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A PROPOSAL FOR A "BIG BANG" CORPORATE TAX REFORM

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SUMMARY

To put it in simple terms, Canada's corporate income tax is a mess. It discourages capital investment most heavily in many service sectors, is highly distortionary and overwhelmingly complex, impeding economic growth. With current inflation rates, these distortions are even larger. With so many tax preferences, the combined federal-provincial corporate income tax with a headline tax rate of 26 percent raises revenue little more than 19 percent of corporate profits.

To build up productive capacity in a post-COVID world, a big-bang approach is needed to put Canada into a better position to attract investment and reduce distortions in the business tax system. There are some major revenue-neutral reforms that could improve neutrality and simplify the overly complex corporate tax. Here, we particularly explore a corporate tax on distributed profits without a reduction in corporate tax revenues.

A distributed profits approach means profits from investment activities would only be taxed when they are distributed to investors. This allows profits reinvested in capital to be exempt from taxation. A good example of this design is Estonia's corporate profit tax on distributions, introduced in 2000. This reform resulted in the elimination of the corporate tax on reinvested profits — these profits are only taxed when the profits are distributed. In 1999, prior to the reform, corporate taxes, as a share of taxes, made up 0.9 per cent of GDP. In 2019, they made up 1.7 per cent of GDP. Estonia has also had remarkable investment performance since with fixed capital formation equal to 27 percent of GDP compared to 23 percent in Canada since 2015.

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Taxes generally distort economic activity — production of the taxed good or service is reduced when effective tax rates are increased. The value of the lost production is greater than the value of the tax added to government revenue. This results in several distortions: intertemporal, inter-industry, inter-asset, international, risk-taking, financing and business organization. The corporate tax on distributed profits, while still having some disadvantages, does have several advantages in reducing these distortions.

The proposal considered here would tax deemed distributions of profits including share buybacks and certain deemed payments to prevent erosion of the tax base. Passive income and capital gains earned by the corporation would remain taxed similar to existing rules. The revenue-neutral corporate tax on distributed profits would be an estimated 16 per cent at the federal level and 11.2 per cent on a provincial average tax rate, when brought forward to the 2022/23 fiscal year results in the same corporate tax revenues collected as in 2022 ($37 billion). While it seems that a distributed tax that exempts reinvested profits would lower the corporate taxable income, it actually doesn't lower it much. Due to tax incentives, taxable corporate income ($370 billion for 2022/23) is significantly below corporate operating profits ($515 billion). The distributed tax removes the need for tax incentives, no longer providing those tax savings.

This proposed model is not perfect, but it is better than the current system, which is distortionary, with high economic, compliance and administrative costs. A distributed profits design would make the corporate income tax fairer and simpler, reducing administrative and compliance costs, while not significantly eroding corporate tax revenues.

In the 2020 Tax Competitiveness report (Bazel and Mintz 2021), we concluded that Canada's corporate tax system is attractive to encourage investment in marginal projects, although it has become much more distortionary and non-neutral due to incentives, thereby undermining the productive use of resources. It has a relatively high corporate income tax rate compared to most advanced countries, making Canada less attractive for lumpy greenfield projects with high economic rents from intangible or resource investments.

In this paper, I look at possible major revenue-neutral reforms to the corporate income tax with the aim to improve neutrality and simplify the system. Canada could further pursue its corporate tax reforms by lowering tax rates and broadening tax bases to reflect economic income. However, this approach to reform, which has been the focus for Canada since 1985, seems to have reached its limit in reducing corporate income tax rates due to political opposition to corporate tax reduction, which is not unusual.[1]

Instead, a fundamental tax reform could help tilt the playing field towards Canada to boost investment, reduce tax distortions and simplify administration and compliance, without a loss in revenue. I call this a big-bang reform. The basic proposal is to convert the corporate tax into a tax on distributed profits that would improve static and dynamic efficiency in the corporate tax system.[2] It is not a perfect system, but it could be a practical approach to boost growth and make the corporate tax more efficient and fairer.

There are some important advantages to the approach, particularly reducing tax distortions that discourage investment, especially for the service sectors in the economy. The proposed structure would also be compatible with international tax systems, even under the proposed global corporate minimum tax, and continue support for small businesses. It does have one disadvantage — it would potentially be distortionary in financing decisions by favouring retained earnings over other funding sources. Recommendations will be made to the taxation of share buybacks, corporate passive income and capital gains that would create potentially greater neutrality among financing sources compared to the existing system.

The paper begins with a discussion of the problems with the corporate income tax in Canada. This will be followed by a description of the proposed corporate tax on distributed profits, including a review of both the positive and negative aspects of the proposal. A rent-based approach to the taxation of corporate distributions is considered, which would be consistent with a personal tax reform along the lines of the expenditure tax approach.

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1 In 1997, I had access to unpublished poll results showing that Canadians then believed that corporations do not pay enough taxes as they do today. Similarly, Gallup reports that roughly 70 per cent of Americans believe corporations pay too little tax. The Gallup opinion poll is quite stable no matter the state of the economy between the years 2004 and 2019. About 63 per cent believe high-income taxpayers do not pay enough in 2019, similar to 2004. About 43 per cent believe the middle class pays too much in 2019, which is about the same as 2004. See https://news.gallup.com/poll/1714/taxes.aspx.

2 Our proposal could also be adjusted to tax only corporate rents by redefining the tax base as distributed profits net of the new equity financing (although this would require a substantially higher corporate income tax rate to make up for the loss of revenues). This approach would be appropriate if the personal income tax is also reformed to remove the tax on savings. We will discuss this further below.

WHY IS THERE A CORPORATE TAX AND WHY IS IT FAILING IN ACHIEVING ITS PURPOSE?

The corporate income tax plays an important role in financing federal and provincial government public services. It raises close to $100 billion, almost 10 per cent of consolidated general government revenues (Statistics Canada 2021). Despite its importance, questions have been raised as to whether it should be abolished.[3] It has been criticized as being the economically costliest tax, hurting growth and productivity the most (Dahlby and Ferede 2018). It has also attracted criticism for being unfair by being passed on by corporations as higher prices charged to consumers (Baker et al. 2020) or by reducing employment and wages paid to workers (McKenzie and Ferede 2018). To the extent that the corporate tax falls on returns to shareholders, its incidence still falls not just on high-income investors, but also many middle and low-income households, including worker pension plans.

Why do we have a corporate income tax? The principle for corporate tax design in Canada, and most countries in the world, is based on the notion of taxing comprehensive income for both personal and corporate income tax purposes. Comprehensive income includes annual income from labour and capital net of expenses to earn income. It includes employment compensation, business income, property or investment income (dividends, interest and rents) and capital gains. In principle, comprehensive income is adjusted for inflation and measured net of any losses in business and capital income (if the tax base is negative, a refund should be paid equal to the tax rate multiplied by the loss).

In principle, the corporate tax is not needed if profits are attributed to shareholders for personal income and withholding tax purposes, similar to partnership income. This is administratively complex with tiers of corporate ownership, as well as requiring investors to pay tax on income that has not yet been distributed.[4] Alternatively, a government could tax accrued capital gains from the change in the market value of assets each year rather than realized capital gains upon the disposal of assets. However, this forces owners to sell assets if they have insufficient liquidity, as well as being difficult to administer in the case of non-traded assets with no observable market value. Further, non-resident shareowners would be out of reach for capital gains taxation since they are only taxed by their resident governments.

