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Tax Expenditures and Evaluations

2008

Canada

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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 an analytical paper entitled "Considerations in Setting Canada's Corporate Income Tax Rate."

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 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 that reflect society's priorities. The tax system can also be used directly to achieve public policy objectives through the application of special tax rates, exemptions, deductions, rebates, deferrals and credits that affect the level and distribution of tax. These measures are often described as "tax expenditures" because they achieve policy objectives at the cost of lower tax revenue.

To identify and estimate 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 defined 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 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. This includes not only measures that may reasonably be regarded as tax expenditures but also other measures that may be considered part of the benchmark tax system. The latter are listed separately under "memorandum items." For instance, the dividend tax 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 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 a full range of measures.

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 beneficiaries of tax expenditures, 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 varying 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.
- 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 2008 Report

New tax measures were introduced and others modified in Budget 2008 and in the 2008 *Economic and Fiscal Statement*. The major changes introduced are described below,[1] along with some improvements in the estimation methodology for several ongoing measures.

Personal Income Tax

Eliminating Capital Gains Tax on Donations of Certain Exchangeable Securities

Budget 2008 announced the extension of the existing capital gains tax exemption for donations of publicly traded securities. Effective February 26, 2008, capital gains realized on the exchange of certain unlisted securities for publicly traded securities that are donated within 30 days of the exchange are eligible for the exemption.

Registered Education Savings Plans (RESPs)

Budget 2008 announced changes that make RESPs more responsive to the changing needs of families and students by:

- raising the maximum time limit that an RESP may remain open by 10 years;
- raising the maximum time during which contributions can be made by 10 years; and
- providing a six-month grace period for students applying to receive Educational Assistance Payments from RESPs.

The changes to RESP time limits apply to the 2008 and subsequent taxation years. The grace period applies to RESP beneficiaries who cease to be enrolled in a qualifying program after 2007.

Increasing the Northern Residents Deduction

Budget 2008 announced increases to the maximum daily residence deduction from $15 to $16.50. This increase will bring the maximum annual amount of the residency deduction to $6,022.50 from $5,475 for residents of the Northern Zone and to $3,011.25 from $2,737.50 for residents of the Intermediate Zone.

This measure is effective as of January 1, 2008.

[1] A number of measures introduced in Budget 2008 to improve the application of the goods and services tax/harmonized sales tax to a range of health care services, prescription drugs and medical devices as well as a number of clarifying measures are not described in this document.

Medical Expense Tax Credit (METC)

Budget 2008 announced additions to the list of eligible expenses under the METC to include the cost to purchase, operate and maintain the following devices prescribed by a medical practitioner:

- altered auditory feedback devices for the treatment of a speech disorder;
- electrotherapy devices for the treatment of a medical condition or a severe mobility impairment;
- standing devices for standing therapy in the treatment of a severe mobility impairment; and
- pressure pulse therapy devices for the treatment of a balance disorder.

In addition, Budget 2008 extended eligibility under the METC to recognize eligible expenses for service animals specially trained to assist an individual who is severely affected by autism or epilepsy to cope with the individual's impairment.

These measures are effective for the 2008 and subsequent taxation years.

Tax-Free Savings Account

Objective: To improve incentives for Canadians to save by reducing taxes on savings.

Budget 2008 introduced a new Tax-Free Savings Account (TFSA). The TFSA is a registered, general-purpose savings account that allows individuals to earn tax-free investment income.

Starting in 2009, Canadian residents 18 years and older will automatically acquire $5,000 of TFSA contribution room each year, with unused room being carried forward. The $5,000 limit will be indexed to inflation in $500 increments. TFSA contributions will not be deductible, but investment income, including capital gains, earned in the account and amounts withdrawn will not be included in income for tax purposes or taken into account in determining eligibility for federal income-tested benefits and credits. Withdrawals will also create contribution room for future savings.

Mineral Exploration Tax Credit for Flow-Through Share Investors

The mineral exploration tax credit is a reduction in tax, available to individuals who invest in flow-through shares, equal to 15 per cent of specified mineral exploration expenses incurred in Canada and transferred to flow-through share investors. The credit was introduced on a temporary basis in 2000 and has been extended since then. Budget 2008 extended eligibility for the credit for an additional year, to flow-through share agreements entered into on or before March 31, 2009. Under the one-year "look-back" rule, funds raised with the benefit of the credit in 2009, for example, can be spent on eligible exploration up to the end of 2010.

One-Time Reduction in Required Minimum Withdrawals From Registered Retirement Income Funds (RRIFs)

The November 2008 *Economic and Fiscal Statement* announced a reduction of 25 per cent in the required minimum withdrawal amount for RRIFs for 2008. The measure is expected to reduce federal revenues by $200 million for the 2008 taxation year. This tax expenditure is not presented as a separate item in this document but is part of the Registered Retirement Savings Plan (RRSP) tax expenditure. It is reflected in lower tax revenues collected on withdrawals for 2008 and hence a higher RRSP tax expenditure.

Flow-Through Share Deductions

Flow-through shares are a financing mechanism that assists oil and gas, mining and renewable energy corporations to raise capital for exploration, development and project start-up expenses—specifically Canadian Exploration Expenses (CEE), Canadian Development Expenses (CDE), and Canadian Renewable and Conservation Expenses (CRCE). In addition to receiving an equity interest in the issuing corporation, an investor buying a flow-through share is also entitled to claim deductions on account of CEE, CDE and CRCE transferred to him/her by the corporation. Investors are willing to pay more for such shares than for regular equity because of the flow-through tax deductions. Flow-through shares are typically issued by corporations that are not able to immediately use deductions themselves, e.g. because they are not taxable.

In previous years, in the absence of sufficiently detailed data, flow-through share deductions were covered as part of a broader memorandum item titled "deduction of resource-related expenditures." This item reflected the fiscal cost of deductions for both exploration and development expenses incurred indirectly by individuals through investment in flow-through shares, as well as those expenses incurred directly by individuals (e.g. as prospectors). This year, new segregated data has facilitated isolation of the expenses transferred under flow-through shares.

The tax expenditure associated with flow-through shares is equal to the difference between the fiscal cost of the flow-through deductions claimed by the investor and the deductions forgone by the issuing corporation. A tax expenditure arises to the extent that: (i) the deduction is taken by the investor earlier than it would have been taken by the corporation (indeed, in many cases, the corporation may never have been able to use the deduction), or (ii) where the investor is an individual, his or her tax rate is higher than the corporate tax rate.

The estimates indicate the fiscal cost of the deduction by individuals of expenses transferred to them under flow-through shares. The estimates represent an upper bound on the value of the tax expenditure associated with flow-through shares, since it is effectively assumed that the issuing corporations would never have been able to deduct the transferred expenses. To the extent that they could, the tax expenditure would be smaller than the estimates in this document. There is no data, however, to allow determination of when, if ever, the expenses would otherwise have been deducted by the issuing corporations. The data does indicate that in 2006, for example, 98 per cent of expenses transferred under flow-through shares were from corporations that were not taxable, and thus not in a position to immediately deduct the expenses themselves.

A parallel item for flow-through share expenses transferred to corporate investors appears in the section below on corporate income tax.

Reclassification of Expenses Under Flow-Through Shares

This ongoing provision allows a corporation to reclassify as Canadian Exploration Expenses (CEE—100 per cent deductible in the year incurred) the first $1 million of eligible oil and gas Canadian Development Expenses (CDE—30 per cent deductible per year) renounced to shareholders under a flow-through share agreement. The reclassified amounts are referred to as "deemed CEE."

In previous years, this measure was covered by a memorandum item that reflected the fiscal cost of the deemed CEE claimed in a year for both individuals and corporations. This year, new data has facilitated isolation of the reclassified expenses transferred under flow-through shares to individuals and corporations. This new data allows the actual tax expenditure to be estimated by comparing the tax value of the deemed CEE claimed by individuals to a benchmark where the underlying CDE is flowed out as CDE rather than being reclassified as CEE. It is assumed that the issuing corporations would have been able to fully flow out the expenses as CDE, even though CDE is generally less attractive to investors than CEE. To the extent that they could not, the tax expenditure would be higher than this estimate.

Like any measure that accelerates the timing of deductions and defers taxes payable, this measure results in a positive tax expenditure in the initial year(s) of any particular investment, and a negative tax expenditure in the later years. A parallel item for reclassification of expenses transferred to corporate investors in flow-through shares appears in the section below on corporate income tax.

Corporate Income Tax

Scientific Research and Experimental Development (SR&ED) Tax Incentive Program

Budget 2008 announced measures to enhance the availability and accessibility of the financial support for research and development by small and medium-sized businesses. The expenditure limit for the 35 per cent SR&ED investment tax credit was raised from $2 million to $3 million and the upper limit for the taxable capital phase-out range was increased from $15 million to $50 million. The upper limit of the taxable income phase-out range was also increased, from $600,000 to $700,000.

In addition, Budget 2008 announced that SR&ED investment tax credits would be available for some salary or wage expenses incurred for SR&ED carried on outside Canada, up to a limit of 10 per cent of the total salary and wages directly attributable to SR&ED carried on in Canada by the taxpayer during the year.

These changes are applicable for taxation years ending on or after February 26, 2008, with applicable limits pro-rated based on the number of days in that taxation year that are after February 25, 2008.

Flow-Through Share Deductions

This is a new item reflecting the fiscal cost of the deduction of expenses transferred to corporate investors in flow-through shares, which is explained above in the parallel item in the personal income tax section. Estimates are made using the same assumptions as for the personal income tax case. They represent an upper bound on the value of the tax expenditure associated with flow-through shares held by corporate investors.

Reclassification of Expenses Under Flow-Through Shares

A new tax expenditure estimate is included this year relating to the measure that allows a corporation to reclassify as Canadian Exploration Expenses (100 per cent deductible in the year incurred) the first $1 million of eligible oil and gas Canadian Development Expenses (30 per cent deductible per year) renounced to corporate shareholders under a flow-through share agreement. The tax expenditure estimate is discussed above in the parallel item in the personal income tax section.

The Tax Expenditures

Tables 1 to 3 provide tax expenditure values for personal income tax, corporate income tax and the goods and services tax (GST) for the years 2003 to 2010. The estimates for the years 2003 to 2006 are based on tax data supplied by the Canada Revenue Agency, or are calculated from data supplied by Statistics Canada and other government departments and agencies, with a few exceptions. In these cases, and for all projections, the values shown are determined from the historical relationship between a tax expenditure and relevant economic variables. The economic variables used to develop the projections are generally based on the average of private sector forecasts presented in the November 2008 *Economic and Fiscal Statement*. See Chapter 1 of *Tax Expenditures: Notes to the Estimates/Projections*[2] for additional details on the methodology.

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" ("small") indicates that the absolute value of the tax expenditure 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.

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

Table 1

*Personal Income Tax Expenditures**

	Estimates			Projections				
	2003	2004	2005	2006	2007	2008	2009	2010
	($ millions)							
Charities, Gifts and Contributions								
Charitable donations credit	1,825	2,000	2,260	2,390	2,505	2,640	2,790	2,955
Reduced inclusion rate for capital gains arising from donations of publicly listed securities and ecologically sensitive land[1]	6	9	9	27	45	46	46	46
Non-taxation of capital gains on gifts of cultural property[2]	8	18	9	9	8	10	11	11
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]	11	22	26	26	14	27	14	14
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	5	5	5	5	5	5	5	5
Apprentice vehicle mechanics' tools deduction[4]	–	–	S	S	S	S	S	S
Education tax credit[5]	235	240	220	225	200	210	210	220
Tuition tax credit[5]	270	290	265	270	250	265	275	290
Textbook tax credit[5,6]	–	–	–	82	78	81	82	83
Education, tuition and textbook tax credits carried forward from prior years[7]	290	345	365	365	350	390	410	425
Transfer of education, tuition and textbook tax credits[8]	440	460	450	500	490	500	505	515
Partial exemption of scholarship, fellowship and bursary income[9]	11	11	11	37	38	38	38	39
Registered Education Savings Plans[10]	130	150	145	170	185	170	230	300
Student loan interest credit	63	58	55	58	57	59	60	62
Employment								
Canada employment credit[11]	–	–	–	470	1,790	1,860	1,905	1,975
Deduction for income earned by military and police deployed to high-risk international missions[12]	–	26	20	28	31	31	34	34
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[13]	480	725	945	1,080	1,145	1,040	825	865
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.

* 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 website (www.fin.gc.ca), for a discussion of the reasons for this.

