SUBMISSION TO HOUSE OF COMMONS STANDING COMMITTEE ON FINANCE

STUDY ON STRUCTURE OF CANADA'S FEDERAL REVENUE-RAISING SYSTEM

APRIL 14, 2008

fei[SM]

financial executives international

dirigeants financiers internationaux

canada

April 9, 2008

Mr. Rob Merrifield
Chair
House of Commons
Standing Committee on Finance
House of Commons
Ottawa, Canada
K1A 0A6

Dear Mr. Merrifield,

Financial Executives International Canada (FEIC) is pleased to respond to the House of Commons Standing Committee on Finance (FINA) invitation to present a submission to assist in its study of Canada's taxation policies. As an organization representing more than 2,100 senior Canadian financial executives, FEIC is acutely aware of the role of our tax system in encouraging savings and investment, in fostering innovation, productivity and initiative, and in growing the economy so as to enhance the economic and social well-being of all Canadians.

Our submission addresses three broad-based concepts which are considered fundamental to the attainment of a sustainable economic environment and a revenue raising system which results in each Canadian taxpayer, whether corporate or individual, paying their fair share of the tax burden. These concepts include competitiveness, efficiency (especially their impact on productivity), and accountability of federal spending.

COMPETITIVENESS

In today's global economy, competitiveness is critical to the long-term prosperity of, and in certain cases, the survival of, Canadian businesses. Competitiveness implies production with the most efficient use of resources, notably capital and labour, consistent with the desired degree of product quality, access to the capital required to invest in modern machinery and equipment, increased rates of productivity, and enhanced training and education. Competitiveness requires access to current research and the ability to capitalize on innovative product development. Competitiveness requires the accumulation of critical masses of labour and investment capital, and dictates that corporations accumulate, and retain, sufficient cash flow to expand and modernize their physical manufacturing structures. As demographics change, Canada faces a severe labour shortage. We must attract and retain the brightest and best talent with the know-how required to increase productivity and competitiveness. Competitiveness must further be achieved, not only on domestic fronts, but on international fronts as well.

FEIC congratulates the federal government for implementing two recent initiatives that we believe will foster enhanced Canada's competitiveness:

- A 1% reduction in the corporate income tax rate in 2008, followed by annual reductions until 2012, which will reduce the federal rate to 15%; and
- the recent legislation eliminating the domestic withholding tax on arm's-length interest payments as of January 1, 2008.

These promising measures (which parallel similar provisions in other countries) support the government's commitment to enhance Canadian productivity. Such policies help to achieve the more important overall objective – that of improving the economic and social well-being of individual Canadians as we compete on the global stage.

We urge the government to implement mechanisms that support Canadian economic value creators, encourage their global development, and improve Canada's domestic business climate. A supportive tax system is a critical element in enhancing the competitiveness of the Canadian economy.

i) Free Flow of Capital

FEIC recommends that FINA urge the government to reduce withholding on dividend payments to non-residents to the 5%/15% model in most new treaty negotiations.

Elimination of the withholding taxes will ensure that Canadian businesses can access global debt markets at the lowest possible cost. There is a strong link between elimination of withholding tax on interest and dividends, and increased foreign direct investment and the free flow of capital.

Withholding taxes constitute a barrier to the free flow of capital. Within the European Union, the EU parent-subsidiary eliminates withholding taxes on direct dividends on cross-border payments within corporate groups. The U.S., a major source and recipient of investment capital for Canadian businesses, has negotiated a zero withholding tax rate under certain of its treaties for dividend payments since 2003. We believe that Canada should strive to eliminate withholding taxes, especially on the payment of dividends.

Withholding taxes on dividends create a bias for debt financing in Canada which can create issues regarding thin capitalization rules for many foreign-controlled Canadian companies, as well as generally adding to the cost of raising equity versus debt. The elimination of withholding taxes on dividends would greatly improve the ability of Canadian companies to attract foreign capital and compete effectively with other jurisdictions.

ii) Human Resources Training and Development

FEIC recommends that FINA urge the government to encourage Canadian businesses to enhance the skills and qualifications of Canadian employees by:

a) broadening the definition of what is currently deductible as qualifying education and training expenses;

and

b) introducing a refundable tax credit for qualified education and training.

To stimulate development of world class champions of continuing education, FEIC recommends that FINA urge the government to establish a Centre for Continuing Workplace Education and Training.

