

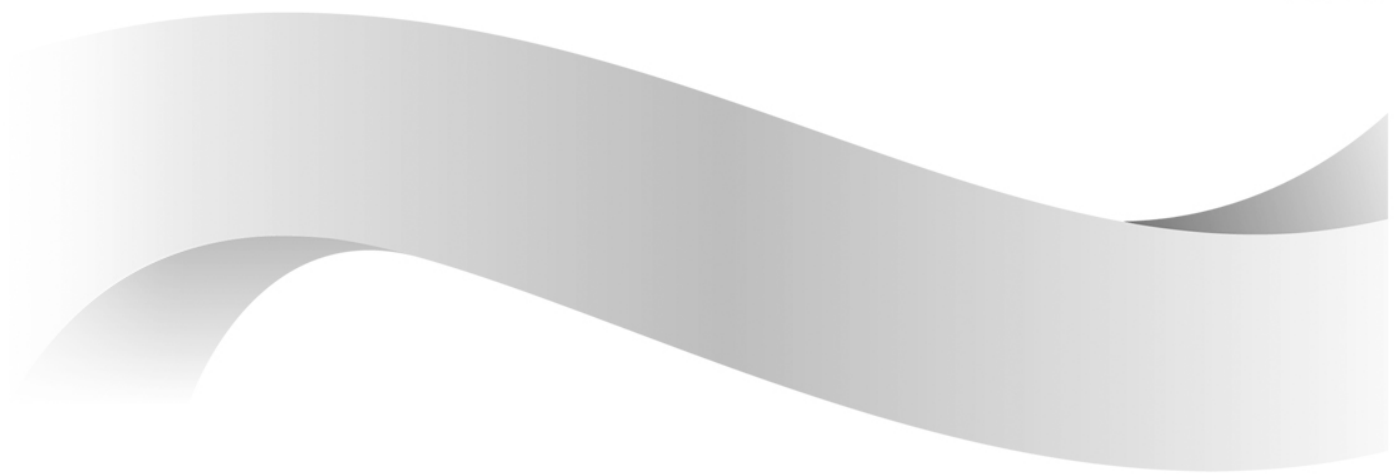


Department of Finance
Canada

Ministère des Finances
Canada

Tax Expenditures and Evaluations

2013



Canada

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Preface

The Department of Finance first reported on federal tax expenditures in December 1979, and has published estimates and projections of tax expenditures for personal and corporate income taxes as well as for the Goods and Services Tax (GST) since 1994. Beginning in 2000, the tax expenditure report has been separated into two documents. This document, *Tax Expenditures and Evaluations*, is published annually. It provides estimates and projections for broadly defined tax expenditures as well as evaluations and analytical papers addressing specific tax measures. This year's edition includes a statistical perspective on flow-through shares as well as a paper on the taxation of small businesses in Canada.

The second document, *Tax Expenditures: Notes to the Estimates/Projections*, is a reference document which presents the objective of each tax expenditure and explains how the estimates and projections are calculated. This document is published periodically and the 2010 edition is available on the Department of Finance website.

Part 1

Tax Expenditures: Estimates and Projections



Introduction

The principal function of the tax system is to raise the revenues necessary to fund government expenditures. The tax system can also be used directly to achieve public policy objectives through the application of special measures such as low tax rates, exemptions, deductions, deferrals and credits. 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 part of the benchmark tax system and hence about what should be considered a tax expenditure.

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 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.

A more detailed discussion of how the estimates and projections of the tax expenditures are calculated is available in the 2010 edition of *Tax Expenditures: Notes to the Estimates/Projections*.

Caveats

Care must be taken in interpreting the estimates and projections of tax expenditures presented in this document 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 in some cases, 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 partial inclusion of 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 2013 Report

New tax measures were introduced and others modified in Budget 2013. Changes affecting estimates and projections of tax expenditures are described below.

Personal Income Tax

Adoption Expense Tax Credit

The Adoption Expense Tax Credit (AETC) is a 15% non-refundable tax credit that allows adoptive parents to claim eligible adoption expenses relating to the completed adoption of a child under the age of 18, up to a maximum of \$11,669 in expenses per child for 2013. To better recognize that there are costs that adoptive parents must incur prior to being matched with a child, Budget 2013 extended the definition of the adoption period for the purpose of the AETC to better reflect the time at which the adoption period begins. This measure applies to adoptions finalized after 2012.

First-Time Donor's Super Credit

Budget 2013 introduced the First-Time Donor's Super Credit (FDSC). The FDSC supplements the Charitable Donations Tax Credit with an additional 25% tax credit for a first-time donor on up to \$1,000 of donations. A first-time donor will be entitled to a 40% federal credit on donations of \$200 or less, and a 54% federal credit for the portion of donations over \$200 but not exceeding \$1,000. The FDSC applies to donations made on or after March 21, 2013 and may be claimed only once in the 2013 or a subsequent taxation year before 2018.

Lifetime Capital Gains Exemption

Budget 2013 increased the Lifetime Capital Gains Exemption (LCGE) to \$800,000 from \$750,000 on dispositions of qualified small business shares and qualified farm and qualified fishing property, effective for the 2014 taxation year. In addition, the LCGE limit will be indexed to inflation for taxation years after 2014.



Labour-Sponsored Venture Capital Corporations Tax Credit

Budget 2013 announced the phase-out of the federal Labour-Sponsored Venture Capital Corporations (LSVCC) tax credit. The federal LSVCC tax credit will remain at 15% when it is claimed for a taxation year that ends before 2015 and will be reduced to 10% for the 2015 taxation year and 5% for the 2016 taxation year. The federal LSVCC tax credit will be eliminated for the 2017 and subsequent taxation years.

Deduction for Safety Deposit Boxes

Budget 2013 announced that the cost of renting a safety deposit box from a financial institution will no longer be deductible as an expense incurred for the purpose of earning business or property income, for taxation years beginning on or after March 21, 2013. For prior taxation years, the tax expenditure associated with this deduction is included under “Deduction of carrying charges incurred to earn income” in Table 1.

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% 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 generally been extended on an annual basis since then. Budget 2013 extended eligibility for the credit for an additional year to flow-through share agreements entered into on or before March 31, 2014. Under the one-year “look-back” rule, funds raised with the benefit of the credit in 2014, for example, can be spent on eligible exploration up to the end of 2015.

Corporate Income Tax

Special Tax Rate for Credit Unions

Budget 2013 announced the phase-out of the additional deduction for credit unions over five years. The additional deduction provides credit unions with access to the small business income tax rate on a preferential basis that is not available to other corporations. Larger credit unions are the primary beneficiary of the additional deduction.

For 2013, a credit union is permitted to deduct only 80% of the amount of the additional deduction otherwise calculated. The percentage of the additional deduction, otherwise calculated, that a credit union will be permitted to deduct will be 60% for 2014, 40% for 2015 and 20% for 2016. For 2017 and subsequent years, the additional deduction will be eliminated. This measure is prorated to apply only to the portion of the 2013 taxation year that is on or after March 21, 2013 and is also prorated for all taxation years that do not coincide with the calendar year.

Exemption From Tax for International Banking Centres

Budget 2013 announced the elimination of the International Banking Centre rules effective March 21, 2013. These rules exempted prescribed financial institutions from tax on certain income earned through a branch or office in the metropolitan areas of Montréal and Vancouver.



Goods and Services Tax

Historical Revision to the Canadian System of National Accounts

Some of the GST tax expenditure estimates and projections are generated using data from the Canadian System of National Accounts (CSNA). The CSNA is subject to regular statistical revisions to incorporate the most current information (from censuses, annual surveys, administrative statistics, public accounts, etc.) and improved estimation methods. Periodically, the CSNA undergoes comprehensive historical revisions that are much broader in scope than regular revisions, incorporating conceptual, classification, presentational and other major statistical changes.

The most current input-output tables (for 2009) were historically revised in 2012. The tables now show a more detailed breakdown of service-producing industries, and a less detailed breakdown of goods-producing industries and the commodities they produce. The sectoral detail has also changed: notably, expenditures by non-profit institutions serving households and Aboriginal governments have been removed from the estimate of household final consumption expenditures. The most recent historical revision also includes a new investment category for intellectual property.

Because of the improvements in the economic data and commodity definitions stemming from Statistics Canada's historical revision, the estimates and projections for GST tax expenditures presented in this report may not be directly comparable to those published in previous years.

For more information about the CSNA historical revision, visit Statistics Canada's website at www.statcan.gc.ca/nea-cen/hr2012-rh2012/start-debut-eng.htm.



The Tax Expenditures

Tables 1 to 3 provide tax expenditure values for personal income tax, corporate income tax and the GST for the years 2008 to 2013. Values for the years 2008 to 2011 are generally 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. Values for the 2012 and 2013 projections are usually determined from the historical relationship between a tax expenditure and relevant economic variables. These economic variables are generally based on the forecast presented in the November 12, 2013 *Update of Economic and Fiscal Projections*. See Chapter 1 of the 2010 edition of *Tax Expenditures: Notes to the Estimates/Projections* for additional details on the methodology.

Tax expenditures in each table 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 are not available to support a meaningful estimate/projection, a dash means that the tax expenditure is not in effect, and the letter “X” indicates that the estimate or projection is not published for confidentiality reasons. The inclusion in the report of items for which estimates and projections are not available reflects the intention 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.

Changes in the estimates and projections from those in last year’s report, as well as variations from year to year, may result from a number of factors, including legislative changes, changes in the economic variables affecting the tax expenditures, the availability of new data, and methodological improvements. Legislative changes affecting the estimates and projections are described in *Tax Expenditures: Notes to the Estimates/Projections*, in the “What’s New in the 2013 Report” section of this publication and in the notes to the tables.

Broad-based changes to the tax system may affect tax expenditure estimates and projections to the extent that these changes modify the effective tax rates otherwise faced by taxpayers under the benchmark tax system. A reduction (increase) in the effective tax rate under the benchmark tax system will generally result in lower (higher) tax expenditure estimates and projections. During the period covered by this publication, estimates and projections were affected, to varying degrees, by the following changes:

- For personal income tax expenditures, the introduction or enhancement of broad-based non-refundable tax credits, including the credit for the Basic Personal Amount, the Age Credit, the Spouse or Common-Law Partner Credit and the Eligible Dependant Credit, had the effect of reducing the estimates and projections for most tax expenditures.
- For corporate income tax expenditures, the recent reductions in the general corporate income tax rate (from 19.5% to 19% on January 1, 2009, 18% on January 1, 2010, 16.5% on January 1, 2011, and 15% on January 1, 2012) had the effect of reducing the estimates and projections for most tax expenditures, with a few exceptions such as investment tax credits.



Table 1

Personal Income Tax Expenditures*

millions of dollars

	Estimates				Projections	
	2008	2009	2010	2011	2012	2013
Charitable Donations and Political Contributions						
Charitable Donations Tax Credit (excluding donations of assets eligible for capital gains exemption) ¹	2,270	2,020	2,180	2,205	2,170	2,225
Donations of publicly listed securities						
Charitable Donations Tax Credit	90	98	140	140	125	125
Non-taxation of capital gains	27	29	48	42	32	32
Total tax expenditure	117	127	188	182	157	157
Donations of ecologically sensitive land						
Charitable Donations Tax Credit	9	8	5	7	7	8
Non-taxation of capital gains	3	3	S	S	S	3
Total tax expenditure	12	11	7	9	9	11
Donations of cultural property						
Charitable Donations Tax Credit	21	20	18	17	18	19
Non-taxation of capital gains	7	6	6	5	6	6
Total tax expenditure	28	26	24	22	24	25
Political Contribution Tax Credit ²	31	23	21	31	22	24
First-Time Donor's Super Credit ³	–	–	–	–	–	20
Culture						
Assistance for artists	S	S	S	S	S	S
Children's Arts Tax Credit ⁴	–	–	–	32	35	38
Deduction for artists and musicians	S	S	S	S	S	S
Education						
Adult basic education—deduction for tuition assistance	5	5	5	5	5	5
Apprentice vehicle mechanics' tools deduction	4	5	4	4	4	4
Education Tax Credit ⁵	220	200	200	200	200	205
Textbook Tax Credit ⁵	36	33	32	32	32	33
Tuition Tax Credit ⁵	255	255	270	285	305	320
Transfer of Education, Textbook and Tuition Tax Credits	485	520	535	565	570	570
Carry-forward of Education, Textbook and Tuition Tax Credits ⁶	540	480	545	615	660	670
Exemption of scholarship, fellowship and bursary income	41	39	40	43	44	44
Registered Education Savings Plans	155	165	160	165	155	145
Student Loan Interest Credit	63	44	41	42	43	45

* The elimination of a tax expenditure would not necessarily yield the full tax revenues shown in the table. See the 2010 edition of *Tax Expenditures: Notes to the Estimates/Projections* for a discussion of the reasons for this.



Table 1

Personal Income Tax Expenditures

millions of dollars

	Estimates				Projections	
	2008	2009	2010	2011	2012	2013
Employment						
Canada Employment Credit	1,905	1,915	1,935	1,995	2,070	2,130
Child care expense deduction	790	810	850	900	925	955
Deduction for income earned by military and police deployed to high-risk international missions	36	36	37	35	20	20
Deduction of home relocation loans	S	S	S	S	S	S
Deduction of other employment expenses	990	930	945	985	985	1,000
Deduction for tradespeople's tool expenses	4	3	3	3	3	3
Deduction of union and professional dues	755	755	785	825	860	895
Deferral of salary through leave of absence/sabbatical plans	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Disability supports deduction	S	S	S	S	S	S
Employee benefit plans	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Employee stock option deduction ⁷	760	430	690	740	610	720
Moving expense deduction	125	105	100	100	105	105
Non-taxation of certain non-monetary employment benefits	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.
Northern residents deductions ⁸	160	160	160	170	170	175
Overseas Employment Credit ⁹	78	72	73	75	75	65
Tax-free amount for emergency service volunteers	14	14	14	12	12	12
Volunteer Firefighters Tax Credit ¹⁰	–	–	–	15	15	15
Family						
Adoption Expense Tax Credit	S	3	3	3	3	3
Caregiver Credit	90	97	100	105	105	110
Child Tax Credit	1,470	1,470	1,480	1,510	1,555	1,590
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.
Family Caregiver Tax Credit ¹¹	–	–	–	–	160	165
Infirm Dependant Credit	5	5	5	5	5	6
Spouse or Common-Law Partner Credit ¹²	1,225	1,385	1,410	1,425	1,485	1,535
Eligible Dependant Credit ¹²	750	785	785	790	805	825
Inclusion of the Universal Child Care Benefit in the income of an eligible dependant ¹³	–	–	5	5	5	5



Table 1

Personal Income Tax Expenditures

millions of dollars

	Estimates				Projections	
	2008	2009	2010	2011	2012	2013
Farming and Fishing						
Lifetime capital gains exemption for farm and fishing property ¹⁴	385	320	325	385	460	470
Cash basis accounting	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deferral of capital gains through intergenerational rollovers of family farms, family fishing businesses and commercial woodlots	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deferral of income from destruction of livestock	S	S	S	S	S	S
Deferral of income from sale of livestock during drought, flood or excessive moisture years	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deferral of income from grain sold through cash purchase tickets ¹⁵	45	-10	-10	70	15	15
Deferral through 10-year capital gain reserve	S	S	S	S	S	S
Exemption from making quarterly tax instalments	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
AgriInvest (farm savings account)	20	15	20	25	11	10
Agri-Québec (farm savings account) ¹⁶	–	–	–	5	5	5
Flexibility in inventory accounting	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Tax treatment of the Net Income Stabilization Account ¹⁷						
Deferral of tax on government contributions	S	S	–	–	–	–
Deferral of tax on bonus and interest income	S	S	–	–	–	–
Taxable withdrawals	S	S	–	–	–	–
Federal-Provincial Financing Arrangements						
Logging Tax Credit	S	S	S	S	S	S
Quebec Abatement	3,605	3,415	3,665	3,885	4,035	4,215
Transfer of income tax points to provinces	17,585	16,260	17,385	18,340	19,045	19,905
General Business and Investment						
\$200 capital gains exemption on foreign exchange transactions	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.
Accelerated deduction of capital costs	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deduction of carrying charges incurred to earn income	1,200	920	1,005	1,085	1,100	1,165
Deferral through use of billed-basis accounting by professionals	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deferral through five-year capital gain reserve	35	20	30	30	30	30
Investment tax credits	20	17	16	18	18	18
Flow-through share deductions	235	190	285	340	210	205
Mineral Exploration Tax Credit for flow-through share investors ¹⁸	45	65	110	100	45	40
Reclassification of expenses under flow-through shares ¹⁵	-11	-12	S	-7	-10	-7
Partial inclusion of capital gains ¹⁹	2,995	2,445	3,630	3,800	3,420	3,945
Taxation of capital gains upon realization	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Tax-Free Savings Account ²⁰	–	65	165	160	295	410



Table 1

Personal Income Tax Expenditures

millions of dollars

	Estimates				Projections	
	2008	2009	2010	2011	2012	2013
General Business and Investment (cont'd)						
<i>Small Business</i>						
Lifetime capital gains exemption for small business shares ¹⁴	620	475	540	590	610	620
Deduction of allowable business investment losses	30	35	35	30	35	35
Deferral through 10-year capital gain reserve	S	S	S	S	S	S
Labour-Sponsored Venture Capital Corporations Credit ²¹	120	125	130	140	150	150
Non-taxation of provincial assistance for venture investments in small businesses	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Rollovers of investments in small businesses	10	5	3	4	4	4
Health						
Children's Fitness Tax Credit	105	110	110	110	115	115
Disability Tax Credit	635	620	650	675	690	700
Medical Expense Tax Credit ²²	995	1,000	1,080	1,135	1,200	1,295
Non-taxation of business-paid health and dental benefits ²³	1,595	1,685	1,780	1,850	1,955	2,065
Income Maintenance and Retirement						
Age Credit ²⁴	1,840	2,295	2,410	2,530	2,700	2,830
Deferred Profit-Sharing Plans	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	20	20	19	20	21	22
Non-taxation of Guaranteed Income Supplement and Allowance benefits ²⁵	175	89	100	115	125	125
Non-taxation of investment income from life insurance policies ²⁶	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.
Non-taxation of social assistance benefits ²⁷	165	145	155	160	165	170
Non-taxation of up to \$10,000 of death benefits	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)	S	S	S	S	S	S
Non-taxation of veterans' disability pensions and support for dependants	150	135	135	105	100	100
Non-taxation of veterans' Disability Awards	19	22	32	22	26	32
Non-taxation of workers' compensation benefits	695	620	625	625	600	595
Registered Disability Savings Plans	S	S	S	3	5	6
Pension Income Credit	990	965	1,010	1,035	1,055	1,085
Pension income splitting	850	865	895	950	1,010	1,090