Table 1

Personal Income Tax Expenditures (cont'd)

	Estimates			Projections				
	2003	2004	2005	2006	2007	2008	2009	2010
	($ millions)							
Northern residents deduction[14]	135	135	135	140	140	150	155	155
Overseas employment credit	58	45	40	40	40	40	40	40
Tax-free amount for emergency service volunteers	14	14	14	14	14	14	14	14
Deduction for tradespeople's tool expenses[15]	–	–	–	15	15	15	15	15
Working Income Tax Benefit[16]	–	–	–	–	560	565	565	570
Family								
Adoption expense tax credit[17]	–	–	3	3	4	5	5	5
Caregiver credit	73	79	79	85	80	85	85	90
Child tax credit[18]	–	–	–	–	1,415	1,455	1,480	1,515
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	6	6	5	5	5	5	5	6
Spouse or common-law partner credit[19]	1,190	1,195	1,205	1,230	1,280	1,300	1,395	1,440
Eligible dependant credit[20]	660	665	665	695	755	770	810	835
Farming and Fishing								
Lifetime capital gains exemption for farm/fishing property[21]	240	255	255	280	325	325	325	325
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[22]	S	9	-10	S	S	S	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[23]	S	S	22	-9	-21	9	5	4
Deferral through 10-year capital gain reserve	S	S	S	S	S	S	S	S
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[24]								
Deferral of tax on government contributions	45	S	S	S	S	S	S	S
Deferral of tax on bonus and interest income	22	21	7	S	S	S	S	S
Taxable withdrawals	-98	-180	-155	-8	S	S	S	S
AgriInvest (farm savings account)[25]	–	–	–	–	–	110	45	45
Federal-Provincial Financing Arrangements								
Logging tax credit	S	S	S	S	S	S	S	S
Quebec abatement	3,215	3,345	3,405	3,490	3,525	3,695	3,885	4,110
Transfer of income tax points to provinces	14,235	14,980	15,935	16,970	17,185	18,025	18,955	20,045

Table 1

Personal Income Tax Expenditures (cont'd)

	Estimates			Projections				
	2003	2004	2005	2006	2007	2008	2009	2010
				($ millions)				
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	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deferral through 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	20	23	21	23	20	21	21	22
Investment tax credits	43	55	58	82	83	84	85	86
Flow-through share deductions[26]	260	335	465	695	660	540	540	545
Mineral exploration tax credit for flow-through share investors[27]	45	50	75	110	165	85	-20	-5
Reclassification of flow-through shares[28]	7	17	11	14	S	S	S	S
Partial inclusion of capital gains[29]	2,040	2,840	4,015	5,065	5,745	5,230	4,130	4,335
Taxation of capital gains upon realization	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Tax-Free Savings Account[30]	–	–	–	–	–	–	45	155
Small Business								
Lifetime capital gains exemption for small business shares[31]	305	380	430	450	525	480	380	395
Deduction of allowable business investment losses	30	30	24	24	25	25	26	26
Deferral through 10-year capital gain reserve	S	S	S	S	S	S	S	S
Labour-sponsored venture capital corporations credit[32]	160	150	125	130	125	125	125	125
Rollovers of investments in small businesses	4	4	6	5	5	5	5	5
Health								
Children's fitness tax credit[33]	–	–	–	–	95	95	100	100
Disability tax credit	365	390	395	400	375	395	405	420
Medical expense tax credit	700	795	805	865	895	970	1,035	1,120
Non-taxation of business-paid health and dental benefits	2,010	2,155	2,170	2,330	2,450	2,590	2,720	2,860
Refundable medical expense supplement[34]	68	76	92	105	110	120	125	130
Income Maintenance and Retirement								
Age credit[35]	1,435	1,490	1,400	1,750	1,685	1,795	1,815	1,900
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	14	14	14	15	16	17	18	19
Non-taxation of Guaranteed Income Supplement and Allowance benefits[36]	295	295	245	175	140	165	150	160

Table 1

Personal Income Tax Expenditures (cont'd)

	Estimates			Projections				
	2003	2004	2005	2006	2007	2008	2009	2010
				($ millions)				
Non-taxation of investment income on life insurance policies[37]	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[38]	220	205	180	175	100	105	90	87
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)[39]	4	3	3	S	S	S	S	S
Non-taxation of veterans' disability pensions and support for dependants[40]	145	150	145	150	145	155	150	150
Non-taxation of veterans' Disability Award[40]	–	–	–	3	11	16	16	15
Non-taxation of workers' compensation benefits	630	630	620	665	685	725	770	820
Registered Disability Savings Plans[41]	–	–	–	–	–	S	S	S
Pension income credit[42]	430	440	420	810	915	950	965	990
Pension income splitting[43]	–	–	–	–	665	700	730	765
Registered Pension Plans (RPPs)[44]								
Deduction for contributions	6,615	7,740	8,355	9,885	8,980	9,295	9,615	9,950
Non-taxation of investment income	7,525	10,385	12,285	13,965	16,175	15,675	14,555	14,765
Taxation of withdrawals	-6,575	-7,090	-7,335	-7,595	-6,855	-7,195	-7,535	-7,925
Net tax expenditure	7,565	11,035	13,305	16,255	18,300	17,775	16,635	16,790
Registered Retirement Savings Plans (RRSPs)[45]								
Deduction for contributions	6,000	6,410	6,820	7,570	8,055	8,595	9,155	9,760
Non-taxation of investment income	3,655	5,400	6,750	7,770	8,975	8,695	8,075	8,195
Taxation of withdrawals	-3,670	-4,005	-4,280	-4,580	-4,680	-4,850	-5,415	-5,830
Net tax expenditure	5,985	7,805	9,290	10,760	12,350	12,440	11,815	12,125
Supplementary Information: Present value of tax assistance for retirement savings plans[46]	6,820	7,450	8,120	9,550	9,870	10,330	10,870	11,415
Saskatchewan Pension Plan	S	S	S	S	S	S	S	S
Treatment of alimony and maintenance payments	115	105	95	105	110	115	120	125
Other Items								
Deduction related to vows of perpetual poverty	S	S	S	S	S	S	S	S
Deduction for clergy residence	70	67	70	70	70	75	75	75
Non-taxation of capital gains on principal residences[47]								
Partial inclusion rate	1,830	2,605	3,580	4,520	5,790	5,730	5,615	5,730
Full inclusion rate	3,655	5,210	7,160	9,040	11,580	11,465	11,235	11,460

Table 1

Personal Income Tax Expenditures (cont'd)

	Estimates			Projections				
	2003	2004	2005	2006	2007	2008	2009	2010
				($ millions)				
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
Public transit tax credit[48]	–	–	–	45	110	120	125	130
Memorandum Items								
Avoidance of Double Taxation								
Dividend gross-up and tax credit[49]	1,290	1,480	1,730	2,415	2,655	2,740	2,740	2,750
Foreign tax credit	580	615	655	670	680	690	700	710
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[50]	535	570	570	720	725	740	750	765
Deduction of carrying charges incurred to earn income	725	775	895	1,010	1,125	1,060	1,055	1,125
Deduction of union and professional dues	600	615	630	660	680	705	730	755
Disability supports deduction (attendant care deduction)[51]	S	S	S	S	S	S	S	S
Moving expense deduction	82	88	100	105	110	110	115	120
Loss Offset Provisions								
Capital loss carry-overs[52]	165	250	305	340	350	355	360	370
Farm and fishing loss carry-overs	10	14	15	15	15	15	15	15
Non-capital loss carry-overs	62	62	50	50	50	50	50	50
Social and Employment Insurance Programs								
Canada Pension Plan and Québec Pension Plan								
Employee-paid contribution credit	2,455	2,570	2,510	2,680	2,745	2,870	3,000	3,140
Non-taxation of employer-paid premiums[53]	3,730	3,835	3,960	4,180	4,415	4,630	4,860	5,100
Employment Insurance								
Employment Insurance contribution credit[54]	1,050	1,020	970	995	970	980	1,020	1,060
Non-taxation of employer-paid premiums	2,085	1,990	1,995	1,905	1,910	1,910	1,995	2,090

Table 1

Personal Income Tax Expenditures (cont'd)

	Estimates			Projections				
	2003	2004	2005	2006	2007	2008	2009	2010
				($ millions)				
Other								
Basic personal amount[55]	21,705	22,860	23,410	24,355	25,695	26,160	27,790	28,765
Deduction of farm losses for part-time farmers	61	59	58	56	57	60	61	62
Deduction of other employment expenses	825	870	890	930	960	995	1,030	1,060
Non-taxation of lottery and gambling winnings[56]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Non-taxation of allowances for diplomats, military and other government employees posted abroad[57]	33	30	26	28	29	30	35	30
Partial deduction of meals and entertainment expenses[58]	75	62	64	65	80	95	105	115

Notes:

[1] The increase in the tax expenditure in 2006 reflects the elimination in that year of capital gains tax on donations to public charities of both publicly listed securities and ecogifts. The further increase in 2007 reflects Budget 2007's announcement of an extension to private foundations of the elimination of capital gains tax on donations of listed securities. Finally, the slight increase in 2008 reflects Budget 2008's elimination of capital gains tax on donations of exchangeable shares.

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 $6 million to $46 million between 2003 and 2010. 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 $49 million to $201 million between 2003 and 2010, as shown below (in millions of dollars):

2003	2004	2005	2006	2007	2008	2009	2010
49	76	71	119	196	201	200	200

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

[2] Estimates and projections vary from those in prior reports due partly to a methodological change in how the Canadian Cultural Property Export Review Board represents the value of its determinations in a given fiscal year. In addition, assumptions regarding the marginal tax rates of donors of certified cultural property have been changed to match those used in the calculation of the tax expenditure for donations of ecologically sensitive land and publicly listed securities.

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 cultural property would have been made in the absence of this measure, then (as shown in the main table) the total cost ranges from $8 million to $18 million between 2003 and 2010. 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 $15 million to $72 million between 2003 and 2010, as shown below (in millions of dollars):

2003	2004	2005	2006	2007	2008	2009	2010
35	72	40	15	26	36	38	38

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

[3] The increase in the tax expenditure in 2004 reflects both the impact of contributions in respect of the 38th general election and an increase of $200 in the three political contribution tax credit thresholds, for 2004 and subsequent years. The higher levels for the tax expenditure in 2005 and 2006 reflect the fact that contributions in respect of the 39th general election were spread over two calendar years. The tax expenditure is expected to be higher in 2008 as a result of contributions in respect of the 40th general election. It is assumed that the next general election will be held at a time beyond the period covered by these estimates.

[4] Estimates presented in last year's document were based on Statistics Canada data on the number of apprentices in eligible trades and on the typical costs they incur. Tax data now available indicate that the value of this tax expenditure was lower in 2005 than previously estimated. Amounts for future years have been adjusted accordingly.

[5] This tax expenditure relates to amounts earned in the year and claimed by the student (i.e. neither transferred nor carried forward).

[6] This measure was introduced in Budget 2006, effective January 1, 2006.

[7] For a given year, the tax expenditure represents the value of education, tuition and textbook tax credits earned in past years, and used in that year. The tax expenditure does not include the pool of unused education, tuition and textbook tax credits that have been accumulated but will be deferred for use in future years. For example, in taxation year 2008, it is projected that taxpayers will defer $39 million of education, tuition and textbook tax credits (tax value) accumulated in past years, for use in 2009 and future taxation years. The tax expenditure for this measure increases substantially in 2008 and later years due to the impact of the Canada employment credit, the textbook tax credit and the full exemption of scholarship, fellowship and bursary income, which were introduced in Budget 2006, as well as the increase in the basic personal amount that was implemented in the 2007 *Economic Statement*. These measures contribute to reduce the amount of tax payable, resulting in more credit amounts not being used by students while studying but rather being carried forward.

[8] The tax expenditure for the transfer of these credits for 2006 and beyond increases substantially due to the impact of the Canada employment credit, the textbook tax credit and the full exemption of scholarship, fellowship and bursary income, which were introduced in Budget 2006, as well as the increase in the basic personal amount that was implemented in the 2007 *Economic Statement*. These measures contribute to reducing the amount of tax payable by students, resulting in more credit amounts not being used while studying but rather being transferred.

[9] The tax expenditure equals the tax revenue forgone from exempting scholarship, fellowship and bursary income from tax. Budget 2006 introduced a measure that makes all amounts received for post-secondary scholarships, fellowships and bursaries exempt from tax, where these amounts are received in connection with enrolment in a program for which the student can claim the education tax credit. Budget 2007 extended this treatment to elementary and secondary school students, effective 2007. All other scholarships, fellowships and bursaries receive a tax exemption on the first $500.

[10] The tax expenditure equals the tax revenue forgone 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. Projections for 2008 and 2009 are lower than in last year's report due to lower estimates of RESP income, which is estimated based on the rate of return on government bonds, and a revised projection methodology based on administrative data from Human Resources and Social Development Canada.

[11] This measure was introduced in Budget 2006. Because this measure started in July 2006, the maximum amount on which the credit is calculated for the 2006 taxation year is $250. For 2007, the maximum amount on which the credit is calculated was increased from $500 to $1,000. This maximum amount is indexed for years subsequent to 2007.

