Taxation

ALTERNATIVE FEDERAL BUDGET 2017 / TAXATION

HIGH STAKES

- Our tax system has become overly complex and riddled with loopholes and provisions that worsen inequalities.
- Canada's last comprehensive tax review (the Carter commission) happened 51 years ago.
- Our tax system needs to be made more equitable.
- Tax havens have become a common way for corporations to avoid paying their fair share.
- Our corporate tax structure does not fairly address foreign companies.

CLEAR CHOICES

- Eliminate regressive and ineffective tax loopholes.
- End corporate tax dodging and make corporations pay their fair share.
- Tax foreign e-commerce companies to level the playing field.
- Increase taxes on banks and finance.
- Introduce wealth/inheritance taxes and make income taxes more progressive.

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Background

The Liberal government has taken several positive steps, all of them promoted in past Alternative Federal Budgets, to make the federal tax system fairer. It has added another top tax bracket of 33% on incomes above $200,000. It replaced the Universal Child Care Benefit with a more progressive Canada Child Benefit, which should reduce child poverty by 14%, according to AFB estimates. It cancelled family income splitting and the previous government's planned doubling of the annual tax-free savings account contribution limit, both highly regressive tax measures that benefited mainly Canada's well-off. It has closed some tax loopholes and increased the capacity of the Canada Revenue Agency to go after high-income individuals evading taxes through offshore tax havens.

While these actions are a good start, much more needs to be done to reform our tax system. Not only will the measures proposed below make taxes fairer in Canada, they will allow the government to fund the social, economic, and environmental services and investments Canadians deserve, and help pay for other promises the government has made but not yet delivered on. The last time Canada conducted a comprehensive tax review (the Diefenbaker-appointed Carter commission) was 51 years ago. Since then, our tax system has become overly complex and riddled with loopholes that worsen inequalities. The system does not address our current challenges, nor does it fairly tax new business structures.

AFB Actions

There are a number of straightforward tax measures that could generate significant revenue for public services, broaden our tax base, make the tax system fairer, reduce inequalities, and promote economic and productivity growth.

Action: Eliminate regressive and ineffective tax loopholes and simplify the tax system (savings: $16 billion a year).

Recent analysis by the Canadian Centre for Policy Alternatives exposes how over 90% of federal personal tax expenditures provide greater benefits to higher-income earners.[1] It is clear proof of how Canada's tax system disproportionately benefits the wealthy and at a great cost to the public. The federal government has initiated a review of its tax expenditures, hoping to generate $3 billion in annual savings. But this is a very modest target.[2] The government could save at least $16 billion through the following 10 simple tax reforms.

1. Eliminate the stock option deduction (savings: $670 million a year)
This loophole allows corporate executives to pay tax on their stock option compensation at half the statutory rate that the rest of us pay on our working income. Not only is the deduction highly regressive, with over 90% of the benefit going to the top 1% of tax filers (who make more than $250,000 annually), it is also bad for the economy, as it encourages CEOs to inflate short-term stock prices through share buybacks instead of investing in the economy.[3]

2. End the abuse of the small business tax rate (savings: about $500 million a year)
Tax laws allow accountants, dentists, doctors, and small business operators to provide their services through Canadian-controlled private corporations (CCPCs) rather than as employees. These individuals then pay tax on income held within these businesses at the much lower small business rate of 11% on their first $500,000 of income instead of at federal personal income tax rates of up to 33%. Individuals may also split personal income among family members to avoid paying taxes.[4]

3. Tax income from capital gains and investments at the same rate as employment income (savings: $10 billion a year)
Individuals who profit from the sale of investments or assets pay tax at half the rate of tax on income from employment thanks to the partial inclusion of capital gains. Over 90% of the benefit of this loophole on the personal income tax side goes to the richest 10% of income earners and 87% goes to the top 1%.[5] Corporations also pay tax on half of their capital gains. This provision was supposedly introduced to encourage sav-

ings and investment, but since it was expanded business investment as a share of the economy has declined. Under our plan the government would tax capital gains for individuals and businesses at the same rate as employment and other income, but would allow an adjustment for inflation. This would encourage longer-term productive investments rather than short-term speculation. There are also generous lifetime capital gains exemptions for farming, fishing, and small business that our plan preserves in the interest of maintaining family businesses. We further maintain the capital gains exemption for principal residences, as the family home is one of the few significant assets most Canadians have.

