Tax Expenditures and Evaluations

2005

Canada

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Department of Finance Canada
Ministère des Finances Canada

Available from the

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Ottawa, Ontario K1A 0G5
Tel: (613) 943-8665
Fax: (613) 996-0901

Price: $16.00 (including GST)

This document is available free on the Internet at
www.fin.gc.ca

Cette publication est également disponible en français.

Cat No.: F1-27/2005E
ISBN 0-660-19536-4

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PREFACE

Since 2000, the tax expenditure report has been separated into two documents. This document, *Tax Expenditures and Evaluations*, is published on an annual basis. It provides estimates and projections for broadly defined tax expenditures as well as evaluations and descriptive papers addressing specific tax measures. This year's edition includes a paper entitled "Marginal Effective Tax Rates on Business Investment: Methodology and Estimates for Canadian and US Jurisdictions."

The companion document, *Tax Expenditures: Notes to the Estimates/Projections*, was published in 2004. It is a reference document for readers who wish to know more about how the estimates and projections are calculated and who want descriptions of or information on the objectives of particular tax expenditures. New tax expenditures, as well as changes to existing tax expenditures, since last year's report are described in the relevant section of this document.

PART 1
TAX EXPENDITURES:
ESTIMATES AND PROJECTIONS

INTRODUCTION

The principal function of the tax system is to raise the revenues necessary to fund government expenditures. The amount of revenue raised is determined to a large extent by tax bases and tax rates. It is also a function of a range of measures—special tax rates, exemptions, deductions, rebates, deferrals and credits—that affect the level and distribution of tax. These measures are sometimes called "tax expenditures" because they have an impact on government revenue (i.e. they have a cost) and they reflect the policy choices of the Government.

In order to determine these tax expenditures, it is necessary to establish a "benchmark" tax structure that applies the relevant tax rates to a broadly defined tax base—e.g. personal income, business income or consumption. Tax expenditures are then measured as deviations from this benchmark. Reasonable differences of opinion exist about what should be considered a normal part of the tax system and hence about what should be considered a tax expenditure. For example, a deduction for expenses incurred in earning income is generally considered as part of the benchmark and thus not as a tax expenditure. But, in some cases, the deduction may confer some personal benefit, making its classification ambiguous.

This report takes a broad approach and includes estimates and projections of the revenue loss associated with all but the most fundamental structural elements of the tax system, such as the progressive personal income tax rate structure. As a result, this includes not only measures that may reasonably be regarded as tax expenditures but also other measures that may be considered as part of the benchmark tax system. The latter are listed separately under "memorandum items." For instance, the dividend gross-up and credit is listed under this heading because its purpose is to reduce or eliminate the double taxation of income earned by corporations and distributed to individuals through dividends. Also included under this heading are measures for which there may be some debate over whether they should be considered as tax expenditures or where data limitations do not permit a separation of the tax expenditure and benchmark components of the measure. This approach provides information on as full a range of measures as possible.

Caveats

Care must be taken in interpreting the estimates and projections of tax expenditures in the tables for the following reasons.

- The estimates and projections are intended to indicate the potential revenue gain that would be realized by removing individual tax measures. They are developed assuming that the underlying tax base would not be affected by removal of the measure. However, this is an assumption that is unlikely to be true in practice as the behaviour of economic agents, overall economic activity and other government policies could change along with the specific tax provision.
- The cost of each tax measure is determined separately, assuming that all other tax provisions remain unchanged. Many of the tax expenditures do, however, interact with each other such that the impact of several tax provisions at once cannot generally be calculated by adding up the estimates and projections for each provision.
- The federal and provincial income tax systems interact with each other to various degrees. As a result, changes to tax expenditures in the federal system may have consequences for provincial tax revenues. In this publication, however, any such provincial effects are not taken into account—that is, the tax expenditure estimates and projections address strictly the federal tax system and federal tax revenue.
- In the case of the harmonized sales tax in effect in Nova Scotia, New Brunswick, and Newfoundland and Labrador, only the federal cost of the tax expenditures is reported.

The tax expenditure estimates and projections presented in this document are developed using the latest available taxation data. Revisions to the underlying data as well as improvements to the methodology can result in substantial changes to the value of a given tax expenditure in successive publications. In addition, estimates and projections for some tax measures, such as the half inclusion rate on capital gains, are particularly sensitive to economic parameters and hence may also differ significantly from one publication to the next.

WHAT'S NEW IN THE 2005 REPORT

A number of new tax measures have been proposed or legislated since last year's report and others have been modified. These are described below.

Personal Income Tax

Adoption Expense Tax Credit

Objective: *This measure provides tax recognition to parents for costs that are unique to the decision to adopt a child. (Budget Plan, 2005)*

In order to provide tax recognition of the exceptional costs of adoption, Budget 2005 proposed a 16% non-refundable tax credit to recognize specified adoption expenses, up to a maximum of $10,000.

This measure, which applies for the 2005 and subsequent taxation years, allows adoptive parents to claim a range of eligible expenses such as adoption agency fees, legal expenses, and travel and living expenses for the child and the adoptive parents.

Basic Personal Amount

Budget 2005 increased the basic personal amount, the amount that all Canadians may earn without paying federal income tax, to $10,000 by 2009, and made corresponding increases to the amount for a dependent spouse or common-law partner and the equivalent amount for an eligible dependant.

Child Disability Benefit

Budget 2005 increased the maximum annual Child Disability Benefit to $2,000 from $1,681 per child beginning in July 2005.

Disability Supports Deduction

Budget 2005 proposed to expand the list of expenses eligible for the disability supports deduction, introduced in Budget 2004, to include costs such as job coaches, deaf-blind interveners and Braille note-takers.

Disability Tax Credit

Budget 2005 proposed a number of changes to the disability tax credit (DTC), including:

- Extending eligibility for the DTC to individuals who face multiple restrictions that together have a substantial impact on their everyday lives.
- Amending the DTC to ensure that more individuals requiring extensive life-sustaining therapy on an ongoing basis are eligible.

Medical Expense Tax Credit

Budget 2005 proposed to double the maximum amount of medical and disability-related expenses that can be claimed by caregivers to $10,000 from $5,000.

Non-Taxation of Veterans' Income Support Benefit

Objective: *The provision recognizes that these benefits provide a basic level of support to veterans.*

Beginning in 2006, as part of the modernization package for Canadian Forces veterans and their families, veterans may be eligible to receive the Canadian Forces Income Support Benefit. This tax-free benefit provides income support to those who have completed rehabilitation and are able to work, but who have not yet found employment.

Non-Taxation of the Veterans' Disability Award

Objective: *The provision recognizes that these benefits compensate for the non-economic effects of a veteran's service-related disability.*

Beginning in 2006, as part of the modernization package for Canadian Forces veterans and their families, veterans may be eligible to receive a tax-free lump-sum Disability Award payment. This compensates Canadian Forces veterans for the non-economic effects of a service-related disability, such as pain and suffering, functional loss, and the loss of enjoyment of life. It will replace the current veterans' Disability Pension for those with new service-related disabilities.

Refundable Medical Expense Supplement

Budget 2005 increased the maximum amount of the refundable medical expense supplement to $750 from $571 per year.

Registered Pension Plan and Registered Retirement Savings Plan Limits

Budget 2005 increased the limits for registered pension plans (RPPs), registered retirement savings plans (RRSPs) and deferred profit sharing plans (DPSPs) as follows:

- The money purchase RPP annual contribution limit will be increased to $19,000 for 2006, $20,000 for 2007, $21,000 for 2008 and $22,000 for 2009. Corresponding increases will be made to the maximum pension limit for defined benefit RPPs, bringing it to $2,111 for 2006, $2,222 for 2007, $2,333 for 2008 and $2,444 for 2009.
- Because RPP limits are based on current year earnings while RRSP limits are based on prior year earnings, the RRSP limits are lagged one year behind the corresponding RPP limits. Accordingly, the RRSP annual contribution limit will be increased to $19,000 for 2007, $20,000 for 2008, $21,000 for 2009 and $22,000 for 2010.

- The DPSP limit will remain at one-half of the money purchase RPP limit.
- The limits will be indexed to average wage growth, starting in 2010 for RPPs and DPSPs, and in 2011 for RRSPs.

Corporate Income Tax

Deferral of Tax on Patronage Dividends Paid by Agricultural Cooperatives

In order to improve the capitalization of agricultural cooperatives, Budget 2005 proposed a measure to allow members of agricultural cooperatives to defer paying tax on patronage dividends they receive in the form of shares until the shares are disposed of.

> ***Objective:*** *Agricultural cooperative corporations play an important role in rural communities. To aid their capitalization, Budget 2005 proposed to allow members of such cooperatives to defer paying tax on patronage dividends paid to them in the form of eligible shares rather than as cash distributions. (Budget Plan, 2005)*

Cooperatives can distribute earnings to their members in the form of patronage dividends, which are paid in proportion to the amount of business the member has undertaken with the cooperative. In computing its income, a cooperative may deduct patronage dividends paid to its members. Accordingly, income paid out in the form of patronage dividends is not subject to tax at the cooperative level. Patronage dividends received by a member, other than those received in respect of consumer goods and services, are included in the recipient's income and are taxable in the year they are received.

This measure permits eligible members of eligible agricultural cooperatives to defer the inclusion in income of all or a portion of any patronage dividend received as an eligible share until the disposition (or deemed disposition) of the share. Eligible shares must be issued after 2005 and before 2016.

This measure is considered a tax expenditure because it constitutes a departure from the benchmark system by allowing members of eligible agricultural cooperatives to defer the inclusion in income of patronage dividends received in the form of shares until the disposition (or deemed disposition) while other patronage dividends are usually included in the recipient's income and are taxable in the year they are received.

Goods and Services Tax

Expanded Goods and Services Tax/ Harmonized Sales Tax Health Care Rebate

Public hospitals are entitled to an 83% rebate of the goods and services tax (GST) and the federal portion of the harmonized sales tax (HST) that they pay on purchases used to provide exempt health care services. The 2005 budget announced the extension of the application of the 83% rebate to eligible charities and non-profit organizations in respect of the GST and federal component of the HST paid on purchases related to their health care services that are similar to those traditionally performed in hospitals. Further, eligible entities—including public hospitals—that incur substantially all of their GST/HST on goods and services for use in respect of the supply of health care services now qualify for the 83% rebate on all of their GST and the federal component of the HST that they incur. These measures have been legislated and are effective January 1, 2005.

THE TAX EXPENDITURES

Tables 1 to 3 provide tax expenditure values for personal income tax, corporate income tax and the goods and services tax for the years 2000 to 2007.

Estimates and projections are developed using the methodology set out in Chapter 1 of *Tax Expenditures: Notes to the Estimates/Projections* (2004).[1] The economic variables used to develop the estimates and projections are based on the private sector average forecast presented in the February 2005 budget.

The tax expenditures are grouped according to functional categories. This grouping is provided solely for presentational purposes and is not intended to reflect underlying policy considerations.

All estimates and projections are reported in millions of dollars. The letter "S" indicates that the cost is less than $2.5 million, "n.a." signifies that data is not available to support a meaningful estimate/projection, and a dash means that the tax expenditure is not in effect. The inclusion in the report of items for which estimates and projections are not available is warranted given that the report is designed to provide information on measures included in the tax system even if it is not always possible to provide their revenue impacts.

Work is continuing to obtain quantitative estimates and projections where possible. For example, in previous years, data limitations prevented the split between the scientific research and experimental development and Atlantic investment tax credit of investment tax credits claimed in the current year but earned in prior years (carry-forwards) as well as investment tax credits earned in the current year but applied against prior years' taxes (carry-backs). With the availability of new data, it is now possible to provide an estimate of the cost of these carry-forwards and carry-backs. As a result, the total cost of each of these measures can now be provided more accurately.

[1] Available on the Department of Finance Canada website at www.fin.gc.ca.

Table 1
Personal Income Tax Expenditures[*†]

	Estimates			Projections				
	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
				($ millions)				
Charities, Gifts and Contributions								
Charitable donations credit	1,495	1,490	1,580	1,605	1,635	1,670	1,700	1,745
Reduced inclusion rate for capital gains arising from donations of publicly listed securities and ecologically sensitive land[1]	19	6	3	6	6	7	7	8
Non-taxation of capital gains on gifts of cultural property[2]	7	6	3	13	9	7	7	7
Non-taxation of gifts and bequests	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Political contribution tax credit[3]	19	8	9	11	22	15	17	17
Culture								
Assistance for artists	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deduction for artists and musicians	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Education								
Adult basic education—tax deduction for tuition assistance	–	–	10	5	5	5	5	5
Apprentice vehicle mechanics' tools deduction	–	–	10	10	10	10	10	10
Education credit[4]	140	260	250	260	275	280	280	280
Tuition credit	310	275	275	295	305	320	325	330
Education and tuition credits carried forward from prior years[5]	165	170	245	250	255	255	255	260
Transfer of education and tuition credits	325	390	420	435	450	460	465	470
Partial exemption of scholarship, fellowship and bursary income[6]	29	21	22	22	22	23	23	23
Registered education savings plans[7, 8]	97	95	120	120	135	135	130	115
Student loan interest credit	66	66	60	62	63	64	66	68

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[*] **The elimination of a tax expenditure would not necessarily yield the full tax revenues shown in the table. See the publication *Tax Expenditures: Notes to the Estimates/Projections*, published in 2004 and available on the Department of Finance Canada website (www.fin.gc.ca), for a discussion of the reasons for this.**

† The February 2000 budget fully indexed, effective January 1, 2000, those parameters that were previously only partially indexed. The *Economic Statement* and *Budget Update* of October 2000 reduced all personal income tax rates and eliminated the deficit reduction surtax, effective January 1, 2001. These rate reductions lower the value of exemptions and deductions, as well as those non-refundable tax credits whose values depend on a tax rate, in the year the change was introduced, but this is generally followed by growth in their value over time in line with increases in the underlying tax base.

Table 1
Personal Income Tax Expenditures *(cont'd)*

	Estimates			Projections				
	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
				($ millions)				
Employment								
Deduction for income earned by military and police deployed to high-risk international missions	–	–	–	–	30	30	30	30
Deduction of home relocation loans	S	S	S	S	S	S	S	S
Deferral of salary through leave of absence/sabbatical plans	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Employee benefit plans	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Employee stock options[9]	690	650	415	480	400	350	300	250
Non-taxation of certain non-monetary employment benefits	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Non-taxation of strike pay	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Northern residents deductions	135	125	130	130	130	135	135	140
Overseas employment credit	55	57	62	62	63	64	65	66
Tax-free amount for emergency service volunteers	14	14	14	14	14	14	14	14
Family								
Adoption expense tax credit[10]	–	–	–	–	–	5	5	5
Canada Child Tax Benefit[11]	6,610	7,370	7,755	7,985	8,650	9,210	9,605	9,850
Caregiver credit[12]	35	57	65	65	70	70	75	75
Deferral of capital gains through transfers to a spouse, spousal trust or family trust	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Infirm dependant credit[12]	5	6	6	6	6	6	7	7
Spouse or common-law partner credit[13,14]	1,215	1,160	1,180	1,210	1,275	1,315	1,380	1,455
Eligible dependant credit[13,14]	620	610	630	645	665	680	700	730
Farming and Fishing								
$500,000 lifetime capital gains exemption for farm property[15]	325	215	255	240	245	255	265	275
Cash-basis accounting	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deferral of capital gains through intergenerational rollovers of family farms and commercial woodlots	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deferral of income from destruction of livestock[16]	S	3	S	S	9	-9	S	S
Deferral of income from sale of livestock during drought years	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deferral of income from grain sold through cash purchase tickets[17]	5	-26	21	S	S	11	13	13
Deferral through 10-year capital gain reserve	S	S	S	S	S	S	S	S

Table 1
Personal Income Tax Expenditures *(cont'd)*

	Estimates			Projections				
	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
				($ millions)				
Exemption from making quarterly tax instalments	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Flexibility in inventory accounting	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Tax treatment of the Net Income Stabilization Account[18]								
Deferral of tax on government contributions	74	66	170	45	–	–	–	–
Deferral of tax on bonus and interest income	34	31	26	23	22	7	S	S
Taxable withdrawals	-86	-76	-105	-100	-185	-160	-8	S
Federal-Provincial Financing Arrangements								
Logging tax credit	S	S	S	S	S	S	S	S
Quebec abatement	3,175	2,965	3,050	3,195	3,270	3,475	3,705	3,980
Transfer of income tax points to provinces	14,105	13,555	13,585	14,145	14,530	15,435	16,465	17,675
General Business and Investment								
$200 capital gains exemption on foreign exchange transactions	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
$1,000 capital gains exemption on personal-use property	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deduction of accelerated capital cost allowance[19]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deferral through use of billed-basis accounting by professionals	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deferral through capital gains rollovers	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deferral through five-year capital gain reserve	64	20	31	32	32	33	34	35
Investment tax credits	28	33	36	33	34	35	36	37
Mineral exploration tax credit for flow-through share investors[20]	9	12	25	45	59	56	-21	–
Partial inclusion of capital gains[21]	2,500	1,985	1,665	2,120	2,150	2,195	2,235	2,285
Taxation of capital gains upon realization[22]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Small Business								
$500,000 lifetime capital gains exemption for small business shares[23]	740	345	305	310	315	320	325	335
Deduction of allowable business investment losses	39	44	48	49	50	51	53	54
Deferral through 10-year capital gain reserve	S	S	S	S	S	S	S	S
Labour-sponsored venture capital corporations credit[24]	255	215	180	160	200	200	200	200
Rollovers of investments in small businesses	3	6	3	4	4	4	4	4