[12] This measure was introduced in Budget 2004, effective for 2004 and later years. The tax expenditure declined in 2005, largely as a result of the reduction in the Canadian component of the NATO-led Stabilization Force mission in Bosnia-Herzegovina. The growth in the Canadian Forces presence in Afghanistan is largely responsible for the tax expenditure increase for 2006 and beyond.

[13] The projected year-over-year changes in the value of the S&P/TSX Composite Index have been used as a proxy to assess the projected tax expenditures beyond 2007 (see footnote 29).

[14] Budget 2008 announced a 10-per-cent increase in the maximum daily residency deduction, effective 2008.

[15] This measure was introduced in Budget 2006, effective May 2, 2006.

[16] This measure was announced in Budget 2007, effective 2007.

[17] This measure was introduced in Budget 2005, effective 2005.

[18] This measure was introduced in Budget 2007, effective 2007.

[19] Budget 2007 and the 2007 *Economic Statement* announced enhancements of the spouse or common-law partner credit, effective 2007. At the same time, however, pension income splitting reduces the value of this measure starting in 2007 (see footnote 43 for details). Also, Universal Child Care Benefit (UCCB) payments are included in the net income of the lower-income spouse or common-law partner, thus reducing the value of this measure. UCCB payments commenced in July 2006, and 2007 is the first full year for these payments.

[20] Budget 2007 and the 2007 *Economic Statement* announced enhancements to this measure, effective 2007.

[21] Budget 2006 extended the lifetime capital gains exemption (LCGE) to qualifying fishing property, effective May 2, 2006. Budget 2007 announced an increase in the LCGE to $750,000 from $500,000, effective March 19, 2007. To reflect the potential impact of recent financial market developments on LCGE claims for qualifying farming and fishing property, no growth in the tax expenditure is projected beyond 2007.

[22] The tax expenditure estimate for 2004 is 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 was reported in 2005, resulting in a negative tax expenditure for that year.

[23] Estimates are based on Statistics Canada data available up to 2005, which includes cash purchase tickets for wheat, barley, oats, canola, flax and rye. Projections are calculated using a historical average growth rate.

[24] The data for the Net Income Stabilization Account (NISA) program are observed values up to 2004. NISA and the Canadian Farm Income Program were replaced by the Canadian Agricultural Income Stabilization (CAIS) program, with the effect that government contributions under NISA, as well as other program elements, ceased as of December 31, 2003. All funds in participant accounts will have to be paid out by March 31, 2009. Tax expenditure estimates and projections reflect the wind-down schedule. It should also be noted that CAIS does not result in a tax expenditure.

[25] This measure was announced in Budget 2007. The tax expenditure represents the deferral of federal income taxes on contributions to AgriInvest accounts.

[26] See the description of the estimation methodology in the "What's New in the 2008 Report" section.

[27] The credit was introduced on a temporary basis in 2000 and has been extended since. It is currently set to expire on March 31, 2009. The negative figures for 2009 and 2010 are a result of the rule that requires an individual who earns the credit in a year to include in income for the following year an amount equal to the credit. Since the individual has been allowed to claim a deduction for the full amount of the eligible exploration expense transferred to him or her, this effectively reverses the deduction in respect of the portion of the expense that was effectively paid for by the credit.

[28] See the description of the estimation methodology in the "What's New in the 2008 Report" section. The small tax expenditure for 2007 and subsequent years reflects a projected decline in exploration from 2006 to 2007.

[29] Projections for 2006 and 2007 are based on preliminary tax return information. Projections beyond 2007 are based on actual and forecast year-over-year changes in the value of the S&P/TSX Composite Index. It is assumed that market prices observed at the end of October 2008 are maintained for the remainder of the year and throughout 2009, and will increase in 2010 at a pace more in line with long-term growth rates. This results in a year-over-year decline in the S&P/TSX Composite Index of 9 per cent in 2008 and 21 per cent in 2009, and 5 per cent growth in 2010. As in previous years, the approach does not take account of the ability of individuals to apply capital losses against previous-year capital gains.

[30] The Tax-Free Savings Account (TFSA) was introduced in Budget 2008 and is effective January 1, 2009 (see the "What's New in the 2008 Report" section).

[31] Budget 2007 announced an increase in the lifetime capital gains exemption to $750,000 from $500,000, effective March 19, 2007. The year-over-year changes in the value of the S&P/TSX Composite Index have been used as a proxy to assess the projected tax expenditures beyond 2007 (see footnote 29).

[32] The projections of this tax expenditure for 2006 and 2007 are based on preliminary information regarding sales of shares of labour-sponsored venture capital corporations. Projections assume sales remain constant after 2007.

[33] This measure was introduced in Budget 2006, effective 2007. Budget 2007 enhanced this measure for children with disabilities (see the "What's New in the 2007 Report" section in the 2007 *Tax Expenditures and Evaluations* for details). In prior years' publications, tax expenditure estimates for this credit were based on the original cost estimates for the measure, as published in Budget 2006. The decline in this tax expenditure relative to last year's publication reflects the availability of preliminary tax data for 2007.

[34] The increase in the projected tax expenditure reflects enhancements to the credit announced in Budget 2005 and Budget 2006. Specifically, Budget 2005 increased the maximum amount of the supplement from $571 to $750 per year, effective 2005, and Budget 2006 subsequently increased the maximum amount from $767 to $1,000, effective 2006.

[35] The age credit amount was increased by $1,000, from $4,066 to $5,066, in the Tax Fairness Plan (announced October 31, 2006, and confirmed in Budget 2007), effective 2006.

[36] The projected declines in this tax expenditure starting in 2006 are mainly explained by increases to the basic personal amount and other non-refundable credits relevant to seniors (such as the age credit and the pension income credit).

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

[38] The decline in this tax expenditure starting in 2006 reflects recent increases in the basic personal amount, reductions in the lowest personal income tax rate, increases in the spouse or common-law partner amount, and the introduction of the child tax credit.

[39] This tax expenditure is based on data received from Veterans Affairs Canada. As part of the New Veterans Charter, in 2006 the Canadian Forces Income Support Benefit was established as a tax-free amount for eligible low-income veterans.

[40] This tax expenditure is based on data received from Veterans Affairs Canada. As of 2006, the new Disability Award has replaced the Veterans Disability Pension for eligible new applicants (current disability pensioners have been grandfathered).

[41] This measure was introduced in Budget 2007, effective 2008.

[42] Budget 2006 increased the maximum amount that can be claimed under the pension income credit from $1,000 to $2,000 for the 2006 and subsequent taxation years. The introduction of pension income splitting in 2007 will increase the number of individuals claiming the pension income credit and thus increase the value of this tax expenditure.

[43] This measure, announced on October 31, 2006 in the Tax Fairness Plan and confirmed in Budget 2007, allows Canadian residents to allocate up to one-half of eligible pension income to their resident spouse or common-law partner, effective 2007.

Pension income splitting will have an impact on other tax expenditures starting in 2007. This measure reduces the effective tax rate on Registered Pension Plan (RPP) benefits and withdrawals from Registered Retirement Savings Plans (RRSPs) and Registered Retirement Income Funds, thus increasing the net value of the RPP/RRSP tax expenditures. Also, since eligible pension income allocated to a lower-income spouse retains its character, some couples will be able to receive a second pension income credit where previously only one was available. This increases the pension income credit tax expenditure. At the same time, since eligible pension income allocated to a lower-income spouse or common-law partner will raise his or her net income, estimates for the spouse or common-law partner credit tax expenditure are lower than they would be in the absence of pension income splitting.

[44] Estimates and projections vary from those in last year's report due to changes in tax rates and projected levels of contributions, withdrawals and investment income. In general, tax expenditure estimates and projections will be higher in years in which assets grow strongly, reflecting the tax forgone on that investment income, and lower in years in which assets grow slowly or decline. Recent financial market developments are reflected in the projections after 2007, mainly through lower forgone tax revenues on investment income. Recent market developments could also eventually result in increases in Registered Pension Plan contributions required to finance funding deficits, which would increase the tax expenditure. The required contributions, however, could be spread over several years. The 2008 *Economic and Fiscal Statement* allowed plans to extend their solvency funding payment schedule from 5 to 10 years (in respect of solvency deficiencies as at December 31, 2008).

[45] Estimates and projections vary from those in last year's report due to changes in tax rates and projected levels of contributions, withdrawals and investment income. In general, tax expenditure estimates and projections will be higher in years in which assets grow strongly, reflecting the tax forgone on that investment income, and lower in years in which assets grow slowly or decline. Recent financial market developments are partly reflected in the projections after 2007, mainly through lower forgone tax revenues on investment income. The projections also reflect a 25-per-cent reduction in the required minimum withdrawal from a Registered Retirement Income Fund for 2008 (see the "What's New in the 2008 Report" section for details).

[46] 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.

[47] The estimates and projections for this tax expenditure can vary from year to year, reflecting the cyclicality of the housing market and its impact on the number of residence resales and in the average price of residences. Estimates and projections are based on housing market data and forecasts provided by Canada Mortgage and Housing Corporation and the Canadian Real Estate Association.

[48] This measure was introduced in Budget 2006, effective July 1, 2006. Budget 2007 extended the credit to electronic fare cards and weekly passes used on an ongoing basis. In prior years' publications, tax expenditure estimates for this credit were based on the original cost estimates for the measure as published in Budget 2006 and Budget 2007. This year's publication reflects the availability of preliminary tax data for the 2006 and 2007 taxation years. The decline in this tax expenditure relative to last year's publication partly reflects tax changes introduced in Budget 2007 and the 2007 *Economic Statement* that reduced the number of individuals subject to tax.

[49] The projections include the revenue impact associated with both the enhanced dividend tax credit introduced in 2006, mainly applicable to dividends from large businesses, and the basic dividend tax credit applicable to other dividends, mostly from small businesses. Budget 2008 announced changes to the dividend gross-up and enhanced dividend tax credit beginning in 2010 to reflect general corporate income tax reductions announced in the 2007 *Economic Statement*.

[50] Prior to 2006, some families with young children who claimed little or no child care expenses were eligible to receive the Canada Child Tax Benefit (CCTB) under-7 supplement. Thus the value of the tax expenditure was partially offset by the increase in the CCTB under-7 supplement that would follow any decrease in the amount of child care expenses claimed. The increase in the tax expenditure in 2006 and later years reflects the phase-out of the CCTB under-7 supplement as of June 30, 2006, for children under the age of 6, and June 30, 2007, for 6-year-old children.

[51] Budget 2004 replaced the attendant care deduction with a broader disability supports deduction, beginning with the 2004 taxation year. Budget 2005 expanded the list of expenses eligible for the disability supports deduction.

[52] This tax expenditure represents the revenue impact resulting from the application of previous-year capital losses against the net capital gains realized in a particular year.

[53] Self-employed individuals may deduct the employer share of their Canada Pension Plan/Québec Pension Plan contributions paid for their own coverage. This is included in the tax expenditure for the non-taxation of employer-paid premiums.

[54] Projections include contributions paid to the Quebec Parental Insurance Plan (QPIP). The QPIP became effective January 1, 2006.

[55] The basic personal amount was increased by amounts over and above the inflation protection provided by full indexation in Budget 2005, Budget 2006 and the 2007 *Economic Statement*.

[56] Tax expenditure estimates and projections for this measure are not available, mainly because data on payouts/winnings are incomplete. 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 are available on the payouts/winnings from activities sponsored by charities and other non-government organizations.

It is important to note that 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 to ensure that the rights of the provinces in that field are not reduced or restricted.

[57] The tax expenditure has been adjusted to reflect the incorporation of new detailed administrative data supplied by the Department of National Defence for the 2007–08 fiscal year.

[58] Deductions of meals and entertainment expenses declined in 2004 and 2005 relative to 2003. This affects the projected tax expenditure for future years. Budget 2007 increased the deductible portion of the cost of food and beverages consumed by long-haul truck drivers during eligible periods of travel. Thus, the projected tax expenditure increases starting in 2007.

Table 2

*Corporate Income Tax Expenditures**

	Estimates				Projections[1]			
	2003	2004	2005	2006	2007	2008	2009	2010
	($ millions)							
Charities, Gifts and Contributions								
Deductibility of charitable donations[2]	245	510	385	500	480	410	405	430
Deductibility of gifts of cultural property and ecologically sensitive land	10	8	14	24	12	12	12	12
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)[3]	175	165	140	140	160	145	135	160
Political contribution tax credit[4]	S	S	S	S	S	–	–	–
Culture								
Canadian film or video production tax credit	145	180	175	190	200	205	215	225
Non-deductibility of advertising expenses in foreign media	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	1,210	1,455	1,645	2,045	2,125	2,000	2,055	2,240
Logging tax credit[5]	16	45	40	56	39	28	28	29
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	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Taxation of capital gains upon realization	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Partial inclusion of capital gains[6]	2,175	2,900	3,630	5,060	5,720	4,925	3,820	3,950
Expensing of advertising costs[7]	-190	20	-20	-140	-20	45	45	50
Atlantic investment tax credit								
Earned and claimed in current year	63	125	135	95	130	120	125	135
Claimed in current year but earned in prior years	86	135	280	75	180	170	175	190
Earned in current year but carried back to prior years	13	4	5	5	8	8	8	8
Total tax expenditure	162	264	420	175	318	298	308	333
Scientific research and experimental development investment tax credit[8]								
Earned and claimed in current year	1,745	1,965	2,075	2,305	2,565	2,715	2,870	3,035
Claimed in current year but earned in prior years	545	1,095	860	960	1,065	1,150	1,240	1,335
Earned in current year but carried back to prior years	110	120	100	110	110	110	110	115
Total tax expenditure	2,400	3,180	3,035	3,375	3,740	3,975	4,220	4,485
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.