Table 1

Personal Income Tax Expenditures

millions of dollars

	Estimates				Projections	
	2008	2009	2010	2011	2012	2013
Income Maintenance and Retirement (cont'd)						
Registered Pension Plans ²⁸						
Deduction for contributions	9,835	11,945	12,200	12,780	13,255	13,770
Non-taxation of investment income	6,730	7,145	10,120	10,535	13,415	13,680
Taxation of withdrawals	-6,830	-6,605	-7,140	-7,525	-7,845	-8,335
Net tax expenditure	9,735	12,485	15,180	15,790	18,825	19,115
Registered Retirement Savings Plans ²⁸						
Deduction for contributions	7,240	7,005	7,245	7,450	7,750	8,005
Non-taxation of investment income	3,825	4,085	6,755	6,985	8,875	10,430
Taxation of withdrawals	-4,825	-4,375	-4,810	-5,250	-5,190	-5,355
Net tax expenditure	6,240	6,715	9,190	9,185	11,435	13,080
Supplementary information: present-value of tax-assisted retirement savings plans ²⁹						
	9,105	10,150	10,470	10,945	11,515	12,160
Saskatchewan Pension Plan	S	S	S	S	S	S
Treatment of alimony and maintenance payments	92	93	88	88	86	86
U.S. Social Security benefits ³⁰	S	S	S	S	S	S
Other Items						
Deduction for certain contributions by individuals who have taken vows of perpetual poverty	S	S	S	S	S	S
Deduction for clergy residence	82	85	87	87	88	90
First-Time Home Buyers' Tax Credit ³¹	–	120	105	110	110	115
Home Renovation Tax Credit ³²	–	2,265	–	–	–	–
Non-taxation of capital gains on principal residences ³³	3,015	3,785	4,105	4,700	4,255	4,005
Non-taxation of income from the Office of the Governor General of Canada ³⁴	S	S	S	S	S	–
Non-taxation of income of status Indians and Indian bands earned on reserve	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
Public Transit Tax Credit	135	140	150	160	165	170
Memorandum Items						
<i>Avoidance of Double Taxation</i>						
Dividend gross-up and credit ³⁵	3,405	3,805	3,790	4,145	4,370	4,825
Foreign Tax Credit	750	660	670	740	845	930
Non-taxation of capital dividends	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<i>Loss Offset Provisions</i>						
Capital loss carry-overs ³⁶	145	230	410	350	310	320
Farm and fishing loss carry-overs	15	11	14	16	16	16
Non-capital loss carry-overs	55	56	49	63	70	75



Table 1

Personal Income Tax Expenditures

millions of dollars

	Estimates				Projections	
	2008	2009	2010	2011	2012	2013
Memorandum Items (cont'd)						
<i>Social and Employment Insurance Programs</i>						
Canada Pension Plan and Quebec Pension Plan						
Employee-Paid Contribution Credit	2,875	2,815	2,880	3,070	3,205	3,315
Non-taxation of employer-paid premiums	4,650	4,520	4,640	4,945	5,150	5,325
Employment Insurance and Quebec Parental Insurance Plan						
Employee-Paid Contribution Credit ³⁷	955	960	985	1,065	1,145	1,220
Non-taxation of employer-paid premiums	1,885	1,870	1,915	2,075	2,230	2,390
<i>Refundable Tax Credits Classified as Transfer Payments³⁸</i>						
Canada Child Tax Benefit ³⁹	9,368	9,753	10,013	10,049	10,266	n.a.
Refundable Medical Expense Supplement	120	130	135	135	140	145
Working Income Tax Benefit ⁴⁰	480	1,025	1,055	1,080	1,105	1,125
<i>Other</i>						
Basic Personal Amount ⁴¹	26,205	27,880	28,350	29,020	30,210	31,220
Deferral through capital gains rollovers	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Non-taxation of lottery and gambling winnings	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Non-taxation of allowances for diplomats and other government employees posted abroad	33	39	42	44	44	45
Partial deduction of meals and entertainment expenses	150	175	185	185	185	190

Notes:

- ¹ The tax expenditures associated with the Charitable Donations Tax Credit on donations of publicly listed securities, ecologically sensitive land and cultural property are presented separately. The estimates and projections presented on this line reflect the Charitable Donations Tax Credit associated with all other donations. The total tax expenditure for the Charitable Donations Tax Credit would take into account all relevant components.
- ² The higher levels for this tax expenditure in 2008 and 2011 are due to contributions in respect of the 40th and 41st general elections.
- ³ This measure was introduced in Budget 2013, effective 2013. See the "What's New in the 2013 Report" section for details.
- ⁴ This measure was introduced in Budget 2011, effective 2011. The lower value for this tax expenditure relative to the cost presented in Budget 2011 reflects a lower-than-expected take-up of the measure.
- ⁵ These tax expenditures relate to amounts earned and claimed in the year by students (i.e., neither transferred nor carried forward). The methodology used to calculate the Textbook Tax Credit has changed this year, resulting in a downward revision of estimates and projections.
- ⁶ For a given year, this tax expenditure represents the value of Education, Textbook and Tuition Tax Credits earned in past years and used in that year. The tax expenditure does not include the pool of unused Education, Textbook and Tuition Tax Credits that have been accumulated but will be deferred for use in future years.
- ⁷ This measure was changed in Budget 2010, effective March 4, 2010.
- ⁸ Budget 2008 enhanced this measure, effective 2008.
- ⁹ The phase-out of this measure was announced in Budget 2012. See the "What's New" section of the 2012 edition of this report for details.
- ¹⁰ This measure was introduced in Budget 2011, effective 2011. The decrease in the value of the tax expenditure for the tax-free amount for emergency service volunteers in 2011 reflects the introduction of the Volunteer Firefighters Tax Credit.
- ¹¹ This measure was introduced in Budget 2011, effective 2012. An enhanced amount of \$2,000 (indexed for years subsequent to 2012) can be claimed for an infirm dependant under one of the existing dependency-related credits (i.e., Spouse or Common-Law Partner Credit, Eligible Dependant Credit, Child Tax Credit, Caregiver Credit or Infirm Dependant Credit).
- ¹² Budget 2009 enhanced the credit, effective 2009.
- ¹³ This measure was introduced in Budget 2010, effective 2010.
- ¹⁴ Budget 2013 increased the Lifetime Capital Gains Exemption (LCGE) to \$800,000 from \$750,000 effective for the 2014 taxation year.



- In addition, the LCGE limit will be indexed to inflation for taxation years after 2014. See the “What’s New in the 2013 Report” section for details.
- ¹⁵ For an explanation of why this tax expenditure may be negative in some years, see the 2010 edition of *Tax Expenditures: Notes to the Estimates/Projections*.
- ¹⁶ This measure was introduced in Budget 2011, effective 2011.
- ¹⁷ The Net Income Stabilization Account (NISA) and the Canadian Farm Income Program were replaced by the Canadian Agricultural Income Stabilization Program, with the effect that government contributions under NISA ceased as of December 31, 2003. All funds in participant accounts were paid out by March 31, 2009. Tax expenditure estimates reflect the wind-down schedule.
- ¹⁸ This credit was extended in Budget 2013 and is set to expire on March 31, 2014. See the “What’s New in the 2013 Report” section for details.
- ¹⁹ This tax expenditure does not take into account the tax value of current-year capital losses applied against previous-year capital gains.
- ²⁰ This measure was introduced in Budget 2008, effective January 1, 2009.
- ²¹ Budget 2013 announced the phase-out of this measure by 2017. See the “What’s New in the 2013 Report” section for details.
- ²² Budget 2010 made expenses incurred for purely cosmetic procedures ineligible for the credit (effective after March 4, 2010). Budget 2011 removed the \$10,000 limit on eligible expenses that can be claimed under the Medical Expense Tax Credit in respect of a dependent relative, effective 2011.
- ²³ The methodology used to calculate this tax expenditure was changed to assume that employer-paid health premiums would be eligible for the Medical Expense Tax Credit if they were taxable.
- ²⁴ Budget 2009 increased the Age Credit amount by \$1,000, to \$6,408 from \$5,408, effective 2009.
- ²⁵ The decline in this tax expenditure in 2009 is mainly explained by the increase in non-tax-paying seniors due to increases in the Basic Personal Amount and other non-refundable credits relevant to seniors (such as the Age Credit).
- ²⁶ Although this measure provides tax relief for individuals, it is implemented through the corporate income tax system. Tax expenditure amounts are shown under “Investment income credited to life insurance policies” in Table 2.
- ²⁷ The decline in this tax expenditure in 2009 mainly reflects the Budget 2009 increase in the Basic Personal Amount and related amounts.
- ²⁸ Estimates and projections vary from those in last year’s report due to changes in estimated levels of assets, contributions, investment income, capital gains/losses and withdrawals. 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.
- ²⁹ 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. The present-value estimates do not reflect the potential effect of Tax-Free Savings Accounts on the average tax rate used to calculate the present value of the forgone tax on investment income.
- ³⁰ This measure was changed in Budget 2010, effective January 1, 2010.
- ³¹ This measure was introduced in Budget 2009, effective January 28, 2009.
- ³² This temporary measure was introduced in Budget 2009 for the 2009 tax year only. See note 46 of Table 1 in the 2010 edition of this report for details.
- ³³ The estimates and projections for this tax expenditure reflect the cyclicity of the housing market and its impact on the number of residence resales and on the average price of residences. Estimates and projections are based on housing market data and resale forecasts provided by Canada Mortgage and Housing Corporation and the Canadian Real Estate Association. Data on major additions and renovations obtained from Statistics Canada are used to estimate the average amount of capital expenditures on principal residences, which reduces the estimated amount of capital gains.
- ³⁴ This exemption was ended in Budget 2012, effective 2013. See the “What’s New” section of the 2012 edition of this report for details.
- ³⁵ The estimates and projections include the revenue impact associated with both the enhanced Dividend Tax Credit and the ordinary Dividend Tax Credit. Budget 2008 introduced reductions in the enhanced Dividend Tax Credit rate and gross-up factor beginning in 2010 to mirror the general corporate income tax reductions introduced in the 2007 Economic Statement. Budget 2013 introduced changes to the ordinary Dividend Tax Credit and gross-up factor to ensure the appropriate tax treatment of dividend income.
- ³⁶ This tax expenditure represents the revenue impact resulting from the application of prior years’ capital losses against net capital gains realized in the current year.
- ³⁷ Effective in 2010, a tax credit is also provided in respect of premiums paid by a self-employed individual under the *Employment Insurance Act*.
- ³⁸ As a result of the new accounting standard regarding tax revenues issued by the Public Sector Accounting Board, tax credits that have been reclassified as transfer payments under the new standard are no longer considered tax expenditures, but are shown separately as memorandum items. See the “What’s New” section of the 2012 edition of this report for details.
- ³⁹ This tax expenditure is presented on a fiscal year basis as reported in the *Public Accounts of Canada* (e.g., the amount for 2012 corresponds to the expenditure reported in the *Public Accounts of Canada* for the 2012–13 fiscal year, ending March 31, 2013).
- ⁴⁰ Budget 2009 enhanced this measure, effective 2009.
- ⁴¹ The Basic Personal Amount was increased by amounts over and above the inflation protection provided by full indexation in Budget 2009, effective 2009.



Table 2

Corporate Income Tax Expenditures*

millions of dollars

	Estimates				Projections	
	2008	2009	2010	2011	2012	2013
Charitable Donations, Gifts, Charities and Non-Profit Organizations						
Deductibility of charitable donations ¹	425	325	395	395	405	415
Donations of publicly listed securities						
Deductibility of donations ²	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Non-taxation of capital gains	105	36	63	67	58	63
Total tax expenditure	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Donations of ecologically sensitive land						
Deductibility of donations	4	11	S	5	S	5
Non-taxation of capital gains	4	10	S	S	S	S
Total tax expenditure	8	21	3	5	S	6
Donations of cultural property						
Deductibility of donations	7	4	25	6	35	22
Non-taxation of capital gains	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total tax expenditure	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deductibility of gifts of medicine	S	S	S	S	S	S
Deductibility of gifts to the Crown	S	S	S	S	S	S
Non-taxation of registered charities	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Non-taxation of non-profit organizations (other than registered charities)	160	140	125	110	71	89
Culture						
Non-deductibility of advertising expenses in foreign media	S	S	S	S	S	S
Federal-Provincial Financing Arrangements						
Income tax exemption for certain provincial and municipal corporations	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Transfer of income tax points to provinces	1,725	1,900	2,050	2,440	2,765	2,845
Logging Tax Credit	5	4	8	10	10	10
General Business and Investment						
Accelerated deduction of capital costs	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<i>Capital Gains</i>						
Deferral through five-year capital gain reserve	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Partial inclusion of capital gains ³	4,810	3,110	3,255	3,790	3,995	4,085
Taxation of capital gains upon realization	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 2010 edition of *Tax Expenditures: Notes to the Estimates/Projections* for a discussion of the reasons for this.



Table 2

Corporate Income Tax Expenditures

millions of dollars

	Estimates				Projections	
	2008	2009	2010	2011	2012	2013
General Business and Investment (cont'd)						
<i>Non-Refundable Investment Tax Credits</i>						
Atlantic Investment Tax Credit ⁴						
Earned and claimed in current year	60	62	92	63	84	100
Claimed in current year but earned in prior years	71	24	30	40	86	90
Earned in current year but carried back to prior years	4	7	18	14	155	11
Total tax expenditure	135	93	140	117	325	201
Scientific Research and Experimental Development Investment Tax Credit ⁴						
Earned and claimed in current year	830	840	690	770	795	765
Claimed in current year but earned in prior years	740	680	740	765	790	795
Earned in current year but carried back to prior years	175	105	160	45	115	215
Total tax expenditure	1,745	1,625	1,590	1,580	1,700	1,775
Apprenticeship Job Creation Tax Credit						
Earned and claimed in current year	60	51	50	53	63	63
Claimed in current year but earned in prior years	9	9	12	14	19	19
Earned in current year but carried back to prior years	5	4	6	5	4	4
Total tax expenditure	74	64	68	72	86	86
Investment Tax Credit for Child Care Spaces	S	S	S	S	S	S
<i>Small Business</i>						
Deduction of allowable business investment losses	20	16	15	27	9	17
Low tax rate for small businesses ⁵	4,575	4,450	4,260	3,880	3,205	2,905
Non-taxation of provincial assistance for venture investments in small businesses	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
International						
Exemption from 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.
Exemption from tax for international banking centres ⁶	X	X	X	X	X	X
Exemptions from non-resident withholding tax						
Dividends ⁷	2,130	1,290	1,630	1,975	1,815	1,870
Interest	1,250	1,635	1,410	1,385	1,470	1,515
Rents and royalties	290	325	330	350	335	345
Management fees	125	160	150	170	155	160
Non-taxation of life insurance companies' foreign income	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Tax treatment of active business income of foreign affiliates of Canadian corporations and deductibility of expenses incurred to invest in foreign affiliates	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.



Table 2

Corporate Income Tax Expenditures

millions of dollars

	Estimates				Projections	
	2008	2009	2010	2011	2012	2013
Sectoral Measures						
<i>Farming</i>						
Cash basis accounting	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deferral of income from destruction of livestock	S	S	S	S	S	S
Deferral of income from sale of livestock during drought, flood or excessive moisture years	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deferral of income from grain sold through cash purchase tickets ⁸	30	-9	-8	42	8	S
Flexibility in inventory accounting	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Agricultural co-operatives—patronage dividends paid as shares	7	5	5	8	8	8
AgriInvest (farm savings account)	3	S	3	3	S	S
Agri-Québec (farm savings account) ⁹	–	–	–	S	S	S
Exemption for farmers' and fishers' insurers	S	5	7	7	10	10
<i>Natural Resources</i>						
Corporate Mineral Exploration and Development Tax Credit ¹⁰	25	21	24	58	54	37
Deductibility of contributions to a qualifying environmental trust ¹¹	S	S	S	5	S	S
Earned depletion	4	S	11	S	S	S
Flow-through share deductions	74	69	69	81	54	51
Reclassification of expenses under flow-through shares ⁸	-4	-3	S	S	S	S
<i>Other Sectors</i>						
Exemption from branch tax for transportation, communications, and iron ore mining corporations	38	7	44	41	12	29
Special tax rate for credit unions ¹²	83	81	79	64	42	37
Surtax on the profits of tobacco manufacturers	X	X	X	X	X	X
Other Items						
Deductibility of countervailing and anti-dumping duties	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deductibility of earthquake reserves	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.
Holdback on progress payments to contractors	65	32	29	43	44	42
Investment income credited to life insurance policies	270	275	260	285	275	270
Tax status of certain federal Crown corporations	X	X	X	X	X	X



Table 2

Corporate Income Tax Expenditures

millions of dollars

	Estimates				Projections	
	2008	2009	2010	2011	2012	2013
Memorandum Items						
<i>Avoidance of Double Taxation—Integration of Personal and Corporate Income Tax</i>						
Investment corporation deduction	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Refundable capital gains for investment and mutual fund corporations	89	51	185	195	110	110
Refundable taxes on investment income of private corporations						
Additional Part I tax ¹³	-2,360	-1,780	-1,760	-2,325	-2,780	-2,875
Part IV tax	-4,685	-3,350	-2,785	-3,030	-3,305	-3,360
Dividend refund	8,160	6,190	5,275	5,615	6,145	6,240
Net tax expenditure	1,115	1,060	730	260	60	5
<i>Loss Offset Provisions</i>						
Capital loss carry-overs						
Net capital losses carried back	535	440	295	84	130	125
Net capital losses applied to current year	420	215	445	460	415	410
Farm and fishing loss carry-overs						
Farm and fishing losses carried back	14	14	14	11	11	11
Farm and fishing losses applied to current year ³	32	45	49	69	44	49
Non-capital loss carry-overs						
Non-capital losses carried back	6,200	3,395	2,795	1,950	1,715	1,475
Non-capital losses applied to current year	3,955	4,575	3,970	4,225	4,415	4,360
<i>Refundable Tax Credits Classified as Transfer Payments¹⁴</i>						
Atlantic Investment Tax Credit	13	13	14	14	17	18
Scientific Research and Experimental Development Investment Tax Credit	1,545	1,535	1,500	1,520	1,575	1,590
Canadian Film or Video Production Tax Credit	215	225	210	235	260	265
Film or Video Production Services Tax Credit	99	73	87	105	110	110
<i>Other</i>						
Deferral through capital gains rollovers	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deduction for intangible assets	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Partial deduction of meals and entertainment expenses	305	265	270	275	285	285
Patronage dividend deduction	435	350	285	340	245	250

**Notes:**

- ¹ This tax expenditure excludes the deductibility of charitable donations of ecologically sensitive land and cultural property. The estimates and projections presented on this line reflect the deductibility of all other charitable donations. The total tax expenditure for the deductibility of charitable donations would take into account all relevant components.
- ² There are no data available that allow this tax expenditure to be separated from the "Deductibility of charitable donations" category. Therefore, the value of this tax expenditure is included under "Deductibility of charitable donations."
- ³ Changes in the estimates and projections for this tax expenditure from those in last year's report partly reflect methodological improvements.
- ⁴ Estimates and projections of the tax expenditure in respect of the refundable portion of this credit are shown separately under "Refundable tax credits classified as transfer payments" (see note 14). The total amount of tax assistance provided by this credit is the sum of its non-refundable and refundable components. Changes to this measure were announced in Budget 2012. See the "What's New" section of the 2012 edition of this report for details.
- ⁵ The amount of this tax expenditure reflects the impact of Budget 2009, which increased the amount of small business income eligible for the lower tax rate. The reduction in the tax expenditure between 2008 and 2012 primarily reflects the reduction in the general corporate income tax rate.
- ⁶ Budget 2013 announced the elimination of the International Banking Centre rules, effective for taxation years that begin on or after March 21, 2013. See the "What's New in the 2013 Report" section for details.
- ⁷ This category includes the tax expenditure attributable to the exemption of estate and trust income distributions, including distributions by income trusts.
- ⁸ For an explanation of why this tax expenditure may be negative in some years, see the 2010 edition of *Tax Expenditures: Notes to the Estimates/Projections*.
- ⁹ This measure was introduced in Budget 2011. See the "What's New" section of the 2011 edition of this report for details.
- ¹⁰ The phase-out of this measure was announced in Budget 2012. See the "What's New" section of the 2012 edition of this report for details.
- ¹¹ The measure was expanded in Budget 2011 to include trusts established after 2011 that are required to be established to fund reclamation costs associated with pipelines. No impact on the tax expenditure is anticipated from these changes until 2015. See the "What's New" section of the 2011 edition of this report for details.
- ¹² The phase-out of this measure was announced in Budget 2013. See the "What's New in the 2013 Report" section for details.
- ¹³ This item includes the additional 6 $\frac{2}{3}$ % refundable tax on investment income as well as the Part I tax paid on investment income in excess of the benchmark rate.
- ¹⁴ As a result of the new accounting standard regarding tax revenues issued by the Public Sector Accounting Board, tax credits that have been reclassified as transfer payments under the new standard are no longer considered tax expenditures, but are shown separately as memorandum items. See the "What's New" section of the 2012 edition of this report for details.



