

An Overview of Tax Policy for Tax Practitioners

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Introduction

- Overview
- Note on Sources and Bibliography
- Structure of Presentation
 - Relation of Tax Policy and Tax Practice
 - Tax Policy Theoretical Framework
 - Different Types of Taxes
 - Questions

Relation of Tax Policy and Tax Practice

“In theory there is no difference between theory and practice, but in practice there is.” Yogi Berra

- Understanding the tax system
- Obtaining changes to tax rules
- Obtaining administrative results
- Dealing with anti-avoidance

Tax Policy Theoretical Framework

- Public Policy
- Classic Tax Policy Goals
 - Revenue raising
 - Economic efficiency
 - Equity
 - Administerability
- Other Goals for Taxation
- The Question of Tax Incidence
- Optimal Tax Theory

Revenue Raising Purpose

- At first instance, the main purpose of raising tax revenues for governments is to provide for expenditures that benefit the public at large.
- These expenditures are most often made in a way that effects redistribution of income (wealth) from those with more to those with less.
- Such redistribution involves the use of tax revenue both to finance the provision of public goods at nil or subsidized prices to the public at large, and to finance cash transfers to individuals based on their income.
- Much theoretical work has been done by economists to determine methodology for designing taxes to achieve a given amount of revenue, taking account of the effects on economic efficiency and equity goals (refer to Optimal Tax Theory below).

Tax Revenue Estimation

- Static approach to revenue estimation begins with a baseline using actual tax and other data, adjusted for projections of economic growth, assuming no tax changes. Proposed tax changes, including transition, are then factored in to provide revenue estimates for future years.
- Dynamic approach to revenue estimation begins with the static approach, but adds on the estimated effects of certain projected behavioural reactions to the proposed tax changes—e.g. increased or decreased labour or investment in the economy.
- Tax expenditure analysis (created by Stanley Surrey in the late 1960s) is an attempt to analyze tax system relieving provisions that are more akin to spending measures, by identifying and quantifying the cost of tax provisions that deviate from an idealized “benchmark” tax system.
 - See Finance Canada, *Tax Expenditures and Evaluations 2012*.
 - This is a process fraught with difficulty and controversy.

Raising Tax Revenue in Canada

- The Constitution Act (Canada) provides that the Federal government may raise revenue using any kind of tax, but provincial governments may only raise revenue with “direct taxes in the province”.
 - This allows provincial income and sales taxes; but not provincial tariffs, non-resident withholding tax or intermediate (indirect) sales tax.
 - Municipal and local taxation is provided for by provincial law.
- For a federal state Canada has a large degree of “harmonization” of federal/provincial taxation and administration—e.g. PIT, CIT and HST.
- Federal and provincial governments generally follow a parliamentary Budget process to impose or alter taxes, though this can be, and often is, done outside the Budget process.

Raising Tax Revenue in Canada (2011)

(millions of dollars)

	<u>PIT</u>	<u>CIT</u>	<u>Sales and Excise Taxes</u>	<u>Property Tax (+other local)</u>	<u>Social Insurance</u>	<u>Other</u>
Federal	118,851	32,841	42,900	---	18,585	5,866
Provincial	73,922	22,034	64,999*	53,929	11,463	---
Total	192,773	54,875	107,899	53,929	30,048	5,866

Federal Total = 219,043

Provincial Total = 226,347

445,390

Source: Karin Treff and Deborah Ort, *Finances of the Nation, 2012* (Toronto: Canadian Tax Foundation, 2013), Tables A.4 and 2.2. See Notes on following Slide.

*2009 data from Karin Treff and Deborah Ort, *Finances of the Nation, 2011* (as above, 2012), Table 5.2.

Notes for “Raising Tax Revenue in Canada (2011)”

- “Tax revenues” do not include CPP/QPP contributions of about \$38 billion, and predominantly provincial resource royalties in the range of \$20 billion, both of which could be considered as taxes. This would make total taxes of about \$504 billion. Together with \$156 billion of other revenue, total government revenue in Canada in 2011 was about \$660 billion, or 38% of GDP.*
- Sales and Excise Taxes include GST, HST, provincial RST, Federal Excise Tax and other similar taxes, and import tariff duties.
- Social Insurance Taxes includes payroll taxes such as EI and Workers’ Compensation contributions and various healthcare levies and similar taxes.
- Other taxes include withholding taxes and other miscellaneous tax revenues.

*See Treff and Ort (2013), Tables A.3 and A.4.

Economic Efficiency

- “Economic efficiency” connotes the allocation of economic resources in an economy in a manner which optimizes the production of goods and services, and maximizes total welfare.
- A perfectly competitive market for a product will allocate economic resources, such as labour and capital, efficiently by determining price equilibrium where the marginal cost of production equals the marginal benefit in consumption.
- An “externality” is a cost or benefit that results from production or consumption that involves a third party that is not directly involved in the transaction.
 - Negative externalities (e.g. costs from pollution) cause market prices to understate marginal costs; positive externalities (e.g. general value of R&D) cause market demand to understate total social benefits.
- Additional factors operating on a market which alter equilibrium from the optimum allocation of resources are considered “distortions”.