* 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 website (www.fin.gc.ca), for a discussion of the reasons for this.

Table 2

Corporate Income Tax Expenditures (cont'd)

	Estimates				Projections[1]			
	2003	2004	2005	2006	2007	2008	2009	2010
	($ millions)							
Apprenticeship job creation tax credit[9]	–	–	–	20	55	70	75	75
Investment tax credit for child care spaces	–	–	–	–	S	S	S	3
Small Business								
Deduction of allowable business investment losses[10]	22	18	18	19	20	22	22	22
Low tax rate for small businesses[11]	3,225	3,045	3,395	4,100	4,470	4,070	3,930	3,855
Accelerated rate reduction for small businesses[12]	45	10	–	–	–	–	–	–
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[13]								
Dividends[14]	450	635	1,015	870	915	925	930	935
Interest								
On deposits	140	110	185	155	165	165	165	170
On corporate debt[15]	215	380	385	405	425	460	460	465
Other[16]	295	260	190	235	250	250	255	255
Rents and royalties								
Copyright royalties	29	28	38	35	37	37	37	37
Rents and royalties for the use of, or right to use, other property	120	91	115	105	115	115	115	115
Research and development royalties	6	4	4	4	4	4	5	5
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	68	72	84	82	87	87	88	89
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[17]	S	5	S	S	S	S	S	S
Deferral of income from grain sold through cash purchase tickets[18]	S	S	15	-5	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[19]	–	–	–	30	30	30	30	30

Table 2

Corporate Income Tax Expenditures (cont'd)

	Estimates				Projections[1]			
	2003	2004	2005	2006	2007	2008	2009	2010
	($ millions)							
Resource								
Corporate mineral exploration tax credit[20]	S	13	20	6	20	11	13	14
Deductibility of contributions to a qualifying environmental trust	S	S	7	3	3	S	S	S
Earned depletion[21]	11	25	40	32	33	22	21	21
Net impact of the resource allowance and the non-deductibility of Crown royalties and mining taxes[22]	77	11	44	17	5	–	–	–
Tax rate on resource income[23]	-230	-490	-615	-515	-120	–	–	–
Transitional arrangement for the Alberta Royalty Tax Credit[24]	S	S	S	S	S	–	–	–
Flow-through share deductions[25]	180	205	275	190	170	130	125	115
Reclassification of flow-through shares[26]	S	S	4	-3	-3	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[27]	100	85	115	120	125	130	140	145
Low tax rate for credit unions	74	61	56	65	66	63	61	55
Manufacturing and processing allowance[28]	500	95	–	–	–	–	–	–
Surtax on the profits of tobacco manufacturers[29]	-75	-55	-50	n.a.	n.a.	n.a.	n.a.	n.a.
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	S	S	S	S	S	S	S	S
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[30]	25	30	30	40	45	45	45	50
Interest credited to life insurance policies	75	81	79	84	84	86	89	93
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	S	S	S	S	S	S	S	S
Refundable capital gains for investment and mutual fund corporations[31]	55	115	345	415	475	415	325	340
Refundable taxes on investment income of private corporations[32]								
Additional Part I tax[33]	-805	-1,140	-1,540	-2,085	-2,325	-2,440	-2,470	-2,765
Part IV tax	-1,585	-1,995	-2,170	-2,580	-2,800	-2,710	-2,610	-2,760
Dividend refund	3,265	3,950	4,450	5,505	5,970	5,775	5,560	5,890
Net tax expenditure	880	815	740	840	845	625	480	365

Table 2

Corporate Income Tax Expenditures (cont'd)

	Estimates				Projections[1]			
	2003	2004	2005	2006	2007	2008	2009	2010
	($ millions)							
Recognition of 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.	n.a.	n.a.	n.a.
Loss Offset Provisions								
Capital loss carry-overs								
Net capital losses carried back[35]	460	220	79	61	115	130	140	135
Net capital losses applied to current year	190	360	290	660	630	595	585	585
Farm and fishing loss carry-overs								
Farm and fishing losses carried back	11	12	15	14	15	16	17	17
Farm and fishing losses applied to current year	20	29	37	58	31	29	29	29
Non-capital loss carry-overs								
Non-capital losses carried back	2,200	1,590	1,810	1,790	1,765	1,850	2,005	2,005
Non-capital losses applied to current year	3,995	4,895	5,860	5,325	5,520	5,080	5,040	5,160
Other								
Non-resident-owned investment corporation refund[36]	135	–	–	–	–	–	–	–
Partial deduction of meals and entertainment expenses[37]	345	345	360	415	430	400	390	390
Patronage dividend deduction	330	270	290	340	345	315	315	320

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 and improvements to the methodology used to derive the estimates/projections. The estimates and projections reflect the impact of reductions in the general corporate income tax rate from 25 per cent to 23 per cent on January 1, 2003, 21 per cent on January 1, 2004, 19.5 per cent on January 1, 2008, 19.0 per cent on January 1, 2009 and 18.0 per cent on January 1, 2010. The 4-per-cent corporate surtax (equivalent to a 1.12-per-cent corporate income tax rate), was eliminated on January 1, 2008.

[2] Donations in 2004 and 2006 were significantly higher than the historical average. The projections include the estimated impact of the Budget 2007 announcement permitting an additional deduction for donations of medicines to the developing world.

[3] The figures for 2005 and 2006 are projections based on 2004 non-profit organization information returns and the growth in gross domestic product.

[4] The Federal Accountability Act prohibits political contributions from corporations as of January 1, 2007. Some tax expenditure occurs in 2007, however, as many firms reporting income in the 2007 tax year earned a portion of that income in the 2006 calendar year.

[5] The credit used in the 2004 and 2005 tax years reflects significant improvements in industry performance in those years. The high use of the credit in 2006 in part reflects the settlement of the Canada-U.S. softwood lumber dispute.

[6] The drop in 2008 and 2009 reflects the impact of the current financial situation.

[7] The amount of this tax expenditure fluctuates significantly from year to year depending on the amount of advertising expenses claimed. Since this tax expenditure is estimated on a cash-flow basis, annual advertising costs above the average of the previous two years will result in a positive estimate of the tax expenditure. Advertising costs under this average will result in a negative tax expenditure. For more information about this measure, see the publication *Tax Expenditures: Notes to the Estimates/Projections*, published in 2004 and available on the Department of Finance website at www.fin.gc.ca.

[8] Figures for 2006 are based on the projected growth of investment tax credits.

[9] Actual data for 2006 show a substantially lower cost than indicated in Budget 2006. Projections for 2007 to 2010 have been revised downward as a result.

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

[11] The reduction in the tax expenditure between 2003 and 2004 results from the reduction in the benchmark rate, i.e. the general corporate income tax rate. The tax expenditure for 2003 and subsequent years reflects the impact of Budget 2003 and Budget 2006, which increased the amount of small business income eligible for the lower tax rate, and Budget 2004, which accelerated the Budget 2003 increase. In addition, Budget 2006 reduced the small business tax rate and the 2007 *Economic Statement* accelerated the rate reduction. Finally, the reduction in the tax expenditure between 2007 and 2010 reflects the reduction in the benchmark rate (see footnote 1).

[12] This measure was announced in Budget 2000 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 per cent. The decline in the tax expenditure is a result of the reduction in the general corporate income tax rate and the increase, announced in Budget 2003, 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 per cent. Some tax expenditure occurs in 2004, however, as many firms reporting income in the 2004 taxation year earned a portion of that income in the 2003 calendar year.

[13] Estimates and projections were computed on the basis of an analysis of payments to non-residents and withholding tax collections available for 1997 to 2005. Due to data limitations, the 2006 non-resident withholding tax expenditure is projected as opposed to estimated. Variations from last year's estimates and projections are mainly due to revised and new data, as well as to certain methodological changes.

[14] This category includes the tax expenditure attributable to the exemption of estate and trust income distributions, including distributions by income trusts. The significant increase in 2005 reflects growth in income trust distributions and dividend payments to residents of the United States.

[15] Budget 2007 announced agreement in principle on updates to the Canada-U.S. Tax Treaty, including an exemption from withholding tax for interest paid to U.S. residents. This exemption would be phased in for interest paid to non-arm's length U.S. residents and be fully effective in the year of ratification of the updated treaty for arm's length U.S. residents. Budget 2007 also announced the Government's intention to legislate an exemption from withholding tax for all interest payments to arm's length foreign lenders, effective as of the date on which the proposed changes to the Canada-U.S. Tax Treaty come into effect. This latter exemption was subsequently legislated with effect as of January 2008. Projections for this category therefore include the cost of the statutory exemption from withholding tax for interest payments to all arm's length non-U.S. foreign lenders starting in 2008. The changes to withholding tax rates for interest payments to U.S. lenders (both arm's length and non-arm's length) that were announced in Budget 2007 are contained in the Canada-U.S. Tax Treaty; these changes alter the benchmark and therefore do not affect the tax expenditure for this category.

[16] This category includes exemptions for interest paid to non-resident persons or organizations that would be exempt from income tax in Canada were they residents in Canada. Also included are exemptions on interest paid under certain securities-lending arrangements set out in subparagraph 212(1)(b)(xii) of the Income Tax Act, and interest exempt under certain other domestic and treaty provisions which, due to data limitations, cannot be specifically divided between benchmark items and tax expenditures.

[17] Estimates are based on actual data obtained from Statistics Canada.

[18] Projections are calculated using a historical average growth rate. Since this tax expenditure is 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 narrowly defined sector. Estimates, which include 2007 for this item, and projections are based on data obtained from Statistics Canada.

[19] This measure applies only to patronage dividends paid after 2005. See the "What's New in the 2005 Report" section at the beginning of the 2005 *Tax Expenditures and Evaluations* for further details about this measure.

[20] This credit was introduced in Budget 2003 and phased in at 5 per cent in 2003, 7 per cent in 2004 and 10 per cent in subsequent years.

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

[22] The tax expenditure is 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 was phased out and a deduction for Crown royalties and mining taxes phased in, so that by 2007, this tax expenditure is eliminated. Costs for 2007 relate to companies that do not have a December 31 year-end for which the 2007 year includes a portion of 2006. Year-to-year variation reflects volatility in the relationship between the resource allowance and Crown royalties. See the technical paper "Improving the Income Taxation of the Resource Sector in Canada" (Department of Finance, March 2003) for further details.

[23] The general corporate income tax rate was extended to resource income over a five-year phase-in period beginning in 2003. Although the rate difference between the general and resource rates no longer exists as of 2007, there are still costs in that year associated with 2006 rates for companies with off-calendar taxation years, for which the 2007 tax year includes some income earned in 2006.

[24] The Alberta government announced on September 21, 2006 that the Alberta Royalty Tax Credit (ARTC) program would be discontinued effective January 1, 2007. Although the ARTC no longer exists as of 2007, there are still costs in that year associated with the measure for companies with off-calendar taxation years, for which the 2007 tax year includes some royalty credits earned in 2006.

[25] See the description of the estimation methodology in the "What's New in the 2008 Report" section.

[26] See the description of the estimation methodology in the "What's New in the 2008 Report" section. The negative tax expenditure for 2006 and subsequent years reflects data indicating a decline in deemed Canadian Exploration Expenses transferred to corporations from 2005 to 2006 and a projected decline in exploration from 2006 to 2007.

[27] The figure for 2006 is a projection based on 2005 corporate income tax return data and the growth rate of gross domestic product.

[28] This measure was effectively eliminated on January 1, 2004, when the general corporate income tax rate was reduced to 21 per cent. Some tax expenditure occurs in 2004, however, as many firms reporting income in the 2004 taxation year earned a portion of that income in the 2003 calendar year.

[29] The decrease in this tax expenditure is due to the decrease in tobacco manufacturers' profits. For confidentiality reasons, estimates and projections for the 2006 to 2010 period are not published.

[30] The amount of this tax expenditure can fluctuate from year to year depending primarily on the level of construction activity.

