

TAX LOSS UTILIZATION AND CORPORATE GROUPS: A POLICY CONUNDRUM

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SUMMARY

There are both theoretical and practical tax policy considerations that favour a broad recognition for the value of corporate income tax losses— including for businesses operated within corporate groups. Ideally, an equitable and economically efficient tax system could obviate the need for loss netting against income by providing for the tax value of losses from business to be refundable by tax authorities in cash to owners. This approach, however, involves many serious difficulties, including revenue cost to governments and potential for abuse by both domestic and foreign businesses. Accordingly, loss refundability tends to be provided for only sparingly, if at all; while many corporate income tax systems—such as in the U.S. the U.K., Japan and many other OECD countries—deal with loss netting within corporate groups through a formal system of tax loss transfer or tax consolidation.

While Canadian policymakers have considered introduction of such a system over a long period of time, they have yet to come up with a satisfactory formal system for Canada. So, corporate groups in Canada have been left to make do with an informal self-help loss trading system that presents a number of problems compared to formal systems.

As a federal country with substantial corporate taxation levied at the provincial level, Canada appears unusually constrained in what it can do to bring greater equity and efficiency to corporate group tax loss utilization. Moreover, the inefficiencies in the current system are small in aggregate terms, and the informal self-help system has a relatively generous threshold for access. Accordingly, while Canada's current informal self-help corporate group loss system is far from ideal, it appears to remain as a workable approach. Alternatives to the status quo should be considered cautiously, as they have the potential to do more harm than good.

I. INTRODUCTION

The income tax treatment of corporate groups has been a vexed question of Canadian tax policy for a very long time. In May 1985, then minister of finance, Michael Wilson, released a paper entitled “A Corporate Loss Transfer System for Canada,”¹ which put forward for discussion a proposal to allow the transfer of losses among a commonly owned group of corporations for the purposes of corporate income tax. No changes to the Canadian corporate income tax system resulted from this initiative, and little was said by governments in Canada since that time until the release of a consultation paper, entitled “Taxation of Corporate Groups,”² by the federal Department of Finance in November 2010. Considerable discussion among experts and stakeholders has followed the release of the 2010 paper, but after two subsequent federal budgets, it is not clear that there is any significant movement toward changes in the corporate income tax in this area.³

Given that the corporate tax systems of many other OECD countries contain some formal mechanisms for the recognition of losses of one corporation in a group against the profit of another,⁴ questions naturally arise as to what it is that makes this issue of the taxation of corporate groups such a difficult one in the Canadian context, and what, if anything, should be done about it. This paper will explore and analyze the issue of corporate group taxation in Canada, and related questions of tax loss utilization, from a tax policy perspective. It will suggest that an important part of the reason for the lack of major change in this area is the absence of an optimal alternative to the status quo that can be practically implemented in the Canadian context. This exploration and analysis begins with Section II, which discusses issues of net income taxation and the purpose of the corporate income tax. In Section III the issue of loss utilization under the Canadian corporate income tax is discussed. In Section IV the tax policy principles and issues to be taken into account with respect to loss utilization and corporate groups are explored, and three alternative approaches for possible changes to the Canadian tax system are described and briefly analyzed. Section V then summarizes our conclusions.

¹ “A Corporate Loss Transfer System for Canada,” Finance Canada (1985).

² “The Taxation of Corporate Groups,” Finance Canada (2010).

³ The most recent federal budget plan of March 29, 2012 does state at page 126 that: “Economic Action Plan 2012 reaffirms the Government’s commitment to continue exploring whether new rules for the taxation of corporate groups could improve the functioning of the corporate tax system.”

⁴ For example, the United States, the United Kingdom, Germany, France, the Netherlands and Japan.

II. NET INCOME TAXATION

General Approach

The basic theory of a comprehensive income tax for individual taxpayers as applied in many personal income tax systems such as Canada's would generally determine the use of a broad income base, defined in terms of all amounts that add to or subtract from the economic resources of the taxpayer, determined on a *net basis*, in order to gauge the taxpayer's "ability to pay."⁵ However, while most income tax systems provide for income from a business or investment source to be determined on a net basis, and for losses from various sources to be netted by a taxpayer against income from other sources in a year, significant restrictions on netting of costs often exist with respect to income from employment.⁶

Most income tax systems also provide for some carry-back or carry-forward of net losses in a year, by the taxpayer, to reduce income subject to tax in other tax years, though usually within certain time limits.⁷ Direct cash refunds by the tax authority to the taxpayer of the tax value of unused net tax losses are, generally, not provided. Loss carryovers are usually applied at their nominal value — that is, there is no recognition of the time value of money if they are used later than the year incurred — so that obtaining value for net tax losses through transfer of losses to others, either through explicit provisions of the tax system or through self-help loss trading (often involving tax shelters), is of interest to taxpayers. Most net income tax systems contain various constraints to discourage self-help loss trading beyond approved limits.⁸

Corporate Income Tax

The purpose and structure of the corporate income tax, which has a somewhat different underlying function than the individual income tax, needs to be borne in mind when examining loss utilization by corporations. One or more of three possible functions for the corporate income tax are usually recognized.

The first of these functions is for corporate income tax to serve as a withholding mechanism to prevent deferral of tax on the income of a business carried on in, or investment income earned by, a resident corporation that is yet to be distributed to resident shareholders; and to ensure that a final rate of tax is levied on such income that is to be distributed to non-resident shareholders, who do not normally pay income tax in the jurisdiction. The second possible function attributed to the corporate income tax is to levy a final tax on corporations as legal entities. This tax is viewed as a form of user fee paid by the corporation in exchange for the legal and economic benefits that corporations receive from governments, such as limited liability or general use of public infrastructure. The third possible function for a corporate income tax is to serve as a tax on economic rents that would otherwise bear a lesser tax burden.

⁵ This approach in its very comprehensive form is often identified as the Haig-Simons income base: see in this regard Henry Simons, *Personal Income Taxation: The Definition of Income as a Question of Fiscal Policy* (Chicago: University of Chicago Press, 1938). It is now recognized that there are other approaches for an income tax base that have some potential advantages compared to the comprehensive income tax base: see in this regard Robin Boadway et al., *Taxes on Capital Income in Canada: Analysis and Policy*, Canadian Tax Foundation, 1987.

⁶ See, for example, sections 5,6 and 8 of the Income Tax Act.

⁷ See the discussion of the Canadian rules in Section III below.

⁸ A number of countries with tax loss transfer or consolidation systems also have anti-loss trading rules — see the U.S. federal corporate income tax for example.

In the case of business or investment income earned by corporations in a jurisdiction with a general individual income tax based on net taxation, corporations are also usually taxed on a net basis — that is, on the profit left from business or investment activities after subtracting expenses incurred for the purpose of earning the revenues, all as calculated under the specific tax rules of the particular system. Following generally the individual income tax, this net income would be determined on a taxpayer legal-entity basis with some carry-over of losses in time without interest.

Because corporations are usually seen as providing a withholding function, and because they are artificial legal constructs, additional tax policy issues arise with respect to taxation of corporate income. One such issue is the possibility of double taxation of corporate earnings, once at the corporate level and again at the shareholder level. Thus in many corporate tax systems, the corporate income tax of a resident corporation is partially or fully “integrated” with the income tax of resident shareholders, such that double taxation of corporate business earnings is reduced or eliminated. This is normally accomplished through the use of some form of “imputation” system, whereby corporate level income is, effectively, imputed to shareholders, often by use of some form of an advance corporate level tax on distributions combined with shareholder credits for this tax against their personal tax liability on dividends received from the corporation.⁹ This is often combined with favourable tax treatment of capital gains on shares. For example, the Canadian corporate income tax system has, over time, moved some considerable distance in the direction of full imputation — though with some important limitations¹⁰ — by use of a non-refundable dividend tax credit for resident individual shareholders on their dividends received from Canadian resident corporations, and by reduced taxation of capital gains.¹¹

Another important issue that arises in corporate income taxation is whether, and to what extent, the income or loss of several different corporations, with identical or overlapping ownership, is to be combined for income tax purposes — that is, taxed on a net basis. This is the issue of corporate group taxation. As discussed below, this question is part of a broader issue of net income taxation and loss utilization in the income tax system.