Table 1
Personal Income Tax Expenditures *(cont'd)*

	Estimates			Projections				
	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
				($ millions)				
Health								
Child Disability Benefit[25]	–	–	–	15	40	50	65	65
Disability tax credit[26]	275	330	350	370	380	465	480	495
Medical expense tax credit[27]	550	570	635	700	765	820	880	950
Non-taxation of business-paid health and dental benefits	1,610	1,710	1,875	2,060	2,240	2,430	2,625	2,805
Refundable medical expense supplement[28]	42	55	64	70	75	85	90	95
Income Maintenance and Retirement								
Age credit	1,385	1,320	1,355	1,400	1,460	1,515	1,555	1,620
Deferred profit sharing plans	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Non-taxation of certain amounts received as damages in respect of personal injury or death	15	15	15	17	17	18	19	19
Non-taxation of Guaranteed Income Supplement and Allowance benefits[29]	290	265	265	290	285	300	305	310
Non-taxation of investment income on life insurance policies[30]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Non-taxation of RCMP pensions/compensation in respect of injury, disability or death	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Non-taxation of social assistance benefits[31]	290	245	225	220	205	200	185	175
Non-taxation of up to $10,000 of death benefits	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Non-taxation of veterans' allowances, income support benefits, civilian war pensions and allowances, and other service pensions (including those from Allied countries)[32]	5	5	4	3	3	3	S	S
Non-taxation of veterans' disability pensions and support for dependants[33]	135	135	140	150	155	165	165	165
Non-taxation of veterans' Disability Award[33]	–	–	–	–	–	–	16	20
Non-taxation of workers' compensation benefits	665	650	700	745	760	800	840	885
Pension income credit	425	405	415	425	435	445	455	470
Registered pension plans[34]								
Deduction for contributions	4,895	4,575	5,325	7,300	9,100	9,405	10,000	10,630
Non-taxation of investment income	9,390	2,785	335	11,520	9,370	10,005	10,670	11,320
Taxation of withdrawals	-6,695	-6,415	-6,670	-7,125	-7,380	-7,870	-8,340	-8,830
Net tax expenditure	7,590	940	-1,010	11,695	11,090	11,540	12,330	13,120

Table 1
Personal Income Tax Expenditures *(cont'd)*

	Estimates			Projections				
	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
				($ millions)				
Registered retirement savings plans[34]								
Deduction for contributions	7,155	6,225	5,915	6,030	6,305	6,720	7,225	7,760
Non-taxation of investment income[35]	4,600	1,280	17	6,300	5,095	5,485	5,905	6,355
Taxation of withdrawals	-3,515	-3,465	-3,510	-3,855	-4,105	-4,490	-4,880	-5,305
Net tax expenditure	8,240	4,040	2,425	8,475	7,295	7,720	8,250	8,815
Supplementary Information:								
Present value of tax assistance for retirement savings plans[36, 37]	6,465	6,140	6,365	7,475	8,760	9,130	9,520	9,930
Saskatchewan Pension Plan	S	S	S	S	S	S	S	S
Treatment of alimony and maintenance payments	170	115	115	115	110	110	110	110
Other Items								
Deduction related to vows of perpetual poverty	S	S	S	S	S	S	S	S
Deduction for clergy residence	68	67	74	75	75	77	78	79
Non-taxation of capital gains on principal residences[38]								
Partial inclusion rate	1,000	885	1,405	1,835	2,335	2,385	2,440	2,500
Full inclusion rate	1,530	1,770	2,810	3,665	4,670	4,770	4,880	5,000
Non-taxation of income from the Office of the Governor General	S	S	S	S	S	S	S	S
Non-taxation of income of Indians on reserves	n.a.	n.a	n.a	n.a.	n.a.	n.a.	n.a.	n.a.
Special tax computation for certain retroactive lump-sum payments	S	S	S	S	S	S	S	S
Memorandum Items								
Avoidance of Double Taxation								
Dividend gross-up and credit	970	1,215	1,260	1,310	1,365	1,420	1,470	1,540
Foreign tax credit	580	635	665	675	685	695	705	720
Non-taxation of capital dividends	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Recognition of Expenses Incurred to Earn Income								
Child care expense deduction[39]	595	530	535	535	535	545	550	560
Deduction of carrying charges incurred to earn income	875	825	730	735	745	855	895	940
Deduction of union and professional dues	590	550	575	605	610	630	650	675
Disability supports deduction (attendant care deduction)[40]	S	S	S	S	15	20	20	20
Moving expense deduction	71	81	88	91	92	95	97	100

Table 1
Personal Income Tax Expenditures *(cont'd)*

	Estimates			Projections				
	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
				($ millions)				
Loss Offset Provisions								
Capital loss carry-overs[41]	225	86	91	150	125	100	100	100
Farm and fishing loss carry-overs	14	16	15	12	12	13	14	15
Non-capital loss carry-overs	91	78	82	85	85	88	90	92
Social and Employment Insurance Programs								
Canada Pension Plan and Quebec Pension Plan[42]								
Employee-paid contribution credit	1,845	1,980	2,245	2,460	2,535	2,625	2,710	2,820
Non-taxation of employer-paid premiums[43]	2,485	2,160	2,140	2,100	1,985	2,005	2,045	2,105
Other								
Basic personal amount[14]	20,905	20,460	21,085	21,715	22,650	23,370	24,350	25,570
Deduction of farm losses for part-time farmers	59	60	61	52	53	56	60	63
Deduction of other employment expenses	770	735	775	810	820	845	870	905
Deduction of resource-related expenditures[44]	125	155	175	245	300	325	280	280
Reclassification of flow-through shares[45]	24	33	31	31	37	41	39	39
Non-taxation of lottery and gambling winnings[46]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Non-taxation of specified incidental expenses[47]	4	–	–	–	–	–	–	–
Non-taxation of allowances for diplomats, military and other government employees posted abroad	9	9	10	10	10	10	10	10
Partial deduction of meals and entertainment expenses	86	85	72	73	73	75	76	77

Table 1
Personal Income Tax Expenditures *(cont'd)*

Notes:

[1] The decline in the tax expenditure in 2001 reflects both the decline in capital markets after 2000 and the reduction in the normal capital gains inclusion rate from three-quarters to one-half in 2000.

The total tax expenditure cost of this measure has two components: the revenue forgone as a result of the reduced inclusion rate (which is shown in the main table), and the increased cost of the charitable donations credit from any increase in donations that results from the measure. If all of the donations of listed securities and ecologically sensitive land would have been made in the absence of this measure, then (as shown in the main table) the total cost ranges from $3 million to $19 million between 2000 and 2007. If, on the other hand, all donations of listed securities and ecologically sensitive land came about as a result of the reduced inclusion rate on capital gains, and if in the absence of the measure the shares and land would have been sold instead of donated, then the cost of the measure ranges from $32 million to $80 million between 2000 and 2007, as shown below (in millions of dollars):

2000	2001	2002	2003	2004	2005	2006	2007
80	42	32	45	46	53	54	55

The true costs fall somewhere between the lower and upper bounds set by the ranges indicated.

[2] The estimates and projections for this tax expenditure are different from those in previous publications due to an improvement in the methodology, which provides a more accurate estimate of the total cultural gifts donated by individuals.

The total tax expenditure cost has two components: the revenue forgone as a result of the reduced inclusion rate (which is shown in the main table), and the increased cost of the charitable donations credit from any increase in donations that results from the measure. If all of these donations of cultural property would have been made in the absence of this measure, then (as shown in the main table) the total cost ranges from $3 million to $13 million between 2000 and 2007. If, on the other hand, all donations of cultural property came about as a result of this measure, and if the property would otherwise have been sold instead of donated, then the cost of the measure ranges from $18 million to $72 million over the period 2000 to 2007, as shown below (in millions of dollars):

2000	2001	2002	2003	2004	2005	2006	2007
25	31	18	72	48	36	36	36

The true costs fall somewhere between the lower and upper bounds set by the ranges indicated.

[3] While the large tax expenditure in 2000 is primarily a result of the federal general election in that year, the projected increase in 2004 reflects both the impact of the election and the onset of two additional factors. First, the three political contribution tax credit thresholds were increased by $200 each, for 2004 and subsequent years. Second, An Act to amend the Canada Elections Act and the Income Tax Act, which received Royal Assent on May 14, 2004, enables additional political parties to become registered and eligible for the tax credit.

[4] The tax expenditure amount is the credit amount earned and claimed in the year. The October 2000 *Economic Statement and Budget Update* increased the education credit to $400 per month for full-time students and $120 per month for part-time students, effective January 1, 2001. The 2001 budget introduced a measure extending the education credit, beginning 2002, to people who receive taxable assistance for post-secondary education under certain government programs. Effective taxation year 2004, Budget 2004 extended the education credit to students who pursue post-secondary education related to their current employment, provided that their employer does not reimburse the cost of education in whole or in part.

Table 1
Personal Income Tax Expenditures *(cont'd)*

[5] For a given year, the tax expenditure represents the value of education and tuition credits earned in past years and used in that year. The tax expenditure does not include the pool of unused education and tuition credits that have been accumulated but will be deferred for use in future years. For example, in taxation year 2005, it is projected that taxpayers will defer $290 million of accumulated education and tuition credits for use in future years. In addition, the tax expenditure for the carry-forward for 2002 and beyond has increased by approximately 50% compared to last year's publication. This reflects the impact of changes introduced in taxation year 2000 (increase in the scholarship exemption) and 2001 (doubling of the education credit) on the stock of carried-forward credits used in 2002 and beyond.

[6] The 2000 budget raised the exemption for scholarship, fellowship and bursary income from $500 to $3,000 for students eligible for the education credit. In addition, for 2000 and later tax years, the tax expenditure reflects the additional funds made available to students under the Canada Millennium Scholarship Foundation.

[7] The tax expenditure equals the tax revenue foregone on the tax-sheltered income earned on registered education savings plan (RESP) assets, minus the revenue from taxing withdrawals of income (as an Educational Assistance Payment or Accumulated Income Payment) from RESPs.

[8] Projections include the impact of the Canada Learning Bond introduced in the 2004 budget.

[9] The tax expenditure reflects the higher value of the stock option deduction, which was increased to 50% in 2000 to reflect the reduced inclusion rate for capital gains. The results for 2000 and, to a lesser extent, 2001 were also affected by market appreciation, especially in the technology sector, as well as increased take-up. Projections for 2003 and subsequent years reflect an assumption of reduced market volatility and reduced take-up due to non-tax considerations.

[10] This measure was proposed in the 2005 budget.

[11] Although the program year is July–June, payments are reported on a calendar year basis. The 2000 budget and the October 2000 *Economic Statement and Budget Update* fully indexed the Canada Child Tax Benefit (CCTB) starting January 2000, increased the per-child benefit amounts and the National Child Benefit (NCB) supplement and CCTB base benefit phase-out thresholds and, effective July 1, 2004, reduced the CCTB base benefit phase-out rates. The 2003 budget increased the NCB supplement, beyond indexation adjustments, by an annual amount of $150 per child in July 2003, $185 in July 2005 and $185 in July 2006. The projections for 2003 to 2006 do not include the projections for the Child Disability Benefit, which are shown separately.

[12] The October 2000 *Economic Statement and Budget Update* increased the amount on which the caregiver and infirm dependant credit are based from $2,368 to $3,500 in 2001. The amount is indexed to inflation for subsequent years.

[13] The spouse or common-law partner credit was previously known as the spousal credit. The eligible dependant credit was previously known as the equivalent-to-spouse credit.

[14] Budget 2005 increased the basic personal amount by $100 in both 2006 and 2007, and made corresponding increases to the amount for a dependent spouse or common-law partner and an eligible dependant.

[15] The decline in this tax expenditure from 2000 to 2001 reflects, in part, reductions to the inclusion rate for capital gains from three-quarters to one-half in 2000.

[16] The projected tax expenditure for 2004 is slightly higher than in other years due to the effects of the outbreak of avian flu in British Columbia. Because this provision is a deferral measure, the deferred income from 2004 will be reported in 2005, resulting in a negative tax expenditure that year.

[17] Estimates are based on Statistics Canada data available up to 2004, which includes cash purchase tickets for wheat, barley, oats, canola, flax and rye. Projections after 2003 are calculated using a historical average growth rate.

[18] The data for the Net Income Stabilization Account (NISA) program are observed up to 2004. Since NISA has been replaced by the Canadian Agricultural Income Stabilization (CAIS) program, tax expenditure projections reflect wind-down provisions that require amounts in NISA accounts be withdrawn by March 31, 2009. Projections also reflect recent data from Statistics Canada, which indicates that withdrawals from the government portion of NISA accounts reached record levels in 2004. It should also be noted that CAIS does not result in a tax expenditure.

Table 1
Personal Income Tax Expenditures *(cont'd)*

[19] Data for unincorporated businesses is not available to estimate this tax expenditure with precision.

[20] The estimates and projections have been revised to reflect recent data and a one-year extension of the temporary measure announced in the 2004 budget. The negative figure for 2006 reflects the inclusion in income for that year of an amount equal to the credit claimed in 2005. A deduction for the full amount of the eligible exploration expenditure is allowed for the year for which the credit is claimed. An amount equal to the credit is required to be included in income the following year, however, so as to reverse the deduction in respect of the portion of the expenditure that was effectively paid for by the credit.

[21] The 2000 budget reduced the capital gains inclusion rate from three-quarters to two-thirds, effective February 28, 2000. The October 2000 *Economic Statement and Budget Update* further reduced the capital gains inclusion rate from two-thirds to one-half, effective October 18, 2000. The estimates for this tax expenditure can vary significantly from year to year, primarily due to unanticipated year-to-year fluctuations in realized capital gains.

[22] No data is available, as it is difficult to estimate the value of unsold assets.

[23] The decline in this tax expenditure for 2001 and subsequent years reflects the reduction in the capital gains inclusion rate from three-quarters to one-half in 2000. The decline from 2000 to 2001 is also the result of a 28% reduction in the number of claimants making use of this measure and a 26% reduction in the average amount of capital gain that they reported for the purpose of this measure.

[24] The tax expenditures for 2002 and 2003 are based on preliminary information on sales of shares of labour-sponsored venture capital corporations (LSVCCs) for those years; the decline in the tax expenditure is the result of reduced sales of LSVCC shares. Projections assume sales remain constant after 2003.

[25] The Child Disability Benefit (CDB) is delivered as a supplement to the Canada Child Tax Benefit. The CDB was introduced in the 2003 budget and came into effect in July 2003. The 2005 budget increased the maximum annual CDB from $1,681 to $2,000 per child beginning in July 2005. It also amended the disability tax credit to ensure that more individuals are eligible, which will consequently increase the number of children eligible for the CDB.

[26] The 2000 budget enhanced the disability tax credit (DTC) by extending eligibility to individuals requiring extensive therapy and by expanding the list of relatives to whom the DTC can be transferred. The 2000 budget also provided a $2,941 supplement amount for children eligible for the DTC effective 2000. The October 2000 *Economic Statement and Budget Update* increased the amount on which the DTC is based from $4,293 to $6,000, and the amount of the supplement for children to $3,500, effective 2001. Both amounts are indexed to inflation for subsequent years. The 2005 budget proposed to extend eligibility for the DTC to individuals who face multiple restrictions that together have a substantial impact on their everyday lives, and to amend the DTC to ensure that more individuals requiring extensive life-sustaining therapy on an ongoing basis are eligible.

[27] The increase in the projected tax expenditure reflects anticipated growth in medical expense claims as well as enhancements to the credit announced in the 2003, 2004 and 2005 budgets.

[28] The increase in the projected tax expenditure reflects anticipated growth in medical expense claims as well as the enhancement introduced in the 2005 budget (increase in the maximum amount of the supplement from $571 to $750 per year, effective 2005).

[29] The Guaranteed Income Supplement (GIS) and Allowance benefits are indexed for inflation by the Consumer Price Index. However, in both its frequency of application and in the months covered, the GIS indexation factor differs from that used for most of the parameters in the personal income tax system. Differences between the indexation factors cause the tax expenditure to grow at a faster or slower rate, in a given year, than if the two elements shared a common indexation factor.

[30] Although this measure does provide tax relief for individuals, it is implemented through the corporate tax system. See under "interest credited to life insurance policies" in Table 2 of this report for an estimate of the value of this tax expenditure.

[31] The decline in this tax expenditure in 2001 reflects reductions in tax rates for low-income individuals in the 2000 budget and the October 2000 E*conomic Statement and Budget Update.*

Table 1
Personal Income Tax Expenditures *(cont'd)*

[32] Beginning in 2006, the Canadian Income Support Benefit will be established for eligible low-income veterans. Estimates and projections are based on data received from Veterans Affairs Canada.

[33] Beginning in 2006, the new Disability Award will replace the veterans' disability pension for eligible new applicants (current disability pensioners will be grandfathered).

