ANNEX IV

CORPORATE TAX HARMONIZATION —
CREATING A MORE COMPETITIVE TAX CLIMATE FOR BUSINESS

CREATING A MORE COMPETITIVE TAX CLIMATE FOR BUSINESS

Strengthening Ontario's competitiveness requires creating a climate for investment growth while ensuring that the government has the resources it needs to make strategic investments in the people and economy of the province.

A competitive tax system is essential to attract business investment and foster economic growth in a highly competitive global economy. Ontario already has a competitive corporate tax system. Ontario's combined federal–provincial statutory corporate income tax rate for manufacturing is below the average for the United States. It is also below the combined rate in each of the Great Lakes states against which Ontario competes most directly.

To further enhance Ontario's investment climate, the Ontario capital tax is being phased out. The capital tax, which taxes business investment rather than profits, is widely recognized as a barrier to investment. As a key element of the government's strategy to promote new investment, economic growth and job creation, a plan to eliminate Ontario's capital tax by 2012 was legislated. The 2006 Ontario Budget built on that plan by accelerating the capital tax rate cut. Starting on January 1, 2007, every corporation still paying capital tax will have its rate cut by five per cent.

The following table sets out the legislated capital tax elimination plan:

ONTARIO'S CAPITAL TAX ELIMINATION PLAN[1]

		Rates (%)			
			Financial Institutions		
				Taxable Capital Above $400 M	
	Deduction ($ M)	Regular Corporations	1st $400 M of Taxable Capital	Non-Deposit Taking	Deposit Taking
Jan. 1, 2004	5	0.3	0.6	0.72	0.9
Jan. 1, 2005	7.5	0.3	0.6	0.72	0.9
Jan. 1, 2006	10	0.3	0.6	0.72	0.9
Jan. 1, 2007	12.5	0.285	0.57	0.684	0.855
Jan. 1, 2008	15	0.285	0.57	0.684	0.855
Jan. 1, 2009	15	0.225	0.45	0.54	0.675
Jan. 1, 2010	15	0.15	0.3	0.36	0.45
Jan. 1, 2011	15	0.075	0.15	0.18	0.225
Jan. 1, 2012	Eliminated				

[1] Shading denotes the five per cent capital tax rate cut announced in the 2006 Ontario Budget and enacted on May 18, 2006.

Ontario's tax system also provides a variety of corporate income tax incentives and rate reductions to encourage economic growth and job creation. These include[1]:

- $380 million in annual support for research and development through Ontario-only tax deductions and tax credits
- $900 million annually to provide a reduced tax rate for small businesses
- $255 million annually to provide a reduced tax rate on income from manufacturing and processing, mining, logging, farming and fishing
- $150 million annually in tax credits to support the entertainment and creative industries.

To further support job creation and Ontario's competitiveness, the government has introduced or enhanced a number of income tax credits:

- The Apprenticeship Training Tax Credit was implemented to encourage the hiring and training of apprentices.
- Tax credits for film and television production, computer animation, sound recording, book publishing and interactive digital media have been enhanced.
- A new, enhanced dividend tax credit is proposed, starting in 2006, that would encourage greater investment in Ontario corporations and better integrate the corporate and personal income tax systems. Ontario taxpayers would pay less tax on their dividends from large Canadian companies, which would, in turn, create a more competitive business and investment climate. This would provide a benefit to investors of $40 million in 2006–07, rising to $120 million when fully implemented in 2010–11.

While a competitive tax system is an important element in enhancing Ontario's attractiveness as a place to invest, other factors also play a key role in business location decisions. For example, publicly funded health care is a major competitive advantage for the province. Ontario has numerous other competitive strengths, including a well-trained labour force, proximity to markets and a high quality of life. The Ontario Government continues to make key investments in infrastructure, health, education and innovation to help strengthen Ontario's business environment.

A 2006 study by KPMG found that the overall cost of doing business in Ontario (including taxes paid by businesses) is below that of most major cities in the United States and other industrialized countries. In fact, among the 24 large cities in the G7 featured in that study, Toronto had the third-lowest cost of doing business.