Figure 1.1: Economic Efficiency of Markets

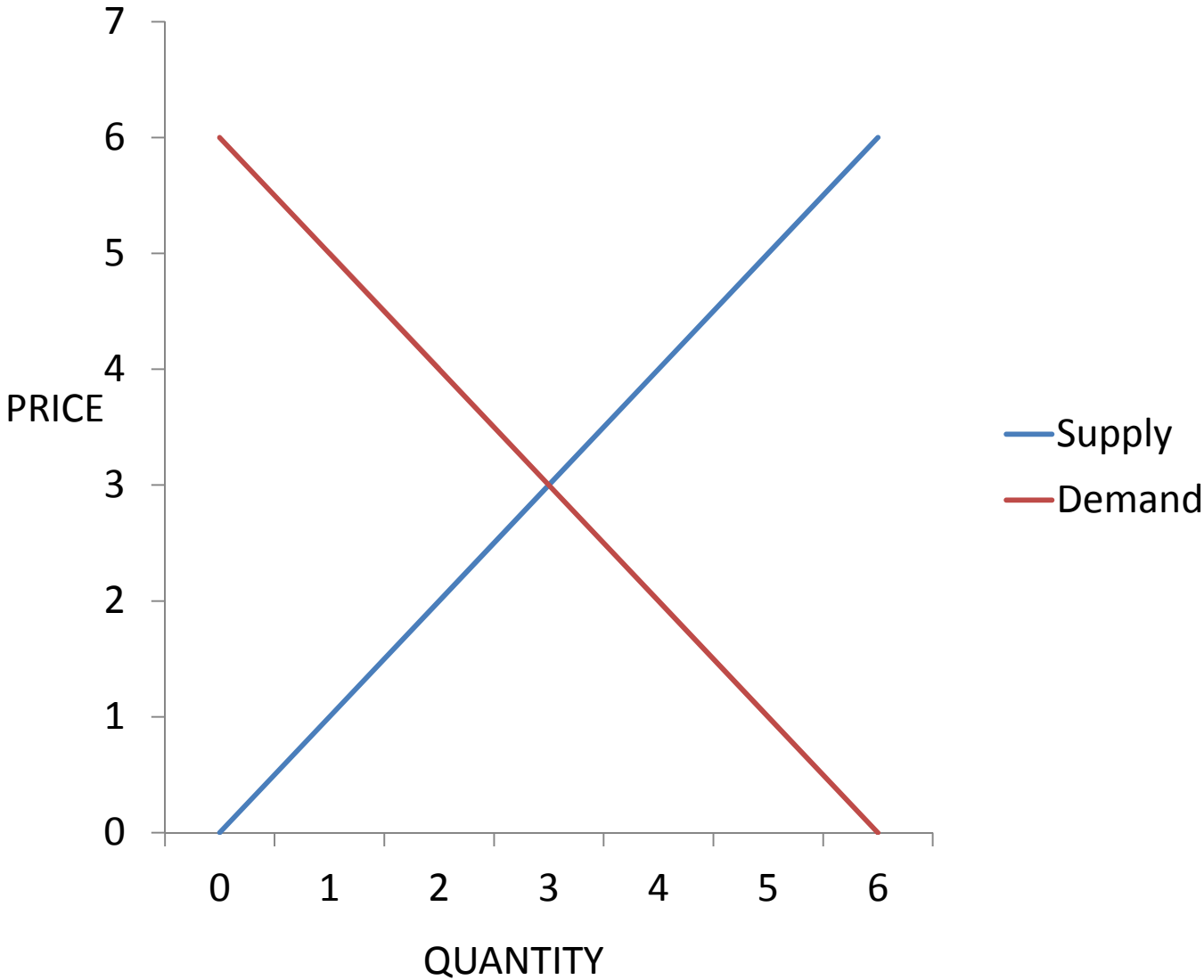
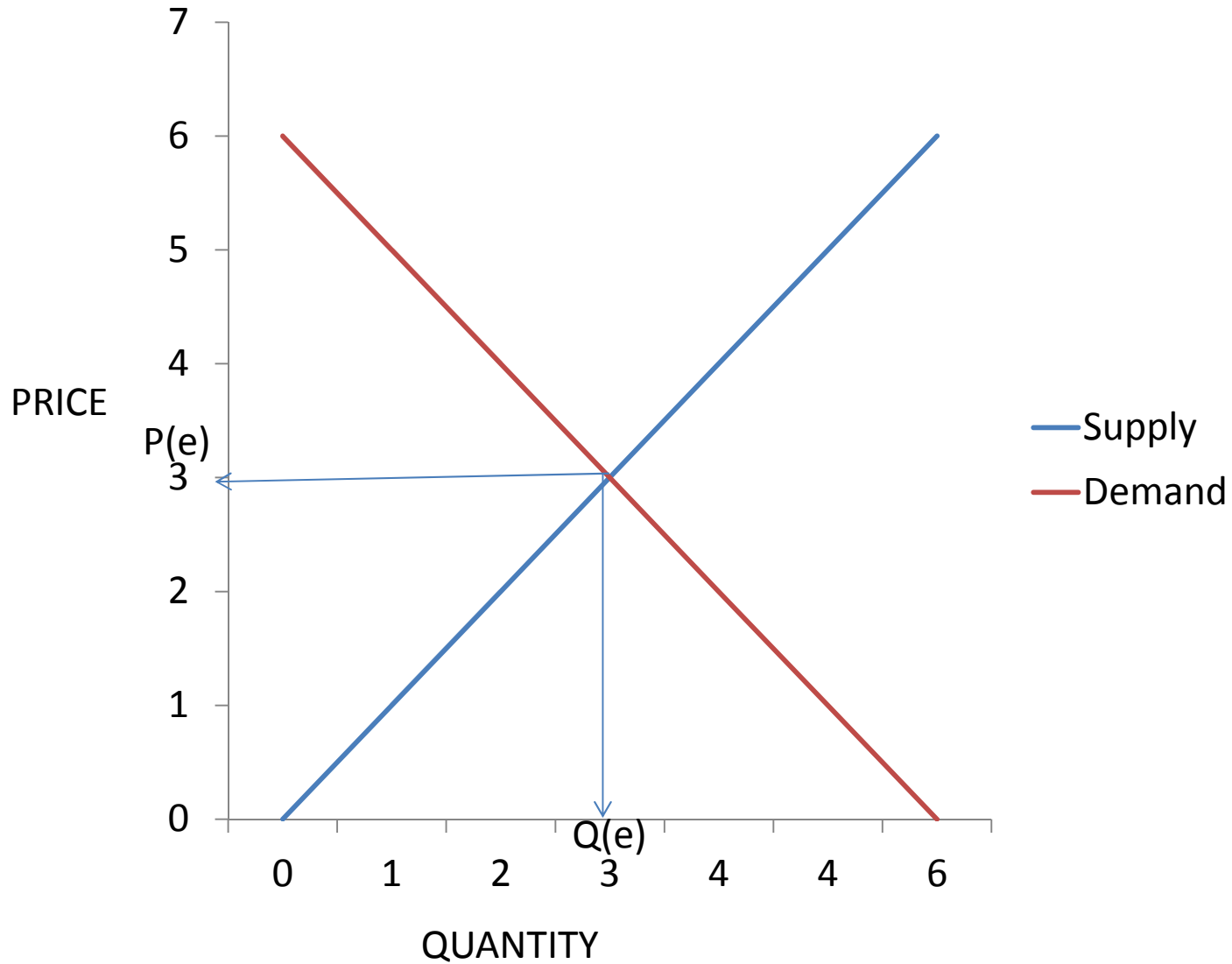


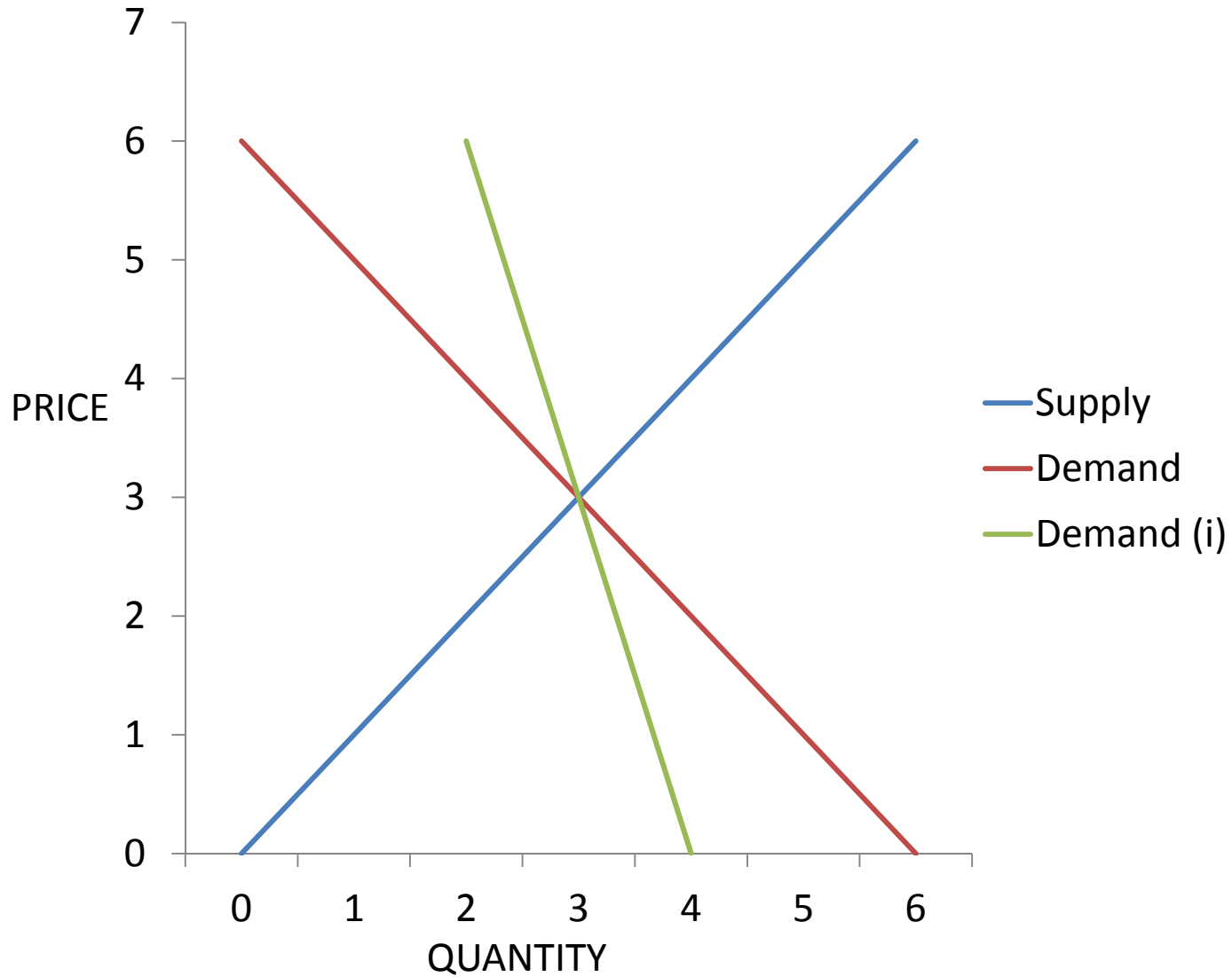
Figure 1.2: Economic Efficiency of Markets: Equilibrium