[34] Estimates and projections vary from those in last year's report due to changes in tax rates and estimated/projected levels of registered pension plan/registered retirement savings plan (RPP/RRSP) contributions, investment income and withdrawals. In particular, updated data indicate that RPP/RRSP investment income and RPP contributions were higher in certain years than was previously anticipated, resulting in higher tax expenditure estimates and projections. As well, starting in this year's report, the foregone tax on RPP and RRSP investment income is calculated by applying separate tax rates to the estimated amount of interest income, dividend income and capital gains (losses) implied by the overall rate of return on RPP/RRSP investments, taking into account the applicable tax treatment of each component. Year-to-year variations in the net tax expenditure estimates can also be sizeable. For example, total RPP/RRSP assets declined in 2002, which significantly lowers the tax expenditure associated with the tax foregone on RPP/RRSP investment income. Since the observed level of RPP and RRSP assets for 2000–2003 is used to determine the rate of return on investment, the tax expenditure will naturally vary from year to year, depending on the derived rate of return. Tax expenditure estimates will be higher in years where assets grow strongly, reflecting the tax foregone on that investment income, and lower in years where assets grow slowly or decline. For years where RPP and RRSP asset growth is projected, the tax expenditure projections are much more stable since a 6.4% nominal annual rate of return is used for those years. This is consistent with the rate of return used to calculate the present-value tax expenditure estimates and projections for RPPs and RRSPs (for more details on the derivation of the rate of return, see the paper "Present-Value Tax Expenditure Estimates of Tax Assistance for Retirement Savings" in the 2001 *Tax Expenditures and Evaluations* report).

[35] The ratio of 1999 RRSP assets reported in Statistics Canada's Survey of Financial Security (SFS) to 1999 RRSP assets reported in the Statistics Canada publication *Pension Plans in Canada* is used to adjust RRSP assets for 2000–2004 to reflect the more comprehensive SFS estimate, which includes funds in self-administered plans (the ratio is $408 billion/$268 billion or 1.52).

[36] The present-value estimates reflect the lifetime cost of a given year's contributions. This definition is different from that used for the cash-flow estimates and thus the two sets of estimates are not directly comparable. Further information on how these estimates are calculated is contained in the paper "Present-Value Tax Expenditure Estimates of Tax Assistance for Retirement Savings," which was published in the 2001 edition of this report.

[37] The present-value tax expenditure estimates for the 2000–2003 period presented in this year's report are lower than in last year's report due to updated estimates of applicable tax rates and adjustments to the methodology that better reflect the effect of all taxes on non-registered investments. These changes have also affected projections for the 2004-2007 period, but are offset by RPP contributions that are higher than previously anticipated in these years.

[38] The decline in the tax expenditure for the partial inclusion rate for 2001 reflects the reduction in the capital gains inclusion rate in 2000 from three-quarters to one-half. Projected tax expenditures reflect anticipated increases in home resales and resale housing prices. The estimates and projections for this tax expenditure can vary significantly from year to year. This is primarily the result of unanticipated year-to-year fluctuations in the number of residence resales and in the average price of residences.

[39] The 2000 budget increased the deduction limit from $7,000 to $10,000 for children eligible for the disability tax credit.

[40] The 2004 budget replaced the attendant care deduction with a broader disability supports deduction, beginning with the 2004 tax year. The 2005 budget proposed to expand the list of expenses eligible for the disability supports deduction.

[41] Estimates and projections have been updated to reflect market conditions.

[42] This includes employee- and employer-paid premiums by and for self-employed workers.

Table 1
Personal Income Tax Expenditures *(cont'd)*

[43] Prior to 2001, self-employed individuals could claim a non-refundable credit at the lowest marginal rate on the employer share of their Canada/Quebec Pension Plan contributions. For 2001 and subsequent years, self-employed individuals may deduct the employer share of their Canada/Quebec Pension Plan contributions paid for their own coverage. The estimates and projections shown are relative to a benchmark system in which no such deduction (or credit) is provided.

[44] Large increases relative to last year's projections reflect the availability of new data and higher oil and gas prices.

[45] This tax expenditure applies to a subset of resource-related deductions. Data are available for 1999 to 2003 on the volume of reclassified shares and are used to calculate the 2000–2002 estimates and the 2003 projection. Due to volatility, the projections for 2004 to 2007 are based on a three-year historical average.

[46] A number of substantial methodological difficulties call into question the accuracy and utility of estimates and projections of the revenue implications of non-taxation of lottery and gambling winnings. The first methodological difficulty is that the data on payouts/winnings is incomplete. There is solid information on aggregate payouts only for government-run lotteries and bingos. Data on payouts at casinos, video lottery terminals, horseracing, and racetrack slot machines, which constitute a rising share of total spending on gaming, is fragmentary. In addition, no data is available on the payouts/winnings from activities sponsored by charities and other non-government organizations. Second, even if complete information on aggregate payouts were available, the revenue implications of non-taxation still could not be determined with precision. For example, if the benchmark tax system were to include taxation of gambling and lottery winnings, consideration would have to be given to including a deduction for expenses incurred in earning this income, i.e. ticket purchases or wagers/losses. This deduction could be allowed either against all income or against only lottery and gambling winnings. A threshold below which winnings would not be taxable would also be necessary, due to the large administrative cost of taxing very small prizes. In the absence of information on the distribution of prizes and the incomes of winners, the resulting potential tax base is difficult to estimate. Further, it would be impractical to tax some forms of winnings (e.g. slot machines) because of the way in which prizes are paid out.

Also, under federal-provincial agreements negotiated in 1979 and 1985, the federal government, in exchange for an ongoing payment, undertook to refrain from re-entering the field of gaming and betting and to ensure that the rights of the provinces in that field are not reduced or restricted.

[47] Allowances for members of Parliament and senators are no longer tax-exempt, effective January 2001.

Table 2
Corporate Income Tax Expenditures*

	Estimates		Projections[1]					
	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
				($ millions)				
Charities, Gifts and Contributions								
Deductibility of charitable donations[2]	375	410	270	290	320	340	355	355
Deductibility of gifts of cultural property and ecologically sensitive land[3]	13	12	27	9	9	9	9	9
Deductibility of gifts to the Crown	S	S	S	S	S	S	S	S
Non-taxation of registered charities	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Non-taxation of other non-profit organizations (other than registered charities)	165	185	175	160	150	145	165	195
Political contribution tax credit	S	S	S	S	S	S	S	S
Culture								
Canadian film or video production tax credit	180	175	185	195	205	215	225	240
Non-deductibility of advertising expenses in foreign media[4]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Federal-Provincial Financing Arrangements								
Income tax exemption for provincial and municipal corporations	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Transfer of income tax room to provinces[5]	1,160	1,145	1,065	1,210	1,375	1,480	1,540	1,550
Logging tax credit	35	17	23	18	19	20	20	21
General Business and Investment								
Accelerated write-off of capital assets and resource-related expenditures	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deferral through capital gains rollovers[6]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Taxation of capital gains upon realization[7]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Partial inclusion of capital gains[8]	2,340	4,095	1,990	2,010	2,045	2,125	2,240	2,345
Expensing of advertising costs[9]	57	63	40	40	40	40	40	40

* **The elimination of a tax expenditure would not necessarily yield the full tax revenues shown in the table. See the publication *Tax Expenditures: Notes to the Estimates/Projections*, published in 2004 and available on the Department of Finance Canada website (www.fin.gc.ca), for a discussion of the reasons for this.**

Table 2
Corporate Income Tax Expenditures *(cont'd)*

	Estimates		Projections[1]					
	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
				($ millions)				
Atlantic investment tax credit[10]								
Earned and claimed in current year	82	105	89	100	105	110	115	120
Earned in current year but carried back to prior years	15	18	7	13	13	14	14	14
Claimed in current year but earned in prior years	170	220	220	200	205	210	210	215
Total expenditure	267	343	316	313	323	334	339	349
Scientific research and experimental development investment tax credit[10]								
Earned and claimed in current year	1,490	1,745	1,785	1,830	1,870	1,915	1,965	2,010
Earned in current year but carried back to prior years	71	86	88	90	92	94	95	100
Claimed in current year but earned in prior years	545	490	505	515	525	540	550	565
Total expenditure	2,106	2,321	2,378	2,435	2,487	2,549	2,610	2,675
Write-off of capital assets before available for use	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Small Business								
Deduction of allowable business investment losses[11]	34	28	26	25	23	23	24	26
Interest on small business financing loans[12]	S	–	–	–	–	–	–	–
Low tax rate for small businesses[13]	3,225	3,185	3,220	3,040	3,010	3,040	3,185	3,210
Accelerated rate reduction for small businesses[14]	–	50	65	35	5	–	–	–
Non-taxation of provincial assistance for venture investments in small business	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
International								
Exemption from Canadian income tax of income earned by non-residents from the operation of a ship or aircraft in international traffic	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Exemption from tax for international banking centres	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Exemptions from non-resident withholding tax[15]								
Dividends	205	275	275	255	265	395	450	470
Interest								
On deposits	495	375	170	105	105	110	115	120
On long-term corporate debt	130	195	130	165	165	175	180	190
Other[16]	380	220	340	435	330	355	365	385

Table 2
Corporate Income Tax Expenditures *(cont'd)*

	Estimates		Projections[1]					
	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
				($ millions)				
Rents and royalties								
Copyright royalties	23	22	24	30	28	30	32	34
Royalties for the use of, or right to use, other property	20	87	83	79	84	89	94	99
Research and development royalties	3	3	4	3	3	3	4	4
Natural resource royalties	S	S	S	S	S	S	S	S
Rents from real property	S	S	S	S	S	S	S	S
Management fees	48	42	44	49	50	53	56	58
Estate or trust income	33	11	21	6	14	14	15	16
Non-taxation of life insurance companies' world income	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Tax exemption on income of foreign affiliates of Canadian corporations	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Sectoral Measures								
Farming								
Cash-basis accounting	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deferral of income from destruction of livestock	S	S	S	S	5	3	S	S
Deferral of income from grain sold through cash purchase tickets[17]	S	-15	15	S	S	S	S	S
Flexibility in inventory accounting	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Agricultural cooperatives[18]	–	–	–	–	–	–	30	30
Resource								
Corporate mineral exploration tax credit[19]	–	–	–	26	32	58	55	64
Deductibility of contributions to a qualifying environmental trust	S	S	S	S	S	S	S	S
Earned depletion[20]	40	43	21	34	37	39	35	32
Net impact of the resource allowance and the non-deductibility of Crown royalties and mining taxes[21]	415	295	435	595	615	640	300	–
Tax rate on resource income[22]	–	-60	-215	-395	-575	-515	-255	–
Transitional arrangement for the Alberta Royalty Tax Credit	–	–	–	S	S	S	S	S
Other Sectors								
Exemption from branch tax for transportation, communications, and iron ore mining corporations	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Film or video production services tax credit[23]	62	80	75	120	125	130	135	145
Low tax rate for credit unions[24]	53	75	79	69	65	70	72	73

Table 2
Corporate Income Tax Expenditures *(cont'd)*

	Estimates		Projections[1]					
	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
				($ millions)				
Manufacturing and processing allowance[25]	2,045	1,380	1,060	640	115	–	–	–
Surtax on the profits of tobacco manufacturers[26]	-40	-80	-75	-75	-75	-75	-75	-75
Temporary tax on the capital of large deposit-taking institutions[27]	-49	–	–	–	–	–	–	–
Other Measures								
Deductibility of countervailing and anti-dumping duties	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deductibility of earthquake reserves	6	7	5	5	5	5	6	6
Deferral through use of billed-basis accounting by professional corporations	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Holdback on progress payments to contractors[28]	30	25	40	40	40	40	40	40
Interest credited to life insurance policies[29]	90	66	68	76	78	81	83	86
Non-taxation of certain federal Crown corporations	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Memorandum Items								
Mechanisms for the Integration of Personal and Corporate Income Tax								
Investment corporation deduction[30]	S	S	S	S	S	5	6	7
Refundable capital gains for investment corporations and mutual fund corporations[31]	690	520	35	60	305	320	335	350
Refundable taxes on investment income of private corporations[32]								
Additional Part I taxes[33]	-615	-655	-690	-925	-1,200	-1,455	-1,620	-1,715
Part IV tax	-1,735	-2,110	-1,990	-2,225	-2,425	-2,555	-2,715	-2,845
Dividend refund	3,245	4,150	3,900	3,745	4,095	4,330	4,610	4,855
Net expenditure	895	1,385	1,220	595	470	320	275	295
Expenses Incurred to Earn Income								
Deduction for intangible assets	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deductibility of provincial royalties (joint venture payments) for the Syncrude project (remission order)[34]	n.a.	n.a.	n.a.	n.a.	n.a.	–	–	–
Loss Offset Provisions								
Capital loss carry-overs								
Net capital losses carried back[35]	190	420	730	180	125	85	85	85
Net capital losses applied to current year	475	445	230	205	205	215	225	235
Farm and fishing loss carry-overs	18	18	19	19	19	19	20	21

Table 2
Corporate Income Tax Expenditures *(cont'd)*

	Estimates		Projections[1]					
	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
				($ millions)				
Non-capital loss carry-overs								
Non-capital losses carried back	1,760	2,840	1,390	1,500	1,390	1,440	1,535	1,670
Non-capital losses applied to current year	4,790	3,480	3,625	3,670	3,875	3,765	3,790	3,790
Other								
Aviation fuel excise tax rebate[36]	n.a.	–	–	–	–	–	–	–
Non-resident-owned investment corporation (NRO) refund[37]	280	280	415	125	–	–	–	–
Partial deduction of meals and entertainment expenses[38]	355	340	345	340	340	355	375	390
Patronage dividend deduction[39]	190	240	390	365	385	410	425	430

Notes:

[1] Unless otherwise indicated in the footnotes, changes in the projections from those in last year's edition of this document as well as variations from year to year result from changes in the explanatory economic variables upon which the projections are based. These changes and variations also reflect the availability of new data. Projections for 2002 and subsequent years reflect the impact of the reduction in the general corporate income tax rate to 25% on January 1, 2002, 23% on January 1, 2003 and 21% on January 1, 2004. The corporate surtax raised these rates by 1.12 percentage points.

[2] Donations in 2000 and 2001 were significantly higher than the historical average. Donations in the projection period are expected to return to their historical average.

[3] Gifts in 2002 were significantly higher than the historical average. Gifts in 2003 and subsequent years are expected to return to their historical average.

[4] This treatment should result in a negative tax expenditure since the deduction of an expense incurred to earn income is denied. Under the benchmark tax system, advertising expenses in foreign media incurred to gain or produce income from a business or property would be deductible whether targeted at foreign or domestic markets.

[5] The drop in 2002 is explained by a significant reduction in corporate taxable income in that year.

[6] This is a tax expenditure because under the benchmark system capital gains would be taxed on an accrual basis.

[7] The tax deferral associated with taxation of capital gains upon disposition of property, rather than on an accrual basis, represents a deviation from the benchmark tax system and is therefore a tax expenditure.

[8] The 2000 budget reduced the capital gains inclusion rate from three-quarters to two-thirds, effective February 28, 2000. The October 2000 *Economic Statement and Budget Update* further reduced the capital gains inclusion rate from two-thirds to one-half, effective October 18, 2000. The increase in this tax expenditure for 2001 reflects increased capital gains and the reduction in the capital gains inclusion rate, partially offset by a lower corporate income tax rate. The decline in 2002 reflects a projected decrease in capital gains as well as the reduction in the corporate income tax rate.

Table 2
Corporate Income Tax Expenditures *(cont'd)*

[9] The amount of this tax expenditure can fluctuate significantly from year to year depending primarily upon advertising expenses claimed. Therefore, it is projected at its historical average.

[10] In previous years, data limitations prevented the split between the scientific research and experimental development and Atlantic investment tax credit of investment tax credits earned in the current year but carried back to prior years and those claimed in the current year but earned in prior years.

[11] The amount of this tax expenditure can fluctuate from year to year depending upon the amount of current year losses and the availability of income against which to apply these losses.

[12] This measure was effective between February 25, 1992, and the end of 1994. The five-year maximum term for small business financing loans means, however, that the measure continued to create a tax expenditure up to 1999. Further, many firms reporting income in the 2000 taxation year earned a portion of that income in the 1999 calendar year, before the tax expenditure was eliminated.

[13] The reduction in the tax expenditure from 2002 to 2004 results from reductions in the benchmark rate. Projections for 2003 and subsequent years reflect the impact of the 2003 budget's increase in the amount of income eligible for the small business deduction, and the 2004 budget's acceleration of this increase.

[14] This measure was announced in the 2000 budget and became effective January 1, 2001. On that date the general federal corporate income tax rate on income between $200,000 and $300,000 earned by a Canadian-controlled private corporation from an active business carried on in Canada was reduced to 21%. The lower rate on the general income of small businesses and the change in the general federal corporate income tax rate effective January 1, 2001, only partially affect the estimate for tax year 2001 since many firms reporting income in the 2001 tax year earned a portion of that income in the 2000 calendar year, before the rate reductions were introduced. Subsequent declines in the tax expenditure are a result of the reduction in the general corporate income tax rate and the increase, announced in the 2003 budget, in the amount of income eligible for the small business deduction. This measure was effectively eliminated on January 1, 2004, when the general corporate income tax rate was reduced to 21%. Some tax expenditure occurs in 2004, however, as many firms reporting income in the 2004 tax year earned a portion of that income in the 2003 calendar year. The changes in the estimates for this year relative to last year are due to the availability of new data.

[15] Estimates and projections were computed on the basis of an analysis of payments to non-residents and withholding tax collections available for 2000 to 2003. The variations in 2001, 2002 and 2003 reflect changes in the payments and exemptions as observed from newly available data.

