Rationalizing the Canadian Income Tax System

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Context

Current system still nominally informed by Carter Report: Emphasis on comprehensive income base with CIT as backstop

Piecemeal tax reforms result inconsistencies, irrationalities, out-dated design: far from comprehensive base

Economic circumstances, tax principles and practices worldwide have evolved: What to do?

Outline of talk

- Summary of anomalies, inconsistencies and irrationalities
- Tax policy principles and practices: draw on Mirrlees Review
- Implications for feasible directions of income tax reform

Anomalies and Inconsistencies in Tax System: Incoherent Asset Sheltering

Mix of income and sales taxation favors all capital income

Tax-deferred sheltering devices

- RPPs
  - Contribution limits with no carryforward
- RRSPs
  - Contribution limits with unlimited carryforward
  - RRSP limits related to RPP contributions
  - RRSPs withdrawn without penalty
- CPP/QPP like imperfect tax-deferred savings
- Human capital investment also like tax-deferred asset

Incoherent Asset Sheltering, cont'd

Tax-prepaid sheltering devices

- Housing, with no limits
- TFSAs
  - Contribution limit independent of RPPs/RRSPs and lower
  - Carry-forward of unused limits and withdrawal without penalty

PIT integration devices

- Capital gains exemption and dividend tax credit
- Neither convincing; favor holding Canadian equity

Other anomalies

- Tax-deferral sheltering captures rents/windfalls
  Tax-prepaid sheltering does not
- Personal business income not sheltered
  Except LCGE, passive income preferences

Issues with Corporation Income Tax

Integration with PIT unnecessary and imperfect

- Most shareholder income not liable for PIT
- Incidence of CIT largely shifted to labor
- Instruments of integration imperfect

Structure of CIT outdated

- Withholding rationale discredited
  Unnecessary distortion of investment and debt finance
- SBD justified for small, growing firms with significant chances of failure and limited access to capital markets
  But, SBD available to older, non-risky, non-growing firms
- Loss-offsetting imperfect

Issues with Personal Income Tax

PIT rate structure inconsistent and complicated

1. Some tax credits affecting vertical equity are nonrefundable
   e.g., Basic personal amount
2. Some NRTCs are redundant
   Others discriminatory
   Clawback rates inconsistent and lead to stacking
   Some compensate for costs so should be deductions
3. Some exemptions more beneficial to high-income earners
   Capital gains exemption, housing

Upshot: Lack of progressivity at lower incomes; narrower base and lower rates than necessary at the top

And, inheritances not taxed (except for deemed realization of capital gains)

Some Principles for a Modern Tax System: Personal Income Taxation

- Tax normal capital income preferentially, but rents fully
- Shelter savings for retirement purposes
  - Consistently across sheltering devices
  - Limited upper bounds
  - Penalties for early withdrawal
  - Avoid sheltering above-normal returns
- Rationalize rate structure
  - Make NRTCs refundable and harmonize taxback rates
  - Simplify credits for transparency and fairness
  - Enhance CWB, without excess penalty if unable to find a job
- Eliminate dividend tax credit and capital gains exemption for uniform treatment
- Tax unincorporated business on cash-flow-equivalent basis so fully sheltered (comparable to treatment of CCPCs below)

Some Principles: Corporation Income Taxation

- Case for using CIT as withholding device outdated
- Evidence of significant rents in corporate profits
- Base CIT on rents, using cash-flow-equivalent tax (ACE)
- Tax both real and financial cash flows
- Full loss-offsetting, without refundability
  Implies small firms at a disadvantage
- Preferential treatment for small, growing firms up to cumulative limit
- Territorial principle preferable to destination or worldwide principles, despite compliance issues
  (Rents attributable to institutions in origin country)

Some Principles: Other Taxes

Sales Taxation

- Sale/income tax mix implies adequate preferential treatment of capital income: adjust as desired
- No need for income tax system to favor capital income except to encourage retirement saving
- No case for differentiating commodity taxes for redistribution: Better to enhance refundable tax credits

Inheritance Taxation

- Increasing proportion of saving for bequest purposes
- Large wealth holdings have above-average rate of return
- Case for inheritance tax over threshold for equality of opportunity

Reform Implications for Canadian Tax System

Objective: Fairer, more efficient tax system, addressing international circumstances Canada faces, and corresponding with best practices and modern tax policy principles

Focus on general directions for reform rather than details

1. Taxation of Capital Income
2. Taxation of Business Income
3. Personal Income Tax Base and Rate Structure

Taxation of Capital Income

- Tax normal capital income progressively and preferentially
  Higher tax on above-normal returns to capital
  - Mix of HST/QST (type of tax-deferred sheltering)
  - Further HST harmonization with provinces
- Retain and rationalize tax sheltering of saving for retirement
  - Penalty on early withdrawals
  - Case for favoring tax-deferred instruments
    Retain lower limits on TFSA contributions
- Tax capital gains on housing above some threshold
- Eliminate integration
  - Dividend tax credit and capital gains exemption
  - LCGE, passive investment income sheltering
- Tax unincorporated businesses on rent basis using cash-flow equivalent tax

Taxation of Business Income

- Abandon withholding rationale, given extent of tax sheltering and evidence on CIT incidence
- Adopt rents as the objective of business tax
  - Cash-flow tax on real and financial flows with full loss-offsetting (carryforward with interest); or,
  - ACE tax: cost-of-finance deduction for equity finance using normal return to equity
- Use territorial principle, but pursue tax compliance and enforcement
- Maintain SBD, but restrict to small growing new firms
  - Reinstating cumulative income limit
  - Consider making labor costs refundable
- Other issues
  - Harmonize resource taxes as rent taxes with differential rates
  - Consider preferential treatment of patent income
  - Consolidated accounting for cross-jurisdiction tax allocation

Personal Income Tax Base and Rate Structure

- Broaden tax base to enhance progressivity at top
  As mentioned:
  - Eliminate dividend tax credit and capital gains exemption
  - Tax housing capital gains beyond some threshold
- Reform tax credits to enhance progressivity at bottom
  - Consolidate credits that serve mainly redistributive role
  - Eliminate ineffective or discriminatory credits
  - Make all tax credits refundable
  - Condition tax credits on income at common rate, with basic credit conditioned on family size and disability
  - Enhance CWB, integrate with consolidated refundable credit
- Reinstitute general income averaging to supplement self-averaging by sheltering devices
- For longer term, consider introducing a cumulative lifetime inheritance tax with a reasonable threshold

Some Concerns

Sheltering income within corporation should be addressed by means other than CIT

Effect on Tax Revenues

- Some reforms reduce revenues (CIT base)
- Others enhance revenues (PIT base

Political Feasibility

- System more progressive, addresses growing inequality
- Putting suggested reforms on table serve useful purpose