4. Put a lifetime limit on tax-free savings accounts (savings: $100 million, increasing to the billions of dollars in the future)

Tax-free savings accounts (TFSAs) were originally justified on the basis they would provide low-income individuals with a more tax-effective way to save for retirement than RRSPs. However, the benefits of TSFAs primarily go to people making higher incomes and their cost, in terms of foregone government revenues, will escalate to many billions of dollars annually unless total contributions are capped. The cumulative amount individuals can contribute to TFSAs was $46,500 in 2016. The AFB would put a lifetime cap of $50,000 on TFSAs to avoid a revenue sinkhole in the future and to ensure benefits aren't further concentrated among high-incomes earners.

5. Reduce the annual RRSP contribution limit to $20,000 and cancel pension income splitting

The AFB would enhance public retirement programs instead, including the Canada Pension Plan, Old Age Security, and the Guaranteed Income Supplement (see the Seniors and Retirement Security chapter).

6. Review and replace ineffective boutique tax credits (savings: $200 million a year)

Canada's tax system is riddled with so-called boutique tax credits for public transit, trades tools, search and rescue, volunteer firefighters, etc. Navigating these credits makes filling out annual tax forms much more complicated. Furthermore, they have generally not been effective in their intended objectives and are more likely to be used by higher-income families.[6]

7. Eliminate flow-through share (FTS) deductions and the mineral exploration tax credit (savings: $125 million a year)

These tax incentives are supposed to help boost exploration in the resource and energy industries, but there is little evidence they are working.[7] Nearly 80% of FTS investors are in the highest marginal tax bracket.[8]

8. Cancel the corporate meals and entertainment expense deduction (savings: $400 million a year)

Businesses are allowed to deduct half their meal and entertainment expenses, including the cost of season's tickets and private boxes at sports events. These loopholes are widely abused, according to one study of similar measures in the U.S.[9] The meal expense for long-distance truckers would be maintained.

9. Limit deductions for executive compensation (savings: $150 million a year)

Canadian corporations can deduct CEO and other executive compensation from their expenses. The average compensation of the top 100 Canadian CEOs was $9.5 million in 2015, 193 times what the average worker made that year.[10] The AFB adopts the U.S. model, where the deduction is limited to $1 million each for the CEO and other executives.

10. End fossil fuel subsidies (savings: as much as $1.5 billion a year)

While some fossil fuel subsidies are being phased out, new ones have been introduced and extended. Federal tax subsidies to the fossil fuel industries averaged $1.5 billion a year between 2013 and 2015.[11] (For more on subsidies, see the Environment and Climate Change chapter.)

Action: End corporate tax dodging and make corporations pay their fair share (revenue: $13.6 billion a year).

Corporations rely heavily on public services for their operations. These can include transportation infrastructure, utilities, education, training, health care, social services, law enforcement, and the justice system. High-quality public services are more important contributors to corporate productivity and competitiveness than low corporate taxes or labour costs. There is a lot more economic activity in countries with quality public services and higher corporate taxes than in countries with low corporate taxes and low-quality public services.

Canada has some of the lowest corporate tax rates among peer competitor countries, which has contributed to driving these rates down elsewhere.[12] Federal corporate tax rates were slashed almost in half between 2000 and 2008 — from 29.1% to 15% — and yet business investment as a share of the economy declined instead of increasing as it was supposed to. Over that time, corporations created few new jobs and made ever-higher record profits, amassing over $700 billion in surpluses and excess cash.[13]

While corporate profits take up record shares of the national income, there has been little increase in the share companies contribute through corporate income taxes. In addition, business taxes have been reduced and shifted onto households in other ways, with the elimination of most corporate capital taxes, a shift to value-added taxes, and reductions in business property taxes. Large corporations and investors have also benefited from weak tax rules and lax enforcement by shifting profits to tax havens and paying less tax.

Analysis commissioned by Canadians for Tax Fairness has found that 56 of the TSX 60's largest publicly traded companies in Canada had a total of 973 subsidiaries in recognized tax havens. Tax avoidance and evasion has been even more damaging for lower-income and developing countries in Africa and Asia, which desperately need revenues to provide better health, education, and other public services. The main way multinational corporations are able to legally avoid taxes is through “transfer pricing” and “profit shifting” — applying artificially high or low prices for goods or services between affiliated companies so their profits are concentrated in countries where they pay zero or negligible taxes.

The AFB increases the corporate federal tax rate from 15% to 21% and increases the small business rate to 15% to preserve proportionality between small and general corporate tax rates. This also maintains the tax rate’s consistency with the lower rate on personal income, and tackles the abuse of the CCPC regime by individual professionals, as described above. This measure, which would net the government $11 billion a year in new tax revenue, would leave the general federal corporate tax rate lower than it was in 2006 and considerably lower than the 34–35% statutory federal corporate rate in the United States.