[31] The amount of this tax expenditure can fluctuate from year to year depending on the amount of capital gains realized by the shareholders of these corporations. The drop in 2008 and 2009 reflects the impact of the current financial situation.

[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, see the publication *Tax Expenditures: Notes to the Estimates/Projections*, published in 2004 and available on the Department of Finance website at www.fin.gc.ca.

[33] This item includes the additional $6^{2}/_{3}$ per cent refundable tax on investment income as well as the Part I tax paid on investment income in excess of 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 large value in 2003 reflects, for the most part, the capital losses recorded in 2003 resulting from declines in the market value of technology stocks.

[36] This measure was repealed in 2000. To allow for an orderly restructuring of their operations, however, existing non-resident-owned investment corporations were entitled to retain their status until the end of their last tax year that began before 2003.

[37] In general, the Canadian tax system limits the deductibility of business-related meal and entertainment expenses to 50 per cent of the amount otherwise allowable as a deductible expense. Budget 2007 increased to 80 per cent, over five years, the deductible portion of the cost of food and beverages consumed by long-haul truck drivers during eligible periods of travel. This measure also applies to employers that pay, or reimburse, such costs incurred by long-haul truck drivers that they employ. This measure applies to eligible expenses incurred on or after March 19, 2007.

Table 3

*GST Tax Expenditures**

	Estimates[1]				Projections[2]			
	2003	2004	2005	2006[3]	2007[3]	2008[3]	2009	2010
	($ millions)							
Aboriginal Self-Government								
Refunds for Aboriginal self-government[4]	S	S	S	S	S	S	S	S
Business								
Exemption[5] 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[6]	20	15	20	20	20	15	15	15
Exemption and rebate for legal aid services	25	25	25	30	30	25	25	25
Non-taxability of certain importations[7]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Rebates for foreign visitors[8]	75	75	80	70	20	n.a.	n.a.	n.a.
Foreign Convention and Tour Incentive Program[8]	n.a.	n.a.	n.a.	n.a.	10	10	10	10
Small suppliers' threshold	170	180	195	195	190	170	175	185
Zero-rating[9] of high-cost agricultural and fishing equipment	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	270	285	295	300	290	255	265	280
Rebates for non-profit organizations	70	75	75	70	70	60	65	65
Education								
Exemption for education services (tuition)[6]	485	520	555	540	525	460	485	505
Rebates for book purchases made by qualifying public institutions	30	30	30	30	30	25	30	30
Rebates for colleges	85	80	80	80	80	70	70	75
Rebates for schools	380	400	425	430	415	360	380	400
Rebates for universities	240	260	270	260	250	220	230	240
Health Care								
Exemption for health care services[6]	495	520	585	575	555	490	515	545
Rebates for hospitals	425	465	515	515	500	435	455	480
Zero-rating of medical devices[6]	160	175	195	195	190	165	175	185
Zero-rating of prescription drugs[6]	600	645	725	730	710	620	650	680
Households								
Exemption for child care and personal services[6]	135	140	155	150	145	130	135	140
Goods and services tax/harmonized sales tax credit[10]	3,180	3,330	3,450	3,510	3,570	3,615	3,660	3,720
Zero-rating of basic groceries[6]	3,630	3,795	3,920	3,765	3,675	3,200	3,360	3,520

* 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 website (www.fin.gc.ca), for a discussion of the reasons for this.

Table 3

GST Tax Expenditures (cont'd)

	Estimates[1]				Projections[2]			
	2003	2004	2005	2006[3]	2007[3]	2008[3]	2009	2010
	($ millions)							
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)[6]	1,270	1,335	1,375	1,340	1,310	1,150	1,215	1,275
Rebates for new housing	830	915	960	900	915	815	845	890
Rebates for new residential rental property	50	55	55	50	50	45	45	50
Municipalities								
Exemption for municipal transit[6]	110	160	175	170	165	145	150	160
Exemption for water and basic garbage collection services[6]	200	235	255	260	250	220	230	240
Rebates for municipalities[11]	805	1,445	1,730	1,805	1,755	1,520	1,595	1,675
Memorandum Items								
Recognition of Expenses Incurred to Earn Income								
Rebates to employees and partners	115	115	115	105	100	85	85	85
Other								
Exemption for quick method accounting	215	230	245	240	235	200	210	220
Partial input tax credits for meals and entertainment expenses[12]	130	135	135	140	135	120	125	130

Notes:

[1] Unless otherwise indicated in the footnotes, estimates are based on administrative data from the Canada Revenue Agency and Statistics Canada.

[2] Unless otherwise indicated in the footnotes, changes in the projections from last year's report are the result of revised forecasts of economic indicators from the Department of Finance and the Conference Board of Canada.

[3] The goods and services tax rate was lowered from 7 per cent to 6 per cent effective July 1, 2006, and to 5 per cent effective January 1, 2008. The 2006 rate reduction lowers the tax expenditures for 2006 and 2007, and the 2008 rate reduction reduces them further for 2008, 2009 and 2010. In addition, there is more uncertainty than usual in the tax expenditure projections, as the economic effects of the rate changes are not yet reflected in the underlying data.

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

[5] Vendors are not entitled to claim input tax credits to recover the GST/HST paid on inputs to exempt supplies. Final consumers and businesses do not pay the direct sales tax on exempt goods and services.

[6] The National GST Model used to generate these estimates is based on the 2004 national input-output tables from Statistics Canada and the 2006 National Income and Expenditure Accounts.

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

[8] The Visitor Rebate Program (VRP) was replaced by the Foreign Convention and Tour Incentive Program effective April 1, 2007. Estimates for the VRP do not include amounts credited by suppliers at the point of sale.

[9] A large range of generally high-cost agricultural and fishing equipment is zero-rated to reduce cash-flow problems for farmers and fishers.

[10] Estimates are based on personal income tax data. The GST rate reductions do not affect the credit.

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

[12] Based on estimated expense claims reported for the personal and corporate income tax systems. Projections include the increased deductibility of meal expenses during eligible periods of travel by long-haul truck drivers. See footnote 37 in Table 2 for additional details.

Part 2
Research Report

Considerations in Setting Canada's Corporate Income Tax Rate

Introduction and Summary

The Government of Canada is committed to achieving the lowest overall tax rate on new business investment in the Group of Seven (G7). In order to achieve this objective, the Government announced in its October 2007 *Economic Statement* that the federal statutory tax rate on corporate income earned by large firms would be reduced from 22.12% (including the corporate surtax) in 2007 to 15% by 2012. This reduction has now been enacted through legislation. It builds on other actions that have made the tax system more neutral with respect to investment in specific assets and sectors, as well as the choice of business structure. These initiatives help ensure that investment is made on the basis of economic rather than tax considerations while also contributing to a lower tax burden on investment. The federal government is also encouraging the provinces to reduce their statutory rates to 10% by 2012, in order to achieve a combined federal/provincial rate of 25%. This paper discusses some of the considerations that are relevant in setting Canada's corporate income tax rate, particularly as they relate to international competitiveness.

Lower corporate income taxes result in more business investment by both domestic and foreign firms operating in Canada, which leads to new and better jobs and increased living standards for Canadians. The large volume of global capital that can be invested in a variety of locations makes foreign direct investment (FDI) highly sensitive to tax rate differentials. Tax reductions also help protect the tax base, which mitigates the revenue loss associated with lower tax rates. An important, but by no means the only, consideration in setting Canada's corporate income tax rate is therefore international competitiveness.

A complicating factor in setting a competitive tax rate in this context is that some of Canada's key competitors have international tax regimes designed to make their multinational enterprises (MNEs) indifferent between investing at home and abroad despite lower tax rates in foreign countries. This raises the prospect that tax reductions might reduce tax revenues without having a large impact on investment. An examination of this "treasury transfer" effect indicates, however, that it is not likely to be a large concern in Canada's case.

This paper considers the cost-effectiveness of tax reductions—defined as the additional investment per dollar of tax revenue forgone—when assessing how Canada should position itself on corporate income taxation. The adverse effects of taxes on domestic investment, FDI and the tax base all increase as tax rates rise, which results in smaller revenue gains from successive rate increases along with growing negative impacts on investment. Tax reductions reverse this process: cuts are highly cost-effective over a certain range of rates but become less so with successive rate reductions. Declining cost-effectiveness does not mean that the benefits of lower tax rates disappear as rates are brought down; but it does mean that benefits per dollar of revenue forgone diminish.

The evidence reviewed in this paper suggests that with a 25% statutory rate of corporate income tax, Canada would be well placed to encourage domestic investment, attract FDI and protect its tax base. Analysis is required on an ongoing basis, however, since the appropriate position for Canada at any given time must take into account corporate income tax rates in other countries, which are subject to frequent change, as well as evolving trade and investment patterns. In addition to competitiveness, corporate income tax policy is affected by more general considerations such as fairness, simplicity and its impact on economic efficiency.

The outline of this paper is as follows: First, it discusses how taxes affect business investment and the allocation of profits across countries. Second, it sets out a framework for assessing the cost-effectiveness of corporate tax reductions. Third, it reviews the role of international competitiveness in determining how Canada should position itself on corporate tax rates. Fourth, it assesses the potential for a treasury transfer effect as the statutory rate is reduced. Finally, it discusses the benefits of provincial participation in reducing corporate taxes.

Lower Taxes Increase Business Investment and Protect the Tax Base

The decision to invest is sensitive to the expected rate of return on the investment. Taxes clearly affect the rate of return on investment, so there is a theoretical expectation that tax reductions will raise business investment. Recent empirical work confirms this expectation. For example, a recent Department of Finance study[3] examined the impact of the federal corporate income tax rate reductions implemented over the 2001 to 2004 period and found a strong relationship between taxation and investment: a 1% reduction in the cost of capital arising from lower taxes raised investment by 0.7%. This finding is consistent with a number of other studies that have examined the impact of taxes on investment.[4]

Tax rates impact investment decisions by both domestic and foreign firms. As production facilities can be located in a variety of countries, inbound FDI is highly sensitive to tax rate differentials. There are a large number of studies[5] demonstrating that FDI responds to both the statutory rate of corporate income tax and the overall tax burden on a new investment—the marginal effective tax rate or METR.[6] A key assumption underlying the calculation of the METR is that the investment being considered has an expected rate of return, adjusted for risk and inflation, equal to the minimum return required by the suppliers of financial capital. That is, the METR applies to the "normal" rate of return on the investment while above-normal returns are taxed at the statutory rate, so both can affect investment decisions.

Canada, like other countries, obtains substantial benefits from attracting (and retaining) investment by MNEs: the corporate tax base expands and the use of innovative technology and management techniques can spill over to domestic firms. For example, researchers at Statistics Canada "find robust evidence for productivity spillovers from foreign-controlled plants to domestic-controlled plants."[7]

In addition to affecting the global distribution of FDI, statutory rates affect the global distribution of profits. MNEs have an incentive to arrange their financial activities in a tax-efficient manner across countries in order to minimize their worldwide tax liabilities. As a result, lower statutory tax rates will help protect the tax base by better aligning Canada's share of global taxable income with its share of global investment. Studies examining profit allocation strategies used by MNEs typically find a substantial impact from differences in statutory tax rates.[8]

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3 Department of Finance Canada (2007).

4 These studies are summarized in Department of Finance Canada (2007) and Parsons (2008).

5 See de Mooij and Ederveen (2003) for a review of studies based on data up to the early 1990s. More recent studies include Altshuler and Grubert (2004) and de Mooij and Ederveen (forthcoming). These studies examine the impacts of both statutory rates and marginal effective tax rates on FDI flows.

6 A detailed discussion of the METR methodology is available in Department of Finance Canada (2005).

7 Baldwin and Wulong (2005). See also Griffith, Redding and Simpson (2004) and Anon-Higon and Vasilakos (2008).

8 See Zodrow (2008) for a review of these studies.

Cost-Effectiveness of Tax Reductions

Taxes have an unavoidable impact on economic efficiency by affecting decisions to invest, save and work. These negative impacts become stronger as tax rates rise, which shows up in lower revenue gains in response to successive tax rate increases. Further, beyond a certain point, higher tax rates are likely to be counterproductive: the disincentives created could cause the tax base to shrink by enough to offset the direct impact of the rate increase and total revenues could actually decline. This is commonly referred to as the "Laffer Curve"[9] effect. At a low tax rate, total revenue rises rapidly as the tax rate increases, but at higher levels, successive rate increases generate less additional revenue as rising rates create more disincentives and may ultimately cause revenues to fall.

This relationship indicates that the cost-effectiveness of tax reductions, defined as the additional investment per dollar of tax revenue forgone, varies with the level of tax rates. At relatively high rates, the sensitivity of revenues to tax rate changes is low, but the adverse effect on investment is relatively high, implying a particularly high cost-effectiveness of tax reductions. At lower rates, investment continues to increase but at a slower pace, while the loss in revenue grows larger, indicating a declining cost-effectiveness of tax reductions.