As pointed out by the Carter Report (Government of Canada 1966), the corporate tax may have two purposes. First, the corporate tax is a backstop to the personal tax by operating as a withholding tax — the profit tax would be refunded once income

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3 For example, L. Kotlikoff, "Abolish the Corporate Income Tax," *New York Times*, January 5, 2014. See also E. Dolan, "The Progressive Case for Abolishing the Corporate Income Tax," 2017, https://www.milkenreview.org/articles/the-progressive-case-for-abolishing-the-corporate-income-tax-2.

4 As noted by a Congressional Research Report in the United States: "One integration approach would be to eliminate the corporate tax and allocate earnings directly to shareholders in a manner similar to which partnerships … allocate income to their partners and shareholders" (Keightley and Sherlock 2014).

is distributed to investors.[5] Second, the corporate income tax withholds profits from foreign investors who might also credit Canadian tax against their foreign tax liabilities, resulting in a transfer of revenue from foreign to Canadian treasuries without a loss of investment. The Technical Committee on Business Taxation (1997) further argued that the corporate tax is a surrogate "benefit" tax when governments provide public services such as infrastructure and limited liability laws that enhance the profitability of corporations in the absence of user fees to recover the cost of public provision.

In recent years, the tension between the domestic and international roles for the company tax has played a significant role in corporate tax policy developments. With greater global capital mobility since 1990 and the erosion of corporate tax crediting,[6] countries have reduced corporate income tax rates and broadened corporate tax bases to attract investment, improve tax efficiency and keep profits in their jurisdiction. For international competitive reasons, Canada has lowered its combined federal and corporate income tax rate from 43 per cent in 2000 to 26 per cent by 2012 while curbing, to some degree, accelerated depreciation, investment tax credits and other tax preferences.[7] This brought Canada's corporate income tax rate in line with other countries, rather than being the highest among OECD countries in 2000. The consequence, however, was that the corporate tax rate fell below the top personal rate, reducing the withholding role of the corporate income tax.[8] As Finance Canada has observed, a portion of the personal income tax base shifted to the corporate sector to reduce personal tax payments that would be subject to much higher tax rates (Government of Canada 2015). Currently, the average top federal-provincial personal income tax rate is roughly 52 per cent.[9]

While these arguments for corporate taxation are well known, they are a basis for suggesting a few principles for corporate tax design. Insofar as corporate tax discourages economic activity, it should be designed to discourage as little economic activity as possible, and so impose the lowest possible cost on the economy. Only in

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5 The withholding role could imply that the corporate tax should be applied to economic rents, especially if consistent with the personal tax (Institute of Fiscal Studies (Meade Report) 1978; Mirrlees Report 2011). Some argue for the corporate tax to be applied to economic rents even if personal income continues to be taxed at the personal level (Boadway and Tremblay 2014; McKenzie and Smart 2019). We will return to these arguments below.

6 The crediting argument lost some appeal as countries moved away from taxing dividends paid by foreign affiliates to their parents. Crediting still applies to branch income, passive income, non-treaty income and, under U.S. law, global intangible low-income tax (GILTI) income. Further, recent global discussions that would result in countries agreeing to impose a minimum corporate income tax at the rate of 15 per cent would reinstate the importance of the crediting argument.

7 After 2012, Canada corporate income tax changed modestly until 2018 when it introduced temporary accelerated depreciation in response to U.S. tax reform (that reduced the U.S. corporate rate somewhat below Canada's (Bazel and Mintz 2019).

8 Top corporate and personal income tax rates were roughly aligned in the previous decade. In 1999, the top personal income tax and corporate income tax rates were almost equal (46 and 45 per cent respectively). Back in 1987, the top personal income tax rate was 51 per cent and the top corporate income tax rate was about 52 per cent.

9 Tax preferences also result in corporate tax payments as a share of profits dropping below the statutory rate. Further, small Canadian-controlled private corporations are taxed at preferential rates at about a combined federal-provincial rate of 12.5 per cent (Mintz, Smith and Venkatachalam 2021).

the presence of a market failure would deviations from neutrality be desirable, such as taxing pollution or subsidizing research, given the inability for innovators to fully appropriate returns. However, even in the case of market failures, it is still necessary to demonstrate that a tax policy is better to correct for market failures compared to other interventionist tools, such as subsidies or regulations. For example, research can be supported by grants instead of tax credits and pollution can be corrected by regulations instead of taxes. Evaluating the benefits and costs of specific tax deviations from neutrality compared to other forms of public intervention goes beyond the focus of this paper. However, one can achieve corporate tax neutrality and correct market failures with more suitable public policies.

AN EVALUATION OF THE EXISTING CORPORATE INCOME TAX

It is one thing to design a perfect corporate income tax, but it is another to achieve perfection given other political and institutional considerations. Nonetheless, it is worthwhile to evaluate the existing corporate income tax in terms of its impact on tax policy considerations with respect to economic efficiency, equity and cost of compliance and administration (Mintz 2018). These tax structure considerations are important to consider in setting tax policy.

ECONOMIC EFFICIENCY

Taxes generally distort economic activity. They reduce the production of the taxed good or service, including capital and labour services, with the quantum of reduction determined by the elasticity of supply and demand for such goods or services. The value of this lost production will be greater than the value of the tax added to government revenue. These efficiency considerations are broken down into several types of distortions.

Intertemporal Distortion

The corporate tax discourages investment and the capacity to produce goods and services for future domestic consumption and exports (dynamic inefficiency). It creates a wedge between the pre-tax return and after-tax return on capital. The larger (smaller) the wedge, the less (more) capital will be employed by businesses. Assuming the full phasing out of accelerated depreciation (that begins in 2023), the existing corporate income tax imposes a wedge equal to 19.5 per cent between pre- and post-tax rates of return of capital with a higher wedge for services (e.g., communications at 22.1 per cent) compared to manufacturing and forestry (13.7 per cent) (Table 1).

Inter-industry and Inter-asset Distortions

Distortions in the corporate tax system result in a suboptimal use of capital in the economy as capital is allocated to business activities with lower marginal economic

returns due to tax preferences.[10] Static efficiency is illustrated by the differentiation in inter-industry and inter-asset effective tax rates on marginal investments (METR[11]). As shown in Table 1, the variation is quite significant, even with the phasing out of accelerated depreciation. Since 2015, Canada's static inefficiency has more than doubled (Bazel and Mintz 2019). The efficiency cost can be approximated as a dispersion index (the weighted standard deviation of METRs per dollar of marginal tax revenue (Bazel and Mintz 2019). The overall dispersion index in 2020 is 7.2 per cent, with the inter-asset dispersion equal to 2.9 per cent and inter-industry dispersion equal to 1.5 per cent. Thus, inter-asset distortions are more important than the inter-industry distortions.