In order to stop businesses and investors from simply moving more of their money into tax shelters, the AFB replaces Canada’s difficult-to-enforce “arms-length rule” with a unitary taxation regime that would apportion tax payments by multinational companies to different governments according to the amount of business they do in each jurisdiction. This is similar to how business revenue is apportioned between different provinces in Canada. More immediately, the following measures would have a significant effect on curbing tax avoidance:

- Require corporations to prove their offshore transactions have substantial economic purpose aside from reducing taxes owed. Private member’s bill C-621, introduced in the last Parliament by Murray Rankin, provides a good legislative example of how this could be done.[14] We estimate this measure would raise $400 million a year.
- Reinstate the restriction on how much corporations can deduct in interest payments to offshore subsidiaries for tax purposes, as the OECD recently recommended through the Base Erosion and Profit Shifting (BEPS) action plan. We recommend limiting the deductibility of interest to the entity’s share of the group’s consolidated net interest expense, apportioned by earnings (EBITDA), combined with a fixed cap of 10%.[15] This measure should raise at least $200 million annually in tax revenue.
- Apply a 1% withholding tax on Canadian assets held in tax havens. Investment by Canadian corporations in their top 10 favourite tax havens increased to a reported $270 billion in 2015, amounting to over a quarter of all Canadian direct investment abroad. Applying a 1% withholding tax on Canadian assets held in tax havens would generate over $2 billion a year.

Action: Tax foreign e-commerce companies to level the playing field (revenue: $1 billion a year).

E-commerce-based companies such as Netflix, Facebook, Amazon Prime, Google (YouTube), Amazon, Uber, and Airbnb, among others, are capturing a growing share of the Canadian market but pay little or no HST/GST or corporate income taxes. Because these firms have no physical presence in Canada they are not considered to be "carrying on business" here.[16] This policy needs to be updated to reflect changing business realities.

The foreign-owned e-commerce sector now has revenues of more than $30 billion a year. Google and Facebook together capture 64% of all Internet advertising dollars spent in Canada (over $2.4 billion annually) but pay little or no taxes here. Meanwhile, domestic broadcasters and media producers, including newspapers, have seen their advertising revenues plummet, leading to mass layoffs and an erosion of avenues for broad public discourse.[17]Companies like Netflix and other "over-the-top" media services are also not required to produce, broadcast, or contribute to Canadian content, contribute to the Canadian Media Fund, or levy taxes on their services.

The European Union, New Zealand, Australia, Norway, South Korea, Japan, Switzerland, and South Africa have modernized tax laws to respond to a changing e-commerce reality.[18] The OECD, in its BEPS action plan, "Addressing the Tax Challenges of the Digital Economy," has recommended ways governments can collect value-added taxes where a product is purchased to help level the playing field between foreign and domestic suppliers.[19]

The AFB will level the playing field in two ways. First, it makes sure all e-commerce companies with Canadian income above $500,000 (the small business threshold) pay corporate income tax on profits from products or services sold or rented in Canada, whether or not the company has a physical presence here. This would raise $600 million a year. Second, the AFB cancels the GST/HST tax exemption for e-commerce service companies that sell to Canadians. We estimate this would raise $400 million a year.

Action: Introduce a stronger and more progressive carbon tax (revenue neutral).

The Trudeau government says it wants to see a nationwide minimum national carbon price of $10 per tonne in 2018 increasing to $50 per tonne by 2022. This is similar to the national harmonized carbon tax proposed by the AFB, but it is too modest. The government's plan also does not mandate that the revenues should be used for progressive investments in complementary environmental measures or to support vulnerable people, industries, and communities affected by these changes.

The AFB plan introduces a national harmonized $30-per-tonne carbon tax starting July 1, 2017, but increasing by $10 per tonne a year until it reaches $50 per tonne in 2019. Where provinces do not have a broad-based carbon price in place at these levels, the federal government would apply one. Revenues generated through the carbon tax would be spent on a "green" tax refund — an annual cheque equivalent to $10 for every adult and $5 per child for every $1 per tonne in carbon tax (e.g., $300 per adult for a carbon tax of $30 per tonne). The remainder of the revenues would go to complementary investments in climate change mitigation and adaptation, green infrastructure, and to just transition measures to assist affected workers, communities, and industries. The AFB would also apply border tax adjustments to ensure our industries are not at a competitive disadvantage, and to put pressure on other countries to introduce similar measures (with exemptions for impoverished nations).

Action: Increase taxes on banks and finance (revenue: $5 billion a year).

Many experts consider the financial sector to have grown too big for the good of the economy. This has led to greater speculative activity, economic instability and crises, increased inequality, and poor allocation of resources. The financial sector also benefits from a preferential tax regime (e.g., exemption of most services from value-added taxes like the GST/HST), the relative ease with which companies can exploit tax havens, and guarantees of solvency in the event of a crisis through government bailouts of firms considered "too big to fail."

