ See for example, Boadway and Bruce (1992), and Devereux and Freeman (1995).
- ⁷ See the survey of empirical work provided by McKenzie and Thompson (1996), Technical Committee Working Paper 96-7.
- ⁸ In some countries, dividends paid by resident corporations derived from income received from foreign sources is not eligible for dividend tax credits or equivalent relief. See the discussion in Devereux (1996), Technical Committee Working Paper 96-5.

- ⁹ Portfolio dividends received by Canadian corporations are taxable with a credit only given for withholding taxes. Thus, portfolio dividends received by Canadian corporations bear at least two levels of corporate income tax – foreign and Canadian. The dividend tax credit for dividends derived by Canadian corporations from foreign portfolio investments only offsets the Canadian level of corporate income tax.
- ¹⁰ The actual mechanics of the dividend gross-up and tax credit are slightly more complicated than we have described here, in order to achieve results on a basis that combines the effects for both federal and provincial income tax purposes.
- ¹¹ Similar tax relief is also provided with respect to certain dividends received by resident corporations from foreign affiliate corporations. See Chapter 6.
- ¹² In November of 1997, the Chancellor of the Exchequer of the United Kingdom proposed the elimination of the advance corporation tax. This follows recent changes to the U.K. imputation system, which reduced the amount of the credit and the personal income tax rate on dividends, and eliminated the refundability of the credit.
- ¹³ This reflects an assumed combined federal and provincial corporation income tax rate of 20 percent that is imposed as a percentage of pre-tax income.
- ¹⁴ The Committee notes that a 25 percent ownership interest is used in the provisions for Part VI.1 tax on dividends on certain preferred shares (with some additional restrictions), and that such a threshold might be considered for this circumstance.
- ¹⁵ The fact that the full amount of federal and provincial income taxes can be offset against CDT liabilities would limit the situations in which net CDT will be payable. For example, a corporation paying full tax at our proposed general federal-provincial rate of 33 percent on one quarter of its income and paying one half of its net after-tax accounting income as dividends will avoid any CDT liability.
- ¹⁶ For example, for many years the receipt of non-taxable foreign-source income by U.K. resident multinational corporations created large amounts of excess advance corporation tax (ACT) in the U.K. corporate tax system. This led to many difficulties that were ultimately dealt with by effectively eliminating the ACT liability on dividends paid out of foreign income.
- ¹⁷ The market capitalization of public offerings of all forms of income units trusts (Royalty Unit Trusts, Real Estate Investment Trusts and other Investment Trusts) have increased from less than \$2 billion in January 1996 to almost \$8 billion by May 1997 and is still growing. See Wilson and Murphy (1997), Technical Committee Working Paper 97-5.
- ¹⁸ The income or royalty trust combines the advantages of the lack of personal liability and the liquidity of individual investment interests that are usually associated with the shares of an incorporated company with the tax advantages of an unincorporated business.
- ¹⁹ In 1996, trustee private and public pension plan holdings in Canada were about \$350 billion and RRSP assets were \$220 billion. Pension and RRSP plans account for about 21 percent of net wealth in Canada. See Wilson and Murphy (1997), Technical Committee Working Paper 97-5.
- ²⁰ Certain of these entities are subject to restrictions on their activities in order to maintain their tax-exempt status.
- ²¹ It has been argued that this treatment of registered pension and retirement savings plans is both efficient and fair since savers pay the same amount of tax over time compared to consumers. Under a regular income tax, a person who consumes earned income immediately pays tax only once. A person who saves part of the earned income for future consumption purposes pays more tax, since not only is the earned income immediately taxed, but also the income earned from the savings is taxed over time. With registered pension and retirement savings plans, individuals avoid immediate payment of tax on their saved earnings by deducting contributions from their income in the year that it is earned. Income that accrues to the plan each year is not subject to tax. When the individual withdraws accumulated contributions and income from the plans, the withdrawals are included in income and subject to tax. Effectively, once taking into account the time value of money, the tax savings arising from contributions to registered plans is equal to the tax paid on withdrawals, as long as tax rates are constant over time.

- ²² See McDonnell (1997), Technical Committee Working Paper 97-9.
- ²³ See Wilson and Murphy (1997), Technical Committee Working Paper 97-5, for an estimate of the maximum amount of federal and provincial corporate income tax revenue that could be eroded (\$240 million in 1997).
- ²⁴ Brussa (1997).
- ²⁵ See Pesando, Smart and Wilson (1997), Technical Committee Working Paper 97-10, for discussion on efficiency issues.
- ²⁶ Further discussion may be found in McDonnell (1997), Technical Committee Working Paper 97-9.
- ²⁷ Though the qualification is based on the definition of “small business corporations,” there is no restriction related to the size of the corporation. Shares of many large Canadian-controlled corporations qualify for the lifetime capital gains exemption.
- ²⁸ See McKenzie and Thompson (1995) and Jog (1995).
- ²⁹ The proposal provides a somewhat more beneficial treatment for assets held in earlier years, when the maximum limit for RRSP contributions was generally lower than that available today.
- ³⁰ Intergenerational tax-deferred roll-overs are already available for qualifying farm property.

Taxes as User Charges: Employer Contributions to Employment Insurance

8

Introduction

As we observed earlier in our Report, Canadians and Canadian businesses pay several taxes intended to compensate for the costs of using certain public resources that provide direct benefits to businesses and individuals. With regard to both efficiency and fairness, the Committee believes that as a matter of general principle, businesses should pay taxes more closely related to the economic benefits that they receive from public goods or services, or to the costs that they impose on society. With the user pay principle in mind, the Committee considered the desirability of restructuring two existing federal taxes – employer contributions for Employment Insurance (EI), and taxes on gasoline and other motive fuels (see Chapter 9) – to introduce some partial recognition of the costs of use of public resources and programs by businesses.

The effect of the restructuring would be to more closely relate the levy with the consumption of public resources: a program funded by public expenditure in the case of EI, and the social costs arising from the use of environmental resources such as air, water and land, in the case of motive fuel taxes. Levies assessed on business on a user pay basis are not generally linked to profitability. Instead, they are linked to some measure of the public program or environmental costs that result from a business' activities in order to ensure that business decisions more appropriately take such costs into account.

In the absence of user charges, individuals and businesses have an incentive to take actions to save private costs, but not costs imposed on others. Thus, when there is a mismatch of private benefits and charges, the efficient use of resources is impaired. It is the Committee's view that restructuring employer contributions for EI and the fuel excise tax can improve our prospects for economic growth and job creation.

The Overall Context: Payroll Taxes – General Revenues or Fees Related to Benefits?

We believe that it is important to set our discussion of EI contributions in the context of our overall views on payroll taxes. In Chapter 3, we reviewed the expected impacts on employment, wages and labour costs of payroll taxes that are used to finance specific benefits, and of payroll taxes that are used to raise general revenues. The Committee regards the use of payroll taxes to finance specific benefits as an appropriate application of the user pay approach to taxation, a view that underlies our approach in this section of the Report.

However, we see little merit in using employer payroll taxes as a general revenue source. As the analysis in Chapter 3 suggested, a major part of such taxes may well be largely shifted back to employees in the form of lower wages in the long run. If this occurs, while the inhibiting effect of the payroll tax on employment will be reduced or even eliminated,

the tax becomes the equivalent of a general labour income tax with one likely exception: the tax will discriminate between the employed and the self-employed assuming, as may often be the case, that earnings of the latter are not subject to the payroll tax.

There will also likely be circumstances in which general payroll taxes are not fully shifted back to employees. This will frequently be the case in the short run, and may occur in the longer run for workers whose wages have little downward flexibility due to minimum wage rates or other factors. To the extent that this occurs, general payroll taxes will increase the cost of labour, which in turn will tend to work against achieving higher employment levels.

The Committee does see potential merit in employer payroll taxes (coupled with employee contributions) when used to finance income-replacement social insurance programs, where eligibility for benefits is linked to employment and the size of potential benefits is linked to earnings subject to contribution. At the federal level, such an approach is used to finance EI; it is also used for the Canada Pension Plan (CPP) and Quebec Pension Plan (QPP) which, as well as covering employees, cover the self-employed who contribute at a rate equal to the sum of the employer and employee contribution rates.

At the provincial level, workers' compensation programs are financed through employer contributions. Such programs are currently the only Canadian example of a social insurance system where the contribution rates vary across industries in accordance with differences in the incidence of benefits. Employer contribution rates vary quite sharply by industry depending on the average incidence of industrial accidents. In Ontario, for example, employer contributions rates in 1996 ranged from substantially less than \$1 per \$100 of payroll for industries mainly involving office work, to over \$15 per \$100 of payroll for certain sectors of the construction industry.¹

Provincial workers' compensation plans apply different rates to industry sub-sectors on the basis of average accident experience. In addition, they generally adjust an individual employer's contribution rate in relation to the amount by which the employer's accident experience is above or below the average for its sector. This is referred to as "experience rating." The charges levied on employers under provincial workers' compensation programs thus represent an area of taxation in which the user charge approach has been developed quite fully and appears to be well accepted.

As we stated in Chapter 1, since the financing of the CPP was the subject of recent negotiations between the federal and provincial governments, the Committee has not examined further the structure of the premium systems for this plan. The Committee has focussed its attention solely on the structure of EI contributions, and in particular on employer contributions, given that these have the closest link to business taxation.²

Employment Insurance: Discussion of the Issues

The Principle of User Pay Applied to Employment Insurance Premiums

Employer premiums for EI currently total about \$11 billion, of which some two thirds – or over \$8 billion – is paid by business employers, and the remainder is paid by government and non-profit-sector employers. These contributions are thus a significant government charge on business, the equivalent in 1996 of about half of the federal corporate income tax. The Committee is of the view that a restructuring of employer contributions could contribute significantly to the goals of promoting employment and growth and enhancing fairness.³

Applying the user pay principle to EI focusses attention on the structure of employer contributions as opposed to their average level. The issue considered by the Committee is whether such contributions should be more closely linked to the costs of providing benefits to employees whom an employer has laid off.

In addressing this issue, it is important to recognize that:

- the existence of EI benefits in general makes it easier for employers with less stable employment to attract labour,⁴ and
- a decision by an employer to lay off workers triggers a cost to the EI system.

These points, together with the existing employer contribution structure, mean that the existing system in effect provides a subsidy to businesses that readily resort to layoffs, and imposes a tax on businesses that minimize layoffs through smoothing of production and the use of work-sharing arrangements.

EI Benefits to Employers?

Although EI direct benefits go to individuals and the benefits to employers are indirect, in the discussion in this Chapter, we use a few shorthand terms:

- “benefits to businesses” refers to benefits to the associated labour force;
- “net subsidies” refers to cases where “benefits” exceed contributions; and
- “net taxes” refers to cases where contributions exceed “benefits.”

The Committee believes that establishing a closer link between benefits and contributions would increase the overall neutrality of the business tax system, in that it would reduce the economic distortion created by an EI system that currently subsidizes some industries and penalizes others. But of potentially greater importance are the probable impacts on the functioning of the labour market and on individual employers’ management of their employment. If an employer’s contributions varied directly with its layoffs, the employer would have an incentive – when faced with varying demands for its product – to reduce instability in its employment. This might be achieved, for example, by making greater use of variation in hours and less use of layoffs, and/or by reducing variation in production by managing inventory stock.⁵ Greater stability in employment would reduce average unemployment.

Current Employment Insurance Contribution Rates Relative to Benefits

Under the EI system, contribution rates are set each year so as to achieve a balance between contributions and system costs in the longer run. Currently, all employers pay a uniform rate equal to 1.4 times the uniform employee rate.⁶ For 1998, employees will contribute \$2.70 per \$100 of earnings on the first \$39,000 of annual earnings; the employer rate is \$3.78 per \$100 of earnings on the same earnings base.

While all employers contribute at the same rate, EI benefits paid to the labour force associated with an employer differ systematically by employer and industry depending on a number of factors, including seasonal and cyclical variability in employment, growth or decline of the industry and the employment management practices of the individual employer. Patterns of benefit use relative to contributions in the Canadian EI system in the late 1980s have been the subject of careful study.⁷ While there have recently been significant modifications to the benefit structure, it is believed that the patterns of benefits relative to contributions observed in the late 1980s are still broadly representative of the current situation.⁸

Table 8.1 provides summary information on patterns of EI benefits relative to contributions for employers grouped in broad industry categories. For each category, the Table indicates the share in total payrolls in the economy (column 1), the ratio of benefits to contributions (employer plus employee) in a situation where total benefits and contributions are assumed to be in balance (column 2), and the amount by which total contributions fall short of (-) or exceed (+) benefits expressed as a percentage of total labour costs (column 3).

It will be seen that benefit/contribution ratios vary widely, with benefits being almost five times contributions in forestry but less than one half of total contributions in communications and utilities. The difference between benefits and contributions may be viewed as a net subsidy to the industry when benefits exceed contributions (negative figure in column 3), or as a net tax in the reverse case (positive figure in column 3). The differences between contributions and benefits, when expressed as percentages of total labour costs (column 3), are quite substantial for several industries. Forestry, agriculture and construction receive the equivalent of net subsidies equal to 6 to 13 percent of their labour costs, while many of the utility and service sectors are subject to net taxes equal to 1 to 2 per cent of their labour costs. The large divergences in benefits relative to contributions for specific industries are persistent over time, with similar broad patterns holding through the 1970s and early 1980s.⁹

Table 8.1
EI: Benefits/Premiums by Industry (1989-90 average)

Industry	(1)	(2)	(3)
	Industry Share of Wages and Salaries (%)	EI Benefits/Total Contribution	Net EI Subsidy (-) or Tax (+) as % of Labour Costs
Agriculture	0.7	3.19	-8.1
Fishing and Trapping ^a	0.2	4.26	-16.9
Forestry	0.5	4.96	-13.4
Mining	1.2	1.18	-0.6
Oil and Gas	1.2	0.74	0.8
Manufacturing	18.5	1.06	-0.2
Construction	6.1	2.94	-5.9
Transportation	3.9	0.90	0.4
Storage	0.2	0.79	0.8
Communications	1.8	0.37	2.3
Electric Power, Gas and Water Utilities	1.5	0.35	2.4
Wholesale Trade	7.2	0.77	0.9
Retail Trade	7.9	0.99	0.0
Other Finance	5.8	0.55	1.4
Deposit Accepting Institutions	2.3	0.38	2.6
Public Administration and Defence	11.9	0.53	1.7
Commercial Services	13.1	1.17	-0.6
Non-commercial Services	14.1	0.43	2.3
Unclassified	2.4	3.65	-8.8
All Industries	100.0	1.00	0.0

^a Estimates for this industry sector are subject to a larger error margin than estimates for other industries.

Note: Components in column (1) may not sum exactly to total due to rounding.

Source: Committee secretariat calculations, based on data from Corak and Pyper (1995b). The contribution rates have been adjusted to represent a system operating with benefits equal to contributions.

The range of net subsidy or net tax, relative to payroll, is even larger if one considers narrow industry categories or individual employers. Within the same industry, some employers are net contributors, others net beneficiaries. Table 8.2 demonstrates this point for a sample of employers. For example, within the industry categories where, on average, benefits were more than twice premiums (agriculture, fishing and trapping, forestry, and construction – see Table 8.1), it is still the case that a substantial fraction of employers were never subsidized over the four-year period (1986-89) covered by Table 8.2.

Table 8.2
EI Status of Employers within Industries, 1986-89

Industry	Number of Employers (% of employers in the Industry)			Total Number of Employers
	Never ^a Subsidized	Sometimes ^b Subsidized	Always ^c Subsidized	
Agriculture	21,514 (50.0)	14,462 (33.6)	7,024 (16.3)	43,000
Fishing and Trapping	489 (15.4)	935 (29.4)	1,761 (55.3)	3,185
Forestry	690 (13.7)	2,066 (41.1)	2,274 (45.2)	5,030
Mining	1,304 (35.1)	1,573 (42.4)	836 (22.5)	3,713
Manufacturing	13,096 (32.6)	21,635 (53.9)	5,440 (13.5)	40,171
Construction	15,148 (23.2)	33,270 (51.0)	16,814 (25.8)	65,232
Transportation	9,188 (37.6)	11,516 (47.1)	3,742 (15.3)	24,446
Trade	50,424 (38.8)	69,134 (53.2)	10,420 (8.0)	129,978
Finance	27,002 (67.9)	11,927 (30.0)	863 (2.2)	39,792
Community, Business and Personal Services	92,066 (45.4)	92,604 (45.7)	17,920 (8.8)	202,590
Public Administration	1,770 (34.8)	2,195 (43.2)	1,116 (22.0)	5,081
Total	232,691 (41.4)	261,317 (46.5)	68,210 (12.1)	562,218

^a Never subsidized businesses never accounted for more EI benefits than contributions.

^b Sometimes subsidized businesses accounted for more EI benefits than contributions for one, two or three years.

^c Always subsidized businesses accounted for more EI benefits than contributions for each of the four years.

Notes:

- For businesses operating in each year from 1986 through 1989.
- Components may not sum exactly to totals due to rounding.
- Data not available for communications and electric power, gas and water utilities industries.

Source: Corak and Pyper (1995b).

Given this substantial intraindustry as well as interindustry variation, if benefits are to be taken into account in setting premium rates, the link should be made at the level of the individual employer. Applying a rate according to industry or sector would be unfair to many individual employers within a given sector. Furthermore, as the motivation for establishing the relationship between contributions and benefits is in part to improve incentives for employers to act in ways that will stabilize employment, the “price signal” provided by variation in EI premium rates needs to operate at the individual employer level.

Previous Assessments and International Experience with Experience Rating

Schemes in which an employer's contribution rate varies, either with its layoff rate or with the amount of EI benefits paid to employees whom the employer has laid off, are commonly referred to as "experience rated" systems. In introducing the 1971 reform of the Canadian EI system, the Government of Canada stated its intention to phase in an element of experience rating, under which an employer's contribution rate would vary between one and two times the uniform employee contribution rate, depending on layoff patterns. The proposal was not implemented.

Two subsequent reviews of EI – the Task Force on Unemployment Insurance which reported in 1981, and the Commission of Inquiry on Unemployment Insurance (Forget Commission, 1986) – did not recommend experience rating of employer contributions. Both doubted that the gains in terms of improved incentives for employers of a limited degree of experience rating would be worth the increased administrative and compliance costs. They were also concerned with the impact on seasonal industries.

On the other hand, the Royal Commission on the Economic Union and Development Prospects for Canada, (the Macdonald Commission), argued strongly in favour of introducing a degree of experience rating:

Our Canadian government's current method of financing the unemployment insurance system tends to subsidize industries with unstable employment patterns and to tax those with stable employment patterns. ... the extent of this cross-subsidization is very large.

... as a consequence of cross-subsidization, a larger proportion of output and employment will be characteristic of industries with unstable employment patterns, and a smaller proportion will characterize industries with stable employment patterns.

... On the financing side, an important reform would be to relate premiums closely to the risk of layoff. This process of experience rating should be done on business-by-business, rather than an industry-group, basis. This Commission views experience rating as the most important change that should be made to Canada's existing UI (Unemployment Insurance) system.¹⁰

The United States and Experience Rating

Unemployment insurance systems in a number of countries provide for some variation in employer contribution rates depending on industry. However, only the United States makes substantial use of experience rating in setting individual employer contributions. While unemployment insurance in the United States is administered at the state level, there is federal umbrella legislation providing for very strong financial incentives for states to make use of experience rating. Though their systems differ in detail, all states currently use some form of experience rating. It should be noted that although various forms of experience rating have been in effect in most states since unemployment insurance was introduced in the 1930s, unemployment insurance is financed solely by employer contributions in the great majority of states. Heavy dependence on employer contributions would appear to fit well with a system that varies premium rates on the basis of the individual employer's layoff experience.

Experience rating in the United States is seen by its proponents as leading to a fairer allocation of the costs of unemployment insurance across firms, and as contributing to economic efficiency by minimizing differential taxes and subsidies on different industries.¹¹ As well, experience rating provides a useful incentive to employers to work toward more stable employment patterns in their own firms, and to help avoid abuse of the system. At the same time, there are concerns that experience rating increases administrative costs because it encourages employers to launch appeals regarding the "chargeability" of an employee's benefits to the employer. There is also concern that

the system could bias employers toward dismissing employees for cause, or inducing them to quit, rather than laying them off due to lack of work, since only the latter results in a charge against the employer's experience rating.

It is important to note that the experience rating commonly employed in U.S. states is only partial, in the sense that contribution rates for a business do not generally fully reflect the expected benefits paid to its labour force. Some benefits are not effectively charged to individual employers, because, for example, the employer has gone out of business, or because a laid-off employee has not worked a sufficient length of time with the employer in question to be charged against that employer. Such employees may have sufficient earlier employment with other employers to qualify for unemployment insurance benefits. More importantly in terms of program design, U.S. state systems all have maximum contribution rates; this means that, beyond a certain level, increased layoffs do not result in higher employer contributions.

For purposes of establishing a particular employer's contribution rate it is necessary to measure its experience over a period of time. In the United States the time frame is generally three years or longer. The range of employer contribution rates in U.S. states averages about 6 percentage points, from an average minimum rate of less than 1 percent of the covered wage base, to an average maximum rate of about 7 percent. Even though, as noted earlier, the U.S. states' experience rating systems are only partial, they result in a much narrower range of net subsidies and net taxes by industry than in Canada. The contrast is evident in a study that used broad industry categories for its analysis. U.S. average benefit/contribution ratios were found to vary from 0.6 (finance, insurance and real estate) to 1.7 (construction), whereas the Canadian average ratios varied from 0.5 (also finance, insurance and real estate) to 2.9 for construction and 4.6 for agriculture, fishing and forestry.¹²

The substantial history of experience rating in U.S. unemployment insurance programs, as well as the variation across states, provides a basis for analysing the impact of experience rating on employment patterns. A recent survey of empirical studies suggests that increasing the degree of experience rating from the current level of roughly two thirds to full, would reduce the unemployment rate by 0.6 percentage points¹³ primarily by reducing temporary layoffs rather than permanent separations. This is not to suggest that setting premiums in such a way that they vary fully with an employer's layoff record is optimal from an economic point of view, but it does provide an indication of the magnitude of changes that can be expected from a change in the degree of experience rating.

Introducing Experience Rating in Canada

While the Committee believes that introducing a degree of experience rating at the level of the individual employer has the potential to create benefits to Canada of the sort experienced in the United States,¹⁴ any such approach should take into account our country's particular circumstances.

It is the Committee's view that some benefits currently provided under the Canadian EI system, such as sickness, maternity and parental benefits, and benefit payments resulting from special eligibility provisions applicable in certain regions, should not be included in assessing an employer's experience for purposes of setting contribution rates.

With respect to the remaining general benefits that would be taken into account, we note that a fundamental element of a true insurance system is the "pooling of risks." There is no particular merit in charging an employer for benefits associated with events that are beyond its control or that are not systematically associated with the employer's line of activity.¹⁵ In insurance systems of any kind one generally has to accept some trade-off between improving incentives to reduce risk versus fulfilling the insurance function of providing protection against genuinely unexpected costs arising from random events. Use of an upper limit on contribution rates is one way of addressing this trade-off in EI. On the one hand, the limit protects employers that experience very adverse circumstances from facing the full costs of benefits to their employees. But on the other hand, upper limits on rates do lessen the incentive effects for employers who already face the maximum rate.

Thus, the insurance principle itself suggests that it would not be desirable to have employer contribution rates vary fully with benefits paid to laid off employees.¹⁶ Furthermore, the Committee recognizes that full experience rating would impose major increases in contribution rates on some businesses and industries and could cause these businesses and their employees to face an overly burdensome transition.

It is also the Committee's view, however, that the current financial status of Canada's EI system offers the possibility of introducing a degree of experience rating without increasing the contribution rate of any single employer. Owing to the large current annual surpluses being run by the EI system, average contribution rates will be declining over the next several years as the level of total contributions is brought into line with the level of total benefits. Human Resources Development Canada has estimated that employee contribution rate could be reduced from its 1998 level of \$2.70 per \$100 of covered earnings to \$2.00 or less, in order to balance contributions and benefits over the business cycle.¹⁷ As prescribed by the current system, the employer contribution rate would fall in similar proportion.

Under the system we envisage, there would be no change relative to the current system in the approach to setting contribution rates for employees. A single contribution rate would continue to apply to employees, and we expect this rate would be reduced over time to about \$2.00. For employers, it would be possible to introduce a degree of experience rating if reductions in employer contribution rates, from the uniform 1998 rate of \$3.78, were based on an employer's relative layoff experience (instead of moving to a uniform rate of \$2.80). In short, while no single employer's contribution would rise, some employers' rates would decline more than others. One could, therefore, over the same period in which employee contribution rates were being reduced to \$2.00, move to a situation in which employer contribution rates ranged from \$3.78 to, say, \$2.00, while maintaining the total revenue yield of the EI system at the same level as it would have been under the current system with the expected decline in average contribution rates.

Under the proposed system, employer contribution rates would vary over a range of almost 2 percentage points, compared with the 6 percentage point range found in the United States. The Committee was not in a position to undertake a detailed study of the impacts of this partial degree of experience rating on unemployment and output in Canada. We did, however, consider it important to obtain some basis for judging whether such impacts would be of some significance. The results of U.S. studies, referred to above, provide a basis for estimating the magnitude of the impact. Our proposal corresponds to about 25 percent of full experience rating. Based on the U.S. results, a move from zero to one quarter experience rating in Canada is roughly estimated to reduce unemployment by one half a percentage point.¹⁸ The output of the economy, and average real incomes, could also be expected to increase by at least 0.5 percent. We view potential gains of this size as being clearly worth pursuing.

The Committee wishes to emphasize that, in the event that this or a similar system were to be adopted, a mechanism for setting the average contribution rate should be selected that does not accentuate the peaks and valleys of the business cycle. If economy-wide average contribution rates were set in such a way as to track economy-wide benefit levels with little delay or cushioning, average employer contribution rates would tend to rise in periods of high unemployment, just when it is particularly important to avoid discouraging new hiring. Thus, the system we envisage would continue to require a substantial reserve account that would allow economy-wide average premium rates to be maintained at stable levels intended to cover the cost of benefits over a full economic cycle. Average employer premium rates should be stabilized to the extent possible while keeping benefits and contribution in balance over a period of several years. However, individual employer premium rates would vary relative to the average.

Finally, the Committee recognizes that the impact of experience rating on employer behaviour would depend in large measure on the specifics of implementation. A number of challenging program design issues would have to be resolved before an experience rating system as set out above could be introduced. The questions to be resolved include:

- How would experience be measured? The alternatives are a full tracking of relevant benefits paid to laid-off employees of a business or some simpler measure of layoff rates. Special provisions for employees with more than one recent employer may be required.
- Over what period should experience be measured? A period of at least three years – in line with the U.S. approach – seems desirable to smooth out random annual variations,¹⁹ though the initial phasing in of employer rate reductions might be based on shorter periods.
- Should there be many rate classes with small gradations between them, or only a few – say four rate brackets? U.S. states tend to have quite a large number of rate brackets. Since the rate is specified as a single rate to apply to covered payroll for a given year, even relatively small variations in the rate can give rise to significant changes in contributions relative to the change in the experience factor. This argues for a reasonably finely graduated contribution rate scale.
- Would the general system apply to even the smallest employers or might very small employers be subject to a different rule, perhaps rated on the basis of their industry?
- How would new employers with no record of experience to rate be treated? Possibilities include starting at the mid-rate for employers in the same industry or at the mid-rate for the system as a whole.
- How would employer contribution rates vary with experience? Three general approaches may be considered:
 - a) Setting contribution rates so that they vary in full proportion to benefit experience subject to the ceiling and floor on contribution rates.
 - b) Setting contribution rates so that they vary in partial proportion to benefit experience subject to the ceiling and floor. With contribution rates varying more gradually with experience than in (a), the range of experience covered between the ceiling and floor would be larger. Thus, a smaller portion of employers would be “at the ceiling or floor contribution rates” than in (a).
 - c) Setting contribution rates on the basis of the ranking of employers in terms of experience. The rate for the employer (or small group of employers) with the lowest benefit costs would be set at the floor. Successively higher ranked employers would be assigned successively higher contribution rates such that, for example, an employer ranking in the 50th percentile (weighted by covered payroll) in terms of experience would be assigned a rate 50 percent of the way between the floor and ceiling contribution rates.

A comparison of approaches (a) and (b) illustrates a basic trade-off under partial experience rating with a ceiling and floor on contribution rates: the stronger the variation of contribution rates with experience (and thus the stronger the incentive for change in employer behaviour for those employers potentially subject to a contribution rate change), the larger the fraction of employers that will be at the ceiling or floor contribution rates. The latter employers face no change in contribution rates, or in other words, face no incentive to make marginal changes in their layoff practice.

Under approach (c), only a few employers would be at the ceiling and at the floor contribution rates. Thus, almost all employers would face some change in contribution rate (because they would experience some change in ranking), if they changed their layoff behaviour by a modest amount. However, in some ranges, there might be only a very gradual change in contribution rate as experience varied. Thus, under this approach, virtually all employers would face some incentive effect from potential change in contribution rates, but this effect would tend to be weaker than for those employers under approaches (a) or (b) that were not at the ceiling or floor contribution rates. (See inset entitled “Employer Contribution Rates under an Experience-rated System – An Illustrative Example.”)