Table 3

GST Tax Expenditures*

millions of dollars

	Estimates				Projections	
	2008	2009	2010	2011	2012	2013
Status Indians and Aboriginal Self-Governments						
Non-taxation of personal property of status Indians and Indian bands on reserve	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Refunds for Aboriginal self-governments	5	5	5	5	5	5
Business						
Exemption for domestic financial services	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Exemption for ferry, road and bridge tolls ¹	15	15	15	15	15	15
Exemption and rebate for legal aid services	20	20	20	20	20	25
Non-taxability of certain importations	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Foreign Convention and Tour Incentive Program	10	10	10	15	15	15
Small suppliers' threshold	130	185	170	175	180	190
Zero-rating of agricultural and fish products and purchases	S	S	S	S	S	S
Zero-rating of certain purchases made by exporters	S	S	S	S	S	S
Charities and Non-Profit Organizations						
Exemption for certain supplies made by charities and non-profit organizations ¹	875	890	905	890	910	905
Rebate for poppies and wreaths ²	–	–	S	S	S	S
Rebate for registered charities	270	260	265	280	290	300
Rebate for qualifying non-profit organizations	70	70	75	70	70	70
Education						
Exemption for educational services (tuition) ¹	450	485	515	545	565	580
Rebate for book purchases made by qualifying public institutions	25	25	20	20	20	25
Rebate for colleges	75	80	100	100	105	105
Rebate for schools	360	370	360	375	390	395
Rebate for universities	220	225	260	260	270	275
Health Care						
Exemption for health care services ¹	535	570	595	650	665	675
Rebate for hospitals	485	515	560	615	635	650
Rebate for specially equipped motor vehicles ²	S	S	S	S	S	S
Zero-rating of medical devices ¹	260	275	290	300	310	315
Zero-rating of prescription drugs ¹	635	665	695	715	735	755
Households						
Exemption for child care and personal services ¹	140	150	160	170	180	185
GST/HST Credit	3,555	3,645	3,760	3,870	3,995	4,115
Travellers' exemption	130	155	170	190	205	230
Zero-rating of basic groceries ¹	3,280	3,475	3,580	3,725	3,820	3,925

* The elimination of a tax expenditure would not necessarily yield the full tax revenues shown in the table. See the 2010 edition of *Tax Expenditures: Notes to the Estimates/Projections* for a discussion of the reasons for this.



Table 3

GST Tax Expenditures

millions of dollars

	Estimates				Projections	
	2008	2009	2010	2011	2012	2013
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.
Exemption for residential rent (long-term) ¹	1,285	1,415	1,305	1,360	1,425	1,510
Rebate for new housing	735	585	590	570	590	620
Rebate for new residential rental property	60	50	50	55	55	60
Municipalities						
Exemption for municipal transit ¹	155	155	165	160	165	170
Exemption for water and basic garbage collection services ¹	205	215	235	250	255	265
Rebate for municipalities	1,775	1,895	2,050	2,025	2,090	2,160
Memorandum Items						
<i>Recognition of Expenses Incurred to Earn Income</i>						
Rebate to employees and partners	80	75	75	70	70	70
<i>Other</i>						
Partial input tax credits for meals and entertainment expenses	140	135	135	145	145	155

Notes:

¹ This tax expenditure is estimated using data from Statistics Canada's historically revised input-output tables. For more information, see the "What's New in the 2013 Report" section.

² This is the first time this measure is included in this report, due to the availability of new data.

Part 2

Tax Evaluations
and Research Reports



Flow-Through Shares: A Statistical Perspective

Introduction

Flow-through shares are a financing mechanism that helps mining, oil and gas and clean energy generation corporations raise capital for the exploration and development of natural resources in Canada, and also supports the deployment of clean energy technology. When purchasing a flow-through share, an investor receives both a common share of the issuing corporation and certain tax benefits. Flow-through shares are a long-standing feature of the Canadian tax system.

Flow-through shares occupy an important place in equity financing in Canada: from 2007 to 2012, approximately \$1.4 billion per year in public equity for the oil and gas, mining and clean energy sectors was raised via flow-through shares. While they are available to all corporations incurring eligible expenses, flow-through shares assist primarily junior exploration companies whose access to other sources of financing may be limited. Through the flow-through share regime, the Government provides significant support for the exploration and development of natural resources: during the 2007 to 2012 period, federal tax expenditures associated with public and private issuances of flow-through shares, in addition to the Mineral Exploration Tax Credit (an incentive for investment in certain mining flow-through shares), averaged \$440 million per year. This support is complemented by additional incentives to flow-through share investors that are provided by certain provincial governments.

A formal evaluation of flow-through shares was published by the Department of Finance Canada in 1994. This paper provides an update of certain key results of the 1994 evaluation using stock market data from 2007 to 2012 as well as tax data. The first three parts provide background information, descriptions of trends in exploration and development spending, as well as descriptive statistics on the characteristics of flow-through share issuers and investors. The fourth part analyzes flow-through shares from the point of view of the parties to the transaction:

- **Resource companies** issue flow-through shares to transfer tax deductions to investors in exchange for a premium over the market price of the corporation's common shares. This paper analyzes the average flow-through share premium received by corporations.
- **Investors** in flow-through shares receive a common share of the issuing corporation, in addition to certain tax benefits. This paper discusses the investment performance of flow-through shares.
- The **federal government** forgoes tax revenues in the form of tax benefits to investors. This paper provides estimates of federal tax expenditures and how the tax benefits are allocated between flow-through share issuers and investors.



Background

The current flow-through share regime was introduced in 1986, but previous forms of the regime have been allowed by the *Income Tax Act* since the 1950s.¹ A flow-through share is a newly issued common share of a corporation that is accompanied by an agreement to transfer for tax purposes certain expenses to an investor, up to the price paid for the share. An investor who purchases a flow-through share may deduct the transferred expenses when calculating taxable income. Individual investors who invest in a mining flow-through share may also be eligible for investment tax credits, including the federal 15% Mineral Exploration Tax Credit² and certain provincial investment tax credits.³ Some of these generous tax attributes are partially recaptured over time: when the flow-through share is subsequently disposed of by the investor, the full proceeds of the disposition are recognized as a capital gain as opposed to only the appreciation in share value. In addition, the value of any applicable investment tax credits is generally included in income in the following year.

The tax rules do not require that investors hold the flow-through share for a certain period in order to access the tax benefits. However, many flow-through share agreements include a clause that restricts the investor from selling the shares within a specified time period, which may range from 4 months to as many as 24 months. These clauses are aimed at preventing downward pressure on share prices when investors seek to sell the shares after taking advantage of the tax benefits. In addition, many flow-through shares are issued via private placement. In general, securities regulations require a 4-month hold period for shares issued under a private placement.

There is no tax benefit that directly accrues to the corporation as a result of issuing flow-through shares. In fact, to the extent that a corporation eventually becomes profitable, the inability to use the expenses transferred via flow-through shares to reduce taxable income implies that the tax burden would be higher once the corporation becomes profitable than it otherwise would have been. The following expenses may be renounced to investors via flow-through shares:

- Canadian Exploration Expenses (CEE)—deductible at 100%;
- Canadian Renewable and Conservation Expenses (CRCE)—deductible at 100%; and
- Canadian Development Expenses (CDE)—deductible at a 30% rate on a declining-balance basis.⁴

¹ Previously, flow-through share investors had been required to incur eligible exploration and development expenses directly. See the annex for a brief history of the flow-through share regime.

² Eligible exploration expenses for the Mineral Exploration Tax Credit are limited to above-ground greenfield exploration (i.e., expenditures for exploration in the vicinity of an operating mine, or formerly operating mine, are not generally eligible) and do not include expenses relating to exploration for oil and gas, coal, oil sands or oil shale.

³ Investment tax credits for mining flow-through shares are available in Ontario (5%), Manitoba (30%), Saskatchewan (10%) and British Columbia (20%). In addition, Quebec allows a 150% deduction for Canadian Exploration Expenses renounced by qualifying companies.

⁴ Small oil and gas corporations may “reclassify” up to \$1 million of CDE renounced to flow-through share investors as CEE.



Under the general rule, expenses must be incurred by the corporation within 24 months after the flow-through share agreement has been entered into, and they must be renounced before March 1 of the year that follows that 24-month period. An important exception to this general rule is the “look-back” rule, which allows the corporation to transfer the expenses effective as of the year in which the flow-through share agreement is entered into, but before actually incurring the expenses. Under this rule, the company is required to incur the expenses before the end of the following calendar year. In the event that a company issuing flow-through shares does not incur the exploration or development expenses it undertook to incur within the prescribed timeframe, it is required to adjust the renunciation made to flow-through share investors. In addition, the company is required to pay a charge equal to 10% of the balance of unexpended renunciations. This charge recognizes the costs incurred by the Government in reassessing the investors. It also deters companies from renouncing expenses in excess of the amounts they will actually incur and thus reduces the likelihood that investors will unexpectedly be denied the deductions they previously claimed.

Trends in Exploration and Development

This section considers exploration and development activity since the 1970s, first in the mining sector and then in the oil and gas sector.

Mining Sector

Chart 1 compares trends in inflation-adjusted exploration and deposit appraisal expenditures in Canada in the mining sector to mineral and metal prices from 1972 to 2012, as well as the mining stock index.

As shown in Chart 1, exploration and deposit appraisal spending in the mining sector has been volatile. It was relatively low in constant dollar terms in the 1970s, before increasing at the beginning of the 1980s. After that it fell steeply and remained relatively subdued through the 1990s and early 2000s. The period since 2004 has generally been characterized by historically strong exploration and development spending. Available preliminary data for 2012 suggests that exploration spending has softened more recently.

Mineral and metal prices are known to be an important factor in investment decisions in the mining sector. Throughout the period from 1972 to 2012, trends in exploration and development spending were closely correlated with mineral and metal prices. Exploration and development spending by “junior” mining companies⁵ seems to be particularly susceptible to price fluctuations, growing significantly during upswings and declining when prices fall.

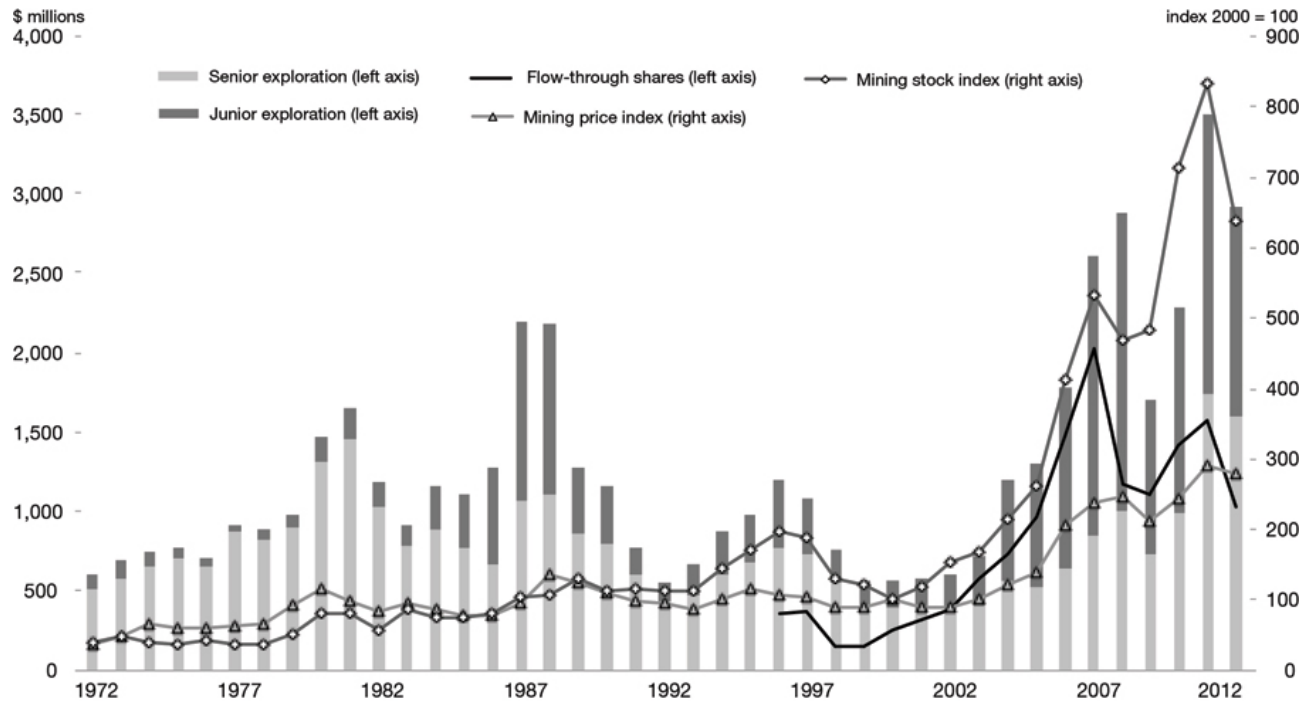
Trends in equity raised via mining flow-through shares (for which data are only available starting in 1996) generally follow closely exploration and development spending, mineral and metal prices, and the mining stock index.

⁵ Junior mining companies are typically defined as companies that are primarily engaged in mineral exploration activities and not mineral production.



Chart 1

Mining Exploration and Deposit Appraisal Expenditures and Equity Raised via Mining Flow-Through Shares, 1972 to 2012



Notes: Figures for exploration and deposit appraisal expenditures include a narrower range of expenses than those eligible for flow-through shares. Data on equity raised via mining flow-through shares are only available starting in 1996. All data have been adjusted for inflation and are expressed in 2008 dollars.

Sources: Natural Resources Canada; Bank of Canada; Department of Finance Canada.

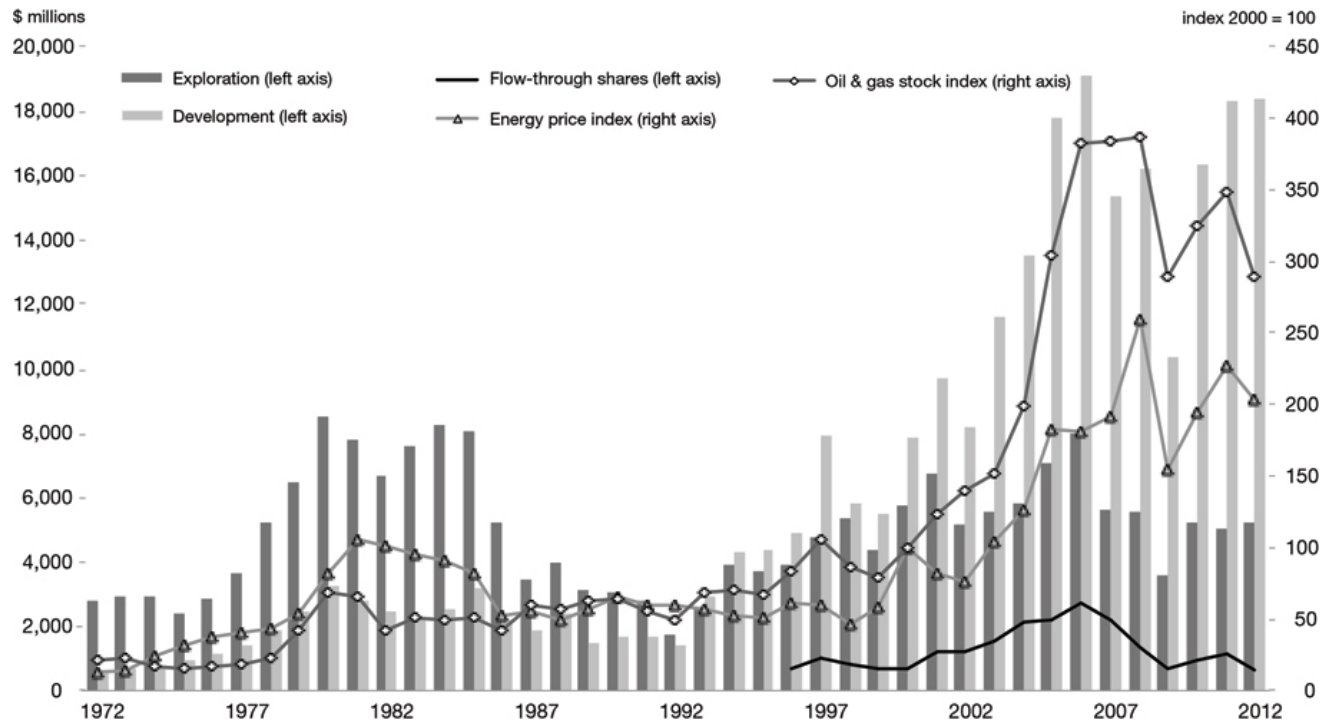
Oil and Gas Sector

Chart 2 compares inflation-adjusted exploration and development expenditures in the conventional oil and gas sector to energy prices from 1972 to 2012. It shows that spending declined throughout the 1980s and remained relatively low throughout most of the 1990s. Since 2000, exploration and development activity has generally been strong, tracking upward trends in energy prices.

Fluctuations in oil and gas flow-through share offers are less strongly correlated with expenditures on exploration and development drilling and commodity prices than in the case of mining flow-through shares.

Chart 2

Conventional Oil and Gas Exploration and Development Drilling and Equity Raised via Oil and Gas Flow-Through Shares, 1972 to 2012



Notes: Data on equity raised via oil and gas flow-through shares are only available starting in 1996. All data have been adjusted for inflation and are expressed in 2008 dollars.

Sources: Canadian Association of Petroleum Producers; Bank of Canada; Department of Finance Canada.