Governments have traditionally extolled the virtues of life-long learning and re-training. Canadian workplaces require highly skilled and trained individuals to increase the productivity of Canadian businesses. Increased labour productivity is dependent on the development of a highly educated and trained workforce. Up-to-date in-house training is especially critical to the development of workplace technical and IT employees. Government is urged to put more effort toward encouraging the creation of Canadian corporate champions of continuing education and training and to more publicly support corporations which are recognized worldwide for their creative and innovative approaches to employee skills development.

Tax incentives are most effective when targeted directly at the desired outcome. Business responds to incentives which benefit operations. Selective and carefully designed tax credits (e.g. the small business deduction) have achieved their intended results. An employee education and training credit will spur businesses to increase spending in this vitally necessary area. The effectiveness of this refundable tax credit should be monitored to ensure positive net benefits are realized.

A centre of continuing education established at a leading university or community college is needed to augment in-house training programs and the skills developed by Canadian technical and vocational institutions. The proposed Centre would collect information on all workplace related continuing education programs in Canada, host conferences, seminars and workshops, and publish articles on best practices in the continuing education field. The federal cost of this initiative is minimal as, other than a small initial funding grant, all expenditures are financed through donations to the designated centre.

iii) Corporate Tax Rates

FEIC recommends that FINA urge the government to:

(a) accelerate the announced corporate income tax rate reductions;

(b) reduce the proliferation of non-neutral tax preferences, with a view to normalizing the effective rate across industrial sectors;

and

(c) encourage the provinces to normalize their corporate income tax rate structures and repeal remaining provincial capital taxes.

The statutory rate (the base rate established in the tax legislation) dominates the corporate tax rate debate. However, the more important tax metric is the effective tax rate, i.e., the rate corporations actually pay. The current federal statutory rate on business income in Canada (22%) is scheduled to fall to 15% by 2012. FEIC congratulates the government for introducing these statutory rate reductions, and the previously announced repeal of the federal corporate surtax and capital tax.

Currently some individual corporations reduce their statutory burden by claiming accelerated depreciation, the manufacturers and processing profits deduction, investment tax credits and other credits. Consequently, the Canadian economy is characterized by significant effective tax rate differentials across industries.

Whereas effective rate differentials at the federal level relate to eligibility for specific rate reductions, greater disparity is created when provincial corporate rates and credits are considered.

Corporate taxation in Canada must be internationally competitive for the benefit of domestic businesses and in order to attract foreign direct investment. Canada's effective tax rate is still too high. Many countries are significantly reducing their corporate income tax rates to attract increasingly mobile capital. FEIC continues to advocate further reductions in the corporate income tax rate as these changes will enhance Canada's competitiveness.

By 2012, the C.D. Howe Institute[i] estimates that effective tax rates on capital investment (i.e., income, consumption and other capital-related taxes) will vary across Canada depending upon the industry. Ontario corporate taxpayers, for example, will have effective rates of between 21.7% (forestry) and 40.8% (communications). The service sector is particularly affected by varying effective tax rates. Although Canada's statutory corporate rate on business income is 16th highest of the 30 OECD countries, it is 10th highest in terms of effective rates.

Ireland is arguably the western country which has most radically reduced its tax rates in recent years. Between 2000 and 2003 Ireland reduced its corporate tax rate from 24% to 12.5%. According to recent OECD statistics[ii], Ireland's GDP has increased from U.S. $130B in 2002 to $161B in 2005; real GDP growth has been between 4% and 5.5%; employment has increased; and the percent of GDP spent on R&D has increased. Although government debt has risen as a percent of GDP (the 2005 debt to GDP ratio is now a relatively low 1.09%), *the tax yield has continued to increase, as a percent of GDP, each year since the reduction in the basic corporate tax rate.*

EFFICIENCY

Efficiency refers to the manner in which a tax measure achieves its stated goals and objectives, and how costly the measure is in terms of administration and compliance in comparison to the tax yield. A tax system is inefficient if it distorts the free choice of individuals or adds unnecessary costs to the compliance burden of taxpayers. In terms of efficiency, a simple tax system is a virtue. When evaluating a tax measure, or a component of the tax system, one must ask:

- Does the measure raise the projected revenue or result in the intended social or economic behaviour?
- Does the measure facilitate the use of fiscal policy for economic stabilization and growth? Tax measures that blend into overall fiscal policy are more desirable than ones that do not, as they tend to accomplish their objective more efficiently.
- Where tax policy is used to achieve other objectives, can these be accomplished so as to minimize interference with the equity of the system?

In our view, several aspects of the Canadian tax system fail one or more of these tests.