A number of researchers have developed empirical estimates of the Laffer Curve.[10] The methodology may not, however, be robust enough to allow identification of either the peak of the Laffer Curve, where further tax increases result in less revenue, or the range in which rate reductions become less cost-effective.[11] The available empirical estimates are far from definitive due to a number of factors, including the following:

- There is insufficient information to control for the possibility that the observed association of lower rates with higher revenues arises because low rates are accompanied by measures to broaden the tax base.
- Empirical work does not take into account administrative and institutional factors that may affect the incentive for MNEs to allocate taxable income to a particular country, which would make it more difficult to estimate precisely the impact of statutory rates on revenues.

These considerations suggest that while the Laffer Curve provides a useful analytical framework, it does not provide explicit guidance on the appropriate level for the corporate income tax rate. Further analysis is required in order to determine the cost-effectiveness of rate reductions, including consideration of Canada's competitors for mobile capital. This is addressed in the next section.

[9] The point at which higher tax rates could result in less rather than more revenue was articulated by Arthur B. Laffer, but the first formal presentation was by Wanniski (1979).

[10] Brill and Hassett (2007), Clausing (2007) and Mintz (2007).

[11] See, for example, Gravelle and Hungerford (2008) for a detailed critique of both the theoretical underpinnings of the Laffer Curve and recent empirical estimates of its shape.

International Competitiveness Considerations

International competitiveness has two aspects: attracting and retaining FDI and protecting the tax base to ensure that a country's share of global profits is broadly aligned with its share of global investment.

With respect to attracting and retaining FDI, one method of determining precisely who are Canada's competitors for FDI would be to assume that globalization has progressed to such an extent that MNEs "compete with everyone from everywhere for everything."[12] While this may be a reasonable assessment for some firms, taking it literally would imply reducing the corporate tax rate below that of any conceivable competitor. Adopting such a tax rate is unlikely to be cost-effective—the benefits of tax reductions would decline substantially as tax rates are lowered below rates in countries that are not realistic alternatives to investment in Canada, or that account for a small share of world FDI.

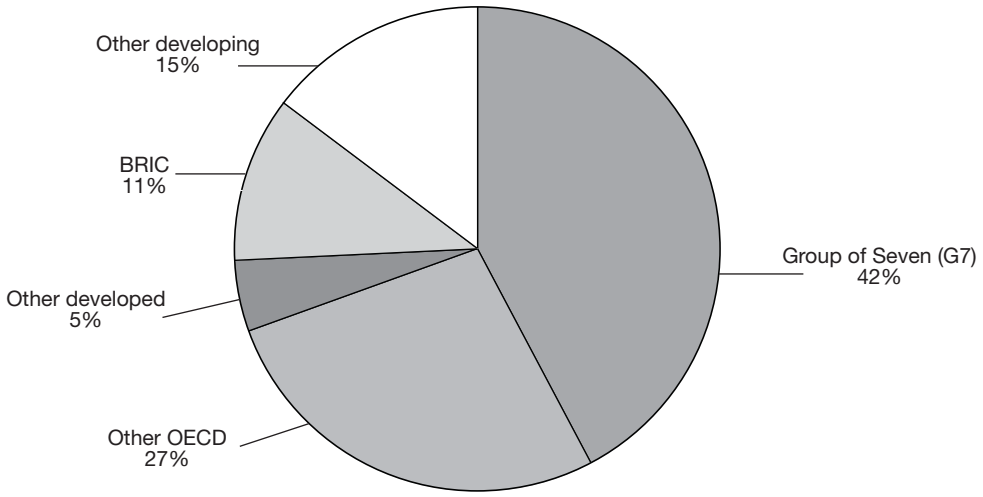
Another approach to determining competitors would be to identify which countries are the significant sources of inbound FDI (by foreign firms investing in Canada) and destinations for outbound FDI (by Canadian firms investing abroad). These flows are dominated by transactions with the United States and a small number of other countries (see annex). This approach may be too restrictive, however, since it does not recognize that countries supplying FDI to Canada would not necessarily only be comparing after-tax rates of return in Canada and the home country. In many cases, suppliers of FDI would be comparing after-tax rates of return in many countries. For example, a US MNE considering an investment abroad could be comparing Canada with Mexico, which is not an important source or destination of Canada's FDI. On the other hand, a number of the important destinations for Canada's outbound FDI are small countries without a substantial economic base, suggesting that they are not the ultimate destination of the FDI outflow and therefore that they are not competing with Canada for real investment.

A third method would be to examine Canada's trading partners, since a substantial proportion of FDI is made in support of trade flows. For example, MNEs may decide to serve a foreign market from a facility in or near that market as well as from their home country. Such firms exporting to Canada would be comparing competitiveness in Canada and at home, while Canadian exporters would be undertaking a parallel calculation. In addition, Canadian firms "outsourcing" the production of goods or the supply of services may also invest in the source country to enhance security of supply and to protect intellectual property. Canada's trade flows are dominated by the US and several of the other countries that are important suppliers of or destinations for Canada's FDI. The analysis confirms that Mexico should be included and suggests that China be added to the list of potential competitors for mobile capital (see annex).

[12] Sirkin, Hemerling and Bhattacharya (2008).

The final approach considered here is to examine global FDI inflows by destination country, which recognizes that suppliers of capital compare after-tax returns in a number of countries. Almost 70% of the world's inbound FDI is directed to the 30 industrialized countries that are members of the Organisation for Economic Co-operation and Development (OECD); two other developed economies (Hong Kong Special Administrative Region, or SAR, and Singapore) account for a further 5% (Chart 1). This exercise also highlights the importance of the large and rapidly growing emerging economies of Brazil, Russia, India and China (BRIC), which are the destination for approximately 10% of global inbound FDI. This approach suggests that 35 countries are potentially important competitors for FDI. Note that this approach captures all of the countries that are important final destinations for Canada's outbound FDI.

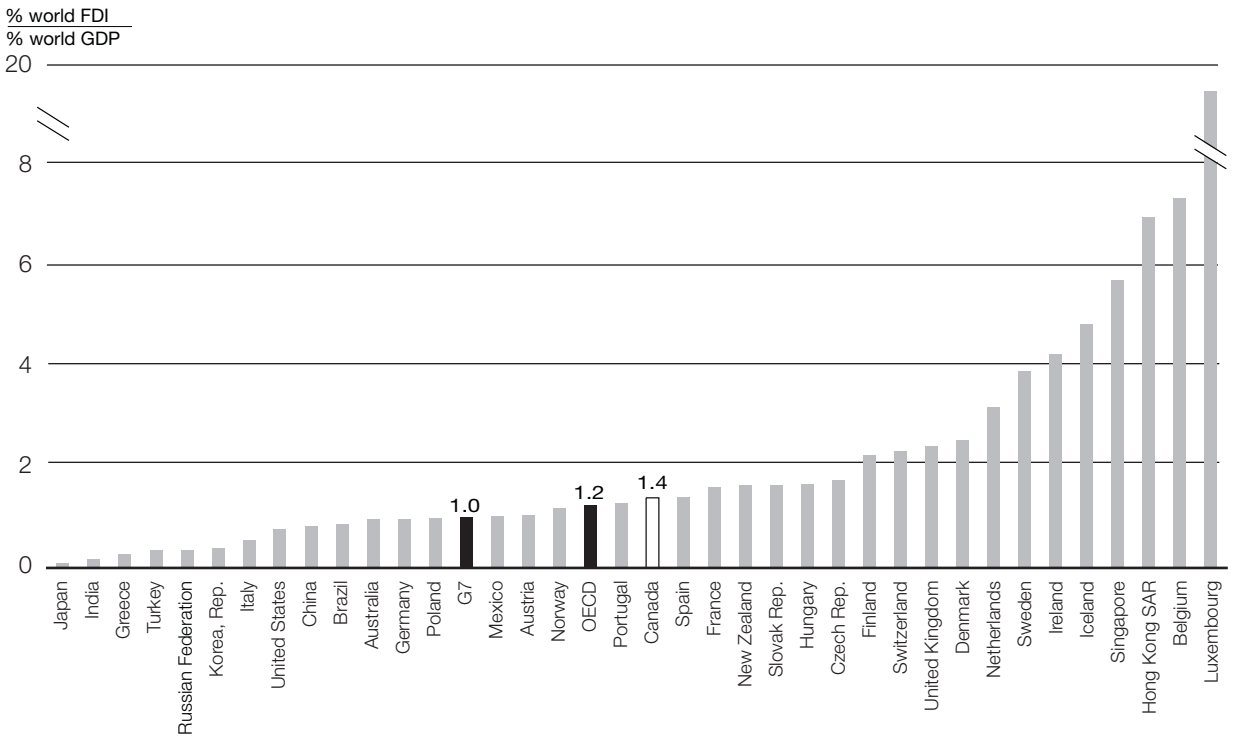
Chart 1
Share of Total World FDI Inflows
(10-Year Average, 1997–2006)



Source: United Nations Conference on Trade and Development (UNCTAD) FDI online database.

Further analysis of FDI flows to these countries suggests, however, that they may not always be the ultimate destination for the inflows. Some of these countries receive a share of world FDI that is highly disproportionate to their share of world output (Chart 2). Defining what is highly disproportionate requires some judgement, but Singapore, Hong Kong SAR, Belgium and Luxembourg are exceptional cases—it is highly likely that a substantial portion of their inflows are reinvested in other countries, a situation that has led some observers to describe such countries as "conduits" because they have large flows of both inbound and outbound FDI.[13] Iceland, the Netherlands and Switzerland are also characterized by FDI inflows and outflows that are large relative to their output. In most cases, these large two-way flows increase the tax base without a commensurate rise in real investment. For example, some of these countries have special provisions unrelated to statutory rates that make them attractive locations for managing intra-group financial activities. As a result, attempting to compete with these seven countries on the basis of statutory tax rates is not likely to result in either substantial additional inflows of FDI or provide additional protection to Canada's tax base, leaving 28 countries as important competitors.

Chart 2
Share of World FDI Relative to Share of World GDP
(10-Year Average, 1997–2006)



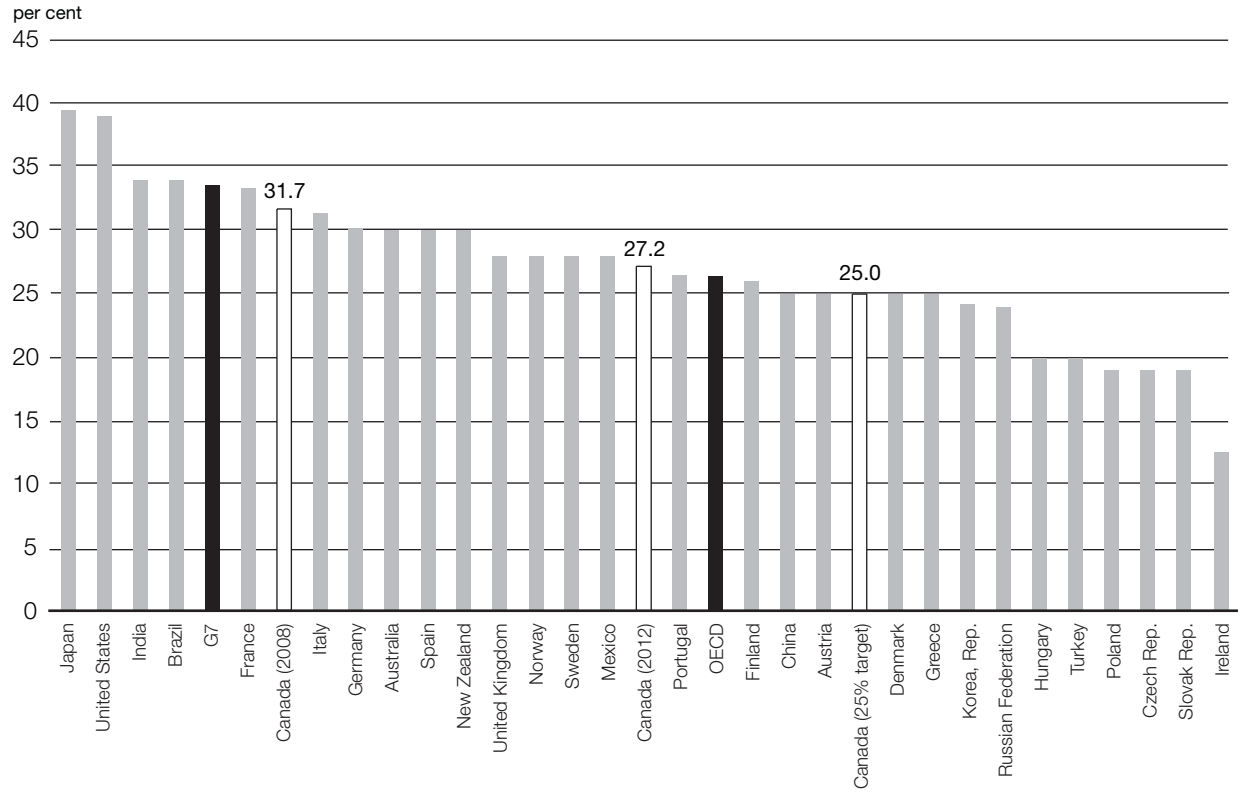
Sources: UNCTAD; IMF, World Economic Outlook database.