Employer Contribution Rates under an Experience-rated System – An Illustrative Example

As a simple illustration, consider a case where there are only five employers, A, B, C, D and E, each of which employs the same number of workers. EI benefits associated with the individual employers are equal to 0 percent (A), 1 percent (B), 2 percent (C), 4 percent (D) and 8 percent (E) of their covered payrolls. The average rate will then have to equal 3 percent to cover the cost of the program. In addition, it is assumed that, as a matter of policy, it has been decided that the lower and upper limits on contribution rates are 2 percent and 4 percent.

To illustrate the three general approaches to rate setting noted in the texts:

- a) Under full variation of contributions with associated benefits within the limits, C's rate could be set at 3 percent; B's rate would be set one point lower at 2 percent. As a result of the operation of the limits, A's rate would be set at 2 percent, and D's and E's at 4 percent.
- b) A second possibility would be to decide that rates would vary by only one half the variation in associated benefits, around an average rate that would balance benefits with costs. A's and E's rates would still be set at the lower and upper limits of 2 percent and 4 percent respectively. B's rate should be set .5 percent points lower than C's (one half the difference in benefit percentages) and D's rate 1 percent point higher than C's. With B at 2.33 percent, C at 2.83 percent and D at 3.83 percent, the overall rate structure would have the required average rate of 3 percent.
- c) The third possibility involves assigning contribution rates from the floor to the ceiling based on ranking the businesses according to associated benefits. Under this approach, A's rate would be set at 2 percent, B's at 2.5 percent, C's at 3 percent, D's at 3.5 percent, and E's at 4 percent.

Table 8.3 shows an approximate employer premium structure that could result in Canada, at the broad industry level, if approach (c) were applied (with account taken of an industry's total employment, as well as its ranking in terms of benefits to covered payroll). It is based on average patterns of benefits use in 1989-90^a. It should be emphasized that while the Table shows average results at the industry level, under the Committee's proposal, an employer's contribution would be governed by the employer's own experience rather than by the average experience of the industry to which it belongs.

The first column simply notes that employers in all industries are subject, in 1998 under the current EI system, to an employer contribution rate of \$3.78 per \$100 of covered earnings. The second column shows an approximate average contribution rate for employers in the relevant broad industry group, consistent with our general proposed approach of introducing partial experience-rating while keeping contribution rates within a range of \$2.00 to \$3.78 per \$100 of earnings. The average employer rate of \$2.89 represents a rough estimate of the rate required to achieve an overall balance between contributions and benefits (with an employee rate of \$2.00).

The final column simply shows the percentage change from the current standard rate (column 1) to the partial experience rated rate under a balanced system (column 2). The largest percentage reduction occurs for the utilities sector, which has the lowest benefits relative to covered payroll (see Table 8.1). The forestry sector would experience no reduction, reflecting the high level of benefits for that industry sector.

^a According to estimates provided in Canada, Human Resources Development Canada (1996), the amendments to the EI system introduced in 1996 were not expected to result in major changes to the benefit/contribution ratios by industry.

Table 8.3

Illustrative Industry Average Rates – With Individual Employer Premiums Subject to Partial Experience Rating

Industry	Employers EI Contribution Rates		
	(1)	(2)	(3)
	1998 Employer Contribution Rates ^a – Current System	Illustrative Partial Experience Rated Contribution Rates ^a	% Reduction Relative to 1998 Rates
	(%)	(%)	(%)
Agriculture	3.78	3.72	-1
Fishing and Trapping	3.78	3.78	0
Forestry	3.78	3.78	0
Mining	3.78	3.60	-5
Oil and Gas	3.78	2.68	-29
Manufacturing	3.78	3.19	-16
Construction	3.78	3.66	-3
Transportation	3.78	2.85	-25
Storage	3.78	2.81	-26
Communications	3.78	2.04	-46
Electric Power, Gas and Water Utilities	3.78	2.00	-47
Wholesale Trade	3.78	2.75	-27
Retail Trade	3.78	2.96	-22
Other Finance	3.78	2.61	-31
Deposit Accepting Institutions	3.78	2.08	-45
Public Administration and Defence	3.78	2.45	-35
Commercial Services	3.78	3.47	-8
Non-commercial Services	3.78	2.22	-41
Unclassified	3.78	3.75	-1
All Industries	3.78	2.89	-24

^a Percent contribution rate on covered earnings.

Source: Committee secretariat calculations.

Conclusions and Recommendation

The Committee believes that the introduction of partial experience rating of EI employer contributions would offer significant employment and economic benefits. A number of program design issues remain to be worked out, and the Committee is aware that the relationship between the EI administration and employers would become somewhat more complex. However, reasonable solutions appear to be available, as evidenced by the record of unemployment insurance in the United States and of workers' compensation programs in Canada.

While some might question whether introduction of a rather partial degree of experience rating would be worth the increased complexity and administrative costs, we believe that there is a solid basis for expecting the economic benefits to far outweigh these added administrative costs. Administrative record systems already employed in operating the current system would provide most of the information necessary to apply experience rating. A recent study for Human Resources and Development Canada²⁰ concluded that introduction of experience rating might increase total administrative costs by 6 percent to 14 percent, or by \$45 to \$107 million. By comparison, the rough estimate noted above that the proposed partial experience rating scheme might increase in GDP by the order of 0.5 percent,²¹ suggests a potential gain in incomes for Canadians of some \$4 billion. While the extent of the economic gains is subject to a substantial range of uncertainty, the Committee is confident that the potential gains in economic performance would be many times the potential increase in administrative and compliance costs.

The approach we suggest would be to adopt the current employer contribution rate as the maximum, with reduced contribution rates being introduced for employers with superior layoff experience (or superior EI benefit claims history for laid-off employees) relative to a reference level. These lower rates could be phased in over the next few years as it becomes possible to wind down the current annual surplus on the EI account. Thus employers with good layoff experience would benefit from reductions in contribution rates, but no employers would face increases in rates.

R E C O M M E N D A T I O N

The Committee recommends that employer contributions under the Employment Insurance program be set so as to give weight to employer layoff experience on an employer-by-employer basis. Further, we recommend that this be introduced as reductions in average employee and employer contribution rates occur over the next few years.

Endnotes

- ¹ Association of Workers' Compensation Boards of Canada (1996).
- ² We have restricted ourselves to one aspect of the EI program – employer contributions – since it would be beyond our mandate to consider the structure of benefits under the program. As well, we view employee contributions as being more an area of personal taxation than of business taxation; thus we have not examined issues associated with employee contributions, nor with the balance between employer and employee contributions.
- ³ The Committee notes that total EI contributions currently (1997) exceed total benefits and administrative costs by some \$7 billion per year, and that the cumulative surplus in the EI account is expected to exceed \$13 billion by the end of 1997. See Canada, Human Resources Development Canada, (1997). Given our general view that payroll taxes have little merit as a source of general revenues, we would not favour running surpluses on a sustained basis. We recognize, however, that it is appropriate to build up a stabilization reserve, and that the pace at which contributions are reduced to bring them in line with the average level of benefits must give weight to considerations of overall fiscal policy.
- ⁴ Our earlier suggestion that general payroll taxes would largely be shifted to employees in the longer run would also apply to shifting of the impact of uniform social insurance benefits tied to employment: such benefits, everything else being equal, would be expected largely to increase the real after-tax income of employees rather than be shifted to employers through reduced pre-tax wages. Payroll tax rates and social insurance benefits may also vary across employers. When this occurs, differences from the average tend to be borne by employers. See Anderson and Meyer (1997).
- ⁵ Achieving greater stability in employment through means such as these may increase an employer's costs. But layoffs also have costs to workers and to the EI system. The goal should be to achieve a situation in which both sets of costs are appropriately balanced.
- ⁶ Employer contribution rates may be reduced for employers who provide their own sick leave benefit plans.
- ⁷ See Corak and Pyper (1995a) and (1995b).
- ⁸ See Canada, Human Resources Development Canada (1996).
- ⁹ See Corak and Pyper (1995a).
- ¹⁰ Canada, Royal Commission on the Economic Union and Development Prospects for Canada (1985), vol. 2, pp. 604, 605, 611.
- ¹¹ This discussion draws heavily on Vroman (1996).
- ¹² See Vroman (1996), Table 4.
- ¹³ See Vroman (1996), p 61. For the recent major studies surveyed by Vroman, the estimates from recent major studies range from about .4 to about .8, around the average value of .6. See also Beauséjour, Sheikh and Williams (1995).
- ¹⁴ Greater stability in employment would be favoured both by improved incentives for individual businesses in their management of labour use, and by encouraging relatively more employment in more stable industries. As well as tending to reduce temporary unemployment associated with seasonal factors, there should also be some tendency to reduce the extent of cyclical variation in the economy. See Beauséjour, Sheikh and Williams (1995).
- ¹⁵ If future contribution rates varied fully with past experience, then – at least for businesses that did not go out of business – the system would not provide insurance but would merely be an arrangement for delayed payment of the full cost of unemployment benefits provided to the employees of a business.

- ¹⁶ In principle, there is a case for having rates vary fully with **expected** future benefits, but, in general, expected future benefits (an average of a range of possible outcomes) will vary less than the actual outcomes.
- ¹⁷ Canada, Human Resources Development Canada (1997).
- ¹⁸ As noted earlier, an average estimate for the United States is that a move from two thirds to full experience rating (i.e. an increase of 30 to 35 percentage points in the degree of experience rating) in the United States would reduce the unemployment rate by .6 percentage points. Our order of magnitude estimate of the impact of our proposed degree of experience rating obviously depends on the validity of our simple proportionality assumption in relating potential impacts in Canada to actual U.S. experience. There is some reason to believe that the favourable impacts on unemployment could be appreciably larger than indicated by our very rough estimate. It is often the case that the gains from reducing tax distortions are non-linear that is, an initial x percentage point reduction in a set of distortions provides larger gains than provided by successive further x percentage point reductions in the tax distortions. As well, the proposed change in Canadian contribution rates would apply to a higher covered wage base than do the U.S. contribution rates. Thus, the impact of a given percentage point change in Canadian contribution rates might well have a larger impact on employer behaviour than suggested by the above estimate, which assumes parallelism with results of U.S. studies.
- ¹⁹ A number of U.S. states base the employer contribution on the full history of a business' contributions and associated benefits since the "birth" of the business, or the commencement of the unemployment insurance regime.
- ²⁰ See Mercer (1995).
- ²¹ As well as acknowledging that substantial work would have to be undertaken to resolve program design issues prior to implementation, we acknowledge that there is much room for refinement of these estimates of impact on the unemployment rate and on GDP. Such estimates should take account of the specific structure of employer contributions proposed.

Taxes as User Charges: Environmental Taxes

9

Introduction

As noted in the previous chapter, the Committee believes as a matter of general principle, that business taxes unrelated to profits or capital should, where appropriate, reflect the benefits received by the business from publicly provided goods and services, or the costs imposed by the business on society. This fuller application of the user pay principle would promote both economic efficiency and greater fairness, by helping to ensure that businesses bear more of the social costs imposed by their actions. In this chapter, we examine the potential for applying the user charge approach to environmental costs, and propose that a restructured federal fuel excise tax be given such a role.

Federal and provincial governments share the responsibility for protecting Canada's environment. Along with their regulatory and expenditure powers, governments across Canada have introduced some taxes and fees to encourage better environmental practices. These include provincial vehicle efficiency taxes and excise taxes on heavy vehicles, and special provincial taxes on tires, lead acid batteries, beverage containers, disposable diapers, and other commodities. Federal and provincial governments have also provided corporate income tax incentives, including special write-offs for renewable energy and energy-conservation investments, energy efficiency, water and air pollution control, and wetland rehabilitation.

Federal and provincial excise taxes on motive fuels – gasoline, diesel, and jet fuel – could be viewed as emissions taxes because combustion of these fuels produces a number of air contaminants. However, these excise taxes were not generally designed with environmental objectives in mind. The federal fuel excise tax, for example, was imposed in 1975 as part of a package of measures intended to raise revenue and curb reliance on imported oil. It continues to be an important source of revenue for the federal government. Provincial gasoline excise taxes also raise significant revenue and are, in part, a charge for the use of roads and highways provided by government. These fuel excise taxes were thus not set on the basis of assessments of environmental damage or to achieve environmental targets.

While provincial gasoline levies are arguably related to the use of highways and roads, the federal tax lacks this relationship. Some have argued that the federal excise tax contributes to a better environment through its impact on fuel consumption. The existing federal fuel excise is not the best instrument for pursuing environmental objectives, however. The tax base is not closely related to the causes of urban air pollution; neither is the tax base well designed from the perspective of climate change. In 1995, only 27 percent of Canada's greenhouse gas emissions came from fuels used in the transportation sector, compared to 57 percent from combustion of fossil fuels that are not subject to specific federal taxes.¹

In supporting the application of the user pay principle to environmental matters, the Committee also notes that businesses, in 1995, already pay \$1.8 billion in federal fuel excise taxes. These excise taxes adversely affect those parts of the transport sector that compete with operators in the United States facing lower input taxes, as well as generally adding to the cost structure of Canadian businesses. (The following inset provides more information on the federal fuel excise tax and its economic impacts.)

The Federal Fuel Excise Tax

The federal fuel excise tax applies to gasoline and motive fuel products consumed by individuals and businesses. The rate of tax is 10 cents per litre for gasoline and 4 cents for diesel. Alternate transportation fuels – methanol, ethanol, compressed natural gas and propane from renewable sources – are exempt from tax. Provinces also apply taxes on motive fuels and provide similar exemptions.

The federal and provincial fuel excise taxes have a number of important impacts on the Canadian economy:

- As the excise taxes apply to a specific product from oil (gasoline and motive fuels), they result in a higher cost of gasoline and discourage its consumption relative to other products.
- As certain forms of energy are exempt from taxation, the fuel excise taxes encourage use of these tax-exempt forms relative to gasoline and other motive fuels.
- Fuel excise taxes apply to gasoline and motive fuels used by businesses and increase the cost of production for many businesses. To recover the fuel excise taxes, businesses may charge higher prices to consumers and other businesses that purchase their products. The fuel excise taxes thus have uneven effects on final prices of goods and services sold to consumers, since the taxes affect business costs at different stages of production and distribution.
- Fuel excise taxes in Canada, including provincial taxes, are higher than rates applying to fuel in the United States, thereby affecting the competitiveness of many businesses in Canada, including the transportation and tourism industries.

As stated in the Introduction to this Chapter, other rationales, besides revenue raising, have been suggested for levying federal and provincial excise taxes on gasoline and motive fuels. At the provincial level, the fuel excise tax has been viewed as a tax on owners of vehicles for the use of highways and roads built and maintained by provincial and municipal governments. This rationale for the federal fuel excise tax, however, is not applicable, since the federal government is not directly responsible for highways and roads.

Another suggestion has been that the federal fuel excise tax encourages a more efficient use of oil resources at the consumer level. These efficiencies have positive effects on the environment by reducing emissions of various pollutants. The Committee, therefore, considers it appropriate to examine how well the federal excise tax currently contributes to better environmental practices in Canada.

The Committee is aware of proposals to increase federal fuel excise rates to promote environmental objectives. There are also proposals in Canada and elsewhere to introduce over the longer term significant new taxes to reduce the growth of global greenhouse gas emissions and other pollutants. The possible use of fuel excise taxes as environmental policy instruments raises several broad policy issues considered by the Committee. Are taxes an appropriate policy tool for achieving environmental objectives? What are the respective roles of federal and provincial governments? How do Canada's environmental practices and existing indirect taxes compare to those of other countries.? Finally, could the federal fuel excise tax be restructured in ways that would raise equivalent revenue, but also incorporate environmental considerations in the tax base and rate structure, and enhance economic efficiency?

Achieving Environmental Quality Objectives

Natural resources, including environmental resources – land, air and water – are integral to Canada's development and the well-being of its residents. When environmental resources are degraded, Canadian living standards and the productive capacity of the economy are impaired, as greater effort must be devoted to cleaning up the environment to preserve our health and quality of life, rather than to producing consumer and producer goods and services that are beneficial to Canadians.

A primary cause of environmental degradation is the fact that individuals and businesses are not faced with the full costs of their use of natural resources and the associated environmental damage. Because many environmental resources are not “owned” by any individual or group, there are no markets to determine how much a person should pay for damaging the environment. In the absence of markets to provide incentives to manage and protect urban, rural and natural environments, too much pollution and waste will be discharged into our soils, atmosphere and waters. The traditional response to this lack of environmental markets has been to introduce various forms of environmental regulation.

Over the past 25 years, indicators of environmental quality in Canada suggest that our performance has been mixed, with improvements in some areas and declines in others.² Water quality in the Great Lakes has improved since the 1970s, for example, and sulphuric deposition (also called acid rain) in central and eastern Canada has diminished over the same period. Significant environmental problems remain, however, including air quality concerns in central Canada and greater Vancouver arising from ground-level ozone, and particulates; poor ground and surface water quality in many parts of Canada due to discharges of a large variety of toxic compounds; contamination of soils from a variety of waste products; and more global concerns such as the reduction in stratospheric ozone, and rising emissions of carbon dioxide and other greenhouse gases. Canada’s emissions per capita, or relative to value added or employment, are higher than those for many developed countries as measured by a number of environmental indicators. Chart 9A provides information on Canadian emissions of sulphur and nitrogen oxides, total suspended particulates, and greenhouse gases over the period 1970-95. Of these pollutants, sulphur oxides and total suspended particulates show a consistent downward trend, while greenhouse gas emissions and nitrogen oxides have increased over the period.

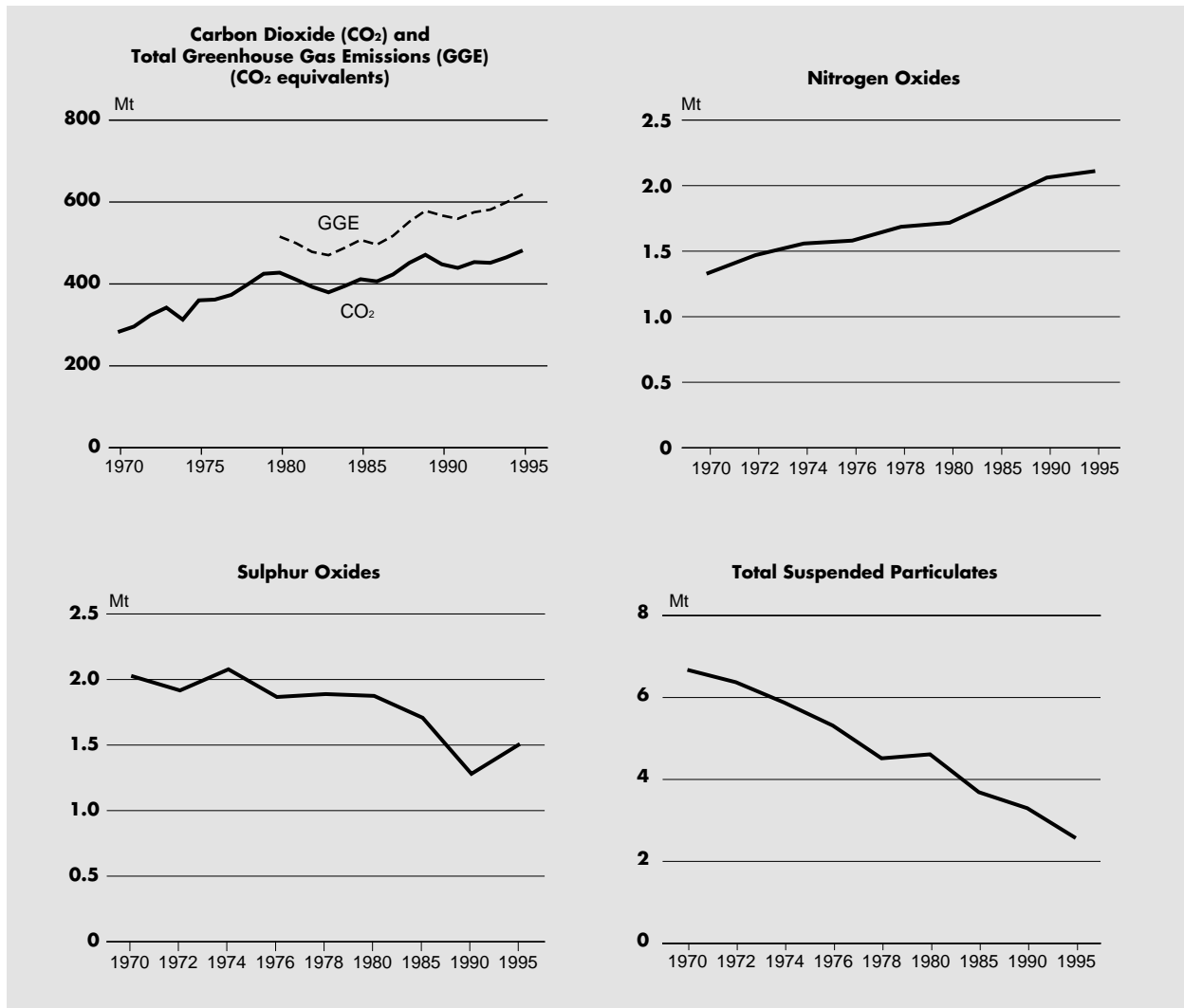
Canada’s economic circumstances and trade relations are also important factors in considering the potential role for environmental taxes. While there have been suggestions for increased use of environmental taxes, particularly to raise the overall price of fossil fuels, the Committee is aware of the potential competitiveness impacts of unilateral action. If Canada imposes higher taxes or more stringent controls on emissions than other major countries, Canadian industry could be placed at a disadvantage. Canadian policy must take account of more general international developments, including the gradual rise in environmental standards (reflected in part in the increased use of environmental taxes) and the implications of international negotiations on a range of environmental issues.

Finally, in considering the potential for restructuring the federal fuel excise tax, the Committee is also aware of the economic advantages of environmental taxes. As discussed in more detail below, such taxes and other economic instruments offer a way of improving both the efficiency of resource use, and the fairness of the net impacts of use on the wider community. These benefits parallel those of user charges for publicly provided goods and services. This suggests that better environmental policies – including replacing existing taxes with well-designed environmental taxes – have the potential to promote better living standards in Canada.

Environmental Protection: Regulation and Market-based Instruments

Two broad classes of policy commonly employed to deal with the generation of environmental contaminants and changes in environmental quality are direct regulation and market-based (or economic) instruments. Regulatory policies seek to achieve environmental objectives by using emission standards to control the quantities of pollutants released by specified types of sources, or by prescribing technology-based standards setting out the type of production processes or pollutant-control technologies to be used.

Chart 9A

Canadian Emissions of Key Air Pollutants, 1970-1995**Notes:**

- Data for carbon dioxide represent emissions from fossil fuels only, not all sources of carbon. Fossil fuels account for approximately 90 percent of all inventoried carbon dioxide emissions since 1980.
- Figures for sulphur oxides (SO_x) and nitrous oxides (NO_x) for 1970-80 are for sulphur dioxide (SO₂) and nitrogen dioxide (NO₂) respectively.
- Preliminary figures for 1995 emissions of nitrous oxides, sulphur oxides and total suspended particulates provided by Pollution Data Branch, Environment Canada.
- Mt = million tonnes

Sources: Deslauriers (1996), Canada, Environment Canada (1986), Jacques, Neitzert and Boileau (1997) and Kosteltz and Deslauriers (1990).

Market-based instruments aim to alter the behaviour of decision makers by attaching an explicit cost to emitting pollutants or to undertaking other activities with adverse environmental impacts. These “pricing” instruments include taxes, user charges and fees, tax incentives and disincentives, and markets for transferable emissions permits, as discussed further below.³ These measures make businesses and individuals take account of the wider impacts of their decisions; the measures achieve reductions in the use of polluting processes and goods by raising their price relative to those generating less pollution.

While Canada has depended primarily on the regulatory approach, in recent years, many have advocated greater use of market-based incentives. It is argued that, in many circumstances, they are more cost-effective; specified environmental targets may be reached at less cost to business and with fewer distortions to the economy than with traditional regulation.⁴ These advantages apply to both taxes and tradable emissions permits.⁵ Tradable emissions permits are less relevant to the assessment of environment-related federal taxes, however, because they would not generate the revenue that the existing excise taxes do, unless they were auctioned by the government. All tradable emissions permits in use today were initially given to polluters by governments without charge, rather than being sold.

The general principle of environmental taxation is to set the tax equal to the difference between the private marginal costs of producing and using the good, and the full social costs of production and consumption, including all environmental consequences. While the principle is widely accepted, in practice these social costs in the form of pollution and other kinds of environmental degradation are often very difficult to quantify with precision. The rates for existing environmental taxes around the world have been determined according to a mix of environmental considerations, revenue objectives and political factors.

Environmental taxes can take a number of forms. While a tax on emissions usually makes the clearest link between environmental quality and the good or activity with adverse effects, in practice it is often difficult to measure and monitor emissions. Tax bases that are proxies for measured emissions may be used in such cases. These include taxes on the inputs that lead to waste discharge or excise taxes on pollution-intensive goods such as fuels, pesticides, batteries, paints and tires. The closer the link between environmental damages and the use of the input or good, the better the proxy these taxes are for emission taxes. No single type of policy response is appropriate for all environmental problems. The choice of instrument depends on a range of factors, including the nature of the environmental problem, the jurisdiction of the taxing authority, and the trade characteristics of polluting industries.

A further advantage of environmental taxes over many general taxes is that they have the potential to correct market distortions rather than introducing new ones. The replacement of an existing distortionary tax with a corrective environmental tax – one that works to reduce the difference between private and social costs – can have the effect, therefore, of improving the efficiency of the tax system as a whole. The reduction in the use of distortionary taxes on production, employment and investment can improve incentives to invest and create jobs.⁶

Environmental taxes can also have the effect of stimulating innovation and technological change in a way that is not achieved by regulations that prescribe technology.⁷ The latter policies lock a polluter into using the technology specified by the regulation. An environmental tax, on the other hand, provides a continuous incentive to search for ways to minimize the use of the taxed input or output. In the case of a tax on emissions of a pollutant, for example, it is in the interests of the taxpayer to continue to search for better and cheaper technologies to reduce the taxed emissions.

Other Countries' Experiences with Environmental Taxation

Environmental taxes make up an increasing share of total tax revenue in many European countries, where the trend in tax reform is to shift away from income taxation toward value-added taxes and other indirect taxes, including environmental taxes. The rationale for these reforms is to reduce adverse impacts on labour and capital markets while providing incentives to improve environmental quality. The most significant changes are under way in Denmark, Norway, Sweden and the Netherlands. Environmental taxes in these countries now comprise 5 to 10 percent of total tax revenues and 2.5 to 4.9 percent of GDP. The Netherlands is considering introducing differential value added tax rates that would depend on environmental characteristics of products.

The introduction of environmental taxes has been a component, but not a significant one, of recent tax reforms in Austria, Germany, France, Belgium and the United Kingdom. In these countries there appears to be a general trend toward greater use of product charges and taxes, and transportation and energy taxes. In energy taxes, the trend is toward restructuring existing tax measures to give consumers incentives to use energy in ways less harmful to the environment. At the same time, there has been a general reduction in the use and significance of income tax incentives, such as accelerated depreciation for environmentally friendly investments.

Excise Taxes on Fuels and Other Energy Taxes

Excise taxes on fuels warrant special attention, because they are the most common environmentally related taxes in OECD countries and raise the greatest share of revenue. Some countries have used the revenues from new or increased energy taxes to reduce other taxes. Australia, the Netherlands, the United Kingdom and the United States have all announced rate increases for various fuel or energy excise taxes. The United Kingdom's policy is specifically designed to meet targets for reductions in greenhouse gas emissions, with excise tax rates on motive fuels rising over time. Finland has restructured its fuel tax from an excise partly based on the carbon component to a combined carbon/energy tax on diesel and gasoline. Sweden has differentiated fuel excise taxes on diesel and gasoline, based on energy and carbon content.

Other approaches being considered commonly seek to broaden the tax base beyond petroleum-based products to include other energy forms and sources of environmental contaminants. Sweden has introduced a specific charge on nitrogen oxide emissions from industry. Norway has imposed a tax at various rates on carbon dioxide that is contained in petroleum products, or emitted from offshore oil and gas production. Table 9.1 summarizes the use of key energy and environmental taxes in selected OECD countries.

Table 9.1
Environmentally Related Taxes in Selected OECD Countries, 1994 to 1997

Country	Unleaded Gasoline (C\$/litre) ^a	Non-automotive Fossil Fuels	Electricity	Ozone-depleting Substances	Other Goods and Services ^b	Deposit-refund System ^c
	1997	latest avail.	latest avail.	1994	1994	1994
Australia	0.44	no	no	yes	no	yes
Canada	0.25	no	no	no	yes	yes
Denmark	0.71	yes ^d	yes	no	no	yes
Finland	0.86	yes ^d	yes	no	yes	yes
France	0.92	yes	no	no	no	yes
Germany	0.80	yes	no	no	yes	no
Japan	0.60	no	no	no	yes	no
Netherlands	0.84	yes ^d	yes	no	no	no
Norway	0.92	yes ^{d,e}	yes	no	yes	no
Sweden	0.79	yes ^{d,e}	yes	no	yes	yes
United Kingdom	0.82	Yes	no	no	no	no
United States	0.14	yes ^f	no	yes	yes ^f	yes

^a Values represent all non-value-added taxes imposed by all levels of government for 1997, converted to Canadian dollars using exchange rates for first quarter 1997.