⁹ Such a system is sometimes described as an Advance Corporation Tax. It generally operates such that a special tax is levied at the corporate level on dividend distributions at the mainstream corporate tax rate, with mainstream corporate tax liability creditable against this special tax. Then the recipient shareholder (often limited to residents of the jurisdiction) receives a tax credit against the corporate level tax (in some systems this credit has been refundable if insufficient shareholder tax is payable). This system ensures that corporation tax that has been paid is at least equal to the amount of the shareholder distribution tax credit.

¹⁰ The non-refundable dividend tax credit provided for in the Canadian income tax system is not based on a form of Advance Corporation Tax — that is, there is no mechanism that requires that the corporation paying the dividend has borne corporate level tax on the underlying profits being distributed. Thus the amount of dividend tax credit provided to Canadian resident shareholders can be in excess of the amount of tax paid at the corporate level. See sections 82 and 121 of the Income Tax Act.

¹¹ The Canadian corporate tax system also contains special provisions intended to integrate the corporate and shareholder levels of taxation on investment income earned through private corporations. See subsection 83(2), section 129 and Part IV of the Income Tax Act.

Loss Trading

Most corporate income tax systems follow their individual income tax approach in providing for no, or for very limited, direct refundability of the tax value of losses. The absence of immediate refundability of the tax value of losses (and limits on express loss transfer or consolidation for corporate groups) creates an incentive for taxpayers to participate in tax arbitrage through self-help transactions such as financings, asset sales and leases, and corporate reorganizations designed to transfer losses from a corporation that sustained the loss, but cannot use it immediately, to another corporation that has income against which it can use such loss. Very rarely, as in the Canadian corporate tax system, an informal regime of self-help loss trading is provided as a substitute for an explicit loss transfer or consolidation system for corporate groups.¹²

Self-help trading of a corporate business or investment tax loss is implicitly equivalent to the loss corporation obtaining a refund in cash from the tax authority of some or all of its value. However, in self-help loss trading the amount of compensation paid to the loss-selling corporation should always (except potentially where there is identical economic ownership in the two corporations) be less than full tax value, as the price will reflect a discount for (i) uncertainties of their quality or ultimate usability by the buyer, (ii) possible loss of time value, or (iii) transaction costs and profit element for the buyer. The less restriction there is in the tax system on the effective transfer of losses, the higher the price that will be paid to the seller, which will tend toward the limit of its full tax value. In a tax system with freely transferable corporate business losses, these losses should all be utilized on a current period basis up to a maximum of the total amount of corporate income subject to tax and available for netting. By comparison, full refundability of loss tax value by governments could result, from time to time, in a total revenue cost to government that exceeds taxes paid, thus placing the government in the position of having negative income tax revenue in a period.

III. LOSS UTILIZATION IN CANADIAN CORPORATE INCOME TAX

General Approach

How does the Canadian corporate income tax system fit into the framework for net income taxation described above? Under the Canadian income tax system, taxpayers are generally permitted to determine the loss from each source of business or investment income on a net basis and to reduce income from one source by a loss in the year from another source.¹³

¹² See discussion of this approach in Section III below. Also note that corporate tax consolidation was formally provided for in Canadian income tax law from 1932 to 1952, subject to stringent conditions. See: Stephen R. Richardson, "Transfers Within Corporate Groups," 1984 Annual Conference Report, Canadian Tax Foundation (1984).

¹³ See section 3 of the Income Tax Act. However, this is not uniformly the case: see, for example, the loss deduction limits in section 31 of the Income Tax Act regarding restricted farm losses, and other such source-based limits. As well, capital losses may, subject to a few exceptions, be deducted only against capital gains.

Determining net income from a single source, such as a business, involves taking all of the revenue of the business in a period and subtracting all expenses of the business incurred to earn that revenue, according to the express rules of the applicable tax legislation.¹⁴ Canadian corporate taxpayers with negative taxable incomes are not entitled to refunds of tax value from the tax authority, though in limited circumstances, where certain tax credits exceed the tax payable, they are entitled to obtain a direct refund of part or all of the net tax value of such credits.¹⁵ Unused business tax losses may be carried back up to three years or carried forward up to 20 years to offset future tax liabilities of the taxpayer.¹⁶ Capital losses may be carried back three years and carried forward indefinitely. In addition, the discretionary nature of the deduction of certain capital expenditures such as capital cost allowance (tax depreciation) allows for a similar carry-forward effect.¹⁷

These loss carryovers are, however, based on the nominal value of the loss involved, such that losses or deductions that cannot be used immediately, but only in future years, have a diminishing economic value because of the loss of the time value of money. These loss carryovers also normally have a value that reflects a further reduction because of uncertainty of their ultimate use — that is, there always exists the possibility that losses may become trapped in a corporation with no source of net income, or may otherwise expire before use. This latter risk is increased in the Canadian tax system because it contains specific rules aimed at limiting trading in tax losses: These rules prevent the application of corporate tax losses to certain income sources, or they eliminate these losses completely in the corporate entity that incurred them where there is an acquisition of control of that corporation.¹⁸ The rationale for the precise structure of these rules is less clear, though it seems generally to be based on a rough determination of whether there is continuity of economic ownership of a corporation over time.

¹⁴ See sections 9, 12, 18 and related provisions of the Income Tax Act.

¹⁵ Canadian-controlled private corporations are able to claim a scientific research and experimental development tax credit at an enhanced rate of 35 per cent on the first \$3 million of expenditure each year (the general tax credit rate now being reduced from 20 per cent to 15 per cent). For these CCPCs, these tax credits are refundable with respect to the first \$3 million of expenditure each year — current expenditures at 100 per cent and capital expenditures at 40 per cent; expenditures in excess of the first \$3 million each year are refundable to them at 40 per cent. The special CCPC rate is phased out based on certain size measurements.

¹⁶ The horizon for carry-forwards has increased from seven years to 20 years since 2004. Different carry-forward periods apply to capital losses and “Allowable Business Investment Losses” of small businesses. This paper focuses mainly on non-capital losses, which are the bulk of tax losses claimed by corporate taxpayers.

¹⁷ For example, a corporation entitled to claim an amount of capital cost allowance for a year may, generally, either claim the maximum deductible amount or a lesser amount. Where it claims an amount in excess of its remaining taxable income, this will create a loss for carryover. In some circumstances, such as where the corporation does not have sufficient income in the year to use all the potential deduction, it could either turn some or all of the allowable deduction into a loss, or refrain from claiming the maximum allowance, which leaves it claimable in future years.

¹⁸ Subsection 111(4) of the Income Tax Act provides that on an acquisition of control of a corporation in a year, its net capital losses are eliminated and the tax value of certain property is reduced to fair market value, with the difference being transformed into a loss. Subsection 111(5) provides that on an acquisition of control of a corporation in a year, its non-capital losses (business losses) are only deductible against income in taxation years following the acquisition of control if: (i) the loss-business continues to be carried on for profit or with a reasonable expectation of profit, and (ii) it can apply these losses to reduce income from that same business or a business substantially all the income of which is derived from trading, renting or dealing in similar property or providing similar services as the loss business.