Elasticity of Supply and Demand

- Price “elasticity” of supply or demand is the percentage change in supply or demand divided by the percentage change in price.
- The more elastic the supply or demand, the more it will increase or decrease with price; the more inelastic, the less it will change.
- On a Supply and Demand chart the “supply curve” and “demand curve” are represented by straight or curved lines; “elasticities” of supply and demand depend on the slopes of the lines as well as the ratio of the price to the quantity:
 - A vertical demand or supply curve indicates zero elasticity or complete inelasticity; a horizontal demand or supply curve indicates infinite or complete elasticity.
- Much empirically based analysis is done to attempt to calculate actual elasticities for various goods and services; however, results can be controversial, with considerable uncertainty remaining as to actual elasticities.

Figure 1.3: Economic Efficiency of Markets: Price Elasticity



Economic Efficiency and Taxation

- The imposition of a tax will almost always cause a change in the allocation of inputs and a reduction in production in the economy—i.e. taxes normally cause distortions. This effect is increased to the extent that the tax creates non-neutralities across different sectors or types of economic activity.
- The “excess burden” of taxation is a measure of the loss of producer and consumer surplus from the change in allocation of resources in the economy less the tax revenue collected from the tax. This is also sometimes called “deadweight loss” or “allocative inefficiency”.
- Different taxes with different structures can cause more or less distortion of economic activity (refer to Optimal Tax Theory below).
- Imposition of price floors or caps have similar distorting effect as taxes, and subsidies have a distorting effect which is inverse to that of tax.