[16] This category includes interest paid to non-resident persons or organizations that would be exempt from income tax in Canada were they residents in Canada. Also included is interest paid under certain securities-lending arrangements exempt under subparagraph 212(1)(b)(xii) of the Income Tax Act, and interest exempt under certain other domestic and treaty provisions.

[17] Projections are calculated using a historical average growth rate. Since tax expenditures are estimated on a cash-flow basis, an increase in the balance of uncashed grain tickets represents additional income that is being deferred and results in a positive tax expenditure. A decrease in the balance of uncashed grain tickets indicates that less income is being deferred and results in a negative tax expenditure. The tax expenditure estimates and projections are volatile over time since a small number of corporations are affected in a very specific sector. Estimates and projections are based on data obtained from Statistics Canada.

[18] This measure will apply only to patronage dividends paid after 2005. See the "What's New in the 2005 Report" section at the beginning of this document for further details.

[19] This tax credit was introduced in the 2003 budget and applies to 2003 and subsequent tax years. It was phased in starting at 5% in 2003, 7% in 2004 and 10% in subsequent years.

[20] Additions to earned depletion pools were eliminated as of January 1, 1990. Determination of the tax expenditure reflects the projected use of existing earned depletion pools.

Table 2
Corporate Income Tax Expenditures *(cont'd)*

[21] The tax expenditure is calculated as the revenue cost of the resource allowance net of non-deductible Crown royalties and provincial mining taxes. Over a five-year period beginning in 2003, the resource allowance is being phased out and a deduction for Crown royalties and mining taxes phased in so that, by 2007, the tax expenditure is effectively reduced to zero. See the technical paper "Improving the Income Taxation of the Resource Sector in Canada," Department of Finance Canada, March 2003, for further details. The large increases relative to last year reflect the availability of new data and higher oil and gas prices.

[22] Budget 2003 announced an extension to resource income of the lower general corporate tax rate, to be phased in over five years beginning in 2003. By 2007, when the resource rate equals the general rate, the tax expenditure amount will be reduced to zero. See the technical paper "Improving the Income Taxation of the Resource Sector in Canada," Department of Finance Canada, March 2003. The increases relative to last year reflect the availability of new data and higher oil and gas prices.

[23] Projections for 2003 and subsequent years reflect the impact of the 2003 budget increase in the rate of the credit from 11% to 16%.

[24] The tax expenditure is higher in 2001 and 2002 due to higher taxable income of credit unions. After 2002, projections are lower due to reductions in the general corporate income tax rate.

[25] Although this tax expenditure was eliminated on January 1, 2004, when the general corporate income tax rate was reduced to 21%, many firms reporting income in the 2004 taxation year earned a portion of that income in the 2003 calendar year.

[26] The increase in this tax expenditure from 2000 to 2002 partly results from the increase in the tobacco manufacturers' surtax from 40% to 50% of the Part I tax on profits from tobacco manufacturing, effective April 6, 2001.

[27] This measure expired on October 31, 2000.

[28] The amount of this tax expenditure can fluctuate significantly from year to year depending primarily upon the level of construction activity. Therefore, it is projected at its historical average.

[29] The tax expenditure is lower in 2001 and 2002 because of personal income tax reductions. The increase in subsequent years is due to higher investment income.

[30] This measure allows a public corporation that qualifies as an investment corporation to benefit from elements of the integration system, which are usually available only to private corporations.

[31] The substantially lower levels in 2002 and 2003 are due to a decline in capital gains distributions.

[32] Refundable tax provisions of the corporate income tax system provide some integration of the corporate and personal income tax regimes. For more information about these measures, please refer to the document *Tax Expenditures: Notes to the Estimates/Projections* (2004) available on the Department of Finance Canada website at www.fin.gc.ca.

[33] This item includes the additional 6⅔% refundable tax on investment income as well as, for years after 2000, the Part I tax paid on investment income in excess of the benchmark rate. The increase after 2001 results from the increase in the difference between the Part I tax on investment income and the benchmark rate.

[34] The cost of the Syncrude Remission Order ("Order Respecting the Remission of Income Tax for the Syncrude Project" P.C. 1976-1026, May 6, 1976 [C.R.C. 1978 Vol. VII, c. 794]) is published annually in the Public Accounts of Canada (ISBN 0-660-177792-7). The order expired on December 31, 2003.

[35] The increases in 2001 and 2002 reflect, for the most part, the capital losses recorded in these two years resulting from declines in the market value of technology stocks.

Table 2
Corporate Income Tax Expenditures *(cont'd)*

[36] This measure, which was effective for calendar years 1997 to 2000, provided an excise tax rebate on the aviation fuel used by airline companies. The rebate was limited to $20 million per year per associated group of companies. In order to receive a rebate, a company had to agree to reduce its income tax losses by $10 for every $1 of rebate.

[37] Figures for 2000 to 2003 are estimates. This measure was repealed in 2000. To allow for an orderly restructuring of their operations, however, existing NROs were entitled to retain their status until the end of their last tax year that began before 2003. The sharp decline in 2003 relative to last year's estimate reflects much lower than projected total refunds.

[38] Fifty per cent of these expenses are deductible for income tax purposes, given that a portion of meal and entertainment expenses is incurred to earn income and is therefore a legitimate business expense, while the remaining portion reflects personal consumption. The estimates and projections provided reflect the additional tax revenue that would be received if no deduction were allowed.

[39] Patronage dividends are somewhat discretionary and vary from year to year. The projections are higher after 2001 due to larger patronage dividend distributions.

Table 3
GST Tax Expenditures*

	Estimates				Projections			
	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
	($ millions)							
Aboriginal Self-Government								
Refunds for Aboriginal self-government[1,2]	S	S	S	S	S	S	S	S
Business								
Exemption[3] for domestic financial services	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Exemption for ferry, road and bridge tolls[4]	S	S	S	S	S	S	S	S
Exemption and rebate for legal aid services	20	25	25	25	30	30	30	30
Non-taxability of certain importations[5]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Rebates for foreign visitors[6]	80	85	85	65	75	75	80	85
Small suppliers' threshold	145	160	170	175	190	200	205	215
Zero-rating[7] of agriculture and fish products and purchases	S	S	S	S	S	S	S	S
Zero-rating of certain purchases made by exporters	S	S	S	S	S	S	S	S
Charities and Non-Profit Organizations								
Exemption for certain supplies made by non-profit organizations	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Rebates for registered charities[1]	215	240	250	265	280	295	310	325
Rebates for non-profit organizations[1]	55	60	60	65	70	70	75	80
Education								
Exemption for education services (tuition)[4]	360	375	400	435	460	485	515	545
Rebates for book purchases made by qualifying public institutions	40	40	40	40	45	50	60	75
Rebates for colleges[1]	65	80	85	85	90	95	100	105
Rebates for schools[1]	350	375	380	380	395	415	440	460
Rebates for universities[1]	150	180	205	240	255	265	280	295

* **The elimination of a tax expenditure would not necessarily yield the full tax revenues shown in the table. See the publication *Tax Expenditures: Notes to the Estimates/Projections*, published in 2004 and available on the Department of Finance Canada website (www.fin.gc.ca), for a discussion of the reasons for this.**

Table 3
GST Tax Expenditures *(cont'd)*

	Estimates				Projections			
	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
				($ millions)				
Health Care								
Exemption for health care services[4]	530	535	570	630	655	695	745	805
Rebates for hospitals[1]	340	390	395	425	445	505	540	565
Zero-rating of medical devices[4]	125	140	150	160	170	175	190	200
Zero-rating of prescription drugs[4]	460	500	545	585	615	645	685	730
Households								
Exemption for child care and personal services[4]	135	135	135	135	140	150	160	170
GST/HST credit[8]	2,965	3,005	3,070	3,180	3,310	3,420	3,495	3,565
Zero-rating of basic groceries[4]	3,230	3,415	3,565	3,700	3,880	4,090	4,335	4,605
Housing								
Exemption for sales of used residential housing and other personal-use real property	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Exemption for residential rent (long-term)[4]	1,295	1,280	1,320	1,375	1,430	1,510	1,625	1,755
Rebates for new housing[9]	590	640	790	845	970	1,015	945	920
Rebates for new residential rental property[10]	25	40	45	50	55	60	55	55
Municipalities								
Exemption for municipal transit[4]	90	95	105	105	110	115	120	130
Exemption for water and basic garbage collection services[4]	145	150	160	165	175	180	195	205
Rebates for municipalities[1,11]	645	700	725	805	1,475	1,540	1,635	1,710
Memorandum Items								
Recognition of Expenses Incurred to Earn Income								
Rebates to employees and partners[12]	105	105	110	110	110	110	110	115
Other								
Exemption for quick method accounting	190	200	205	220	230	245	255	265
Partial input tax credits for meals and entertainment expenses[13]	115	120	125	130	140	145	150	160

Table 3
GST Tax Expenditures *(cont'd)*

Notes:

[1] The public sector body rebates are based on Canada Revenue Agency administrative data for the years up to and including 2003. The projected values for 2004 onwards are based on the Sales Tax Model of the Department of Finance Canada.

[2] These refunds are paid to Aboriginal governments that have an agreement providing for a GST/HST refund for goods and services acquired for self-government activities.

[3] Final consumers and businesses pay no tax on exempt goods and services. Vendors, however, are not entitled to claim input tax credits to recover the GST/HST paid on inputs to these products.

[4] The Sales Tax Model used to generate these estimates is based on the 2001 national input-output tables from Statistics Canada and the latest release of the National Income and Expenditure Accounts.

[5] Certain importations are tax-free including, for example, duty-free personal importations by Canadian travellers.

[6] The methodology for estimating this tax expenditure was derived as part of the review of the Visitors' Rebate Program conducted during 1997 and has been updated to reflect more recent information. The reduction in rebates for foreign visitors, beginning in 2003, reflects a reduction in the number of foreign visitors to Canada.

[7] Final consumers and businesses pay no tax on zero-rated goods and services. Vendors of zero-rated products are entitled to claim input tax credits to recover the GST/HST paid on inputs to these products.

[8] Based on personal income tax data.

[9] Estimates for the housing rebate are based on information provided by Statistics Canada.

[10] The new residential rental property rebate was introduced in the 2000 budget for new construction or substantial renovations commencing after February 27, 2000.

[11] The rebate rate for municipalities increased from 57.14% to 100% effective February 1, 2004.

[12] This item includes the apprentice vehicle mechanics' tools deduction.

[13] Based on tax expenditure estimates and projections reported for the personal and corporate income tax systems.

PART 2
EVALUATION REPORT

MARGINAL EFFECTIVE TAX RATES ON BUSINESS INVESTMENT: METHODOLOGY AND ESTIMATES FOR CANADIAN AND US JURISDICTIONS

INTRODUCTION

The decision to invest is highly sensitive to the rate of return generated by the asset. Taxes imposed on businesses affect the rate of return and hence the amount of investment undertaken. While the statutory corporate income tax rate is a key indicator of how the tax system is affecting investment, it does not paint a complete picture. The effective tax rate on investment can be different because of deductions and credits available through the corporate income tax system as well as other taxes paid by corporations, such as capital taxes.

These considerations have led to the development of what are known as marginal effective tax rates (METRs) in order to provide a comprehensive indicator of the impact of the corporate tax system on the decision to invest. METRs can also give a perspective on how the tax system is affecting the allocation of investment by type of asset and by industry. Finally, a comparison of METRs in various jurisdictions provides an indicator of how taxes are affecting the distribution of investment within Canada and of the international competitiveness of the Canadian tax system.

Since 2000, the federal government has substantially reduced taxes on business investment while improving the tax structure. The motivation for these tax reductions has been to increase investment and productivity and ultimately raise incomes and living standards of Canadians.

In a globalized economy, the impact of tax reductions on internationally mobile capital is a key determinant of their effectiveness. Implemented and planned tax reductions would result in a combined federal-provincial-territorial statutory tax rate that is considerably lower than its US equivalent by 2010. But when all elements of the tax system are taken into consideration, the Canadian advantage narrows significantly. In addition, the overall advantage hides large differences across jurisdictions in both countries, making it more difficult to assess the overall impact of the corporate tax system on competitiveness.

Recent federal tax policy initiatives have improved the tax structure by:

- Eliminating the federal capital tax, which is a particularly harmful way to raise tax revenue.
- Applying the same rate of corporate income tax to all sectors.
- Aligning capital cost allowances with useful lives for selected assets.

The analysis undertaken in this study indicates, however, that variations remain in the tax burden on new investment across jurisdictions, assets and industries. These variations can distort investment choices, which harms economic performance.

MARGINAL EFFECTIVE TAX RATES—METHODOLOGY

A marginal effective tax rate is a forward-looking indicator of the tax burden on new investment. It includes not only the statutory tax rate but also deductions and credits associated with purchasing capital goods (e.g. interest expense and capital cost allowance) and other taxes paid by corporations, such as capital taxes. A METR measures the extra return on an investment required to pay corporate-level taxes, expressed as a percentage of the total return on the investment.[1]

Tax Parameters

The METRs presented in this study capture the following elements of the tax system:

- Statutory income tax rates.
- Interest deductibility.
- Capital cost allowances.
- Inventory accounting methods.
- Research and development (R&D) tax incentives.
- Investment tax credits.
- Capital taxes.
- Retail sales taxes on capital goods.

The METRs exclude property taxes and other business taxes imposed by municipal governments.[2] The main reason for their exclusion is that part of local taxes represents a fee for services received, but data limitations preclude determination of the fee-for-service element.

Most of the items listed above are well-known elements of the tax system, but some background information on capital cost allowances, inventory accounting and retail sales taxes is helpful in understanding their impact on METRs.

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[1] A detailed description of the METR methodology is available in Patry, A. and D. Lemay, "Marginal Effective Tax Rates for Canadian and US Jurisdictions: Methodology and Estimates," Department of Finance Canada Working Paper, forthcoming. The pioneering work on Canadian METRs is presented in: Boadway, R., N. Bruce, and J. Mintz (1984), "Taxation, Inflation, and the Effective Marginal Tax Rate on Capital in Canada," *Canadian Journal of Economics*, vol. 17, p. 262-79. The methodology and estimates are also discussed in McKenzie, K., M. Mansour, and A. Brûlé (1998), "The Calculation of Marginal Effective Tax Rates," Working Paper 97-15, prepared for the Technical Committee on Business Taxation, Department of Finance Canada; Jung, J., "The Calculation of Marginal Effective Corporate Tax Rates in the 1987 White Paper on Tax Reform," Working Paper 89-6, Department of Finance Canada.

[2] In contrast to Canada, municipalities in some US states impose sales taxes or corporate income taxes as well as broad-based property taxes. This is an issue in at least nine states, including California, New York and Pennsylvania. The amount of revenue raised appears, however, to be small relative to total corporate taxes imposed by the federal and state governments.

Capital cost allowance (CCA) is a deduction for tax purposes that recognizes the annual expense resulting from the depreciation of a capital asset over its useful life. CCA rates will therefore have an impact on the METR only to the extent that they do not accurately reflect the useful lives of assets. In the METR model, the useful lives of assets are approximated by economic depreciation rates developed by Statistics Canada.

The choice of *inventory accounting methods* can influence tax liabilities. There is usually a lag between when goods are produced and when they are sold. Under first-in, first-out (FIFO) accounting, the cost of goods sold is determined by the cost of the oldest inventory item, i.e. the first in. As a result, in an inflationary environment, company profits and taxable income are higher than if the cost of goods sold were determined by current production costs, which would be well approximated by the last item placed in inventory, as it is in the last-in, first-out (LIFO) inventory accounting convention. This difference in taxable income results in a higher METR under FIFO accounting than under LIFO. Firms are permitted to use LIFO accounting for tax purposes in the US but not in Canada.

Retail sales taxes are imposed not only on consumer spending but also on intermediate materials and capital goods used by businesses. Most retail sales tax structures provide some exemptions for capital goods, particularly for machinery and equipment. Nevertheless, the effective retail sales tax rate on capital inputs was about half of the nominal rate in both Canada and the US in 2000. As a result, retail sales taxes have a substantial impact on the METR on capital. In contrast, under value-added taxes (such as the goods and services tax/harmonized sales tax and the Quebec sales tax) the effective tax rate on capital goods is virtually zero.[3]

The federal, provincial and territorial tax parameters used in the model are presented in Annex A and their US counterparts are presented in Annex B.

Economic Assumptions and Caveats

Calculation of METRs also requires making assumptions about the financial cost of capital and a number of other economic variables. The financial cost of capital is a weighted average of the return on debt and equity paid by firms. The weights are determined by the economy-wide debt-equity ratio of approximately two-thirds. The returns on debt and equity are measured in real terms (i.e. observed returns are reduced by the inflation rate, assumed to be 2%) and adjusted for risk. The adjustment for risk recognizes that suppliers of capital require a premium for investing in riskier assets, but in the long run expect to obtain the same real, risk-adjusted rate of return on all

[3] The only exceptions to the zero-tax status of capital goods are road vehicles less than 3,000 kg. used by business in Quebec.

investments.[4] Note that these economic assumptions are used to develop estimates for both Canada and the US in order to restrict Canada-US comparisons to differences in the tax systems in the two countries. That is, the comparisons examine the impact of applying the Canadian and US corporate tax systems to the same investment in Canada.