Loss Transfer

In Canada there is no explicit formally legislated system of corporate group taxation to provide for transfer of tax losses from one corporation to another or consolidation of their income for tax purposes, except in limited circumstances like amalgamation and wind-up.¹⁹ However, there is an articulated policy, flowing from the non-application of the legislated general anti-avoidance rule, of allowing corporate taxpayers to undertake self-help transactions that can effect the transfer of tax losses from one corporation to another, where these corporations meet a defined test of relationship.²⁰ This self-help loss transfer approach can involve many different mechanisms, though it can often utilize intercompany debt and preferred shares to move a loss by creating an interest expense in the transferee corporation and matching interest income in the transferor. The relationship test that is used for this purpose is, in general, *de jure* control of one corporation by the other corporation or common control of both, with “control” being measured by ownership of 50 per cent plus one of the voting shares of a corporation.²¹ Use of this informal self-help loss trading system can involve significant transaction costs, and a complete certainty of the result is not always obtainable.²² Moreover, availability of this self-help approach can vary throughout the corporate sector, in particular as it is more readily utilized by larger, more sophisticated corporations, and it may be more difficult for some corporations in certain regulated sectors to effect the required transactions.²³ The Canadian corporate tax system also permits some other self-help loss trading transactions through the sale of tax shelters to investors.²⁴

Where a corporation cannot avail itself of self-help loss transfer transactions, for example because of non-tax constraints such as regulatory limitations, this approach to corporate loss utilization puts Canadian corporations with losses in a potentially worse situation than those in other countries that provide formal tax loss transfer or tax consolidation systems. However, where Canadian corporations are able to transfer losses using the informal self-help system, they are in many cases in a better position than corporations in other jurisdictions with explicit loss transferor consolidations systems, because the ownership threshold for permitting such transactions in the Canadian system is generally lower than that of other countries with explicit systems, and the scope for potential transfer may be greater. As noted above, the test for informal loss transfer in the Canadian tax system depends, generally, only on ownership of 50 per cent plus one of voting shares, which implies common ownership as low as about one-half.

¹⁹ See sections 87 and 88 of the Income Tax Act.

²⁰ This is set out in Technical Notes issued by the Department of Finance which comment on the circumstances of application of the “general anti-avoidance rule” in section 245 of the Income Tax Act.

²¹ This control test is applied for this purpose both directly and indirectly through intermediate corporations. Regarding the definition of “related” corporations, see section 251 of the Income Tax Act and related provisions.

²² For example, while Advance Income Tax Rulings can be obtained from the Canada Revenue Agency on certain aspects of such a transaction, there could remain questions about the original quantum or quality of losses that are transferred.

²³ For example, certain corporate groups operating in the regulated financial sector.

²⁴ Anecdotal evidence suggests that tax shelter transactions that are expressly provided for by statute can be financially very inefficient, with significant portions of the tax value of the selling corporation’s expenditure going to purchasers and transaction costs.

In fact, this test permits loss transfer in circumstances where common ownership is even less than 50 per cent, where the controlled corporation has other, non-voting participating shares outstanding. By comparison, most explicit tax loss transfer or tax consolidation systems require relatively high common ownership, measured across all outstanding equity securities (sometimes with an exception for certain fixed-value preferred shares), in the range of 75 per cent to 80 per cent.²⁵

Economic Implications

The absence of general refundability of tax loss value causes certain problems in the Canadian tax system (as in other jurisdictions), because effective tax rates will differ among taxpayers, both currently and over time. This has significant potential implications for the economic efficiency and productivity of investment decisions. In particular:

- Non-refundability of the value of tax losses increases the expected effective tax rate for any taxpayer facing a positive probability of future tax losses, since taxes on future profits are not symmetrically offset by refunds on losses. The magnitude of this effect is debatable, for reasons discussed further below. But the effect tends to be largest for taxpayers with a high probability of loss, suggesting that the problem is greatest in sectors subject to cyclical effects or other income risks. Thus, deferral of refunds tends to deter risky investments, relative to safe ones.²⁶
- Moreover, the effect is greatest where there is high persistence of losses over time, since a taxpayer experiencing a loss in the current tax year is less likely to have previous-year taxes against which to carry back the loss, and the expected time over which losses must be carried forward is greater. This suggests that the problem is greatest for start-up firms.²⁷
- A corporation carrying forward losses from previous years faces an effective tax rate on new income equal to zero. This causes the expected marginal tax rate on new investments to differ between loss-carrying and taxable corporations. In general, the direction of this distortion is unclear. While net income of the loss-carrying corporation is effectively tax exempt in the short run, which reduces its marginal tax rate, it also cannot, in the short run, avail itself of tax deductions for interest payments, capital cost allowance, and other deductible expenses, all of which tends to increase the marginal tax rate of loss-carrying corporations relative to taxable ones. Many assets are likely to generate negative taxable income in the initial years following investment — particularly machinery and equipment investments that are eligible for accelerated capital cost allowance, and eligible expenditures under the scientific research and experimental development tax credit and other tax credits. In such cases, the deferral of deductions for a loss-carrying corporation tends to increase the marginal tax rate on investment above what it would be in a system of

²⁵ For example, the general relationship requirement in the U.S. for tax consolidation is 80 per cent ownership, and the requirement in the U.K. for tax loss transfer is 75 per cent ownership.

²⁶ These arguments were first laid out in detail by Auerbach (1986). Under some circumstances, even a corporate tax with immediate refundability may discourage risk taking; see: Jack Mintz, "Some Additional Results on Investment, Risk Taking, and Full Loss Offset Corporate Taxation with Interest Deductibility," *Quarterly Journal of Economics* 96 (1981): 631-642.

²⁷ See the computations in: Jack Mintz, "An Empirical Estimate of Corporate Tax Refundability and Effective Tax Rates," *Quarterly Journal of Economics* 103, 1 (1988): 225-231.

full refundability.²⁸ While no recent evidence is available on these effects for Canada, it is reasonable to think that loss-carrying corporations face slightly higher marginal tax rates, at least in manufacturing and processing sectors where tax depreciation rates are most likely to exceed economic depreciation rates.²⁹

- Non-refundability may also change corporate financial decisions in a way that is unproductive for the economy as a whole. Since interest payments are not deductible until the corporation returns to taxpaying status, their value is lower to a loss-carrying corporation than to a taxable one, which changes the returns to issuing new debt versus new equity. In general, then, the existing treatment of losses should discourage corporate leverage.
- Self-help loss trading transactions create additional deadweight costs for the economy. To the extent that self-help loss trading transactions provide a measure of indirect refundability to taxpayers, this tends to reduce the efficiency costs of non-refundability described above. In this sense, loss trading is economically desirable, despite the potential revenue losses to the treasury. This benefit of loss trading must, however, be weighed against the costs incurred by the taxpayer to effect the loss transactions, in the form of professional fees and profits ceded to the purchaser of losses. Anecdotal evidence suggests that pure “deadweight” transaction costs are probably of such a magnitude that, on balance, self-help loss trading does in fact increase the economic efficiency of the tax system.

The Extent of the Issue

The current non-refundable loss system is costly to the taxpayer to the extent that tax loss transfer involves uncertainty and expense, and because of foregone interest on the deferral of the tax refund. Since tax loss carry-forwards are denominated in nominal terms, the relevant opportunity cost of deferral is the nominal interest rate. In the current environment of low inflation and low real rates of return, this opportunity cost is rather low, particularly compared to the high nominal interest rate environment of the 1980s, when the Department of Finance first proposed a formalized system of intra-group loss transfers. According to summary data presented in the Department of Finance’s “The Taxation of Corporate Groups,”³⁰ the stock of unused losses in 2008 was \$206 billion, or nearly 100 per cent of corporate taxable income for the same year.³¹ Assuming a 25 per cent effective tax rate and a five per cent nominal rate of interest, the cost of carrying this stock for a single year is on the order of “only” \$5 billion, equivalent to about 2.5 per cent of corporate taxable income, or 0.3 per cent of gross domestic product. This implies that the inefficiencies of the current system are small in present value terms. Of course, nominal interest rates may rise in future, and it is better to have a tax system that is robust to this possibility.