Table 1. Federal-Provincial METRs by Industry and Province 2020

2020	Agriculture	Forestry	Electrical Power, Gas & Water	Construction	Manufacturing	Wholesale Trade	Retail Trade	Transportation & Storage	Communications	Other Services	Aggregate
Canada	18.3%	13.3%	19.0%	23.0%	13.7%	23.2%	24.7%	17.8%	22.1%	24.5%	**19.5%**
Newfoundland	12.8%	-5.3%	18.9%	25.1%	-3.9%	25.6%	26.0%	17.6%	21.5%	24.0%	**13.3%**
Prince Edward Island	4.7%	-22.4%	19.8%	26.1%	-33.9%	26.7%	27.3%	22.7%	22.0%	27.0%	**16.3%**
Nova Scotia	10.8%	-5.7%	18.5%	24.3%	-8.0%	25.0%	25.8%	17.6%	21.1%	24.3%	**17.1%**
New Brunswick	6.2%	-5.6%	18.3%	24.3%	-2.6%	24.8%	25.5%	18.8%	21.0%	23.8%	**15.6%**
Quebec	18.4%	5.1%	16.2%	21.8%	5.7%	22.5%	23.3%	15.9%	18.2%	22.8%	**15.8%**
Ontario	18.8%	16.2%	16.8%	22.1%	17.8%	22.6%	23.9%	17.2%	19.4%	22.7%	**19.3%**
Manitoba	22.5%	9.1%	26.8%	28.7%	4.8%	27.3%	28.0%	23.2%	30.3%	32.1%	**24.5%**
Saskatchewan	22.2%	16.5%	25.9%	27.8%	17.9%	27.9%	27.8%	21.0%	31.9%	31.0%	**24.0%**
Alberta	14.6%	14.5%	13.7%	18.8%	16.8%	19.2%	19.5%	12.5%	15.9%	18.2%	**15.5%**
British Columbia	24.4%	23.4%	28.9%	30.0%	23.4%	28.6%	30.4%	24.4%	34.8%	34.7%	**28.7%**

Note: Assumes accelerated depreciation is fully phased out. METRs measure corporate income taxes, sales taxes on capital purchases, real estate transfer taxes and other relevant capital taxes as a share of corporate profits earned on a marginal investment.

International Distortions

From a national perspective, a corporate tax in Canada could distort export and import capital flows, in part depending on relative corporate tax rates elsewhere, assuming all other economic factors are the same. The corporate tax encourages businesses to shift their investment to lower-taxed foreign jurisdictions, leading to a loss of income and employment in the Canadian economy. It also discourages foreign investors from lower taxed jurisdictions to fund Canadian operations. A high corporate income tax incents companies to shift profits to low-tax jurisdictions by booking expenses in Canada and under-pricing goods and services sold to foreign affiliates (transfer pricing). To that end, the corporate tax should bear in mind the relationship of Canada's corporate

10 Baquee and Farhi (2020) find that the static inefficiency in the allocation of capital reduces productivity by 15 per cent. Similarly, Da-Rocha, Mendes Tavaremal and Retuccia (2020) find that misallocation due to differential taxes on establishments causes substantial productivity losses — one-half due to the static effect and the other half to a dynamic effect.

11 The marginal effective tax rate (METR) is explained in Bazel and Mintz 2021. Briefly, it is the amount of corporate income tax, capital taxes, transfer taxes and sales taxes on capital purchases paid as a share of corporate profits for marginal investments — those investments that earn sufficient profit to cover the cost of equity and debt financing.

income tax with that of other jurisdictions, while also considering international capital flow distortions.[12] Including accelerated depreciation, Canada's current METR on manufacturing and services of 15.6 per cent is below those of the U.S., Europe, G7, G20, OECD and 94-country averages, but our corporate income tax rate of 26.2 per cent is higher than the U.S. (25.7 per cent), Europe (23.6 per cent) and the 94-country weighted average (25.4 per cent) (Bazel and Mintz 2021).[13] New rules to limit interest deductions for foreign companies operating in Canada and the minimum tax applied by foreign countries on the income earned by their resident companies operating in Canada could result in foreign-owned investments bearing a higher burden on capital compared to domestic-owned investments.

Risk-taking Distortions

The corporate tax discourages risk taking by taxing the profits earned but not sharing the losses incurred by investors (Mintz 1988). If profits and losses were treated symmetrically under the income tax system, a government would be acting as a silent partner in sharing risks. Given the lack of full refundability, non-risky investments are tax-preferred and startup companies are less able to compete with profitable incumbent firms in a market.[14]

A simple example is the following: Suppose the expected return on farming is five per cent: a 50 per cent chance of sufficient rain so that a 15 per cent rate of return is earned and a 50 per cent chance of a drought with a negative five per cent rate of return (the expected return is sum of the probability times the rate of return in each state). If the corporate income tax rate is 25 per cent and there is no refundability of losses, the rate of return with sufficient rain falls from 15 per cent to 11.25 per cent (the five per cent loss in the drought remains the same since the government does not share the loss). The after-tax expected return falls from five per cent to 3.13 per cent, implying an effective tax rate of 37.4 per cent instead of 25 per cent.

One could adopt the full refundability of corporate tax losses and tax credits, at least in principle, but this comes with three potential costs. The first would be a shift of expenses into the corporate sector from personal tax to take advantage of refundability that is not provided generally under the personal income tax. Second, a corporate tax would make Canada a dumping ground for losses from abroad as

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12 The OECD Base Erosion and Profit Shifting studies are reducing some of the international distortions but cannot completely do so. Only a world of equal effective tax rates among all countries would achieve global capital allocation neutrality.

13 The U.K. has announced it is increasing its corporate income tax in 2023 from 19 to 25 per cent (to be slightly below the Canadian tax rate) and the Biden administration will be pushing for a higher corporate income tax rate in the U.S.

14 Under Canadian tax law, some refundability is provided, but not full refundability. A company can carry back operating losses for three years and claim a refund of past taxes paid for three years. It can carry forward operating losses for 20 years to reduce operating profits in future years, although amounts are not indexed for either inflation or borrowing interest rates. Capital losses can be carried back three years or forward indefinitely but written off only against capital gains. Some taxable losses or credits are refundable, such as research and development tax credits for Canadian-controlled private corporations and flow-through shares of oil, gas and mining companies that renounce deductions in favour of investors who claim the deduction under their personal income tax.

other countries do not provide full refundability for losses. Third, as found with the full refundability of the research and development scientific credit in the early 1980s, tax evasion could arise, such as investors moving to other countries after cashing refunds without carrying out activities. Thus, one cannot expect limits on refundability resulting in higher taxes on risky activities.

Financing Distortions

In the absence of taxation, corporations will fund capital expenditures with retained earnings, new equity issues or debt. Retained earnings may be preferred since a company uses internal resources rather than having to issue securities at a higher cost to outside investors who have less knowledge about the firm. Debt is preferable to lenders if they have a first claim to assets should the firm go bankrupt. New equity issues attract a wider market of owners. Each financing source has its beneficial economic attribute.

Since interest expense is deductible from corporate income (subject to certain limitations), debt financing is encouraged compared to retained earnings and new equity issue financing (Mintz 1995). However, interest paid to individual investors is fully taxed under the personal income tax while dividends and capital gains are preferentially taxed in recognition of the profits, prior to their distribution or reinvestment in the company, having already been subject to one level of tax.[15] This can be seen in Table 2 with respect to taxes paid on income derived from a large Ontario corporation.

Table 2. Tax on Various Sources of Income Derived from a Large Ontario Corporation (2021)

	Dividend Paid to Canadian Investor	Reinvested Earnings	Profit Paid out as Deductible Expense (e.g., interest, royalties, employment income)
Corporate Profits	$100.00	$100.00	$100.00
Corporate Tax	$26.50	$26.50	$0
Net Profit	$73.50	$73.50	$100.00
Personal Tax (1)	$28.91	$19.67	$53.47
Net Income	$44.59	$53.83	$46.53

(1) Assumes the investor is the high-income investor. Dividend tax rate (39.34 per cent) includes the dividend tax credit for eligible dividends. It is assumed capital gains tax rate of 26.76 per cent applies on the gain realized in the same year.

Table 2 assumes corporate profits are taxed at the combined statutory federal-Ontario rate of 26.5 per cent. The marginal investor for the Ontario company resides in Ontario, paying a tax rate of 39.34 per cent on distributed profits (taking into account the dividend tax credit). Reinvested earnings increase the value of the firm, dollar for dollar, and, assuming the shares are disposed in the current year, are subject to capital gains tax (only half of capital gains is taxed). Interest and other deductible charges paid out as income to the investor are fully taxed.