^b Tax on one or more "pollution-intensive" commodities.

^c Temporary taxes in the form of refundable deposits on beverage containers and other products.

^d Tax on the carbon content of the fuel.

^e Tax on the sulphur content of the fuel.

^f The Hazardous Substances Superfund Tax.

Source: Information on excise taxes on gasoline, other fossil fuels and electricity from International Energy Agency (1997). Supplementary information on fossil fuels taxes and information on non-excise taxes compiled from Organization for Economic Co-operation and Development (1995).

Denmark is gradually increasing its excise taxes on electricity and coal with the intention of aligning them with the energy content of the excise tax on oil. In 1996, the state of Minnesota introduced an energy tax in the form of charge of US\$50 per ton of carbon on fuels and electricity consumed in the state, to be phased in over five years.⁸ The tax is expected to raise US\$1.5 billion annually, with equivalent reductions in property and payroll taxes.⁹

The Potential for Using Environmental Taxes in Canada

Any consideration of the scope for applying the user pay principle to pollutants under federal jurisdiction through environmental taxes, must take into account the respective roles of Canada's federal and provincial governments, the emissions characteristics of Canadian businesses and the wider economic context. The main types of emissions considered are toxic industrial releases and energy-related pollutants.

Federal and Provincial Roles in Environmental Taxation

Canada's federal structure puts constraints on the environmental taxes that may be levied by each level of government, with many of the relevant regulatory powers being split between the federal and provincial jurisdictions. Under Section 92 of the *Constitution Act*, provinces have power over local works, property and civil rights within the province, matters of a local or private nature, and authority over provincially owned lands and resources. Section 92A gives each province exclusive jurisdiction over the development, conservation and management of its energy and forest resources, and hydroelectric power facilities.

Section 91 of the *Constitution Act* gives the federal government powers over ocean and inland fisheries, navigation and shipping, and over federal lands and waters. This provides the basis for environmental regulation over water pollution under the *Fisheries Act* and *Navigable Waters Protection Act*. Ottawa also has exclusive powers to enter into international treaties, and there are many significant international agreements to which Canada is a party that touch on the environment in one way or another. These include numerous air pollution agreements such as the Montreal Protocol for ozone-depleting compounds and the Bergen Declaration on greenhouse gas emissions, the Basle Convention on Toxic Wastes, and a number of bilateral agreements with the United States concerning the Great Lakes.

Finally, the federal government has an overriding authority to enact legislation under the "peace, order, and good government" clause in the preamble to Section 91. Under this power it has introduced the *Canadian Environmental Protection Act*, a major piece of legislation dealing primarily with toxic materials.

The federal government has the responsibility to develop and implement environmental policies, including federal environmental taxes, to deal with national and international environmental issues such as air pollutants and toxic chemicals, whose effects go beyond a single province. The Committee considers that the federal government has the additional responsibility to assist the provinces in co-ordinating and harmonizing environmental policies, so as to reduce both the economic and compliance costs arising from their implementation. In an effort to reduce overlap, federal and provincial governments have taken some steps in recent years to harmonize their environmental policies. Given the complexity of jurisdictional and economic issues, the Committee suggests that there should be consultations between the federal and provincial governments before introducing any environmental taxes with broad implications.

Canadian Industrial Pollution and Toxic Emissions

The National Pollutant Release Inventory (NPRI) is a comprehensive database on releases of toxic contaminants to air, water or land, collected under the *Canadian Environmental Protection Act* by Environment Canada.¹⁰ Under this Act, all facilities with 10 or more full-time employees which “manufacture, process, or otherwise use any of the NPRI substances in concentrations greater than one percent and in quantities equal to or greater than 10 tonnes”¹¹ must file a report with Environment Canada, and report any releases or transfers of wastes.

The NPRI compiles data on 230 substances of varying toxicity.¹² Airborne emissions associated with air contaminants and suspended particulates, such as those shown in Chart 9A, are not included in the NPRI, but are measured and reported by Environment Canada as ambient concentrations of the pollutant at monitoring stations throughout the country.

A number of indicators of the toxic intensity of Canadian production have been calculated using NPRI data and Statistics Canada industry data. These indicators measure emissions, or estimate relative toxic impacts, expressed as a ratio to either the number of production workers or the value of output for each industry.¹³ These indicators are designed for comparisons across industries and across countries, and can be viewed as a preliminary reference point for the pollution intensity of industries, and the associated potential risks to the environment or human health.

The volume of emissions per employee or per dollar of output, shown in the “Emissions” column of Table 9.2 do not provide an indication of the degree of public exposure or environmental impact, as the emissions data is not weighted according to toxicity. The absence of toxicity weighting is significant because the potential impact of NPRI-listed substances varies widely. Without some form of weighting, some high-volume releases of less toxic substances may appear to be more of a danger than lower-volume releases of highly toxic substances, when, in fact, the opposite may be true. In the case of paper and allied products, for example, methanol represents over 60 percent of total releases, but it is not very toxic. The wood industry, on the other hand, releases only a low volume of emissions per job or per dollar of output, but these are relatively toxic, as a significant portion of the releases is formaldehyde. Impacts also depend on population densities in affected areas, environmental conditions and pre-existing concentrations of toxic materials.

One approach to developing measures that provide a more reliable indication of the relative impact of emissions from different industries is to narrow the scope of the type of toxins under consideration. Thus the next two columns of the table identify the volume of carcinogenic releases and environmental toxins. This approach reduces the variation in impact of a given mass of substances, but does not eliminate it. A more appealing approach to accounting for the differential impacts of each substance in the inventory is to weight releases according to scientific studies assessing their overall toxicity. The results of such a weighting are presented in the final column of Table 9.2.

The information presented in Table 9.2 indicates that the quantities of emissions and their toxic intensities vary widely among different industries, based on aggregated releases.¹⁴ As indicated by their ranking in both per employee and per dollar of output ratios, four industry sectors have consistently very high toxicity rankings: refined petroleum and coal, chemicals, mining, and primary metals. Industries of medium toxicity include crude petroleum and natural gas, paper and allied products, non-metallic minerals, rubbers, plastics and transportation equipment. Industries with consistently low values include food, beverage, machinery, leather, and electrical and electronics.

Table 9.2
**Canadian Toxic Emissions and Toxic Intensity Indicators,
 by Industry, 1994**

Industry	SIC Code	Emissions (tonnes/job or \$)	Carcinogenic Releases (tonnes/job or \$)	Environmental Toxins (tonnes/job or \$)	Overall Toxic Intensity (index)
Emissions and Impact per Employee					
Refined Petroleum and Coal	36	1.581	0.127	1.241	1,165
Chemicals	37	1.213	0.122	0.921	823
Mining	6	0.675	0.105	0.276	428
Crude Petroleum and Natural Gas	7	0.530	0.053	0.138	304
Primary Metal	29	0.312	0.115	0.329	300
Paper and Allied Products	27	0.414	0.009	0.103	215
Rubber	15	0.127	0.010	0.133	118
Plastics	16	0.100	0.055	0.032	76
Non-metallic Minerals	35	0.077	0.017	0.067	65
Transportation Equipment	32	0.047	0.008	0.047	38
Printing and Publishing	28	0.020	0.006	0.013	15
Fabricated Metal	30	0.017	0.004	0.021	13
Furniture and Allied Products	26	0.014	0.001	0.012	12
Textile Products	19	0.013	s.	0.005	11
Primary Textiles	18	0.012	0.003	0.012	10
Other Manufacturing	39	0.010	0.001	0.006	9
Wood	25	0.007	0.006	0.006	8
Electrical and Electronic	33	0.006	0.003	0.010	5
Leather	17	0.006	s.	0.006	3
Machinery	31	0.002	s.	0.002	1
Beverage	11	0.001	s.	0.003	1
Food	10	s.	0.001	0.002	s.
Weighted Average		0.144	0.021	0.093	100
Emissions and Impact per Million Dollars of Output					
Chemicals	37	2.235	0.225	1.697	756
Mining	6	2.073	0.324	0.847	655
Primary Metal	29	0.879	0.325	0.926	422
Rubber	15	0.661	0.054	0.693	305
Plastics	16	0.612	0.333	0.197	232
Refined Petroleum and Coal	36	0.619	0.050	0.486	227
Non-Metallic Minerals	35	0.373	0.082	0.325	157
Crude Petroleum and Natural Gas	7	0.181	0.018	0.047	52
Furniture and Allied Products	26	0.124	0.009	0.106	51
Transportation Equipment	32	0.107	0.018	0.107	43
Fabricated Metal	30	0.107	0.022	0.131	42
Printing and Publishing	28	0.104	0.033	0.068	39
Textile Products	19	0.093	s.	0.035	39
Paper and Allied Products	27	0.126	0.003	0.031	33
Other Manufacturing	39	0.073	0.008	0.044	31
Primary Textiles	18	0.058	0.016	0.058	23
Leather	17	0.062	0.004	0.061	19
Wood	25	0.031	0.024	0.027	17
Electrical and Electronic	33	0.020	0.012	0.033	9
Machinery	31	0.011	s.	0.008	3
Beverage	11	0.002	s.	0.006	1
Food	10	0.001	0.004	0.005	s.
Weighted Average		0.288	0.043	0.187	100

Notes:

- The employment numbers used for ratios refer to “activity employment”; they measure production workers and exclude administrative and other office employees.
- Output is the value of shipments of own manufacture in millions of dollars.
- An ‘s’ indicates an overall toxicity index of less than 0.5, or that releases were less than 0.0005 tonnes per job or per million dollars.
- The NPRI Summary Report for 1994 did not report releases nor transfers for the Tobacco and Clothing sectors.

Source: Calculated from Canada, Environment Canada (1996b), Statistics Canada industry data (Canada, Statistics Canada (1996a)), Pohanish and Greene (1993) and Lewis (1993).

Important additional information may be derived from a comparison of Canadian manufacturing industries with their U.S. equivalents. Table 9.3 summarizes a comparison of toxic releases from Canadian manufacturing industries to similar operations in the United States.¹⁵ The Table indicates the Canadian industry groups with higher, lower and approximately equivalent emissions per job and per dollar of output when compared to U.S. industries.

Table 9.3

Releases of Toxic Emissions in Canada Relative to the United States by Manufacturing Industry, 1994

Industries where the volumes of Canadian toxic releases exceed those in the United States by more than 50 percent (as measured per employee and per dollar of output)

Chemicals and Chemical Products	Refined Petroleum and Coal
Non-metallic Minerals	Rubber and Plastics
Paper and Allied Products	

Industries where the volumes of toxic releases are comparable in Canada and the United States

Primary Metal	Textile Products
Printing and Publishing	Transportation Equipment

Industries where the volumes of U.S. toxic releases exceed those in Canada by more than 50 percent

Electrical and Electronic	Leather
Fabricated Metal	Machinery
Food and Beverage	Wood and Lumber
Furniture and Fixtures	

Note: These groupings are based on the volumes of releases (unweighted for toxicity) for both per employee and per million dollars of output, consistent with the methodology used in the 'Emissions' column of Table 9.2. Only industry sectors that fall in the same grouping on both the per employee and per dollar of output bases are included in the Table.

Source: Calculated from Canada, Environment Canada (1996b), Statistics Canada industry data (Canada, Statistics Canada (1996a)), and the U.S. Toxic Release Inventory for 1994 (United States, Environmental Protection Agency (1994)).

In general, the sectors for which Canadian manufacturing emission intensities are significantly above those of the United States are those sectors with the highest emission intensities. The sectors for which Canadian industries are less emission-intensive than their U.S. counterparts are generally those with low emissions per job and per dollar of output. In short, Canadian industries that perform least well in controlling emissions are those that have the greatest potential for causing environmental damage – refined petroleum and coal, chemicals, rubber and plastics, paper and allied products, and non-metallic minerals. Overall, emissions per job and per dollar of output from Canadian manufacturing industries are 50 percent higher than releases from U.S. manufacturing industries.

Given the order of magnitude of the difference in emissions intensities between Canada and the United States, these divergences warrant further analysis. A few studies have suggested that Canadian manufacturing is more pollution-intensive because our environmental regulations are not as stringent as those in the United States.¹⁶ Canadian manufacturers may also be using technology that releases more pollutants per job or unit output, or may be producing different products than their counterparts in the United States. Differences in the scale and age of Canadian plants may also play some role. Finally, the contrast with the United States may be at least in part due to differences in sectoral definitions, methodologies, and the coverage of the inventories of toxic substances.

In order to examine whether emissions varied by the size of the firm, the 1994 NPRI data were disaggregated according to the number of full-time employees. The results, presented in Table 9.4, suggest that the largest firms have the lowest emissions and toxic intensity per employee. One possible explanation for the relatively high toxic intensity of the small and medium-sized firms is that they may not have the facilities, technologies or capital to reduce emissions of toxic compounds. Another factor is that smaller firms tend to be less subject to regulations and public scrutiny than larger enterprises, and thus have less incentive to invest in pollution-abatement equipment or activities.

Table 9.4
Emissions and Toxic Intensity by Firm Size, 1994

Firm Size (full-time employees)	Emissions and Impact per Full-time Employee			
	Emissions (tonnes/job)	Carcinogenic Releases (tonnes/job)	Environmental Toxins (tonnes/job)	Overall Toxicity (Index)
1 to 25	.363	.126	.382	94
26 to 50	.465	.123	.312	123
51 to 100	.251	.110	.244	71
101 to 200	.416	.114	.212	85
201 to 500	.770	.072	.507	191
501 to 1000	.334	.048	.202	85
Over 1000	.183	.026	.122	51
Weighted Average	.378	.056	.246	100

Source: Calculated from Environment Canada (1996b), Pohanish and Greene (1993) and Lewis (1993).

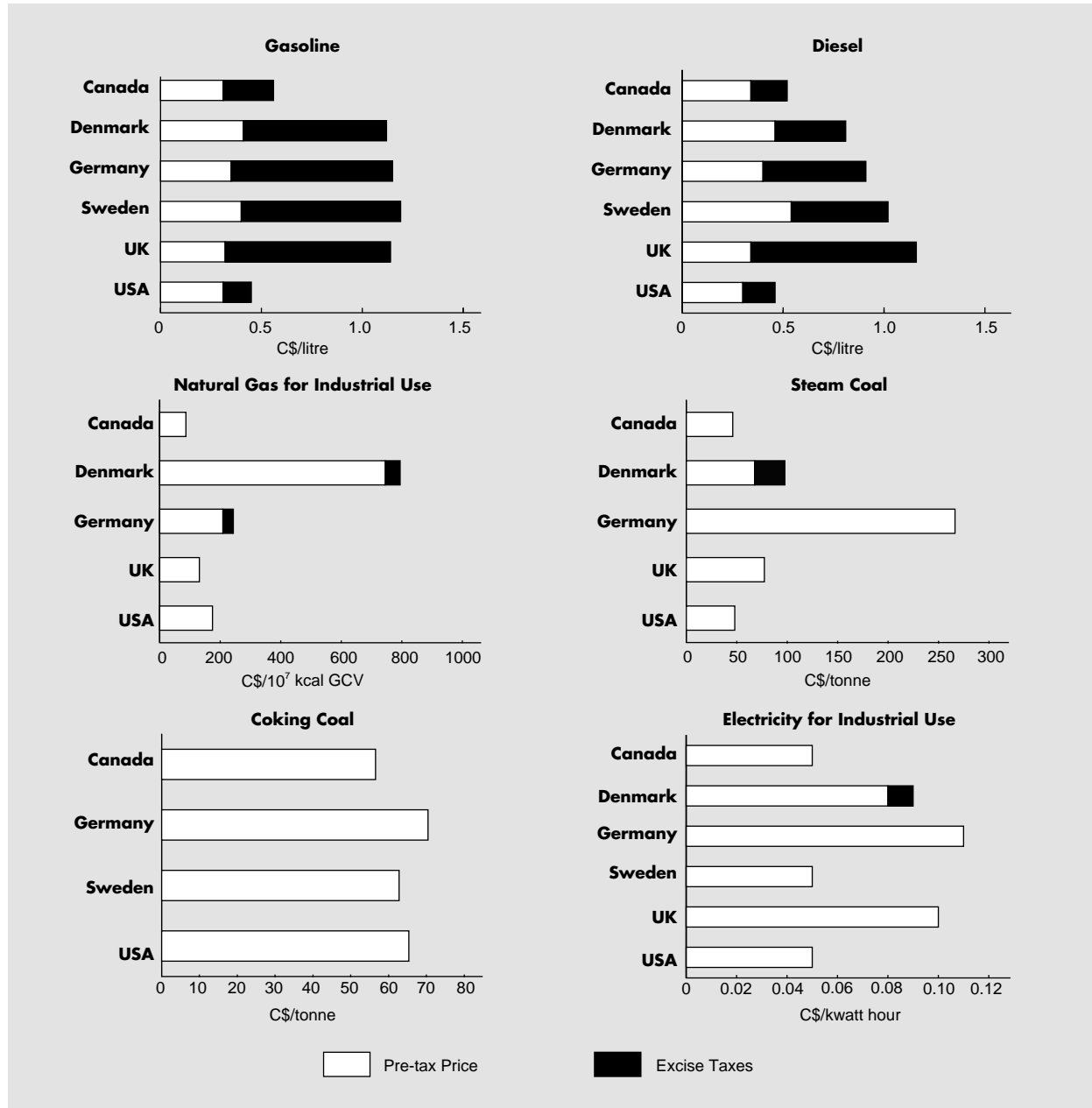
The analysis presented in Tables 9.2, 9.3 and 9.4, while preliminary in nature, strongly suggests that there are significant differences between businesses in terms of their impact on the environment. This, in turn, suggests that the adoption of appropriate environmental taxes, or other incentive-based instruments, has the potential to reduce the toxic emissions of firms. To the extent that these environmental impacts represent uncompensated costs imposed on other Canadians, environmental taxes hold the promise of being able to enhance Canadian economic efficiency, fairness, and environmental quality.

Fuel Taxes and Prices

Canadian fuel taxes and prices are generally lower than those of other countries, with the important exception of the United States.¹⁷ Perhaps more importantly, however, this tax burden is not evenly distributed across fuels and energy sources. As shown in Chart 9B, in most countries, oil products bear the highest taxes, while coal bears the lowest. This tax treatment is the reverse of the pollution characteristics of these two energy sources, with coal combustion generally resulting in significantly more environmental contaminants per unit of energy than the combustion of oil products. A rebalancing of excise taxes on fuels to account for their environmental impact would increase taxes on coal and, more modestly, on natural gas relative to those currently on oil.

Chart 9B

Energy Prices and Excise Taxes for Selected Countries, 1997 or Latest Available Data



Notes:

- "Excise taxes" are defined to include all product taxes and special charges, other than valued-added taxes which are refundable when the energy product is used for commercial purposes. These include excise taxes, gasoline and automotive diesel taxes, non-refundable sales taxes (Canada, U.S.), special taxes (Germany, U.S.), environmental taxes (Denmark, U.S.), emergency storage fund (Germany), energy taxes (Sweden), carbon dioxide taxes (Sweden), sulphur taxes (Sweden) and inspection fees (U.S.).
- Data are for the first quarter of 1997, with the following exception: U.K. natural gas and steam coal is for fourth quarter 1996, Canadian electricity and natural gas is for fourth quarter 1994, German electricity, natural gas and coking coal is for 1995, German steam coal is for 1994, Swedish coking coal is for 1989 as this series has been discontinued. (The current price for Swedish steam coal is not shown, due to the variation in taxes based on carbon dioxide and sulphur.)
- The "pre-tax price" shown for Canadian electricity and U.S. natural gas and steam coal may include provincial sales taxes and general state sales taxes respectively. Sales taxes on U.S. electricity are not shown. Data on Canadian coal prices use U.S. export prices.

Source: International Energy Agency (1997).

At a general level, this suggests that most countries could meet environmental objectives more effectively and with fewer economic distortions, if they broadened their tax bases to reflect known environmental impacts. A more neutral treatment, taking account of environmental considerations, would improve overall economic efficiency.¹⁸ More specifically for Canada, there appears to be some scope for rebalancing excise taxes on fuels by replacing the federal fuel excise tax with a more broadly based environmental tax. This might enhance our competitiveness with the United States. A reduction in taxes paid on oil products could make Canadian industries that use oil relatively intensively (such as transportation) more competitive with comparable industries in the United States that face lower tax rates on motive fuels. On the other hand, increases in taxes on non-oil energy products would add to production costs for some industries. The Committee suggests that the federal government, following consultation with the provinces, set the tax rates for the restructured fuel excise tax keeping in mind these trade-offs.

A commonly used approach in considering the environmental impact of existing excise taxes on fossil fuels is to convert the current rates into an implicit tax on the carbon content of these fuels. Carbon may be regarded as an imperfect proxy for a range of environmental damages from these fuels, such as the impacts on local and regional air quality (reducing visual amenity, damaging ecosystems, and the contribution to a range of health problems), and the contribution to potential climate change impacts. In addition, data on fossil fuel use and carbon content are reliable and widely available.

Table 9.5
**Implicit Carbon Taxes, Energy Intensity and
Carbon Intensity of Selected OECD Countries, 1997**

	Implicit carbon taxes ^a (C\$/tonne carbon)	Energy intensity ^b (tonnes oil equivalent/ C\$ thousands)	Carbon intensity ^c (tonnes carbon dioxide/ C\$ millions)
United States	47	0.24	0.60
Japan	107	0.11	0.25
Canada	112	0.27	0.53
OECD average^d	128	0.17	0.41
Australia	136	0.21	0.64
New Zealand	151	0.21	0.38
Netherlands	189	0.16	0.38
United Kingdom	243	0.15	0.38
OECD Europe^d	269	0.13	0.30
Germany	280	0.13	0.35
Italy	288	0.10	0.26
Sweden	372	0.16	0.17
France	424	0.14	0.21

^a Based on the Hoeller and Coppel estimate of implicit carbon taxes, representing total fossil fuel and energy tax revenues per tonne of carbon, adjusted for changes between 1988 and 1997 in exchange rates and excise rates on unleaded gasoline, under the assumption of no change in the mix of energy sources.

^b Estimated Total Primary Energy Supply in tonnes of oil equivalent per thousand U.S. dollars of GDP at 1990 prices and exchange rates, converted to Canadian dollars using 1997 exchange rates.

^c Estimated energy-related CO₂ emissions per million U.S. dollars of GDP at 1990 prices and exchange rates, converted to Canadian dollars using 1997 exchange rates.

^d OECD countries as of 1988, other than Greece, Luxembourg, Turkey and Iceland.

Source: Hoeller and Coppel (1992) and International Energy Agency (1994, 1996, 1997).

Table 9.5 expresses existing fuel excise taxes in selected OECD countries in terms of the average tax rate on the carbon content of total fossil fuel consumption. The table indicates that implicit carbon taxes vary widely across the OECD countries, due to the large differences in excise tax rates, fuel mix and the types of fuel that are subject to tax (as shown in Chart 9B and Table 9.1). Canada's implicit carbon tax is the third-lowest of the countries shown, but is nonetheless over two times that of the United States. Table 9.5 also shows the energy and carbon intensity of each country (calculated as primary energy measured in tonnes of oil equivalent per thousand dollars of output and energy-related carbon emissions per million dollars of GDP). Canada's carbon intensity is 30 percent above the OECD average, making it the third most carbon-intensive economy in the OECD (behind Australia and the United States).¹⁹ It is likely that Canada's below average implicit carbon taxes, which reflect Canada's relatively low fuel tax rates and narrow fuel excise base, have contributed to this high intensity, along with relatively low fossil fuel prices, cold climate, geography, and low urban and rural population densities.

Restructuring the Federal Fuel Excise Tax

As the discussion above illustrates, Canada has made relatively little use of environmental taxes to assist in meeting our domestic environmental objectives. Though the federal government has responsibilities for policies on pollutants that cross provincial and national borders, there are virtually no federal taxes with an explicit environmental purpose. The Committee endorses the principle that environmental damages associated with particular activities should be incorporated in the prices that Canadians pay for the related goods and services. There are, however, two important limitations to federal influence that the Committee wishes to underscore.

The first is that some environmental issues are best addressed through international co-operative efforts, particularly when there are significant environmental spillovers between countries. The phenomenon of acid rain between Canada and the United States, and greenhouse gas emissions which are produced by both developed and developing countries, are examples of instances where Canada has been and continues to be a party to international initiatives to address environmental problems. The Committee's second concern also relates to jurisdictional issues: we believe that the federal and provincial governments must work together in developing policies – with our own special interest being tax policies – that aim to promote better environmental practices.

The Committee does not regard the current fuel excise tax levied by the federal government as an appropriately structured environmental tax. This federal tax on motive fuels was initially designed to raise revenue and encourage self-sufficiency in petroleum, and not for the purpose of promoting the efficient use of energy resources taking into account environmental damages generated by energy use. The Committee is of the view that by placing a disproportionate burden of taxes on certain petroleum products, the current fuel excise tax has major shortcomings from both an economic and an environmental perspective. Combustion of petroleum products for transportation purposes is far from the only source of environmental degradation. The Committee believes that it would be appropriate to consider broader based taxes on pollutants from a wide variety of sources, including energy use and industrial emissions.

Energy Component

One environmental tax could include in its base the domestic consumption of all fuels and other major energy sources, including oil, natural gas, coal, biofuels and electricity, with rates set to raise approximately the same revenue as the existing federal fuel excise tax.²⁰ The purpose of the tax would be to set rates to reflect the environmental damage associated with energy sources. The government might consider basing the tax rates on an index of the relative damage of environmental

pollutants – carbon dioxide, sulphur and nitrogen oxides, particulates, and volatile organic compounds – and energy content as a proxy for other environmental damage. The tax should be levied on domestic consumption of fuels and other energy. Thus, imports of fuels and electricity should be taxed as part of domestic consumption, and exports should not be taxed.

The excise tax restructured in this manner would lower the federal rate on motive fuels – gasoline, aviation and diesel – and, in broadening the base, would raise taxes on certain other energy sources. An environmental tax, of the kind suggested, would level the playing field among major energy sources, and would help to ensure that the costs of goods and services produced by using these sources would better reflect actual environmental costs.

The emissions of pollutants could be expected to decrease under such an environmental tax because the tax base, and therefore the costs to business, would better reflect actual environmental costs. Modifications in the behaviour of energy consumers will take time, although the Committee expects that an environmental tax would result in reduced energy consumption and a shift to consuming energy sources that are less pollution-intensive. The sensitivity to prices in the demand for energy fuels is small over the short term, but tends to increase over time as consumers switch to substitute fuels and replace current equipment with more energy-efficient technologies.²¹

Since the federal tax is only one component of the retail price of gasoline, it is not expected that a reduction in the federal excise rate would result in a substantial increase in gasoline consumption – assuming provincial rates remain the same. The broadening of the tax base under our suggested tax would result in higher taxes on other fuels, and therefore lower consumption and emissions from currently untaxed energy. This would more than offset any increases in emissions due to lower taxes on motive fuels, as demand for the currently untaxed products tends to be more price sensitive. In addition, there would be secondary impacts throughout the Canadian economy over time. As noted earlier, the transportation sector and tourism would benefit with the reduction in gasoline, diesel, and aviation fuel taxes, as Canadian rates are brought closer to those in the United States. However, other industries that rely on energy sources that are not currently taxed, including coal, hydroelectricity, natural gas and biofuels, would face higher costs.

The Committee also draws attention to the distributional impact of our proposal. The current excise tax is regressive, in that low-income individuals spend a higher proportion of their income on taxed products relative to those at higher-income levels. Household savings in federal fuel excise taxes under our proposal would likely offset the relatively small increase in taxes on electricity and other fuels. As transportation costs fall, the costs of food and many other products would also decline. However, the price of some products will rise due to the increased costs of business energy use. The net effect of these price changes requires further study. If lower-income households were to be adversely affected by the environmental tax, the Committee suggests that an income tax credit be provided along the lines of the current GST credit.

Another issue raised by the potential restructuring of the federal fuel excise is the possibility that the tax would have greater effects on some regions of the country than others. Parts of the country that use coal as either a direct energy source or as the feedstock for electricity generation will pay proportionately more than those regions dependent on hydropower and natural gas. Impacts on regions with above-average consumption of coal will be offset to some degree by reductions in excise rates on motive fuels.

In summary, it is the Committee's view that a restructuring of the federal fuel excise tax, in a revenue neutral manner, to better reflect environmental damage, would level the playing field with respect to energy resources and would assist the Canadian economy by improving economic efficiency.

Toxics Component

In addition to energy consumption, another major environmental concern is the level of toxic substances currently being released. It is, however, the Committee's view that current knowledge about the environmental consequences of discharging particular substances into our atmosphere, soils and water is not advanced enough to propose appropriate tax rates on the full range of substances discharged. The Committee also considered that the number of substances being released is too large to reasonably impose specific emission taxes on each.

What is required is an index of the toxic intensity of important emissions which, when correlated with the toxic release data from Environment Canada's NPRI database, would permit the incorporation of toxic emissions into our proposed restructured tax. Our proposed restructured tax would move Canada closer to a broad-based pricing of environmental damages.

R E C O M M E N D A T I O N

The Committee recommends that the federal government, in co-ordination and consultation with the provinces, consider replacing the federal fuel excise tax with more broadly based environmental taxes that raise equivalent revenue and that are designed to reduce emissions of pollutants and environmentally damaging activities.

