CANADIANS FOR TAX FAIRNESS
CANADIENS POUR UNE FISCALITÉ ÉQUITABLE

Three Smart Ways to Raise More Revenue

Brief to House of Commons Finance Committee

Pre-Budget Consultations in Advance of the 2017 Budget

From Canadians for Tax Fairness

August 2016

The federal government cannot deliver on all its promises and adequately address the many social, economic and environmental challenges we face unless it can find a way to raise significant amounts of new revenue. Deficit financing will not be sufficient.

There are three ways the government could raise additional revenue that should be given serious consideration. **We estimate that these options, if fully implemented, could raise an additional $20 billion annually.**

1. Close Tax Loopholes

There are many tax expenditures that are unfair or have outlived their usefulness and that should be ended. This would not only save billions of dollars but would make the tax system simpler and fairer and easier to enforce.

The 2016 Federal Budget promised a review of all tax expenditures and the Finance Minister has said they expect to be able to find $3 billion in savings. The promise to review tax expenditures is welcome but the government needs to set a more ambitious savings target. We think there is at least **$16 billion** in savings that could be realized from closing unfair and ineffective tax loopholes.

We hope there will be an opportunity in addition to the Finance Committee's Pre-Budget Consultations to provide more detailed input to the government on their review of tax expenditures but here are some of the most obvious candidates for elimination:

a. **Eliminate the stock option deduction**: This loophole allows corporate executives to pay tax on their stock option compensation at half the statutory rate most pay on their working income. Not only is the deduction highly regressive, with over 90% of the benefit going to the top 1% of tax filers who make more than $250,000 annually, it is also bad for the economy as it encourages CEOs to inflate short-term stock prices through share buybacks instead of investing in the economy. Annual savings are estimated to be about **$840 million.**[i]

b. **End abuse of small business corporations tax rate***:* Tax laws allow accountants, dentists, doctors and small business operators to provide their services through Canadian-controlled private corporations (CCPCs) rather than as employees. These individuals then pay tax on income held within these businesses at the much lower small business rate (11%, declining to 9%) on their first $500,000 of income instead of at the federal personal income tax rates of up to 33%. Some also pay family members, who actually don't do any work for the business. Closing this loophole would save about **$500 million** a year.

c. **Limit capital gains deduction***:* Individuals and corporations who profit from the sale of investments or assets are able to pay tax at half the rate of tax on income from employment. We recommend maintaining the lifetime capital gains exemptions, but income from capital investments should be taxed at the same rate as employment income after adjusting for inflation. Allowing for an inflation adjustment would still provide some tax deferral benefit to investors but encourage longer term investments rather than short term speculative investments. Annual savings would be **$10 billion.**

d. **Lifetime limit for Tax Free Savings Accounts***:* The decision to reverse the doubling of the annual contribution limit for TFSAs is welcome as the benefits of TFSAs primarily go to those earning higher incomes. But the cost in terms of foregone revenues will still continue escalate to many billions annually unless a lifetime limit is set. The cumulative amount individuals can contribute to TFSAs will be $46,500 in 2016. We suggest therefore that a $50,000 lifetime cap be put on TFSAs to avoid a revenue sinkhole in the future. Annual savings would be modest **at $100 million** initially, but would increase to billions of dollars in future years.

e. **Reduce RRSP contribution limits***:* High RRSP contribution limits provide government support to high income people who don't need help with their retirement savings while leaving less revenue available to support lower income seniors who need help the most. Lowering the annual contribution limit to $20,000 could save **$2 billion** a year while still providing a retirement savings option for most middle and lower income Canadians.

f. **Review and replace ineffective boutique tax credits**: Under the previous government, Canada's tax system became riddled with "boutique tax credits" for specific activities. These made filling out annual tax forms much more complex, and have generally not been effective in their intended objective. The 2015 Federal Budget eliminated several of these credits. But there are still more that should be cancelled. Ineffective and regressive credits should be eliminated or replaced with effective and equitable measures. Annual savings of up to **$500 million** could be realized by doing this.