After many years, momentum is building again in Europe for broad-based financial transaction taxes (FTT). Such measures have existed for centuries in different forms and in different countries. For example, FTTs are actively adjusted in China and Taiwan to cool real estate or stock markets. The International Monetary Fund has also proposed a financial activities tax (FAT) on profits and remuneration in the financial industry as a way to apply a value-added tax to this sector. Quebec has had a version of a FAT in its special tax on remuneration in the financial industry. The AFB would either introduce a FTT in collaboration with the provinces, which have jurisdiction over securities regulation, or a FAT rate of 5% on profits and remuneration in the financial sector.

Action: Introduce wealth/ inheritance taxes and make income taxes more progressive (revenue: $4.8 billion a year).

Canada should have broader-based and more progressive wealth and inheritance taxes to combat persistent inequalities. The only wealth we tax now is property, which is regressive, since a home is usually the only asset of significant value for middle-income families. The IMF has estimated Canada could generate $12 billion annually from a tax of just 1% on the net wealth of the top 10% of households. Introducing a broad-based wealth tax like this would involve co-ordinated action.

In the interim the AFB introduces a minimum inheritance tax of 45% on estates valued above $5 million, similar to the estate tax in the U.S., which would net an estimated $2 billion annually in new revenues. The AFB also reverses the income tax cut introduced for the middle tax bracket (i.e., returns the rate to 22%), since the maximum benefits from this cut actually go to those with taxable incomes over $90,000 a year, which would produce revenues of $2.8 billion per year.

Notes

1 David Macdonald. (2016). *Out of the Shadows: Shining a light on Canada's unequal distribution of federal tax expenditures*. Ottawa: Canadian Centre for Policy Alternatives.

2 Liberal Party of Canada. (2015). *A New Plan for a Strong Middle Class*, election platform, p. 80.

3 Many of the revenue estimates are taken from Finance Canada's Report on Federal Tax Expenditures - Concepts, Estimates and Evaluations 2016: http://www.fin.gc.ca/taxexp-depfisc/2016/taxexp1602-eng.asp#_Toc442180630.

4 Herbert J. Schuetze. (2016). "Income splitting among the self-employed." *Canadian Journal of Economics*, Vol. 39, No. 4.

5 Brian Murphy, Mike Veall, and Michael Wolfson. (2015). "Top-End Progressivity and Federal Tax Preferences in Canada: Estimates from Personal Income Tax Data." Canadian Tax Journal, Vol. 63, No. 3.

6 Neil Brooks. (2016). "The Case Against Boutique Tax Credits and Similar Tax Expenditures." Canadian Tax Journal, Vol. 65, No. 1. pp. 65–134.

7 Lindsay Tedds, "Why the mineral exploration tax credit is such a bad idea," Maclean's, September 2, 2015.

8 Department of Finance Canada. Tax Expenditures and Evaluations 2013, Part 2.

9 Richard Schmalbeck and Jay A. Soled. (2009). "Elimination of the Deduction for Business Entertainment Expenses." *Tax Notes*, May 11, 2009.

10 Hugh Mackenzie. (2017). *Throwing money at the problem*. Ottawa: Canadian Centre for Policy Alternatives.

11 "Unpacking Canada's Fossil Fuel Subsidies," a joint project of IISD and Global Subsidies Initiative: http://www.iisd.org/faq/ffs/canada/

12 "Competitive Alternatives: KPMG's guide to international business costs, 2016 edition": https://www.competitivealternatives.com/reports/compalt2016_execsum_en.pdf

13 Jordan Brennan. (2015). *Do Corporate Income tax Rate Reductions Accelerate Growth*. Ottawa: CCPA.

14 Rankin describes his private member's bill here: https://openparliament.ca/bills/41-2/C-621/

15 For details on this issue see the G20 submission to the U.K. parliament on behalf of the BEPS Monitoring Group: https://bepsmonitoringgroup.files.wordpress.com/2016/01/bmg-submission-to-uk-all-party-parliamentary-group.pdf

16 Canada Revenue Agency. Carrying on business in Canada, GST/HST Policy Statement P- 051R2, Date of Revision. April 29, 2005. This policy statement cancels P-051R1, dated March 8, 1999: http://www.cra-arc.gc.ca/E/pub/gl/p-051r2/p-051r2-e.html

17 John Anderson. (2016). *Over the Top Exemption*. Ottawa: CCPA, p. 11.

18 Ibid., pp. 18–21.

19 OECD. (2015). *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report:* http://www.oecd.org/tax/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report-9789264241046-en.htm