Figure 2.1: Economic Efficiency and Taxation

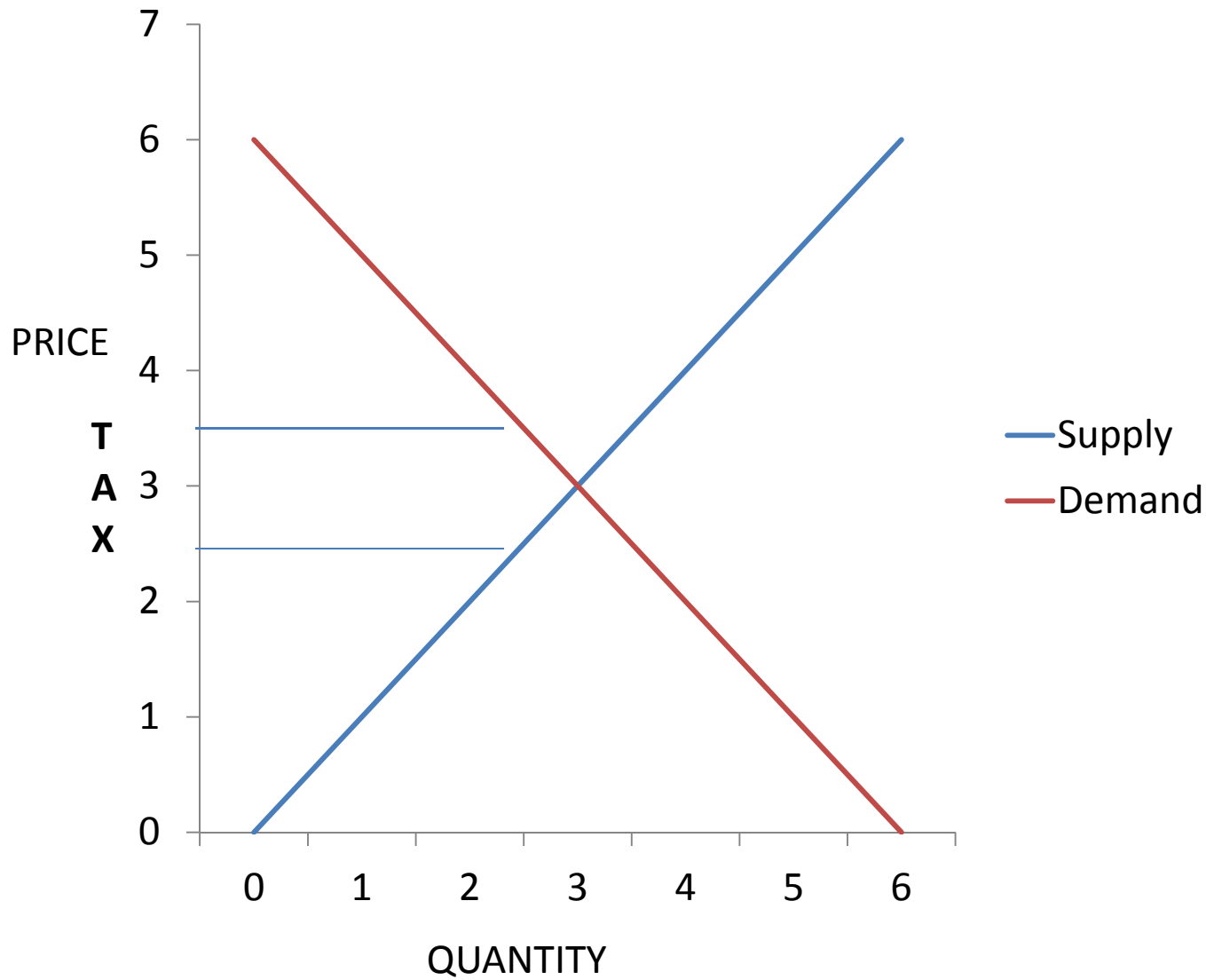


Figure 2.2: Economic Efficiency and Taxation

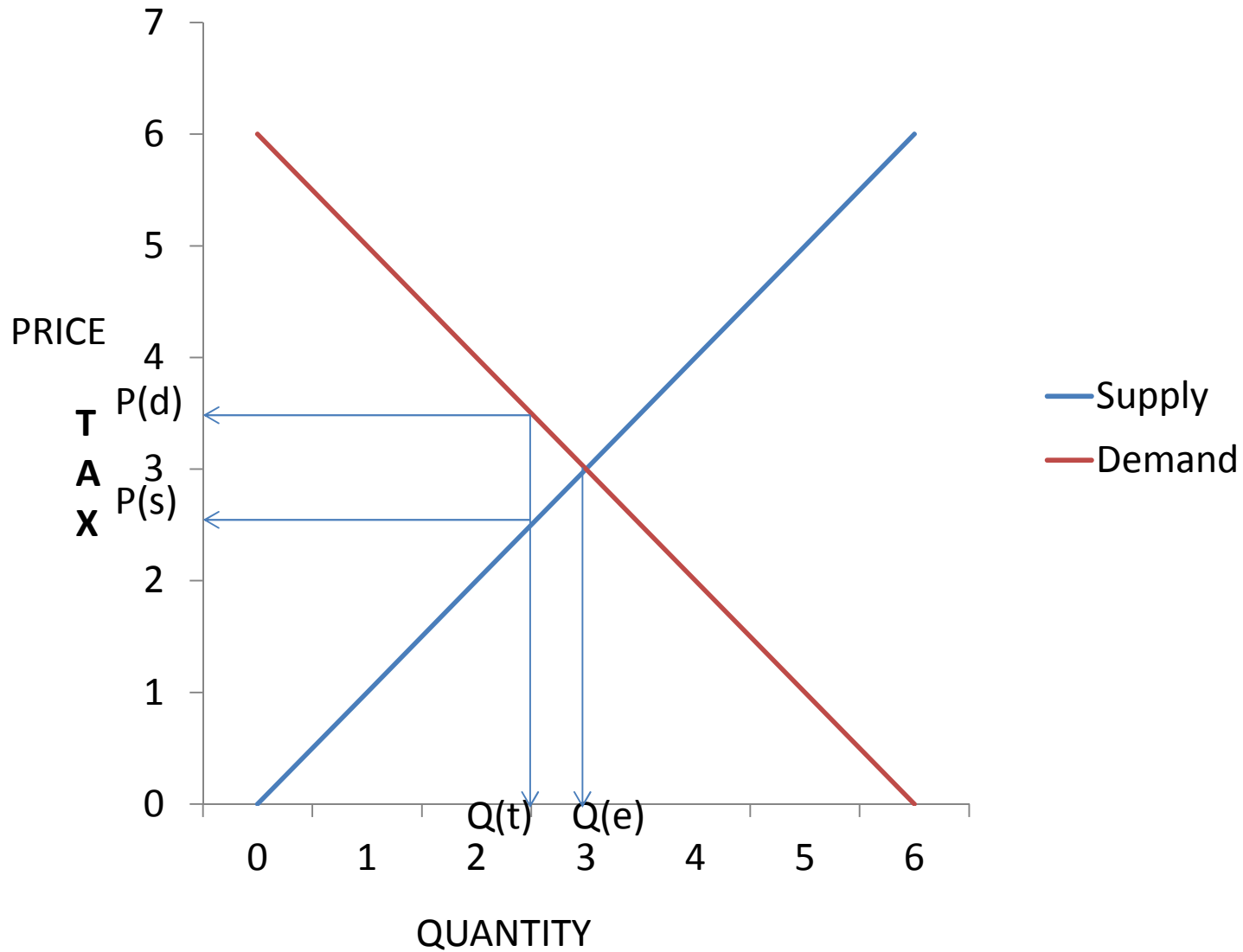
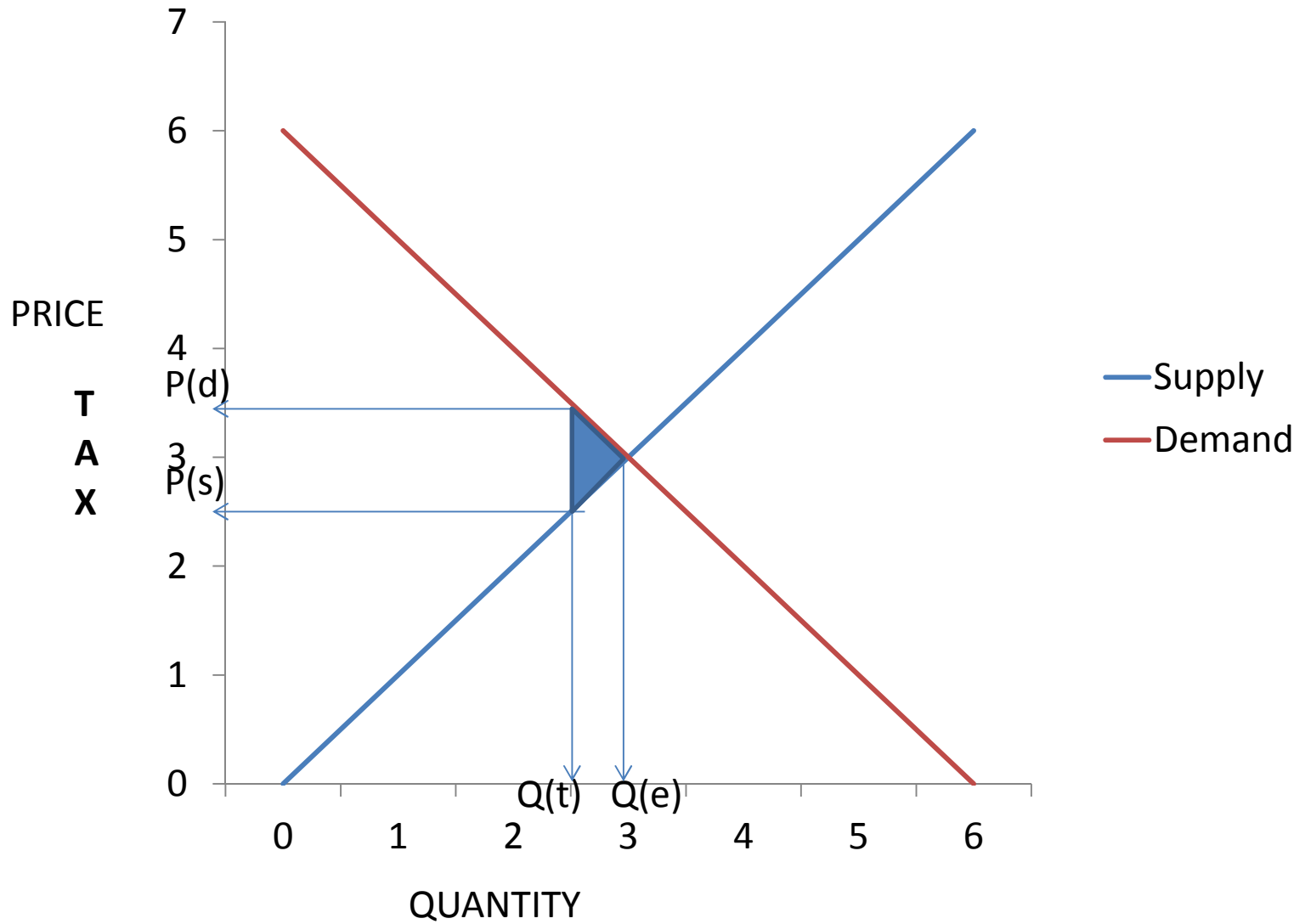


Figure 2.3: Excess Burden of Taxation



Efficiency of Taxation: Economic Rents

- Cost of inputs in the production process include cost of labour, cost of capital, and “economic rent”.
- “Economic rent” (or “pure profit”) is the portion of income paid to a factor of production in excess of that needed to induce or maintain production—i.e. excess returns to the factor above normal risk-weighted returns.
- Economic rents result from natural or contrived exclusivity—e.g. licence to produce or ownership of especially scarce assets like natural resources.
- Reduction in economic rents should not affect market equilibrium pricing because it is a surplus and not part of the required return to producers. As such, they provide a special target for more economically efficient taxation.

Horizontal Equity

- “Horizontal equity” connotes the equal treatment of two different taxpayers in essentially the same economic circumstances.
- Determination of what are essentially similar circumstances is not always easy in practice.
- Horizontal equity in taxation is, in many circumstances, consistent with neutrality, which means better economic efficiency.
- Examples of horizontal equity in the Canadian income tax are:
 - the comprehensive treatment of retirement savings of employees who belong to pension plans and those who do not;
 - the provisions which tax the investment income of a private corporation the same as if the income was instead earned by the individual resident shareholders.