g. **Cancel the corporate meals and entertainment expense deduction**: Businesses are allowed to deduct half their meal and entertainment expenses, including the cost of

season's tickets and private boxes at sports events. This is widely abused, according to the U.S. study of a similar measure there.[ii] The meal expense for long-distance truckers could be maintained. Annual savings of **$600 million** could be expected.

h. **End fossil fuel subsidies:** While some fossil fuel subsidies have been reduced, federal tax subsidies to the fossil fuel industries still amount **to $1.6 billion** annually according to a recent report from Oil Change International. Canada signed on to a G20 commitment to eliminate fossil fuel subsidies and it is time we delivered on this promise.

2. Stop Corporate Offshore Tax Dodging

The government has taken some welcome steps to combat tax haven facilitated tax evasion by wealthy individuals this year. But we estimate that individual use of tax haven tax evasion schemes is only about one third of the problem. Two thirds of revenue losses related to tax haven abuse is likely due to corporate tax dodging.

Many large and some medium sized companies have offshore subsidiaries. A study we commissioned found that 56 of the 60 major companies listed on the TSX had a total of 973 subsidiaries in tax havens.

Many corporations claim that their use of tax haven subsidiaries is perfectly legal. But the best that can be said is that it is a grey area. There is evidence both in Canada and in other jurisdictions that the primary function of tax haven subsidiaries is to shift profits in order to reduce corporate tax payments. Outdated international corporate tax rules do indeed allow a lot of legal latitude for multinational companies to shift profits in order to minimize taxes. Because of weak enforcement, some corporations are able to cross the line of what is legal, calculating that the risk of getting caught and having to pay up are far outweighed by the additional profits that can be made by short changing governments.

International agreement is needed to fix some corporate tax law problems such as the continued application of the difficult to enforce "arms-length rule" by replacing this with unitary taxation regime that would apportion tax payments by multinational companies to different governments according to the amount of business they do in each jurisdiction (similar to how business revenue is apportioned between different provinces in Canada).

But there are several measures the Canadian government could take to reform corporate tax rules and stem the revenue losses due to corporate profit shifting to tax havens:

a. **Economic substance** - One way to restrict corporate tax haven abuse would be to require economic substance for any offshore subsidiary to be recognized as a separate corporate entity for tax purposes. Bill C-621, introduced in the last parliament by Murray Rankin, provides a good legislative example of how this could be done.[iii] We estimate this measure **could raise $400 million a year**.

b. **Capping interest payments to offshore subsidiaries** - Canada used to have a cap on tax deductibility of interest payments to offshore subsidiaries but this was removed by the previous government. It is time to re-instate this measure in order to curb offshore abuse. The OECD has recommended doing this in their Base Erosion and Profit Shifting (BEPS) Action Plan. The British government introduced this measure in their 2016 budget, though their fixed cap at 30% is far too high to be very effective. We recommend a Group Ratio Rule, limiting the deductibility of interest to the entity's share of the group's consolidated net interest expense, apportioned by earnings (EBITDA). If this is combined with a fixed cap, it should be set at the lowest level of 10%.[iv] We estimate this measure could raise at least **$200 million** annually.

c. **Applying a 1% withholding tax on Canadian assets held in tax havens -** Canadian direct foreign investment in tax havens increased to $270 billion in 2015. This amounts to a quarter of all Canadian direct foreign investment abroad. The main reason for channeling investments through tax havens is to evade or avoid paying taxes in Canada. Applying a 1% withholding tax on Canadian assets held in tax havens would likely raise revenue of over **$2 billion** a year.

3. Tax E-commerce Companies to Level the Playing Field

E-commerce companies such as Netflix, Amazon Prime, and Google (YouTube), Amazon, Uber, and Airbnb, are capturing a huge and growing share of the Canadian market but pay little or no taxes. They have been exempted from paying taxes by the Canada Revenue Agency because they have no physical presence in Canada and therefore are deemed not to be "carrying on business" in Canada.[v] This policy is outdated.