15 If it is assumed that a dollar of retained earnings is invested in the firm's capital, it increases the value of the firm by one dollar. The capital gain for shareowners is subject to tax when the shareowner sells interests in the company.

Given the relatively low capital gains tax rate, reinvested earnings are the least costly form of finance from a tax perspective in this example. The combined corporate and personal tax rate on reinvested earnings is 42.17 per cent. On bond interest and other deductible charges, the tax rate is 53.47 per cent and on dividends, 55.41 per cent (thereby discouraging new equity issues the most).

The financing distortions, however, are much more complicated than shown here:

- The corporate tax rate varies by size of business (a 13.5 per cent tax rate is applied to the first $500,000 profits earned by Canadian-controlled private corporations in Ontario). This increases the attractiveness of retained earnings as a source of finance. The concessionary rate is clawed back when passive income is more than $50,000;
- With tax incentives, the average tax rate (corporate income taxes as a share of corporate profits) is lower than the general statutory tax rate. For example, in the 2016 taxation year, the average federal corporate tax rate on net financial income was 7.9 per cent[16] even though the statutory tax rate was 15 per cent. This lower effective tax rate makes retained earnings and new equity issues even more attractive since the dividend tax credit and concessionary capital gains tax rate are based on a notional profit tax rate of 26.5 per cent;
- The lack of inflation adjustments results in the overstatement of profits when depreciation and inventory valuation is based on historical rather than replacement prices (even at an annual two per cent inflation, historical values from 20 years ago are roughly two-thirds of today's prices). However, interest expenses, unadjusted for inflation, favour debt finance, which is becoming even more important today with recent inflation rates after 2020;
- The investor often holds shares for a longer period than one year. If so, the capital gains tax, which only applies to realizations, is deferred until the shares are sold. Although interest rates are low these days, the deferral advantage reduces the effective tax rate on capital gains. On the other hand, the lack of full refundability for capital losses and inflation increases the effective capital gains tax rate on real income;
- Pension plans do not pay tax on dividends, interest or capital gains but their income derived from corporations is subject to corporate income tax. For pension plans, debt finance (and other deductible charges such as royalties and rents) is preferable to avoid corporate tax payments;
- Dividends and interest paid to non-residents are subject to Canadian withholding tax (most interest is exempt from withholding tax by treaty).
- Capital gains as well as interest and dividends are subject to corporate or personal income tax in foreign jurisdictions (with a credit for withholding taxes). Overall, the tax paid by foreign investors varies from zero to the top income tax rate in the country. Debt is often preferable if foreign investors pay little tax on Canadian investments.

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16 Based on the latest year available from the Canada Revenue Agency: https://www.canada.ca/content/dam/cra-arc/prog-policy/stats/t2-corp-stats/2012-2016/t2-crp-sttstcs-tbl10-e.pdf.

The choice of financing decisions, therefore, depends on relevant corporate and personal income tax rates. The marginal source comes from investors who would be indifferent between equity and bond assets (Miller 1977). This implies that the marginal investor would be taxed on income at equal effective tax rates on equity and bonds, accounting for both corporate and personal taxes. Assuming binding constraints limiting short selling of securities, other investors would only hold debt or equity depending on their personal tax rates. Using Miller's example, suppose the marginal investor is not taxed on capital gains and dividends at the personal level but fully taxed on interest. This would imply that the marginal investor holding Ontario stocks would have a personal tax rate on interest equal to 26.5 per cent (those with higher personal tax rates would only buy equity and those with lower tax rates would buy only bonds).[17]

In a global context, the story becomes far more complicated since there are many corporate income tax rates, as well as personal income tax rates.[18] An Ontario corporation would have a lower corporate tax rate than one in Japan, which is currently 30.6 per cent. A Japanese corporation would have an incentive to invest in the Ontario corporation's equity, financing it with debt borrowed in Japan. An international capital market equilibrium would result in the international marginal investor being indifferent between Japanese equity and bonds with the Ontario corporation being fully equity financed by the Japanese corporation. Using the Miller assumption of a zero tax on equity, the international investors would hold Japanese debt facing a tax rate of 30.6 per cent with higher income taxpayers buying Japanese or Canadian equity and low-income taxpayers buying Japanese bonds (since the Canadian company would not issue bonds).

Obviously, Japanese corporations would be unable to own all global corporate equity in the world. Most important, companies do not go to the extreme of all debt or all equity finance since they are trading off tax benefits with other economic factors, such as default costs, signalling costs and use of tax losses (Mintz 1995). Complicated international tax structures encourage indirect financing structures to take advantage of interest, leasing and general administrative write-offs for tax purposes (Mintz and Weichenrieder 2010). The main point is that the simple case in Table 2 is not representative. The financial decisions depend on the interaction of corporate and personal taxes globally with corporate policies selecting clienteles to hold their securities. A key conclusion is that countries with higher corporate income tax rates like Canada would attract more debt finance in global markets, even if an international marginal investor is indifferent between Canadian and other international securities.

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17 For indifference, the Miller equilibrium generally implies that u+ t(1-u) = m with u= corporate income tax rate, t= personal income tax rate on equity and m = personal income tax rate on debt. With retained earnings finance, in Ontario, u=.265 and t=.2675 and so u+t(1-u) = .426. The combined tax rate on equity income is equal to the tax on bond finance when m = 42.6 per cent.

18 This discussion follows some very early work when I looked at multiple corporate income tax rates such as the case of differential corporate income tax rates on manufacturing and non-manufacturing profits (Bartholdy, Fisher and Mintz 1987). See also Mintz and Weichenrieder (2010), chapter 3, comparing the effect of corporate and personal taxes on financing decisions for parents, subsidiaries and conduit entities.

Business Organizational Distortions

Distortions also arise with respect to the organization of businesses, which can be done in corporate or non-corporate forms, such as sole proprietorships, unlimited or limited liability partnerships or trusts. When alternative vehicles receive better income tax treatment than corporations, those businesses that are carried on in corporate form for economic reasons suffer a competitive tax disadvantage that distorts investment and production.[19] The existing corporate tax system encourages the formation of corporations compared to sole proprietorships and partnerships whose owners earn income that is subject to a higher income tax rate.

Prior to October 31, 2006, trusts had been favourably treated since they could distribute income to avoid payment of corporate tax with the distributions taxed favourably as dividends (Mintz and Richardson 2006). With income trusts becoming taxable as specialized flow-through income trusts (SIFTs) in 2006, the incentive to reorganize companies as income trusts only remains for real estate investment trusts.

EQUITY

A major concern in corporate taxation is horizontal equity, the equal treatment of taxpayers with similar resources under the tax system. Non-neutrality creates unfairness where one segment of taxpayers carrying on a business activity are taxed more favourably than another segment of taxpayers carrying on that same business activity. This occurs, for example, with differential corporate tax rates for different sectors, with corporations, with different corporate tax rates for different types of ownership or by use of more favourably taxed business vehicles.

As well, corporate taxation can be viewed by some as raising questions about vertical equity, whereby taxes paid will vary according to ability to pay. For example, corporations and their shareholders are paying at a lower tax rate than other businesses or individuals who have lower incomes. As discussed above, the effect of corporate tax on vertical equity is not straightforward. If corporate taxes fall on labour income or on consumers through higher prices charged for goods and services, it can be regressive. If it falls on capital, it will impact higher income Canadians more heavily, but it will also reduce pension plan returns and those lower and middle-income Canadians who own equity. The point is that the corporate tax is a clumsy way to achieve redistribution through the tax system.

