Corporate income tax sharing: The Canadian way

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April 2018

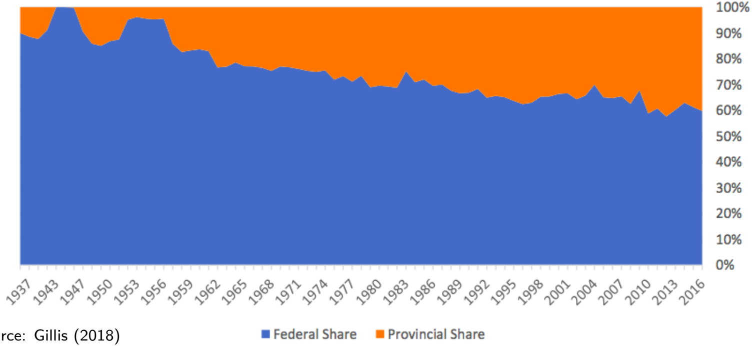
Overview of the system

I. Tax base sharing

Corporate tax base shared between federal and provincial governments

- provinces have freedom on rates
- receive about 40% of consolidated revenues
- general statutory tax rates 12-16% (compared to 15% federal)

Federal and provincial CIT revenue shares, 1937-2016



Source: Gillis (2018)

Overview of the system

II. Tax policy and administration

- Ottawa has Tax Collection Agreements with 8 of 10 provinces
  - federal legislation and administration of common tax base
  - "one stop shopping" for taxpayers
  - collection costs borne federally
  - incremental cost pricing to administer provincial tax measures
- Two non-acceding provinces have independent taxes, but ...
  - coordinate closely on policy
  - largely rely on federal audit and enforcement

Overview of the system

III. Revenue allocation

Provincial formula apportionment (FA)

- applies to corporations with PEs in multiple provinces
- equally weighted sales and payroll
- special weights for transport, finance, etc.
- set in federal legislation, but also adopted by non-acceding provinces

But no group consolidation

- separate accounting (SA) for affiliates
- so FA is in effect elective for taxpayers
- potential for tax loss shifting and profit shifting across provinces
  - through leasing, financing, and transfer pricing, etc.

Overview of the system

III. Fiscal equalization

Federal capacity equalization grants are paid in respect of most provincial revenue sources – including CIT

- Equalization currently paid to 7 of 10 (small, poor) provinces
- provinces receive grants compensating for difference between own CIT base and a standard level, valued at national average tax rate
- so, if all provinces set same tax rate, this converts CIT allocation formula into an equal per capita grant!
- this changes provincial government incentives dramatically...

Assessment

I. Goals of the system

Is it possible to design a system that respects the principle of subsidiarity while:

- limiting tax avoidance through income shifting, tax base mobility
- controlling tax competition by governments
- sharing revenue fairly
- reducing complexity and compliance costs for taxpayers

Well, no.

- winners and losers under FA
- economic distortions may be larger, and competitive pressures stronger, under FA

But arguably Canada's system works reasonably well in all these dimensions.

How?

Assessment

II. How important is apportionment in controlling income shifting?

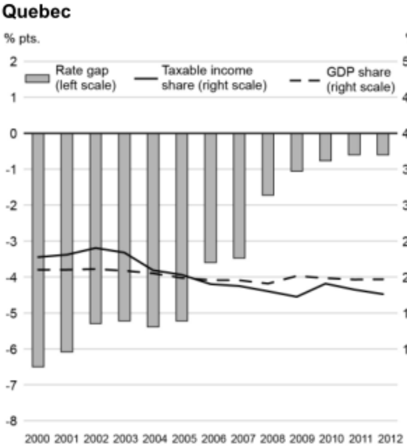
- Mintz and Smart (2004) estimate elasticities of corporate taxable income
- much higher avoidance responses under SA than FA