²⁸ This point is elaborated in Alan J. Auerbach and James M. Poterba, “Tax Loss Carryforwards and Corporate Tax Incentives, In *The Effects of Taxation on Capital Accumulation*, ed. Martin Feldstein (Chicago: University of Chicago Press, 1987).

²⁹ Cooper and Knittel (2010) simulate marginal tax rates for U.S. corporations and find a small tax disadvantage, on average, for loss-carrying firms.

³⁰ “The Taxation of Corporate Groups,” Finance Canada (2010).

³¹ While this figure is somewhat elevated due to the effects of the 2008-09 recession, the stock of losses has exceeded 10 per cent of GDP in all years since 2000 (“Corporate Loss Utilisation through Aggressive Tax Planning,” OECD (2011)).

The remaining cost of deferral is the risk of non-utilization, including possible expiry. There is, however, evidence that the probability of expiry in the long run is relatively small. Of non-capital losses incurred for the 2000 tax year, 19 per cent were carried back and immediately refundable, and 46 per cent were carried forward and claimed in future tax years. The balance of 2000 tax losses either expired at the then seven-year limit (11 per cent), or were lost due to the dissolution of the taxpayer or “another restriction” (25 per cent). In general, these statistics suggest that expiry is not a significant problem for most taxpayers, especially given that the time limit for carry-forwards has since been extended to 20 years. However, these aggregate statistics mask important intersectoral allocation effects which, as noted above, tend to cause reallocation of investment between sectors and between established firms and start-ups in a way that is unproductive for the economy overall.³²

It is important to note that these data reflect not only the tendency of corporations to return to taxable status and, so, to use previous tax losses, but also their ability to transfer losses to related taxpayers through various self-help loss transfer transactions as discussed above. A majority of the stock of loss carry-forwards have accrued to corporations that are part of groups of two or more related corporations,³³ so that currently available loss transfers exert a substantial effect on the working of the system as a whole. Without such transactions, the prevalence of tax losses and their expiry would presumably be greater.

At the same time, the data on the stock of losses carried forward cannot be used to simulate precisely the impact on losses and tax revenues of an alternative tax regime, such as a formalized system of loss transfers or income consolidation for corporate groups. If such a system were introduced with elective elements, some groups might prefer to continue to carry forward some tax losses, as a means of smoothing income or for other non-tax reasons. Furthermore, at least some losses are carried forward in corporate groups that are not reporting positive taxable income in any of their affiliates, so that a more expansive system of group loss transfers would have no effect. While direct evidence on these possibilities is not available from the data, it is worth noting that, in several countries with formalized loss transfer regimes or group consolidation, the stock of losses carried forward is nevertheless larger than it is in Canada.³⁴

Rationales for Restrictions on Loss Utilization

Given that there are some economic costs of limitations on loss refundability, why is refundability, or at least free trading of losses, not provided for generally and in particular in the Canadian corporate tax system? Conventional explanations see these restrictions as a means of preventing undue erosion in the corporate income tax base. In particular, a less restricted tax-loss utilization regime might give rise to:

- A general reduction of corporate income tax revenues, which could be made worse over time where domestic taxpayers obtain the value of start-up or similar losses in Canada by refund but then arrange to shift the later related income out of Canada.

³² Using data for an earlier period, Mintz (1988) found substantial differences among sectors in the speed with which losses were utilized and the probability that they expired unused — with the effective rate of refundability highest in the service sector, but lower in the manufacturing and, especially, resource sectors. Mintz also notes that the effects were most pronounced in risky sectors. See also Auerbach and Poterba (1987) for a related analysis using U.S. data.

³³ Of the \$191 billion in the average stock of non-capital losses in the 2005-2008 period, \$101 billion were held by members of corporate groups with 100 per cent common ownership of two or more members.

³⁴ In Australia, for example, the stock of non-capital losses in 2008 was 14.5 per cent of GDP, compared to 13.0 per cent in Canada (“Corporate Loss Utilisation through Aggressive Tax Planning,” OECD (2011)).

- Revenue loss from corporate-loss dumping into the Canadian tax jurisdiction by non-residents which cannot obtain equivalent loss utilization in their home jurisdictions, which are located in lower tax jurisdictions, or which may be able to achieve double relief for the value of losses. Double relief may occur in some cases, for example when a dual-resident corporation with a tax loss avails itself of the income consolidation or loss transfer regimes of two separate countries in which it has affiliates. This double relief may be difficult to control through conventional means available to tax authorities, when transactions involve complex financial instruments and hybrid entities that are not taxed in the same way in all countries in which they are regarded as resident.³⁵
- An increase in the value of various existing tax shelters beyond already generous levels. Corporations in the resource sector, those with claims under the scientific research and experimental development and other tax credits, or those in the manufacturing and processing sectors availing themselves of accelerated capital cost allowance, may, in principle, face negative effective tax rates on investment, especially for highly leveraged investments. In such cases, the probability of tax losses is high, particularly in the early years of an investment plan; limitations on refundability may then be construed as part of a broader attempt to limit access to tax shields that might be viewed as excessive.
- Loss of revenue from evasion and fraud in the tax system from activities that improperly create or increase tax losses. For example, cash refundability of loss value tends to increase significantly the propensity for claims based on overvalued or fictitious expenses or assets.³⁶

IV. POLICY AND ALTERNATIVES

Tax Policy

The goal of the tax system is to raise revenue while optimizing equity among taxpayers and economic efficiency. “Horizontal equity” connotes that taxpayers in similar circumstances should bear the same burden of taxation. “Economic efficiency” connotes that taxation should have the least possible effect on the allocation of resources in the economy — including that key economic decisions of taxpayers should not be unduly influenced by tax considerations (neutrality). Also, a tax system should seek to avoid levels of complexity that are administrable only with excessive difficulty or by using resources that are unduly costly for tax authorities or for the taxpayer. The foregoing discussion of the treatment of corporate tax losses in the Canadian corporate tax system suggests that the current system raises issues of horizontal equity and economic efficiency, including the issue of loss utilization within corporate groups.

³⁵ Several countries have recently introduced rules that are aimed at denying relief for losses that are deductible or have been claimed for deduction in another country. The United Kingdom, for example, has rules disallowing capital and non-capital losses arising from certain transactions for this reason.

³⁶ Some of the activities that responded to the provision of a Canadian refundable investment tax credit for scientific research and development from 1983 to 1985 (the SRTC) provided some good examples of these effects, and contributed to the removal of this refundable credit.