[19] Goolsbee (1997) estimates the economic cost associated with organizational distortions is relatively small, accounting for 10 to 20 per cent of corporate tax revenues.

COMPLEXITY AND ADMINISTRABILITY

The corporate income tax is often criticized for its high level of structural and legislative complexity, resulting in high compliance costs for taxpayers and administrative costs for governments. Complexity arises from various sources:

(i) Complex business arrangements that make it difficult to determine profit;

(ii) Policies that require a line to be drawn between targeted and non-targeted activities, such as manufacturing, small business, clean energy and research and development;

(iii) Constant changes to the corporate tax base and structure that require transitional arrangements;

(iv) International flows of capital and income that require special rules to determine profits subject to tax.

No doubt the corporate income tax is complex, particularly in the areas of intercorporate and international activities. It is unrealistic to think that a corporate income tax system will ever be simple, although some forms of taxation can reduce compliance and administrative costs compared to others.

To conclude, the strongest arguments made for corporate taxation is with respect to its neutrality to ensure it operates as a backstop to the personal tax, withholds income (or rents) accruing to non-residents and performs, when needed, as an efficient benefit tax. However, the existing system is failing at achieving these roles at a significant economic cost.

WHY A "BIG-BANG" CORPORATE TAX REFORM TODAY?

Three economic reasons can be given for a big-bang corporate tax reform:

1. To rejuvenate private sector investment in Canada by reducing the intertemporal distortion that would improve labour productivity, encourage the adoption of new technologies and grow the Canadian economy;

2. To reduce inter-asset and inter-industry distortions in the corporate tax to ensure capital is allocated to the best economic use;

3. To simplify the corporate tax system.

While Canada could pursue a strategy to improve the existing corporate income tax by achieving greater neutrality, it is unlikely to deal with many distortions, in some cases due to inherent difficulties to avoid them, such as inflation, financing distortions and risk taking. A new approach to corporate taxation would spur investment and improve the allocation of capital resources.

Much has been written about corporate tax design. As discussed in detail above, the Carter Report (1966) made a classic argument for a corporate income tax based on comprehensive income. In later years, several important studies have argued in favour

of expenditure taxation, which would imply a tax on economic rents, the latter being the surplus of income in excess of the opportunity costs of using capital, labour and other inputs in production. The rent approach is discussed in the final section.

A third approach is a tax on distributed profits. One can view this as a deferral approach to corporate taxation whereby profits from investment activities are only taxed when they are distributed to investors, implying that profits reinvested in capital are exempt from taxation (an exception would apply to passive income that would be taxed at the corporate level). Deferral taxation has been used in various contexts in the past. In many companies, foreign profits of subsidiaries have been taxed when distributed to the parent company (and still prevails in some cases today). In Chile, reinvested corporate profits have been taxed at lower rates compared to distributed profits up until 2017.

The deferral approach is also used for capital gains taxation. Realized capital gains are taxed only upon disposal and, in selected cases like venture capital or real estate, could be deferred further if an investment is rolled over into another qualifying investment. Realized capital gains may also be deferred for share exchanges when companies are merged. The deferral of tax can result in much lower effective tax rates on capital. However, with negative or low real interest rates in recent years, deferral is not as beneficial as it once was.

The reason countries adopt such provisions is to reduce the inefficiency of taxing realized capital gains. A capital gains tax on disposals causes a locked-in effect whereby an investor would rather hold a less well-performing asset for a longer period rather than buy more profitable investments. Thus, rollovers remove a tax barrier to readjust investment portfolios. A deferral approach for the corporate tax could also have a positive impact on investments by enabling companies to postpone corporate taxation if profits are reinvested in new capital projects for economic gain.

While Chile has disbanded its favourable taxation of retained earnings, some new countries have adopted a corporate tax on distributed profits in recent years. Here, we pay particular attention to Estonia's corporate income tax.

ESTONIA'S CORPORATE PROFIT TAX ON DISTRIBUTIONS

In 2000, Estonia introduced a unique approach to corporate taxation applied to all companies operating in Estonia (also adopted by Latvia in 2018). Instead of applying tax to profits, only corporate distributions (dividends and other deemed amounts) are taxed. The Estonian corporate tax exempts profits from active business income, passive (investment) income and capital gains from the sale of assets. However, when the profits are distributed to residents or non-residents, whether earned domestically or internationally, they are subject to a 20 per cent tax[20] with further personal tax on residents or withholding tax on non-residents. Distributed profits include dividends, share buybacks, capital reductions, liquidation proceeds and deemed profit

[20] The tax rate on dividends is equal to 20/80 or 25 per cent to be equivalent to the corporate rate of 20 per cent on distributed dividends.

distributions. In principle, profit and loss accounting under the Estonian tax is irrelevant since all profit distributions are taxed, even if the distribution is more than profits.

Although a country could levy a personal income tax rate higher than the corporate income tax, Estonia has made its tax simpler by adopting a flat personal income tax rate on residents at 20 per cent. Distributions are exempt at the personal level since they have already been subject to the corporate tax.

Estonian companies are taxed on their worldwide income. However, with dividends paid from profits received as dividends or branch income from other residents, the EU and foreign entities with a minimum 10 per cent ownership are exempt from Estonian corporate tax to avoid double taxation. Dividend income received from low-tax countries or tax havens is deemed to be distributions when passed on to investors.

As of 2018, the tax rate was reduced to 14 per cent on distributions that are less than the average of the past three years. However, such distributions are subject to a special withholding tax of seven per cent on residents and non-residents (unless reduced by treaty for non-residents to five per cent or zero).

Deemed dividend amounts include fringe benefits, donations, non-business expenses and certain payments paid to entities in tax havens. Loans to shareholders may be deemed to be hidden profit distributions. Stock dividends (share bonuses) are exempt from the corporate tax. Gifts and donations made to certain qualifying recipients are only subject to corporate tax if expenses exceed three per cent of the social tax base for the existing year or 10 per cent of the profit of the last financial year according to statutory financial statements. Latvia also includes bad debts, excess interest payments and transfer pricing adjustments as part of deemed amounts.

The result of the Estonian reform is to eliminate the corporate tax on reinvested profits. Such profits would be taxed when the profits are eventually distributed. The profits are defined as book profits with no adjustments for accelerated depreciation and loss carry forwards/backs. Estonia eschews tax credits given its exemption for reinvested profits.

Among other policies, including a flat personal income tax, tax reform has made Estonia quite attractive for investment. As we show in Bazel and Mintz (2021), it had a 31 per cent increase in investment from 2015 to 2019 but overall growth has picked up since its initial reform. Although not many studies have been published, there is evidence the Estonian approach has contributed to a more robust business sector. One of the few careful studies was done by Maso, Meriküll and Vahter (2011). It shows that Estonian companies held more liquid assets and reduced debt after the reform, enabling them to better withstand the 2008 financial crisis. They also found improvement in both investment and labour productivity using a difference-in-difference econometric approach that compares Estonia to other Baltic states.

Since 1999, corporate tax revenues in Estonia have increased fivefold from 105 to 509 million euros in 2019. As a share of taxes, corporate taxes made up 5.5 per cent of revenues in 2019 (1.7 percent of GDP), compared to six per cent in 1999 (0,9 percent of GDP), prior to the adoption of the new corporate tax system. In other words, there has not been little erosion in corporate tax revenues.

The OECD discussions on base erosion and profit shifting has led to an agreement for countries to impose a 15 per cent corporate tax rate on the profits earned by foreign affiliates of resident multinationals. Special provisions apply to those countries with eligible distribution tax regimes whereby deemed distribution taxes would be included as part of covered taxes to calculate the tax paid in the host country (OECD 2021).