While METRs are the most comprehensive measure of the impact of corporate taxes on the rate of return and hence the decision to invest, they do have two important limitations.

- *METRs are calculated on the assumption that a taxable firm makes an investment that is small relative to its ongoing operations*. As a result, the firm can always apply the deductions and credits earned on a new investment against taxable income earned on earlier investments. Start-ups and firms suffering periodic losses face a higher effective tax rate over the life of the investment to the extent that they cannot make immediate use of deductions and credits.
- *The investment is assumed to earn just enough to pay suppliers of financial capital the minimum rate of return*. It is assumed that a firm will only undertake investments that are expected to generate at least enough income (net of wages and other direct production costs and depreciation) to pay for the financial cost of capital and taxes. Projects that are expected to exceed this hurdle rate will be undertaken first, and the expected return on the last, or marginal, project carried out will be exactly equal to the financial cost of capital plus a provision for taxes. Firms investing with the expectation of earning more than the minimum rate of return would be particularly concerned about the statutory rate, since all income above the minimum return is taxed at the statutory rate.

The METRs presented in this study exclude mining and the extraction of oil and natural gas as well as financial institutions.[5] In addition, the aggregate estimates exclude the impact of R&D tax incentives since a relatively small number of firms receive most of the benefits. R&D incentives are discussed in the context of their impact on METRs in industries that invest intensively in R&D. Finally, the estimates apply to large firms only.

[4] The risk-free rate of return on debt is assumed to be 6%, which is the average return on Government of Canada 10-year bonds over the 10-year period ending in 2004. The risk-free return on equity is not observed in the marketplace. It can however, be estimated by imposing the long-run condition that the return on debt and equity, net of personal taxes, be equal and then calculating the implicit gross-of-tax return on equity. Average personal tax rates of 24.9% on bonds and 16.2% on equity (dividends plus the effective rate on capital gains), along with 6% return on debt, imply a gross-of-tax risk-adjusted return on equity of 5.4%. Given a 60% share for equity financing, the weighted average return to suppliers of financial capital is 5.6% in nominal terms and 3.6% in real terms.

[5] Modelling natural resource industries and financial institutions raises a number of unique issues that are still under review. The estimates will be made public when this review is complete.

Measuring the Competitiveness of a Tax System

The statutory tax rate on corporate income is often used as an indicator of how the tax system is contributing to retaining and attracting internationally mobile capital. It is readily available for international comparisons, highly visible and easily understood. In addition, comparisons of statutory rates provide a key measure of the incentive for multinational enterprises to shift taxable income across international boundaries.

The marginal effective tax rate combines in a single measure the key elements of the overall corporate tax structure, including the statutory tax rate that applies on corporate income, factors that affect the tax base such as capital cost allowances, and profit-insensitive taxes such as capital and sales taxes. As a result, it is a more comprehensive indicator of tax competitiveness than the statutory rate.

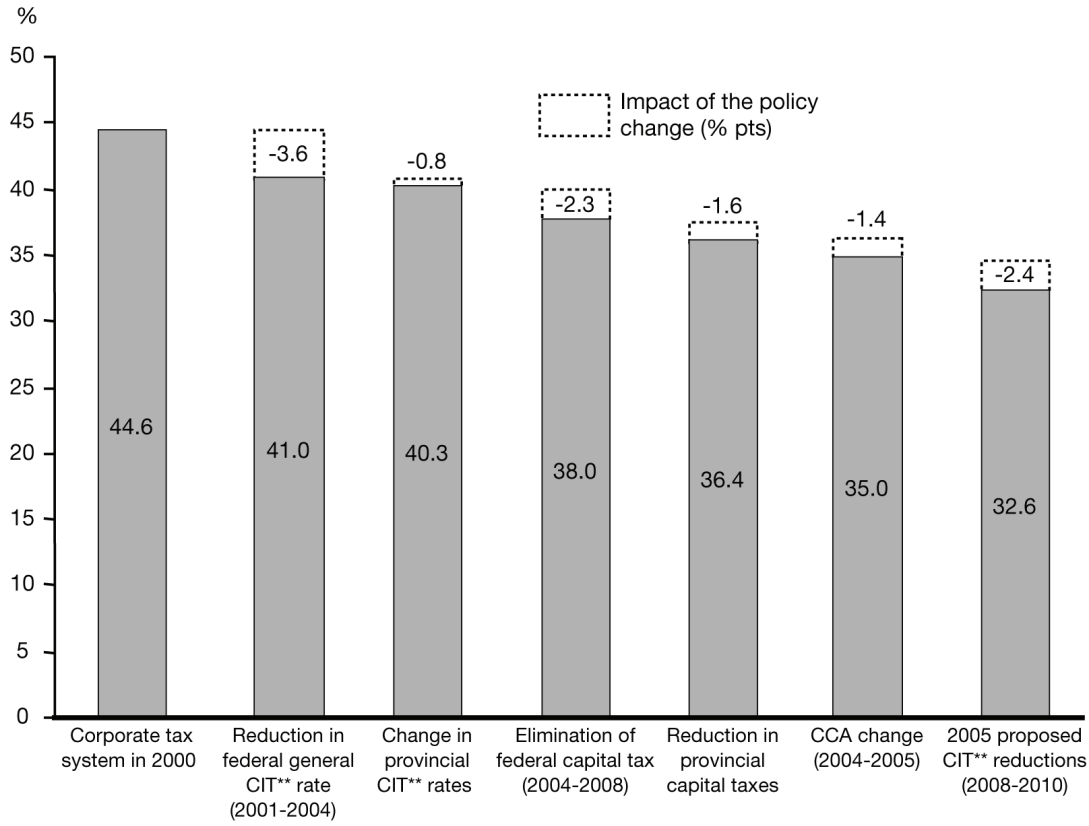
There are, however, circumstances in which the statutory rate is a more relevant indicator of competitiveness. A key assumption underlying the METR calculations is that the investment has an expected rate of return, adjusted for risk and inflation, equal to the minimum return required by the suppliers of financial capital. While this appears to be a reasonable assumption for firms already active in the Canadian market, it has been argued that foreign direct investment generates rates of return that are above the minimum required rate. As noted in the text, firms investing with the expectation of earning substantially more than the minimum return would be particularly sensitive to differences in statutory rates.

These considerations suggest that it is important to consider both the statutory rate and the marginal effective tax rate when assessing the competitiveness of a tax system.

EVOLUTION OF THE NATIONAL METR IN CANADA

In 2000, the combined federal-provincial-territorial effective tax rate on a typical marginal investment by a large firm was estimated to be approximately 45% (Chart 1). Policy decisions since 2000, together with those proposed in the 2005 federal budget, would have the effect of reducing the METR at the end of the federal government's five-year planning horizon in 2010 by about a quarter, to just under 33%. Federal initiatives would reduce the METR by 9.7 percentage points, which amounts to 80% of the total decline from 2000 to 2010. The statutory tax rate reductions proposed in Budget 2005 would contribute 2.4 percentage points to the decline in the METR.

Chart 1
Impact of Recent Corporate Tax Reductions on the Canadian METR*



* Excluding resource industries, financial institutions and R&D assets.
** Corporate income tax.

Since 2000, the federal government has:

- Reduced the general corporate income tax rate from 28% to 21% and applied the general rate to all sources of income earned by large firms (phased in by 2007 for resource income).
- Legislated the elimination of the capital tax, which will be phased out by 2008.
- Aligned CCA rates with useful lives for a number of assets, in particular computers as well as broadband, Internet and other data network infrastructure equipment.

In Budget 2005, the federal government proposed a reduction in the general corporate income tax rate of a further 2 percentage points to 19% in 2010 and the elimination of the 4% corporate income surtax (equivalent to a 1.12-percentage-point reduction in the general rate) in 2008.

Key tax reduction initiatives at the provincial level have been:[6]

- A 50% reduction in Ontario's capital tax by 2010 and elimination by 2012.
- A 50% reduction in Quebec's capital tax, financed by a 3-percentage-point increase in the statutory corporate income tax rate.
- The elimination of British Columbia's capital tax.
- Reductions in statutory corporate income tax rates in Alberta and New Brunswick (4 percentage points) and in British Columbia and Manitoba (3 percentage points).

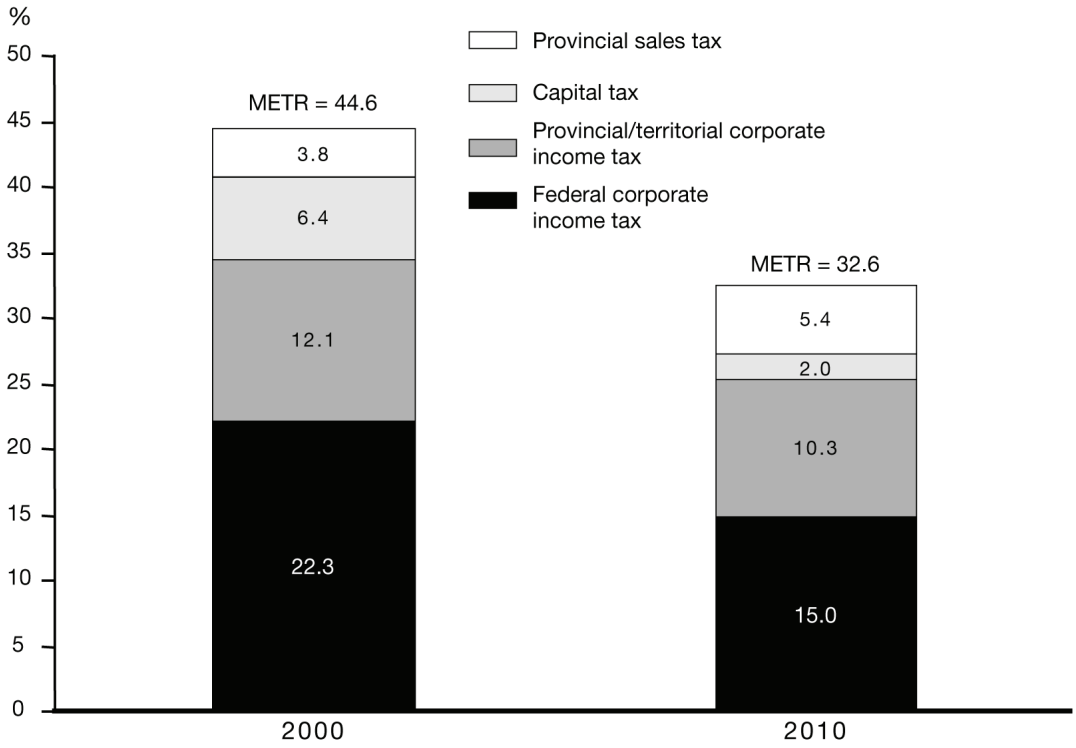
As a result of these initiatives, the structure of taxation in Canada will improve substantially by 2010. Capital taxes, which are a particularly damaging way to raise revenues,[7] will add 2 percentage points to the national METR in 2010, down from 6.4 percentage points in 2000 (Chart 2).[8] Note also that the federal corporate income tax METR will decline by a third from 2000 to 2010.

[6] Mesures proposed after September 15, 2005, are not included.

[7] See "Taxation and Economic Efficiency: Results From a General Equilibrium Model," *Tax Expenditures and Evaluations*, 2004, Department of Finance Canada.

[8] Since no substantial changes to provincial retail sales taxes on capital goods are expected over the 2000-2010 period, they become a larger share of the total tax burden.

Chart 2
Decomposition of Canadian METR in 2000 and 2010*



* Excluding resource industries, financial institutions and R&D assets.

CANADA-US COMPARISON

The statutory rate reductions implemented since 2000, coupled with the proposed reductions announced in Budget 2005, would give Canada a 6.2-percentage-point advantage over the US by 2010 (Table 1). METR calculations show that Canada's advantage is reduced to about 2 percentage points when the effect of other elements of the tax system on business investment is factored in[9] (Chart 3). Canada's statutory rate advantage is eroded by other elements of the corporate tax system, notably provincial/state capital taxes, investment tax credits and inventory accounting practices. Note also that the Canadian statutory tax rate advantage is reduced by interest deductibility, since deductibility is worth more in the US given the higher statutory tax rate.

Table 1
Statutory Tax Rates on Corporate Income—Canada and the US Combined Federal/Provincial/Territorial-State

	Canada	US	Difference (Canada-US)
	(%)		(% pts)
2000			
General income	43.4	39.4	4.1
Manufacturing	34.7	39.4	-4.7
Combined	39.5	39.4	0.1
2010			
General income	32.2	39.4	-7.1
Manufacturing	31.2	36.5	-5.3
Combined	31.9	38.0	-6.2

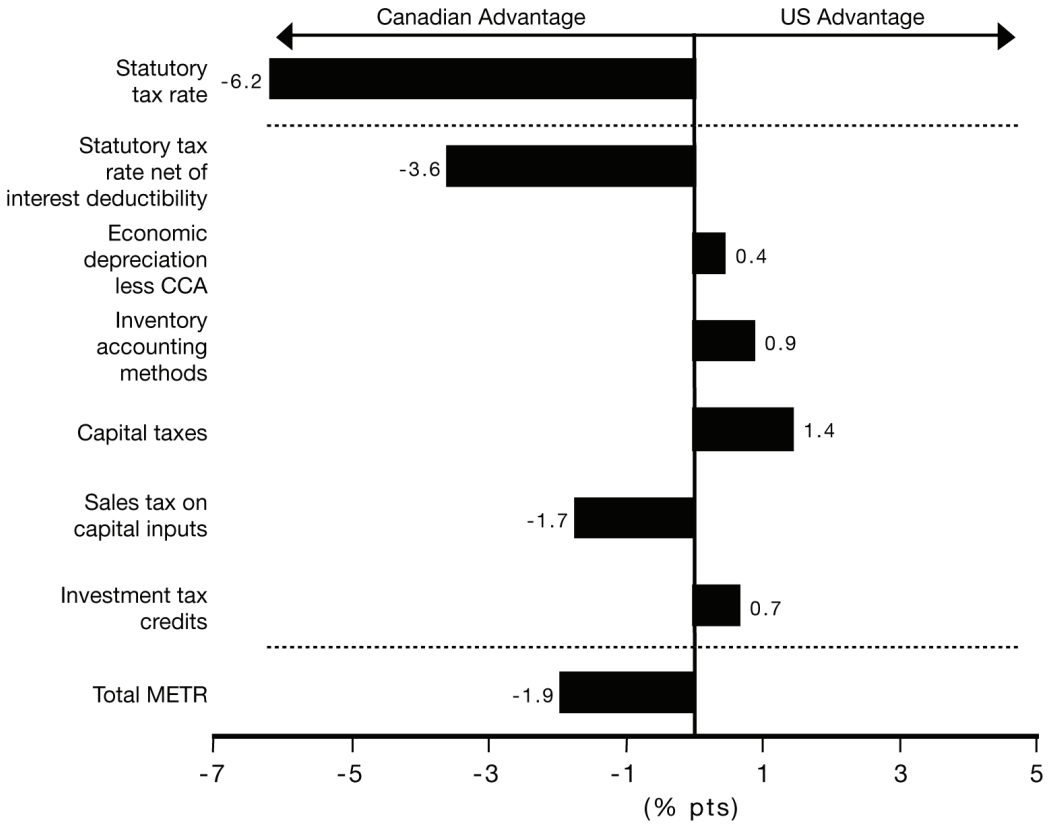
In both countries, capital cost allowances are, on average, somewhat higher than warranted by the useful lives of assets, thereby putting downward pressure on the METR.[10] This effect is slightly more pronounced in the US than in Canada, which causes an erosion of 0.4 percentage points in Canada's statutory rate advantage.

As discussed earlier, firms are permitted to use LIFO inventory accounting for tax purposes in the US but not in Canada. Survey information indicates, however, that LIFO inventory accounting is used by less than half of US firms, in part because only taxable firms experiencing rising inventory values can reduce tax liabilities by adopting LIFO inventory accounting. Further, there are disadvantages associated with switching accounting methods, so a potential reduction in taxable income may not be sufficient to

[9] Recall that Canadian economic assumptions are used to develop METRs for both the US and Canada.
[10] This comparison does not include the impact of inflation on the real value of CCA.

induce firms to adopt LIFO accounting.[11] In the absence of solid information on the use of LIFO accounting, the estimates in this study are based on the somewhat arbitrary assumption that half of taxable US firms use LIFO. As a result, the increased flexibility in inventory accounting gives the US an METR advantage of 0.9 percentage point.

Chart 3
Decomposition of the METR on Business Investment*
(% Point Contribution to the Canada-US Gap in 2010)



* Excluding resource industries, financial institutions and R&D assets.

[11] A survey of 600 large publicly traded firms conducted by the American Institute of Certified Public Accountants (AICPA) indicates that the share of firms using LIFO accounting for some or all of their inventories declined from 47% in 2000 to 42% in 2003. Less than 4% of firms in the sample used LIFO exclusively while 14% used LIFO for less than 50% of inventories on average over the 2000 to 2003 period. See AICPA, *Accounting Trends and Techniques*, 58th edition, 2004, p. 177. For a discussion of reasons why firms choose particular inventory accounting methods, see Cushing, Barry E. and Marc J. Leclere, "Evidence on the Determinants of Inventory Accounting Policy Choice," *The Accounting Review* (April 1992), p. 355-66. Reasons cited by taxable firms for choosing FIFO (or average cost) over LIFO include concerns about reporting lower net income and a lower value of inventories on the balance sheet; declining inventories from either price or volume effects; and higher bookkeeping costs.