[13] See, for example, Mintz (2004).

With respect to protecting the tax base, or ensuring rough alignment of global shares of taxable income and investment, the list of potential competitors is much longer. Considering only those countries with a substantial economic base, however, eliminates countries that use extremely low tax rates to attract global taxable income but not real investment. With this limitation, protecting the tax base involves considering competitiveness with virtually the same 28 countries identified above.

In 2008, only five countries—Japan, the United States, India, Brazil and France—in this group of 28 potential competitors have a higher tax rate than Canada's average federal/provincial statutory tax rate of 31.7%. Based on tax rates in place or announced as of November 2008, the Canadian average rate will be 27.2% in 2012. This rate will be competitive with those of half of the countries identified as key competitors (Chart 3) accounting for almost 60% of adjusted global FDI flows.[14] A rate of 25% would make Canada competitive with an additional eight countries (from Portugal to the Russian Federation in Chart 3) accounting for about 13% of global FDI inflows, bringing total "coverage" to almost three-quarters of both global FDI and global gross domestic product (GDP). The next five countries, with statutory rates ranging from 20% to 19%, account for about 3% of FDI inflows and global GDP, suggesting a decline in cost-effectiveness from reducing Canada's statutory rate below rates in these countries. The last remaining country, Ireland, has a 12.5% statutory tax rate.

Chart 3
International Comparison of Statutory Tax Rates[1]



[1] Includes tax parameters in force by 2012 legislated as of September 1, 2008 and November 19, 2008 (Canada). G7 and OECD: averages excluding Canada.

[14] All FDI shares in the remainder of this section include an adjustment for the artificial increase in FDI inflows due to flows into conduit countries.

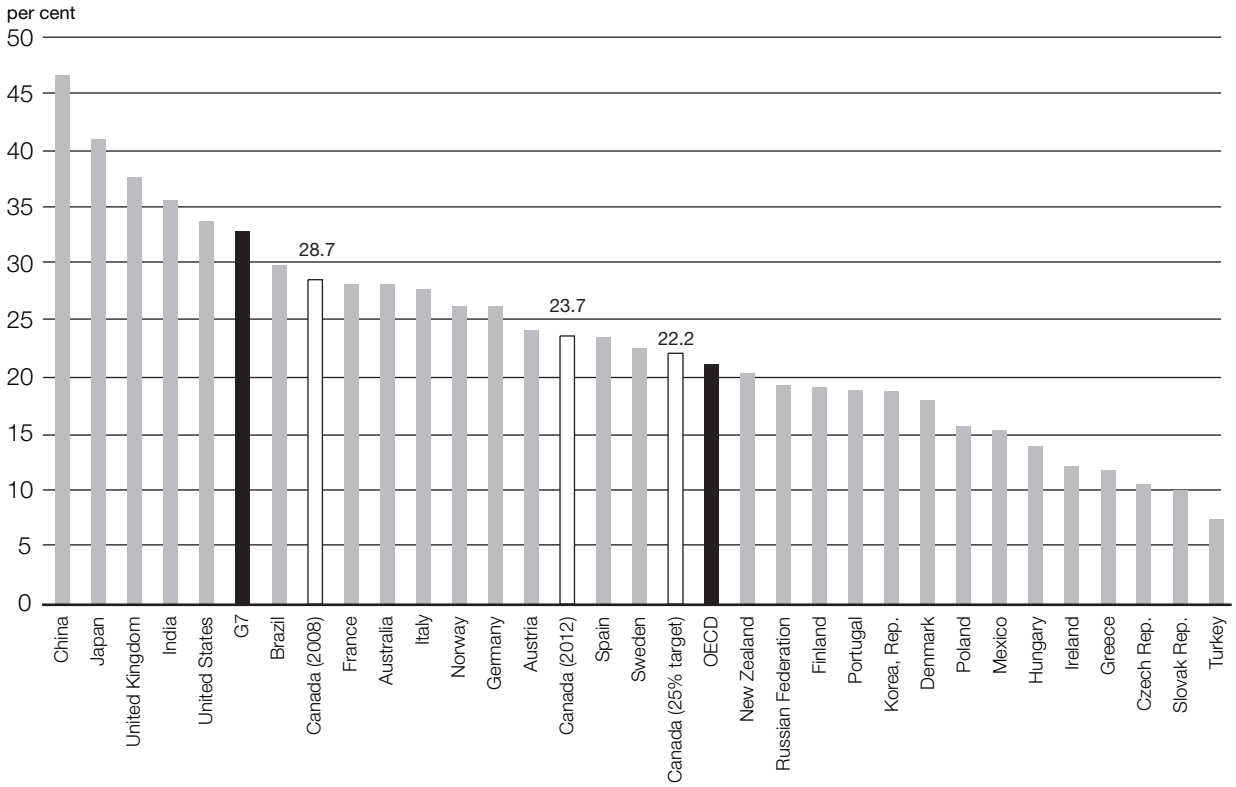
While the "headline" statutory rate is an important signal about competitiveness, the marginal effective tax rate (METR), which takes into account other features of the tax system that affect the burden of taxation, is also an important indicator of competitiveness, as measured by the ability to attract and retain FDI. Assuming no further tax rate changes in other countries, a 25% statutory rate would give Canada a METR that is competitive with 14 of the 28 countries in the comparison group, ranging from China to Sweden in Chart 4. These 14 countries include all of the other G7 countries, all of the BRIC countries except Russia, Australia and four smaller European nations, which account for about two-thirds of global FDI inflows and global GDP.

Many of the remaining 14 countries have substantially lower per capita incomes than Canada and other countries in the comparison group, which may make them less important competitors for world FDI flows. Even without considering this possibility, however, further rate reductions would be subject to declines in cost-effectiveness. For example, cutting the target statutory rate in half would lower the METR sufficiently to compete with an additional nine countries that account for only about 9% of world FDI. Nevertheless, reducing the METR below 22% would still provide a net benefit to Canada by increasing domestic investment and drawing in some additional FDI.

In summary, based on current international tax rates as well as trade and investment flows, statutory rate reductions below 25% are likely to result in smaller gains in competitiveness, as measured by the additional FDI that could be redirected to Canada and lower potential revenue gains from protecting Canada's tax base. This type of evidence, however, needs to be reassessed from time to time in order to take into account changing tax parameters in various countries, as well as the evolution of trade and investment patterns. Considerable judgement is required to determine Canada's competitors for mobile capital.

Chart 4

International Comparison of Marginal Effective Tax Rates[1]



[1] Includes tax parameters in force by 2012 legislated as of September 1, 2008 and November 19, 2008 (Canada). G7 and OECD: averages excluding Canada.

The Treasury Transfer Effect

Taxpayers in certain countries, in particular the United States and the United Kingdom, are taxed by their home jurisdiction on their worldwide income, with a credit for foreign taxes paid. For MNEs based in these countries, income earned from investments in another country is taxed, in principle, at the higher rate of either the host or the home country, although in practice other tax rules can affect this result. In the case of FDI in Canada by MNEs based in these countries, it is therefore possible that lower taxes in Canada would not reduce the overall tax liability of the MNE. Under the "treasury transfer effect," the revenue forgone by Canada could simply reduce the amount that the home country allows as a credit for foreign (i.e. Canadian) taxes, thereby increasing taxes payable in the home country. Such an outcome would result in a revenue loss for Canada without any favourable impact on investment.

This is a potentially important concern with respect to the US, since it supplies about half of Canada's inbound FDI. The UK, which accounts for 13% of Canada's inbound FDI, announced in late November its intention to introduce legislation in 2009 to exempt foreign dividends from UK tax. The tax treatment of foreign source income is also under review in the US.

Given current institutional arrangements, however, the transfer of tax revenue to the US treasury should not now be considered a serious constraint on Canada's choice of statutory rate:

- Many analysts hold the view that the US credit system does not affect investments financed by retained earnings, which account for about one-third[15] of Canada's FDI from the US. According to this view, since a US firm with a subsidiary in Canada has to pay an additional tax on repatriation either up front (by distributing the earnings immediately to the US parent) or at the end of the investment period, the repatriation tax will not affect the decision of where to invest retained earnings. Retained earnings will be allocated to the country that has the higher after-tax rate of return.[16]
- US MNEs are also able to use tax-planning techniques to indirectly repatriate income from low-tax jurisdictions without incurring additional US tax.[17]
- US MNEs are able to pool incomes from high- and low-tax jurisdictions when calculating additional US taxes payable upon repatriation of dividends, so a low rate in Canada would not necessarily result in a treasury transfer.

In addition, in 2004, US MNEs were allowed a one-time, 85% tax-free repatriation of dividends from controlled foreign corporations, provided that the funds were reinvested in the US. As a result, firms may be adjusting the expected value of the repatriation tax for the probability that such an event will occur again.

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[15] Over the 10 years ending in 2007, retained earnings accounted for 35.7% of total FDI, but only 10.4% over the last 5 years.

[16] This view was first articulated by Hartman (1985). See also Sinn (1993) for a discussion of how the repatriation tax could affect the size of the initial investment abroad by a US MNE. As discussed in footnote 17, less definitive results are obtained if subsidiaries are assumed to be able to invest in other affiliated corporations in addition to reinvesting or repatriating their earnings (Altshuler and Grubert [2003]).

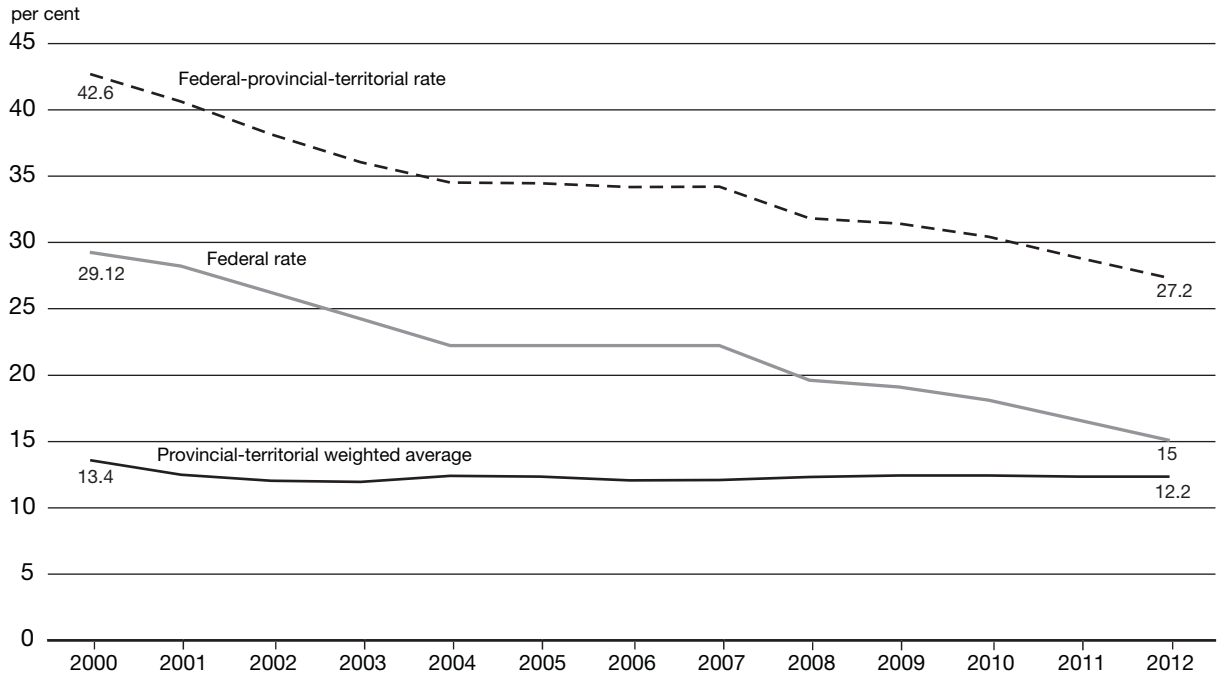
[17] As described in Altshuler and Grubert (2003), one way to achieve this outcome is to have a subsidiary in a low-tax jurisdiction invest in an affiliated firm in a high-tax jurisdiction. This equity injection is used to fund the operations of the high-tax affiliate. If all of the earnings in the high-tax affiliate are paid out in dividends to the low-tax affiliate, the equity investment of the parent can be returned without US tax consequences. Dividends paid by the high-tax affiliate to the low-tax affiliate will not incur any taxes (they will be either exempt or sheltered by tax credits), and when these dividends are eventually repatriated the taxes paid in the high-tax jurisdiction will be creditable against US taxes. The end result is repatriation of earnings from a low-tax jurisdiction with no additional US taxes payable, although there is an additional cost in the form of higher taxes on the earnings of the low-tax affiliate that are invested in the high-tax affiliate.