There are several different possible views of the horizontal inequities caused by limited direct or indirect refundability of corporate tax losses in the Canadian tax system. The narrow view is based on the fact that because a corporation is an *artificial* person, the possibility easily arises that a single or multiple businesses owned by the same shareholder or group of shareholders could be divided among more than one corporation for reasons other than taxation purposes — for example, management, financing, liability or regulatory considerations. In such a case, where more than one corporation is owned by the same economic interests, horizontal equity suggests that these multiple corporations be allowed in some way to combine or net income from one source in one corporation against a loss from a source in one of the other corporations. By comparison, a broader view of horizontal equity in terms of corporate loss utilization, is that the amount of tax on a specific business activity or asset of the ultimate economic owner, whether positive or negative (loss utilization), should be the same for all taxpayers, regardless of specific business organization or a taxpayer's other business activity or lack thereof, past or present.³⁷

With respect to economic efficiency, as discussed above, anything less than full current refundability of the value of net corporate tax losses in cash by the tax authority will introduce distortions of after-tax returns, which will contribute to misallocation of investment capital in the economy, and reduce potential economic growth. The broadest view of the goal of economic efficiency would involve completely symmetrical taxation effects for net income and net losses of economic owners of corporations on a basis that integrates the corporate tax effects with the shareholder tax effects.³⁸

To see some of these implications of equity and economic efficiency for the tax treatment of losses, consider a simple example. An economic asset earns a stream of (net) economic income (Y_1, Y_2, Y_3, \dots) over its useful life. The goal is to design a tax system, that is, a stream of tax liabilities (T_1, T_2, T_3, \dots) payable in respect of the asset. There is some sequence of discount rates (r_1, r_2, r_3, \dots) that may vary over time, but that is common to all assets and asset owners in the economy. In this context, a tax system is equitable if and only if, for all assets, the present value of taxes paid over the asset life is equal to some common proportion τ of the present value of the income stream. This condition must hold whatever the timing of income over the asset's life, and whatever the ownership structure and organizational decisions of the asset's owners, implying that an equitable tax system is also a neutral tax system with respect to these choices. This simple proposition has strong implications for the tax treatment of losses — that is, net income accruing to the asset that is negative for some years. Under full loss refundability, $T_t = \tau Y_t$ for all years (t) and all incomes (Y_t), so that the present value of taxes paid on each asset equals the same fraction (τ) of the present value of net income. In this sense, refundability, with a tax refund $T_t < 0$ when $Y_t < 0$, is a sufficient condition for equity and

³⁷ For example, the narrower view would not deal with any horizontal inequity in the following situation, whereas the broader view should seek to address it: Corporation A is a stand-alone start-up business which incurs a loss of \$x. Corporation B starts up a similar business and also loses \$x, but at the same time it is operating a separate successful business which is producing taxable income of at least \$x. Corporation A cannot use its loss and receives no current value for it, whereas Corporation B, by virtue of the operation of its other unrelated business, can utilize its loss immediately to reduce its tax liability from that business.

³⁸ As noted in the discussion above in Section III, the Canadian corporate tax system partially integrates income of corporations with that of resident shareholders, but does not integrate net losses of corporations, except in rare circumstances of flow-through mechanisms.

neutrality of taxation as defined above. It is also clear that restrictions on refunds and transfers of tax losses, for which $T_t > \tau Y_t$ when $Y_t < 0$, tend to raise the effective tax rate on the asset in a way that violates horizontal equity. An asset that earns losses in some years pays a higher present value effective tax rate than an asset that earns a steady stream of income over time, even if the present value of income in the two cases is the same.

However, it is important to note that these results for equity and neutrality from refundability hold only in the “first-best” case — that is, in a closed system in which tax authorities may perfectly observe the net income accruing to the asset in all states of the world. If some owners can move income or loss, whether present or future, in or out of the jurisdiction, or if they can exaggerate expenses or underreport positive income streams, then refundability creates significant problems for equity and neutrality. In particular, the lifetime present value effective tax rate falls below the desired proportion τ , resulting in inequity and non-neutrality. There is therefore some theoretical basis, in addition to the difficult practical issues described at the end of Section III above, that lends some support to the concerns of governments and revenue authorities as to the erosion of the revenue base from increased refundability of corporate tax losses.

The Provincial Dimension

In Canada, both the federal government and the provinces have constitutional authority to levy a corporate income tax,³⁹ though provinces are limited to direct taxation within the province. Where corporations carry on business in more than one province, the provincial corporate tax base is apportioned to each province where the corporation has a permanent establishment, according to a formula that considers certain business factors, namely sales and employee remuneration in a province.⁴⁰ This system of provincial corporate taxation, combined with the absence in Canada of any formal loss transfer system, results in two especially important implications for provinces in connection with the taxation of corporate groups and the netting of losses.

The first important implication for provinces is that this system using separate accounting provides multi-province businesses some considerable degree of flexibility for tax planning by organizing the location and activities of various corporations in the group in a way that minimizes overall provincial taxation, through shifting of elements of income or loss among corporations with different provincial allocations, or in some cases with no allocation to a relevant province.⁴¹ For example, use of different, and changing, mixes of debt and equity among corporations in a group can shift income or loss from one to another to obtain a lower provincial tax rate on net income. Moreover, corporations in a group using approved (for federal corporate income tax purposes) self-help loss trading transactions within the group are netting income and loss for federal purposes, but may also be shifting income or loss from one province to another.

³⁹ Under section 91 of the Constitution Act, the federal government may raise money by any mode or system of taxation, while under section 92, the provinces may use only direct taxation within the province to raise revenues.

⁴⁰ The general formula for allocating income is the sum of shares of payroll and sales in a province, divided by two. Some other formulas are used for special cases such as transportation and financial industries — these replace the sales factor with other indicators, such as passenger miles and assets. See Part IV of the Regulations to the Income Tax Act.

⁴¹ This could result where a corporation in the group with income from the group has a permanent establishment in only one province. An example would be the use of a dedicated financing corporation, within a corporate group, with a permanent establishment only in one low-tax province.

These considerations apply to all manner of transactions between corporations in a group with permanent establishments in different provinces, whether they are designed for tax planning or other purposes. In particular, there are a variety of transfer pricing and financial arrangements between corporations that are designed to arbitrage differences in provincial tax rates and tax bases in a way that minimizes the total provincial tax payable by the corporate group. The available evidence suggests that, during periods when tax rate differences between provinces have been high, there has been considerable provincial revenue loss through interprovincial income shifting.⁴² If tax planning causes reported taxable income to shift to provinces where less tax will be paid, then aggregate provincial revenues are reduced — an obvious concern to provincial treasuries. Moreover, income shifting creates a potential for tax competition, placing downward pressure on the tax rates imposed by all provinces.

The second important implication for provinces of the Canadian approach to corporate taxation is that the institution of a formal system of tax loss transfer or consolidation, which would operate at the provincial corporate income tax level as well as at the federal level, could cause a potential increase in the amount of corporate tax loss being shifted from one province to reduce income earned in another province. In such a system the federal government, which would be matching all transferred or consolidated loss with income in its own system over time, would suffer a revenue loss to the extent that losses are applied on a more timely basis, net overall, whereas particular provinces could suffer absolute revenue reduction from their corporate income tax by increased shifting of corporate tax loss into the province to net against income earned in the province. These provincial (and federal) revenue effects would, of course, depend on whether the particular loss transfer or consolidation system that is implemented would result in increased or decreased corporate loss transfer as compared to the status quo, which includes the informal self-help loss trading system.⁴³

Alternatives

As discussed above, there is a strong theoretical argument in an ideal, closed corporate income tax system, where all taxpayer activity can be observed and measured accurately, for full, direct refundability by government of the cash value of tax losses. This would achieve horizontal equity and eliminate various non-neutralities such as those in the timing of investment, in the organization and ownership choices of firms, and between assets with different risk characteristics.

The Canadian corporate income tax system is not in this sense ideal, nor is it closed to the rest of the world. Thus both theoretical issues and practical difficulties — in particular, considerations relating to protection of government revenues, and risks related to the difficulty of administration and compliance — make a system of full, direct loss refundability

⁴² Mintz and Smart (2004) looked for evidence of interprovincial income shifting using tax return data for the 1986-2000 period. During the period under study, statutory tax rates in Quebec were several percentage points lower than in Ontario and other provinces, and concerns had arisen about certain classes of transactions that appeared designed to shift income into Quebec affiliates. Consistent with these concerns, Mintz and Smart found that taxable income of corporations using separate accounting for provincial tax was highly responsive to provincial-tax rate differentials, compared to corporations whose income was allocated by formula.