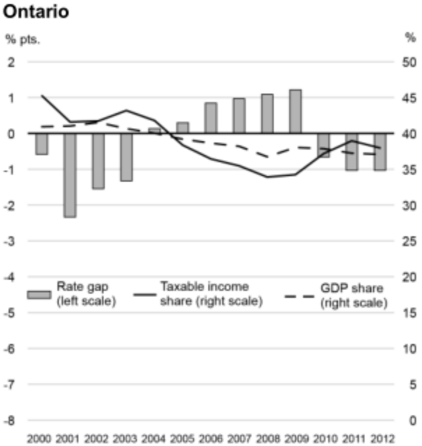
firm type	estimated elasticity
single-province subsidiaries (SA)	4.6
other large firms (FA)	2.3

- Department of Finance (2014) replication (with better data) also finds greater provincial tax avoidance under SA than FA
- in aggregate, provinces' share of base responds to tax rate differences (example)

Assessment

Tax base shares respond to rate differentials





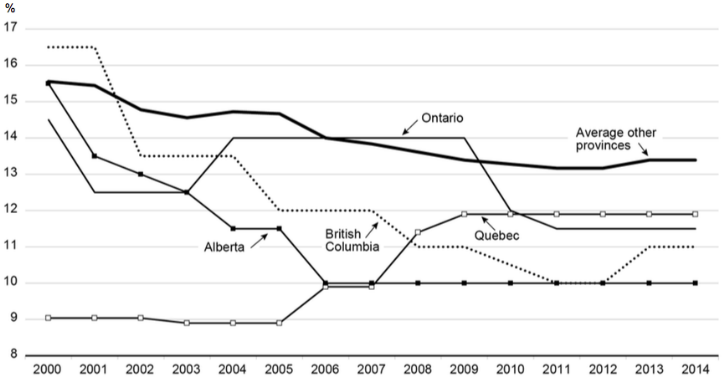
Source: Department of Finance (2014)

Assessment

III. What limits tax competition among provinces?

While federal CIT rates have declined, provincial rates have been stable.
Why is there not more provincial tax competition?

Provincial Statutory General Corporate Income Tax Rates, Selected Provinces, 2000 to 2014



Notes: Statutory general CIT rates are those applicable as of December 31 of the reference year. The average for other provinces refers to the unweighted average of all provinces except Quebec, Ontario, Alberta and British Columbia.

Source: Department of Finance.

Assessment

III. What limits tax competition among provinces?

While federal CIT rates have declined, provincial rates have been stable. Why is there not more provincial tax competition?

1. Role of apportionment ... but:
   - without group consolidation, SA and income shifting persist
   - FA is not a panacea anyway...
2. Role of Equalization
   - consider a rate reduction to attract tax base from other provinces
     - this may increase own-source tax revenue
     - ... but it reduces Equalization grants nearly dollar-for-dollar!
   - so Equalization mitigates tax competition incentives
   - evidence (Smart, 2007):
     - tax rates are typically higher in grant-receiving provinces (graph)
     - tax rates rise when Equalization is enriched
     - based on a structural model, tax rates would be 38% lower in grant-receiving provinces if grants were abolished

Assessment

IV. What explains stability of the Canadian system?

FA creates winnners and losers ... and new tax competition games. Yet:

- most provinces have signed on for common tax base
- no province has deviated substantially from federal FA weights

Why?

1. Small numbers
   - perceived benefits to a harmonized system and federal leadership
   - strategic defection may be easier to control with just 10 provinces
2. Fiscal dimension
   - Direct federal financial incentives
     - free or low-cost administration of provincial taxes
     - "transitional" payments to acceding provinces
   - Equalization grants align provincial incentives:
     - low-income, high-tax provinces might be disadvantaged by current FA formulas
     - but Equalization grants offset such revenue losses – why complain?

Concluding remarks

Features of the Canadian system:

- (mostly) harmonized tax base
- strong federal role, maintained at federal expense (tax administration, Equalization grants)
- common FA system in all provinces
- reasonable limits on income shifting, tax competition

Questions and critiques:

- FA is in effect elective for corporate groups – why?
- would sales weighting be fairer? less distortionary?
- would status quo survive without federal fiscal incentives?

Corporate tax rates, 1987-2015

Equalization receiving and non-receiving provinces