Vertical Equity

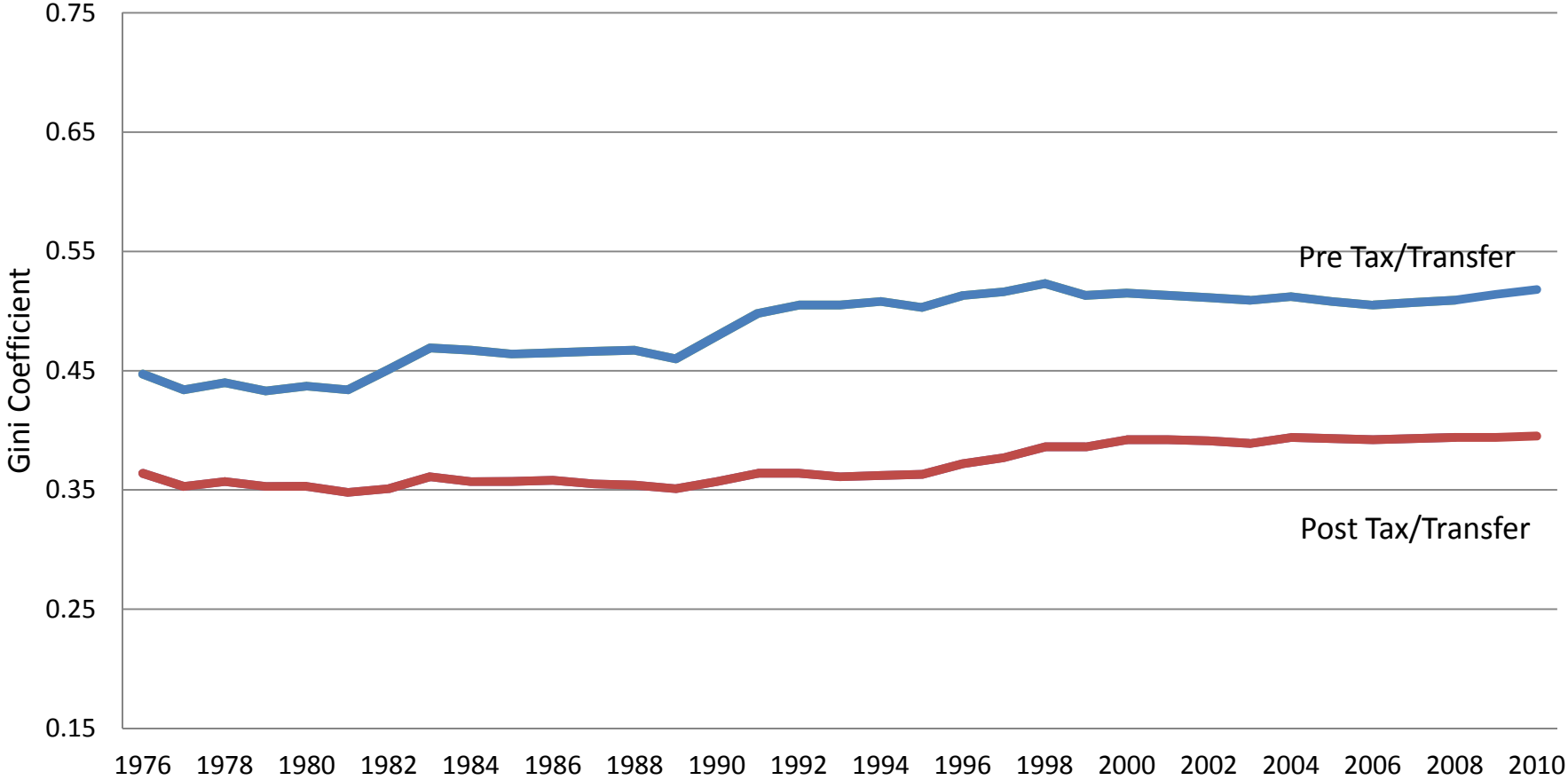
- “Vertical Equity” is commonly explained as the idea that those who have a higher ability to pay should pay proportionately more taxes than those who have less ability to pay. Ability to pay, in this sense, is often measured by net income.
- This idea leads to “progressive” taxation, such as where those with higher income pay progressively higher marginal tax rates on that income.
- Levying of taxes on a progressive basis, combined with provision by government of (i) public goods and services at nil or subsidized prices and (ii) cash transfers to individuals based upon their income level, effects substantial redistribution of income.
- Whether, and to what extent, income should be redistributed is not determinable by tax policy analysis, but can only be based on normative judgements on the desirable form of income distribution in a society.

Vertical Equity (continued)

- In addition to use of progressive tax rates, redistribution is effected through the tax system by:
 - income testing access to certain deductions or tax credits (such as the CCTB), using phase-out rates;
 - “exemption with progression”: providing certain income tax exemptions or deductions in the form of a tax credit converted at the lowest marginal tax rate (such as the ITA “personal amount”);
 - provision , in effect, for negative income tax by making certain individual tax credits refundable on an income tested basis where insufficient tax is paid (such as CCTB or the GST/HST credits).
- Imposition of higher rates of tax for vertical equity purposes increases the excess burden of taxation (reduces economic efficiency) by reducing incentives to earn income at the margin.
 - This effect can be moderated by the structuring of particular tax measures (refer to Optimal Tax Theory below).

Figure 3: Redistribution by Tax and Transfer

Gini Coefficients for Income Distribution in Canada (All Families) 1976-2010



Inter-Generational Equity

- “Inter-generational equity” connotes the idea of fairness of tax burden as between different generations-- more generally, between older and younger (or unborn) taxpayers.
- The concept does not often directly involve the structure of current taxation, but more the overall level of taxation.
- If current taxes are imposed at an overall level insufficient to produce revenues that fully fund government expenditures, and governments run deficits, then future taxes will need to increase to repay government debt that is used instead.
- This is a major looming problem given the fiscal policies of many developed economies where government spending, fueled by a high levels of social benefits, is well in excess of current tax revenues.
 - For example, government spending in the U.S. is about 40% of GDP (2012) and revenues about 32%; while for Canada in 2012 these were about 41% and 38%.

Administerability

- This goal involves keeping tax compliance difficulty and cost to a minimum for both taxpayers and tax administration.
- The goal is often referred to as “simplicity”; but this terminology is generally inapt, as imposition of taxes is not simple and will always produce a measure of complexity.
- Complexity of taxation appears at several levels:
 - linguistic complexity
 - calculation complexity
 - administrative complexity
 - substantive structural complexity
- Reduction of complexity usually has a negative impact on equity, efficiency or revenue.
- Some Canadian examples of substantive structural complexity reduction: removal of QI and CDA, Resource Allowance, FIEs.