⁴³ See the discussion in Section IV below of possible loss transfer systems that might result in a reduction of loss utilization by virtue of using a higher ownership threshold condition.

unachievable. Crucially, with the “first-best” solution for loss utilization of full, direct refundability off the table,⁴⁴ it is difficult to identify a single optimal approach to justify a particular treatment of losses within a corporate group. Taken together with the provincial considerations identified above, this may help to explain why Canada has made do for so long with an informal self-help system of loss transfer within corporate groups, overlaid by various rules aimed at limiting tax loss trading.

This situation suggests either leaving the current Canadian corporate tax system of loss utilization unchanged, or considering limited improvements in horizontal equity and economic efficiency through “second-best” alternatives for changes to tax loss utilization rules, either generally or focused on corporate groups. Below we will describe and analyze three such alternatives which are representative of a broad range of possible approaches.

1. INTEREST ON LOSS CARRY-FORWARDS.⁴⁵

A generalized alternative system that could achieve greater equity and economic efficiency, but that ensures that overall government corporate tax revenues will never be negative, would involve retaining some of the current system while adding a mechanism that would adjust each year the amount of unused corporate tax loss carry-forward — for both federal and provincial purposes — by an interest factor at the rate, based on the example above, of rt . Under this system, one dollar in losses in year t can offset $1+rt$ dollars of taxable income in year $t+1$, and so on, with the intended result that the present value of tax paid is independent of the timing of accrued gains and losses.

If it were a certainty that all losses are eventually fully utilizable by the entity that incurred them, this approach would be neutral for all aspects of taxpayer decisions related to the timing of losses, as all deferred tax assets would potentially earn at least rt per period on losses, regardless of organizational decisions. Indeed, subject to this condition, where the taxpayer’s own cost of capital equals the rate rt paid on losses, there is no present-value cost to deferral, and there would be no purely economic incentive for the taxpayer, including corporations in groups, to change economic decisions to accelerate the refundability of losses. Moreover, relative to loss refundability, this approach should be somewhat less susceptible to abuse by taxpayers. For example, it would be more difficult to claim losses and then later transfer related income sources out of the jurisdiction, leaving later positive income streams unaccounted for.

These potential benefits of this approach are diminished by the fact that there is no certainty that all corporate tax losses will be utilizable by the corporation that incurred them. There are, in practice, several circumstances in which there would be levels of uncertainty about future loss utilization — for example, where the losses are incurred in a failed start-up business, or where there are overhanging legal liabilities in a loss corporation. The presence of such issues would reduce the value of loss carry-forwards that carry an interest factor to below 100 per cent of tax value (as adjusted for that factor), so that in these circumstances loss-carrying

⁴⁴ As well, another theoretically appealing corporate income tax approach that would deal with issues of loss utilization, namely complete corporate/shareholder integration through full attribution of corporate income and loss to ultimate individual economic owners, is considered, for the purpose of this analysis, to be completely impractical.

⁴⁵ Loss carry-backs would not receive similar treatment as, in the paradigm refundability system, cash loss refunds are made currently in the year of the loss.

corporations would still have some incentive to change decisions in order to exhaust losses, or to attempt to trade the losses for current value.⁴⁶

It is presumed that such a system of present value adjusted loss carryovers would retain current rules to transfer loss carry-forwards (as adjusted) on wind-up or amalgamation of a loss-carrying corporation. However, a good argument can be made that, to improve horizontal equity among loss corporations in different circumstances, it would be important at the same time to remove the existing informal self-help loss transfer system, and to broaden existing limits on loss trading. Otherwise, various non-tax factors, such as regulatory limitations, would continue to result in unequal access by various corporate groups to the benefits of loss utilization. Also, as discussed above, some of these transactions create concern because the tax planning involved creates deadweight costs. If these changes are made to compliment the system of interest adjusted losses, then this could leave some corporate groups with loss corporations in a worse position, in terms of obtaining value for a loss, than under the status quo.

Another significant weakness of the interest-bearing loss approach involves the difficulty of determining the rate of interest to be credited to loss carry-forwards. Standard corporate finance theory suggests that interest should accrue to all taxpayers at the pre-tax risk-free rate — for example, the Government of Canada long bond rate. The idea is that differences in firms' internal rates of return reflect risk differences, and on a risk-adjusted basis, all investors actually receive the risk-free rate in expectation. This argument is especially weak for start-up businesses, or other corporations that are credit constrained, and which presumably would prefer immediate refundability to an interest-bearing asset that cannot be traded nor easily monetized. In such cases, where cash is required sooner than when the loss will be used, or where accounting treatment would lead to better financial accounting results with earlier utilization, there remains an incentive to engage in transactions to accelerate refundability of losses even at a discounted cash value.

2. FORMAL LOSS TRANSFER OR CONSOLIDATION SYSTEM: THE FINANCE CANADA CONSULTATION PAPER.

The 2010 Department of Finance consultation paper on the taxation of corporate groups states that the current Canadian corporate tax system does not include a formal mechanism for transfer of losses within a group of corporations that are being operated in a manner that integrates the economic operations of the group, and points out concerns about resulting economic inefficiencies. It also notes that issues of horizontal equity and costs and complexity arise in the current system, which depends on an informal self-help loss trading approach for related corporations.⁴⁷ At the same time, the paper emphasizes the importance of the corporate income tax as a source of revenues for both federal and provincial governments, and recognizes the reductions in overall revenue and changes to revenue allocation among provinces that could result from a formal system of loss transfer or consolidation.⁴⁸

⁴⁶ This could also occur through the application of the source limitation rules in section 111 of the Income Tax Act discussed above, were they to be retained.

⁴⁷ "The Taxation of Corporate Groups," Finance Canada (2010) 2-4.

⁴⁸ Ibid, 5-6, and Annex 2.

The 2010 Finance Canada paper does not go on to make a specific recommendation for a formal corporate tax-loss or consolidation system. Rather it discusses in more general terms some possible approaches along a spectrum of potential systems, running from full consolidation at one end to itemized loss transfer on the other, and it describes various policy and design issues in play. With a view to the general parameters set out in this paper, the following section discusses some important policy issues that need to be addressed in formulation of any such system.

Structure of the System: Determining the guiding policy principle for the structure and design of such a loss transfer or consolidation system is not a straightforward task, given that, as discussed above, the “first-best” approach to increasing horizontal equity and efficiency through general loss refundability is not achievable. In this sense, the consultation paper does not provide a great deal of guidance, though it suggests that some additional amount of corporate loss netting could be a good tax policy result subject to issues of reduced government revenue. Accordingly, in order to find a rationale for corporate loss transfer in such circumstances, it may well be necessary to fall back to the narrower version of the horizontal equity and neutrality principles often identified in the circumstances of corporate taxation: namely, the principle of treating multiple-entity corporate groups with common ownership the same as individual corporations.

Allowing corporations to net losses of one against income of another, to the extent they have the same ultimate economic ownership in the period of earning the income as in the period of incurring the loss, should advance the policy goal of horizontal equity, as compared to the status quo, albeit incompletely. For example, this approach makes no change to other circumstances involving horizontal inequities, such as the treatment of tax losses of a start-up business in a single corporate venture, as compared to the same start-up business in a corporation (or group of corporations) with other sources of business income unrelated to the start-up. The use of the common ownership principle for corporate group loss netting could also be viewed as consistent with a corporate tax system of imputation, as it is based on the idea that both income and loss of the corporation is considered to be economically that of the shareholders.