A CORPORATE TAX ON DISTRIBUTED PROFITS FOR CANADA

Here, we look specifically at the corporate distribution tax to minimize tax distortions and improve the investment climate. The basic elements of the tax on distributed profits are proposed as follows:

- The corporate tax would be applied to distributed profits defined as dividends, share buybacks and deemed corporate distributions related to items, including the payment of non-business expenses and tax haven payments. There would be no differentiation in tax rates by sector or size of profit to minimize complexity;
- Distributions would be taxed without being limited by undistributed profit accounts in the year[21];
- Intercorporate dividends would be tax free between resident companies, as under the existing corporate income tax, to avoid double taxation. Once the tax is applied to corporate distributions of one company paid to another company, it would be exempt from further tax on distributed profits thereafter;
- Profit distributions from affiliates in treaty countries with at least 10 per cent ownership would pass through to investors as exempt income. Otherwise, foreign tax payments would serve as a credit to be claimed against the tax on distributed profits. If a minimum tax is imposed on foreign affiliates as currently discussed internationally, it would apply to countries with a tax rate of at least 15 per cent on accrued income;
- Canadian residents would receive a dividend tax credit based on the corporate tax rate applied to deemed distributions from the corporations;
- Since reinvested earnings that increase the value of the company's shares are not taxed, a concessionary tax on capital gains on the sale of shares by investors is no longer necessary. Thus, capital gains would be taxed at a rate of 100 per cent rather than subject to partial exclusion (inflation adjustments are recommended to avoid taxing nominal capital gains) . Real estate capital gains could be fully taxed (with inflation adjustment);
- Withholding taxes on dividends paid to non-residents would continue to be applied according to treaty arrangements;
- While Estonia exempts all reinvested profits, whether sourced from income or capital gains, the proposal is adjusted to include a refundable withholding tax on investment income and capital gains earned by companies so that investors

[21] This is the approach used in Estonia. It is possible to limit the tax on distributions to income earned in the year and undistributed profits in past years. Distributions in excess of undistributed profits would be treated as a return of capital.

have less incentive to use the corporate form to avoid personal income taxes. This tax on passive income and capital gains reduces the deferral advantage of leaving passive income undistributed to shareholders, following a similar approach used for Canadian-controlled private corporations.

We estimate the revenue-neutral corporate tax on distributed profits would be 16 per cent at the federal level (Table 3). The revenue-neutral corporate tax rate is estimated using 2018 corporate dividend payment in Statistics Canada data. Share buybacks are added as a proportion of dividends based on the Federal Reserve study for OECD countries for 2012-2014 (15 per cent of dividends) (Federal Reserve 2017). Values are brought forward to 2022/3 based on the Economic and Fiscal Update 2020 estimates of corporate income taxes. The provincial average tax rate on corporate distributed profits is estimated to be 11.2 per cent. That results in the same corporate tax revenues collected as in 2022 ($37 billion). Dividend distributions could decline in favour of retained earnings, but with the increase in the capital gains tax rate, it is not clear what the ultimate impact would be on revenues.

One might be surprised that the revenue-neutral corporate tax on distributed profits that exempts reinvested profits altogether is so close to the existing corporate income tax rate (26.2 per cent). Corporate taxable income ($370 billion in the fiscal year 2022/3) is substantially below corporate operating profits ($515 billion) due to tax incentives. Since reinvested profits are exempt, tax incentives, including non-refundable investment and employment tax credits, no longer generate tax savings for companies.

In Table 3, any additional personal capital gains tax on realizations by moving to full taxation of capital gains from disposing corporate shares is not included as revenue. Some revenue loss would be experienced, resulting from a lower personal tax rate on ineligible dividends, resulting from a higher corporate tax rate on distributed profits. Any additional revenues could be used to reduce personal income tax rates.

Table 3. Revenue Estimate from Corporate Tax in Distributed Profits for 2022

	Tax Base (billions)	Federal Corporate Taxes (billions)
Projected 2022/3 Corporate Tax Base and Revenues*	$370	$52.7
Corporate Operating Profits Before Tax	$515	
Dividends**	$287	
Deemed Distributions***	$43	
Corporate Tax on Distributed Profits Base	$330	
Corporate Tax on Distributed Profits at 16 Per Cent		$52.8

*Based on the Fall Economic Update, Finance Canada, 2020, https://budget.gc.ca/fes-eea/2020/home-accueil-en.html.

**November Statistics Canada (n.d.) Table 36-10-0117-01. Includes dividends paid to residents and non-residents.

***Includes share buybacks.

Using this revenue-neutral corporate tax rate of 27 per cent on distributed profits, the METR on capital can be estimated (Table 4). The purpose of shifting from the existing corporate income tax to a tax on distributed profits is to reduce the effective tax

rate on capital funded by reinvested profits to zero.[22] However, the tax on corporate distributions would increase the cost of raising equity finance depending on the dividend payout ratio (this argument is based on the traditional theory of finance (Mintz 1995)). Other taxes, such as sales taxes on capital purchases and real estate transfer taxes, continue to be applied.

Comparing Table 4 with Table 1 (where temporary accelerated depreciation is assumed to have been fully phased out), we see that the average METR falls from 19.5 per cent to 15.8 per cent. Several sectors would be more heavily taxed since tax incentives no longer matter to the investment decision — these sectors benefited from low marginal effective tax rates. Thus, the METR for manufacturing rises from 13.7 per cent to 14.2 per cent, primarily due to the loss of tax preferences in Quebec and the Atlantic Provinces. The METRs remain highest in British Columbia, Saskatchewan and Manitoba due to retail sales taxes that add to capital purchase costs.

Table 4: Corporate Tax on Distributed Profits at a 27 Per Cent Rate

2020	Agriculture	Forestry	Electrical Power, Gas & Water	Construction	Manufacturing	Wholesale Trade	Retail Trade	Transportation & Storage	Communications	Other Services	Aggregate
Canada	15.4%	15.3%	16.2%	14.7%	14.2%	14.4%	15.7%	15.4%	17.2%	17.6%	**15.8%**
Newfoundland	12.0%	14.9%	14.9%	14.8%	14.9%	14.9%	15.1%	15.0%	14.9%	15.2%	**14.9%**
Prince Edward Island	16.3%	15.5%	15.7%	15.5%	15.5%	15.8%	16.2%	16.4%	15.7%	18.2%	**16.1%**
Nova Scotia	15.2%	14.6%	14.9%	14.6%	14.8%	14.8%	15.6%	15.0%	14.9%	15.8%	**15.1%**
New Brunswick	15.0%	14.5%	14.7%	14.5%	15.0%	14.6%	15.1%	14.9%	14.7%	15.4%	**14.8%**
Quebec	15.0%	13.4%	13.7%	13.3%	13.5%	13.7%	14.4%	13.9%	13.8%	16.8%	**14.0%**
Ontario	15.2%	12.8%	13.7%	13.4%	13.0%	13.6%	14.7%	14.2%	13.8%	15.2%	**13.9%**
Manitoba	18.6%	23.9%	24.2%	21.1%	24.1%	18.8%	19.4%	21.5%	28.3%	26.0%	**23.3%**
Saskatchewan	17.9%	22.0%	23.3%	20.0%	22.0%	19.9%	19.2%	18.7%	27.8%	24.8%	**21.7%**
Alberta	11.1%	11.0%	11.1%	11.0%	11.1%	11.1%	11.1%	11.1%	11.1%	11.1%	**11.1%**
British Columbia	20.6%	19.5%	26.1%	22.3%	18.1%	20.1%	22.0%	21.6%	30.6%	28.7%	**24.2%**

EVALUATION

The corporate tax on distributed profits has several advantages in reducing distortions, and some disadvantages.