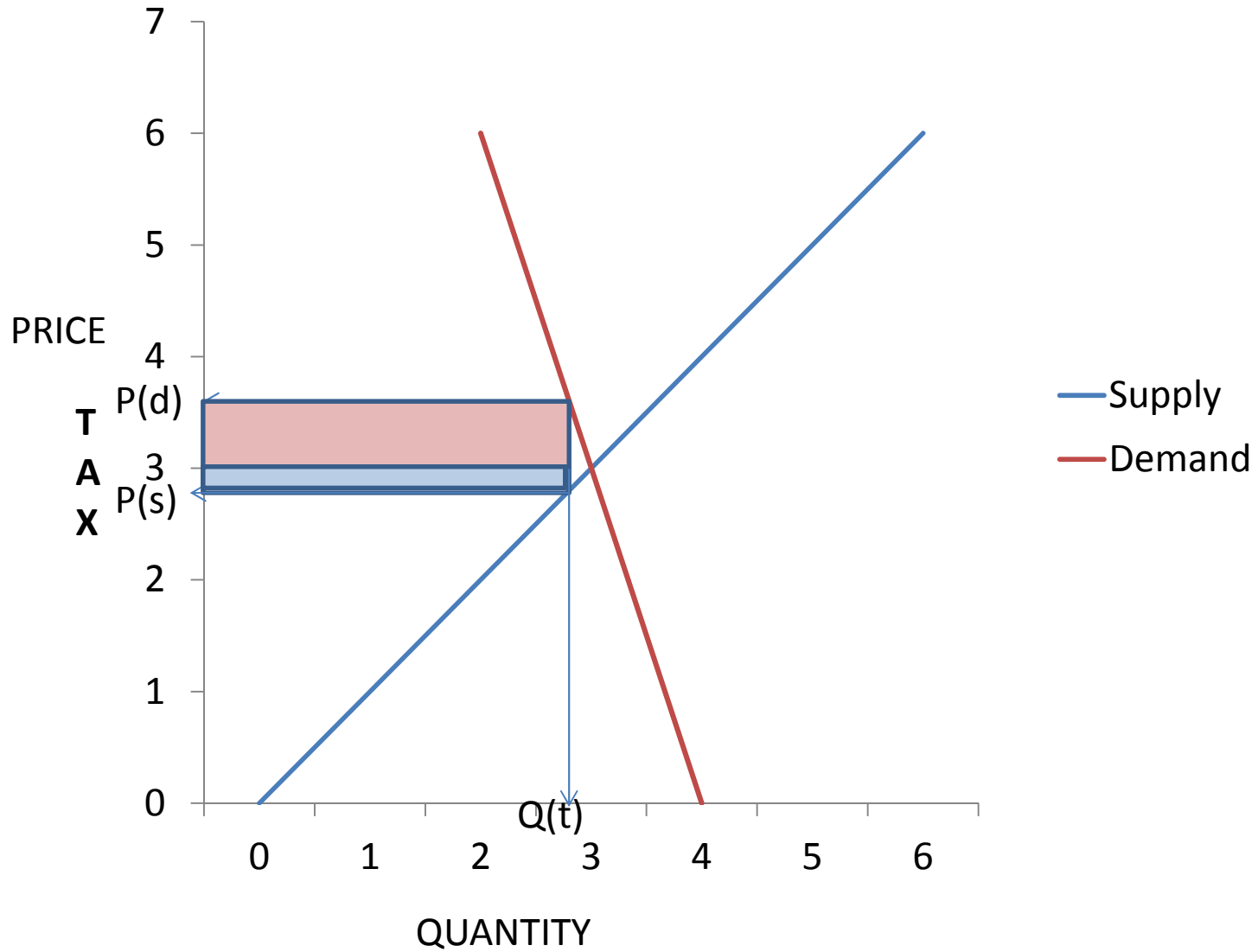
Other Goals for Taxation

- Taxation is often used for other, non tax-policy, goals—particularly to effect economic policy or social policy.
 - Economic policy examples include accelerated tax depreciation, differential CIT rates, and tax free zones and tax holidays.
 - Social policy examples include low income child benefits; non-income tested tax credits for situations like disability, old age and special children’s activities; and high tax rates on undesirable activities, such as tobacco use.
- Aside from the question of whether such goals are desirable in themselves, the tax system is not always the best way to target and deliver results, as compared to government grants or subsidies.
- As taxes, these measures often cost more than grants in terms of revenue loss, and create distortions and inequities in the tax system.

The Question of Tax Incidence

- “Tax incidence” involves the concept that the person who is legally charged to pay a tax is not necessarily the person who bears the economic cost or burden of the tax.
- The economic burden of relevant taxes (“incidence”) is distributed in a market between consumers of goods or services and producers according to the relative price elasticities of supply and demand.
- Where demand is less elastic than supply, consumers will bear a larger portion of the tax burden; and where supply is less elastic than demand, producers will bear a larger portion.
 - Taxes related to products that are easily substituted are borne mostly by the producer, as demand for these would usually be quite elastic compared to supply.
 - Taxes related to mobile factors of production such as financial investment, are borne almost entirely by the consumers, as supply for these would usually be highly elastic compared to demand.
- Special issues of tax incidence arise with corporations, because the economic burden of the corporation’s tax will fall on some combination of owners , employees, customers and other suppliers.

Figure 4: Tax Incidence



Optimal Tax Theory

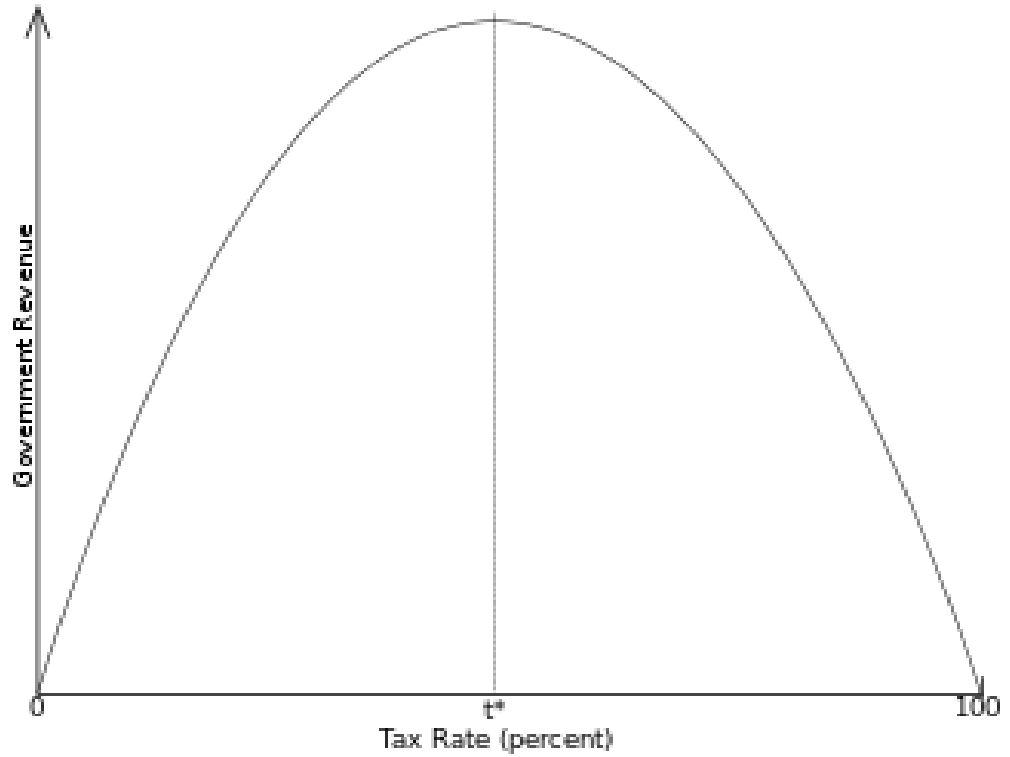
- “Optimal Tax Theory” involves development of methodology for designing taxes to raise a given amount of revenue at the lowest efficiency loss while still achieving equity goals.
- A lump sum tax such as a per capita poll tax creates no excess burden as it has no effect on economic incentives, but is undesirable for reasons of equity.
- Up to 100% taxation of economic rents should not create excess burden, as basic incentive structures and production are not affected.
 - Natural resources are often taxed extra heavily by use of government royalties and extraction taxes (e.g. mining tax).
 - Similar proposals have been made to heavily tax the undeveloped component of land (e.g. by Henry George in the 19th century).

Optimal Tax Theory (continued)

- Frank P. Ramsey, around 1927, developed an approach to commodity taxation that would reduce excess burden from taxation to a minimum, under the constraint of perfectly elastic supply, by setting the tax rate on each commodity inversely proportional to its elasticity of demand.
 - This would be very difficult if not impossible to do in practice.
- Since then, much theoretical work has been done on this subject, with general trends emphasizing the importance of:
 - reducing economic distortions using broader tax bases (and lower rates)
 - minimizing the disincentive effects of marginal tax rates on labour income (even taxing leisure)
 - structuring taxes to capture economic rents for the public sector
 - increased use of consumption tax instead of income tax
 - taking account of lifetime taxation

Optimal Taxation: The Laffer Curve

Arthur Laffer, using the curve below, has illustrated how changes in tax rates have both an arithmetic and an economic effect. Note that the curve need not be symmetrical nor have a peak (t^*) at 50%. See Laffer (2004-06) "The Laffer Curve, Past, Present and Future", Heritage Foundation.



Different Types of Taxes

- Personal Income Tax (PIT) and Corporate Income Tax (CIT)
 - Tax Unit
 - Tax Base
 - Tax Rate
 - Taxation of Corporations and Their Shareholders
 - International Taxation Issues
- Sales Tax and other Consumption Taxes
- Environmental Taxes
- Payroll Taxes
- Property Taxes
- Death and Wealth Taxes
- User Fees

Note that most jurisdictions use a variety of taxes, but with a very different tax mix.