Finally, the maximum foreign tax credit allowed under US tax law is substantially less than foreign taxes actually paid due to the allocation of expenses incurred by the US parent to foreign subsidiaries in calculating the credit and different definitions of taxable income under Canadian and US tax rules. As a result, it appears that Canada could reduce its statutory rate of corporate income tax substantially below the US rate without creating potential additional US tax liabilities on repatriated dividends. This "threshold" rate is further reduced by the existence of withholding taxes on dividend payments.[18]

The Benefits of Lower Provincial Business Taxes

At 15%, the federal statutory corporate income tax rate in 2012 will be 14 percentage points lower (including the elimination of the corporate surtax) than in 2000. In contrast, based on changes now legislated, the weighted average provincial statutory tax rate in 2012 will be only slightly more than 1 percentage point lower than in 2000. Reaching the 25% target would require all provinces, except Alberta and British Columbia,[19] to reduce their general corporate tax rate to 10% (Chart 5).

Chart 5
Federal and Provincial-Territorial Corporate Income Tax Rates (2000 to 2012)



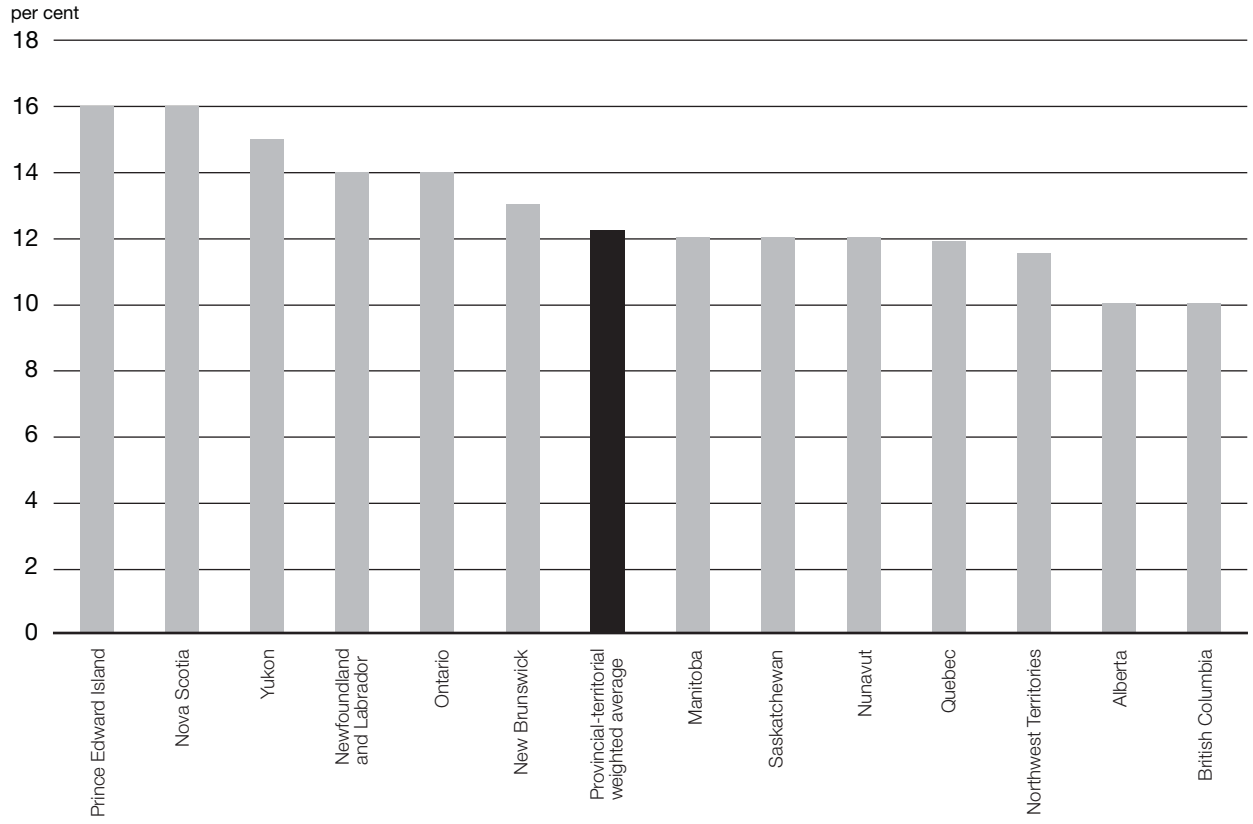
[18] There is a 5% withholding tax on dividends arising from direct investment repatriated to the US. This withholding tax increases the effective tax rate on repatriated earnings, and hence reduces the threshold rate by 3.75 percentage points, assuming a 25% combined federal-provincial tax rate. This estimate is obtained by multiplying one minus the statutory rate (i.e. after-tax income on $1 of profits) by the withholding tax rate.

[19] The corporate income tax rate is 10% in Alberta and will be reduced to 10% in British Columbia by 2011.

A uniform 10% provincial corporate income tax rate would lower the weighted average rate by 2.2 percentage points. This decline would reduce the METR by 1.5 percentage points, which would stimulate additional investment by domestic and foreign firms. In addition, provinces lowering their tax rates would help protect their tax bases from international competition.

Provincial tax rates projected for 2012 range from 10% to 16% (Chart 6). Uniform provincial tax rates would help ensure that investment decisions within Canada are made on the basis of economic rather than tax considerations, which would improve economic efficiency in Canada overall and in the provinces reducing taxes. By reducing incentives for interprovincial tax planning, a uniform provincial corporate income tax rate would also help protect the tax bases of the provinces and simplify tax compliance for corporations.

Chart 6
Provincial-Territorial Corporate Income Tax Rates (2012)



Annex—An Analysis of Canada's Foreign Direct Investment

Canada's foreign direct investment (FDI) inflows and outflows are concentrated among a small number of developed countries and key trading partners. Canada's inbound FDI is predominantly directed to goods-producing industries.[20] Mergers and acquisitions comprise the bulk of Canada's inbound FDI; investment in new plant and equipment, from either retained earnings or cross-border flows, accounts for less than 40% of total inbound FDI.

Over 90% of FDI flows into Canada come from 10 countries. The top five source countries (the US, the UK, the Netherlands, Brazil and France) account for 80% of total inflows[21] (Table A-1). Half of Canadian FDI outflows are to the US and the UK. The Bahamas, Barbados, Bermuda, and the Cayman Islands figure prominently as Canadian FDI destinations, comprising 21% of total Canadian outbound FDI, but given the limited economic base in these countries, they are probably not the final destinations of the outflows.

Table A-1

Top 10 Sources and Destinations of Canadian FDI (Average Share of Total Flows, 1998 to 2007)

Foreign Direct Investment in Canada (Inflows)			Canadian Direct Investment Abroad (Outflows)		
		%			%
1	United States	52.1	1	United States	39.0
2	United Kingdom	12.7	2	United Kingdom	10.8
3	Netherlands	7.7	3	Barbados	8.1
4	Brazil	4.1	4	Cayman Islands	5.6
5	France	3.7	5	Bermuda	4.4
6	Switzerland	2.9	6	Ireland	3.8
7	Luxembourg[1]	2.4	7	France	3.7
8	Sweden	2.2	8	Bahamas	2.9
9	Germany	1.8	9	Hungary	2.3
10	Japan	1.8	10	Switzerland	2.2

[1] Average from 1999 to 2007 due to lack of 1998 data.

Source: Calculated using Statistics Canada CANSIM Table 376-0051.

An examination of trading patterns produces a less extensive yet complementary list of international investment competitors. Based on existing trade relations, Canada's competitiveness concerns would be focused on the US and a handful of other countries. The top five countries ranked by the sum of export and import shares account for 87% of exports, 75% of imports and 81% of total trade flows

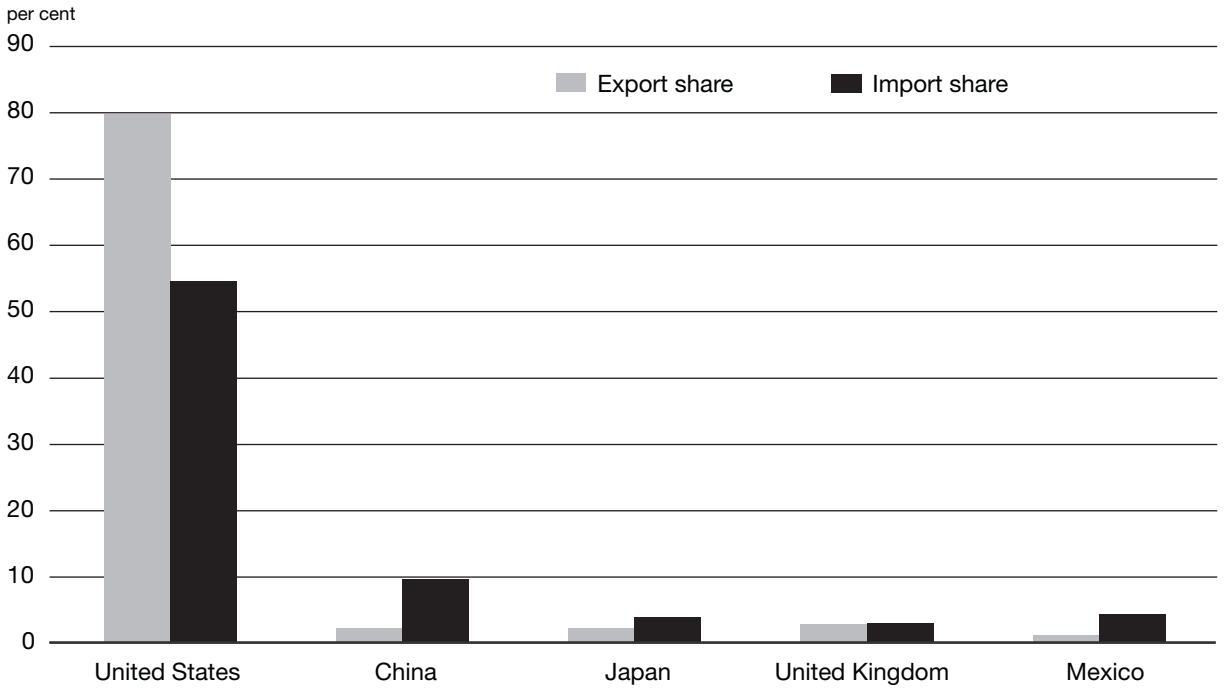
[20] In recent years, about 60% of inbound FDI has been directed to goods-producing industries, which are highly exposed to international trade, suggesting that substantially more than half of FDI is made in support of trade flows. Goods-producing industries exclude utilities and construction in order to focus on goods that are highly exposed to international trade. Using this definition, goods-producing industries account for 23% of total output in Canada.

[21] Note that the Netherlands, as well as Switzerland and Luxembourg, are characterized by high flows of both inbound and outbound investment, suggesting that these countries may not be the original source of the FDI attributed to them.

(Chart A-1). But both domestic and foreign firms invest in Canada to support exports to the US, so additional countries should be brought into the comparison even if they do not have substantial direct trade relations with Canada. For example, a British firm may compare Canada with other locations to serve the US market, most frequently after they have decided to invest in production facilities abroad. In addition to the US itself and Mexico, some countries in Central and South America, particularly Brazil, would be competitors for Canada's inbound FDI.

Inbound FDI in the service sector, which accounts for 40% of inbound FDI, is unlikely to be substantially affected by trade patterns since the service sector is overwhelmingly oriented to the domestic market.[22] The suppliers of Canada's inbound FDI directed to the service sector are very similar to the suppliers of FDI for the goods-producing sector: the US accounts for just over 50% while Europe accounts for most of the remainder.[23] While investors in Canada's service sector could be comparing potential after-tax returns in a wide range of countries,[24] the most relevant comparison may be with rates of return available in countries at a similar stage of development. Viewed in this light, distinguishing between FDI directed to goods and services suggests that many developed economies, not just the trading partners identified above, are competitors for Canada's inbound FDI.

Chart A-1
Canada's Top Five Trading Partners
(Percentage of Merchandise Trade, 2007)



Source: Statistics Canada, Catalogue no. 65-001-XIB.

[22] Between 2002 and 2007, trade in services (excluding transportation of goods) accounted for about 11% of receipts and 14% of payments in Canadian goods and services trade.

[23] Data on FDI by sector is only available for the US and major geographic regions.

[24] For example, Wal-Mart has expanded into Canada's retailing sector, but also into China, Japan, the UK and eight countries in Central and South America.

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