Canada's tax system is overly complex. The current tax system is a patchwork quilt of overlapping tax measures, regulations and Canada Revenue Agency (CRA) administrative practices. All too frequently, tax practitioners and corporate tax managers resort to detailed technical notes to determine the meaning of many budget measures. Consequently, the costs of complying with the tax system are excessive.

Business and individual taxpayers need more stability and consistency in the tax policy-making process and the administration of the tax rules. FEIC believes that Canada's economy will grow at a much faster rate if the talented individuals working on corporate and individual tax reduction strategies could turn their attention to business generation initiatives. Other jurisdictions have created a more streamlined tax system than Canada, a fact noted by non-resident investors when they encounter the bewildering proliferation of Canadian taxing rules and multiple jurisdictions. The following are three examples of our inordinately complicated tax system:

i) Capital Cost Allowance (CCA) Regulations

FEIC recommends that the CCA classes be reduced to ten comprehensive classes, as is the case in numerous European countries. Two or three of these classes could be accelerated CCA classes on selected asset acquisitions.

This proposal would be revenue neutral over time.

Capital cost allowance regulations are too complicated. There are 38 declining balance classes and several straight-line classes. Many similar assets appear in several classes. Each federal budget creates new accelerated classes or redefines the rules related to existing classes. While there are clear incentive reasons for the constant juggling of the CCA regulations, the present system is excessively costly in compliance terms.

ii) Harmonization of Goods and Service Tax (GST) and Provincial Sales Taxes (PST)

FEIC recommends that the federal government work with its provincial partners to advocate adoption of a national Harmonized Sales Tax (HST).

The federal government is encouraged to share in the joint "marketing" of a national HST to populations in provinces that currently impose a PST, to smooth the potential for resistance to the adoption of a broad-based HST at the provincial level. In addition, the government is encouraged to offer financial assistance to each province in order to compensate for the adoption of a HST on a fully-harmonized basis.

Many Canadian corporations transact business in multiple provinces. Large corporations are likely to do so in all ten provinces and one or more territories. Sales tax rates vary from province to province. Differences exist between the GST and PST tax base in some provinces, requiring an onerous knowledge-based investment by businesses. Sales tax registrants are burdened by unnecessary compliance costs as they must submit sales tax returns to multiple taxing authorities.

With respect to the non-harmonized provinces (PEI and all provinces west of Quebec), the 2007 Economic Statement noted that, *"Harmonizing with the GST is the single most important action that these provinces could take to improve their provincial and Canada's overall tax competitiveness."* The International Monetary Fund (IMF)[iii] has indicated that the Canadian economy will be stronger if the provinces and territories reduce the marginal effective tax rate on capital, an objective which can be achieved in part by harmonizing sales taxes.

FEIC recommends that the GST should not be reduced below its current level, as alternative forms of revenue will have to be found and/or spending will have to be reduced to cover the shortfall.

Unlike the HST, businesses in non-harmonized provinces cannot recover the estimated $8B[iv] sales tax they pay on their purchases. Greater harmonization of provincial sales taxes with the GST would enhance competition, reduce red tape, and reduce compliance and administration costs as taxpayers and government would only have to deal with one sales tax authority. The resulting reduction of the PST burden would translate into lower costs to consumers.

Conversion to a national consumption tax results in revenues which are stable through boom and recession, unlike corporate income taxes. Even at the relatively low Canadian consumption tax rates (compared to our European counterparts[v]), revenues are considerable and have steadily increased since the GST's introduction, peaking at $33B before the recent rate cuts. Revenues in the harmonized provinces have increased since harmonization was introduced in 1997[vi].

A harmonized sales tax makes for an efficient tax system. In pure form, it has few exceptions, and is easy to administer. It does not cascade through the business chain, and is generally less susceptible to avoidance. Furthermore, a harmonized sales tax results in lower administration costs because the net economic cost of collecting a dollar of tax revenue is less than for other taxes, at mere cents per dollar[vii].

Harmonization in the Atlantic provinces appears not to have led to a general increase in consumer prices, as increased productivity at the business level and reduced compliance costs have flowed through to consumers.

iii) Group Tax Reporting

FEIC recommends that FINA urge the government to implement either group tax consolidation or a loss transfer system.

Canada is the only western industrialized country which does not permit group tax reporting. Consolidated tax returns can be filed in the United States and Mexico (Canada's NAFTA partners), and many European countries. A loss transfer system is in place in countries such as the United Kingdom, Ireland and Australia. Many European Union Accession countries have introduced either tax consolidation or a loss transfer provision. FEIC research[viii] indicates that some Canadian corporations annually devote over 1,000 person hours, and/or over $500,000 in specialist cost, devising tax strategies whose sole purpose is to achieve the result which could be provided more effectively by either tax consolidation or a loss transfer system. Additional costs are incurred as many of these strategies are intensely scrutinized by the CRA and/or the tax courts before finally being accepted as legitimate tax planning strategies.