Intertemporal Distortions

The intertemporal distortion would be reduced, indicating a greater demand for investment, even under the traditional theory used here to model equity financing. If investment is solely equity financed by retained earnings, the METRs in Table 4 would be closer to zero, leaving retail sales tax on capital purchases in B.C., Saskatchewan and Manitoba and property transfer taxes on capital investment (as well as annual municipal property taxes that are not included in these calculations).

22 When retained earnings is the marginal source of equity finance, the dividend tax has no impact on investment decisions. Distribution taxes are simply lump sum taxes with the opportunity of retained earnings finance being the after-tax profit used to finance investment with the future discounted after-tax dividend payments being return on investment. This has been referred to as the new view of equity finance, implying that the distribution tax rate is irrelevant to the investment decision (Auerbach and Hassett 2003).

Inter-industry and Inter-asset Distortions

The variation in METRs across industries would be significantly reduced relative to the current system. The range in METRs across industries is fairly tight: 14.2 per cent in manufacturing to 17.6 per cent in services. In our analysis, we assume the same financing ratios in order to focus on tax differences. If dividend payouts vary across industries (40 per cent for all firms), the METR variation would be greater than what has been estimated. The overall dispersion index, discussed above, declines from 7.2 per cent to 0.3 per cent, substantially reducing inter-asset and inter-industry tax distortions (the remaining distortions are related to sales taxes on capital purchases and land transfer taxes). Obviously, the corporate income tax would be substantially simplified, reflecting the reduction in policy-induced distortions.

International Distortions

The tax on corporate distributed profits would put domestic and foreign companies on a level playing field from the perspective of Canadian corporate taxation. It would also treat domestic and foreign investments made by Canadian resident companies equally. It would reduce the incentive to borrow debt from abroad since interest deductions would not affect the amount of corporate tax on distributed profits.

Risk-taking Distortions

Given that corporate tax would only be paid when profits are distributed, losses are not relevant in determining the tax on distributions. The corporate tax, therefore, would impose no additional tax on risky investments. A corporation with temporary losses would pay its tax on distributed profits, but this would fall on investors as the dividends distributed to investors would be reduced.

Financing Distortions

Compared to the existing corporate income tax, the tax on distributed profits (including share buybacks) could create more neutrality among financing sources. However, the impact of taxation on financial decision-making is complicated to evaluate given the plethora of domestic and international personal and corporate tax rates. As shown in Table 5 below for Canadian residents:

- Integration of corporate and personal income taxes is preserved for dividends, employment income and other chargeable deductions (rents, royalties and fees). The dividend tax credit would be based on the current treatment of eligible dividends (at the federal rate of 16 per cent and provincial rate of 11 per cent). The combined corporate tax on distributed profits and personal tax on dividends would be equal to the tax on employment income and other deductible payments from the corporate tax base;
- As capital gains realizations from the sale of shares are fully taxed at the personal level, the tax on capital gains realizations would be the same as that on dividends, assuming shares are held for only one year. However, if shares are held for longer periods, the personal income tax is deferred until the shares

are sold — this would lower the effective tax rate on capital gains, favouring retained earnings as a source of finance;

- Given interest deductibility is of no value at the corporate level, companies will have an incentive to reduce leverage compared to the existing system. However, debt finance could be favoured relative to equity to avoid the corporate tax on profit distributions if companies borrow from tax-exempt pension funds or low-tax investors at home or abroad. If debt is borrowed from tax haven entities or tax-exempt shareholders, the loan interest could be deemed to be distribution of profits.

Under the existing corporate tax system, Canadian corporate and withholding taxes are credited against foreign taxes. However, in the case of dividends paid by affiliates operating in Canada, these are generally tax exempt abroad by capital exporting countries. Since only profit distributions are taxed by Canada under its corporate tax, foreign companies will be discouraged to remit income to their parent, resulting in some loss in Canadian tax revenues.[23] Given that Canada does not tax capital gains earned by foreign investors (except for qualifying real estate and resource properties), Canada might want to consider deeming capital gains upon disposal of assets by non-residents as a dividend distribution.

Table 5. Tax on Income with an Ontario Corporate Tax on Distributed Profits

	Dividend Paid to Canadian Investor	Reinvested Earnings	Employment, Interest or Royalty Income
Corporate Profits	$100	$100	$100
Corporate Tax	$27	0	$0
Net Profit	$73	$100	$100
Personal Tax (1)	$23	$50	$50
Net Income	$50	$50	$50

(1) Assumes the investor is the high-income investor at a rate of 50 per cent. Dividend tax rate includes the dividend tax credit equal to 27 per cent of pre-corporate tax distributed profits. Capital gains are fully taxed.

Overall, the proposal would encourage foreign investors to reinvest profits in Canada. Given that non-residents pay capital gains taxes to their home countries and not Canada, foreign investors could have an advantage over Canadian investors in buying Canadian assets if Canada moves to full capital gains taxation (the U.S. tax rate on long-term capital gains is 20 per cent, close to the current Canadian capital gains tax rate).

Business Organization Distortions

The current corporate income tax favours the corporate form since the profit rate is below the top personal income tax rate. With a corporate tax on distributed profits, the tax on retained earnings would be deferred until the profit is distributed, thereby providing an additional incentive to incorporation.

23 Roughly $50 billion in corporate dividends are distributed to non-residents.

In contrast, business income is attributed to owners of sole proprietorships, branches, trusts and partnerships that are subject to current personal or corporate taxation. With the ability to defer the profit tax, the corporate form of business organization would have an advantage over other business organizational forms. Nonetheless, the incentive to avoid current tax by leaving income within the corporation is lessened by taxing passive income from reinvested profits.

OVERALL ASSESSMENT

A corporate tax on distributed profits provides several advantages in reducing distortions. Being more neutral, it would be an improvement over the current corporate income tax. However, it is not a perfect solution. Some investors will be able to defer paying personal taxes by leaving profits in the company rather than distributing them. On the other hand, to the extent that the existing corporate tax is shifted back on labour or forward to consumers, the tax on corporate distributions might be less regressive by primarily affecting the amount of profits distributed to investors. The corporate tax would be substantially simplified by eliminating distinctions between eligible and ineligible dividends since only one corporate tax rate would be applied to distributed profits. As well, many rules associated with tax incentives would no longer be needed since reinvested profits would be exempt from taxation.[24] Other anti-avoidance rules may be required but, overall, the corporate tax system should be less complex.

Tax reform is never simple and raises a host of transition issues. Distributions paid from past taxed profits would be taxed unless exempted initially. Pools of unused tax losses carried forward from earlier years would no longer have value, resulting in a one-time wealth tax.

This different approach to corporate tax reform could be implemented on an experimental basis. For example, given Quebec and Alberta collect their own corporate income taxes, they could try this approach first. However, the international issues would be complex for provincial administration — a corporate tax on distributed profits might need to apply regardless of whether the global distributions have already been taxed. An allocation formula to determine distributed profits for a province would be needed. To avoid negotiations over a new formula, the existing apportionment rules using payroll and sales revenues could be used.