Descriptive Statistics and Analysis

This section analyzes available tax data on flow-through share issuers and investors, in addition to stock market data that pertains to publicly listed common shares issued by mining, oil and gas and clean energy generation companies (collectively, “resource companies”) on the Toronto Stock Exchange (TSX) from January 2007 to December 2012 and the TSX Venture Exchange (TSX/V) from January 2009 to December 2012. In general terms, the TSX serves senior equity markets while the TSX/V is focused on more junior companies and the public venture equity market. Resource companies account for approximately 60% of the number of companies listed on the TSX and TSX/V.⁶

⁶ The tax data reflect all flow-through share investors and issuers. As flow-through shares may be either publicly listed shares or private common shares of corporations, the statistics presented using TSX and TSX/V data are only representative of a subset of total flow-through shares issued. A comparison of TSX and TSX/V data on flow-through shares to available tax data suggests that approximately 70% of flow-through shares issued are publicly listed on one of these two exchanges.



Flow-Through Share Issuers

This section provides a statistical overview of the importance of flow-through shares as a financing instrument for resource companies.

Proportion of Eligible Expenses Financed via Flow-Through Shares

A first measure of the relative importance of flow-through shares for resource companies is the proportion of total eligible expenses that is funded via this mechanism every year. Table 1 (which is based on corporate income tax return data from 2007 to 2012) shows the proportion of total Canadian Exploration Expenses (CEE), Canadian Renewable and Conservation Expenses (CRCE) and Canadian Development Expenses (CDE) incurred during that time period that were renounced via flow-through shares.

Table 1
CEE, CRCE and CDE Incurred From 2007 to 2012 Renounced to Investors

	CEE/CRCE			CDE		
	Renounced (\$ millions)	Total (\$ millions)	% of Total Renounced	Renounced (\$ millions)	Total (\$ millions)	% of Total Renounced
Oil and gas	3,690	23,200	16%	360	54,370	1%
Mining	5,390	19,030	28%	20	24,180	<1%
Clean energy ¹	110	650	17%	n/a	n/a	n/a
Total	9,190	42,880	21%	380	78,550	<1%

Note: n/a = not applicable.

¹ The clean energy sector is composed for this purpose of corporations that incurred CRCE.

Source: Department of Finance Canada.

Table 1 illustrates that flow-through shares account for a large share of the funding for CEE incurred from 2007 to 2012: about one-fifth of all eligible expenses. The reliance on flow-through shares is higher in the mining sector, where flow-through shares financed on average 28% of CEE incurred during the period, versus 16% in the oil and gas sector. Clean energy companies also rely significantly on flow-through shares to finance their clean energy projects (17% of CRCE incurred every year). Conversely, the proportion of CDE financed via flow-through shares is relatively low in the mining and oil and gas sectors (about 1% of eligible expenses or less).

Importance of Flow-Through Shares in Equity Markets

When financing new exploration and development expenses, companies may issue debt or equity, or rely on internal financial resources (e.g., cash flow). The choice between these types of financing mechanisms is influenced by a number of considerations that are specific to each company. Table 2 shows the role that flow-through shares play in equity financing for resource companies, using data from the TSX and TSX/V. It presents the average value of flow-through shares that are raised by exchange and sector.⁷

⁷ The values in Table 1 and Table 2 cannot be directly compared. Table 1 presents the six-year sum from 2007 to 2012. Conversely, Table 2 presents annual averages. Annual averages are presented in Table 2 to allow comparison between the exchanges, since different date ranges are available for each.



Table 2

Average Annual Issues of Flow-Through Shares and Common Shares, by Sector and Exchange

	Flow-Through Shares			Total Common Shares (Including Flow-Through Shares)			Flow-Through Shares as a % of Total	
	Number of Issues	Value (\$ millions)	Average Size (\$ millions)	Number of Issues	Value (\$ millions)	Average size (\$ millions)	Number of Issues	Value
TSX (2007–2012)								
Mining	70	360	5	280	9,110	33	25%	4%
Oil and gas	30	340	11	80	4,270	53	38%	8%
Total	100	700	7	360	13,380	37	28%	5%
TSX/V (2009–2012)								
Mining	440	540	1	1,590	3,420	2	28%	16%
Oil and gas	70	120	2	260	1,810	7	27%	7%
Total	510	660	1	1,850	5,230	3	28%	13%

Source: TSX and TSX/V new financing data.

In interpreting Table 2, it should be kept in mind that flow-through shares only potentially apply to a portion of the financing needs of Canadian resource companies. For example, expenses incurred outside of Canada do not qualify as CEE, CDE or CRCE, and thus are not eligible to be financed using flow-through shares. Nearly 50% of the mining projects of TSX and TSX/V-listed mining companies are located outside of Canada, and more than 35% of oil and gas-listed companies operate outside of Canada.⁸

Table 2 shows that during the sample period flow-through shares accounted for 28% of the total number of new equity issues by resource companies. Flow-through shares also accounted for 5% of the total equity raised by resource companies on the TSX and 13% of the total equity they raised on the TSX/V—a weighted average of 7%.

- The number of flow-through share issues and their value are higher in the mining sector in absolute terms than in the oil and gas sector. Mining companies account for about 44% of companies listed on the TSX and TSX/V, while oil and gas companies account for 10%.⁹
- In contrast, oil and gas companies listed on the TSX rely more on flow-through shares in *relative* terms than mining companies (38% of new issues compared to 25%), while the use of flow-through shares is nearly equal between the two sectors on the TSX/V.
- Flow-through shares represent 16% of new equity raised in the mining sector on the TSX/V, compared to 4% on the TSX. This suggests that in the mining sector, junior companies rely more on flow-through shares for equity financing than larger companies. In the oil and gas sector, the difference is marginal.

Overall, flow-through share issues tend to be smaller than non-flow-through share issues on both the TSX and TSX/V: on average, \$7 million is raised via new flow-through share issues on the TSX versus \$37 million for ordinary common shares; the average flow-through share issue on the TSX/V raises about \$1 million, compared to \$3 million for other common shares.

⁸ Source: TSX and TSX/V sector presentations.

⁹ Source: TSX sector profiles, as at December 31, 2012.



While not presented in Table 2, TSX and TSX/V data show that clean energy companies play a very small role in the flow-through share market (less than 1% of flow-through share activity). Due to the relatively small role of clean energy companies in the flow-through share market, further statistics on the use of flow-through shares by clean energy companies are not presented in this analysis.

Cost of Issuance

Issuing equity, including flow-through shares, involves transaction costs, such as legal, accounting, underwriting, filing and brokerage fees. Comprehensive data on flow-through share issuance costs are not available.

In order to provide a sense of the listing fees faced by flow-through shares issuers, issuing documents were examined for 60 of the largest offers (by sector and exchange) during the 2007 to 2012 period. The results of this analysis are presented in Table 3. Underwriting commissions varied from a low of 2.5% of gross proceeds up to 7.5% during the studied period. Commissions were comparable across mining and oil and gas companies, but junior companies in both sectors (i.e., those listed on the TSX/V) tended to pay on average 1 percentage point more than companies listed on the TSX. Overall, the average commission was 5.3% of gross proceeds for the flow-through share issues reviewed. The median commission was 6%. The analysis did not consider issuing costs for non-flow-through shares.

Table 3

Observed Underwriters' Commissions for Flow-Through Share Issues

% of gross proceeds

	Overall	TSX	TSX/V
Average	5.3	4.8	5.8
Maximum	7.5	6.0	7.5
Minimum	2.5	2.5	5.0

In addition to the underwriters' commissions, many of the documents reviewed reported additional listing fees. Fees do not seem to be correlated with the size of the flow-through share issue and were generally stated as fixed amounts ranging between \$200,000 and \$400,000. For smaller flow-through share issues, these additional fees may sometimes represent a significant proportion of the proceeds of issuing flow-through shares.

Flow-Through Share Investors

This section discusses the characteristics of flow-through share investors based on available tax data.

Flow-through shares may be acquired by either individual or corporate investors. They may also be acquired indirectly via limited partnership structures. In general, limited partnerships pool investors' funds and provide an opportunity to diversify risk by investing in several different flow-through share issues. Limited partnerships account for 50% of total flow-through share investment. Individuals account for roughly 90% of flow-through share investment via limited partnerships.

Table 4 breaks down the composition of flow-through share investors by individuals and corporations. Individuals account for approximately 75% of investment in flow-through shares (45% is accounted for by individuals investing in limited partnerships). The participation of individuals in the flow-through share market is relatively high: by contrast, individuals accounted on average for 28% of the total value of public, private and mutual fund shares held from 2007 to 2012.¹⁰ This could be explained by the fact that individuals generally face higher marginal income tax rates than corporations;¹¹ as a result, the transferred deductions represent greater tax savings to individuals in relative terms. In addition, individuals investing in mining flow-through shares may be eligible for related investment tax credits (e.g., the federal 15% Mineral Exploration Tax Credit), whereas corporations are not. Tax data show that from 2007 to 2012, 76% of CEE renounced by mining companies was eligible for the Mineral Exploration Tax Credit.

Table 4
Proportion of Total Flow-Through Shares Held by Type of Investor, 2007 to 2012
 %

Type of Investor	Proportion of Flow-Through Shares Held
Individual investors	
Direct investment	30
Via limited partnerships	45
Subtotal	75
Corporate investors	
Direct investment	20
Via limited partnerships	5
Subtotal	25
Total	100

Source: Department of Finance Canada.

Table 5 provides data on the taxable income range of individuals who invest in flow-through shares. It shows that 90% of flow-through shares purchased by individuals are acquired by those in the top two federal income tax brackets. The average combined federal-provincial marginal income tax rate of individuals investing in flow-through shares is estimated to be 42%. The role of high-income individuals in flow-through share investment is consistent with overall savings patterns in Canada, which show that individuals with income above \$80,000 account for the majority of investment income earned by individuals in Canada.¹² In addition, flow-through shares may be more attractive to high-income individuals since the value of tax deductions increases with investors' taxable income.

¹⁰ Source: Statistics Canada, Cansim Table 378-0121, National Balance Sheet Accounts. This measure does not include public, private and mutual fund shares held by non-residents. Government claims and foreign investments are also not included.

¹¹ The federal general corporate income tax rate is 15%. By contrast, individuals face marginal federal income tax rates up to 29%, depending on taxable income.

¹² Source: Statistics Canada, Cansim Table 111-0037.



Table 5

Share of Renounced Flow-Through Share Expenses Claimed by Individuals, by Taxable Income of Individual, 2007 to 2010

Federal income tax brackets	Share of Total Renounced Expenses (%)
First tax bracket (less than \$40,970) (15%)	2
Second tax bracket (\$40,970 - \$81,941) (22%)	8
Third tax bracket (\$81,941 - \$127,021) (26%)	11
Fourth tax bracket (over \$127,021) (29%)	79
Total	100

Notes: Individuals were classified in a given year based on the federal income tax brackets applicable for that year. The tax bracket thresholds and tax rates indicated in the table are those applicable for 2010. Tax bracket thresholds are adjusted each year for inflation, while the tax rates indicated in the table have been in effect since 2007.

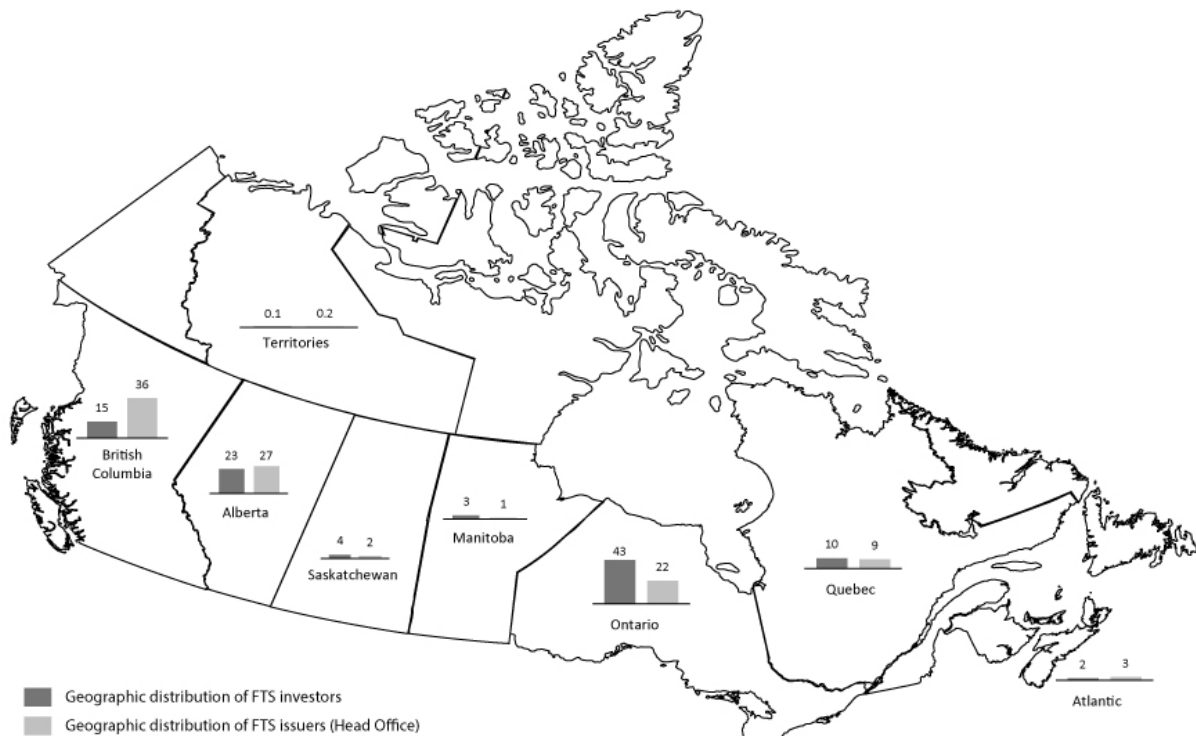
Source: Department of Finance Canada.

Geographic Distribution of Issuers and Investors

This section provides details on the geographic distribution of flow-through share issuers and flow-through share investors. Chart 3 illustrates the geographic distribution of the headquarters of companies that issue flow-through shares and flow-through share investors based on data from 2007 to 2012. The distribution of flow-through share issuers is based on where the companies that issue flow-through shares are headquartered. The distribution of flow-through share investors is based on the total value of CEE and CDE claimed by individual investors on their tax returns and their province of residence.

Chart 3

Provincial/Territorial Distribution of Flow-Through Shares (FTS) Issued and Renounced Expenses Claimed by Flow-Through Share Investors (%)



Source: Department of Finance Canada.



Some 36% of flow-through share issues are made by firms headquartered in British Columbia, 27% by firms in Alberta and 22% by firms in Ontario. The proportion of flow-through share issuers in Quebec, Saskatchewan, the Atlantic provinces and the territories is lower than their share of exploration and deposit appraisal expenditures would suggest, while that of British Columbia stands out as being relatively high compared to the share of expenditures incurred in that province. Nearly all oil and gas flow-through shares are issued by companies headquartered in Alberta.

In general, the distribution of individual flow-through share investors reflects the provincial population distribution, with two notable exceptions: Quebec (10% of flow-through share investors, with about 23% of Canada's population in 2012) and Alberta (23% of flow-through share investors, with about 11% of Canada's population in 2012).

The availability of certain tax credits for investments in mining flow-through shares (Ontario—5%, Manitoba—30%, Saskatchewan—10% and British Columbia—20%), as well as the “bonus” deduction available in Quebec, do not seem to have a large impact on the distribution of flow-through share investors across jurisdictions.

Value of Flow-Through Shares for Corporations and Investors and Tax Expenditure Estimates

Premiums Earned by Corporations

This section discusses the maximum premiums that investors would theoretically be willing to pay for flow-through shares, and provides estimates of observed premiums based on stock market data.

In essence, a flow-through share provides to investors:

- A common share of the capital stock of the issuing corporation; and
- Tax benefits, via an agreement to transfer expenses for tax purposes from the corporation to the investor, plus any applicable investment tax credits at the investor level.

The tax benefits of flow-through shares provide a saving to the investor in terms of reduced tax liability; as a result, investors may be willing to pay a premium for a flow-through share relative to the price that they would be willing to pay for otherwise identical non-flow-through shares. Effectively, the premium compensates the issuing corporation for the tax deductions that it renounces to investors.

Maximum Flow-Through Share Premium

The tax benefits of a flow-through share are known at the time of acquisition and depend on the investor's marginal income tax rate, the availability of investment tax credits and other relevant tax attributes of the investor. The maximum premium that an investor may pay for flow-through shares, in theory, is equal to the tax benefits received by the investor.

Table 6 provides estimates of the maximum premiums for an “average” individual flow-through share investor residing in Ontario, subject to a combined federal-provincial marginal income tax rate of 42% (i.e., the marginal income tax rate of an average flow-through share investor), and able to fully use the deductions. To simplify the analysis, it is assumed that the investor disposes of the flow-through shares in the same tax year that they are purchased, and that renounced expenses are CEE (equal to the price of the flow-through share and deductible at a rate of 100% in the year expenditures are renounced).



Two scenarios are presented, depending on whether or not the investor is eligible for investment tax credits. In each scenario, the maximum premium is equal to the value of the tax benefits. Under these stylized assumptions, the estimated maximum premium ranges between 36% and 69%, depending on whether the investor is eligible for investment tax credits.

Table 6

Maximum Flow-Through Share Premium Under Stylized Assumptions

\$ except when otherwise noted

	Flow-Through Shares Not Eligible for Investment Tax Credits	Flow-Through Shares Eligible for Investment Tax Credits ¹
Value of underlying common share	100	100
Maximum flow-through share premium (net value of tax benefits)	36%	69%
Price of flow-through share	136	169
Premium to market	36	69
Value of flow-through share tax deductions	57	71
Value of flow-through share tax credits	0	33
Income inclusion of tax credits ²	0	(14)
Capital gains tax ³	(21)	(21)
Net tax benefits	36	69

¹ Federal 15% Mineral Exploration Tax Credit plus the 5% Ontario Focused Flow-Through Share Tax Credit.

² In practice, the income inclusion occurs in the following tax year.

³ Calculated as the capital gains tax payable on the value of the underlying common shares (i.e., the incremental capital gain due to the rule deeming the cost of a flow-through share to be nil for tax purposes).

It should be noted that the maximum premiums in Table 6 are illustrative only and that other stylized assumptions would lead to different theoretical premiums. For example, the maximum premium for a corporate investor subject to a combined federal-provincial general corporate income tax rate of 25% would be 16%. The maximum premium would also be lower than presented in Table 6 if the expenses being renounced were CDE rather than CEE, or if the marginal income tax rate in the province where an investor resides were lower than in Ontario. Conversely, the theoretical maximum premium would be higher for an individual in the top tax bracket; for example, for an Ontario resident subject to a combined 49.53% personal income tax rate the maximum premium would be 84%.

In practice, the selling price of flow-through shares is expected to equal the selling price of common shares, plus a premium that is situated between the maximum that an investor may be willing to pay and the minimum premium that a corporation may be willing to accept.