Implementation of this proposal will reduce the compliance costs of Canadian corporate groups. While we recognize that such an initiative may be criticized as an immediate tax revenue loss, we would point out that the lost tax yield is a timing issue, not a permanent reduction in the corporate tax yield.

While we anticipate some objection from the provinces to this proposal, it is still the right thing to do to make Canada's tax system more efficient. Even if the provinces do not accept group reporting, it would still be worthwhile implementing this proposal on a federal basis only.

FEDERAL SPENDING

Government is getting bigger! While not directly related to the federal revenue-raising system, spending by the federal government indirectly affects the revenue system as government must raise the revenues required to pay for its expenditures and service the national debt. FEIC is encouraged by the government's recent initiatives which are projected to reduce the federal debt-to-GDP ratio to 25% by 2011-2012; the new Expenditure Management System, which will maintain federal spending in line with economic growth; and the legislation which places formal limits on programs cost-shared with the provinces.

We note that (a) 2006-2007 federal program spending has increased back to its 1997-1998 level of 13% of GDP, and (b) 2006-2007 budgetary expenses are at their highest level ever. These trends are not conducive to responsible management of federal fiscal resources. Increased spending is justified, however, where necessary improvements are made to Canada's economic and social infrastructure.

Due to debt reduction and decreased interest rates, debt service costs have declined from $47B to $43B over the past 10 years. While the percent of GDP consumed by interest on the national debt, and budgetary expenditures on debt interest, continue to trend downward, future interest rate increases or increased federal spending could halt this trend. An aggressive debt reduction strategy will result in lower interest charges in future years, resulting in more resources available for either tax reductions or necessary increases in program spending. It is critical, therefore, that spending be controlled as a significant percent of federal spending is demographically influenced.

FEIC recommends that FINA urge the government to:

a) continue to monitor federal spending and encourage spending restraint,

b) maintain its projected debt reduction schedule whereby the majority of the annual surplus is directed to the federal debt,

and

c) reallocate funds to enrich federal investments in infrastructure which will lead to economic growth. Transportation, research and development, and post-secondary education of three examples of sectors which would benefit from enhanced infrastructure spending.

CONCLUSION

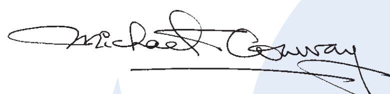
FEIC congratulates FINA for initiating this study. We believe this review of the tax system will generate tax policy changes which will achieve achieve our mutual goals of enhancing Canadian competitiveness, increasing the efficiency of the tax system, and controlling the growth of federal expenditures which do not contribute to economic growth or an increased standard of living for all Canadians.

FEIC encourages FINA to include all provinces and territories in its study so as to ensure that a fair and competitive taxation policy can be achieved across Canada.

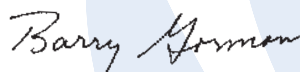
FEIC strongly recommends that FINA encourage the government to consider implementing a regular, formal and comprehensive review of the tax system, not unlike that of the process surrounding *The Bank Act.*

We thank FINA for the opportunity to present FEIC's recommendations on Canada's revenue raising initiatives. We look forward to continuing to work with the Committee and the government in order to ensure that Canada maintains the highest levels of competitiveness and economic growth from which all Canadians will benefit.

Respectfully submitted,



Michael Conway, CA, ICD.D
Chief Executive and National President
Financial Executives International Canada



Barry Gorman, PhD, CA, TEP
Chair, Tax Committee
Financial Executives International Canada

[i] Chen, D. "Flaherty's Missed Opportunity". C.D. Howe Institute. E-brief. December 18, 2007.
[ii] StatExtracts. OECD. (www.stats.oecd.org. Downloaded March 30, 2008).
[iii] Department of Finance. "International Monetary Fund 2008 Article IV Consultation with Canada Preliminary Conclusions of the IMF Mission." News Release, December 12, 2007. (www.fin.gc.ca/news07/data/07-104_1e.html. Downloaded April 4, 2008).
[iv] Research indicates Ontario considers the PST component to be approximately 40% of PST revenues. Using 40% as a benchmark, the PST burden is approximately $9B. It is estimated that approximately $1B is collected from non-business sectors. (Smart, M. C.D. Howe Institute. Commentary #253. "Lessons in Harmony: What Experience in the Atlantic Provinces Shows About the Benefits of a Harmonized Sales Tax". July 2007.
[v] Where median rates are in the 19-20% range.
[vi] Consumption taxes in Nova Scotia, a harmonized province, increased from $752.4M in 1996-97 (the year before harmonization) to an estimated $1,095M for 2007-08 (Province of Nova Scotia. Nova Scotia Assumptions and Schedules, 2007-2008.)
[vii] The U.S., in briefly considering a VAT in 2005, estimated that the total cost of the U.S. tax system on the economy was about $1.20 for every dollar of tax collected.
[viii] Gorman, F. Barry. "Corporate Group Reporting: An Old Chestnut Worth Revisiting?". FEIC Submission to the House of Commons Standing Committee on Finance. September 2002.