The Committee emphasizes that consultation and co-operation with the provinces is vital to the restructuring of the federal fuel excise tax. If provincial governments step in and take up the reduction in the federal fuel excise tax on oil products by raising their fuel excise taxes, the beneficial impacts on economic efficiency will be lost, and the combined federal and provincial excise taxes on energy will disadvantage low income groups and adversely affect certain sectors of the economy and regions of the country.

While the Committee recommends the introduction of broad-based environmental taxes, we recognize that practical issues dictate the manner in which such a tax could be introduced. Sufficient transition mechanisms should be put in place to permit those affected to adjust their production and consumption plans. In addition, the Committee suggests that the federal government consider a sequential process whereby it first implements emission taxes on commodities for which links to environmental damages are well established, and measurement of emissions is practical. As knowledge increases, taxes encompassing other forms of emission and damage could be examined. Thus, the first step would be to restructure the federal fuel excise tax on a broader base, raising approximately the same revenue. As better information about toxic intensity is obtained, the government should examine the potential of phasing in a tax on the emissions of toxic substances.

Endnotes

- ¹ Non-energy related activities (such as carbon dioxide from cement and lime production and methane from landfills and domestic animals) accounted for a further 12 percent of emissions, while non-combustion uses of fossil fuels (such as chemical feedstocks, lubes and greases) accounted for the remaining 4 percent. Canada, Natural Resources Canada (1997).
- ² See Canada, Environment Canada (1996a), for detailed information on measures of environmental quality in Canada.
- ³ User fees for environmental discharges or restoration are closely related to environmental taxes. A user fee is typically interpreted as a fee for service, as, for example, the provision of sewage treatment. Broadly speaking, environmental taxes are a charge or penalty for the discharge of pollutants into the environment. Taxes and user fees are most effective where the charge is directly related to the damaging activity. A weight- or volume-based waste disposal fee is likely to have a greater behavioural impact than a fee unrelated to use. Examples of user charges in Canada include waste-discharge fees, water-use charges, assurance bonds for site restoration, and the “temporary” fee imposed by some provinces in deposit-refund systems on beverage and paint containers.
- ⁴ There is an extensive policy and theoretical literature on the cost-effectiveness of market-based policies in comparison to regulatory policies. See the discussion in Organization for Economic Co-operation and Development (1989), Canada, Environment Canada (1992), United States, Environmental Protection Agency (1991), United States, Environmental Protection Agency (1992), Ontario, Fair Tax Commission (1992a).
- ⁵ Tradable emissions permits are becoming an important market-based policy for mitigating environmental damage from pollutants in the United States and some other countries. Businesses are allocated individual emissions quotas that they may use or sell to others. As a result, each business has an incentive to reduce its emissions. If they are unable to do so cost-effectively, they can purchase additional permits from others. The United States has used transferable discharge permits to phase out the use of lead in gasoline and the production of chlorofluorocarbons, and has recently introduced transferable discharge permits for sulphur oxides from stationary sources. The potential to apply tradable permits to greenhouse gas emissions has been a topic of international meetings.
- ⁶ The benefit arising from replacing an existing distortionary tax with a non-distortionary environmental tax is often referred to in recent analyses as the “double dividend.” The “first” dividend is unambiguously positive, representing both improved environmental quality and the direct improvements in resource allocation associated with the better pricing of environmental services. The size and sign of the “second” dividend – the non-environment-related benefits of the tax shift – depend on both the nature of the existing tax being reduced and on the existing tax-induced distortions. (See Goulder (1995) and Schöb (1997) for a discussion of these issues.)
- ⁷ See Cairncross (1992), Organization for Economic Co-operation and Development (1989), and Porter (1991) for a discussion of these issues.
- ⁸ Electricity produced by nuclear plants is being taxed at the average rate for non-nuclear electricity. Renewable forms of energy are not taxed. The prices of taxed goods are expected to increase 13 cents per gallon for gasoline and fuel oil, 15 cents per thousand cubic feet for natural gas and 1.2 cents per kwh for coal and nuclear-powered electricity. Special relief is available to businesses if the net increase in taxes due exceeds 1 percent of sales revenues. See Morris (1996) for details about the tax.
- ⁹ A broad-based energy tax proposed in 1991 for the European Union would extend to all forms of energy and be based equally on carbon and energy content. No action has yet been taken on the tax. Designed to increase energy efficiency and reduce emissions of carbon dioxide, tax rates were to start at US\$3 per barrel of oil equivalent and rise by US\$1 per year until the tax hit US\$10 per barrel in 2000. It was also proposed that certain energy-intensive industries would be eligible for tax rebates, on competitiveness grounds, until other OECD countries brought in similar taxes. See Commission of the European Communities (1991). For a discussion of the possible macroeconomic effects of the EU proposal on the U.K. economy, see Barker, Baylis and Madsen (1993). Manne and Richels (1993) look briefly at the possible impact of the tax on European economies, and at how a similar tax could affect the United States. A tax on the energy content of most fuels was considered in the United States in 1993, but not passed by Congress.

- ¹⁰ Under the *Canadian Environmental Protection Act*, “a substance is considered to be toxic if it enters or may enter the environment in quantities, concentrations or under conditions that do (or may) result in harmful effects to the environment or to human health.” Canada, Environment Canada and Health and Welfare Canada (1993). Substances are deemed toxic if they are harmful, posing a threat to human health or ecological processes; or if they are highly resistant to chemical and biological breakdown by natural processes, and thus persist in ecosystems after release; or if they accumulate in the food chain, causing adverse effects at higher levels.
- ¹¹ Canada, Environment Canada (1996b).
- ¹² These range from very toxic substances such as benzyl chloride, cadmium, ethylene oxide, methyl chloride, propylene oxide, and 2-ethylhexyl phthalate to ones of much lower toxicity such as aluminum, ethyl acetate, phosphoric acid, and 2-methoxyethanol. Toxicity is defined in terms of carcinogenicity; neurotoxicity; propensity to cause heritable genetic and chromosomal mutation; development, reproductive, acute and chronic toxicity to animals; and envirototoxicity.
- ¹³ The use of these two sets of ratios allows the results to be cross-checked for consistency. The emissions-to-jobs ratios use production workers as the base to allow for comparisons across industries (defined as ‘activity employment’ in Canada, Statistics Canada (1996a)). The emissions per dollar of output ratio tries to control for production techniques requiring different factor intensities by using the output value of shipments of own manufacture. For a detailed discussion of measurement issues arising from the use of NPRI data in this section, see Olewiler and Dawson (1997), Technical Committee Working Paper 97-16.
- ¹⁴ It should be noted that these calculations are based on industry aggregated releases, and that businesses within an industry may be releasing compounds with differing degrees of toxicity.
- ¹⁵ Data for the United States comes from the Toxic Release Inventory (TRI), an inventory similar to the Canadian NPRI. Toxics data for the United States are only collected from manufacturing industries, not primary sectors. A number of pesticides and ozone-depleting substances listed in the TRI have been excluded from the calculation, as they are not covered by the NPRI. A small number of compounds in the NPRI are not covered by the TRI, accounting for 2 percent of total Canadian releases. Their inclusion does not affect any of the results in Table 9.3.
- ¹⁶ See Boardman (1992) for discussion of these issues. In the regulation of toxic compounds, the United States has a more extensive legal and regulatory apparatus in the form of the *Resource Conservation and Recovery Act* of 1976 and the *Comprehensive Environmental Response, Compensation and Liability Act* of 1980. The former Act sets out the U.S. TRI data-gathering apparatus, applies standards for treatment, storage and disposal of toxic wastes, and establishes discharge permits to enforce the standards set. The second Act is directed at cleaning up past hazardous waste-disposal sites. It has also imposed the *Hazardous Substances Superfund Tax* on chemical and petroleum feedstocks used by industry, and on private parties held responsible for past dumping, to finance the mitigation of hazardous sites. Canada has no comparable legislation or tax.
- ¹⁷ Canadian natural gas prices are, however, well below U.S. prices for both industrial and household use. See International Energy Agency (1997).
- ¹⁸ Economic efficiency gains for Canada from environmental taxes may be dampened somewhat due to transborder pollution, particularly in those parts of the country, notably Ontario and Quebec, where environmental quality is affected by pollution from the United States. The rebalancing of the fuel excise tax may have a smaller impact on Canadian environmental quality in these regions, if U.S. emissions of pollutants are not controlled.
- ¹⁹ Canada contributes just over 2 percent of the world’s carbon dioxide emissions, but is the 9th largest source in absolute terms. The two largest sources are the United States at 24 percent and China at 12 percent. See Organization for Economic Co-operation and Development (1996a). If Canada continues with current policies, carbon dioxide emissions are forecast to rise at an annual rate of 1.5 percent over the period 1995-2005, then rise at an annual rate of 0.9 percent from 2005 to 2020. See DRI/McGraw-Hill (1997).
- ²⁰ Non-energy uses of fuels, such as the use of petrochemical feedstocks, would not be taxed.
- ²¹ See Waverman (1992) for a survey and discussion of energy elasticities and substitution possibilities among fuels.

Compliance and Enforcement

10

Introduction

In an ideal tax system, laws would be easy to understand and comply with. Compliance costs would be kept to a minimum, and administration by the taxation authorities would be efficient and non-intrusive. However, the desire to achieve fairness among taxpayers in differing circumstances, the use of the tax system as an instrument of economic and social policy, and the need to deal with other sources of complexity continue, understandably, to present a most formidable challenge to the elusive goal of “simplification” of our tax regime.¹

Complexity in the tax system arises from a number of factors, some of which are beyond the control of governments. As discussed in Chapter 1, the development of new technologies, including electronic commerce, new forms of corporate organization, and the growth of international business, put pressure on governments to amend tax systems in response to these changes in the business environment. Change in the tax system is itself a source of complexity. Moreover, in pursuit of other economic and social objectives, policies are introduced that result in greater compliance costs. However, some compliance costs can be reduced by keeping tax bases as broad and rates as low as possible, and by ensuring that the administration of the tax system is efficient, and easily understood by taxpayers. Further, to improve compliance, it is in the interests of both federal and provincial governments to harmonize both their policies and the administration of their tax systems as much as possible.

The process of administration and collection of tax entails substantial costs. Taxpayers comply with the tax system by keeping records (over and above those required for accounting systems); filing returns; undertaking research and tax planning; and engaging in audits, appeals and litigation. In a study done for the Committee, the costs to comply with corporate income and capital taxes for the 500 largest corporations are estimated to total \$250 million in 1995 or 5 percent of taxes paid by these businesses (see further discussion in Chapter 3).² Small business compliance costs are also substantial and tend to be greater as a proportion of their revenue.³ Compliance costs draw resources from the economy that could otherwise be used for producing goods and services that are of benefit to Canadians. Efforts to reduce compliance costs can improve prospects for economic growth and job creation and can promote fairness in the tax system.

Could Canada’s Business Tax System be Simpler and Less Costly?

Many believe that matters could be made more efficient and less costly within Canada’s tax system (encompassing all forms of government levies). The Committee shares this view, and certainly favours, on the part of those who are responsible for the design of our tax system, a constant search for means to reduce the burdens, economic and otherwise, associated with the implementation and administration of, and compliance with, various tax measures.

Many of the recommendations proposed elsewhere in this Report would contribute to a simpler, less costly and less burdensome system. These include the general reduction of the corporate tax rate coupled with the elimination of certain tax preferences, including the manufacturing and processing profits deduction; capital tax harmonization; and the elimination of Parts IV.1 and VI.1 tax on certain preferred share dividends. In other areas, we have had to make proposals that would add some complexity in order to satisfy other critical objectives.

The Committee had the opportunity to consider aspects of the tax regimes of some of our major trading partners. As mentioned, we had the benefit of studies on compliance issues and their impact on Canadian businesses. We heard informally from representatives from a number of economic sectors, and we benefited from hearings held by the House of Commons Finance Committee with regard to economic and compliance costs of the business tax system. We also discussed existing practices and possible alternatives with Department of Finance and Revenue Canada officials. We are pleased to observe that some of these discussions may have contributed to the development of measures addressing simplification issues and improving compliance.⁴ However, more can be done. Simplification should be viewed as a continual process.

In our opinion, problems associated with coping with a multitude of legislative regimes and complying with such legislation are real and significant, and require concerted efforts by government at all levels. In the course of our discussions and deliberations, it has been impressed upon us that harmonization issues (be it at the federal level only, in relation to provincial tax legislation, or a combination of both) together with the impact of frequent and often extensive changes to tax legislation are significant factors affecting the compliance burden. These are areas in which we believe more can be accomplished.

The Committee is of the view that existing rules can be improved to allow for a more commercial approach on the part of the taxation authorities in dealing with collection matters and settlement of tax disputes. The Committee is also advocating both stronger efforts to reduce the incidence of tax evasion and more effective penalties to deter the promotion of, and participation in, inappropriate tax-avoidance schemes.

Sources of Complexity

By its very nature, a mature tax system in an advanced and dynamic economic environment, such as Canada's, faces multiple sources of complexity. Effective proposals to mitigate the impact of these complexities rest on an understanding of how they are generated. The Committee has identified six distinct sources of complexity for Canadian business taxpayers that it considers to be among the most significant.

Multiplicity of Tax Legislation – Domestic

Canada's three-tiered governmental structure – with each level possessing a general or specific legal authority to impose taxes or similar levies on business – presents a significant obstacle to simplification. In some situations, our governments have avoided duplication by allocating certain tax fields to particular levels of government (for example, property taxes paid to municipalities and provinces, resource taxes to provinces). However, in a significant number of other cases (such as corporate income, capital, payroll and consumption taxes), federal and provincial governments have overlapping regimes.

Corporate income tax is levied by the federal and all provincial governments. Seven provinces, as participants in tax collection agreements, have harmonized their corporate income tax base with, and delegated administration to, the federal government. The governments of Quebec, Ontario and Alberta levy and administer their own tax, although their corporate income tax bases closely parallel that of the federal government. For corporations carrying on business in these jurisdictions, separate

tax returns must be filed and tax accounts maintained. Duplication also exists with regard to elections and appeals processes. In addition, tax auditors from each jurisdiction can make demands on businesses, occasionally seeking the same information.

An additional burden for businesses arises when tax bases vary between the jurisdictions that lack harmonized tax regimes. The problem is especially acute with regard to capital taxes, where tax liabilities may need to be computed on different bases. Of particular concern to the Committee is the tendency for such inconsistencies to create tax-planning opportunities and lead to decision making that is driven by tax results rather than by economic considerations.

The multiplicity of taxes faced by any business – the combination of income, capital, payroll, sales and excise taxes, as well as customs duties and various licensing or other user fees – is itself a source of complexity, especially when one considers how the number of taxes varies from one jurisdiction to another. All these levies also carry with them their own administrative requirements.

Multiplicity of Tax Legislation – International

Issues arising from multiple jurisdictions also prevail at the international level. As increasing numbers of businesses operate internationally, larger numbers of tax authorities become involved. Divergent rules in different jurisdictions create difficulties for multinational businesses including obstacles to the reorganization of multinational corporations, cross-border financing issues, and transfer pricing problems. But, in a world of sovereign states, they are not easily avoidable.

Efforts continue to be made at the international level to facilitate compliance related to multiple jurisdictions. Canada is party to about 60 bilateral tax treaties that are designed to avoid double taxation and prevent tax evasion. Canada is also a participant in and contributor to several organizations working to co-ordinate international taxation matters, including the OECD and the Pacific Association of Tax Administrators.

Increased Complexity of Business Transactions

Business transactions are becoming increasingly complex and changes are occurring at an ever faster pace. The new realities of the labour market have increased the proportion of the self-employed in the labour force, including individuals contracting independently with other businesses. Further, increasing competition and technical advances have given rise to changes in the way that business is conducted. For example, the use of emerging new technologies in a competitive environment has spurred the development of borderless electronic commerce, making the determination of where a transaction takes place more difficult. In addition, the growth of international commerce requires more businesses, including many smaller ones, to cope with complex provisions of the *Income Tax Act* such as those relating to foreign affiliates, transfer pricing and foreign reporting.

The rapid growth in innovative investment instruments and financing techniques, as well as the use of more sophisticated forms of business organization, present additional challenges for tax policy and administration. The use of derivatives for investment and business purposes, and structures such as royalty and income trusts for holding resource and other properties, are examples of new transactions that necessitate analysis, and often result in legislative or administrative reaction by government.

These factors increase pressure on tax policy makers and administrators to respond to changes in today's business environment. The unfortunate but understandable result is tax law that reflects the business realities of increasing complexity and constant change.

Changes to Tax Legislation

As noted above, various factors lead to the introduction of new legislative measures. However, frequent changes to tax laws increase uncertainty and complexity, and place a heavy onus on taxpayers, and their advisors, to “remain current” with new legislation. New tax measures and amendments to existing tax laws are announced in a variety of ways: budgets, technical bills, Notices of Ways and Means motions or press releases. It is not uncommon for proposed tax measures to become law a year or more after they were first announced. The required transitional provisions are themselves a significant source of complexity.

Pursuit of Multiple Objectives

A common complaint among taxpayers is that the tax system is inordinately complex and that our tax law is written in a form that only experts can understand. This is not a recent phenomenon.⁵

Efforts to pursue objectives such as fairness – including the desire to recognize the differing circumstances of taxpayers – and the need to deliver in an efficient manner programs deemed to be socially or economically desirable, have led to increased detail and specificity in legislative drafting and therefore, greater length and complexity in legislation. Tax law has become increasingly sophisticated and complex in an attempt to appropriately include, or exclude, circumstances from coming within its purview. Precise and detailed laws may be required in certain situations, as general provisions may provide opportunity for abuse and also may contribute to taxpayer uncertainty. Thus, it is perceived that, in many situations, attempting to achieve these laudable objectives can cause drafters of tax law to forsake the goal of greater simplicity.

As an important example, tax law becomes complex when tax policy provides for different rates of tax or other different treatment for particular activities. Differential tax rates stimulate taxpayers to avail themselves of the most preferential alternative. When such endeavours are undertaken contrary to the underlying policy objective, amended and more complex legislation usually results – and taxpayers face greater compliance costs. Thus, the underlying cause of much complexity in tax legislation can be reduced by moving toward a more neutral tax system, a system that reduces the incentive for sophisticated tax planning.

Administering Tax Law

There are a number of ways in which the administration of the tax system might be improved to reduce compliance costs. The following three areas are examples considered by the Committee:

- Disputes routinely arise between taxpayers and administrators. Most disputes are resolved at the audit stage or, after a taxpayer has filed a notice of objection to a tax assessment, at the administrative appeals level. Some disputes, nonetheless, must be resolved by the courts, a process that may involve extended periods of time. Unfortunately, the present system does not fully facilitate the ready settlement of disputes to the benefit of both parties.
- There are insufficient mechanisms in the tax system to allow Revenue Canada to adopt a more commercial approach to the settlement of taxes owing. In some circumstances, allowing Revenue Canada to accept less than the full amount of taxes owing would improve compliance by taxpayers and would increase collections by the government.
- Taxpayers are burdened with substantial and complex compliance demands, while tax administrators must handle increasingly large volumes of information generated by taxpayers following the rules. It is not clear to the Committee that, during the process of designing tax policies and drafting legislation, enough attention is given to the impact that new rules will have on the overall compliance burden. The new reporting requirements for foreign affiliates are noted as an example of this. In assessing demands placed on businesses to provide information, a better balance should be struck between the benefits to be obtained from that information, and the costs incurred by taxpayers and administrators in providing and processing that information.

Steps Toward Improved Tax Compliance

Coping with the Multiplicity of Taxes

Harmonization of tax regimes represents one of the primary opportunities to achieve simplification and facilitate compliance. The reconciliation of differences between similar provisions requires the collaboration of federal and provincial authorities, a definition of common objectives and constant attention. As previously stated, taxpayers do complain, in many respects with valid reason, that their businesses are adversely affected by the multiplicity of efforts (with attendant costs) that must be expended to cope with the myriad of laws and regulations that may apply to their activities.

Capital taxes provide a good example of unnecessary duplication in compliance. Large corporations are subject to various federal and provincial capital taxes as discussed in Chapter 4. The capital tax bases are not consistent from jurisdiction to jurisdiction, and also differ between financial and non-financial firms. As previously noted, some of these differences can influence where the business is carried out or the manner in which transactions are implemented.

In addition, disputes arise with respect to the allocation of taxable income among the provinces. The resolution mechanisms available to a business in the case of a dispute between Canada and its tax treaty partners, although cumbersome, are often more complete and adequate than measures in place for similar issues between the provinces.

RECOMMENDATIONS

The Committee recommends that a task force made up of federal and provincial officials, with the assistance of tax specialists and members of the business community, lead the development of harmonized federal and provincial legislative and tax compliance measures to provide Canadian businesses with a reduced compliance burden.

These measures could include harmonizing, where feasible: the calculation of capital tax liabilities; the returns and elections required to be filed pursuant to legislation; legislative and administrative functions, such as audit, collections and appeals; and the creation of a mechanism for resolving differences related to provincial allocation of income. It would also be desirable to have a permanent mechanism or committee to which federal-provincial tax administration matters would be referred for consultation and action.

At the federal level, there are a number of tax statutes that constitute the legislation governing federal taxation. However, each of these statutes carries separate and often dissimilar administrative provisions for its respective application. For example, provisions for timing and frequency of collection vary depending on the Act involved; interest rates on monies owing or receivable are not the same, and neither are rights of appeal. Penalties for non-compliance also differ.⁶ Not only do these variations add complexity to the compliance process, the dissimilarities could also be perceived as unfair.

The Committee recommends harmonization of the administrative provisions in legislation that is currently administered by Revenue Canada (such as the *Customs Act*, *Excise Act*, *Excise Tax Act*, and *Income Tax Act*).

This effort at harmonization would include provisions dealing with interest, penalties, objections and appeals rights; delegation of Minister's powers; audits; requirements for documents or information; search and seizure; inquiries; and collection measures. The Committee suggests that a consolidation of all administrative provisions into a single piece of legislation, as in the province of Quebec, should be assessed and considered as an alternative.

Understanding Tax Law

Taxpayers and their advisors require timely and effective notification of major proposed tax changes. The general expectation of most businesspeople and tax practitioners is that tax policy measures are disclosed in a budget (or some other well-publicized method), and minor "housekeeping" amendments are addressed in technical bills.

The fact that in recent years the federal budget has been tabled in February or March, adds some certainty to the unavoidable process of change. However, the actual text of proposed tax legislation has not been available until many months after its announcement. This situation leads to difficulties in applying and complying with new tax measures. There may be uncertainty as to what details the legislation will contain; as to whether or not proposed measures will be modified prior to their eventual enactment; and sometimes, as to whether or not measures will in fact be enacted. Additional certainty of and promptness in the release of the text of legislation are desirable aims.

The Committee also notes that the practice of including significant tax measures in technical bills continues. While we recognize that the government must not be constrained from introducing policy measures when it is required or desirable to do so, we urge the federal government to provide adequate notification of significant tax changes.

Although transitional provisions (including grandfathering) do create complexities, in the Committee's view they are, in appropriate circumstances, required to ensure that transactions or arrangements undertaken or in existence prior to the tax changes remain subject to previously existing legislation. The Committee also agrees that retroactive legislation that has the effect of altering rights, as of a time prior to the announcement, should be considered only in the rarest of cases. Generally, this has been the case in Canada.

The Committee notes that other countries are examining aspects of their tax systems with a view to addressing legislative drafting style and tax law complexity. As part of the U.K. exercise to review the tax law, significant efforts are being made to move from detailed tax legislation to a more general legislative style (supplemented with more regulations and interpretation guides). Australia has moved to a "map-like" drafting style that involves setting out a statement of purpose followed by a flowchart, or map, of additional provisions. While these and other efforts warrant continued monitoring, the Committee does not propose a wholesale redrafting of the Canadian tax legislation. Such an exercise itself would result, for an extended period, in substantial uncertainties for taxpayers, and would likely lead to unintended changes in the application of the law.⁷ Nonetheless, in our view, improvements in drafting and explaining the law can be achieved, and recommendations to that effect are suggested.

With regard to the language and style of the legislation itself, efforts have been made by the Department of Finance to address problems of comprehension in legislative rule drafting. Further efforts should be made in areas such as use of formulae, better cross references in the legislation, and some increased use of plain language, where possible.

R E C O M M E N D A T I O N

The Committee recommends that new tax legislation be drafted using language and structure (for example, shorter sentences and divisions of text) that facilitate ease of understanding, and that selected portions of existing legislation should be redrafted.

The provisions that should be given priority are those in which current drafting and concepts are unnecessarily complex, and are difficult to comprehend, comply with and administer. For example, many tax professionals have expressed concern with the drafting of the debt forgiveness rules in the *Income Tax Act*. The new rules cover approximately 30 pages encompassing over 50 subsections, whereas the former rules were approximately two pages in length and contained four subsections. Although it is recognized that the old rules may have been deficient in certain regards, many believe that the new rules contain so much detail that they have increased uncertainty as to what they mean and how they will be administered.

The use of a detailed drafting style can also lead to situations in which the underlying purpose of tax legislation is not clear. Technical notes are provided to explain new legislation and to provide examples of its application. The notes do not always fulfil this function. In some instances, they provide a context for the provision that is being amended or introduced, but the explanation of the amendment is little more than the paraphrasing of the amendment itself without adequate explanation of why the amendments are required, what problems they are intended to address, and how the amended provisions are intended to operate. In many cases, explanatory notes could be more descriptive and relevant (see inset entitled “Examples of Technical Explanatory Notes”). In particular, the notes should explain the intended purpose of the legislation. Such information would facilitate understanding of the legislation and its intent.

Examples of Technical Explanatory Notes

The technical explanation provided on the initial introduction of subsection 40(3.5) states:

“New subsection 40(3.5) sets out three special rules that apply for the purposes of the loss deferral rule in new subsection 40(3.4). First, paragraph 40(3.5)(a) provides that a right to acquire a property (other than a right that is security for a debt or similar obligation) is treated for the purposes of subsection 40(3.5) as a property that is identical to the property. Second, paragraph 40(3.5)(b) treats a share that is acquired in exchange for another share under any of sections 51, 85.1, 86 or 87 as identical to that other share. Finally, paragraph 40(3.4)(c) clarifies the result where the property that gives rise to a deferred loss under new subsection 40(3.4) is a share of a corporation that is subsequently wound up into its parent under subsection 88(1). In such a case, the parent corporation is treated as continuing to own the share as long as the parent is affiliated with the transferor.

New subsection 40(3.5) comes into effect on the same basis as new subsections 40(3.3) and (3.4).”

This note attempts to explain the new legislation by basically paraphrasing it. Such notes add little value to a reader’s comprehension of the provision, whereas the following explanation of the proposed amendment to section 219.1, contained in former Bill C-69, provides a description of both what the amendment is and why it is being made, and is therefore more useful:

“Section 219.1 of the Act currently imposes a tax under Part XIV of the Act (commonly known as the ‘departure tax’) where a corporation ceases to be a Canadian corporation. For the 1996 and subsequent taxation years, this amendment to section 219.1 applies the tax not to corporations that cease to be Canadian corporations, but rather to corporations that cease to be resident in Canada. This ensures a better matching of the departure tax and ‘branch tax’ imposed under subsection 219(1) of the Act, and together with the amendments to that provision, simplifies Part XIV and better conforms it to the general scheme of the Act.”

Tax Administration – Resolving Disputes with Tax Authorities

The present system allows for substantial flexibility in resolving disputes (arising either at the level of determining the validity of an assessment – or at the administrative appeals level), but less flexibility for settling accounts due and payable. The Committee believes that some improvements can be achieved in these areas for the benefit of both taxpayers and tax authorities.

Risks of Litigation

Before a tax liability is finally determined, any dispute between taxpayers and the tax authorities can be the subject of discussion at the audit stage, at the administrative appeals level and even while the matter is before the courts. It is undoubtedly in both parties' interests to settle disputes. Under the present income tax rules, the Minister of National Revenue

... has a statutory duty to assess the amount of tax payable on the facts as he finds them in accordance with the law as he understands it. It follows that he cannot assess for some amount designed to implement a compromise settlement ...⁸

Nonetheless, in practice, in most cases these restrictions do not preclude the ability to reach agreement on a tax assessment,⁹ and, in fact, the vast majority of tax disputes are resolved without the need for an actual trial.

- Of the income tax objections filed (50,000 to 55,000 annually) with Revenue Canada, Appeals Branch, historically 90 percent to 95 percent are resolved at this level.
- Of the total income tax appeals filed in the Tax Court of Canada, 65 percent to 70 percent are under the Court's informal procedure (approximately 2,000 to 3,000 annually), and only approximately 50 percent of those go on to hearing, the balance either being settled or withdrawn.
- Of the income tax appeals under the general procedure of the Tax Court of Canada (approximately 1,200 to 1,300 annually), only approximately 30 percent go to trial, the balance being either settled or withdrawn.¹⁰

The present system, however, does not adequately recognize the inherent uncertainties of statutory interpretation. Given the costs, delays and uncertainties involved in resolving issues at trial, it can be of benefit to all parties to achieve compromise settlements in such situations.