Income Tax Unit Structure

- Determination of the unit of taxation is particularly important for taxes that have progressive elements, such as income tax.
- In the PIT, there is some justification in terms of efficiency and equity, for using an economic unit, like the family, as the unit of taxation, though definitional and implementation difficulties make this generally impractical. The individual is thus the usual unit of taxation.
- The PIT systems of a number of countries provide some of the effect of using an economic tax unit through joint tax filing for married couples—though some efficiency and equity issues can remain.
 - Joint filing can result in substantial disincentives for a second labour income (sometimes called the “marriage penalty”); and
 - It can also result in sanctioned income splitting benefits, for example where one spouse has no income.
- PIT systems can also provide for transfer of certain deductions and credits within a family unit, say between spouses (as in the Canadian PIT).

Tax Unit Structure (continued)

- In CIT the corporation is the obvious unit of taxation.
- However, because businesses often have genuine non-tax reasons for operating through more than one corporation, there is a general issue in CIT of facilitation of corporate group taxation where there is common ownership.
- There is also an issue in CIT of prevention of loss trading where economic ownership of corporations changes or is different. Such trading can result in informal “refundability” for losses.
- Most jurisdictions deal with corporate group taxation generally, with formal systems for corporate group tax consolidation or loss transfer.
- In the Canadian CIT these issues are dealt with by a combination of an informal loss transfer system, specific loss transfer rules, and anti-loss trading rules.

Comprehensive Income Tax Base

- This tax base consists of the value a taxpayer's consumption plus or minus the change in his or her net wealth for a period, say, annual.
- It is sometimes referred to as the Haig-Simons income base, after Robert Haig and Henry Simons, the two economists who elaborated the idea.
- A comprehensive income tax base would include, in addition to the commonly enumerated sources of income, items such as capital gains, imputed rent on owner-occupied housing and windfalls.
- The comprehensive approach is seen by many as particularly important for furthering equity goals.
- The comprehensive income tax base is strongly represented in the 1966 *Report of the Royal Commission on Taxation* (the "Carter Commission").

Schedular Income Tax Base

- This tax base comprises an enumerated set of net income sources, such as labour remuneration and rent from use of property.
- It was often the basis for older income tax systems, such as in the U.K. starting in the late 18th century, but is still used today for historical or other reasons.
- A typical characteristic of the older types of scheduler tax base is the failure to tax some important sources of economic returns such as capital gains.
- Some jurisdictions—such as certain Nordic countries—are now using a form of scheduler base (a “dual income tax”) to impose lower tax rates at a flat rate on income from capital and higher tax rates on a progressive basis on income from labour-- in order to reduce distortions on savings and investment and improve economic efficiency.

Comparison to Consumption Tax Base

- This tax base comprises amounts of value consumed by a taxpayer through purchase or rental of goods and services.
- As compared to most income tax bases, the key feature of the consumption tax base is that it does not tax income when it is earned, but only when and if it is consumed. This is the equivalent of not taxing income that is saved:

$$I = C + S \ggg C = I - S \text{ (where } S \text{ is +or-)}$$

- Not taxing income when not consumed reduces distortions on savings and investment and improves economic efficiency.
- A consumption tax base may still require a mechanism for capturing some economic rents.
- A classic formulation of the benefits of a consumption tax base, supported by arguments for economic efficiency and equity, is found in the 1978 *Report of the Committee Chaired by Prof. James E. Meade* (UK).

Rationale for the Corporate Income Tax

- Because a corporation is an artificial legal person, with other persons— holders of its shares and debt—who are the owners of the corporation’s business in economic terms, CIT has been explained as having somewhat different and additional rationales than income tax generally:
 - Corporations should pay some tax to account for the benefit of their use of subsidized or free public goods, and their incorporated status itself.
 - Corporations should pay tax as a withholding against the eventual tax liability of their shareholders (and final tax where such shareholders are non-residents or tax exempts)
- Another consideration is the desirability of levying specially heavy taxation on economic rents, including where they are earned by a corporation.
- Incidence of CIT is a very complex question, though in an open economy the burden of corporate tax is generally thought to fall most heavily on workers in the form of lower wages.

Capital Gains in the Income Tax Base

- The net increase in value of capital assets (capital gains) should, according to comprehensive income tax or related principles, be taxed; though this presents a number of difficult issues for both PIT and CIT.
- It would be correct in theory to tax capital gains on an accrual basis, but this is generally impractical ; taxation of capital gains on a realization basis results in:
 - “lock-in” problem
 - deferral issues including “adverse selection” to trigger losses
- A particularly serious problem in taxation of capital gains relates to adjustment for inflation to reflect “real gains”.
- Special issues arise with taxation of capital gains on shares of corporations (refer to Taxation of Corporations and their Shareholders below).

Other Income Tax Base Characteristics

- PIT and CIT are intended as “net” income taxes, and bases can include either all the worldwide income of a taxpayer, or just income from the jurisdiction.
- PIT bases (such as in Canada) can contain significant consumption tax base elements, such as:
 - non-taxation of gains on owner-occupied housing
 - non-taxation of certain savings income using EET or TEE approaches, including registered pension arrangements
- Taxation of income from labour is generally quite broad, but most PIT systems have very limited recognition for costs incurred to produce labour income.
- Taxation of income from capital (business and investment) in PIT and CIT usually provides for better recognition of costs, but is also more complex, particularly with respect to timing issues, such as cash basis compared to modified or full accrual basis tax accounting.

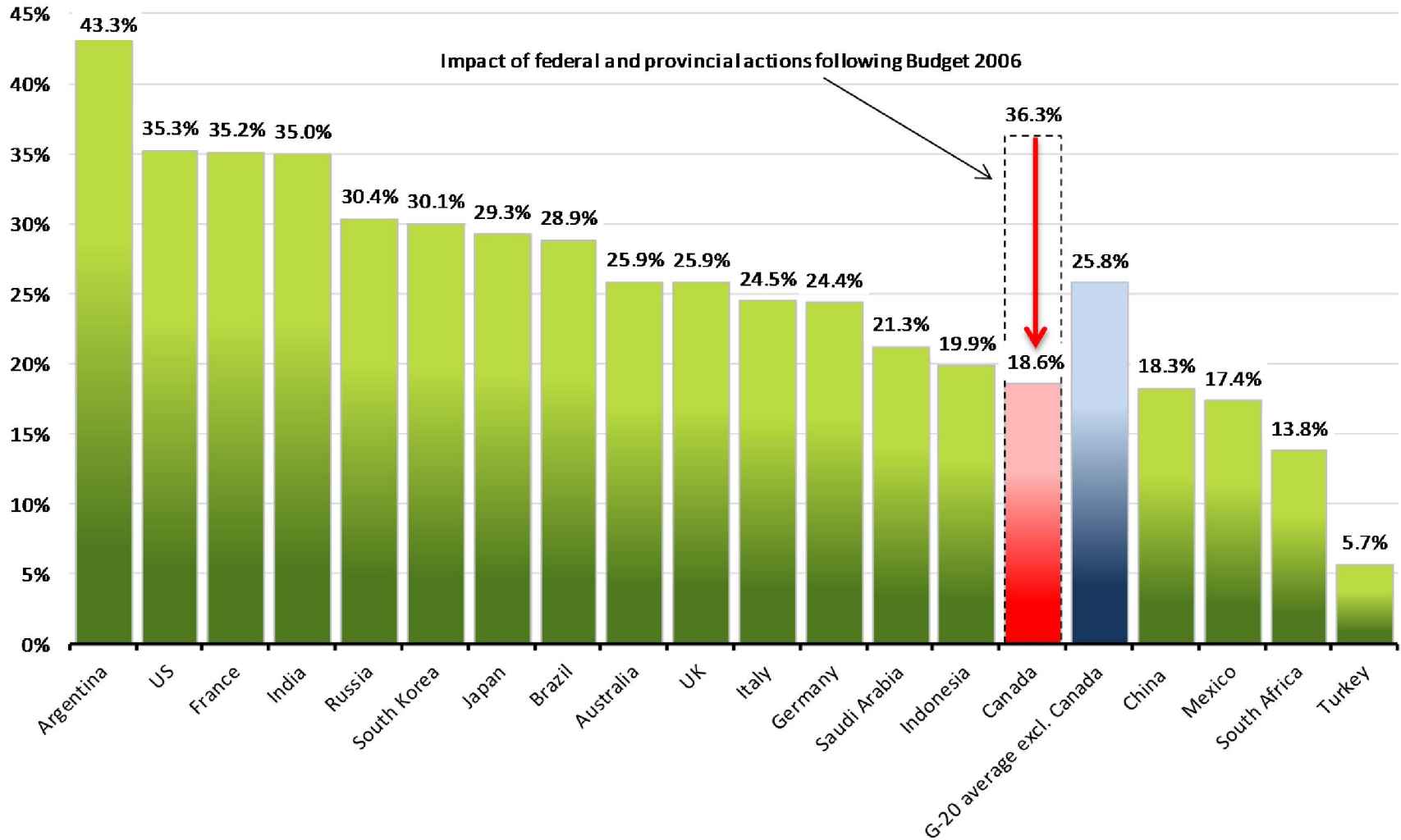
Other Income Tax Base Characteristics (continued)