Entering into a flow-through share transaction instead of simply purchasing regular common shares is of interest to investors because of the associated tax benefits. If the premium paid by an investor were exactly equal to the tax benefits received, the investor would be indifferent between buying a flow-through share or a common share of the corporation. In that situation, there would be no incentive to invest in the flow-through share and flow-through shares would therefore fail to facilitate the raising of capital for issuers. In order to provide an incentive to investors, flow-through share issuers must effectively share a certain proportion of the benefits with investors.



For issuing corporations, entering into a flow-through share agreement is beneficial when it provides a premium over the market price that is of higher value than the corporation's internal valuation of the tax benefits associated with renounced deductions. It may also be beneficial if the associated tax benefits attract incremental investment in the corporation's equity. For corporations with no taxable income and no expectation of earning taxable income in the short to medium term, tax deductions are likely of little internal value.¹³ This would include many junior corporations that are focusing their activities on exploration.

Estimated Flow-Through Share Premium

Table 7 presents estimates of flow-through share premiums that were observed on new equity issued on the TSX from 2007 to 2012 and on the TSX/V from 2009 to 2012, by sector and seniority.

When issuing new equity, corporations frequently "underprice" their new shares relative to the price on the secondary market for outstanding previously issued shares. The estimates of premiums paid for the tax benefits associated with flow-through shares are therefore complicated by the fact that it is not possible to observe at what price a corporation could have sold its shares in the absence of the flow-through share tax benefits. For example, as shown in Table 7, non-flow-through shares were issued at an average 5% discount to market in the sample set.

This analysis estimates the average premium to market for both flow-through shares and non-flow-through shares issued by mining and oil and gas companies. It then calculates an implied flow-through share premium that is equal to the percentage difference between the premium to market for flow-through shares and the (negative) premium to market for non-flow-through shares.

¹³ Tax deductions may be of value to a business even in situations where it is not taxable. For example, unused tax deductions may be a consideration when an investor (the "successor") is considering the potential takeover of another corporation (the "predecessor"). The ability of a successor to make use of a predecessor's resource expense pools (e.g., CEE) may be limited by the "successor rules", which for example limit the ability of the successor to make use of the predecessor's expense pools except against income generated by assets acquired from the predecessor. These rules may reduce the value of unused deductions in net-present-value terms.



Table 7

Average Premiums on New Equity Issued on the TSX (2007–2012) and TSX/V (2009–2012)

%

Sector, Exchange and Seniority of Issuers	Premium to Market ¹		Implied Flow-Through Share Premium ²
	Flow-Through Shares	Non-Flow-Through Shares	
Overall			
TSX—senior	24	-1	25
TSX—junior	20	0	20
TSX/V—Tier 1	18	-2	21
TSX/V—Tier 2	12	-7	20
Average	15	-5	21
Mining			
TSX—senior	19	-2	21
TSX—junior	20	0	20
TSX/V—Tier 1	19	-2	22
TSX/V—Tier 2	12	-7	21
Average	14	-5	20
Oil and gas			
TSX—senior	26	0	26
TSX—junior	20	1	18
TSX/V—Tier 1	12	-6	19
TSX/V—Tier 2	13	-8	23
Average	17	-5	24

Note: "Tier 1" and "Tier 2" companies on the TSX/V correspond to senior and junior companies, respectively.

¹ Premiums to market are calculated based on the five-day volume weighted moving average of closing prices on the day of the issue.

² Implied flow-through share premium = $((1 + \text{flow-through share premium to market}) \div (1 + \text{non-flow-through-share premium to market})) - 1$.

Source: TSX and TSX/V new financing data and daily Trading Summaries.

The results of the analysis indicate that, on average, flow-through shares are issued at an average premium below the theoretical maximum premium for the average flow-through share investor that was derived in the previous section. The premiums across sectors, seniority of issuer and exchange range between 18% and 26%.

The results show that oil and gas flow-through shares command a slightly higher premium on average than mining flow-through shares (24% versus 20%), despite the fact that mining flow-through shares are often eligible for additional incentives (e.g., the Mineral Exploration Tax Credit). Of all categories, senior oil and gas companies listed on the TSX show the highest average premiums (26%).



Table 8 shows that overall implied flow-through share premiums are fairly constant over time in spite of the significant market fluctuations that occurred during the 2007 to 2012 period.

Table 8
Issue Price Premiums for Resource Companies in Different Years

%

	Premium to Market		Implied Flow-Through Share Premium
	Flow-Through Shares	Non-Flow-Through Shares	
2007	24	-1	26
2008	29	8	19
2009	8	-10	20
2010	9	-10	21
2011	18	-3	22
2012	23	3	19

Note: Estimates for 2007 and 2008 are based on TSX data only.

Source: TSX and TSX/V new financing data and daily Trading Summaries.

Investment Performance of Flow-Through Shares

This section provides an analysis of the investment performance of flow-through shares for investors. It estimates the absolute returns to investing in flow-through shares, both before and after consideration of tax benefits.

To analyze the investment performance of flow-through shares, it was necessary to make certain assumptions. The analysis assumes that the flow-through share investor is an individual with a 42% marginal tax rate (i.e., equal to the marginal tax rate of an average individual flow-through share investor). For the purpose of analyzing returns to mining shares eligible for federal and provincial investment tax credits, it is assumed that the investor is an Ontario resident and that the flow-through shares are eligible for both the federal 15% Mineral Exploration Tax Credit and the 5% Ontario Focused Flow-Through Share Tax Credit. The shares are assumed to be held for two years and then sold at the market price. Capital gains tax is assumed to be paid immediately on disposition of the shares. The analysis does not account for the time value of money and the reported returns are for the two-year period (i.e., they are not annualized). An overall weighted average return is then calculated for each year based on relative issue sizes.

The results of this analysis are presented in Table 9 and Table 10, which present two-year weighted average returns on flow-through shares issued on the TSX and TSX/V, respectively. The estimated returns are highly dependent on the market conditions during the time period analyzed. The period analyzed—2007 to 2010 for the TSX and 2009 to 2010 for the TSX/V—was characterized by significant share price volatility due to both the impact of the 2008 recession and significant fluctuations in commodity prices. To provide some context to the reported results, two-year average after-tax returns (using the same assumption regarding marginal tax rates as for flow-through shares) are calculated for the S&P/TSX Canadian Diversified Metals & Mining Index and S&P/TSX Canadian Energy Index. These results are also presented in Table 9 and Table 10.



As shown in Table 9 and Table 10, the pre-tax benefit returns on flow-through shares are frequently negative, although there can be considerable fluctuations in performance. These negative returns are partly driven by the premium paid for flow-through shares that, all else equal, would tend to reduce pre-tax benefit investment returns. Given the nature of flow-through shares, however, investors are more likely focused on post-tax benefit returns.

The tax benefits (not including the federal Mineral Exploration Tax Credit and provincial investment tax credits) improve returns for the average flow-through share investor by 21 percentage points. If the analysis assumed that the investor was in the top tax bracket, the impact would be even larger: for example, in the case of an Ontario investor in the top marginal tax bracket, after-tax returns would be approximately 25 percentage points higher than pre-tax returns. Conversely, those in lower tax brackets would see a smaller improvement in returns due to the tax benefits (for example, for an Ontario individual in the lowest tax bracket, returns would improve by around 10 percentage points). Table 9 and Table 10 show that, when tax credits are available, returns for the average flow-through share investor improve by an additional 11 percentage points, or 32 percentage points above the pre-tax scenario.

Although results vary from year to year, overall, pre-tax benefit returns for mining flow-through shares are higher than pre-tax benefit returns for oil and gas flow-through shares. This is also true in the case of post-tax benefits and especially so when the value of potential investment tax credits is taken into account: allowing for potential investment tax credits, mining flow-through shares provide higher average returns in every year but one (in 2010 on the TSX). In general, returns on the TSX are stronger than those on the TSX/V.

Table 9

Two-Year Weighted Average Return on Flow-Through Share Issues on the TSX

Year of Issue	Mining				Oil and Gas		
	Pre-Tax Benefits	Post-Tax Benefits		S&P/TSX Canadian Diversified Metals & Mining Index (After Tax) ²	Pre-Tax Benefits	Post-Tax Benefits	S&P/TSX Canadian Energy Index (After Tax) ²
		No Tax Credits	With Tax Credits ¹				
2007	-56	-35	-24	-13	-52	-31	-20
2008	10	31	42	53	-33	-12	-13
2009	20	41	52	77	4	25	16
2010	-37	-16	-5	-8	-23	-2	-9
Overall	-22	-1	10	27	-31	-10	-6

¹ Returns are based on the assumption that flow-through shares are eligible for the federal 15% Mineral Exploration Tax Credit and the 5% Ontario Focused Flow-Through Share Tax Credit.

² The return on the index is assumed to be comprised of capital gains taxable at the marginal tax rate of the average flow-through share investor.

Sources: TSX and TSX/V new financing data and daily Trading Summaries; Statistics Canada; Department of Finance Canada.



Table 10

Two-Year Weighted Average Return on Flow-Through Share Issues on the TSX/V

%

Year of Issue	Mining				Oil and Gas		
	Pre-Tax Benefits	Post-Tax Benefits		S&P/TSX Canadian Diversified Metals & Mining Index (After Tax) ²	Pre-Tax Benefits	Post-Tax Benefits	S&P/TSX Canadian Energy Index (After Tax) ²
		No Tax Credits	With Tax Credits ¹				
2009	-16	5	17	77	-27	-6	16
2010	-41	-20	-9	-8	-36	-15	-9
Overall	-33	-12	0	35	-34	-13	4

¹ Returns are based on the assumption that flow-through shares are eligible for the federal 15% Mineral Exploration Tax Credit and the 5% Ontario Focused Flow-Through Share Tax Credit.

² The return on the index is assumed to be comprised of capital gains taxable at the marginal tax rate of the average flow-through share investor.

Sources: TSX and TSX/V new financing data and daily Trading Summaries; Statistics Canada; Department of Finance Canada.

The evaluation of flow-through shares published by the Department of Finance Canada in 1994 examined pre-tax and after-tax returns for selected flow-through share limited partnerships over the period from 1986 to 1990. Its findings were broadly in line with those presented in Table 9 and Table 10. As with the current study, there was year-to-year variation in the estimated returns, but the average pre-tax return was estimated to be negative 31%. Including the value of flow-through share tax benefits, average returns improved to 2.1%, indicating that flow-through shares improved investors' returns by an average of 33 percentage points over the pre-tax result. Differences in the impact of flow-through share tax benefits on returns may be attributed to a variety of factors, including assumptions relating to marginal tax rates. In relative terms, the 1994 evaluation found that an investment in a flow-through share limited partnership "typically fares worse than an investment in the corresponding average share for that industry."



Tax Expenditures

This section presents federal tax expenditure estimates for flow-through shares from 2007 to 2013 and analyzes the degree to which tax benefits are shared between corporations, intermediaries and investors.

Table 11 presents federal tax expenditures related to flow-through shares from 2007 to 2013.

Table 11
Flow-Through Shares: Federal Tax Expenditures

millions of dollars

	2007	2008	2009	2010	2011	2012	2013
Individuals							
Flow-through share deductions	435	235	190	285	340	210	205
Reclassification of expenses under flow-through shares	-4	-11	-12	S	-7	-10	-7
Mineral Exploration Tax Credit for flow-through share investors	150	45	65	110	100	45	40
Corporations							
Flow-through share deductions	120	74	69	69	81	54	51
Reclassification of expenses under flow-through shares	-3	-4	-3	S	S	S	S

Note: An "S" indicates that the absolute value of the tax expenditure is less than \$2.5 million.

Table 12 estimates, in respect of an illustrative flow-through share, the proportion of flow-through share tax benefits that accrues respectively to the investor, intermediaries and the issuing corporation:

- The investor's share is equal to the value of the tax benefits to the investor less the amount the investor paid to acquire those benefits (i.e., the flow-through share premium).
- The share of the tax benefits attributed to intermediaries (i.e., transactions costs) is a function of the commission rate. For the purpose of this analysis, the commission rate is assumed to be 6%, that is, the median rate observed for flow-through shares issuers listing on the TSX/V.¹⁴
- The issuing corporation's share is a function of the premium received, net of commissions.

The analysis assumes that the investor is an Ontario resident with a 42% marginal tax rate and that the mining flow-through shares are eligible for the federal 15% Mineral Exploration Tax Credit and the 5% Ontario Focused Flow-Through Share Tax Credit. It does not consider the extent to which the particular share may represent an "incremental" share that the corporation could not have issued but for the flow-through share benefits.

¹⁴ This analysis assumes that the observed 6% median commission for flow-through shares is generally the same as commissions for non-flow-through shares.



The analysis shows that, on average, between 19% and 53% of the tax benefit related to flow-through shares accrues to flow-through share investors as opposed to the corporations that issue them. It also shows that, in the oil and gas sector, a much higher proportion of the tax benefit goes to issuing corporations (between 69% and 77%) than is the case in the mining sector (45%).

Table 12

Sharing of Flow-Through Share Tax Benefits

\$ except when otherwise noted

	Oil and Gas Senior	Oil and Gas Junior	Mining (Eligible for Tax Credits)
Common share price	100.00	100.00	100.00
Average flow-through share premium	26%	22%	20%
Flow-through share price	126.00	122.00	120.00
Value of tax benefits¹	31.90	30.20	42.80
Investor's share			
Tax benefits accruing to investor	31.90	30.20	42.80
Less: amount of premium	26.00	22.00	20.00
Net tax benefits to investor	5.90	8.20	22.80
Investor's share of tax benefits	18.5%	27.2%	53.3%
Intermediaries' share			
Amount of premium	26.00	22.00	20.00
Multiplied by: commission rate	6.0%	6.0%	6.0%
Commission on premium	1.60	1.30	1.20
Intermediaries' share of tax benefits	5.0%	4.3%	2.8%
Issuer's share			
Premium received from investors	26.00	22.00	20.00
Less: commission on premium	1.60	1.30	1.20
Net premium to issuer	24.40	20.70	18.80
Issuer's share of tax benefits	76.5%	68.5%	44.9%

Note: These estimates assume that the investor is an Ontario resident with a 42% marginal tax rate and that the mining flow-through shares are eligible for the federal 15% Mineral Exploration Tax Credit and the 5% Ontario Focused Flow-Through Share Tax Credit.

¹ The value of the tax benefits is equal to the value of the tax deductions, plus the net value of any available investment tax credits, less incremental capital gains tax on disposition. These calculations are carried out, for example, in Table 7.



Summary

This paper uses stock market data from 2007 to 2012, as well as tax data, to update certain key statistics presented in the evaluation of flow-through shares published by the Department of Finance Canada in 1994. The data show that:

- During the sample period, flow-through shares played a significant role in equity financing for both the oil and gas and mining sectors. From 2007 to 2012, approximately \$1.4 billion per year in public equity for the oil and gas, mining and clean energy sectors was raised via flow-through shares. Based on available stock market data, flow-through shares accounted on average for more than one-quarter of the number of equity issues and between 5% and 13% of the total value of equity raised by mining and oil and gas corporations. Tax data indicate that approximately 21% of total CEE are financed via flow-through shares.
- A survey of 60 flow-through share offers indicates that underwriters' commissions on flow-through share issues generally range between 5% and 6%. Commission rates are comparable across sectors, but junior companies generally pay a higher percentage fee. In addition to commissions, there are fixed costs to issuing that do not seem to be correlated with offer size. These costs ranged between \$200,000 and \$400,000 in the offers surveyed.
- Flow-through share investors are typically high-income individuals. The majority of these individuals invest in flow-through shares via limited partnership structures that allow them to pool their funds with other investors and diversify their risk by investing in multiple flow-through share issues.
- The distribution of flow-through share investors across provinces and territories is in general consistent with Canada's population distribution, but for a relatively high take-up in Alberta and a relatively low take-up in Quebec. The location of flow-through share issuers' head offices is spread across all provinces, with higher proportions in British Columbia, Alberta and Ontario.
- Premiums received by corporations for their flow-through shares are fairly consistent across years, exchanges and sectors—generally on the order of 21%.
- Tax deductions associated with flow-through shares improve returns on flow-through shares by an average of 21 percentage points when compared to the pre-tax rate of return. When investment tax credits are available (e.g., the federal 15% Mineral Exploration Tax Credit and the 5% Ontario Focused Flow-Through Share Tax Credit), returns for the average flow-through share investor improve by an additional 11 percentage points, for a total after-tax return that is 32 percentage points above the pre-tax return.
- Flow-through shares are a significant federal tax expenditure. The resulting tax benefits are allocated between investors, issuers and intermediaries. Stylized assumptions in illustrative examples suggest that tax benefits related to flow-through shares are shared as follows:
 - Between 19% and 53% go to flow-through share investors;
 - Between 3% and 5% go to intermediaries; and
 - Between 45% and 77% go to flow-through share issuers.



Annex—A Brief History of Flow-Through Shares

Various forms of the “expenses-for-shares” financing model for exploration and development activities have been allowed by the *Income Tax Act (ITA)* since the 1950s. The current flow-through share regime was formally introduced in the *ITA* in 1986, when a measure was implemented that allowed companies to incur eligible expenses and then renounce them to flow-through share investors. Previously, the tax rules had required flow-through share investors to incur the expenses directly on behalf of the company in exchange for the shares. The 1986 federal budget stated that the goal of the measure was to support investment in mining and oil and gas exploration by making “the existing flow-through share provisions for the mining sector and the oil and gas sector simpler and more effective.”

Table 13 provides a brief overview of the history of flow-through shares since 1972.

Table 13

Brief History of Flow-Through Share Rules

Pre-1972	Only corporations engaged in mining or oil and gas activities (“principal business corporations” or PBCs) may invest in flow-through shares. Flow-through share investors must incur exploration and development costs directly. Flow-through shares are held as inventory (i.e., proceeds of disposition are taxed as income).
1972	Flow-through shares are expanded to allow investment by non-PBCs, including individuals. Non-PBCs are allowed to deduct flow-through share expenses at 20% per year on a declining-balance basis.
1976	The deduction rate for non-PBC investors is increased to 100% for CEE to match the deduction rate for PBCs.
1981	Flow-through shares are held as capital—proceeds from the disposition of flow-through shares are now taxed as capital gains rather than income.
1985	The look-back rule is introduced, allowing flow-through share investors to deduct CEE incurred in the first 60 days of the calendar year from taxable income in the immediately preceding calendar year.
1986	Flow-through share investors are no longer required to incur exploration and development costs directly, eliminating liability concerns for flow-through share investors.
1992	Small oil and gas companies may reclassify up to \$2 million of CDE (30% deduction rate) renounced to flow-through share investors as CEE (100% deduction rate).
1996	The 60-day limit for the look-back rule is extended to one year. Flow-through shares are extended to allow companies to renounce CRCE to investors. The \$2 million limit on the CDE reclassification is reduced to \$1 million. Canadian Oil and Gas Property Expenses (deductible at a 10% annual declining-balance rate) are no longer eligible for flow-through shares.
2000	The temporary 15% Mineral Exploration Tax Credit for individual investors in certain mining flow-through shares is introduced. This measure has been extended regularly and is currently scheduled to expire on March 31, 2014.



Taxation of Small Businesses in Canada

Introduction

Small businesses play an important role in the Canadian economy, contributing to employment, investment and innovation. The tax system provides a number of preferential measures to help small businesses retain more of their earnings for investment, expansion and job creation.