R E C O M M E N D A T I O N

The Committee recommends that settlement of disputes regarding taxpayers' liability for tax be further encouraged by introducing a legislative mechanism that would authorize Revenue Canada, in appropriate circumstances, to enter into compromise arrangements on the basis of "risks of litigation." The terms of any such compromise should be approved by senior officials.

Collectibility of Taxes Owning

Collecting monies owed to the tax authorities is costly and time consuming. Approximately 10 percent of Revenue Canada's resources are dedicated to collections and instalment activities, and as at March 31, 1997, the uncollected amount of income taxes was approximately \$6.9 billion (excluding accounts receivable for amounts in dispute¹¹ of \$3.3 billion). Table 10.1 provides, for the last five years, the amounts of income tax accounts receivable, uncollectible write-offs and amounts in dispute.

Table 10.1
Income Taxes Receivable, Written Off, and In Dispute

Income Tax Accounts Receivable^a

Fiscal Year Ending	1992-93	1993-94	1994-95	1995-96	1996-97
	(millions of \$)				
Individuals	3,279	3,582	3,853	4,339	4,477
Corporations	1,642	1,545	1,545	1,393	1,402
Other ^b	1,737	1,483	965	1,098	1,073
Total	6,658	6,610	6,363	6,830	6,952

Income Tax Uncollectible Write-offs^c

Fiscal Year Ending	1992-93	1993-94	1994-95	1995-96	1996-97
	(millions of \$)				
Individuals	262	339	381	472	732
Corporations	159	121	229	298	161
Other ^b	165	190	706	124	186
Total	586	650	1,316	894	1,079

Income Tax Amounts in Dispute^d

Fiscal Year Ending	1992-93	1993-94	1994-95	1995-96	1996-97
	(millions of \$)				
Individuals	1,033	1,118	1,297	1,428	1,478
Corporations	1,612	1,540	1,258	1,666	1,854
Total	2,645	2,658	2,555	3,094	3,332

^a Federal and provincial amounts, excluding taxes under dispute.

^b Includes petroleum and gas revenue tax, resource royalties tax, non-resident tax, payroll deductions and scientific research tax credits (SRTC). Other accounts receivable have decreased primarily due to the write-off of SRTC receivables.

^c Federal and provincial revenues, net of refunds, drawbacks and credits.

^d Corporate and individual income taxes owing but against which no collection action may be taken pursuant to subsection 225.1(6) of the *Income Tax Act*.

Source: Canada, Treasury Board, *Revenue Canada Performance Report for the Period Ending March 31, 1997*, 1997. Also earlier *Revenue Canada Estimates Part III* and additional data from Revenue Canada.

Revenue Canada and taxpayers have various relief mechanisms at their disposal for debt collection when a taxpayer is in financial difficulty:

- A taxpayer may apply in appropriate circumstances for relief under the fairness provisions of the *Income Tax Act*, *Customs Act* or the *Excise Tax Act*, in which case part of, or the entire, penalty and interest portions of an assessment could be waived.
- A taxpayer may negotiate a payment arrangement with collections officials based on the particular circumstances.
- A taxpayer may table a proposal under the *Bankruptcy and Insolvency Act* (often resulting in tax authorities collecting less than the amount of taxes due).
- A person may also be released from an otherwise enforceable tax debt by the remission of the debt under the *Financial Administration Act*.¹²

These provisions facilitate debt collections from some financially troubled debtors. However, the tax legislation currently restricts Revenue Canada's ability to settle, in a business-like manner, collection of tax debts that have been finally determined. Accordingly, there are circumstances in which the inability to negotiate a timely settlement with a taxpayer in financial difficulty ultimately results in a lost opportunity to collect at least some amount.

In contrast, the *Internal Revenue Code* in the United States has put in place "compromise" provisions applicable to collection matters. The rationale for these measures is stated as follows:

The IRS [Internal Revenue Service], as any other business, will encounter situations where an account receivable cannot be collected in full or there is a dispute as to what is owed. It is an accepted business practice to resolve these collection and liability issues through a compromise. Additionally, the compromise process is available to provide delinquent taxpayers with a fresh start toward future compliance with the tax laws.¹³

R E C O M M E N D A T I O N

The Committee recommends that, in order to improve taxpayer compliance and the collection of taxes, Revenue Canada be further empowered to apply principles of commercial practice to settle outstanding amounts based on its anticipated ability to collect unpaid amounts, having regard to the assets potentially available for collection and risks of reduced collections. The terms of any such settlement should be approved by senior officials and, in order to demonstrate the integrity of the process, should be made publicly available.

Tax Administration – Advance Tax Rulings

An important aspect of Canada's income tax regime is the provision of income tax rulings. These rulings allow taxpayers to know how tax authorities will interpret and apply specific provisions of tax legislation to proposed transactions, before such transactions are undertaken. This system promotes voluntary compliance and self-assessment by providing certainty and, by all accounts, plays an important role for taxpayers, tax administrators and policy makers. The service is efficient and professional, and compares favourably to a similar process in the United States. Nevertheless, as time pressures continue to escalate in today's global business environment, it is suggested that additional resources be allocated to this function to allow it to enhance its priority service, where taxpayers and their representatives require income tax rulings to be issued within tight deadlines. We also believe that taxpayers would generally be willing to pay a significantly higher fee,¹⁴ if necessary, in order to fund additional resources for priority rulings service.

Tax Evasion

No long dissertation is required to justify strong action against those who commit tax evasion or assist in the process. Tax evasion is a direct attack on the integrity of the tax system and, when left unchecked, threatens to undermine the values upon which our self-assessment system is based.

Unfortunately, tax evasion is a persistent phenomenon. The globalization of business activities, the development of new electronic technologies, the burden of taxation, the growth of self-employment, and the belief on the part of many that tax evasion is somehow acceptable and not a real crime, are just some of the factors that lead many to participate in the underground economy.

The fact that it occurs often in conjunction with other illegal activities (such as drug trafficking and money-laundering operations) is itself an indication that governments need to be equipped with sufficient powers and techniques to counter tax evasion effectively.

The size of the problem is not known with any precision.¹⁵ However, it is likely that unreported income amounts to billions of dollars annually. Currently, Canada's approach to enforcement related to the hidden economy can be summarized as follows:

- Favour and encourage voluntary compliance.
- Strengthen the systems of identifying non-filers and non-registrants.
- Establish local audit teams focussed on high non-compliance sectors of the economy.
- Work closely in conjunction with provincial authorities and, within the limits permitted, with Canada's treaty partners.
- Work with key industrial groups and associations.
- Publicize tax evasion convictions.
- Explore ways to improve reporting.

It is certain that enforcement measures targeted at the underground economy would benefit from additional reporting requirements. For example, the federal government has recently introduced foreign reporting requirements. The Committee views favourably the principle of foreign reporting requirements related to the disclosure of interests in foreign property and of transactions with foreign trusts. However, the foreign reporting requirements for foreign affiliates could be an onerous burden for taxpayers, and do not appear focussed in all cases on areas in which there is a demonstrated high risk of unreported income.

The Committee considered at some length whether to formally recommend more stringent reporting systems, as is done in the United Kingdom, for example, for payments to independent contractors. We have stopped short of recommending additional reporting requirements for transactions carried out in Canada, until the results of the current initiatives of the Canadian tax authorities in these areas can be assessed. Reporting requirements are disruptive and costly and add additional complexity of their own. However, it is the Committee's view that, if the incidence of tax evasion in these areas remains high, such measures should be considered.

The Committee does advocate a more rigorous approach to tax evasion generally. More resources should be allocated to enforcement functions. In appropriate cases, strong representations should be made by prosecutors for prison terms for those convicted of tax evasion.

The Committee is particularly concerned with international aspects of tax evasion and the related phenomenon of money laundering. After meeting with U.S. officials, it became obvious that the U.S. authorities are better equipped to curtail money-laundering activities (and often, as a consequence, tax evasion), as a result of legislation requiring reporting of certain cash transactions by financial institutions and the lifting, in defined circumstances, of other confidentiality provisions found in the *Bank Secrecy Act* and the *Internal Revenue Code*. The Committee believes that to allow for a more effective detection of tax evasion, it may be necessary for the government to consider introducing new measures such as amendments to the *Proceeds of Crime (money laundering) Act*¹⁶ which would have the effect of imposing on Canadian financial institutions and their subsidiaries an obligation to keep adequate records accessible to Canadian tax authorities with respect to transactions involving the transfer of funds abroad.

We strongly favour Canada's participation in international forums and exchange programs with treaty partners. The need to develop common strategies to counter international evasion, the need to know with greater precision the potential dangers for tax administrators, and the need for continued monitoring of technological advances in and ramifications of electronic commerce all speak to the need for a continued concerted effort together with our major trading partners.

Penalties

Earlier in this Chapter, the Committee discussed the need to harmonize penalty provisions found in the various tax statutes and, in Chapter 6, also commented on penalties regarding transfer pricing. In our view, another aspect of penalties also merits attention: the levying of penalties on those who knowingly, or under circumstances amounting to gross negligence, promote activities or provide tax-related advice that results in the making of a false statement or omission in a return.

Some penalties are imposed under the *Income Tax Act* in respect of acts that may be criminal in nature, and others are imposed in respect of conduct that, while short of criminal activity, warrants sanction by payment of a civil penalty.

At present, short of criminal behaviour¹⁷ or in limited circumstances,¹⁸ a promoter or advisor who either knowingly or in a grossly negligent manner, enters into or advises others to engage in transactions or take positions in filing income tax returns that the promoter or advisor knows or ought to know are not in accordance with the *Income Tax Act*, is not subject to penalties.

Whereas criminal liability under subsection 239(1) may extend to any number of persons who participate in the offence, civil penalties¹⁹ have only been applied against the taxpayer whose liabilities or entitlements under the *Income Tax Act* are affected by the improper conduct. In the latter situation, third parties do not risk being sanctioned for their roles in assisting or promoting behaviour that is found to fall outside acceptable bounds.

In the past number of years there have been situations, particularly involving purported tax shelters, where large numbers of investors relied on the representations of promoters and opinions of tax advisors, and entered into transactions with the expectation of certain tax results. The expected tax results were challenged by tax authorities and, in many cases, subsequently denied to investors.

It is the Committee's view that the imposition of broader civil penalties is justified to defend the integrity of the tax system. Such penalties would aim to deter transactions, arrangements and methods of reporting that do not genuinely yield the result claimed by a taxpayer, and would hold advisors and promoters accountable for obviously faulty advice.

R E C O M M E N D A T I O N

The Committee recommends the addition of new civil penalty provisions that would have the effect of expanding the scope of the provisions currently contained in subsection 163(2) of the *Income Tax Act* to provide for the imposition of penalties upon third parties who knowingly, or under circumstances amounting to gross negligence, participate in or otherwise promote or assist, conduct that results in the making of a false statement or omission in a return (as described in subsection 163(2)).

Endnotes

- ¹ Numerous papers, including Brown (1976) and (1996), and Couzin (1984), have discussed the difficulties associated with tax simplification.
- ² Erard (1997a), Technical Committee Working Paper 97-2.
- ³ Plamondon & Associates Inc. (1996), Technical Committee Working Paper 96-9 and Erard (1997c), Technical Committee Working Paper 97-12.
- ⁴ For example, in March 1997, *Compliance: From Vision to Strategy*, a report discussing the issue of compliance was released by Revenue Canada (Canada, Revenue Canada (1997a)), and in April 1997, improvements to the tax appeals process were announced by the Department as part of the Appeals Renewal Initiative.
- ⁵ As is evidenced by the comment made more than 20 years ago by Mr. Justice Collier in a 1975 tax case: “To understand the intricacies of the problem it is necessary to set out the applicable provisions of the statute. To attempt a solution to the problem, I am faced with the scary task of trying, for my first time, to penetrate a portion of the jungle of unpruned verbiage found in the new Act.”
The Great Atlantic and Pacific Tea Co. Ltd. v. The Queen (1975), 75 D.T.C. 5283 at 5285 (F.C.T.D.).
- ⁶ For example, under section 285 of the *Excise Tax Act*, penalties for gross negligence are the greater of \$250 and 25 percent of the tax sought to be evaded, while the same offence carries a penalty of the greater of \$100 and 50 percent under section 163 of the *Income Tax Act*.
- ⁷ Similarly, a proposal simply to renumber sections of the *Income Tax Act* was strongly objected to by the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants “on the basis that the benefit of doing so is greatly outweighed by the significant disruption and confusion it would add to an already extraordinarily complex statute.”
- ⁸ *Frank H. Galway v. Minister of National Revenue* (1974), 74 D.T.C. 6355 at 6357 (F.C.A.).
- ⁹ For example, issues of valuation, which are basically questions of opinion, are often settled by agreement. Also, in situations where disputes arise on many separate issues, a compromise can be generally be reached.
- ¹⁰ Statistics provided by the Appeals Branch, Revenue Canada.
- ¹¹ The expression “amounts in dispute” refers to corporate and individual income taxes owing, for which Revenue Canada is, by law, restricted from initiating collection proceedings because matters under objection or appeal are involved.
- ¹² Remission of a debt under the *Financial Administration Act* is possible whenever it is considered unreasonable or unjust to collect taxes or when it is in the public interest to grant remission. Revenue Canada will generally only consider remission requests involving situations of extreme hardship, incorrect departmental action or advice, financial setback coupled with extenuating factors or unintended results of the legislation.
- ¹³ Procedures regarding section 7122 of the United States *Internal Revenue Code*.
- ¹⁴ Currently, the hourly cost recovery fee allowed to be charged for advance tax rulings is \$90 per hour.
- ¹⁵ On the matter of trying to gauge the size of the underground economy, a study for the Committee concluded: “Indirect methods of estimating the size of the unrecorded sector are found to generate widely varying, and in a number of cases implausible estimates of underground activity.” See Erard (1997b), Technical Committee Working Paper 97-6.
- ¹⁶ *Proceeds of Crime (money laundering) Act*, S.C. 1991, C.26, as amended. At present, this legislation only applies to situations involving laundering proceeds of crime in the case of a designated drug offence or the commission of an enterprise crime offence.

- ¹⁷ Under subsection 239(1) of the *Income Tax Act*, among other offences, every person who made, or participated in, assented to or acquiesced in the making of, false or deceptive statements in a return, certificate, statement or answer filed or made as required by or under the Act or regulation, who willfully, in any manner, evaded or attempted to evade compliance with the Act or payment of taxes, or who conspired with any person to commit an offence under subsection 239(1), is guilty of an offence. In addition to other penalties under the Act, a fine of not less than 50 percent and not more than 200 percent of the tax sought to be evaded or a fine and imprisonment for a term not exceeding two years, may be imposed on those found guilty of such an offence.
- ¹⁸ Under section 237.1, specific penalties may be imposed on promoters who provide false or misleading information with respect to tax shelters.
- ¹⁹ The main civil penalties in this context are contained in section 163. Subsection 163(2) provides for the imposition of penalties on a person who, knowingly, or under circumstances amounting to gross negligence, has made or has participated in, assented to or acquiesced in the making of, a false statement or omission in a return, form, certificate, statement or answer filed or made for the purposes of the *Income Tax Act*.

Federal-Provincial Business Tax Issues

11

Introduction

Provincial governments and municipal governments (over which provinces have constitutional jurisdiction) exercise a central role in the taxation of business in Canada. As we pointed out in Chapter 2, provinces and municipalities raised almost \$52 billion in taxes on business or 61 percent of the total of such taxes in 1995. Provinces raise about one third of corporate income taxes, over two thirds of capital taxes, and about one half of employer premiums or payroll taxes (excluding the CPP/QPP). Property taxes on business are collected exclusively by provincial and municipal governments, and provinces – as owners of natural resources – receive almost all royalties and stumpage fees paid by mining, oil and gas, and forestry industries operating within their boundaries¹. Moreover, the total of all provincial and municipal taxes on business has been increasing faster in recent years than federal business taxes.

Given the significant roles of federal and provincial governments in the business tax field, each has a responsibility to ensure that the business tax structure can facilitate economic growth and job creation, fairness and compliance while providing adequate resources for the public sector in their jurisdiction. The federal government is responsible for collecting its own taxes in a manner that treats all regions fairly, and does not compromise the free flow of capital and labour across provincial boundaries in the Canadian economic union. It also administers corporate taxes on behalf of provinces that have entered into tax collection agreements. The provinces, in turn, have responsibilities to ensure that their business tax structure achieves their economic objectives without impairing economic growth and job creation in other provinces and ultimately, in Canada as a whole. Given the close economic linkages of our Canadian regions and the mobility of capital in today's world, it is imperative for all governments to recognize their responsibilities in providing an efficient and fair business tax structure.

As discussed in Chapter 1, the Committee recommends substantial changes to the business tax structure. These recommendations will have a significant impact on the provinces. The Committee is convinced that making the business tax structure more neutral and offering businesses in Canada internationally competitive tax rates is the best way to achieve greater economic growth and to promote job creation. We hope that provincial governments share that conviction, and that they will act on it.

The Committee believes that changes to the business structure that facilitate efficiency and fairness require provincial governments to work in tandem with the federal government. If the provinces were to reduce corporate income tax rates, broaden the business tax base and reduce other taxes in conjunction with the federal tax changes proposed in this Report, the total amount of tax paid to all governments by business would remain roughly the same. In the absence of such a level of intergovernmental collaboration, the opportunity to meet the Committee's objectives – redesigning the business tax structure so as to maximize opportunities for economic growth and job creation for all Canadians – will be severely compromised.

Federal-Provincial Business Taxation – Evolution and Practice

The Canadian Constitution grants provinces the right to levy "direct taxes for provincial purposes" and assigns the ownership of natural resources to the provinces.^a Provinces were not given jurisdiction to levy indirect taxes and custom duties, as these revenue sources would affect the trade of goods and services across provincial boundaries.^b The federal government is entitled to levy any tax. As a result, there is considerable overlap in the taxation powers of federal and provincial governments. Both levels of government can levy "direct" taxes on businesses including the corporate income tax, capital tax, and employer premiums and payroll taxes. Only the federal government may levy withholding taxes on income paid to non-residents.

Given the overlapping jurisdiction of federal and provincial government powers, the federal and provincial governments have sought to harmonize their policies. Prior to the Second World War, provincial governments administered their own independent income, capital and estate taxes. As a result of the "tax jungle" created by the lack of harmonization, the Rowell-Sirois Commission^c recommended that the federal government take over the income and estate tax fields and assume expenditure responsibility for unemployment relief and insurance, as well as for debt relief for, and equalization transfers to, the provinces.

These recommendations were not adopted in full. During the Second World War, the federal and provincial governments agreed to a "tax rental" system under which the provinces left the income and estate tax fields to the federal government and received compensation payments instead. As time unfolded, provinces sought a return to greater autonomy in taxation powers: Quebec and Ontario adopted their own corporate income and capital taxes in 1947 and Quebec adopted its own personal income tax in 1954.

In 1962, the tax rental agreements were replaced by the tax collection agreements of which the most significant provisions were that agreeing provinces would assess a tax on income that would be consistent with the federal base, and that the federal government would continue to administer the income tax without compensation for costs.^d The federal government reduced its tax rates through an abatement of tax to allow provinces to assess their own personal and corporate income tax. In 1980, Alberta decided to collect its own corporate income tax as well.

At present, three provinces collect their own corporate income tax (Quebec, Ontario and Alberta) while Quebec collects its own personal income tax. In practice, those provinces with separately collected corporate income taxes have used definitions of income that are virtually the same as that used by the federal government. This practice has provided significant advantages to taxpayers by reducing compliance costs and making it easier to allocate corporate income to the provinces in a fair and consistent manner.^e Generally, provinces collect their own capital taxes, although the federal government administers new capital taxes on non-financial corporations for New Brunswick and Nova Scotia. Recently Ontario has reformed capital taxes on non-financial businesses to be similar to the federal large corporations tax (LCT). General payroll taxes are collected by four provinces and are not harmonized. All provinces collect their own workers' compensation premiums and fuel taxes. Provincial sales taxes are only harmonized with the federal GST in three Atlantic provinces and, to a lesser degree, in Quebec (Alberta has no provincial sales tax).

^a Under the *British North America Act of 1867 (Constitution Act, 1867)*, the provinces could not levy indirect taxes as royalties except for resources produced from Crown Lands. The *Constitution Act, 1982* expanded provincial powers so that they could levy indirect taxes on resources produced from private lands.

^b The legal and economic incidences of taxes differ in interpretation. In terms of legal incidence, direct taxes have been interpreted as taxes paid by the person subject to the tax, while indirect taxes are "hidden" taxes passed on in the price paid by others. Economists have pointed out that economic incidence of a tax can differ from the legal incidence. For example, a tax on the corporate income accruing to the owners of the corporation, which is viewed as a direct tax for legal purposes, may have quite different economic incidence if the corporate income tax is shifted forward to consumers or backwards to workers.

^c Canada, Royal Commission on Dominion Provincial Relations (1940).

^d The provincial personal income taxes are levied on basic federal tax paid, while the provincial corporate income tax is levied on corporate taxable income. Provinces not only choose the rate of tax but may also levy surtaxes, provide credits and, in certain cases, impose flat taxes on income.

^e Without agreeing to a common base and allocation formula, provincial definitions of income would be inconsistent. For example, if a province taxes corporate income based on an allocation formula different than that used by other provinces, either overtaxation or undertaxation of the same source of corporate income would result, as well as tax minimization opportunities for taxpayers.

In this Chapter, the Committee reviews a number of topics that we regard as crucial to improving Canada's business tax system:

- principles for co-ordinating federal and provincial business taxes in a federal state so as to reduce administrative and compliance costs, improve fairness in tax policies across the range of businesses, and enhance job creation and economic growth through co-operative actions;
- alternative methods by which federal and provincial governments could levy business taxes at federal and provincial levels; and
- specific issues that federal and provincial governments should address to improve the federal-provincial business tax structure.

Principles in Co-ordinating Taxing Authority

In its study of the business tax systems of Canada and other countries, the Committee has identified what it regards as five key principles that federal states such as Canada should adopt in order to achieve an efficient, fair and less costly system. A basic recognition that both federal and provincial governments have vital roles in contributing to these results underlies these principles.

Encouraging the free flow of goods, services, capital and labour in the economic union:

Free trade in goods and services across international boundaries improves economic growth and promotes job creation. A similar principle applies even more strongly to Canada as an economic union: the free flow of trade, capital and labour allows individuals and businesses to seek the best economic opportunities without undue interference from the tax system. Under this principle, all levels of government would refrain from levying taxes that would impair the flow of goods and services, capital and labour across provincial boundaries or that would discriminate against businesses owned by residents of other provinces.

Minimizing the fiscal spillover effects of federal and provincial government tax policies:

Governments levy taxes so that they can finance public services of benefit to their residents. However, there are instances where the tax policies of one government may directly affect the economic well-being of the residents of another jurisdiction. Such interactions, or fiscal spillovers, occur among governments at the same level of jurisdiction (provinces) as well as between federal and provincial governments, and should be minimized.

Spillover effects come in a number of forms, and can have beneficial or harmful effects on other jurisdictions. The three most important are the following:

- *Tax exportation:* Tax exportation arises when a government levies a tax the burden of which falls on residents or governments of other jurisdictions. For example, a province, knowing that a significant portion of capital is owned by non-residents of the province, may attempt to "export" taxes by levying a tax on capital that is unrelated to local services. As another example, a provincial government that levies a tax that is deductible from corporate income can reduce the overall taxable income allocated to, and corporate income taxes paid to, other provinces and the federal government.
- *Tax base flight:* A government that levies a tax on a mobile factor may cause it to move to other jurisdictions, thereby improving prospects for growth or the capacity to raise revenues in other jurisdictions. For example, a higher corporate income tax rate in a province may encourage businesses to shift activity and income to other provinces, where the corporate income tax rate is lower. The province that benefits from a larger corporate tax base can either reduce its tax rates, provide new tax incentives or use the additional revenues for public expenditures.

- *Joint occupancy:* Fiscal spillovers may arise when there is joint occupancy of a tax field by two levels of government. If an increase in one level of government's tax reduces economic activity, the tax revenues of the other government will be reduced. As noted above with respect to tax exportation, spillovers related to joint occupancy may be greater when one level's tax is deductible against the other level's tax.

Fiscal spillovers have the effect of biasing governmental choices among tax instruments, and can result in either too much or too little taxation. If a government is able to export taxes, then its perceived cost of raising taxes to finance public services is lower than it would be if it took account of the cost borne by residents of other jurisdictions. Thus, a government may increase that tax beyond the level that it would choose, if it took the full cost into account. Similarly, if higher taxes in one jurisdiction benefit other jurisdictions because of tax base flight, a government might be inhibited in using that tax since the perceived cost of raising taxes is higher than its economic cost, because there are benefits which accrue to other governments. Minimizing fiscal spillovers improves the choices made by all governments in determining their tax structures and expenditures on public services.²

Minimizing the cost of administration and compliance: Every tax comes with costs: administrative and collection costs incurred by governments, and compliance costs borne by taxpayers. In federal states with several layers of government and a multiple number of jurisdictions, administrative and compliance costs can rise substantially.³ Federal and provincial governments should seek to minimize these costs by harmonizing their tax bases and agreeing to joint administration, collection and auditing.

Facilitating autonomy and flexibility for governments: Each level of government requires access to sources of revenue to fund its activities. Moreover, each government pursues economic policies, including tax policy, to achieve its objectives such as economic growth and job creation. Thus, the availability of adequate revenue sources plays an important role in facilitating autonomous and flexible decision-making by governments.

Improving the accountability of governments: Decisions to spend money on public goods and services, from highways to income transfers, are subject to the scrutiny of the electorate who pay for these programs through the tax system. Requiring that governments fund their programs through taxation, rather than relying on transfers from another level of government, can improve accountability. Provincial government accountability is further enhanced when the burden of such taxes falls most completely on residents of and activities in the province, rather than being shifted onto other governments and taxpayers.

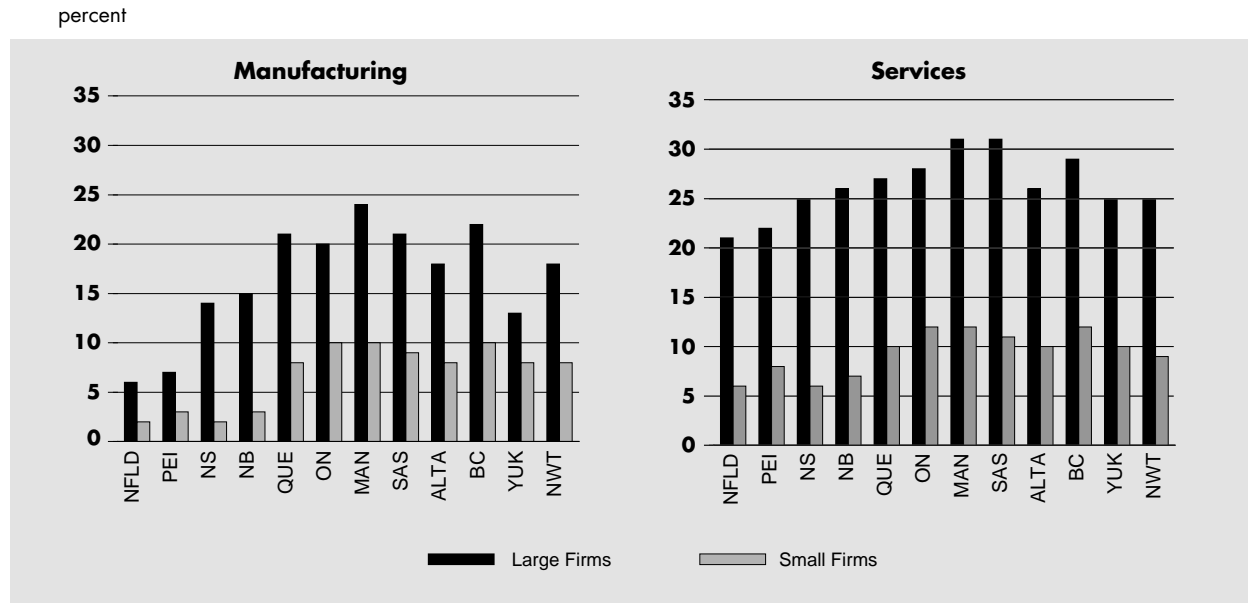
Practical Issues Influencing Federal-Provincial Tax Policy-making

All five principles for the co-ordination of tax authority are, we believe, central to designing an efficient and fair federal-provincial business tax structure in Canada. Nevertheless, the Committee notes that there are a number of factors at work in the current federal-provincial structure that are particularly important to keep in mind when considering the broader recommendations contained in this Report:

- *Variations in effective tax rates:* The free flow of capital across provincial boundaries can be affected by the different levels and structure of federal and provincial corporate income and capital taxes. There is considerable variation across provinces in effective tax rates on marginal investments for manufacturing and services arising from differences in provincial corporate income and capital taxes, and from regional preferences provided by the federal government (specifically, the Atlantic Investment Tax Credit, which is not available to service industries). This is shown in Chart 11A.

Chart 11A

Effective Federal-Provincial Corporate Income and Capital Tax Rates on Marginal Investments in Manufacturing and Service Sectors by Province



Source: Calculations by the Committee based on data and technical assistance provided by the Department of Finance. Services include transportation, storage, communications, public utilities, trade and other services.