In Canada, five provincial governments impose capital taxes, while in the US about one-third of the states have capital taxes. As a result, capital taxes subtract 1.4 percentage points from Canada's statutory rate advantage in 2010.[12]

Almost all US states impose retail sales taxes that affect the price of capital goods, while only five Canadian provinces do so. Although sales taxes add to the Canadian advantage overall, they put the five provinces that levy retail sales taxes at a disadvantage relative to most US states—the average effective sales tax rate on capital goods is 3.5% in the five Canadian provinces compared to 2.8% on average in the US.

In Canada, investment tax credits (ITCs) offered by the federal government (the Atlantic investment tax credit) and by Saskatchewan, Manitoba and Prince Edward Island reduce the national METR by 0.9 percentage points. In the US, 19 states offer ITCs,[13] which reduce the US national METR by 1.5 percentage points.

US tax reductions since 2000 have played only a minor role in reducing Canada's statutory rate advantage. While the US did introduce temporary increases in tax depreciation, the only permanent change has been a 3.15-percentage-point reduction in the tax rate on manufacturing and processing income, which will reduce the US overall METR by 1.1 percentage points by 2010.

The statutory income tax rate reductions proposed in the 2005 federal budget would make a substantial contribution to the improvement in Canada's competitive position. In the absence of these reductions, Canada's 1.9-percentage-point advantage would be transformed into a slight disadvantage (see box below).

[12] Elimination of Ontario's capital tax in 2012 will narrow this gap to roughly 0.5 percentage points.
[13] ITCs designed to promote regional development within a state are not included.

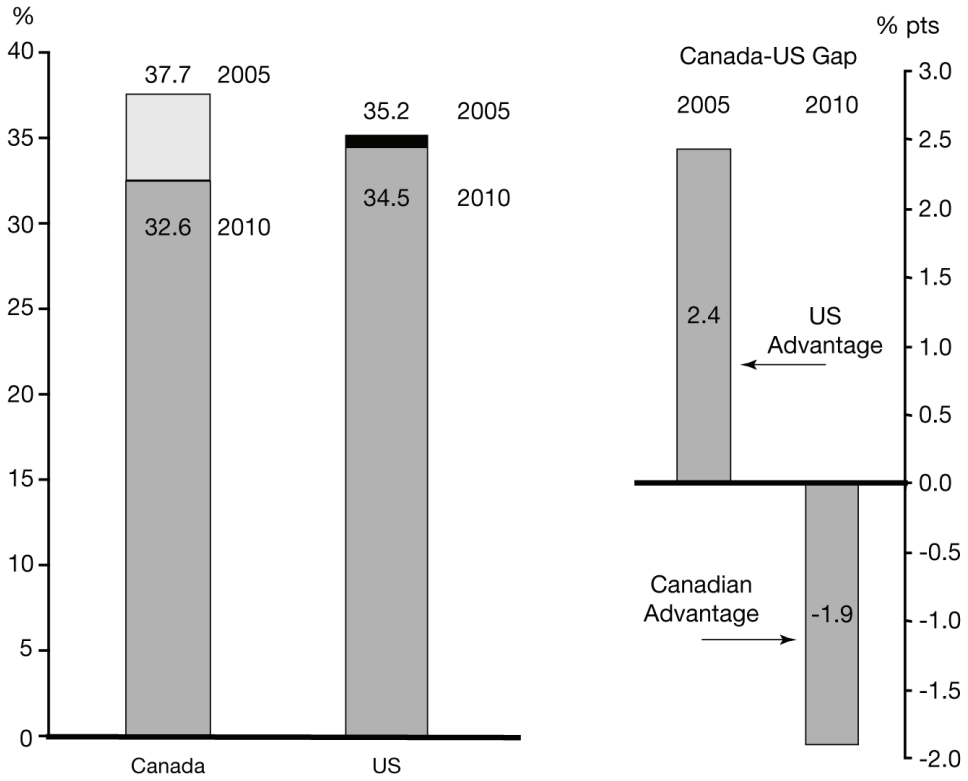
Planned Policy Changes Would Create a Canadian Advantage

Planned corporate tax reductions would establish a Canadian METR advantage by 2010 (see chart). Legislated and proposed policy initiatives are projected to reduce the Canadian METR by 5.1 percentage points from 2005 to 2010.

- At the federal level, completing the phase-out of the capital tax by 2008 and implementing the tax cuts in Budget 2005 would trim 4.2 percentage points from the METR by 2010.
- At the provincial level, Ontario's decision to halve its capital tax by 2010 (and eliminate it by 2012) would subtract 0.7 percentage points from the METR while Quebec legislation reducing its capital tax by 50% (and making up the revenue loss through a higher corporate income tax rate) would cause the national METR to fall 0.2 percentage points by 2010.

The US METR is projected to decline 0.7 percentage points from 2005 to 2010, when a 3.15-percentage-point reduction in the federal tax rate on manufacturing and processing income is fully implemented. The net impact of planned tax reductions would therefore be to change a 2.4-percentage-point Canadian disadvantage in 2005 to a 1.9-percentage-point Canadian advantage in 2010.

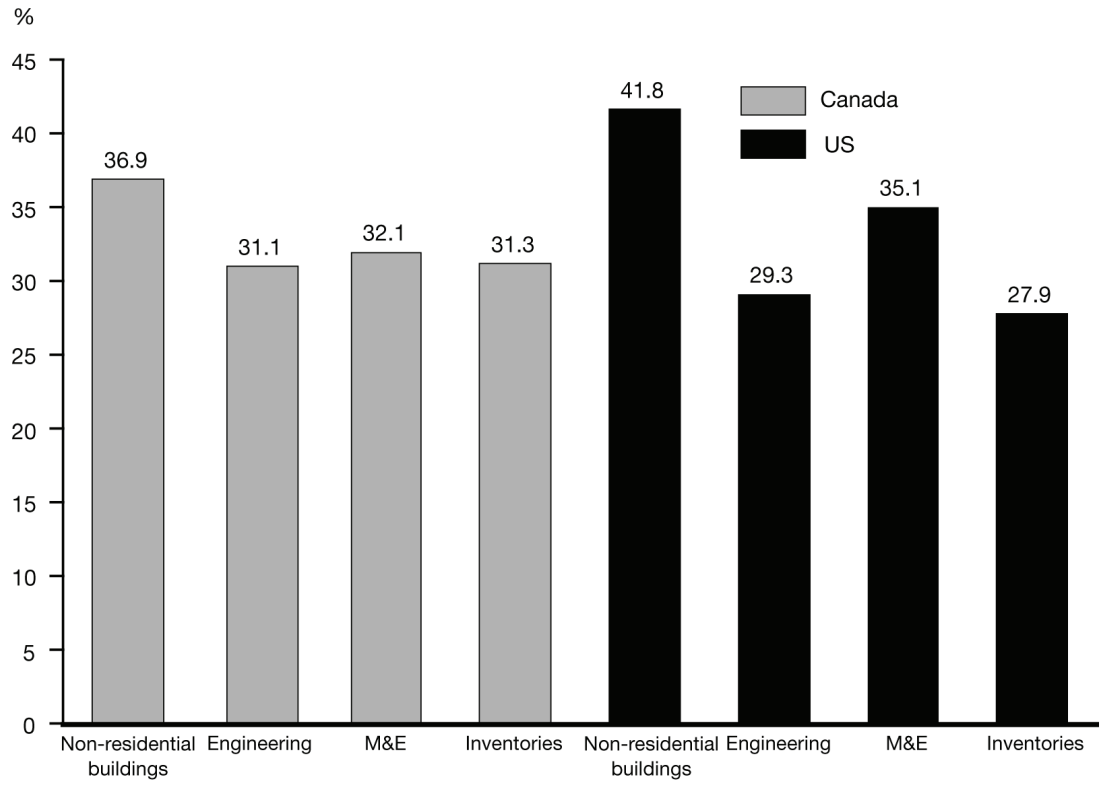
Canadian and US METRs in 2005 and 2010



ESTIMATES BY ASSET AND SECTOR

There is substantial variation in METRs for the major asset groupings (machinery and equipment (M&E), non-residential buildings, engineering structures and inventories) under the US tax system, but the variance is much less pronounced in Canada (Chart 4). In the US, the highest effective rate is on buildings, reflecting a large gap between tax and economic depreciation rates. M&E is subject to substantially higher taxation via sales taxes than buildings and engineering assets. This non-neutral treatment distorts the composition of investment, which harms economic efficiency. The relative uniformity of effective tax rates in Canada reflects the net outcome of several factors: differences in the extent of accelerated depreciation, which raises the METR for buildings; retail sales taxes that fall disproportionately on M&E; and the absence of LIFO inventory accounting.

Chart 4
Canadian and US METRs by Asset in 2010*

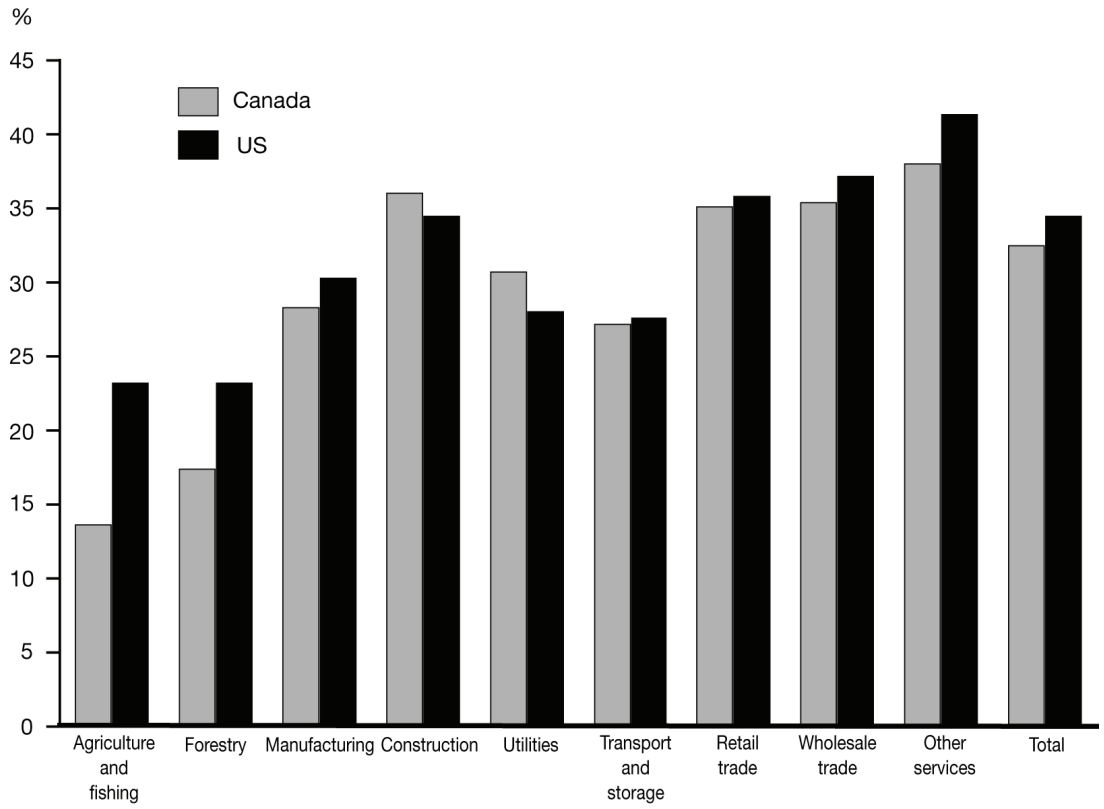


* Excluding resource industries and financial institutions.

Since asset use is not the same across industries, the differences in effective tax rates by asset contribute to the substantial variability in METRs by industry observed for both countries (Chart 5). Other factors contributing to sectoral variability of METRs include:

- Special CCA rates for M&E used in Canadian manufacturing.
- Low tax rates on manufacturing income offered by sub-national jurisdictions in Canada and both levels of government in the US.
- Industry-specific sales tax exemptions.

Chart 5
Canadian and US METRs by Industry in 2010*



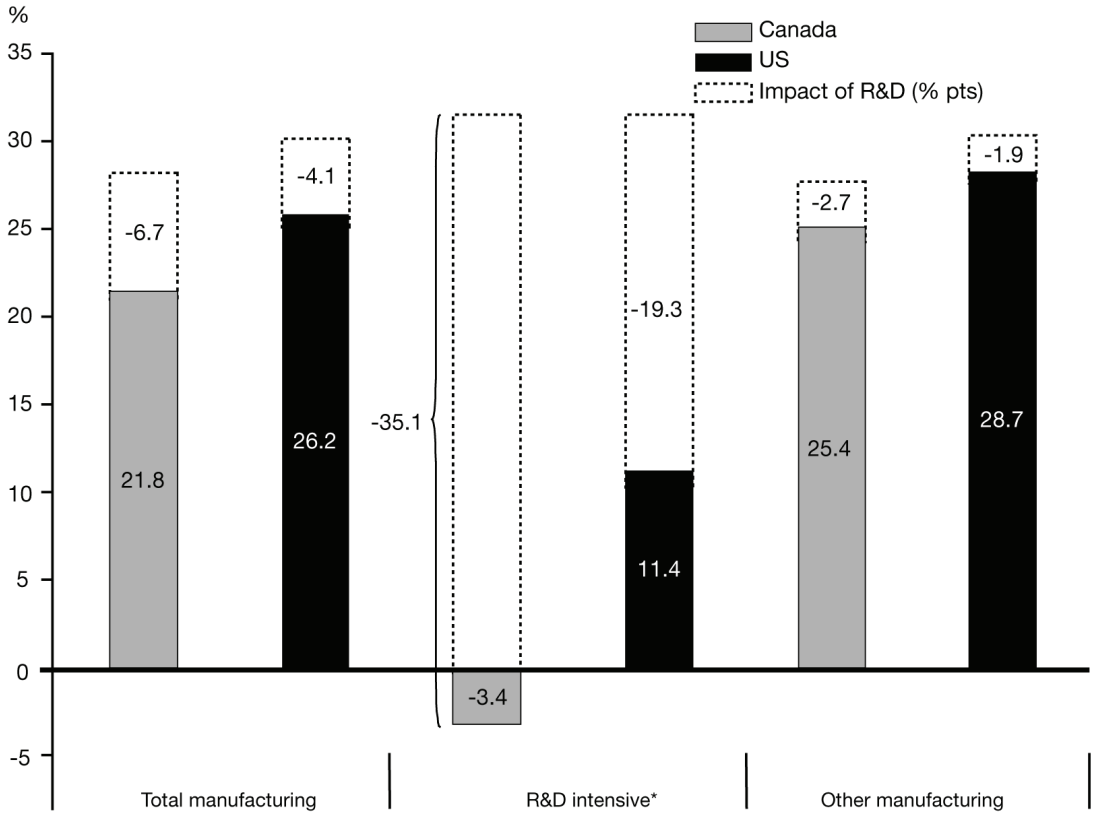
* Excluding resource industries, financial institutions and R&D assets.

Tax competitiveness in manufacturing is often a particular concern since a substantial portion of both international trade and foreign direct investment occur in that sector. This concern may, however, be overstated given the strong linkages between manufacturing and a wide range of service industries, as manufacturers work with designers, software companies and other service sector firms to bring products to market.

With these linkages and the benefits of avoiding tax-induced distortions in mind, the federal government's approach to tax competitiveness is to provide low, common income tax rates for firms in all sectors while improving the tax structure by, for example, eliminating the particularly damaging capital tax. This approach was evident in the Government's proposal in Budget 2005 to implement further broad-based statutory rate reductions in response to the US tax reduction for manufacturing and processing industries.

As in the case of the aggregate METR, Canada's statutory tax rate advantage in manufacturing is eroded by provincial/state capital taxes, less generous investment tax credits and the absence of LIFO accounting. Canada's advantage in manufacturing METRs widens when R&D incentives are included[14] (Chart 6). But as stated earlier, most of these incentives are received by a relatively small number of firms operating in a narrow range of manufacturing industries.

Chart 6
Canada-US METRs for Manufacturing in 2010



* R&D investment represents at least 25% of total investment.

[14] 65% of R&D spending takes place in manufacturing industries.

In recognition of the substantial spillovers on the rest of the economy, investment in R&D is subsidized by the tax system (as indicated by significant negative METRs on R&D in Table 2)[15] in Canada and the US. In particular, labour and other current expenditures, which together represent much of the R&D asset, are eligible for an R&D tax credit in both countries. The net tax subsidy is much larger in Canada largely because the investment tax credits in the US are generally limited to current expenditures exceeding a firm-specific base amount, whereas the credits apply to all current and capital R&D expenditures in Canada. In addition, all Canadian jurisdictions except Quebec allow the immediate write-off of capital assets (except buildings) purchased in order to undertake R&D while normal tax depreciation schedules apply in the US. Note, however, that purchases of eligible tangible capital account for less than 10% of R&D expenses. The substantial subsidy provided to R&D results in a negative total METR for R&D intensive industries in Canada and a total METR for these industries that is less than half the rate in other manufacturing industries in the US (Chart 6). The impact of procurement policies and government grants on R&D is not included in this comparison.