This paper presents information on the taxation of small businesses in Canada. The first section of the paper provides a description of specific tax measures targeted at small businesses in Canada, while the second section presents a statistical profile of small businesses and of their importance in the Canadian economy using corporate income tax data.

Tax Preferences Available to Small Businesses in Canada

What Is a “Small Business”?

A small business can be conducted either directly by one or more individuals, or indirectly through one or more separate legal entities set up by individuals. In Canada, a corporation is the most frequently used legal vehicle in the latter situation, although a business can also be conducted through a trust or a partnership.

There is no agreed-upon threshold at which a business is considered “small” from an economic standpoint. Depending on their focus or interest, analysts, researchers and statisticians have been using different thresholds based on variables such as assets, capital, revenue or number of employees.

Canadian tax laws also do not provide a single definition of “small business” for tax purposes, but a number of tax preferences are targeted at “small” incorporated businesses. Access to these tax preferences is generally conditional on a measure of size. Many of the tax preferences available to “small” businesses are restricted to corporations that are Canadian-controlled private corporations (CCPCs), that is, corporations resident in Canada that are not public or controlled by public corporations or non-residents.

The next two sections present key tax preferences that are available to small incorporated businesses in Canada.



Lower Tax Rate Applicable to Small Businesses

A preferential federal tax rate applies on the first \$500,000 of income earned by a small CCPC from an active business carried on in Canada. This preferential tax rate is intended to increase the amount of after-tax income that may be retained for reinvestment in the active business. The mechanism for reducing the federal corporate income tax rate from the 15% general corporate income tax rate (applicable since January 1, 2012) to the 11% small business tax rate (applicable since January 1, 2008) is known as the “small business deduction”. In order to target the small business deduction to small businesses, the \$500,000 income limit (known as the “business limit”) begins to be reduced when a CCPC’s taxable capital reaches \$10 million, and is eliminated when taxable capital reaches \$15 million.¹ Income other than active business income, such as income from passive investments or income of certain incorporated individuals that is similar to employment income, is not eligible for the small business tax rate.

All provinces and territories² provide for lower tax rates for small CCPCs. Generally, provincial small business tax rates apply to the first \$500,000 of a CCPC’s income derived from an active business carried on in Canada (except in Nova Scotia and Manitoba, where the business limit is \$350,000 and \$425,000 respectively as of 2014), and this business limit is gradually reduced to nil for CCPCs with taxable capital between \$10 million and \$15 million (except in Ontario, where CCPCs—regardless of their size—are provided with a preferential tax rate on their first \$500,000 of taxable income).³

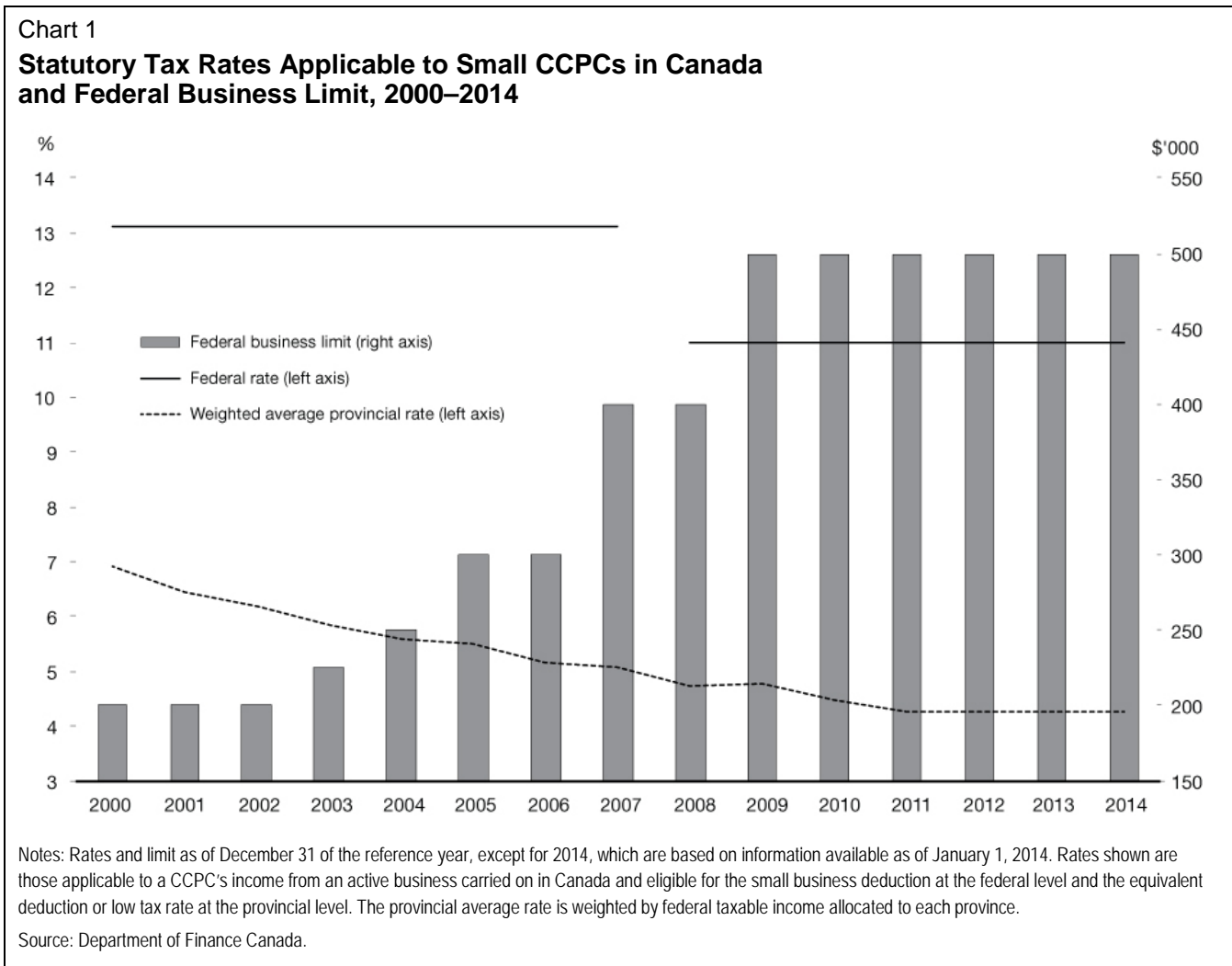
¹ For this purpose, a CCPC’s taxable capital is equal to its taxable capital employed in Canada, and generally includes the sum of shareholders’ equity in the CCPC, retained earnings, and most of the CCPC’s debt liabilities, less certain types of investments in other corporations. Where a CCPC is part of a group of associated corporations, the business limit and taxable capital thresholds apply for the group as a whole.

² From this point forward, references to “provinces” also include the territories.

³ Prior to July 1, 2010, Ontario levied a 4.25% surtax on CCPCs with taxable income in excess of \$500,000 (applicable to firms other than those in the manufacturing sector), the effect of which was to gradually phase out the Ontario small business tax rate and eliminate it entirely for CCPCs with taxable income of \$1.5 million or greater.



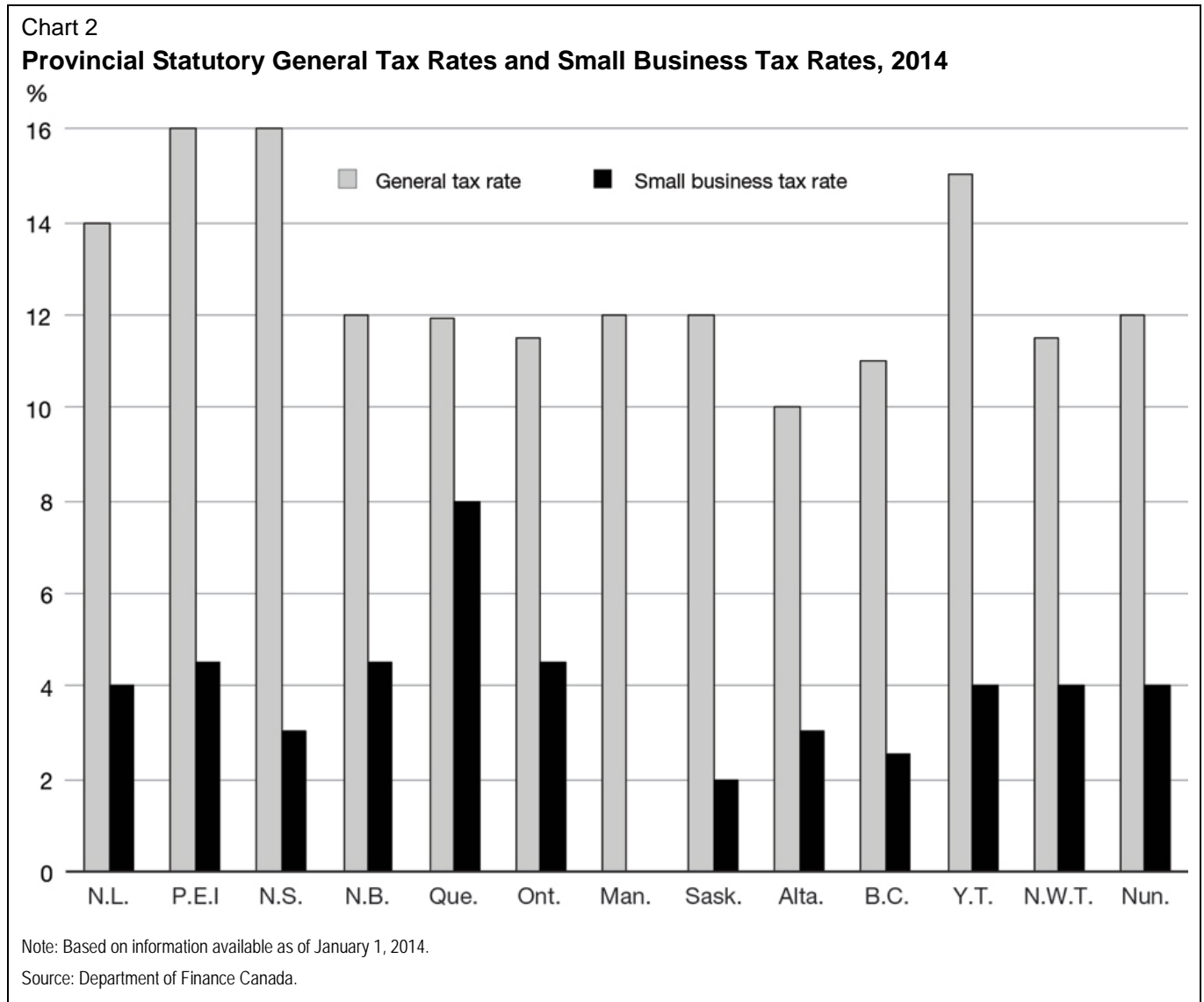
Chart 1 shows the federal tax rate applicable to small CCPCs from 2000 to 2014, along with the weighted average provincial rate and changes in the federal business limit over the period.



Tax rates applicable to small CCPCs have declined since 2000. The federal tax rate was effectively reduced to 11% from 13.12% on January 1, 2008 as a result of a 1-percentage-point reduction in the federal small business tax rate (from 12% to 11%) and of the elimination of the 4% federal corporate surtax in that same year (which effectively reduced the corporate income tax rate by 1.12 percentage point). At the provincial level, the weighted average provincial tax rate decreased from 6.9% in 2000 to slightly less than 4.3% in 2014. The federal business limit on the amount of income eligible for the small business tax rate increased over this period, from \$200,000 in 2000 to \$500,000 by 2009. The business limits applicable in most provinces were typically increased in a comparable manner. As a result of these changes, a small CCPC with \$500,000 in taxable income has seen the amount of federal tax it pays cut by more than one-half since 2000, from \$113,600 to \$55,000, while the amount of provincial income tax it pays has been reduced by about three-fifths, from \$53,750 to \$21,300.⁴

⁴ Provincial tax savings are estimated based on the weighted average provincial small business tax rate and the federal business limit.

Chart 2 shows the spread that exists in 2014 between the general statutory corporate income tax rate and the small business tax rate for each province. Provincial spreads range from a low of 3.9 percentage points in Quebec to a high of 13 percentage points in Nova Scotia.



Other key tax changes have reduced the tax burden of corporations in Canada. Important reductions in general statutory corporate income tax rates—which apply generally to all corporations in Canada, and to a small CCPC’s taxable income in excess of the small business limit—were implemented by both the federal and provincial governments. In addition, the federal capital tax was eliminated for medium-size corporations (i.e., corporations with taxable capital between \$10 million and \$50 million) as of 2004 and phased out for all other corporations by 2006,⁵ and all provincial general capital taxes were eliminated by July 1, 2012.

⁵ The federal capital tax did not apply to corporations with less than \$10 million in taxable capital.



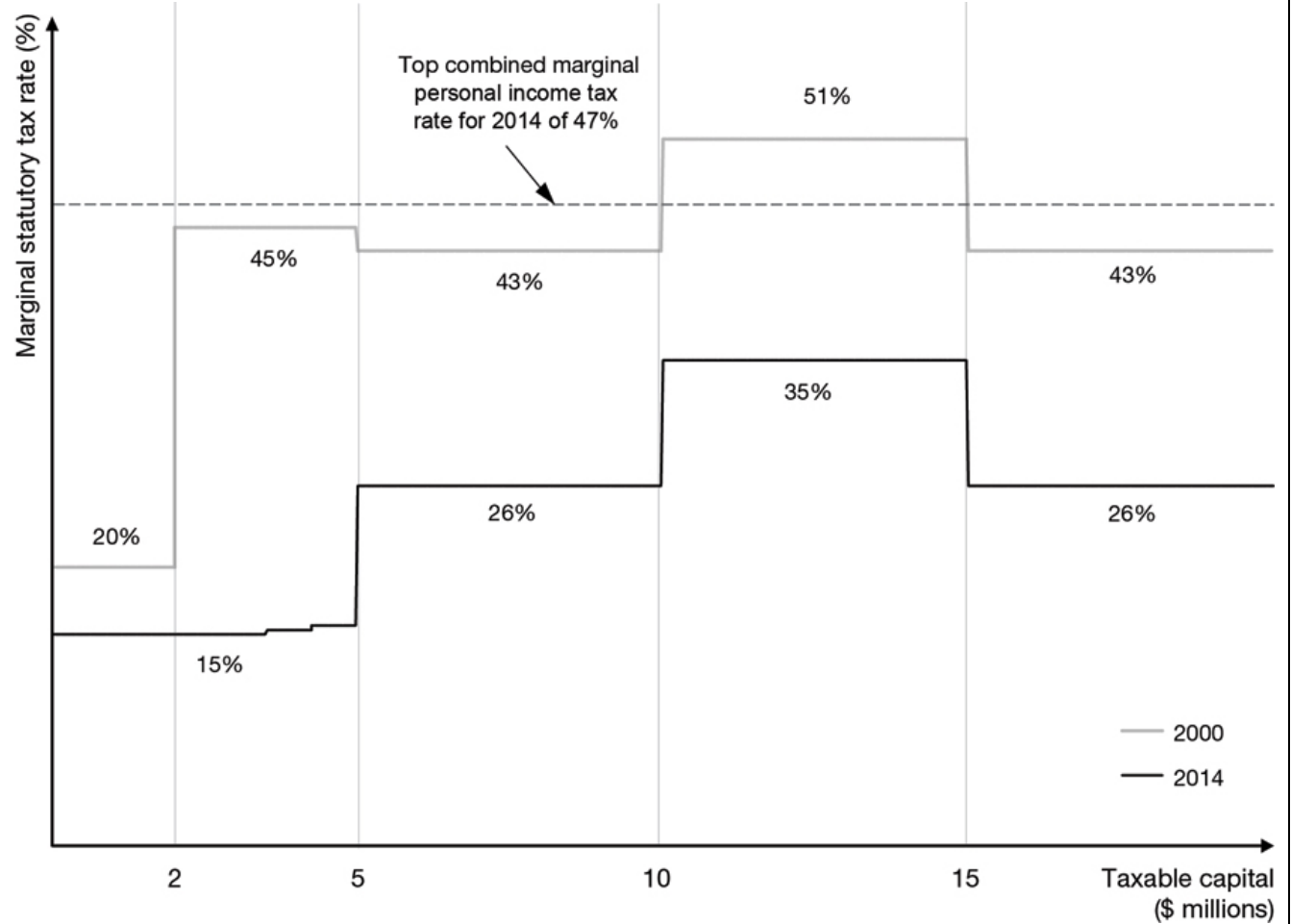
Chart 3 shows the combined federal-provincial tax rate that a small CCPC would be facing in 2000 and 2014 on each additional dollar of income earned as its stock of taxable capital grows (i.e., its “marginal” statutory tax rate). As shown in the chart, a CCPC’s marginal statutory tax rate follows a general pattern consisting of four different phases:

- First, at low levels of taxable capital, all of the active business income of a small CCPC is assumed to be within the small business limit, and therefore eligible for the weighted average combined federal-provincial small business tax rate (20% on up to \$200,000 of taxable income in 2000, and 15% on up to \$500,000 of taxable income in 2014).
- A CCPC may generate taxable income in excess of its small business limit, while keeping its taxable capital below \$10 million (i.e., the threshold at which the small business limit starts to be reduced). At that point, the CCPC will begin paying tax on its marginal income at the combined federal-provincial general corporate income tax rate (43% in 2000 and 26% in 2014), while still being eligible for the small business tax rate on taxable income below the small business limit. In the cases illustrated in Chart 3, this point is reached by the CCPC at \$2 million in taxable capital in 2000 and \$5 million in taxable capital in 2014 (reflecting an assumed 10% pre-tax rate of return on capital).⁶
- A CCPC with taxable capital between \$10 million and \$15 million faces a higher marginal statutory tax rate (51% in 2000 and 35% in 2014) due to the gradual reduction in the amount of income eligible for the small business tax rate as taxable capital rises above \$10 million, which increases taxes payable on the first \$200,000 of taxable income earned in 2000 and the first \$500,000 in 2014.
- Finally, once a CCPC’s taxable capital exceeds \$15 million, the marginal statutory tax rate returns to the level of the combined federal-provincial general corporate income tax rate (43% in 2000 and 26% in 2014).

⁶ The slightly higher marginal rate in 2000 for CCPCs with taxable capital between \$2 million and \$5 million (when compared to CCPCs with taxable capital between \$5 million and \$10 million in 2000) is due to the Ontario surtax that was in place prior to July 1, 2010 (see footnote 3 for details).

Chart 3

Marginal Statutory Tax Rates Applicable to CCPCs in Canada, 2000 and 2014



Notes: This chart shows the combined federal-provincial marginal statutory corporate income tax rates applicable to a CCPC's income from an active business carried on in Canada at different levels of taxable capital, assuming a 10% pre-tax rate of return on taxable capital. It is also assumed that the CCPC is not part of a group of associated corporations. Marginal statutory tax rates do not include the impact of tax measures such as the Scientific Research and Experimental Development tax incentive program or the Atlantic Investment Tax Credit. The rates for 2000 include the impact of the federal corporate surtax (which no longer applies in 2014), but ignore federal and provincial general capital taxes. Lower rates for manufacturing and processing activities that are available in some provinces and that could apply when a corporation earns income above the business limit are also not reflected in this chart.