- Corporate income taxes already largely harmonized:* As described earlier, the federal and most provincial governments have signed tax collection agreements under which the federal government collects and audits corporate income taxes on behalf of the province concerned, thereby reducing administrative and compliance costs and encouraging the harmonization of corporate income tax. Only three provinces – Alberta, Ontario and Quebec – collect their own corporate income tax. These provinces account for about three quarters of corporate taxable income in Canada. In theory, by collecting their own tax, these three provinces give themselves greater autonomy over the tax base. Nevertheless, owing to the complexity of administering the corporate income tax, and the inherent difficulties for both governments and taxpayers associated with different tax policies, all three provinces, by and large, follow the federal income tax base, and use the same formula for allocating corporate taxable income as other provinces. Corporate income taxes are, therefore, significantly though not totally, harmonized. Nevertheless, given the fact that corporations are required to file separate returns in these jurisdictions, and that all three have separate collection and enforcement functions, there are some unnecessary additional compliance and administrative costs.
- Capital, payroll, sales and excise taxes only minimally harmonized:* Unlike the corporate income tax, federal and provincial capital taxes are collected separately, and are harmonized only to a minimal extent. There is also little harmonization of payroll taxes, excise taxes and royalties. As noted, some provinces have harmonized their provincial sales tax with the federal goods and services tax, thus relieving businesses from paying provincial sales taxes on purchases of goods and services from other businesses.
- Spillover effects associated most strongly with corporate and capital taxes:* Fiscal spillovers between government jurisdictions are largely dependent on the sensitivity of tax bases to the level of taxes. The Committee notes that corporate income and, to a lesser extent, capital bases are

most sensitive to tax levels, so that spillovers are common for these taxes as taxpayers take actions to minimize provincial taxes. The fiscal spillovers associated with corporate income and capital taxes are accentuated at the provincial level since businesses are able to shift income or assets from one provincial jurisdiction to another. By the same token, provincial governments have an incentive to adopt tax policies that can attract additional tax base to the province, sometimes at the expense of other jurisdictions.

- *Small fiscal spillover effects from sales, excise and payroll taxes:* Fiscal spillovers arising from sales, excise and payroll taxes are believed to be less significant than in the case of corporate income and capital taxes. Employer payroll taxes may affect the migration of labour to some degree, but corporate income and capital are much more mobile. Moreover, to the extent that the employer taxes are payments for social insurance programs (e.g. workers' compensation, EI and CPP/QPP), the spillover effects are mitigated. Similarly, spillovers of resource royalties and property taxes are also reduced to the extent that they are payments for benefits received by the business sector.
- *Equalization encourages tax co-operation:* Equalization payments currently made to seven provinces (Manitoba, Saskatchewan, Quebec, New Brunswick, Nova Scotia, Newfoundland and Prince Edward Island) compensate for differences in provincial capacities to raise revenue. As a result, any reduction (or increase) in the corporate tax base in a province will be offset by additional (or reduced) equalization payments. Equalization payments may therefore reduce the incentive for recipient provinces to engage in corporate tax competition to attract jobs, if the province believes that any gains will be offset by a reduction in equalization payments.
- *Differences between provinces favour some businesses over others:* Businesses that can take advantage of certain tax-planning opportunities and can shift tax bases from high- to low-tax provincial jurisdictions have an unfair advantage over other businesses that do not have the same opportunities. For example, a corporation with separate entities operating in two provinces, can shift interest deductions from the low- to high-tax rate province, and can reduce its overall payment of corporate income tax.
- *There is still more room to reduce the costs of taxation:* The compliance and administrative costs arising from multiple federal and provincial taxes are affected by the number of business taxes levied by different governments. The cost of compliance arising from unco-ordinated taxes at federal and provincial levels particularly hurts the small business sector, although all businesses face the higher costs resulting from duplication of returns, audits and administration. Efforts to reduce costs include: agreeing to a common definition of the tax base; an allocation formula for corporate income earned by corporations operating in more than one province; joint audits by federal and provincial authorities; concurrent dates for filing returns for taxes (for example, sales and income taxes) and one filing for federal and provincial corporate income taxes under the tax collection agreements; and a common electronic system to begin in 1998 to allow corporations to file federal, Alberta and Ontario tax returns. However, there is much more that could be done to the benefit of taxpayers and governments alike.

The Clear Benefits of Tax Harmonization

Despite the considerable economic gains accruing from increased harmonization, federal and provincial governments have not maximized the advantages of co-ordination. This occurs for a variety of reasons. Some governments believe that having the flexibility to design a specific tax or to choose a particular mix of taxes outweighs the potential economic gains from harmonization, and thus they tend to employ corporate tax policy to pursue objectives such as targeted assistance to industries. It is the Committee's view, however, that the perceived advantages to be had from this autonomy and flexibility are frequently illusory.

In today's economy, the mobility of capital is continually on the increase, across provinces and internationally. When federal and provincial governments pursue autonomous tax policies that are not harmonized, they create a tax environment with unnecessary complexity and cost, which eventually

results in losses of jobs and tax revenues to other parts of the world. Moreover, government actions to attract capital and jobs to certain locations through the tax system invite retaliation from other governments, reducing the efficiency of the overall economy, as well as eroding the tax base for affected governments.

The Committee is also convinced, however, that concerns about autonomy and flexibility must be addressed. Below, we set out a number of mechanisms and arrangements that would accommodate these concerns, while at the same time delivering significant benefits from tax harmonization.

Approaches for Improving Tax Co-ordination

The Committee believes that federal and provincial governments should make efforts to harmonize not just corporate income taxes, but also capital taxes and possibly other taxes, in the longer term. The benefits of harmonizing corporate income and capital taxes would include a more efficient use of resources in productive opportunities, greater fairness in the application of corporate income and capital taxes for all businesses, fewer opportunities for provincial tax arbitrage, and reduced compliance and administrative costs for business and governments respectively. Harmonization of corporate income and capital taxes would also reduce the interactions of federal and provincial policies on one another, since governments would agree to a common base for the taxation of capital. In pursuing this goal, federal and provincial governments have three broad options:

- *Exchange of tax fields:* In some federal countries like Australia and Mexico, only the central government collects corporate income taxes. To achieve a similar result in Canada, federal and provincial governments could agree that the federal government would levy corporate income and capital taxes in exchange for a transfer of an equal-yield federal tax to the provincial governments, such as a portion of the personal income tax. While an exchange of tax fields might improve the harmonization of corporate income and capital taxes, there are several issues that would need to be considered. The most difficult one is that any tax transferred to provinces in exchange for corporate income and capital taxes is unlikely to provide comparable amounts of revenue to all provinces and, moreover, the growth rates of the substitute revenue sources may differ over the long term. Further, given the importance of corporate income and capital taxes for businesses, and the relationship between the corporate income tax and personal income taxes that are shared by the provinces as a source of revenue, the provinces may wish to play some role in the development of corporate tax policies.
- *Revenue-sharing:* In a number of federal states, such as Germany and Brazil, the federal government levies the income tax with a portion of the revenue being transferred to sub-national governments according to a specific allocation formula (such as the share of national income and population). Canada could follow a similar practice for both corporate income and capital taxes. Levied on a single base at a single rate and administered solely by the federal government, the resulting corporate income and capital taxes would generate the maximum gains from harmonization. However, the provinces would have little say in the management of a set of taxes that they regard as having significant impact on their economies.
- *Joint tax collection:* The third approach is to further extend a mechanism already in place. Canada is unique in achieving a significant degree of harmonization through the development of tax collection agreements whereby the federal government collects corporate and personal income taxes on behalf of the agreeing provinces generally without cost recovery. The federal and provincial taxes are levied on the same base with the agreeing provinces choosing their own corporate tax rate, surtaxes and tax credits, according to a set of criteria requiring that any special incentives do not impair Canada's economic union or result in undue complexity. The current set of tax collection agreements has worked well for Canadians. They have reduced administrative and compliance costs while providing some autonomy and flexibility for all governments in developing corporate tax policies.

R E C O M M E N D A T I O N

The Committee recommends that the federal government and the three provinces not now participating in tax collection agreements with respect to corporate income taxes make every effort to conclude agreements for the benefit of taxpayers in these provinces. The Committee also recommends that, should capital taxes be harmonized, as we recommend, tax collection agreements should be considered for these taxes as well.

The Committee is of the view that the joint tax collection approach used for corporate income tax harmonization is a reasonable compromise, in the Canadian context, for encouraging the free flow of capital across provincial boundaries; minimizing spillover effects; reducing administrative and compliance costs and tax avoidance; and addressing the autonomy, flexibility and accountability concerns of the agreeing governments. In making this recommendation, we believe that both levels of government have a responsibility to work together to develop a business tax structure that is efficient, simple and fair.

There will always be some tension between the desire for harmonization in policy and administration, and the desire for autonomy by each government. It is nonetheless critical that, given the global mobility of capital, Canada work to achieve a higher degree of co-operation in the field of corporate taxation.

The Committee is aware that some provinces have expressed a desire for more flexibility and freedom of action in introducing new provincial corporate tax incentives and other measures, with the federal government retaining responsibility for administration. Some provincial proposals relate to incentive measures that are limited to activities within provincial boundaries or restricted to residents of the province.

The federal government has so far been reluctant to agree to administer some of these provisions owing to concerns about impairing the economic union. The Committee shares this view, and has another fundamental concern: specific industry incentives are often undesirable. We believe that such measures most frequently are accompanied by high economic costs and poor results. And to the extent that they are successful, other provinces are induced to adopt similar provisions with the result that the incentive effect in any one province is blunted, and all jurisdictions lose tax revenues. We recognize that in some unusual circumstances, the provinces, like the federal government, may wish to provide tax assistance to specific industries, such as in response to international pressures. Such assistance should be delivered through investment tax credits, so as to avoid altering the tax base.

We are convinced, therefore, that the principle of neutrality – whereby all governments seek to improve the efficiency and fairness of the business tax system by levying similar tax burdens on all business activities – should serve as a touchstone for the harmonization of corporate income taxes. Neutrality dictates that provinces should not impose taxes that would impair the flow of goods, services, capital and labour across provincial boundaries; and that tax policies of the federal government should fairly treat all regions of the country.

The Committee advises federal and provincial governments to develop a set of practices that would recognize the joint responsibilities outlined above:

- *A common, neutral tax base:* While corporate income tax rates may differ for federal and provincial governments, the tax base should be the same and neutral. The federal government is concerned about being obliged to administer provisions that would, in its view, harm the economic

union, or that it regards as not technically feasible. Since the corporate income tax base is subject to continuous change for technical and practical reasons, the federal government will need to respond to events that affect the tax base and amend the law as required in a timely manner. Mechanisms such as the federal-provincial tax committee provide an opportunity for both levels of government to deliberate on major questions in a timely manner. Federal and provincial governments should strive to avoid accelerated depreciation, exemptions and other provisions that affect the common tax base. Instead, they should consider the use of tax credits.

- *Ongoing efforts at harmonization:* Provincial governments not party to tax collection agreements, and the federal government should continue to pursue harmonization of policies and joint administration of corporate income tax. The Committee endorses efforts of federal and provincial governments to co-ordinate audit and administrative practices.
- *Harmonize capital taxes:* As discussed, federal and provincial governments should negotiate tax collection agreements for capital taxes as well. As noted in Chapters 4 and 10, there would be significant advantages to fully harmonizing federal and provincial capital taxes, including simplifying calculations for non-financial and financial corporations. A single administration and filing would provide significant benefits to businesses and governments in terms of simplification while limiting opportunities for inter-provincial capital tax planning.⁴

R E C O M M E N D A T I O N S

The Committee recommends that the federal and provincial governments use a common neutral base, and a common method of allocating income and capital subject to corporate tax in each jurisdiction.

We further recommend that, if either the federal or a provincial government wishes to provide incentives through the tax system or to obtain additional tax revenues from business, the government should use tax credits or surtaxes rather than altering the common tax base.

Specific Federal-Provincial Issues

The key assumption underlying the Committee's comments in this Chapter is that a corporate tax system that is more neutral and harmonized will make it more attractive for businesses to invest and create jobs in Canada. In informal discussions with the Committee, several provincial government officials clearly recognized that there are economic benefits from base harmonization. Interprovincial trade, capital and labour flows in the Canadian economic union mean that a business locating in one region has access to markets in the rest of Canada.

In the course of our deliberations, the Committee identified a number of issues yet to be resolved by federal-provincial government co-ordination and interaction. Specifically, these are issues related to the allocation formula for corporate income, the deductibility of taxes from the corporate income base, taxation of government assistance and taxation of commercial activity of Crown corporations.

Interprovincial Allocation of Corporate Income

When a corporation operates in several provinces, it is necessary to determine how the income should be attributed to each jurisdiction for purposes of calculating corporate income tax. At present, about 45 percent of corporate taxable income is earned by corporations operating in more than

one jurisdiction. The provincial corporate income and capital tax bases are determined by an allocation formula that is based on the share of activity in the province. Provinces that are party to the tax collection agreements use a common allocation formula administered by Revenue Canada. Those provinces not party to the tax collection agreements have also generally used the current allocation formula for their provincial corporate income tax.

Since 1946, when the formula was devised,⁵ this method of allocating corporate income has served Canada well. In the absence of such mutually agreed allocation rules, some income earned by corporations could be taxed by more than one province, while other income could escape taxation altogether. Also, a common allocation formula results in lower compliance costs for businesses and administrative costs for governments. It is vital, therefore, for federal and provincial governments to maintain the benefits arising from a common method of corporate allocation.

In the view of the Committee, there are a number of specific trends that will require attention in the future given the ongoing evolution of the Canadian economy:

- *Changes to the Canadian economy and their impact in determining income allocated to provinces:* Under the corporate allocation formula, revenues are apportioned across provinces according to two criteria: the relative sales volume of the corporation in the jurisdictions in which it has permanent establishments (except for exports); and the relative payroll in such jurisdictions.⁶ When the formula was first developed, it was considered appropriate to use the destination of sales as a factor in allocating revenues. More corporate tax revenues were thereby allocated to those provinces that imported manufactured goods from Ontario and Quebec industries. However, provinces with non-protected industries would also receive less corporate income allocated to them, to the extent that shipments were destined to other provinces. Forty years later, the Canadian economy is different. New methods of selling and distributing goods and services mean that businesses may often have no need for permanent establishments in some provinces. Moreover, Canadian businesses have been rationalizing production processes by consolidating plants and other infrastructure, reducing the number of provinces in which they have a permanent establishment. As a result, the corporate allocation formula should be updated to reflect new business practices, with particular attention to investment income, investment companies and services.
- *Evolving international trends:* As we noted earlier, the development of electronic commerce and the growth of new forms of financial transactions will challenge governments, at the international level, to develop rules for the determination of the location of income earned and sales made. Such trends will also affect the provincial allocation of corporate income, such as determining the place of permanent establishment, the point of sale or origin and the source of financial income.
- *Administration of the corporate allocation formula in an increasingly complex world:* Even though the interprovincial allocations do not affect federal revenues, Revenue Canada plays an important role in administering the corporate allocation formula to ensure that provinces party to the tax collection agreements receive their fair share of corporate income. Given the increased complexity of many corporate transactions, additional resources need to be devoted by Revenue Canada to ensure that the formula is well administered in the interests of the provinces.

The Committee endorses current consultative efforts of federal and provincial governments to review corporate allocation issues with the objective of preserving a common corporate income allocation formula. The Committee recognizes that any changes in the corporate allocation formula will result in more revenues for some provinces and less for others, making agreement difficult. We also believe, however, that from the economic perspective, the continued integrity of the allocation process is paramount. Whatever agreement is reached, care must be taken to ensure that the allocation formula is maintained fairly and effectively.

Deductibility of Profit-insensitive Taxes

In recent years, there has been some uncertainty regarding the deductibility of general provincial payroll and capital taxes for determining corporate income. In 1991, the federal government was concerned that provinces were increasing payroll⁷ and capital taxes more quickly than corporate income taxes, since the former were deductible from the corporate income tax base and thereby reduced taxes paid to other governments. The federal government proposed to eliminate the deductibility of general payroll and capital taxes in excess of \$10,000 per business and to provide an offsetting reduction in corporate income tax. While this measure was not ultimately adopted, the federal government has stated that it would consider limiting the deductibility of provincial general payroll and capital taxes for amounts beyond the levels established in 1991.⁸

The Committee recognizes that the issue of deductibility of payroll and capital taxes is broader than this one case, and that it raises some potentially difficult questions. In some countries, such as the United States, state-level corporate income taxes are deductible from the federal corporate income tax base, while in others, such as Italy, local corporate income taxes are not deductible. In addition to general payroll and capital taxes, there are several federal and provincial profit-insensitive taxes that are currently deductible from corporate income, including provincial and municipal property taxes, provincial retail sales taxes on business inputs, federal and provincial excise taxes and employer premiums (EI, CPP/QPP and workers' compensation) and provincial stumpage fees.⁹

The Committee's observations about the deductibility of provincial taxes from the federal corporate income tax (and federal taxes from provincial corporate income) are as follows:

- *Benefit-related taxes:* The tax may be a payment for a public insurance program (EI, workers' compensation and CPP/QPP) or for public services (certain property tax payments and user fees). If the benefit is also taxable, then it is appropriate to allow the payment to be deductible.¹⁰
- *Economic impact:* When federal and provincial taxes are deductible from the corporate income tax, the overall burden of taxes on business is lessened, although the resulting reduction in revenue for federal and provincial governments may be offset by higher taxes on business or individuals. If higher corporate income tax rates are the result of deductibility, the corporate income tax base will be eroded as Canada's corporate income tax rate is further increased beyond international norms.
- *Interaction effects of federal-provincial fiscal decisions:* As discussed earlier in the Chapter, governments are generally more willing to increase those taxes that, through the mechanism of deductibility, shift the burden of taxes paid on to other governments. As the cost of taxation is lowered for the government with the deductible tax, deductibility influences the choice and level of taxes that are used to finance public expenditures. The potential interactions are two-fold. The deductibility of one level of government's tax reduces the revenue available to other governments. As well, the deductibility of a provincial tax reduces the amount of corporate income allocated, and corporate income taxes paid, to other provinces for corporations with permanent establishments in more than one province.

The conclusions that one should draw from these observations are mixed. Benefit-related taxes, such as EI, CPP/QPP, and workers' compensation premiums, property taxes and resource royalties, should be deducted from corporate income. On the other hand, the deductibility of other profit-insensitive taxes is more questionable if deductibility heightens the interaction of tax policies among governments or if it imposes significant costs associated with base erosion. The latter can arise if tax deductibility results in setting corporate income tax rates further above those of our trading partners.

The Committee's Conclusions about the Current Deductibility Regime

Federal and provincial profit-insensitive taxes traditionally have been deductible from the corporate income tax base. One important exception, and one that we have discussed in Chapter 5, is resource royalties.¹¹ Even though the royalty is arguably a payment for the use of the resource, the federal

government disallowed the deductibility of resource royalties in 1974 in order to reduce the harmful interaction of federal corporate income and provincial royalty policies. Instead, a resource allowance was created that reduced corporate income taxes so that the overall impact of federal and provincial taxes on oil, gas and mining companies would not be affected. The Committee believes that it is appropriate to retain this mechanism, one that is by and large supported by federal and provincial governments as well as by industry.

The Committee also supports the principle that provincial corporate income taxes should not be deducted from the federal-provincial corporate income tax base. Deductibility only heightens the degree of interaction of federal and provincial tax policies and could require the federal government to raise its own corporate income tax rate in order to make up lost revenues. Furthermore, the deductibility of provincial corporate income tax would reduce the amount of income available to be allocated among various provinces, and the resulting impacts would be unevenly spread among them.

As for other profit-insensitive taxes, each case for deductibility should rest on its own merits. The Committee is of view that, at times, interactions between federal and provincial tax policies should be reduced as in the case of resource royalties. As shown in Table 11.1, there has been a significant increase in capital, property and payroll taxes paid by business relative to the corporate income tax. Except for the federal capital tax, all these taxes are deductible from the corporate income tax, thereby affecting the revenues of the other governments. Businesses have been concerned about the impact of these profit-insensitive related taxes on their investments, particularly during recessionary periods.

Table 11.1
**Growth Rates of Different Components of Business
Tax Revenues for the Period 1985-95^a**

	Growth Rate	Taxes Paid by Businesses, 1995
	(%)	(\$ billions)
Federal Corporate Income Tax (excludes capital taxes)	2.7	12.5
Federal Capital Tax (LCT and financial institutions)	n/a ^b	1.4
Employment Insurance plus Canada/ Quebec Pension Plan	8.9	13.4
Provincial Corporate Income Tax ^c	4.4	6.0
Provincial Capital Tax plus Insurance Taxes	9.8	3.8
Provincial General Payroll Taxes	14.5 ^d	4.7
Provincial Workers' Compensation Employer Contributions	5.5	4.3
Provincial Resource Royalties and Taxes ^c	0.4	6.4
Provincial/Municipal Property Taxes	6.2	15.1
Provincial Sales Taxes on Business Inputs	3.8	6.6
Gross Domestic Product	5.0	
Total Federal Revenue	6.0	
Total Government Revenue	6.0	

^a Growth rates are compound annual rates.

^b No federal capital tax in 1985.

^c In this Table, provincial taxes on logging and mining profits have been included with provincial resource royalties and taxes rather than with provincial corporate income tax. (Tables 2.1 and 2.6 included such taxes with corporate income tax.)

^d The annual growth rate of the sum of provincial general payroll taxes and provincial hospital and medical insurance premiums was 7.6 percent for 1985-95.

Source: Committee secretariat calculations.

R E C O M M E N D A T I O N

The Committee recommends that provincial capital taxes should not be deductible from the corporate income tax following an appropriate transition period, and that federal capital taxes should remain not deductible.

This recommended measure should be seen in the context of the Committee's other recommendations concerning the general corporate income tax rate (see Chapter 4). The reduction in the federal-provincial general corporate income tax rates recommended in Chapter 4 would provide a substantial offset to the non-deductibility recommended here, such that the average tax paid by businesses would not increase. However, we recognize that some industries, in particular financial and manufacturing businesses, and businesses in some provinces (British Columbia, Manitoba, Quebec and Saskatchewan), pay above average amounts of capital taxes and thus would be especially affected by this measure viewed in isolation. The Committee also anticipates that governments will reduce their reliance on capital taxes over time, since without deductibility as a feature, there would no longer be as great an incentive to rely on them. Specifically, the Committee suggests that the provinces use part of the additional revenue that they would receive by following the base-broadening measures recommended in this Report to reduce their capital taxes.

The Committee is aware of the fact that New Brunswick and Nova Scotia have recently introduced new deductible capital taxes as permitted by a provision of the harmonization agreement for federal and provincial sales taxes. This provision has, however, been criticized by other provinces as creating a regional inequity. The elimination of the deductibility of capital taxes would require the federal government and the three Atlantic provinces to consider appropriate alternative measures. In any event, the Committee is of the view that Canada would benefit from a more neutral and consistent policy.

The Committee also considered a second-best alternative with respect to provincial capital taxes that would retain them as a deductible expense but would alter the interprovincial allocation formula, so that the burden of capital taxes imposed by a province fell exclusively on the corporate income tax base of that province. This could be achieved by adding back all provincial capital taxes to taxable income for the purpose of the calculations under the interprovincial allocation formula, and then requiring that such taxes be deducted from the income allocated to the province that levied them. Such an approach would still involve a fiscal spillover effect at the federal level; the provincial capital tax would reduce the federal tax base, even though it would eliminate spillovers with other provinces. However, each province would be more accountable for the consequences of the capital taxes that it imposes than in the current situation. Keeping in mind the complexity involved with the calculations, the same treatment might be extended over time to other deductible provincial taxes, such as payroll, property and other levies.¹²

Deductibility of Property Taxes

The Committee recognizes that, in recent years, there has been a very substantial growth in property taxes paid by businesses, growth largely related to the transfer of expenditure responsibilities and the reduction in grants to municipal governments by several provincial administrations. To a certain extent, property taxes are payments for municipal services. To the degree that property taxes are not payments for services, they are largely borne by the owners of land and structures. While the Committee does not recommend limitations for property tax deductions, we raise a caution with respect to the tendency of governments to favour such deductible taxes over non-deductible ones.

Payroll Tax Deductibility

The Committee believes that those payroll taxes linked to taxable benefits should continue to be deducted. Our recommendation to continue payroll tax deductibility is based on two observations. First, to the extent that the payroll taxes are shifted back onto workers, there is no direct interaction between the corporate income tax base and provincial payroll tax, although federal and provincial personal income taxes are affected. Second, to the degree that payroll taxes result in higher employment costs for businesses, the Committee is concerned about the deleterious impact that non-deductibility might have on job creation, especially for low-wage workers. As in the case of property taxes, however, the Committee believes that the government should consider limiting the deductibility of general payroll taxes, if in the future, they continue to grow faster than corporate revenues.

Taxation of Government Assistance

Government assistance to industry is subject to corporate income tax either as income (for example, operating subsidies) or as a reduction in the cost base of depreciable assets (for example, capital subsidies or investment tax credits). Government assistance in other forms, such as preferential corporate income tax rates, tax holidays and accelerated depreciation, is not subject to taxation.

The primary reasons for taxing government assistance are to avoid the stacking of federal and provincial assistance that would result in taxpayers bearing inappropriately little or no costs for investments and to ensure an appropriate measure of income. Since federal and provincial governments may not co-ordinate subsidies supporting a specific industry, the taxation of government assistance reduces the incentive to provide subsidies or targeted tax relief for capital. However, as a result of the taxation of government assistance, there is an interaction between federal and provincial policies of taxing income arising from a government's policy to support an industry. Moreover, to avoid taxation of government assistance, some governments have resorted to possibly less effective base adjustments, tax holidays¹³ or targeted rate reductions rather than tax credits or other forms of taxable assistance and provinces not in the tax collection agreements have an advantage over others in choosing forms of non-taxable government assistance.

As a general principle, the Committee believes that tax preferences for specific activities are less desirable than a tax system with low rates and broad bases. The exceptions to this principle arise only in certain limited situations when market forces lead to too little investment such as in R&D. When tax incentives are appropriate on a selective basis, the Committee believes that the incentives should be delivered by means of tax credits (for example, investment tax credits) rather than changes to the tax base (for example, accelerated depreciation) or preferential tax rates for specific sources of income. In this manner, federal and provincial corporate income taxes would continue to be harmonized, and the corporate income could be allocated to provinces in a fair and consistent manner.

The Committee is of the view that government assistance should generally be taxable. Taxation of government assistance reduces the incentive for governments to provide assistance to industry, including when such assistance is given on an unco-ordinated basis and could therefore result in taxpayers paying little for the cost of their investments. Furthermore, some forms of government assistance may simply be payments made to businesses that provide a service to the government and, for fairness reasons, such payments should be taxable.

As noted above, not all forms of government assistance at present are taxable. This has resulted in provinces choosing ineffective forms of industrial support such as tax holidays compared to tax credits. The Committee has argued that federal and provincial governments should strive to use a common, neutral corporate income base for allocation purposes and, if federal or provincial governments wish to provide tax support to an industry, they should provide tax assistance that would not affect the base, such as tax credits. However, since tax credits are taxable, they would have some impact on the corporate income base used by the federal government and allocated to provinces.

The Committee considered an option whereby federal and provincial governments would agree to permit an exemption from taxation for certain tax credits on a mutual basis and according to an agreed-upon set of criteria – for example, credits for R&D. Under this option, the federal government and all the provinces would agree to the following criteria:

- The assistance qualifying for non-taxability should be generally available for specific activities (for example, R&D) rather than be targeted to specific businesses.
- The exemption of government assistance should not interfere with the functioning of the economic union or result in undue complexity in the tax system.¹⁴
- The exemption should be provided on a co-ordinated basis, so that there is no stacking of incentives, such that the taxpayer bears little or no cost in making the investment.

This option for the taxation of government assistance could encourage provinces, including those provinces not party to the tax collection agreements, to use a common corporate tax base. However, the option would not deal with all of the present inefficiencies arising from the exemption of certain forms of government assistance, while others remain taxable. Nor would it result in totally disentangling policies related to government assistance, as long as other assistance remains taxable.

As we suggested in Chapter 4, should investment tax credits remain taxable, as in the case of R&D, federal and provincial credits should be treated on the same basis and be used to adjust income in the following year.

Taxation of Commercial Activities of Government Bodies and Others

Under the Constitution, federal and provincial governments cannot tax each other. As well, personal property of an Indian or band situated on a reserve is also exempt from federal taxation under the federal *Indian Act*. At times, government and other bodies, exempt from taxation, engage in commercial activity in competition with the private sector. As a result of the exemption from tax, government-owned businesses have an unfair advantage over investor-owned businesses. To the extent that investor-owned businesses are otherwise able to provide products and services at lower economic costs than government-owned businesses, the tax advantage given to commercial activities undertaken by governments can result in a less efficient industrial structure.

In the past, governments have resorted to two policy options to establish neutrality between public and private commercial interests. The first has been to tax their own Crown entities on their commercial activities.¹⁵ The second has been to reduce corporate income taxes paid by investor-owned businesses competing directly with Crown corporations (for example, as under the *Public Utilities Income Tax Transfer Act*, whose repeal was recently legislated).