The foreign-owned e-commerce sector now has revenues of more than $30 billion a year and just Google and Facebook together capture 64% of all internet advertising dollars spent in Canada – over $2.4 billion. Internet advertising is growing rapidly and now captures 34% of all ad spending, compared with 30% for television, 13% for daily newspapers and 14% for radio.[vi]

Foreign e-commerce companies are squeezing out many Canadian media companies, taxi services. hotels and retailers, including many small businesses. Good jobs are being lost and in the few cases where they are replaced, they are part-time and insecure low-wage jobs. Canadian companies are losing because of unfair competition to foreign companies that pay little or no taxes.

Companies like Netflix, referred to as "Over-the-Top" media services are also not required to produce, broadcast or contribute to Canadian content. This has a direct impact on our cultural industry. It is depriving many artists and actors of work and impoverishing the Canadian cultural sector. All Canadians lose when our culture is diminished.

The European Union, New Zealand, Australia, Norway, South Korea, Japan, Switzerland, and South Africa, have modernized tax laws to respond to changing e-commerce reality.[vii]

The OECD in its BEPS Action Plan on Addressing the Tax Challenges of the Digital Economy has recommended ways that governments can collect value added taxes where the product is purchased to help level the playing field between foreign and domestic suppliers.[viii]

Canadians have embraced e-commerce in a major way. However our tax policies have not kept pace. Failure to update our tax policy creates unfair competition, causes significant job losses in the journalism, media and cultural sectors, threatens the vitality of Canadian culture and squanders to opportunity to raise several billion dollars in revenue for both federal and provincial governments.

We recommend that the Canadian government level the playing filed by:

a. Making all e-commerce companies with Canadian income above a certain threshold pay corporate income tax on profits from products or services sold or rented in Canada whether or not they have a physical presence in Canada. It is difficult to estimate how much revenue this would raise as large foreign companies like Google and Netflix do not separate out their Canadian earnings but could be as high as **$600 million** a year.

b. Ending the GST/HST tax exemption for electronic commerce services (above a determined sales threshold) that sell to Canadians and requiring them to collect and remit GST/HST and PST amounts to federal and provincial governments on their sales in Canada. We estimate this would raise **$312 million** a year.

---

[i] Many of the revenue estimates are taken from Finance Canada, Report on Federal Tax Expenditures - Concepts, Estimates and Evaluations 2016. http://www.fin.gc.ca/taxexp-depfisc/2016/taxexp1602-eng.asp#_Toc442180630

[ii] Richard Schmalbeck and Jay A. Soled, Elimination of the Deduction for Business Entertainment Expenses http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=2733&context=faculty_scholarship

[iii] https://openparliament.ca/bills/41-2/C-621/

[iv] For details on this issue see G20 SUBMISSION ON BEHALF OF THE BEPS MONITORING GROUP to UK Parliament, All-Party Parliamentary Group Examination of the OECD'S BEPS recommendations to the G20 https://bepsmonitoringgroup.files.wordpress.com/2016/01/bmg-submission-to-uk-all-party-parliamentary-group.pdf

[v] Canada Revenue Agency, Carrying on business in Canada, GST/HST Policy Statement P- 051R2, Date of Revision April 29, 2005. This policy statement cancels P-051R1, dated March 8, 1999: http://www.cra-arc.gc.ca/E/pub/gl/p-051r2/p-051r2-e.html

[vi] John Anderson, Over the Top Exemption, 2016: Canadian Centre for Policy Alternatives, p.11. https://www.policyalternatives.ca/sites/default/files/uploads/publications/National%20Office/2016/06/Over_the_Top_Exemption.pdf

[vii] John Anderson, Over the Top Exemption, 2016: Canadian Centre for Policy Alternatives, p.18 – 21. https://www.policyalternatives.ca/sites/default/files/uploads/publications/National%20Office/2016/06/Over_the_Top_Exemption.pdf

[viii] http://www.oecd.org/tax/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report-9789264241046-en.htm