[1] Annex V, *Transparency in Taxation*, provides a detailed listing of tax measures provided by Ontario.

CORPORATE TAX HARMONIZATION[2]

The government is taking additional action to further reduce the cost of doing business in Ontario. The Canada–Ontario Agreement of May 2005 committed both governments to work towards concluding an agreement on a single corporate tax administration.

On October 6, 2006, Ontario entered into a Memorandum of Agreement (MOA) with the federal government to streamline the administration of Ontario's corporate tax system. As a result, Ontario businesses will spend less time on paperwork, and more time creating jobs and fostering a strong, prosperous economy.

When fully implemented, Ontario corporations will save $90 million annually in Ontario corporate income tax from a harmonized corporate income tax base and up to an additional $100 million annually in compliance costs from one tax form, one tax administration and one set of tax rules.

SINGLE TAX ADMINISTRATION

The MOA on a single corporate tax administration represents a major step in the government's goals of providing greater efficiency in service delivery and creating a stronger, more productive and competitive economy.

Effective for taxation years ending after December 31, 2008, Ontario corporations will begin filing a single combined federal and Ontario corporate tax return with the Canada Revenue Agency (CRA). Businesses will begin remitting Ontario tax instalment payments to the CRA as early as February 2008.

The CRA will collect and administer Ontario's corporate income tax, capital tax, corporate minimum tax and the special additional tax on life insurers. The CRA administration of these taxes will include assessments, collections, audits and appeals.

In addition, the MOA allows for the delivery of early compliance gains to business, including more coordinated audits and other administrative efficiencies, prior to the single administration in 2009.

CORPORATE INCOME TAX BASE HARMONIZATION

As part of the single tax administration, Ontario will enter into a corporate income tax collection agreement with the federal government that is substantially similar to agreements currently in place with all other provinces, except Quebec and Alberta. Ontario already has a tax collection agreement with the federal government for its personal income tax.

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[2] Federal administration of Ontario corporate taxes and consequential tax proposals will require legislative amendments that must be approved by the legislature.

The Ontario corporate income tax collection agreement, like those of other provinces, will require Ontario to fully harmonize with the federal definition of corporate taxable income. As a result, any Ontario differences from the federal definition of taxable income will expire for taxation years ending after 2008.

To improve Ontario's competitiveness and enhance the benefits of tax base harmonization, most Ontario-only measures that currently apply in calculating Ontario taxable income will not be replaced. Eliminating these differences from the federal tax base will provide business with an Ontario corporate income tax cut of $90 million a year.

The most significant measure that Ontario will not be replacing is the income tax provision that requires an Ontario-based corporation to add back into income a portion of certain management fees, rents, royalties and other similar payments made to certain non-residents. This add-back provision generally has the effect of imposing a five per cent tax on these payments. Eliminating the add-back will provide an estimated $70 million annual tax reduction that will primarily benefit the manufacturing, wholesale and retail trade, and film production sectors, and help foster a more innovative and competitive economy.

The remaining $20 million net annual cut in Ontario corporate income tax will arise from eliminating other Ontario tax measures in order to harmonize with the federal definition of taxable income.

Support for Research and Development

Ontario currently provides $380 million annually in corporate income tax incentives to support research and development (R&D). One of these incentives is a deduction for the portion of the federal investment tax credit that relates to Ontario scientific research and experimental development (SR&ED). This deduction has the effect of enhancing the value of the federal SR&ED investment tax credit for Ontario corporations. However, as an Ontario-only deduction, it does not conform to the requirements of a harmonized tax base.

Given the importance of R&D to a vibrant, innovative and competitive economy, Ontario will replace this deduction with a new 4.5 per cent non-refundable tax credit on SR&ED expenses incurred in Ontario that qualify for the federal investment tax credit. A phased-in three-year carry-back and a 20-year carry-forward will be provided for unused credits. The tax credit will take effect for taxation years ending after 2008.