Table 2
Canada and US METRs for R&D Intensive Industries

	Canada	US	Difference (Canada-US)
	(%)		(% pts)
METRs			
Total assets	-3.4	11.4	-14.8
Tangible assets	31.7	29.8	1.9
R&D	-53.7	-17.0	-36.7

[15] The METR is not calculated in the same way for R&D assets as for other capital assets. The reason for the difference is that R&D is an asset produced, not purchased, by firms. R&D is undertaken using labour (researchers), capital (scientific equipment and buildings) and current expenditures on such items as heating and lighting. The tax treatment of all three inputs determines the METR on R&D. In the absence of any tax incentives, the METR on R&D labour and other current expenses is zero since they are deductible expenses, and the METR on R&D capital is similar to that on other purchased capital assets. The tax credit payable on labour and other current expenditures results in negative METRs for these inputs. In Canada, the combination of tax credits and immediate deductibility results in a negative METR for capital costs as well.

SENSITIVITY ASSESSMENT

The METR estimates for Canada and the US presented above are developed from a common set of assumptions about inflation, the financial structure of firms, the required rate of return on investment, and the useful lives of assets. Assumptions must also be made about how best to model the impact or utilization of various tax measures in the two countries.

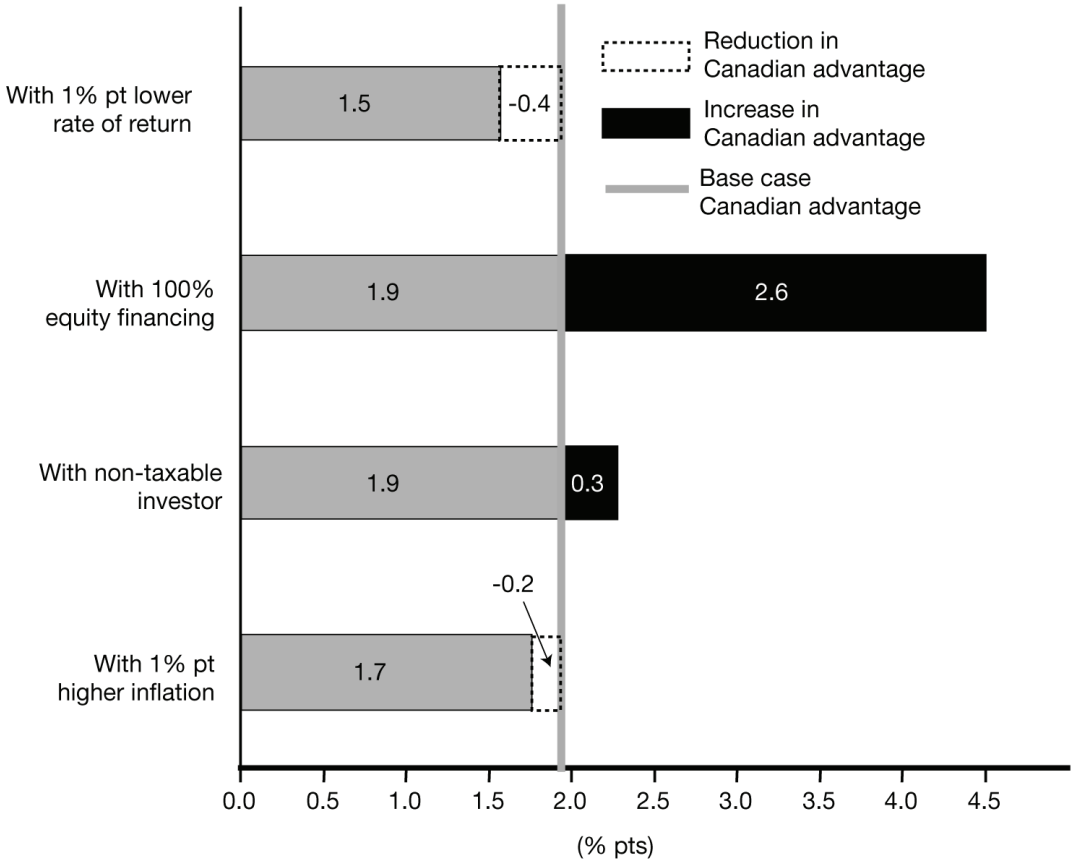
Changes in the common assumptions will affect Canada-US comparisons because they interact with the tax system. Differences in statutory rates play a particularly important role in this context. For example, a lower required rate of return would decrease tax payable in both countries, but relatively more in the US because of a higher statutory rate. As a result, the Canadian advantage declines slightly to 1.5 percentage points with a 1-percentage-point decrease in the required rate of return (Chart 7). Similarly, the deductibility of interest expense reduces the after-tax cost of debt financing, so a decrease in the share of debt relative to equity would increase the METR in both countries, but relatively more in the US because of the higher statutory rate. With 100% equity financing, which is an assumption often used by firms to assess specific projects,[16] Canada would have a more substantial advantage over the US (Chart 7).

The financial cost of capital to firms is calculated assuming that Canadian personal taxes affect the required return to savers.[17] Given the global nature of capital markets, however, it could be argued that the marginal supplier of financial capital to Canadian firms is a foreign saver, such as a taxable individual from the US. The relationship between the personal tax rate on interest and the rate on equity in the US is, however, quite similar to that in Canada, so there would be little impact on the required return to suppliers of financial capital from making this change. Given the large pool of capital held in tax-exempt accounts (pension funds and registered retirement savings plans), it would also be plausible to assume that the marginal supplier is non-taxable. Making such an assumption would increase the rate of return and, as indicated in the previous paragraph, slightly widen the Canada-US advantage (Chart 7).

[16] Project analysis differs from the METR framework in two other important respects. First, required rates of return are typically not adjusted for risk. Second, the project is a stand-alone investment, so the entity undertaking it cannot take immediate advantage of all deductions and credits during the early years of operation, when profits are non-existent or low. This increases the effective tax rate on the project relative to the METR framework, which assumes the investment is small relative to the ongoing operations of the firm.

[17] More precisely, the relationship between taxes on interest income and equity determines the relationship between the gross-of-tax rates of return on bonds and equity. See footnote 4.

Chart 7
Canadian METR Advantage/Sensitivity Analysis*



* Excluding resource industries, financial institutions and R&D assets.

Changes in the inflation rate have more complex interactions with the tax system. Higher inflation causes nominal interest rates to rise, which lowers the METR in both countries (but relatively more in the US) through the impact on interest deductibility.[18] Higher inflation also reduces the real value of CCA, which is specified in nominal terms, thereby boosting the METR. The net effect arising from interest deductibility and CCA expressed in nominal terms is a small rise in the METR in both countries, but the absence of LIFO accounting puts additional upward pressure on the METR in Canada, causing the Canada-US gap to edge down (Chart 7).

The METR estimates are sensitive to the gap between CCA rates and useful lives, which are approximated in the model by economic depreciation rates provided by Statistics Canada. Based on the official Statistics Canada estimates, CCA rates in both Canada and

[18] Note that higher inflation does not directly affect the required real return on financial capital.

the US are on average more than adequate to reflect useful lives. These depreciation rates are, in part, based on analytical work undertaken in the 1980s and hence do not reflect recent developments.[19]

Statistics Canada therefore launched a review of economic depreciation rates in order to make use of more recent data gathered by the agency. Analysis undertaken to date strongly suggests that the official economic depreciation rates are too low, which means that useful lives of assets are overstated.[20] While these updated results are preliminary, further revisions are likely to be small compared to the observed increase relative to the current official estimates. As a result, the METRs reported in this study are based on the preliminary updated estimates of economic depreciation rather than the official estimates. The revised rates raise the Canadian METR by 11 percentage points[21] and result in much more uniform METRs across assets (Chart 8). Note that CCA rates remain, on average, adequate to reflect useful lives.

The provisions of the alternative minimum tax (AMT) may also affect the US estimates. The METR methodology assumes that firms are able to make immediate use of all deductions and credits related to capital investment; but in some cases the AMT will cause firms to delay using deductions and credits, thereby reducing their value and increasing the effective tax rate.[22] The AMT affects firms that control a material portion of the capital stock, but these firms are subject to the AMT for only a short period of time,[23] which would result in a relatively small impact on the effective tax rate.

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[19] A case in point is the depreciation rate for computers. The official Statistics Canada data indicate that the depreciation rate for computers is 30%, which implies a useful life of approximately seven years. There is, however, widespread recognition that useful lives of computers are substantially shorter. Budget 2004 therefore increased the CCA rate on computers to 45%, which is broadly consistent with a useful life of five years.

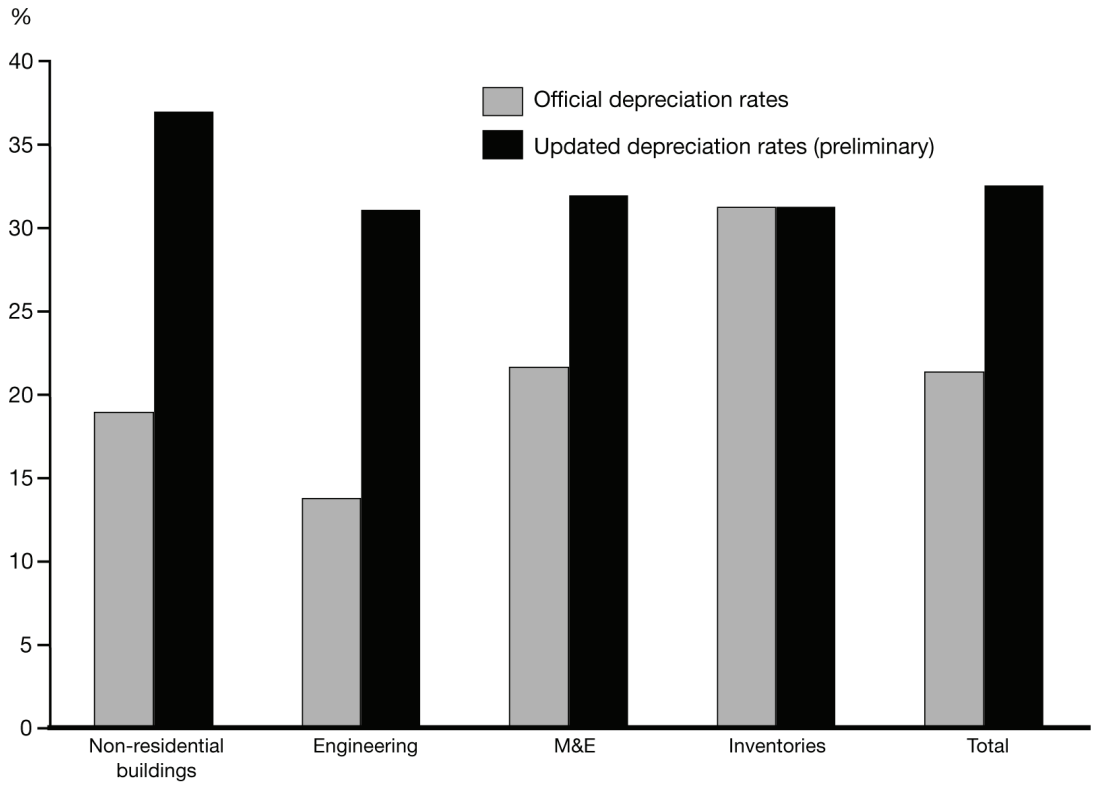
[20] See Gellatly, G., M. Tanguay, and Y. Beiling (2002), "An Alternative Methodology for Estimating Economic Depreciation: New Results Using a Survival Model," *Productivity Growth in Canada*, Statistics Canada, Cat. #15-204-XPE; Tanguay, M. (2005), "Linking Physical and Economic Depreciation: A Joint Density Approach"; and Patry, A. (2005), "Economic Depreciation and Retirements of Canadian Assets: A Comprehensive Empirical Study," Statistics Canada Working Paper, forthcoming.

[21] The rise in the US METR is somewhat greater. The increase in economic depreciation (net of CCA) raises the required return, which has a bigger impact on the METR given the higher statutory tax rate in the US.

[22] More precisely, the AMT may cause firms either to pay more than their regular tax liability, for which they will obtain a credit against future tax liabilities, or to delay claiming deductions and credits when determining their "regular" tax liabilities.

[23] Firms affected by the AMT are estimated to have accounted for about a quarter of all corporate assets in 1998, down from almost 50% of corporate assets in 1990. The duration on the AMT was, however, no more than two years for about half of affected firms over the 1993-98 period. See Carlson, Curtis P., "Who Pays the Corporate Alternative Minimum Tax? Results from Panel Data for 1987-98," National Tax Association Proceedings, 94th Annual Conference on Taxation (p. 349-356).

Chart 8
Impact of Updated Depreciation Rates on Canadian METRs*



* Excluding resource industries, financial institutions and R&D assets.

Sensitivity Analysis: Summary

METR estimates are sensitive to the assumptions made about:

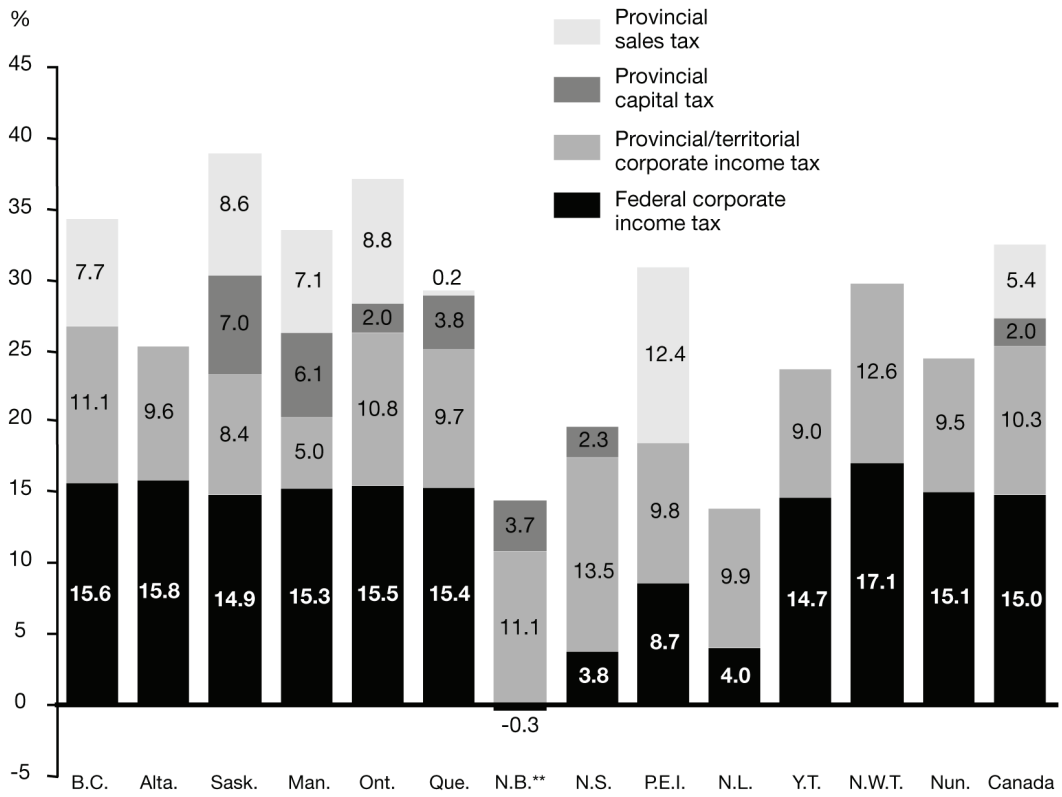
- Economic variables such as the inflation rate.
- The financial structure of the firm, particularly the extent of debt financing or leverage.
- The real rate of return earned on the marginal project.
- The best way to model the impact or utilization of the various tax measures in the two countries.

As a result, the METRs presented in this paper should be viewed as reasonable estimates within a range of possible values.

ESTIMATES FOR PROVINCES, TERRITORIES AND STATES

METRs are highly variable across jurisdictions in Canada, ranging from approximately 14% to almost 40% (Chart 9). Investment tax credits are important in the Atlantic provinces, reflecting the federal Atlantic investment tax credit (AITC) as well as an additional ITC provided by Prince Edward Island.[24] The federal corporate income tax METR is not the same in all jurisdictions, even excluding the AITC, due to differences in the composition of investment, while the variance in the provincial income tax METR reflects differences in tax rates. Capital taxes and sales taxes on capital inputs add considerably to variability across jurisdictions. Note that the METR in Ontario will decline by 2 percentage points in 2012 when the phased elimination of the provincial capital tax is completed.