24 Investment tax credits could be provided by making them refundable against the corporate distribution tax.

CORPORATE TAX ON DISTRIBUTED RENTS

Economic rents are returns on an investment in excess of the normal net-of-risk return on the investment. Another way of describing economic rent is the surplus income in excess of the economic costs of production, including risk costs. In theory, economic rents can be taxed heavily — even up to a 100 per cent tax rate — without reducing the incentive to make the investment and produce from it. However, extremely high-rent tax rates could encourage highly profitable projects to shift to jurisdictions with lower tax rates. Given that risk costs are not observable, economic rents are less than observable profits.[25]

Much, though by no means all, of the activity that produces economic rents is carried out by business corporations in the private sector. Such rents may be earned from ownership of intellectual property and economic or regulatory barriers to entry preventing competition, in addition to ownership of assets, such as natural resources and land. This leads to the idea that, at the very least, corporations deriving earnings in the form of economic rents should be taxed directly on those rents in order to prevent the possibility of reducing the rent tax if it were only taxed at the shareholder level. As some of these rents are shifted to other parts of the economy through higher labour payments, for example, or internationally through licensing agreements, rents need not show up as profit but instead be reflected as employment compensation, royalties or fees.

The concept of a corporate tax applying to rents became popular among economists in the late 1970s with the publication of the 1978 U.S. Treasury report headed by David Bradford (1986) and the U.K. Meade Report (Institute of Fiscal Studies 1978). A key point is that the imputed costs of debt and equity finance would be deductible from the corporate base, unlike the measurement of shareholder profits, which only provides for a deduction for the cost of debt finance.

Two methods have been suggested to tax economic rents: cash flow and (economic) profit bases.[26] The cash flow base would be revenue net of current and capital expenditure. Given the expensing of capital expenditure, which is equivalent to the present value of depreciation and financing costs, neither depreciation nor financing expenses would be deductible from the tax base. The alternative approach is the economic profits base, which is defined as revenues net of the economic cost of depreciation, debt interest expense and an allowance for the corporate equity expense (ACE).

Although the cash flow tax approach has been used for mining and oil/gas rent taxation (Chen and Mintz 2012), it has not been generally used for corporate taxation. One reason is that the tax is not easily applicable to rent unless cash flow includes not only real transaction flows, but also financial ones (Institute of Fiscal Studies 1978), which can be quite complicated once dealing with financial innovations. Another is that it works best with a personal tax applied to expenditure (earnings net of savings

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25 A rent tax may not raise much revenue once risk costs are deducted.

26 Bradford (1986) proposed a cash flow approach. The Mirrlees Report (2011) recommended the economic profits approach as an alternative rent tax.

or exempting the normal return to capital), as discussed in the Meade Report (1978), Bradford (1986) and the Mirrlees Report (2011).

The economic profit approach has been more easily adaptable for the economy as a whole. It has been implemented by providing an allowance for equity financing (ACE) with equity including both retained earnings and shareholder-contributed capital. The ACE is typically set at the government long-term bond rate (such as 10 years), which in recent years could be negative.[27] The ACE was initially adopted in Croatia, but later disbanded. It was then used in Belgium to replace its low-tax regime for headquarters that was being challenged by the European system. Given the accelerating cost of the ACE deduction, Belgium later limited the ACE to new equity issues, similar to Italy. Today the ACE is used by several countries, such as Belgium, Brazil, Cyprus, Italy, Malta and Turkey.

The cash flow and economic profit approaches are not the only ones. Another would be to tax shareholder distributions net of equity issues (King 1987). Thus, the above proposal could be adjusted by treating new equity issues as a negative distribution that would be deducted from the tax base. If the tax base is negative, the amount could be carried back or carried forward at an interest rate reflecting any risk should losses not be eventually used. This would result in the neutral treatment of investment decisions under the corporate tax. If the personal tax is also reformed by allowing savings to be deducted (dissavings would be fully taxed and interest would not be deductible), it would then parallel the corporate income tax, removing both corporate and personal tax on the normal return to investment (rents would be taxed fully).[28]

If only the corporate tax is changed into a rent tax, several consequences would be involved.

First, treating new equity issues as a negative distribution would narrow the corporate tax base, resulting in a higher corporate tax rate if corporate tax revenues are kept constant. Using Statistics Canada data, the estimated revenue-neutral federal-provincial corporate income tax rate would be 55 per cent if new equity issues were subtracted from the distributed profits base.[29] A high corporate tax on dividend payments would encourage companies to pass out rent in other forms of payment to

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27 Belgium set the ACE to be equal to -0.16 per cent in 2021 for large companies and 0.34 per cent for small and medium-size companies: https://www.oecd.org/tax/tax-policy/tax-database/corporate-and-capital-income-tax-explanatory-annex.pdf.

28 Boadway and Tremblay (2014) recommend the corporate cash flow tax in Canada with dividends and realized capital gains taxed at a rate of 100 per cent under the personal income tax (see also McKenzie and Smart 2019). The corporate-only cash flow tax provides substantial benefits by not affecting the investment decision, leaving aside the global personal tax effects on capital decisions. It also raises a number of complexities that are not simple to address: consistency with the personal income tax, measuring the appropriate exempt return on capital, taking into account risk, treatment of tax losses and international tax planning considerations. See the Technical Committee on Business Taxation (1997) and Mintz (2018). See also the discussion below regarding the mixing of a personal income tax with a rent tax on corporate distributions.

29 Calculations based on 2019 data from Statistics Canada. https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=3610011601. https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=3610057801&pickMembers%5B0%5D=2.6&cubeTimeFrame.startMonth=01&cubeTimeFrame.startYear=2020&cubeTimeFrame.endMonth=01&cubeTimeFrame.endYear=2021&referencePeriods=20200101%2C20210101.

resident and non-resident shareholders.

Second, the deductibility of new equity from the corporate tax base suggests that it would be possible to eliminate the dividend tax credit and capital gains exclusion preference since the corporate tax sole purpose is to withhold rents, not income accruing to investors. However, with the deduction for new equity issues at the corporate level, the corporate tax would be paid on that portion of profit reflecting rents. Rents distributed to resident investors as dividends and capital gains, however, would be double taxed. For example, if there is no dividend tax credit, the effective rate on rents paid as dividends to an Ontario investor in Table 3 would be close to 67 per cent. Non-resident investors may also be subject to double taxation on rents paid out as dividends and realized capital gains. Companies will, therefore, look to avoid higher tax rates on rents distributed as equity income by resorting to non-profit payments that are deductible at the corporate level — employment compensation, leasing, royalties, management fees, etc. It would also open new opportunities for domestic and international tax planning that would need to be considered.

Nonetheless, as part of a major tax reform of both corporate and personal income taxes towards rent-based taxation, the option of shifting to a rent-based corporate tax on distributions is intriguing. It would need further study going beyond this paper.

CONCLUSIONS

Canada has taken many steps to reform its corporate income tax since 1985 by reducing corporate rates and broadening the corporate tax base. However, Canada's corporate income tax remains distortionary, with high economic, compliance and administrative costs. Even without politically motivated tax incentives, the lack of indexation for inflation, imperfect loss refundability, international tax interactions and other complexities make a perfect corporate income tax unachievable.

In recent years, the corporate tax reforms have been reversed with the introduction of new tax incentives after 2015. Yet, these changes have failed to lead to a better investment performance in Canada. If Canada is to build up its productive capacity in the post-COVID world, a big-bang approach to corporate tax could be more successful. Here, I propose converting the corporate income tax into a tax on distributed profits. A business tax reform along these lines would put Canada into a unique position to attract investment, as well as reduce many distortions in the business tax system. It is not perfect, but it is better than what we currently have. It could also be turned into a rent tax by treating new equity issues as negative dividends but this approach would need fundamental reform of both the corporate and personal income taxes.

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