In the Committee's view, the former policy is clearly preferable to the latter. An abatement in corporate income taxes for investor-owned businesses competing with government-owned tax-exempt businesses is difficult to administer on a selective basis and undesirable in concept. It requires identifying sources of income subject to abatement, as well as determining which industries should qualify for such an exemption, since government-owned tax-exempt businesses operate in many sectors of the economy. It is preferable, in the Committee's view, for all governments to subject commercial activities of all Crown corporations to taxation. The revenue could be kept by the government owning the corporation, or a reciprocal agreement could be negotiated for governments to tax each others' publicly owned businesses operating in their jurisdiction.

The taxation of commercial activities of Crown corporations is consistent with new developments, whereby Crown corporations are provided more independence to operate at arms' length from the government owner. Managers of government-owned corporations are judged by their ability to earn income and achieve cost efficiencies. Since taxes constitute a cost that enters into the determination of income and profit, the taxation of a Crown's commercial activities should affect the behaviour of public corporations just as it does businesses in the private sector.

Conclusions

Canada's economic growth and prosperity are facilitated by policies that encourage the free flow of goods and services, and the mobility of capital within the Canadian economic union. A neutral business tax structure would promote economic growth and job creation in each of Canada's regions, by allowing entrepreneurs to select opportunities for sound business reasons rather than being unduly influenced by the tax system.

The Committee believes that it is of paramount importance for federal and provincial governments to work together to ensure that the business tax structure is applied efficiently and fairly across Canada. Given the need to attract jobs to Canada and its regions, the reality is that federal and provincial governments have a common interest in working together to achieve a harmonized and neutral tax system.

Canadians have benefited through lower compliance and administration costs and a more efficient tax system as a result of federal and provincial efforts to harmonize corporate income taxes and to agree to a common corporate income tax base. We believe that further efforts should be made to harmonize capital taxes as well.

Our calculations indicate that those provinces party to the tax collection agreements will obtain greater tax revenues from our recommended broadening of the corporate income tax base. Other provinces will have to decide whether to harmonize with the federal changes to the tax base. Given these increased revenues, and in order to achieve the general aims of the Committee's package of recommendations, it is vital that provinces be willing to lower their corporate income tax rates and undertake other possible adjustments such as reducing their capital taxes.

We believe that our recommendations will provide a more efficient and fair business tax structure to encourage economic growth and job creation in Canada. Our hope is that the federal and provincial governments will work together to structure business taxes with the aim of achieving these important objectives for Canada.

Endnotes

- ¹ The federal government collects relatively insignificant amounts of royalties and stumpage fees for resources in lands held by the federal government.
- ² Studies on the relationship between fiscal centralization and the size of the public sector have provided mixed results (Oates (1985) and Anderson and Van den Berg (Forthcoming)). Several studies in the United States have shown that the deductibility of state taxes from federal taxes has resulted in a larger state and municipal government expenditures (Rosen (1988)).
- ³ The survey by Erard (1997a), Technical Committee Working Paper 97-2, provides some evidence of the importance of compliance costs arising from multiple taxes levied by various governments in Canada.
- ⁴ See McQuillan and Cochrane (1996), Technical Committee Working Paper 96-8, for a large list of differences in rules for federal and provincial capital taxes.
- ⁵ A discussion of the history of the allocation formula is provided by Smith (1976).
- ⁶ The general formula is that the share of the base allocated to the province is equal to the sum of a permanent establishment's share of payroll and revenues at the point of sale divided by two. Special formulas apply to income earned from finance and insurance, transportation and other specific activities.
- ⁷ The federal government has agreed so far to pay general provincial payroll taxes for its employees in Ontario, Quebec, Manitoba and Newfoundland.
- ⁸ New capital and payroll taxes in provinces harmonizing their retail sales tax with the federal GST are deductible up to a negotiated amount reflecting the previous amount of retail sales tax applied to business inputs and deductible from the corporate income tax.
- ⁹ Oil and gas and mining royalties are not deductible, although, as discussed in Chapter 5, a resource allowance is provided as a deduction in lieu of provincial royalties.
- ¹⁰ Since workers' compensation benefits are not taxable, provinces reduce the amount of compensation paid to reflect the exemption from tax.
- ¹¹ Another exception is the federal capital tax, which is also not deductible.
- ¹² Provinces may propose that taxable provincial government assistance should also be included in adjustments. The assistance would be deducted from corporate income prior to allocation and would be added back to the province's tax base after allocation.
- ¹³ For an evaluation of the problems arising with tax holidays as an inefficient method of assistance, see Shah (1995).
- ¹⁴ The non-taxability of credits should be taken into account when determining their rate.
- ¹⁵ For example, the federal government taxes federal Crown corporations engaged in commercial activities. The Macdonald Committee recommended that Ontario Hydro should operate using prices incorporating tax costs (see Ontario, Advisory Committee on Competition in Ontario's Electricity System (1996)).

Alternative Taxes

ANNEX

Introduction

In the course of its work, the Committee re-examined the rationale and logic underlying Canada's business taxation structure, measuring it against our objectives of job creation, economic growth, fairness and simplicity. We, therefore, looked at potential alternative tax instruments with a view to determining whether important alternative revenues could be obtained, and whether the fairness and efficiency of our overall system could be improved.

Chief among the alternative taxes the Committee examined were:

- financial transactions taxes (on all financial transactions or just on foreign exchange transactions);
- wealth taxes (including wealth transfer taxes), and;
- business cash flow taxes, including some variants of proposed “flat taxes” for business.

As a result of our examination, the Committee concluded that none of these (nor the other alternative taxes considered) appeared to offer sufficient advantages as to justify their introduction into Canada's business tax system. Nonetheless, the Committee believes that the government should be engaged in a continuous review of new and alternative revenue sources, and must regularly monitor major tax developments abroad to see if they might be usefully considered for adoption in Canada. A brief report on the Committee's review of these three alternative taxes is set out below for reference purposes.

Summary

The Committee concluded that *financial* and *foreign exchange transactions taxes* are inherently flawed, inevitably complex and unfair in their application, and likely to distort markets with resulting significant costs. In addition, a foreign exchange transactions tax would likely be unworkable.

While some forms of *wealth taxes* appeared to the Committee to be conceptually worthy of consideration, we concluded that they would duplicate some of the existing taxes on property and income. We also concluded that in the Canadian context they would be unlikely to yield substantial net revenue and would require off-setting adjustments to existing taxes.

A *business cash flow tax* has significant merit when viewed from the perspective of economic theory. However, the practical disadvantages weigh heavily against its introduction at this time. The tax would need to be assessed at a higher rate than the current corporate income tax to produce the same revenue, resulting in a cash flow rate well above the corporate income tax rate in a number of competing countries. It would put Canada's tax system out of line with the United States and other major countries, distort foreign investment and result in serious transitional problems. The Committee notes, however, that if such a tax were adopted by the United States and other countries, its application in Canada would have to be seriously considered.

Financial or Foreign Exchange Transactions Taxes

The term “transactions tax” refers to a levy on one or more categories of transactions, with the base being the value of the transaction. A number of examples of such taxes may be found, currently and historically, in Canada and elsewhere. Charges on transactions in financial securities exist in several countries. In addition, the stamp duty on cheques, which existed in Canada until 1953, might be viewed as a type of tax on financial transactions, although the amount did not vary fully with the value of the transaction.

A number of proposed transactions taxes have recently attracted attention as potentially significant sources of revenue. One is a tax on all foreign exchange transactions, the “Tobin tax” – named after the American economics Nobel laureate James Tobin, who first proposed it in the early 1970s.¹ Another is a tax on all financial transactions recently put forward in Canada as a possible alternative to the GST.²

The Committee noted that advocates generally do not defend these proposals by appealing to the classic ability to pay, economic fairness or efficiency gains arguments arising from replacement of another tax that is less efficient or fair. Rather, in the case of the proposed tax on all foreign exchange transactions, the prime motivation is to increase the cost of foreign exchange transactions, which some have argued would enhance economic stability and performance (“putting some sand in the wheels of the foreign exchange markets”).³

The Tobin tax reflects a view that it is desirable, on balance, both to lessen the volume of short-term, sometimes speculative, activity in exchange markets, and to increase the autonomy of national monetary and fiscal policy by reducing the sensitivity of foreign exchange flows to small differences in national interest rate levels. However, this argument neglects the positive elements inherent in speculation. Speculation is of economic value, since prices of securities convey information about anticipated changes in the economy. Continuous adjustments in prices help forestall subsequent large shifts in value which can have adverse effects and impose significant costs on the economy. Speculative transactions also increase the liquidity of financial markets, which makes it easier for investors and businesses involved in international trade and investment to buy and sell foreign exchange.

For both variants of transactions taxes, the total size of the tax base appears to be potentially very high – ranging up to GDP multiplied by a factor of ten or considerably more. Thus, in principle, a very low tax rate – for example 0.1 percent or 0.25 percent – could raise substantial revenues. It is very important, however, that any such calculations allow for the substantial shrinkage in the tax base that could be expected to accompany the introduction of a transactions tax. For example, a financial transactions tax in Sweden reduced local trading of bonds by about 85 percent and trading of futures in bonds and bills by 98 percent within one week.⁴

An assessment of the complex arguments for and against a policy of reducing the volume of exchange market transactions is beyond the scope of our mandate. The merits of that discussion aside, however, the Committee is impressed with both the practical difficulties associated with, and the major economic distortions that would be engendered by, either of the proposed transactions taxes.

Inefficiencies and Unfairness Associated with Transactions Taxes

The implementation of transactions taxes is complicated by the tension between two desirable goals: to limit avoidance by making the base of the tax as broad as possible, and to limit the likelihood of significant financial or foreign exchange market distortions by exempting transactions in certain instruments. In general, a financial securities tax, if imposed, would presumably be applied only to the secondary market.⁵ Both a foreign exchange tax and any form of a financial transactions tax could be expected to introduce a number of such distortions, resulting in inefficiencies and unfairness.

Reduction in Market Efficiency and Depth: Efficient and liquid financial markets allow for risk sharing and the conveyance of up-to-date information on asset values to facilitate portfolio allocation decisions. Efficient markets are characterised by low transaction costs associated with these activities. A transaction tax would increase transaction costs directly by the amount of the tax, reducing trading volume and market liquidity. It would thus reduce the incentive to eliminate mispricing through arbitrage trading, and in many circumstances, could be expected to make markets more volatile, not less. It can be argued that a foreign exchange tax – like most restrictions on currency transfers – would induce larger exchange rate fluctuations.

Increased Transactions in Foreign Markets: The globalization of capital markets means that it will be increasingly easy for resident investors to avoid a domestic transactions tax by doing their trading of exchange contracts and domestic financial instruments offshore. Alternatively, financial institutions could develop foreign instruments that are not subject to the tax with risk-return characteristics similar to those of taxable domestic debt or equity instruments. Either response would impose efficiency costs on the economy.

Relative Advantage Given to Non-resident Investors: Application of a transactions tax to Canadian transactions by non-resident investors would significantly reduce the attractiveness of holding or trading financial instruments in Canada. Non-resident investors would demand that they be paid a premium to compensate for the Canadian transactions tax, thus increasing financing costs to Canada and Canadian businesses. If, alternatively, non-resident investors were exempted from the transactions tax, they would have an advantage in trading activities relative to domestic investors and traders.

Discourage Use of Short-term Debt: Imposing the transactions tax on money market instruments (for example, commercial paper, banker's acceptances) would significantly reduce if not eliminate the use of such instruments.⁶

Bias Toward Derivative Market Instruments: Investors and traders would likely seek to avoid either a foreign exchange or financial transactions tax by trading in derivative instruments – contracts that do not directly involve buying either foreign exchange or a financial instrument, but which would yield the same economic result. It would be technically difficult to design a tax that would counter such avoidance. Interest-rate swaps cannot always be matched in a straightforward manner with an underlying instrument, and thus including them in the base of a financial transactions tax for the purposes of calculation, would be difficult. Similar difficulties would arise in finding a comparable basis on which to apply the tax in the case of futures contracts. It has been estimated that a 0.5 percent transactions tax on the notional value of a stock index futures contract, for example, would increase transactions costs for a “round-trip” trade by 2,200 percent. On the other hand, exempting futures contracts would simply encourage investors to use them to avoid the tax.

Use of Intermediaries and Tax Cascading: Taxing intermediaries' transactions can subject trades to multiple levels of taxation. For example, if a mutual fund pays a transactions tax when it buys and sells securities, and a mutual fund unit holder pays a transactions tax on buying and selling units, there is greater taxation in total than when individuals hold the underlying securities directly. The more links in a chain of transactions between an initial seller and a final purchaser, the greater is the effective tax burden from the transactions tax. Designing exemptions to a tax to reduce such “tax cascading” creates additional costs and inefficiencies.

Unfair Incidence: Given the practical realities of complex international markets, sophisticated investors, including large corporations, would undoubtedly find ways to reduce or avoid the burden of a transactions tax, including carrying on transactions outside of Canada, possibly through intermediaries. Thus, the impact of such taxes would inevitably fall more heavily on individuals, including small investors and small businesses.

Implementation is Conditional on International Co-operation: However one assesses the difficulties enumerated above, most would be compounded if a single country – or even a group of countries – tried, in isolation, to impose either a tax on foreign exchange or on financial

transactions. Limiting tax avoidance and evasion, and avoiding resulting market distortions, would be highly problematic given today's electronically integrated markets, and the ease with which transactions can be restructured and/or shifted to other jurisdictions. Achieving the necessary consensus and co-ordination among a sufficient number of countries to mitigate these difficulties seems highly unlikely, given that many national governments may not believe such a tax is desirable.

Committee's View of the Financial Transactions Tax

Implementation of a broad-based transactions tax, co-ordinated across all countries and all financial transactions, seems highly unlikely. In any event, the introduction of such a tax in Canada would result in major distortions and attendant efficiency costs, as well as significant compliance and administrative costs.

Taxes on Wealth

Taxes on property and wealth are currently a significant source of revenue in Canada, equal in total to almost 4 percent of GDP in 1994.⁷ However the mix of such taxes in Canada is somewhat atypical. Canada relies fairly heavily on property taxes and corporate capital taxes, but does not use wealth transfer taxes or annual wealth taxes at all, although a deemed realization of accrued gains on capital assets at death is taxed. Accordingly, the introduction of some form of wealth transfer tax – death and gift taxes – or an annual tax on the net wealth of individuals could be considered as alternative sources of revenue.

Wealth Transfer Taxes

It has been argued that some form of wealth transfer tax in Canada would be an appropriate means for obtaining revenues based on the ability to pay. The types of wealth transfer taxes most often considered include:

- estate tax, usually levied on the total wealth transferred as a result of death (subject to certain exemptions). The rate of tax is largely governed by the size of the estate;
- inheritance tax or succession duty where the tax paid is generally governed by the amount received by the beneficiary;
- accessions tax, where the tax is imposed on the recipient of gifts and bequests. The rate of tax is governed by the total amount received from all such sources, usually on a lifetime basis; and
- gift tax, based on the transfer of wealth during the life of a donor and usually intended to preserve the base, and counter the avoidance, of a death tax.

Evaluated only for their technical attributes, the various alternatives are clearly differentiated. The estate tax is administratively the simplest, while the inheritance tax, and particularly the accessions tax, are considered more equitable, because they take into account the circumstances of the recipient, rather than those of the transferor. An accessions tax is also considered to have an advantage, in that because it is levied on the beneficiary, it can be more finely tuned (and thus fairly applied) to his or her circumstances. The accessions tax can also assist governments in countering some types of tax planning that place the estate of the donor outside the jurisdiction imposing the tax while the beneficiaries remain in the jurisdiction. A significant disadvantage to the accessions tax is its correspondingly higher administration and compliance costs.

Unlike transactions taxes discussed earlier, wealth taxes are not without precedent in Canada and do not pose intractable technical problems. Canada had significant wealth transfer taxes for almost one hundred years, until they were phased out in the 1970s and early 1980s.⁸ They continue to be a part of the tax mix in a large number of developed economies. Many experts believe that wealth transfer taxes have relatively modest effects on incentives for taxpayers during their active years and, therefore, relatively little negative effect on overall economic activity.

In examining wealth transfer taxes, the Committee considered issues beyond those that are the merely technical. In the Committee's view, the difficulties of imposing wealth taxes in Canada extend to philosophical and social issues and, as well, have economic and practical considerations.

In the first instance, how one regards inherited wealth determines one's views of what is appropriate for government to tax. The Carter Commission argued that all accretions of wealth should be included in the tax base, and hence, that inheritance and gifts should be included in the income of the recipient for personal tax purposes. In the view of many others, however, inheritances – particularly of capital assets to be held and used over some period of time – are innately different in character from ordinary annual income. It is argued, furthermore, that since Canada taxes income from capital during a person's lifetime, to also tax transfers of wealth accumulated out of the after-tax income of taxpayers on death constitutes "double taxation" – a penalty on both savings and investment.⁹

Secondly, and on a more practical plane, the prospect of wealth transfer taxes would inevitably give rise to pressures for all manner of exemptions and relief. Among the likely candidates would be transfers of properties to surviving spouses and to dependants, as well as transfers of certain forms of property, including personal residences, farms, small business, cultural property, small estates, and pension and other retirement assets.

Thirdly, even if wealth transfer taxes are viewed as fair in principle, questions arise as to whether they will be fair in practice. For larger estates, sophisticated tax planning techniques can have the effect of substantially avoiding or deferring wealth transfer taxes; the burden of such taxes would thus tend to fall more heavily on the estates of the less mobile middle class. While tax-planning practices can be curbed by introducing anti-avoidance provisions, these would complicate the administration of the tax rules and would add significantly to collection costs. Even with the most effective anti-avoidance provisions, there will be some inducement for taxpayers to move their estates, and possibly themselves and their intended beneficiaries, out of Canada with a consequent erosion of the wealth base of the country.

A fourth concern is jurisdictional. An effective wealth transfer tax in Canada could, in all likelihood, only be administered by the federal government. Long experience has shown that as a general rule, the smaller the jurisdiction imposing the tax, the more likely there is to be leakage in the tax base through asset transfers to other jurisdictions. Mobility of capital across the country would pose innumerable enforcement difficulties for provincial administrations, and even the federal government would face similar collection problems at the international level. The Committee notes that the introduction of wealth transfer taxes by the federal government – where historically the provinces have asserted some claim – would require provincial consultation.

An additional complexity arises from secondary effects that a wealth transfer tax would very likely cause in other parts of the tax system, creating pressure for significant adjustments in, and in one case the elimination of, existing tax instruments. The current income tax system has a deemed realization of capital assets at the date of death, wherein any increase in the value of such property held by a deceased is subject (with some deferrals) to income tax in his or her final personal tax return. Very few countries with wealth transfer taxes also have a deemed realization of capital gains at death for income tax purposes.¹⁰ Levying both forms of tax is regarded by many as double taxation. Implementation in Canada of a wealth transfer tax would almost certainly give rise to pressures for a significant relaxation of the income tax rules on a deemed realization at death.

Perhaps the most telling point arising from the Committee's study of wealth transfer taxes is that in aggregate, the expected revenues (net of revenue losses from modifying the deemed realization rule at death) would be relatively modest. Few countries have raised more than about 0.5 percent of GDP from wealth transfer taxes¹¹ and the net new revenue realized in Canada would likely be less than this¹² (and might be divided between the federal and provincial governments).

Furthermore, collecting a wealth transfer tax of meaningful size would introduce new complexities into the tax system with resulting increased administration costs for revenue authorities and higher compliance costs for taxpayers. It would also place a tax burden on accumulated savings at a time when Canadians' personal savings rate is arguably inadequate.

In the Committee's view, a wealth transfer tax is not worth the range of difficulties it would be expected to create, and we therefore do not favour the adoption of such a tax.

Annual Wealth Taxes

An annual wealth tax differs from wealth transfer taxes in that the amount of tax is based on the net wealth of an individual measured on a periodic (in this case annual) basis. Canada has never levied such a tax, although a limited number of countries impose an annual tax on the net wealth of individuals, usually with substantial exemptions, special valuation rules and other complexities.

One could view our present income tax system, which imposes tax on all income including that part that is saved, as including a form of personal wealth tax. It is, in effect, a tax on savings from current, taxed income, which are accumulated into wealth. Proponents of the annual wealth tax argue that, since the amount of tax is based on net wealth rather than on the income from such wealth, it has less detrimental effect on individuals' economic behaviour. However, a wealth tax still reduces the return on savings since it imposes a tax as a percentage of value of assets thus reducing the rate of return earned on these assets.

It is sometimes argued that such a tax provides a fairer means of distributing tax burdens than an income tax, in that it requires those who hold substantial assets that do not produce immediate revenues to pay current taxes. Regardless of whether one accepts this argument, however, it is evident to the Committee that an annual wealth tax would constitute a new and additional burden on assets acquired out of savings, and could be expected to discourage Canadians from providing for themselves adequate resources for retirement, education and contingencies.

An equally serious argument against levying annual wealth taxes is that they would further bias our tax system away from the taxation of consumption. There is impressive evidence that consumption taxes are inherently more efficient in economic terms than taxes on income. However, exploring this argument would take us deeply into issues of personal taxation, which are well beyond the Committee's mandate.

Again, as in the case of the wealth transfer tax, some of the strongest objections to implementing an annual wealth tax in Canada are rooted in the social and practical difficulties likely to be created. In addition to taxing the yield of income-producing assets under the existing income tax, the value of certain assets, which constitute a large proportion of wealth held by individuals, is already subject to substantial taxation. The most important is the property tax, applied generally to the value of real estate and levied largely by municipalities. Often, such taxes substantially exceed the value of direct services to the property and hence, are at least in part a wealth tax rather than just a charge for benefits. Similarly, corporate capital (including many types of debt) is also already subject to capital taxes. Including corporate capital in the personal wealth tax base could involve heavy taxation of these assets.

The introduction of a wealth tax (the calculation of which includes real property and corporate debt and shares) on top of the existing taxes could therefore result in a high tax burden.

Serious technical and practical issues would also need to be overcome in order to implement an annual personal wealth tax. Numerous types of assets – shares of private companies, housing, jewellery and other personal assets – are difficult to value accurately given the markets within which they are bought and sold. Taxpayers would also be required to compute and report the amount of all personal liabilities each period. It is a well-understood fact of tax administration that the valuation of net assets for tax purposes is often inherently more difficult than measuring the income that flows from them. Most Canadians have a much clearer idea of their annual income than of their net worth.

On the social side, furthermore, there would be intense pressure to provide relief or grant exemptions for many types of assets – family-owned businesses, farms, pensions, life insurance, intellectual property and so on. The pressure would be felt more particularly with respect to many types of assets that have a significant value, but which produce zero or only modest income out of which a wealth tax could be paid – personal residences, art, some farms and small businesses, for example. Administering a wealth tax is likely to be costly, and indeed, the Committee believes it is only practical to consider such a tax when it is structured and administered together with a personal income tax.

In the matter of revenue generation, the experience of other countries is that levies on wealth do not generate substantial monies for government, while collecting the tax is costly and involves some new intrusions of the government revenue authorities into personal affairs. It does not appear that wealth taxes represent a practical new revenue base for Canada, beyond the present important revenues from property and capital taxes.

The Committee does not favour the adoption of an annual wealth tax in Canada.

Cash Flow Tax

The cash flow tax is a levy on business revenues net of the costs of inputs used by businesses in the production of their goods and services: wages, salaries and benefits paid to labour; current inputs purchased from other businesses, and capital expenditures. The cash flow tax has been an important alternative to income taxation considered by certain leading studies and commissions in other countries.¹³

The Cash Flow Tax in Comparison to the Corporate Income Tax

Since a comprehensive cash flow tax would constitute an alternative to the existing corporate income tax – a mainstay of the current Canadian business tax regime – it is important to understand the differences between them.

The two main differences relate to the base on which the taxes are levied.¹⁴ Under a cash flow tax regime, financial income and expenses are not included in the base. The existing corporate income tax, in contrast, includes financial income in the base while allowing interest expenses to be deducted.¹⁵ Under a cash flow regime, capital is expensed rather than depreciated as under corporate income tax – the familiar capital cost allowance or CCA.¹⁶ When assets are sold, the full value of the sale is subject to tax, while under the income tax, the capital gain (or loss) would be added to (or subtracted from) income.

The net impact of these changes on the size of the tax base is open to some question. The corporate income tax is levied on a base from which businesses deduct capital cost allowances and interest costs on borrowed funds, but from which they cannot deduct the imputed cost of equity finance. Accordingly, the base for the cash flow tax would generally be expected to be narrower than that for the corporate income tax. In practice, however, this is not always the case. To the extent that corporate income taxes are assessed on a base that allows businesses to deduct capital costs more generously than economic costs – or provide tax credits – the cash flow base may be larger than the corporate income tax base for a business.

Cash Flow Tax and a Value-added Tax

The cash-flow tax also bears some similarities to the value-added tax (VAT). Used by many countries under the generic label of VAT – and called the GST in Canada – a value-added tax applies to the sale of goods and services, with a credit for the tax on inputs purchased from other businesses.

As a result, the VAT base is, in principle, equal to revenues net of the cost of current and capital purchases from other businesses. Canada's GST base is thus similar to the cash flow tax base, in that both non-capital and capital expenses are deductible. No financial income is included in the base, and interest expense is not deductible.

There are differences, however: value-added taxes do not allow for wages to be deducted from the tax base, and they are generally applied on a "destination basis" whereby exported goods and services are not subject to tax, while imported goods and services are. In principle, a business cash flow tax could be applied on cash flow gross of wages; it could also be applied on a destination basis by exempting revenues from exports, and disallowing the deduction of the cost of imported goods and services.

Under most cash flow tax proposals, however, the tax would be assessed on an "origin basis" by taxing export revenues and deducting the cost of imports from the tax base. Under the origin basis, the cash flow tax applies to the return on business activities whether exported or consumed in Canada. Under the destination basis, the cash flow would apply to the return on business activity consumed in Canada as well as to imports. There is, however, some presumption that adjustments to the exchange rate would offset the differential impacts of these alternative approaches.

There is another similarity with the GST that is useful to highlight, because it provides a fair indication as to how the tax would be administered. Under the version of the cash flow tax most commonly proposed, financial transactions are excluded from the tax base. If implemented, one would need to rely on rules similar to the current GST in delineating non-financial from financial activity. Special provisions would have to apply to financial and insurance institutions, leasing, and other activities that relate to financial transactions. Financial and insurance firms would likely be exempted from the cash flow tax and taxed under a special regime.¹⁷

The Cash Flow Tax and Flat Taxes

In recent years, various proposals have been brought forward to totally restructure the personal and corporate income tax systems by substituting so-called "flat taxes." While there is considerable variation among these many ideas, a number involve replacing the corporate income tax with a cash flow tax levied at a single rate. As most flat tax proposals concentrate attention on the personal income tax, it is beyond our terms of reference to comment on them. The Committee notes, however, that the essential goal of many flat tax proposals is to achieve lower tax rates with a broader base, a basic thrust of the Committee's recommendations.

Revenues

Any assessment of the relative merits of alternate tax regimes must take into consideration the revenues generated, both in the aggregate and in terms of their volatility over time. The Committee compared a potential cash flow tax base to the current corporate income tax base by industry using 1993 data and excluding consideration of any transitional issues.

If a cash flow tax were assessed on non-financial businesses only, the total (gross) tax base would be equal to \$58.4 billion for 1993. However, cash flow "losses" (situations of negative cash flow) would be equal to \$28.8 billion, which could be carried back or forward to future years, reducing the net ultimate cash flow tax base to as low as \$29.6 billion. This latter figure, which would correspond to the cash flow tax base if losses were fully applied to reduce cash flow, would be smaller than the corporate income tax base, which is about \$35 billion (net of application of prior years' losses).

A cash flow tax base for non-financial transactions in the financial sector would be \$15 billion on cash flow, gross of losses, and minus \$18.7 billion on cash flow, net of losses, for 1993. If a cash flow tax were to raise revenues from the financial sector, a much broader base would need to be considered to include financial transactions.

On the other hand, the size of the cash flow tax base could be larger than the corporate income tax base, if, as is likely, current cash flow losses were restricted in being transferred to other enterprises and substantial cash flow losses expired before an enterprise could use them.

There are in addition – as shown in Annex Table 1 – important differences across industries in terms of the impact of a cash flow tax. Those industries relying on debt finance, or that are able to write off capital at relatively fast rates, could find the cash flow tax base to be greater than the corporate income tax base. Thus, the estimated cash flow tax base, even allowing for the full deduction of losses, was larger than the corporate income tax base for businesses in the public utilities, transportation, communications and manufacturing sectors, at least for 1993.