Whether use of the “common ownership” principle as a rationale for a system of netting of corporate losses would have a positive or negative effect on overall economic efficiency is a difficult question, the answer to which would depend on the particular structure of the system. Use of a principle of common ownership as a base for such system should dictate a high common ownership threshold for access, perhaps starting with identical ownership, as represented by 100 per cent of all outstanding shares of the corporation; although this threshold might be adjusted down a bit for *de minimis* exceptional circumstances.⁴⁹ It would also follow that this threshold should be measured on the basis of full equity ownership — that is, participation in profit and loss of the corporations in question — not on some proxy for ownership such as common control, which is utilized in the current informal self-help loss trading system.

⁴⁹ The proposal in Finance Canada (1985) involved an ownership threshold of 95%. That proposal also removed certain fixed value preferred shares from the ownership test on the basis they do not represent open-ended participation in profits.

Moreover, if the Canadian corporate tax system were to add a formal approach permitting tax consolidation or loss transfer for corporate groups, there is a strong argument that the existing informal self-help loss transfer system should be withdrawn, and anti-loss trading rules should be strengthened to prevent loss transfer outside the new system. This would seem to be important as a matter of horizontal equity: The ability to transfer losses in a new formal system should depend only on qualification under its conditions — most importantly, the common ownership condition — and not on other factors that can facilitate or limit use of the informal system, such as corporate organization or regulatory or legal constraints. However, the structure of a higher qualification threshold and removal of the existing informal self-help loss trading system could well have the effect of reducing the amount of loss that can be transferred under such a new formal system as compared to the existing informal system, thereby reducing economic efficiency compared to the status quo.

A full “tax consolidation” system would result in a level of complexity well beyond that of a “loss transfer” system and could have a number of other consequences for corporate income tax purposes beyond basic loss netting. Such complexity and change do not seem warranted based on the above analysis of the extent of the existing situation in Canada. If there were to be a formal system introduced for group loss utilization, it would appear that it would be better structured such that corporations that are members of a group with defined common ownership would retain their individual legal and separate accounting status, while providing a specific mechanism for one corporation in the group to transfer its tax losses, on an itemized basis, to another corporation in the group. Where a group of corporations qualifies for such “loss transfer,” equity and efficiency considerations would seem to suggest that a number of tax attributes, in addition to losses, should be transferrable among them, including for example: unused tax credits and certain expense deduction pools such as capital cost allowance. Of course, many technical design issues arise in this context, including entry of corporations into and out of the group, treatment of loss carry-backs and carry-forwards, and application of existing acquisition of control source streaming limitations. While each of these design parameters would have to be looked at in detail based on the structure and goals of a particular proposal, they should be considered in the context of the guiding principle for loss netting in such a system as described above.

Provincial Implications: The adoption of such a corporate group loss transfer or consolidation system leaves two serious issues of provincial corporate taxation outstanding. First, there could be significant reduction in revenues for some provinces, based on an overall reduction in corporate taxes and the changes to provincial allocations that result. This overall revenue reduction is not a foregone conclusion if the existing informal system is removed and the amount of overall loss transfer does not increase substantially or even declines; but there could still be very different results for individual provinces. Interprovincial effects of transfers can be large relative to total tax saved by the corporate group. Any change that would reduce overall federal corporate income tax revenues would, of course, reduce overall provincial corporate tax revenues. Secondly, the exposure of provinces to tax planning activities would only be reduced to the extent that increasingly robust anti-loss trading rules are made effective for provincial purposes.⁵⁰

⁵⁰ Convergence of provincial tax rates in recent years may have reduced the significance of the tax planning issue somewhat, though the system should still attempt to be robust enough to put some limits on inter-provincial income and loss shifting. Also, there is a problem even with small rate differences and the possibility of loss in one province and income in another — that is, shifting to use province-specific losses, not related to relative rate differentials.

A formal system of corporate group tax consolidation or loss transfer could avoid some of these consequences by applying only at the federal level, while leaving separate provincial taxation according to existing rules. The benefits of such a federal-only system would be very questionable, because the removal of the informal system of self-help loss trading as part of the change would leave no sanctioned mechanism for corporate group loss netting for provincial purposes. On the other hand, if the self-help informal loss transfer system were retained, it would continue to be used for provincial and federal purposes in many cases instead of the new formal system; this could undermine the rationale for the new system, and detract from the existing high degree of compatibility of current federal-provincial corporate income taxation and administration.

In order to help deal with the provincial tax planning issue, consideration could be given to making the new formal loss transfer or consolidation system *mandatory* for all corporations in a corporate group that would meet the defined level of common ownership, regardless of where they have a permanent establishment.⁵¹ This appears to involve a form of “unitary” tax applied at the provincial level, similar to the approach of certain U.S. states, most notably the California “water’s edge” combined reporting system for corporate income tax. Such a combined tax report is different than consolidated reporting, which involves a single consolidated tax return being prepared for the corporation at the ownership apex of a corporate group. In this type of unitary combined reporting system, where one corporation in a corporate group has a strong business “nexus” to a state jurisdiction, that corporation, together with all other corporations in the group that meet a defined common ownership level and have only a limited business connection with the jurisdiction, must file “combined” corporate income tax returns in the jurisdiction. The liability to pay tax in the jurisdiction for each group member is then determined by (i) taking the combined total (net) taxable income of these corporations, (ii) apportioning all or part of this taxable income to the jurisdiction using formula apportionment based on weighted factors such as sales, payroll and property in the jurisdiction, and (iii) computing tax on this amount at the applicable rate in the jurisdiction.⁵² Each corporation in the combined report is then jointly and severally liable for the total corporate income tax payable. In this regard, it is important to note that the unitary tax system, as well as bringing outside income into account to increase tax liability in a particular jurisdiction, can also bring in corporate losses from outside the jurisdiction to reduce tax liability there.

It would be extremely difficult, and perhaps impossible, for a Canadian province to successfully apply a full “unitary” type of corporation tax because of the constitutional limit to taxation by a province “within the province.”⁵³ Even if permitted, the legislative, administrative and compliance aspects of such a tax would make it very hard for a province to administer. Moreover, use of the formula apportionment in the unitary tax system has the potential to increase the economic distortions for business location decisions.

⁵¹ Laurin (2009) makes a proposal along these lines (see page 10).

⁵² For California unitary tax relating to corporations doing business in more than one state or country see: CCH,(Walters Kluwer) State Tax Guide, 1201-1233.

⁵³ See the Constitution Act, section 92.

As regards the potential loss of provincial corporate income tax revenue from a formal corporate group loss transfer system, such a system would allow the precise provincial revenue consequences of the imposition of the system to be measured, and some mechanism of provincial tax-revenue adjustment to be considered relating to intra-provincial loss transfers. Obtaining agreement of all provinces to the introduction of such a mechanism would, of course, be extremely difficult both practically and politically, especially since the impacts of allocation on provincial revenues relative to the status quo are unknown in advance.

One mechanism considered by the European Commission for dealing with intra-Community loss transfers⁵⁴ is to include recapture provisions in the rules for intra-group loss transfer. Under a recapture system, the net losses of one taxpayer would be deducted against the profits of its parent corporation, or of another subsidiary within the corporate group; when the loss-making corporation returns to profitability, this tax accounting transaction would be unwound, and the amount originally deducted would be transferred from the taxable income of the loss-making corporation to the corporation that had previously claimed the deduction for losses. Under a recapture system, loss relief for a taxpayer is explicitly temporary, which may alleviate some concerns about the double deduction of losses in cross-border situations. It also ensures that loss transfers between related corporations resident in different provinces would not consistently result in permanent transfers of tax revenues between provincial governments. The chief disadvantages of the system are its complexity and the difficulty in dealing with situations in which the loss-making subsidiary is wound-up before returning to profitability, or never becomes profitable. As well, if loss relief is not recaptured, then this system has the potential to create other tax distortions to decisions on location of capital and employment.