SUMMARY OF FEIC RECOMMENDATIONS

Competitiveness

To enhance competitiveness, FEIC recommends that FINA urge the government to:

(a) Reduce withholding on dividend payments to non-residents to 5%/15%.

(b) Broaden the definition of qualifying education and training expenditures.

(c) Introduce a refundable tax credit for qualifying education and training.

(d) Establish a Centre for Continuing Workplace Education and Training.

(e) Accelerate the announced corporate income tax rate reductions.

(f) Reduce the proliferation of non-neutral tax preferences.

(g) Encourage the provinces to normalize their corporate income tax rate structures and repeal remaining provincial capital taxes.

Efficiency

To enhance the effectiveness of the tax system, FEIC recommends that FINA urge the government to:

(a) Reduce the number of CCA classes to ten comprehensive classes.

(b) Work with its provincial partners to adopt a national harmonized sales tax.

(c) Not reduce GST below its current level.

(d) Either implement group tax consolidation or a loss transfer system.

Federal Spending

To control federal spending, FEIC recommends that FINA urge the government to:

(a) Continue to monitor federal spending and encourage spending restraint.

(b) Maintain its projected debt reduction schedule.

(c) Reallocate funds to enrich federal investments in infrastructure which will lead to economic growth.

Overall Recommendations

FEIC recommends that the Department of Finance initiate a formal, comprehensive and regular review of the tax system.

About FEI Canada (www.feicanada.org)

Financial Executives International Canada (FEI Canada) is an all-industry professional association for senior financial executives. With eleven chapters across Canada and more than 2,100 members FEIC provides professional development, thought leadership and advocacy services to its members.

The Issues and Policy Advisory Committee (IPAC) is one of two national advocacy committees of FEI Canada. IPAC comprises more than 40 senior financial executives representing a broad cross-section of the Canadian economy who have volunteered their time, experience and knowledge to consider and recommend action on a range of topics of interest to Canadian business and governmental agencies. The current composition of IPAC is formulated to address the following areas: corporate governance, capital markets, pensions, internal controls, public sector accountability and tax policy & competitiveness. In addition to advocacy, IPAC is devoted to improving the awareness and educational implications of the issues it addresses, and is focused on continually improving these areas.

FEI Canada Tax Policies & Competitiveness Sub-Committee

Michael Conway
Chief Executive & National President
Financial Executives International Canada
Toronto, Ontario

Bill Hewitt
Chair – IPAC, FEI Canada
Retired VP Investments, Sun Life
Toronto, Ontario

Peter Ballachey
Consultant
Ballachey Enterprises, Ltd.
Vancouver, British Columbia

Nigel Byers
Executive Vice President
Canadian Institute of Chartered Accountants
Toronto, Ontario

Frank Kopitar
Vice President, Taxation
Nexen Inc.
Calgary, Alberta

Timothy McGillicuddy
Vice President, Taxation
Telus Corporation
Edmonton, Alberta

Darla Sycamore
President
Sycamore Management Consultants
Toronto, Ontario

Barry Gorman
Chair - Tax Committee, FEI Canada
Professor of Accounting, Saint Mary's University
Halifax, Nova Scotia

Louis O'Brien
Chair, FEI Canada
SVP & President - Parcels, Canada Post
Ottawa, Ontario

Rod Butcher
Director of Consulting Services
Brendan Moore Enterprises
Oakville, Ontario

Carl Gauvreau
Chief Financial Officer
Fonds de revenu Hartco
Longueuil, Quebec

Lawrence Kryzanowski
Concordia University Research Chair in Finance
Concordia University
Montreal, Quebec

Grant Smith
Senior Manager, Transaction Advisory - Taxation
Ernst & Young
Ottawa, Ontario

Laurie Tugman
President & Chief Executive Officer
Marsulex Inc.
North York, Ontario