Annex – Table 1
Cash Flow Tax Base 1993

	Corporate Income Base Prior to Application of Losses	Corporate Income Base	Gross Cash Flow	Cash Flow Losses	Net Cash Flow
(\$ billions)					
Non-financial					
Agriculture, Forestry and Fishing	1.1	1.0	1.5	(1.1)	0.4
Mining	0.5	0.2	1.1	(1.0)	0.1
Oil and Gas	4.0	2.8	4.7	(2.8)	1.9
Manufacturing	14.6	12.1	19.0	(6.8)	12.2
Construction	2.9	2.3	4.3	(3.2)	1.1
Transportation and Storage	1.7	1.2	3.3	(1.2)	2.1
Communications	2.2	1.9	3.4	(0.7)	2.7
Public Utilities	1.3	1.2	1.8	(0.2)	1.6
Wholesale Trade	5.0	4.2	6.2	(2.6)	3.6
Retail Trade	2.7	2.3	4.1	(2.9)	1.2
Other Services	6.6	5.7	8.3	(6.0)	2.3
Other	0.3	0.2	0.7	(0.3)	0.4
Total	42.9	35.1	58.4	(28.8)	29.6
Finance					
Banks	2.2	2.1	0.0	(11.8)	(11.8)
Trust Companies	0.2	0.1	0.1	(2.3)	(2.2)
Other Deposit-taking	1.8	1.8	0.2	(6.0)	(5.8)
Consumer and Business Financing	0.8	0.6	1.3	(1.7)	(0.4)
Investment Intermediaries	6.8	5.0	3.4	(6.0)	(2.6)
Insurance ^a and Other	1.3	1.1	0.8	(1.0)	(0.2)
Real Estate Companies	2.8	1.4	8.6	(4.4)	4.2
Real Estate and Insurance Brokers	0.6	0.5	0.6	(0.5)	0.1
Total	16.5	12.6	15.0	(33.7)	(18.7)

^a Excluding life insurance companies for which the data required to make these estimates were not available.

Note: Components may not sum exactly to totals due to rounding.

Source: Calculations by Committee secretariat, using data and technical assistance provided by the Department of Finance.

Cash Flow Tax Advantages and Disadvantages – Summary

With all the factors outlined above in mind, the Committee examined the possibility of replacing the corporate income tax with a cash flow tax. There are several positive features to the cash flow tax worth noting:

First, the cash flow tax does not treat debt and equity finance differently, while the corporate income tax discriminates against equity finance (interest expense for borrowed money is deductible, but the imputed cost of equity finance is not).

Second, since all capital costs are implicitly deducted from the cash flow tax base, business investment is not discouraged.

Finally, in terms of administration, the cash flow tax can be simpler to comply with than the corporate income tax, since there is no need to compute certain components of income such as economic depreciation costs, capital gains income and possible adjustments for inflation.

Despite these attractive features, however, the Committee does not feel that it would be worthwhile to substitute a cash flow tax for the corporate income tax for the following reasons:

- Under Canada's current tax system, both personal and corporate regimes employ an income base for the purposes of assessment. Switching the corporate tax only to a cash flow base would likely introduce new and unwelcome inconsistencies into the broader tax system. For example, a personal income tax applies to financial income, and individual taxpayers are able to deduct interest expense incurred to earn business or investment income. If the corporate tax is based on cash flow, individuals could avoid personal taxes on financial income by transferring assets to a corporation owned by them. Moreover, a business financed by equity capital provided by shareholders could expense capital expenditures under the cash flow tax. In turn, shareholders could deduct interest expense from taxable income incurred in borrowing funds to finance equity provided to the corporation. A corporate cash flow tax, being inconsistent with a personal income tax would engender inefficiencies and unfairness in the income tax system. However, the cash flow tax could be used as a replacement for other taxes paid by businesses, such as mineral royalties or forest stumpage fees.
- The cash flow tax would not be consistent with the income tax systems used by our major trading partners, and for this reason, would result in additional economic compliance costs. International arbitrage could also exploit the differences in tax systems. For example, a multinational business could finance capital in Canada with foreign debt, and would be able to expense capital in Canada and deduct interest expenses on foreign borrowings in other countries. Although the combination of investment in Canada and the deductibility of interest expenses elsewhere might encourage investments by multinationals, we could expect our major trading partners to react negatively. Moreover, smaller domestic firms would be at an economic disadvantage since they would not have the same access to international financial markets as large firms.
- It is far from clear that the cash flow tax would be a creditable tax under current U.S. and other foreign tax rules as corporate income taxes are now.¹⁸ If, for example, cash flow taxes were deductible from U.S. foreign income rather than credited against U.S. taxes, then U.S. and other multinationals operating in Canada would face higher overall taxes on their income earned in Canada, and their investments here could decline.
- If a cash flow tax were adopted as a replacement for the corporate income tax, lengthy and complex transition arrangements would be necessary, since, in the absence of such arrangements, businesses would not be able to deduct depreciation and interest expenses associated with assets and liabilities acquired prior to the implementation of the reform. These transitional rules would significantly reduce cash flow tax revenues, and would complicate compliance and administration for many years.

- The cash flow tax base can be highly variable and the incidence of losses can be significant¹⁹ due to the expensing of all current and capital expenditures. If businesses cannot fully use cash flow losses, they will seek transactions that would allow losses to be transferred to other firms that are paying cash flow taxes, thereby creating instability in the tax base. The government could react by curtailing mechanisms used to effect the transfer of losses but at the cost of increased complexity in the tax system.

Committee's View of the Cash Flow Tax

Assessed only on economic grounds, the Committee believes that the cash flow tax could be a good replacement for the corporate income tax. However, these perceived advantages are outweighed by the substantial international and administrative issues discussed above. Canada could adopt a cash flow tax at this time only with great difficulty. The Committee also considered the cash flow tax as an add-on tax levied at a low rate (2 percent) to replace a portion of either corporate income tax or capital tax revenues. The Committee does not recommend an add-on cash flow tax for two reasons. First, there would be considerable complexity associated with the add-on cash flow tax, particularly with respect to the treatment of losses and financial transactions. Second, most of the economic virtues of the cash flow tax are lost, since the level of tax, and thus the extent of replacement of other less efficient taxes, would be relatively small.

Endnotes

- ¹ Tobin (1974) and Haq, Kaul, and Grunberg (1996).
- ² Toronto Star (1996). See also Grant (1997).
- ³ See Greenaway (1995).
- ⁴ See Campbell and Froot (1994).
- ⁵ Imposing a transactions tax on new issues in primary markets would increase the cost of external finance relative to the cost of internal finance (retained earnings), which would discriminate against younger, rapidly growing firms with capital requirements that outstrip their current resources. For these reasons, it is doubtful that a transactions tax would be imposed on new issues of securities (a 1990 proposal in the United States did not apply to primary transactions).
- ⁶ A 0.25 percent tax on transactions in 30-day commercial paper, for example, would likely drastically reduce the attractiveness of these instruments, relative to longer-term instruments, which are taxed less frequently.
- ⁷ See Organization for Economic Co-operation and Development (1997b). Taxes on property and wealth were \$30 billion, including, in the OECD's terminology "recurrent taxes on immovable property" (real property taxes) of \$25 billion and "recurrent taxes on net wealth" (corporate capital taxes) of \$3.3 billion.
- ⁸ The wealth transfer tax field was abandoned by the federal government in 1972, when it introduced, for the first time, capital gains taxes, including deemed realization of gains at death. Provinces later repealed their succession duties, the last being Quebec in 1985. Provinces still levy probate fees and land transfer taxes.
- ⁹ Still others have argued that a wealth transfer tax is indeed appropriate under a consumption tax system, since the act of bequeathing wealth is a form of consumption that should be taxed like other types of consumption. See Meade (1978).
- ¹⁰ Bird (1991).
- ¹¹ Organization for Economic Co-operation and Development (1997b).

- ¹² The Ontario Fair Tax Commission suggested that a wealth transfer tax of 30 percent on estates exceeding \$1 million with an exemption for transfer to spouses might raise about \$640 million in 1989 for Ontario or, given Ontario's share of total wealth (45 percent), about \$1.5 billion for Canada representing less than 0.25 percent of GDP in 1989. See Ontario, Fair Tax Commission (1993).
- ¹³ See Meade (1978) and United States, Department of the Treasury (1977). The Royal Commission on the Economic Union and Prospects (Canada, Royal Commission on the Economic Union and Development Prospects for Canada (1985)) proposed the consideration of the cash flow tax. Despite the interest in cash flow taxes, only one country, Croatia, has adopted a form of cash flow tax as a general tax on the corporate sector. However, British Columbia, Saskatchewan and Australia have adopted a form of cash flow tax on mining businesses.
- ¹⁴ As pointed out in the Meade Report (Meade (1978)), the cash flow tax would essentially apply to "economic rents," which is the return to owners over and above the compensation paid to inputs that could be used elsewhere in other economic activities. In principle, the corporate income tax applies to both economic rents and the return paid to shareholders as compensation.
- ¹⁵ As emphasized by the Meade Report (Meade (1978)), there are alternative cash flow taxes that could include financial transactions. One base would include financial transactions by taxing any borrowings that add to cash flow and deducting the repayment of principal and interest from the tax base that reduce cash flow. Similarly, financial loans would be deductible from the cash flow base, and financial income and the repayment of the loan's principal would be subject to tax.
- ¹⁶ In principle, the expensing of capital under the cash flow tax is equivalent to the deduction of the real annual economic costs of holding capital over the life of the asset. These annual economic costs include depreciation, the interest cost of debt finance and the imputed interest cost of equity finance, all adjusted for inflation.
- ¹⁷ The inclusion of financial flows in the general cash flow tax would require the tracking of financial income and expenses, as well as assets and liabilities. This approach is being considered in the European Union for assessing VAT on financial institutions only.
- ¹⁸ U.S. law permits withholding and corporate income taxes on foreign income to be credited against U.S. tax on income remitted to the United States. For a tax to qualify for crediting, gross income must be subject to tax and costs, and similar to the U.S. income tax, must be deducted. Recently, Bolivia considered imposing a cash flow tax but the U.S. Treasury argued that the tax would not be creditable. See McLure and Zodrow (1996).
- ¹⁹ One could smooth the cash flow tax base over time and reduce the incidence of losses by requiring businesses to depreciate rather than "expense" capital purchases and carry forward the undepreciated capital cost base indexed at a rate of interest to recognize timing differences.

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List of Recommendations

Chapter 4: Modernizing the Corporate Income Tax – Provisions of General Application

The General Corporate Income Tax Rate

(p. 4.5) “The Committee proposes that the general federal and provincial corporate income tax rates be lowered, after a transitional period, to 33 percent on average. We recommend a general federal rate of 20 percent, and we suggest that provincial rates could be reduced on average by one point to 13 percent from the revenues generated from base-broadening. The Committee also recommends that the federal corporate income surtax for both large and small businesses be repealed.”

Capital Cost Allowances

(p. 4.11) “We recommend that special incentive rates of capital cost allowances – rates that appear to be substantially in excess of economic depreciation – be phased out or reduced over a transitional period. Specifically, we suggest that the neutrality and allocative efficiency of the system would be enhanced by the following measures:

- The capital cost allowance write-off rates applied to class 38 and 43 (including earth-moving equipment and manufacturing and processing assets) be reduced from 30 percent to 25 percent.
- The items included in class 12 (including tools, library books and computer software) be reviewed, and those items with a significant cost and a useful life of four years or more should be moved into a new class with a 50 percent annual rate instead of the present 100 percent rate applied to class 12.
- The generous write-off rates on Canadian-built and other vessels should be reviewed.”

(p. 4.11) “We recommend that the government review the classification and rates of allowance for capital assets for income tax purposes to ensure they take into account economic lives.”

Losses for Tax Purposes

(p. 4.18) “The federal government should consider, in consultation with the provinces, some formal system for transferring losses between members of the same corporate group, starting with a review of the 1985 federal discussion paper.”

(p. 4.18) “The federal government should review the right of taxpayers to claim various deductions on a discretionary basis, with a view to moving toward a better measure of annual income for tax purposes and eliminating inappropriate advantages provided to some taxpayers.”

(p. 4.18) “Given the Committee’s proposed reductions in corporate income tax rates, adjustments should be made to flow-through share rules to reflect the new relationship between corporate and personal income tax rates.”

Corporate Capital Tax

(p. 4.22) “We recommend that federal and provincial governments harmonize their capital tax bases to reduce compliance and administration costs.”

Chapter 5: Modernizing the Corporate Income Tax – Specific Provisions

Small Business

(p. 5.10) “The Committee recommends that, as the general rate of corporate income tax is reduced, the federal corporate income tax on income eligible for the small business deduction should also be reduced. This reduction should be concentrated on those small businesses that create and maintain jobs. Specifically, the Committee recommends that the federal income tax rate applied to small businesses should range from 11 percent to 14 percent (with an expected average of about 12.5 percent instead of the current rate of 13.12 percent including surtax), and that the rate should vary with each corporation’s level of employment. We also suggest that the provinces should reduce their small business tax rates by one percentage point, on average. This revenue loss would be offset by the additional revenues received from base-broadening.”

Tax Incentives to Promote Research and Development

Current and Capital Expenditures

(p. 5.18) “The Committee recommends that the immediate deductibility of SR&ED capital assets be phased out. As a result, SR&ED capital assets that are not specially designed or adapted for research purposes, such as furniture, transportation equipment, or non-specialized computers, would be included in the capital cost allowance class in which they would normally fall. Specialized research equipment and other assets, including special purpose structures, should be placed in a new class with a 35 percent declining balance rate.”

The Overall Level of Tax Support for R&D

(p. 5.21) “The Committee recommends that the general SR&ED tax credit be reduced for large companies, after a transition, to 15 percent from 20 percent, and that the enhanced rate for small business be reduced by a similar proportion, to 27 percent from 35 percent. The reduction in the credit should be phased in over a period of years concurrent with the reduction in corporate income tax rates.”

Refundability

(p. 5.21) “We recommend that qualifying smaller enterprises be able to obtain a full refund of the SR&ED credit, not only for current spending but also for capital spending, within the same overall limit, to assist the financing of such assets.”

Resource Industries

Resource Allowance

(p. 5.31) “The Committee recommends that the federal government consider, after consultation with the provinces, the restructuring of the resource allowance to base it on income from resource activities, net of all deductions, at the current rate of 25 percent.”

(p. 5.31) “We recommend that any changes along the foregoing lines should occur only after an appropriate transition of at least five years.”

(p. 5.31) “We also recommend that the gradual lowering of the general corporate tax rate recommended in this Report should not apply to resource income until such consultations have been carried out, and the interrelation between the base broadening and general rate reduction proposals as applied to this industry and the restructuring of the resource allowance have been fully reviewed.”

Write-off Rates for Capital and Intangible Expenditures

(p. 5.32) “We recommend that the maximum rate of write-off on development costs in both mining and oil and gas should be reduced from 30 percent to 25 percent of the declining balance for expenses incurred after a three-year period of advance notice.”

(p. 5.32) “We recommend that capital costs incurred in connection with new mines or major expansions of existing mines should not be immediately claimable in full against the income from the project. Rather, such costs should be placed in a new class and only be deductible up to a maximum of 25 percent of the declining balance. The recommendation would only apply after a five-year period of advance notice.”

(p. 5.32) “We recommend that the cost of acquiring new mining properties should, as in the case of oil and gas, be treated as a capital cost, deductible at a 10 percent annual rate after transition.”

Atlantic Investment Tax Credit

(p. 5.33) “The Committee recommends that the Atlantic Canada Investment Tax Credit be phased out and replaced by a broad-based, cost effective program of development assistance for the Atlantic region that would not involve the tax system.”

Financial Institutions

(p. 5.37) “The Committee recommends that, to the extent that our proposals in total result in a decrease in the amount of tax paid by the industry, the government should impose a temporary increase in the federal capital surtax on deposit-taking institutions and insurance companies to make up the difference. This surtax should be removed at the time that the government, following the review of our Report and the report of the Task Force, implements a long-term and integrated package of changes in the regulation and taxation of the industry.”

Chapter 6: International Taxation

Taxation of Foreign Income of Canadian Investors

(p. 6.10) “We recommend that the present definition relating to foreign affiliates be strengthened, so that only foreign companies in which Canadian corporations have a significant equity interest can be considered as foreign affiliates.”

Interest Expense Related to Foreign Investment of Canadian Investors

(p. 6.18) “The Committee recommends that interest expense of Canadian taxpayers on indebtedness incurred to invest in foreign affiliates should be disallowed.”

(p. 6.18) “The tracing method should be used for purpose of identifying the amount of indebtedness allocable to investments in foreign affiliates.”

(p. 6.18) “Interest expense that is disallowed should be added to the tax basis of the shares of the relevant foreign affiliate, and accumulated in a ‘disallowed interest account’.”

(p. 6.18) “To prevent small start-up businesses which must resort to borrowing in Canada from being penalized, and also to address the administrative and compliance burden on small and medium-sized business, we recommend an exemption for up to \$10 million of accumulated indebtedness related to investments in foreign affiliates (with the exemption to be shared among members of an associated group).”

(p. 6.18) “Indebtedness incurred or committed to under existing rules should be exempted from the new regime or be eligible for a generous transition period.”

Foreign Accrual Property Income

(p. 6.22) “We recommend that the FAPI exemption for interaffiliate transactions be maintained, but that such payments be included in taxable surplus where the income is received by an entity that, while located in a tax treaty jurisdiction, is expressly denied benefits under that treaty.”

(p. 6.22) “We recommend that the government actively renegotiate its existing tax treaties, to ensure that all tax-privileged entities in treaty countries are denied access to the exemption system with respect to income from interaffiliate transactions.”

(p. 6.22) “The Committee recommends that the provision that provides FAPI exemption for payments from related non-resident corporations that are not foreign affiliates of the Canada taxpayer, be revised to exclude situations in which related party status arises solely as a result of share ownership by foreign parent companies outside Canada.”

(p. 6.23) “The Committee recommends that foreign trust structures identified by Revenue Canada be challenged in the courts, in circumstances in which the trust income may be subject to the FAPI rules, and that, if such challenges prove to be unsuccessful, appropriate amendments be made to the tax legislation.”

Taxation of Income of Non-resident Investors

Withholding Taxes

(p. 6.26) “The Committee recommends that the withholding tax exemption for interest payments to arm’s-length non-resident lenders be extended to all indebtedness, regardless of its term.”

(p. 6.26) “We also recommend that the exemption be denied in circumstances involving back-to-back transactions and similar financial support arrangements, in the same manner as discussed below under the thin capitalization provisions.”

Thin Capitalization Rules

(p. 6.30) “The Committee recommends that the existing thin capitalization ratio of 3-to-1 should be revised to 2-to-1, as a closer proxy for financing that would generally be available in an arm’s-length context.”

(p. 6.30) “The thin capitalization rules should be revised so that they apply, not only to investments in Canadian corporations, but also to Canadian branches of foreign corporations, and to partnerships and trusts.”

(p. 6.30) “The existing provisions with respect to back-to-back arrangements using third-party intermediaries should be strengthened to include all indebtedness (such as amounts on deposit) between a specified non-resident and a third party, where all or a portion of the amount may reasonably be considered to have been loaned or transferred, directly or indirectly, by the third party to a Canadian business.”

Non-resident-owned Investment Corporations (NROs)

(p. 6.31) “The Committee recommends a repeal of the NRO provision, subject to a transitional period.”

Chapter 7: Integration

Integration of the Corporate Income Tax

(p. 7.11) “The Committee recommends the adoption of a system of corporation distribution tax (CDT) and dividend tax credit.”

Capital Gains Taxation

(p. 7.18) “The Committee recommends elimination of the enhanced lifetime capital gains exemption for farm property and qualifying shares of small business corporations, with transitional relief for all gains accrued to the date of the change (to be obtained by election similar to that used for the 1994 repeal of the general lifetime capital gains exemption).”

(p. 7.18) “The Committee also recommends that the exemption be replaced by an enhanced RRSP contribution system that would allow taxpayers to use taxable capital gains on farm property and qualifying small business shares that are earned in a year to increase their RRSP contribution room for previous years, up to the maximum room that would be available if they had had sufficient earned income.”

Chapter 8: Taxes as User Charges: Employer Contributions to Employment Insurance

(p. 8.12) “The Committee recommends that employer contributions under the Employment Insurance program be set so as to give weight to employer layoff experience on an employer-by-employer basis. Further, we recommend that this be introduced as reductions in average employee and employer contribution rates occur over the next few years.”

Chapter 9: Taxes as User Charges: Environmental Taxes

(p. 9.16) “The Committee recommends that the federal government, in co-ordination and consultation with the provinces, consider replacing the federal fuel excise tax with more broadly based environmental taxes that raise equivalent revenue and that are designed to reduce emissions of pollutants and environmentally damaging activities.”

Chapter 10: Compliance and Enforcement

Coping with the Multiplicity of Taxes

(p. 10.5) “The Committee recommends that a task force made up of federal and provincial officials, with the assistance of tax specialists and members of the business community, lead the development of harmonized federal and provincial legislative and tax compliance measures to provide Canadian businesses with a reduced compliance burden.”

(p. 10.5) “The Committee recommends harmonization of the administrative provisions in legislation that is currently administered by Revenue Canada (such as the *Customs Act*, *Excise Act*, *Excise Tax Act*, and *Income Tax Act*).”

Understanding Tax Law

(p. 10.5) “The Committee recommends that new tax legislation be drafted using language and structure (for example, shorter sentences and divisions of text) that facilitate ease of understanding, and that selected portions of existing legislation should be redrafted on this basis.”

Tax Administration

Risks of Litigation

(p. 10.8) “The Committee recommends that settlement of disputes regarding taxpayers’ liability for tax be further encouraged by introducing a legislative mechanism that would authorize Revenue Canada, in appropriate circumstances, to enter into compromise arrangements on the basis of ‘risks of litigation’. The terms of any such compromise should be approved by senior officials.”

Collectibility of Taxes Owing

(p. 10.10) “The Committee recommends that, in order to improve taxpayer compliance and the collection of taxes, Revenue Canada be further empowered to apply principles of commercial practice to settle outstanding amounts based on its anticipated ability to collect unpaid amounts, having regard to the assets potentially available for collection and risks of reduced collections. The terms of any such settlement should be approved by senior officials and, in order to demonstrate the integrity of the process, should be made publicly available.”

Penalties

(p. 10.12) “The Committee recommends the addition of new civil penalty provisions that would have the effect of expanding the scope of the provisions currently contained in subsection 163(2) of the *Income Tax Act* to provide for the imposition of penalties on third parties who knowingly, or under circumstances amounting to gross negligence, participate in or otherwise promote or assist, conduct that results in the making of a false statement or omission in a return (as described in the subsection 163(2)).”

Chapter 11: Federal-Provincial Issues

Approaches for Improving Tax Co-ordination

(p. 11.8) “The Committee recommends that the federal government and the three provinces not now participating in tax collection agreements with respect to corporate income taxes make every effort to conclude agreements for the benefit of taxpayers in these provinces. The Committee also recommends that, should capital taxes be harmonized, as we recommend, tax collection agreements be considered for these taxes as well.”

(p. 11.9) “The Committee recommends that the federal and provincial governments use a common neutral base, and a common method of allocating income and capital subject to corporate tax in each jurisdiction.”

(p. 11.9) “We further recommend that, if either the federal or a provincial government wishes to provide incentives through the tax system or to obtain additional tax revenues from business, that government should use tax credits or surtaxes rather than altering the common tax base.”

Deductibility of Profit-insensitive Taxes

(p. 11.13) “The Committee recommends that provincial capital taxes should not be deductible from the corporate income tax following an appropriate transition period, and that federal capital taxes should remain not deductible.”

Technical Committee on Business Taxation

Terms of Reference^{1,2}

Canadians want their tax system to generate revenue in a fair and simple manner. They also want it to encourage economic growth and job creation. Given the complexity of combining these objectives, the Government of Canada has decided to undertake a review of those aspects of tax law that most affect the creation of jobs.

The review will be conducted by a Technical Committee on taxes related to investment and business activity. The Committee will be asked to examine business taxes and taxes paid on business income, in order to assess both the level and mix of these taxes. The Committee will also consider how compliance and administrative costs can be reduced. Their assessment will be conducted with a view to the following general objectives:

- improving the tax system to promote job creation and economic growth in an open economy;
- simplifying the taxation of business income to facilitate compliance by taxpayers and administration by Revenue Canada; and
- enhancing fairness in the tax system by ensuring that all businesses share the cost of providing government services.

In addition, the assessment will consider the interaction between taxes paid by business – including corporate income, capital and payroll taxes – and taxes paid by individuals on income derived from investments.

Through its review, the Committee will take into account the following two factors influencing the current tax system:

- fiscal constraints faced by the federal and provincial governments, and
- the need to co-ordinate federal and provincial taxes.

The Technical Committee will report to the Minister of Finance later this year³. Consultations with the public will follow the release of this report.

¹ As stated in Department of Finance news release of March 6, 1996.

² In the *Budget Plan*, March 6, 1996, p. 164, the Technical Committee was also asked “to assess the resource tax provisions as part of its review of the business tax system which is focused on encouraging investment, creating jobs and simplification.”

³ Revised, in Department of Finance news release of November 5, 1996, to by “the end of 1997.”

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List of Technical Committee Working Papers

Released: March 1997

Working Paper 96-1

Comparison and Assessment of the Tax Treatment of Foreign-Source Income in Canada, Australia, France, Germany and the United States

Brian Arnold (Goodman Phillips & Vineberg)

Jinyan Li and Daniel Sandler (University of Western Ontario)

Working Paper 96-2

Why Tax Corporations?

Richard M. Bird (University of Toronto)

Working Paper 96-3

Tax Policy and Job Creation: Specific Employment Incentive Programs

Ben Cherniavsky (Technical Committee Research Analyst)

Working Paper 96-4

The Effects of Taxation on U.S. Multinationals and Their Canadian Affiliates

Jason G. Cummins (New York University)

Working Paper 96-5

The Integration of Corporate and Personal Taxes in Europe:

The Role of Minimum Taxes on Dividend Payments

Michael P. Devereux (Keele University)

Working Paper 96-6

International Implications of U.S. Business Tax Reform

Andrew B. Lyon (University of Maryland)

Working Paper 96-7

The Economic Effects of Dividend Taxation

Kenneth J. McKenzie (University of Calgary)

Aileen J. Thompson (Carleton University)

Working Paper 96-8*Capital Tax Issues*

Peter E. McQuillan and E. Cal Cochrane (KPMG, Toronto)

Working Paper 96-9*Compliance Issues: Small Business and the Corporate Income Tax System*

Plamondon and Associates Inc. (Ottawa)

Working Paper 96-10*Study on Transfer Pricing*

Robert Turner (Ernst & Young, Toronto)

Working Paper 96-11*The Interaction of Federal and Provincial Taxes on Businesses*

Marianne Vigneault (Bishop's University)

Robin Boadway (Queen's University)

Working Paper 96-12*Taxation of Inbound Investment*

W.G. Williamson and R.A. Garland (Arthur Andersen, Toronto)

Released: October 1997**Working Paper 97-1***The Sensitivity of the Corporate Income Tax to the Statutory Rate*

Peter Dungan, Steve Murphy, Thomas A. Wilson (University of Toronto)

Working Paper 97-2*The Income Tax Compliance Burden in Canadian Big Business*

Brian Erard (Carleton University)

Working Paper 97-3*Taxes, the Cost of Capital, and Investment:**A Comparison of Canada and the United States*

Kenneth J. McKenzie (University of Calgary)

Aileen J. Thompson (Carleton University)

Forthcoming

Working Paper 97-4

Tax Policy and the Dynamic Demand for Domestic and Foreign Capital by Multinational Corporations

Rosanne Altshuler (Rutgers University)

Jason G. Cummins (New York University)

Working Paper 97-5

Tax-exempts and Corporate Capital Structure: An Empirical Analysis

Thomas A. Wilson and Steve Murphy (University of Toronto)

Working Paper 97-6

A Critical Review of the Empirical Research on Canadian Tax Compliance

Brian Erard (Carleton University)

Working Paper 97-7

The Incidence of the Corporate Tax Revisited

John Whalley (Universities of Western Ontario and Warwick, and NBER)

Working Paper 97-8

Efficiency Considerations in Business Tax Reform

John Whalley (Universities of Western Ontario and Warwick, and NBER)

Working Paper 97-9

Tax-exempt Organizations and the Financing of Taxable Businesses

Thomas E. McDonnell (The McDonnell Consulting Corporation, Toronto)

Working Paper 97-10

Tax-exempts and Corporate Capital Structure: An Analysis of Efficiency and Revenue Implications

James Pesando, Michael Smart and Thomas A. Wilson (University of Toronto)

Working Paper 97-11

Business Taxation of SMEs in Canada

Kenneth Hendricks, Raphael Amit, and Diana Whistler (University of British Columbia)

Working Paper 97-12

The Income Tax Compliance Burden on Small and Medium-sized Canadian Businesses

Brian Erard (Carleton University)

Working Paper 97-13

Effects of the Treatment of Tax Losses on the Efficiency of Markets and the Incidence of Mergers

Michel Poitevin (Université de Montréal)

Working Paper 97-14

Tax Reforms, Debt Shifting and Tax Revenues: Multinational Corporations in Canada

Vijay Jog (Carleton University) and Jianmin Tang (Technical Committee secretariat)

Working Paper 97-15

The Calculation of Marginal Effective Tax Rates

Kenneth J. McKenzie (University of Calgary), Mario Mansour (Department of Finance) and

Ariane Brûlé (Technical Committee secretariat)

Working Paper 97-16

Analysis of National Pollutant Release Inventory Data on Toxic Emissions by Industry

Nancy Olewiler and Kelli Dawson (Simon Fraser University)

Working Paper 97-17

The Evolution of Business Taxes in Canada: Data and Estimates

John H. Sargent, Claude Bilodeau, Jeanine Hage and Mindy Sichel (Technical Committee secretariat)

**Joint Study with the Task Force
on the Future of the Financial Services Sector**

The Task Force and the Technical Committee jointly commissioned a research study on the taxation of financial institutions, by Kevin Dancey (Coopers & Lybrand) and Kenneth J. McKenzie (University of Calgary). On completion, this study is expected to be released by the Task Force.