Chart 9
Decomposition of Provincial and Territorial METRs* in 2010

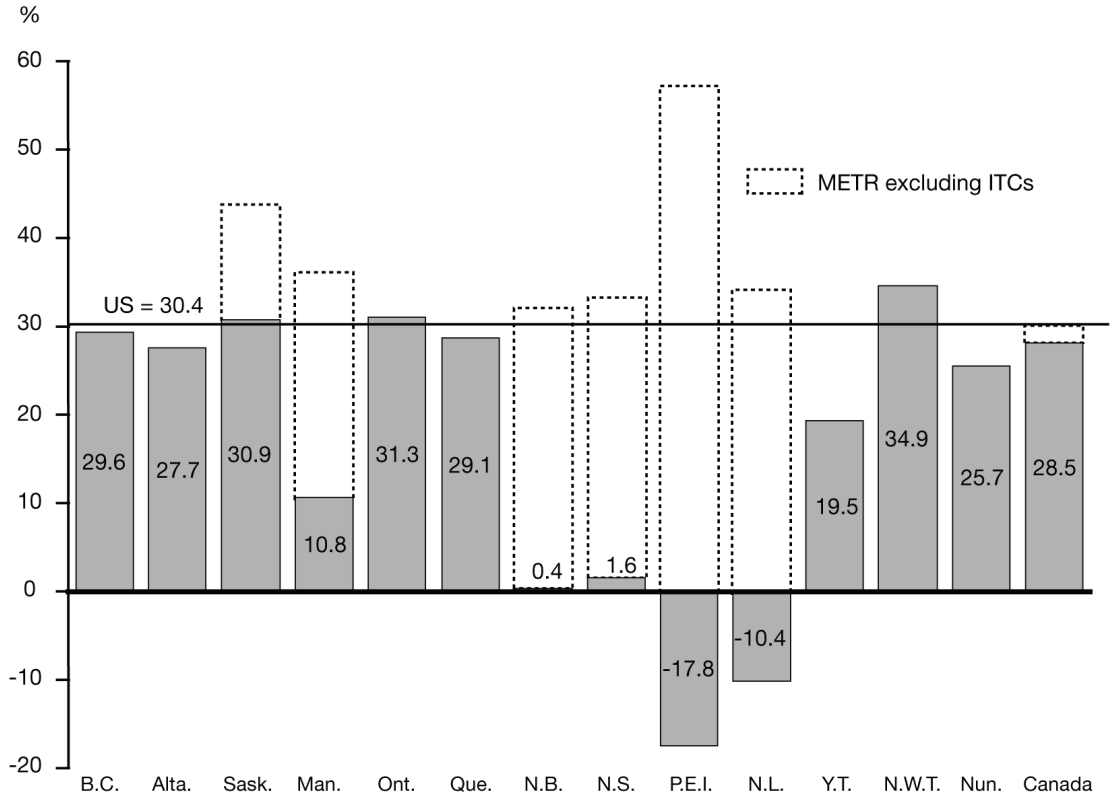


* Excluding resource industries, financial institutions and R&D assets.
** The federal corporate income tax METR is negative due to the Atlantic investment tax credit and a high share of eligible sectors in New Brunswick compared to other Atlantic provinces.

[24] ITCs have a large impact on METRs, even when set at an ostensibly low rate of 5% or 10%. The explanation is that the credit provides an upfront benefit based on the purchase price of a capital good, while tax liabilities are related to the profits generated by the asset, which generally amount to a small fraction of the purchase price.

The manufacturing METR in most jurisdictions is below the US average (Chart 10). Investment tax credits are generally restricted to manufacturing and natural resource industries, so they have a dramatic impact on tax competitiveness: the federal AITC reduces the manufacturing METR in Atlantic Canada by 30 percentage points on average while Manitoba's ITC trims the METR almost 25 percentage points.

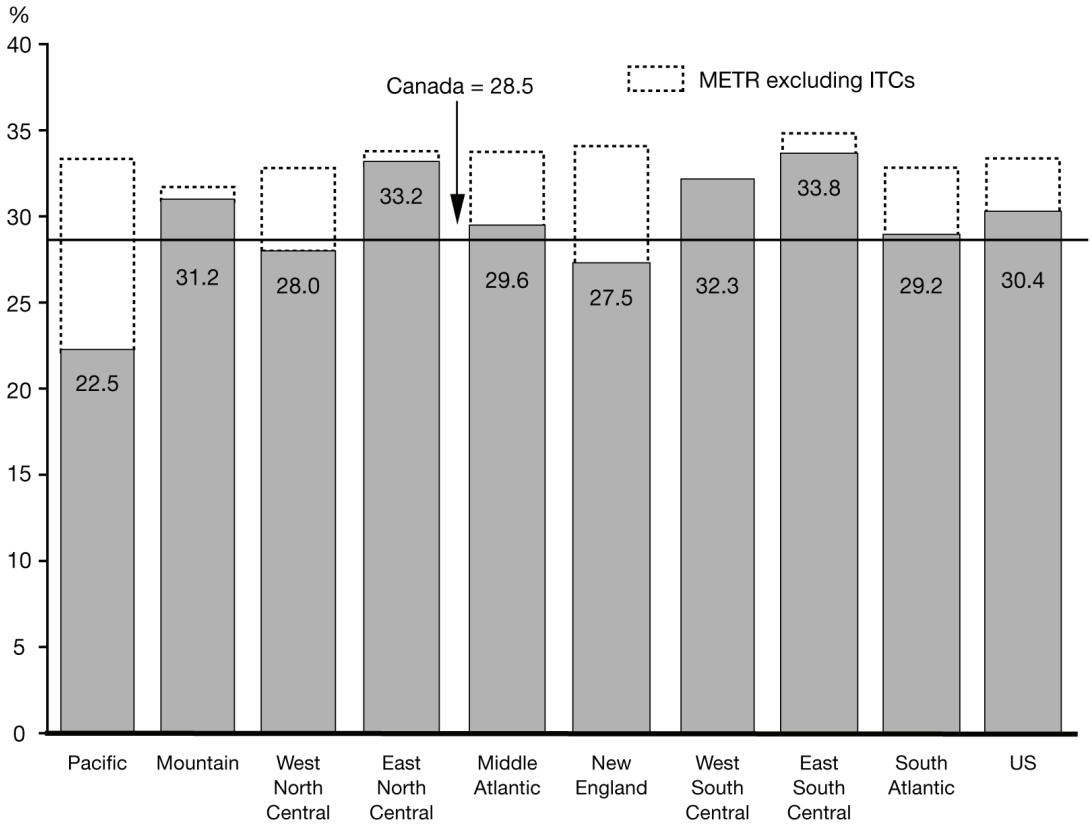
Chart 10
Canadian Manufacturing METRs in 2010
by Province and Territory*



* Excluding R&D assets.

There is also considerable variation in manufacturing METRs across US states. The variance primarily reflects the impact of investment tax credits, sales taxes and capital taxes, all of which are implemented at the state level. Chart 11 shows manufacturing METRs for nine US regions (see Annex C for state METRs presented by region). State ITCs have a substantial impact on the METRs in five regions, reducing the METR in these regions by approximately 6 percentage points on average.

Chart 11
US Manufacturing METRs by Region*



* Excluding R&D assets.

CONCLUSION

This paper reports estimates of METRs for all jurisdictions in Canada and the US. The key findings flowing from this analysis are:

- Policy initiatives undertaken in Canada since 2000, together with those proposed in Budget 2005, would have the effect of reducing the tax burden on new investment by about a quarter by 2010.
- Canada's average METR would be lower than in the US in 2010. The advantage would, however, be smaller than the difference in statutory income tax rates because of other elements of the tax system, notably capital taxes imposed by provincial governments, more generous investment tax credits and tax depreciation in the US, and the absence of LIFO inventory accounting in Canada.
- Competitiveness is a concern in selected jurisdictions, in part due to the widespread use of investment tax credits by US states as well as capital taxes and retail sales taxes that place a burden on capital goods in several provinces.
- Effective rates vary across industries and jurisdictions in both Canada and the US, which can affect the allocation of investment and hence economic efficiency.

These conclusions come with a number of important caveats. First, METRs apply to large taxable firms making an investment that is small relative to the ongoing operations of the firm. Second, the investment is assumed to earn just enough to pay suppliers of financial capital the minimum rate of return. Third, the Canada-US comparison is affected by changes in economic assumptions. Despite these limitations, METRs are a useful summary indicator of how the tax system affects the return on an investment and hence the decision to invest.

ANNEX A

Provincial-Territorial and Federal Statutory Tax Rates (Projected for 2010, %)

Province/Territory	General Corporate Income Tax Rate	Manufacturing and Processing Income Tax Rate	Capital Tax Rate	R&D Tax Credit Rate (Current and Capital Expenditures)[2]	Applicable Federal Atlantic Investment Tax Credit	Manufacturing and Processing Investment Tax Credit Rate	Retail Sales Tax on Capital Goods
Alberta	11.5	11.5	0.0	0.0	0.0	0.0	0.0
British Columbia	13.5	13.5	0.0	10.0	0.0	0.0	7.0
Manitoba	14.0	14.0	0.5	20.0	0.0	10.0	7.0
New Brunswick	13.0	13.0	0.3	15.0	10.0	0.0	0.0
Newfoundland and Labrador	14.0	5.0	0.0	15.0	10.0	0.0	0.0
Northwest Territories	14.0	14.0	0.0	0.0	0.0	0.0	0.0
Nova Scotia	16.0	16.0	0.2	15.0	10.0	0.0	0.0
Nunavut	12.0	12.0	0.0	0.0	0.0	0.0	0.0
Ontario	14.0	12.0	0.15	0.0	0.0	0.0	8.0
Prince Edward Island	16.0	16.0	0.0	35.0	10.0	10.0	10.0
Quebec	11.9	11.9	0.3	17.5[3]	0.0[5]	0.0	0.0[6]
Saskatchewan	17.0	10.0	0.6	15.0	0.0	7.0	7.0
Yukon	15.0	2.5	0.0	15.0	0.0	0.0	0.0
Provincial-Territorial Weighted Average	**13.2**	**12.2**	**0.2**	**4.5**	**0.6**	**0.4**	**4.5[7]**
Federal	**19.0[1]**	**19.0[1]**	**0.0**	**20.0[4]**	**–**	**–**	**0.0**

1 As proposed in Budget 2005.

2 The federal and provincial governments, except Quebec, allow immediate deductibility of R&D capital expenditures.

3 Only labour expenditures are eligible for the credit.

4 The federal government credit is applied to eligible expenditures less government assistance, including provincial scientific research and experimental development tax credits. The effective credit equals 20%*(1-provincial rate).

5 Excludes the impact of the Atlantic investment tax credit in the Gaspé region.

6 The only exceptions to the zero-tax status are road vehicles less than 3,000 kg. used by business in Quebec.

7 Exemptions apply in each province for specific capital goods. The weighted average effective tax rate is 2.0% for Canada and 3.5% for the five provinces imposing retail sales taxes.

ANNEX B

US State and Federal Statutory Tax Rates (Projected for 2010, %)

US States	General Corporate Income Tax Rate	Capital Tax Rate	R&D Tax Credit Rate		Investment Tax Credits Available[4]	Retail Sales Tax on Capital Goods[5]
			Current and Labor Expenditures[3]	Capital Expenditures		
Alabama	6.5	0.0	0.0	0.0	Yes	4.0
Alaska	9.4	0.0	0.0	0.0	No	0.0
Arizona	7.0	0.0	20.0	0.0	No	5.6
Arkansas	6.7	0.3	0.0	0.0	No	5.1
California	8.8	0.0	15.0	0.0	Yes	6.5
Colorado	4.6	0.0	0.0	0.0	No	2.9
Connecticut	7.5	0.0	20.0	0.0	Yes	6.0
Delaware	8.7	0.025[2]	10.0	0.0	No	0.0
District of Columbia	10.0	0.0	0.0	0.0	No	5.8
Florida	5.5	0.0	0.0	0.0	Yes	6.0
Georgia	6.0	0.0	10.0	0.0	Yes	4.0
Hawaii	6.4	0.0	20.0	0.0	No	4.0
Idaho	7.6	0.0	5.0	0.0	Yes	5.0
Illinois	7.3	0.15[2]	6.5	0.0	Yes	6.3
Indiana	8.5	0.0	10.0	0.0	No	6.0
Iowa	12.0	0.0	6.5	0.0	Yes	5.0
Kansas	4.1	0.0	6.5	0.0	Yes	5.3
Kentucky	8.3	0.21	0.0	5.0	No	6.0
Louisiana	8.0	0.3	8.0	0.0	No	4.0
Maine	8.9	0.0	5.0	0.0	No	5.0
Maryland	7.0	0.0	10.0	0.0	No	5.0
Massachusetts	9.5	0.26	10.0	0.0	Yes	5.0
Michigan	1.9	0.0	0.0	0.0	Yes	6.0
Minnesota	9.8	0.0	2.5	0.0	No	6.5
Mississippi	5.0	0.25	0.0	0.0	No	7.0
Missouri	6.3	0.03	0.0	0.0	No	4.2
Montana	6.8	0.0	5.0	0.0	No	0.0
Nebraska	7.8	0.0	0.0	0.0	No	5.5
Nevada	0.0	0.0	0.0	0.0	No	6.5
New Hampshire	8.5	0.0	0.0	0.0	No	0.0
New Jersey	9.0	0.0	10.0	0.0	Yes	6.0
New Mexico	7.6	0.0	0.0	0.0	No	5.0
New York	7.5	0.178[2]	0.0	0.0	Yes	4.3

ANNEX B

US State and Federal Statutory Tax Rates (Projected for 2010, %) *(cont'd)*

US States	General Corporate Income Tax Rate	Capital Tax Rate	R&D Tax Credit Rate		Investment Tax Credits Available[4]	Retail Sales Tax on Capital Goods[5]
			Current and Labor Expenditures[3]	Capital Expenditures		
North Carolina	6.9	0.15	5.0	0.0	Yes	4.5
North Dakota	7.0	0.0	4.0	0.0	No	5.0
Ohio	8.5	0.0	7.0	0.0	No	5.0
Oklahoma	6.0	0.125	0.0	0.0	Yes	4.5
Oregon	6.6	0.0	0.0	0.0	No	0.0
Pennsylvania	10.0	0.0	10.0	0.0	No	6.0
Rhode Island	9.0	0.0	16.9	0.0	Yes	7.0
South Carolina	5.0	0.1	5.0	0.0	No	5.0
South Dakota	0.0	0.0	0.0	0.0	No	4.0
Tennessee	6.5	0.25	0.0	0.0	Yes	7.0
Texas	4.5	0.0	5.0	0.0	No	6.3
Utah	5.0	0.0	6.0	6.0	No	4.8
Vermont	9.8	0.0	10.0	0.0	Yes	6.0
Virginia	6.0	0.0	0.0	0.0	No	3.5
Washington	0.0	0.0	0.0	0.0	No	6.5
West Virginia	9.0	0.7[2]	10.0	0.0	Yes	6.0
Wisconsin	7.9	0.0	5.0	5.0	No	5.0
Wyoming	0.0	0.02	0.0	0.0	No	4.0
State Weighted Average	**6.9**	**0.052**	**6.7**	**0.1**	**–**	**5.4**
Federal[1]	**33.4**	**0.0**	**20.0**	**0.0**	**No**	**0.0**
Combined Statutory Rate (Including Federal Deductibility of State Taxes)[6]	**38.0**					

[1] A rate reduction of 3.15% pts for manufacturing and processing industries from the general rate of 35% is effective 2009.
[2] Taxable capital is defined as total equity invested instead of total assets.
[3] The federal and most state tax credits apply to scientific research and experimental development expenditures in excess of a firm-specific base amount.
[4] Excluding within-state regional development investment tax credits.
[5] Exemptions apply in each state for specific capital goods. The weighted average effective rate is 2.8%.
[6] Federal corporate taxes are deductible in Alabama, Iowa, Louisiana, Missouri and North Dakota.

ANNEX C

METRs on Tangible Assets for the 50 US States and District of Columbia (Projected for 2010, %)

	Manufacturing	All Sectors		Manufacturing	All Sectors
East North Central			**Pacific**		
Illinois	33.0	36.8	Alaska	29.7	29.8
Indiana	33.6	37.2	California	19.3	33.3
Michigan	33.8	37.6	Hawaii	35.5	35.5
Ohio	32.9	35.9	Oregon	28.0	28.1
Wisconsin	32.5	35.5	Washington	29.4	33.7
East North Central	33.2	36.5	Pacific	22.5	32.7
East South Central			**South Atlantic**		
Alabama	29.5	31.8	Delaware	29.4	29.5
Kentucky	35.7	38.9	District of Columbia	40.1	39.9
Mississippi	35.2	39.1	Florida	38.1	37.9
Tennessee	34.4	38.4	Georgia	23.0	29.4
East South Central	33.8	36.9	Maryland	32.0	35.2
			North Carolina	25.2	31.7
Middle Atlantic			South Carolina	32.1	34.1
New Jersey	30.5	36.2	Virginia	30.4	31.9
New York	20.1	30.4	West Virginia	29.7	38.3
Pennsylvania	34.4	37.9	South Atlantic	29.2	33.0
Middle Atlantic	29.6	34.9			
			West North Central		
Mountain			Iowa	1.0	6.2
Arizona	32.5	35.9	Kansas	28.3	32.0
Colorado	29.1	31.2	Minnesota	34.4	38.1
Idaho	27.0	30.9	Missouri	30.7	33.3
Montana	28.1	28.2	Nebraska	38.7	38.5
Nevada	36.8	36.8	North Dakota	30.2	33.0
New Mexico	37.8	37.7	South Dakota	32.4	32.5
Utah	30.8	33.9	West North Central	28.0	31.7
Wyoming	27.7	30.7			
Mountain	31.2	33.4	**West South Central**		
			Arkansas	35.3	38.2
New England			Louisiana	32.9	35.5
Connecticut	23.9	29.6	Oklahoma	31.9	33.7
Maine	33.1	36.2	Texas	31.6	35.6
Massachusetts	29.6	36.6	West South Central	32.3	35.5
New Hampshire	29.1	29.2			
Rhode Island	10.2	31.2	**US**	30.4	34.5
Vermont	21.5	25.9			
New England	27.5	33.5			