Source: Department of Finance Canada.



Comparing how this pattern changed between 2000 and 2014, three key observations can be made:

- The combined federal-provincial small business tax rate applicable during the first phase has been significantly reduced between 2000 and 2014 (from 20% to 15%), and is now available to much larger CCPCs as a result of the cumulative increases in the business limit (from \$200,000 to \$500,000 for the federal business limit).
- The marginal statutory tax rates that a CCPC would face as it grows past this first phase have also been significantly reduced over the 2000 to 2014 period, reflecting the reductions in general statutory corporate income tax rates that were implemented at both the federal and provincial levels.
- CCPCs of all sizes now face marginal tax rates that are much lower than the top federal-provincial statutory personal income tax rate, which is 47% for 2014 (down from 49% in 2000). This provides an incentive for CCPCs to reinvest their earnings and grow their business rather than distribute their earnings as dividends or wages.

Table 1 shows estimated and projected tax expenditures associated with the federal and provincial small business tax rates. The projected tax expenditure for 2013 for the federal small business tax rate is \$2.9 billion.

Table 1

Tax Expenditures Associated With Small Business Tax Rates, 2008 to 2013

millions of dollars

	Tax Expenditures					
	2008	2009	2010	2011	2012	2013
Federal	4,575	4,450	4,260	3,880	3,205	2,905
<i>Selected provinces:</i>						
Newfoundland and Labrador	26	27	32	42	64	63
Nova Scotia	n.a.	n.a.	105	110	114	206
Quebec	239	307	411	468	540	n.a.
Ontario	1,125	850	1,295	1,335	1,515	1,530
Manitoba	137	139	132	177	238	261
Saskatchewan	132	163	139	283	351	n.a.
Alberta	n.a.	n.a.	n.a.	n.a.	n.a.	900

Notes: Tax expenditure estimates for different jurisdictions are not strictly comparable as they may have been derived using different methodologies or different periods (e.g., calendar year versus fiscal year). Tax expenditure estimates are not available for Prince Edward Island, New Brunswick, British Columbia and the territories. Based on information available as of January 1, 2014.

Sources: Department of Finance Canada; various provincial publications.



Other Tax Preferences Available to Small Businesses

Table 2 lists other key tax preferences available to small incorporated businesses in Canada that are of particular significance in terms of policy or fiscal impacts, and provides the associated federal tax expenditures. A brief overview of each of these measures is also provided.⁷

Table 2

Selected Federal Tax Preferences Available to Small Businesses in Canada and Associated Tax Expenditures, 2008 to 2013

millions of dollars

	Federal Tax Expenditures					
	2008	2009	2010	2011	2012	2013
Lifetime capital gains exemption						
Small business shares	620	475	540	590	610	620
Farm and fishing property	385	320	325	385	460	470
Enhanced Scientific Research and Experimental Development Investment Tax Credit for small CCPCs	1,545	1,535	1,500	1,520	1,575	1,590
Rollovers of investments in small businesses	10	5	3	4	4	4
Deduction of allowable business investment losses						
Individuals	30	35	35	30	35	35
Corporations	20	16	15	27	9	17
Deferral through 10-year capital gain reserve	<2.5	<2.5	<2.5	<2.5	<2.5	<2.5

Note: As of 2012, the enhanced Scientific Research and Experimental Development Investment Tax Credit for small CCPCs is classified as a transfer payment under the new accounting standard regarding tax revenues issued by the Public Sector Accounting Board, and is no longer considered a tax expenditure.

Source: Department of Finance Canada.

Lifetime Capital Gains Exemption

Individuals who sell shares of a CCPC can claim an exemption on up to \$800,000 of capital gains realized on the disposition of qualified property. The shares of small CCPCs are eligible provided that more than 50% of the fair market value of the assets of the CCPC was used mainly in an active business carried on in Canada (certain other conditions must also be met).⁸

Budget 2007 increased the lifetime exemption limit from \$500,000 to \$750,000 effective March 19, 2007. The limit was further increased to \$800,000 in Budget 2013 (effective January 1, 2014), and will be indexed for inflation thereafter.

⁷ Additional information on these measures can be found in the 2010 edition of *Tax Expenditures: Notes to the Estimates/Projections*, as well as in the "What's New" sections of the post-2010 editions of this report.

⁸ The shares of a CCPC that are qualified property are referred to as shares of a "small business corporation" in the *Income Tax Act*, even though no particular size limitation applies for this purpose. Qualified property also includes qualified farm and qualified fishing property.



Enhanced Scientific Research and Experimental Development (SR&ED) Investment Tax Credit for Small CCPCs

Eligible CCPCs can claim an investment tax credit in respect of eligible SR&ED expenditures at the enhanced rate of 35% on up to \$3 million of eligible expenditures annually. Also, unused investment tax credits in respect of the first \$3 million of eligible expenditures each year are fully refundable to eligible CCPCs, while 40% of unused credits in respect of eligible expenditures in excess of \$3 million are refundable.

The \$3 million expenditure limit is phased out for CCPCs whose taxable income for the previous taxation year is between \$500,000 and \$800,000 or whose taxable capital employed in Canada for the previous taxation year is between \$10 million and \$50 million (up from \$15 million before February 26, 2008). CCPCs that are above these thresholds as well as non-CCPCs can claim the SR&ED Investment Tax Credit at the rate of 15% (20% before 2014) and are not eligible for a refund of unused credits.

Rollovers of Investments in Small Businesses

Individuals can defer the tax on a capital gain arising from the disposition of shares in a qualified small business if the proceeds are reinvested in shares of another qualified small business within a specified period.⁹ Shares in a qualified small business consist of newly issued shares in an active CCPC with assets not exceeding \$50 million.

Deduction of Allowable Business Investment Losses

Capital losses arising from the disposition of shares and debt instruments are generally deductible only against capital gains. However, a portion of capital losses in respect of shares or debts of a small business corporation, known as “allowable business investment losses”, may be used to offset other income. Unused allowable business investment losses may be carried back 3 years and forward 10 years, and after 10 years revert to ordinary capital losses (which may be carried forward indefinitely).

Deferral Through 10-Year Capital Gain Reserve

If proceeds from the sale of small business shares to children, grandchildren or great-grandchildren are not all receivable in the year of sale, recognition of a portion of the capital gain realized may be deferred until the year in which the proceeds become receivable. However, a minimum of 10% of the gain must be brought into income each year, creating a maximum 10-year reserve period. This contrasts with the treatment of most other property, where the maximum reserve period is 5 years. A similar measure exists for dispositions of farm or fishing property to a child, grandchild or great-grandchild.

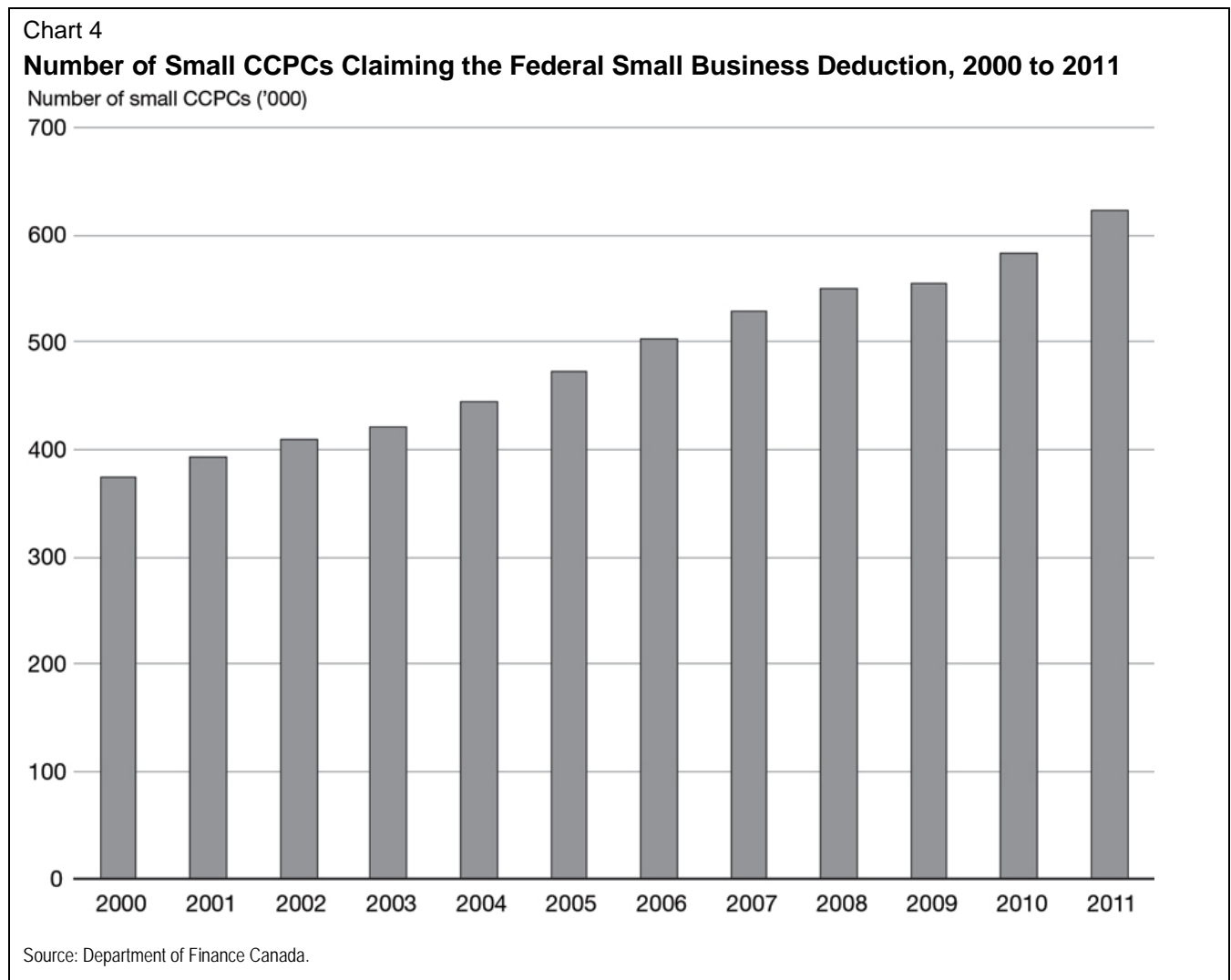
⁹ A qualified small business generally includes an active CCPC.

Statistical Profile of Small Businesses in Canada

Statistical information on small businesses is available from a number of sources.¹⁰ This section adds to this information by providing a high-level statistical profile of small businesses using federal corporate income tax data from 2000 to 2011 (the most recent year for which data is available). The information presented in this section covers small CCPCs that are claiming the small business deduction at the federal level.¹¹

Number of Small CCPCs

Chart 4 shows the number of small CCPCs for 2000 to 2011. Some 622,000 small CCPCs claimed the federal small business deduction in 2011, up from 374,000 in 2000, representing average annual growth of 4.6%. In 2011, more than 97% of CCPCs carrying out an active business (with positive taxable income) claimed the small business deduction at the federal level (or were associated with other corporations that did so).



¹⁰ See in particular the document *Key Small Business Statistics* published by Industry Canada and available at www.ic.gc.ca.

¹¹ Data on unincorporated small businesses, large CCPCs (i.e., those with taxable capital in excess of \$15 million), and incorporated small businesses that are not CCPCs, as well as data on small CCPCs that do not claim the small business deduction at the federal level (e.g., because their taxable income is nil or because they do not earn active business income), are not presented. Except for charts 5 and 6, the data is shown on an unconsolidated basis, and thus does not take into account that small CCPCs may operate via groups of commonly controlled corporations.



Distribution of Small CCPCs by Taxable Income and Taxable Capital

Chart 5 plots the number of small CCPCs by level of taxable income for 2000, 2007 and 2011. The vast majority of small CCPCs are concentrated at low levels of taxable income.

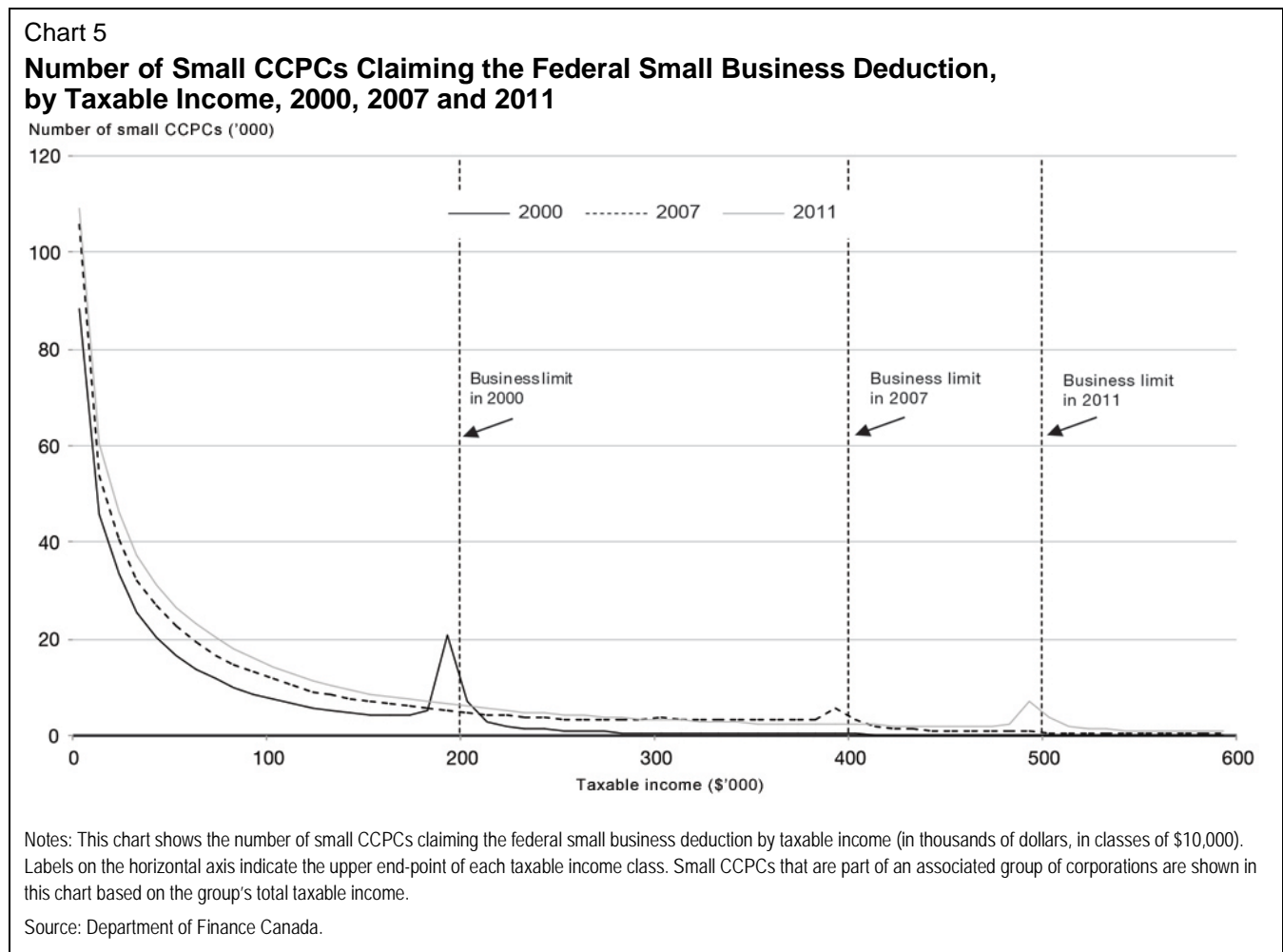
An increased concentration of CCPCs is observed in all three years at levels of taxable income at or just below the applicable business limit for these years (\$200,000 in 2000, \$400,000 in 2007 and \$500,000 in 2011).¹² This concentration (and its movement over the time series) may reflect that small business owners have some flexibility vis-à-vis the timing and form of distribution of the compensation they receive from their small business. A small business owner has a choice between retaining earnings within the small business, or distributing earnings in the form of salaries or dividends. Salaries are deductible for corporate income tax purposes and subject to personal income tax at the owner's marginal tax rate. In contrast, dividends are paid out of post-corporate income tax earnings and subject to personal income tax, with a notional dividend tax credit provided at the personal level that is intended to compensate individuals for corporate income taxes that are presumed to have been paid.

Depending on applicable marginal tax rates, a small business owner may realize tax savings in certain circumstances by increasing his or her own salary in order to keep corporate taxable income of the small business under the business limit. As shown in Chart 3, the marginal statutory tax rate in 2000 was 20% on the first \$200,000 of taxable income (the business limit applicable in that year) but was 45% on income exceeding that business limit. A small business owner facing a marginal personal income tax rate of less than 45% in 2000 and generating earnings above the business limit could have paid him or herself higher wages: this would have ensured that taxes payable on earnings in excess of the business limit are subject to personal income tax rather than corporate income tax. This strategy was more advantageous in 2000 than it was in 2007 or 2011 as, prior to the changes to the tax treatment of dividends that were announced in Budget 2006, the corporate income taxes that were paid on income not eligible for the small business tax rate were only partly relieved at the personal level once that income was paid out as dividends.¹³

¹² While not illustrated in Chart 5 to simplify the presentation, similar concentrations are observed at or just below the applicable business limit every year throughout the period.

¹³ This resulted in the combined federal-provincial marginal personal income tax rate applicable to dividends paid out of income not eligible for the small business tax rate being appreciably higher than the rate applicable to wages. For instance, a taxpayer residing in Ontario would have paid tax on such dividends at a rate of 62.3% in 2000 versus 47.9% on wages (excluding the Ontario Employer Health Tax). Budget 2006 enhanced the dividend tax credit for dividends paid after 2005 out of corporate income subject to the general corporate income tax rate, from 13⅓% to 18.9655% (since then reduced to 15.0198%), and correspondingly increased the dividend gross-up rate applicable to these dividends. This and other tax rate changes resulted in the combined tax rate on dividends paid out of income not eligible for the small business tax rate being less than 1 percentage point higher than the combined tax rate on salaries in 2013.