Another alternative is to rely on intergovernmental clearing arrangements, in which group loss reliefs are permanent rather than recaptured, but immediate payments are made from the treasury of the province where the loss occurred to that of the province where the income is earned against which the loss is being deducted, equal to the revenue cost of loss relief. In cases where the two provinces levy different statutory tax rates, the treasury transfer could be set equal to the amount deducted, multiplied by the lesser of the two tax rates, or by a standardized tax rate such as the national average of provincial tax rates. The chief advantage of clearing over recapture is that the clearing transactions would not be “seen” by the taxpayer, so that there is little potential for them to distort private economic choices. For the eight provinces that currently have corporate income tax collection agreements with the federal government, intergovernmental clearing could be achieved simply by netting the required payments against amounts owing to the provinces. However, accounting for clearing would be considerably more complicated in the case of taxpayers with permanent establishments in several provinces, since the resulting revenue transfers should be apportioned among all affected provinces. Another problem with clearing arrangements is that, as a permanent but immediate revenue cost to the province making the clearing payment, such payments may be viewed by provinces as a permanent incremental revenue loss, such as where the loss corporation would be wound-up prior to becoming profitable, or where it would never become profitable.

⁵⁴ “Tax Treatment of Losses in Cross-Border Situations,” European Commission (2006).

As noted, the clearing mechanism is, unlike recapture, a form of intergovernmental revenue sharing that has no direct consequences for the taxes paid by the taxpayers involved in loss transfers. It is worth noting that Canada's existing system of fiscal arrangements already includes a revenue-sharing grant provided under the Equalization system that implicitly achieves something quite similar to what would occur under an explicit loss clearing system. Under the Equalization formula, eligible provinces are paid a federal grant equal to the difference between their measured tax base for business income taxes and the national average tax base, multiplied by the national average effective rate of business income tax. Consequently, when a loss-transfer transaction shifts taxable income between taxpayers in two Equalization receiving provinces:

- the province losing revenue through deduction of losses automatically receives a higher Equalization payment due to its smaller measured fiscal capacity; and
- the province gaining future revenue through the elimination of losses carried forward automatically receives lower Equalization payments in future years due to its larger measured fiscal capacity.

Under an idealized Equalization formula based on the representative tax system, the compensation for revenue losses due to loss shifting is dollar-for-dollar when all provinces levy the same effective tax rate, and it is nearly dollar-for-dollar even with rate divergence. Recent reforms to the Equalization system have, however, reduced its ability to compensate for fiscal capacity differences — whether due to tax loss shifting or other factors — particularly for the large receiving provinces, Ontario and Quebec.⁵⁵

While the Equalization effect is not completely effective for all provinces over time, it is somewhat reassuring that Equalization is compensating now in some measure for the provincial consequences of corporate tax loss shifting, even for informal loss transfers that cannot always be directly measured by the tax authorities, and would continue to do so within its own limits under a formal loss transfer or consolidation system. In this sense, an explicit system of loss recapture or intergovernmental clearing may not be so important in the Canadian system under a formal system for corporate group tax loss relief.

3. HARMONIZED FEDERAL/PROVINCIAL CORPORATE INCOME TAX.

There is one other possible approach to federal and provincial corporate income tax worth mentioning that could facilitate increased corporate group loss netting. The approach would take advantage of the legal constitutional ability of the federal government to levy a single harmonized federal/provincial corporate income tax across Canada on a corporation's full worldwide tax base, and then allocate the provincial component of the resulting tax revenue by formula apportionment. The key difference from the existing federal/provincial corporate income tax system (beyond the potential increased uniformity in base which may be achieved), would be the elimination of most transactional tax planning involving provincial corporate income tax. This would result because there would be no separate corporate entity tax

⁵⁵ In 2008, the federal government introduced a reform that limits the rate of annual growth of total Equalization payments to the growth rate of nominal GDP. As discussed in Smart (2012), this reform has made Equalization less responsive to provincial tax losses, particular for large receiving provinces.

calculation done for provincial corporate income tax on a separate accounting basis. The corporate income tax base, including loss application and tax crediting, would be calculated by each corporation only once, according to nationally applicable harmonized tax rules; the federal and provincial rates of tax would be applied to this base to determine total tax liability, and then that tax would be divided among provinces based on a formula which uses economic factors.⁵⁶ Transactions between any two corporations paying tax on a different basis in more than one province would have only a limited effect on provincial government revenues, as there would be no separate accounting determination of income or loss per province. Of course, there still could be issues related to the formulation and operation of the allocation formula used in such a system.

If such a harmonized corporate income tax were to be implemented, then a loss transfer or consolidation system could be considered largely without reference to the issue of transactional provincial tax planning by corporations, and without reference to the worst-case scenarios in terms of individual provincial revenue losses. Provincial revenues might not even decrease substantially in total in such a system if a higher common ownership qualification threshold is used for formal corporate group loss netting, and the existing self-help loss trading system is removed. At the same time there would be a reduction in administrative and compliance cost and complexity.

Notwithstanding the significant benefits that could potentially be achieved from a federal/provincial harmonized corporate income tax, it must be recognized that the provincial adoption of such an approach would be hugely difficult, and very unlikely. In particular, provinces would have to give up policy autonomy in the sense that special tax credits used to attempt to induce certain economic activity in the province would be eliminated and a single rate of tax would be required to maximize benefits; revenue costs or gains for provinces would be very difficult to predict; and all provinces would have to accept federal legislative authority for their corporate income tax and administration by the Canada Revenue Agency.

V. SUMMARY OF CONCLUSIONS

In the absence of full tax loss value refundability, and without full corporate level/shareholder level tax integration, we are clearly working with only “second-best” possibilities for corporate income tax loss utilization, in corporate groups or otherwise. The existing Canadian self-help corporate tax loss system — with its relatively low common ownership threshold — is providing substantial benefits in terms of overall economic efficiency by permitting generous access to loss netting among groups of corporations, though this is accomplished at the expense of some remaining horizontal inequities and non-neutralities due to difficulty of access to the system by some, and the expense of a complex transactional basis for obtaining the loss netting. It is not clear that the amount of ultimately unutilized losses in the current system is that large in aggregate, though there could be relatively large effects for particular taxpayers and for some provinces.

⁵⁶ These factors could be the ones currently used in the provincial allocation formula, or as adjusted by agreement of the provinces.

These circumstances suggest that policymakers, and taxpayers, should adopt a cautious approach to possible changes in the current Canadian corporate income tax treatment of losses in corporate groups. Such changes have the potential to do more harm than good.⁵⁷

As our analysis has shown, there are some advantages to potential changes to the current system, such as providing for an interest factor on loss carry-forwards, or creating a new system of corporate tax loss transfer or consolidation (with or without elimination of the current informal system). But these changes would also have some serious potential negative consequences as compared to the status quo. At the same time, a harmonized federal/provincial corporate income tax, a potentially more effective approach for rationalizing and improving the utilization of corporate losses in Canada, looks to be far out of reach. Adoption of any of these approaches would result in transitional costs and additional complexity.

⁵⁷ It is interesting to note in this regard that Cooper (2011), in reviewing the Australian experience with successive attempts at corporate group tax regimes, independently comes to a somewhat similar type of conclusion.

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