The tax credit rate has been set to maintain the same revenue cost to Ontario as the R&D deduction. Ontario's R&D deduction will provide an estimated $200 million of tax support in 2006. By converting the R&D deduction to a tax credit, this tax support would now become taxable for both federal and Ontario tax purposes. While the tax credit rate has been designed to be revenue-neutral to Ontario, the federal government would receive an annual revenue windfall of about $40 million (based on the current $200 million estimate) from the taxation of the credit.

Support for Ontario's Mining Sector

To support jobs and investment in the mining sector, the 2004 Ontario Budget announced that Ontario would not parallel federal legislation to replace the resource allowance with a typically less generous deduction for mining taxes and Crown royalties.

For taxation years ending after 2008, Ontario will be required to follow the federal deduction for mining taxes and royalties. However, to maintain the effect of Ontario's existing resource allowance, a tax credit/debit mechanism, with an indefinite carry-forward for unused credits, will be introduced.

Maintaining the effect of the existing resource allowance will continue to provide an annual benefit of about $40 million, net of the deduction for mining taxes paid, to the mining sector in Ontario's northern communities.

Transitional Rules for Income Tax Base Harmonization

The requirement to parallel the federal definition of taxable income means that federal "pools" for items such as unclaimed depreciation and losses will apply for Ontario purposes starting with taxation years ending after 2008.

Ontario generally parallels federal income tax base changes in order to reduce compliance costs to business. As a result, many corporations do not have significant differences in their tax pools for Ontario and federal purposes. In some cases, however, differences may arise where corporations have deducted different amounts from their tax pools for Ontario and federal purposes.

In the absence of transitional rules, the use of federal tax pools could cause Ontario corporate income tax to be either overstated or understated.

To ensure a smooth transition to the federal tax base, Ontario will introduce a mechanism that is designed to eliminate, over five years, the amounts by which Ontario corporate income tax is overstated or understated.

Ontario will be consulting with the business community on the details of the transitional rules.

CAPITAL TAX BASE HARMONIZATION

Until Ontario's capital tax is eliminated, harmonizing with the federal corporate income tax base will require changes to the calculation of Ontario capital tax. Currently, corporations that are not financial institutions calculate their Ontario taxable capital by restating the balance sheet into Ontario corporate income tax values. Since corporations will no longer be calculating Ontario corporate income tax values after 2008 as a result of income tax base harmonization, Ontario will need to move to a new method of calculating taxable capital.

To further enhance business compliance savings and administrative efficiencies for the Ontario and federal governments, Ontario's capital tax base for non-financial institutions will be harmonized with the federal Large Corporations Tax (Part I.3 of the *Income Tax Act* (Canada)). Ontario's legislated capital tax elimination schedule will continue to apply. In the case of corporations with permanent establishments in Ontario and elsewhere, the capital tax liability will also continue to be reduced to reflect the percentage of income allocated outside Ontario.

Since Ontario's capital tax for financial institutions is already largely harmonized with the federal capital tax, no policy changes are required with respect to the Ontario capital tax for financial institutions, except that it will be administered by the CRA for taxation years ending after 2008.

BENEFITS TO PROVINCES

The MOA contains a number of provisions that will benefit Ontario and other provinces that participate in a corporate income tax collection agreement. These include:

- a federal–provincial review to ensure the provinces are not disadvantaged by the current timing of federal tax payments
- $25 million in annual federal funding for a national initiative to be led by the CRA, comprising enhanced audits of interprovincial income allocation and targeting of interprovincial tax avoidance
- a federal–provincial study on the feasibility of developing a program that would allow corporate income tax refunds to be applied against other provincial and federal tax debts
- an improved management and accountability framework with the CRA.

Provinces will also benefit under their personal income tax collection agreements. For example, the federal government has agreed to waive the charges to the provinces for costs incurred by the CRA to develop the provincial tax-on-income system for personal income tax. This represents a $22 million saving to Ontario.