Chart 6 shows the number of small CCPCs by level of taxable capital for the same years as those shown in Chart 5. Similar to the distribution seen in Chart 5, the vast majority of small CCPCs are concentrated at low levels of taxable capital, with about 97% of small CCPCs claiming the federal small business deduction having less than \$3 million in taxable capital (in order to facilitate the presentation, Chart 6 plots only the number of small CCPCs that have between \$3 million and \$15 million in taxable capital). There is no concentration of CCPCs observed in Chart 6 at the levels of taxable capital at which the small business tax rate is phased out (\$10 million) and eliminated (\$15 million). This suggests that the concentrations observed in Chart 5 at the levels of taxable income at or just below the business limit are likely the result of tax planning, rather than changes in real economic decisions.¹⁴

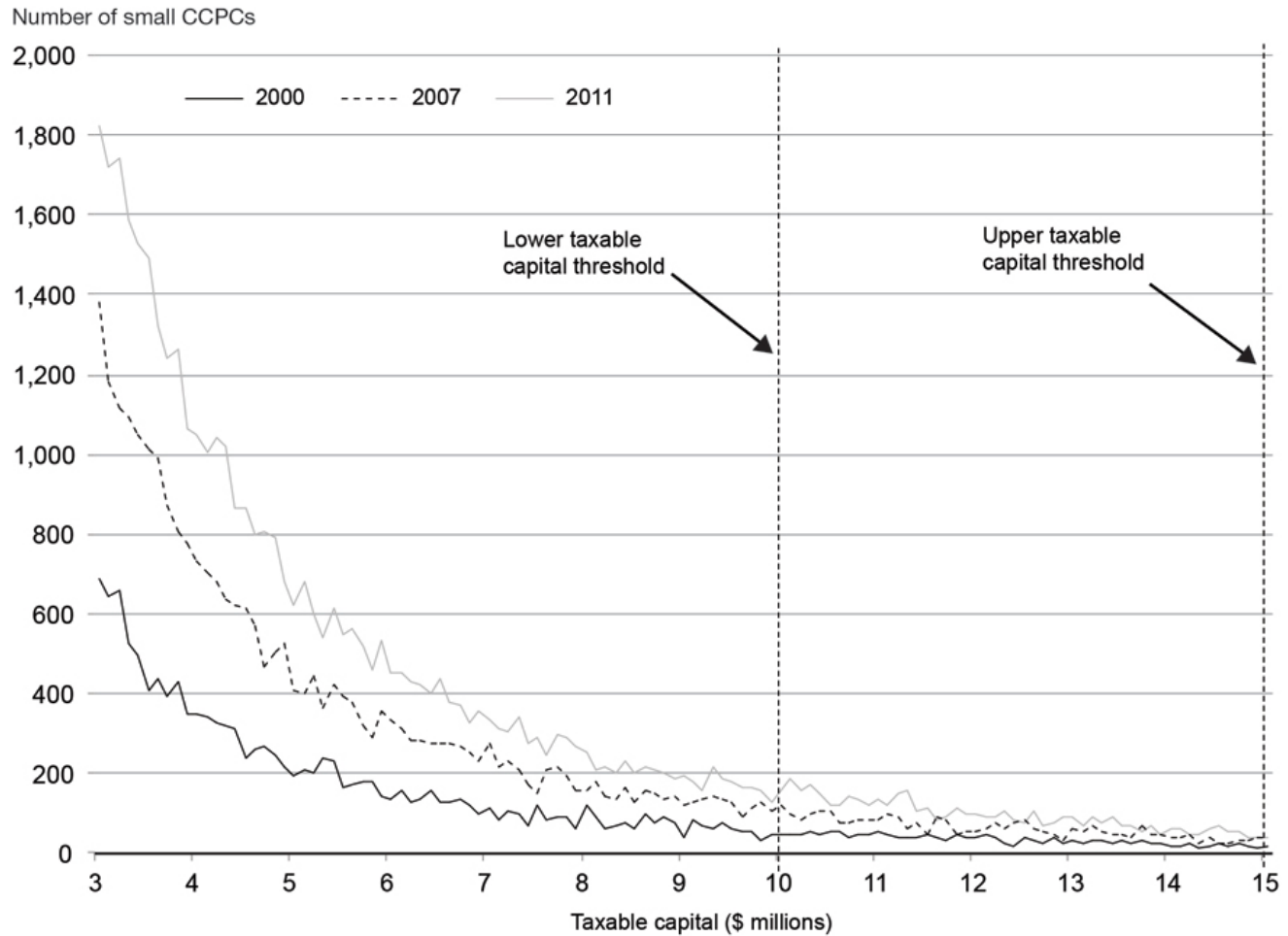


¹⁴ Such tax planning appears to have become less frequent in recent years. This may be due to a number of factors: the increase in the business limit, which resulted in more small business owners being eligible for the small business tax rate for all of their business income; the increased incentive to retain earnings that is caused by the increased differential between the general corporate income tax rate and the top personal income tax rate (see year 2014 in Chart 3); and changes to the tax treatment of dividends announced in Budget 2006 (see footnote 13).



Chart 6

Number of Small CCPCs Claiming the Federal Small Business Deduction, by Taxable Capital, 2000, 2007 and 2011



Notes: This chart shows the number of small CCPCs claiming the federal small business deduction by taxable capital (in millions of dollars, in classes of \$100,000). Only CCPCs with taxable capital between \$3 million and \$15 million are shown to facilitate the presentation. Labels on the horizontal axis indicate the mid-point of each taxable capital class. Small CCPCs that are part of an associated group of corporations are shown in this chart based on the group's total taxable capital. The vertical lines indicate the beginning and end of the range of taxable capital over which the business limit is phased out.

Corporations with taxable capital in excess of \$10 million must report their taxable capital for corporate income tax purposes. Taxable capital is based on information reported by taxpayers or, when not available, is estimated based on balance sheet information from the General Index of Financial Information statement that is filed with a corporation's T2 tax return.

Source: Department of Finance Canada.



Sectoral Distribution

Table 3 provides a breakdown of the number of small CCPCs by sector for 2000 and 2011. Professional, scientific and technical services and construction are the two sectors that account for the largest proportions of small CCPCs in 2011 (19.3% and 13.3% respectively), while the largest growth over the 2000 to 2011 period was seen in the health care and social assistance and transportation and warehousing sectors. An important shift in the sectoral composition of small CCPCs took place between 2000 and 2011, towards the health care and social assistance, professional, scientific and technical services, construction, and transportation and warehousing sectors, from the manufacturing, wholesale trade, retail trade, and finance and insurance sectors.

Table 3
Number of Small CCPCs Claiming the Federal Small Business Deduction, by Sector, 2000 and 2011

	Number of CCPCs			Sectoral Distribution			
	2000 ('000)	2011 ('000)	Change (%)	2000 (%)	2011 (%)	Change in Share (% pts.)	
All sectors	371	590	59.2	100.0	100.0		
Professional, scientific and technical services	60	114	90.0	16.2	19.3	3.1	19.4
Health care and social assistance	17	54	214.3	4.6	9.2	4.5	97.5
Administrative and support, waste management and remediation services	18	27	51.7	4.8	4.6	-0.2	-4.7
Accommodation and food services	15	21	44.9	4.0	3.6	-0.4	-9.0
Other services (except public administration)	17	28	63.9	4.5	4.7	0.1	3.0
Agriculture, forestry, fishing and hunting	23	31	34.8	6.2	5.2	-0.9	-15.3
Construction	43	79	82.3	11.6	13.3	1.7	14.5
Real estate and rental and leasing	21	32	55.5	5.6	5.5	-0.1	-2.3
Finance and insurance	22	25	12.2	6.0	4.2	-1.8	-29.5
Wholesale trade	28	30	5.3	7.6	5.0	-2.6	-33.8
Retail trade	37	47	26.2	10.1	8.0	-2.1	-20.7
Transportation and warehousing	18	38	113.7	4.8	6.5	1.6	34.2
Manufacturing	25	24	-3.5	6.7	4.1	-2.6	-39.4
Management of companies and enterprises	10	13	32.3	2.7	2.3	-0.5	-16.9
Other sectors	17	27	60.8	4.5	4.6	0.1	1.0

Note: Excluding CCPCs for which the sector of activity is unknown.

Source: Department of Finance Canada.

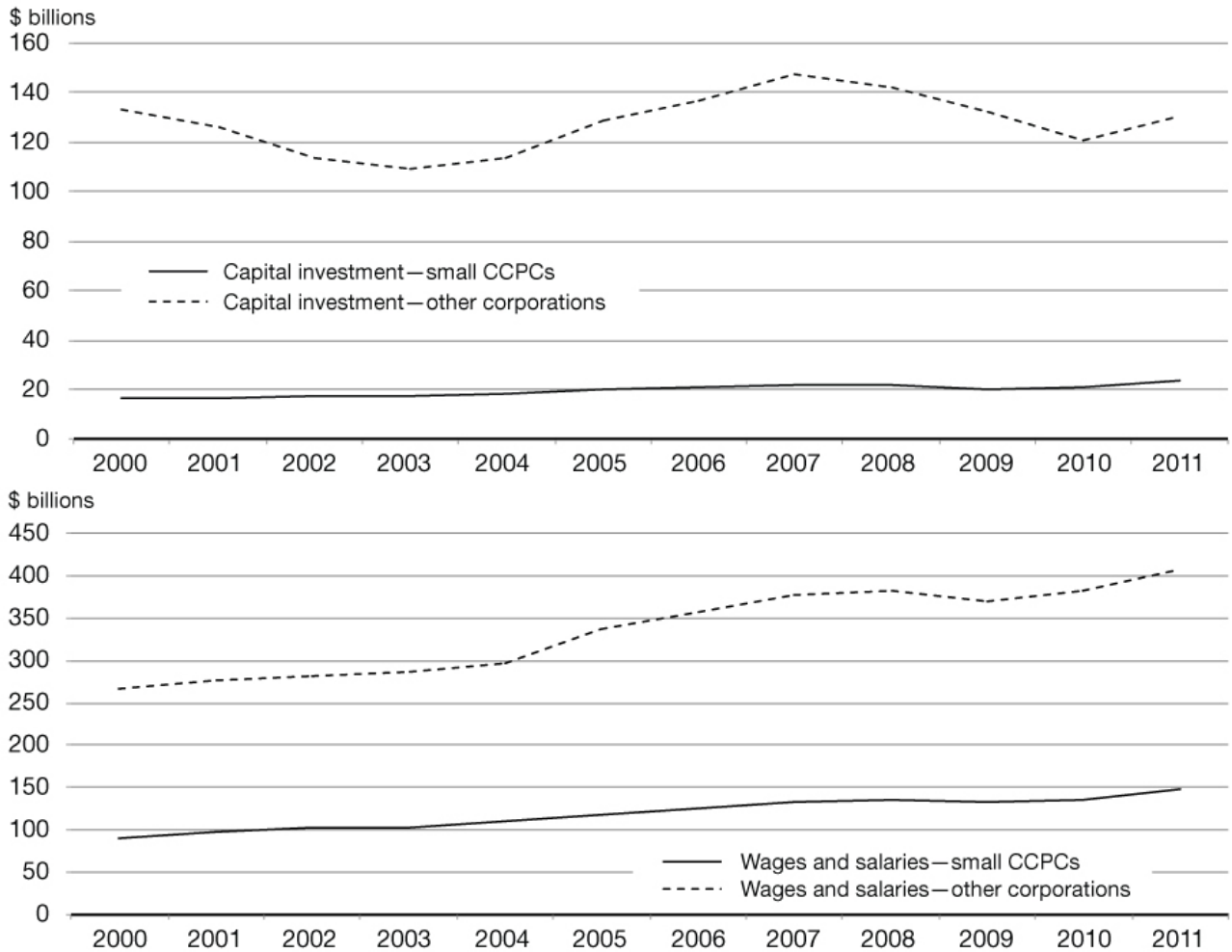
Economic Importance of Small CCPCs

Chart 7 provides an indication of the importance of the role played by small CCPCs in the Canadian economy. The chart shows total capital investment and wages and salaries reported by small CCPCs and other corporations over the 2000 to 2011 period. Capital investment is measured as the total cost of depreciable capital assets acquired in a given year.



Chart 7

Capital Investment and Wages and Salaries, Small CCPCs Claiming the Federal Small Business Deduction and Other Corporations, 2000 to 2011



Notes: Capital investment corresponds to the cost of acquisition of depreciable capital assets as reported on Schedule 8 of the T2 Corporation Income Tax Return. Wages and salaries correspond to the amount reported by corporations on Schedule 5 of the T2 return, the T4 Summary return or the General Index of Financial Information statement.

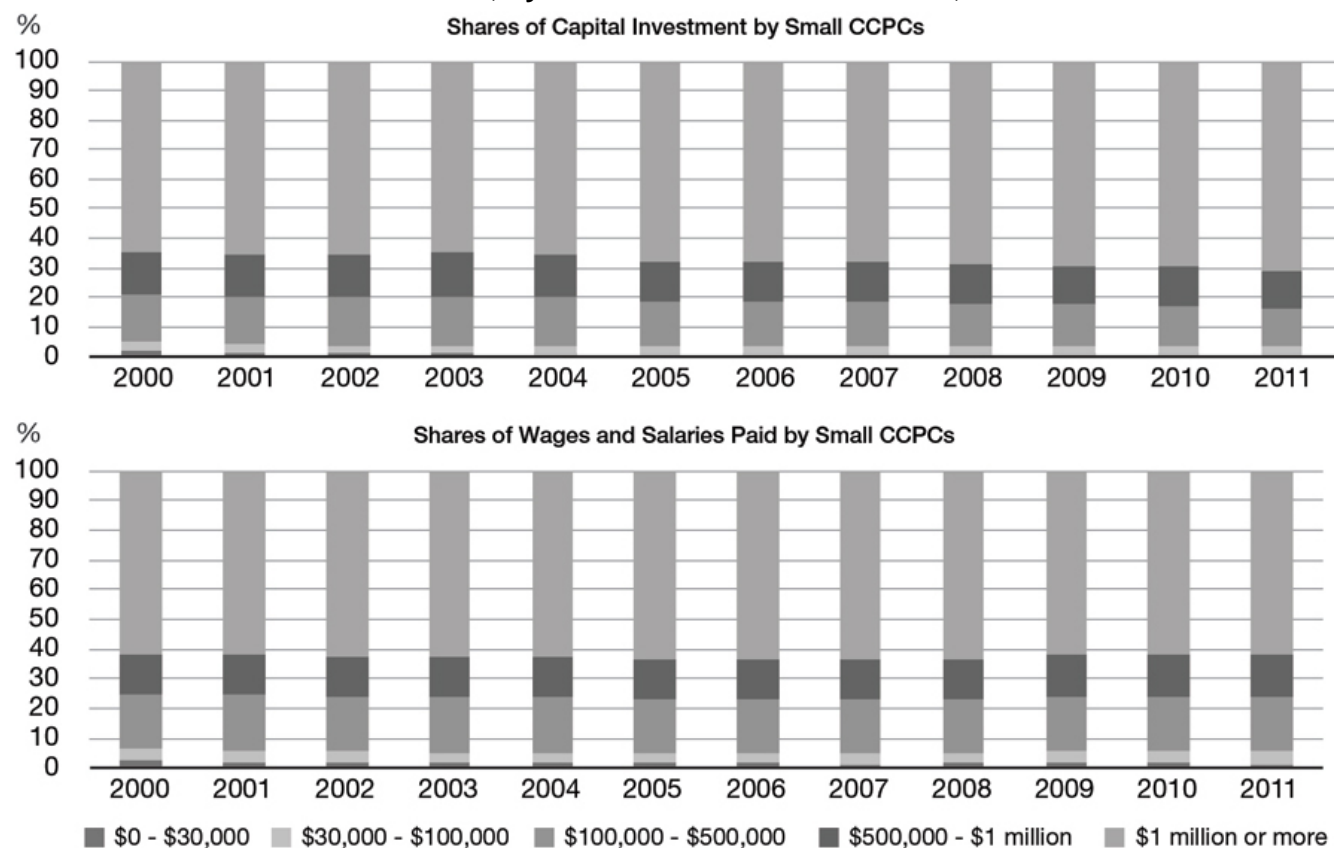
Source: Department of Finance Canada.

Capital investment by small CCPCs reached \$23.8 billion in 2011, up from \$16.4 billion in 2000, and represents 13% on average of total capital investment. Growth in capital investment by small CCPCs over this period was fairly steady at an annualized rate of 3.4%, with only one year of decline in 2009. Growth in capital investment by corporations other than small CCPCs was more variable, with negative growth observed in 6 years out of 11 between 2000 and 2011. The growth in capital investment by small CCPCs partly reflects the growth in sectors with high concentrations of small CCPCs, such as construction, and agriculture, forestry, fishing and hunting.

Trends in wages and salaries paid by small CCPCs and other corporations were similar between 2000 and 2011, and the share of the total accounted for by small CCPCs remained relatively stable (at 26% on average). Wages and salaries paid by small CCPCs totalled \$148 billion in 2011, up from \$90 billion in 2000 (an average annualized growth rate of 4.5%), with growth in the professional, scientific and technical services, construction, and health care and social assistance sectors more than offsetting the small decreases in the manufacturing and finance and insurance sectors.

Chart 8 shows the distribution of capital investment made and wages and salaries paid by small CCPCs, by size of CCPCs (in terms of total assets). The largest among small CCPCs, those with assets of \$1 million or greater (representing about 20% of the number of small CCPCs), account for more than two-thirds on average of capital investment made by small CCPCs, and an even larger share (85%) of the growth in capital investment by small CCPCs observed between 2000 and 2011. Small CCPCs with assets of \$1 million or greater account on average for about 63% of wages and salaries paid by small CCPCs, and for a similar proportion of the growth in wages and salaries paid observed over the period.

Chart 8
Shares of Capital Investment Made and Wages and Salaries Paid by Small CCPCs Claiming the Federal Small Business Deduction, by Total Assets of Small CCPCs, 2000 to 2011



Notes: Total assets as reported by corporations on the General Index of Financial Information statement. See also notes to Chart 7.

Source: Department of Finance Canada.



Summary of Key Findings

This paper describes key tax measures that provide support to small businesses in Canada. It also reviews developments since 2000 in this regard, notably the significant decrease in the corporate income tax rates applicable to the eligible income of small CCPCs and developments in the eligibility criteria.

- A small CCPC with \$500,000 in taxable income now pays less than one-half the corporate income taxes it paid in 2000 at the federal and provincial levels.
- CCPCs of all sizes now face marginal tax rates that are much lower than the top federal-provincial statutory personal income tax rate. This provides an incentive for CCPCs to reinvest their earnings and grow their business rather than distributing their earnings as dividends or wages.

The paper provides information about the distribution of small CCPCs that claimed the federal small business deduction by taxable income and taxable capital:

- Concentrations of CCPCs are observed in all years at levels of taxable income at or just below the limit of taxable income eligible for the small business tax rate in a given year (e.g., \$500,000 in 2011), which may reflect flexibility regarding the timing and form of distributions of the compensation received by small business owners.
- No such concentrations of CCPCs are observed at the levels of taxable capital at which the small business tax rate is phased out (\$10 million) and eliminated (\$15 million).

Other key statistical findings with respect to small CCPCs in Canada that claimed the federal small business deduction are as follows:

- Some 622,000 small CCPCs claimed the federal small business deduction in 2011, up from 374,000 in 2000, representing average annual growth of 4.6%. In 2011, more than 97% of CCPCs carrying out an active business that had positive taxable income claimed the small business deduction at the federal level (or were associated with other corporations that did so).
- An important shift in the sectoral composition of small CCPCs took place between 2000 and 2011, with more small CCPCs now being found in the health care and social assistance, professional, scientific and technical services, transportation and warehousing, and construction sectors.

The vast majority of small CCPCs are concentrated at the low end of taxable income and taxable capital categories, yet small CCPCs account for 13% on average of total capital investment and 26% of total wages and salaries reported by corporations in Canada. The largest among small CCPCs account for a significant proportion of these investments.