- Alternative Minimum Tax is sometimes used to modify a PIT base by re-including certain available deductions and credits, often those from tax shelters.
 - If operating as intended, AMT provides little revenue and can cause economic efficiency and equity problems.
 - The main effect of AMT is “optical”, with sound policy favouring instead dealing directly with substantive problems with any re-included items by changing their terms in the base.
- The CIT base normally encompasses the same broad definition of income as in the PIT.
- The CIT usually provides a mechanism to reduce or eliminate double taxation of earnings of one corporation paid as a dividend to another corporation. Examples include:
 - the section 112 ITA dividend deduction regime in Canada, combined with capital gains tax rates;
 - the partial dividend exclusion and consolidated corporate tax reporting regimes in the U.S.

Different Types of Tax Rates

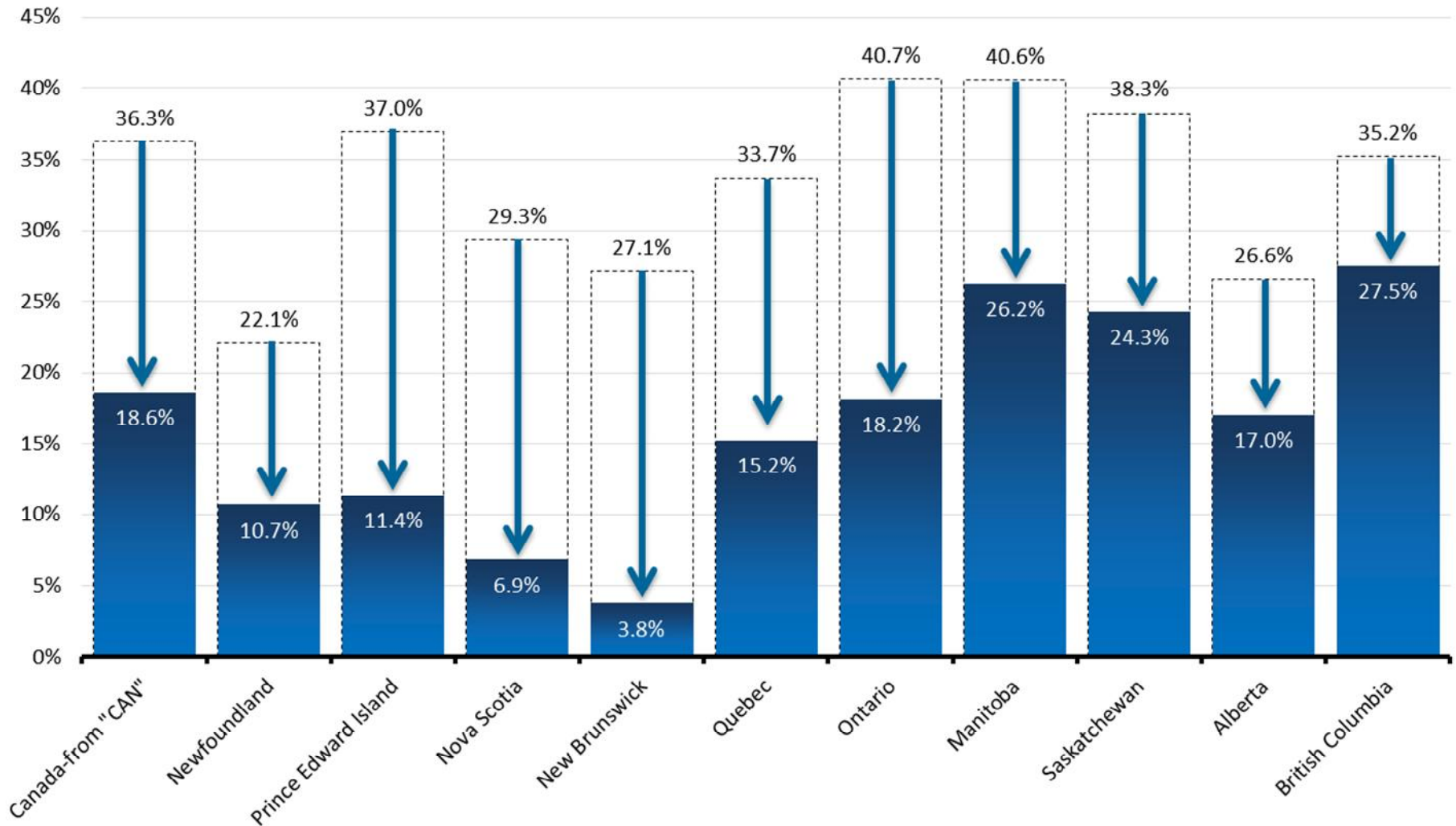
- “Statutory tax rate” is the applicable rate of tax provided for in relevant tax legislation.
- “Average tax rate” usually refers to a tax unit’s total tax as a proportion of its total tax base.
- “Marginal tax rate” is the statutory rate payable on the next dollar added to the tax base.
- “Marginal effective tax rate” (METR) on capital income is the risk weighted pre-tax rate of return on a new marginal investment minus the risk weighted after-tax rate of return, divided by the risk weighted pre-tax rate of return.
- All these have their applications, but METRs are a forward looking measurement of the incentive to make a new investment, and are very influential in business decision-making on investment location.

Marginal Effective Tax Rate¹ on New Investment in G-20 Countries, 2013



1. The marginal effective tax rate (METR) on new business investment takes into account national and sub-national statutory corporate income tax rates, deductions, and credits, and other taxes payable by corporations, including capital taxes and retail sales taxes on business inputs. The methodology for calculating METRs is described in the 2005 edition of *Tax Expenditures and Evaluations* (Department of Finance, Canada). The METR includes measures currently in effect. It excludes the resource and financial sectors, and tax provisions related to research and development.

Marginal Effective Tax Rate¹ on New Investment, by Province 2013 (compared to 2006)



1. The marginal effective tax rate reflects actions taken by federal and provincial governments since 2006, and includes measures announced in 2013 budgets which take effect in 2013. It excludes the resource and financial sectors, and tax provisions related to research and development.

Source: School of Public Policy, University of Calgary

Tax Rate Structures

- A “progressive” tax rate structure is one where, as the tax unit’s tax base increases, the average tax rate increases—e.g. in an income tax with increasing marginal rates.
- A “regressive” tax rate structure could be defined as one where average tax rates decrease with an increase in base; but is usually intended as indicating a tax rate structure where those units with less financial resources pay a higher proportion of their resources than those with more—such as with many sales taxes.
- A “proportional” rate structure is one where all tax units pay the same proportion of their tax base (which is not mutually exclusive of the “regressive” rate structure as described above). This is sometimes referred to as a “flat tax”.

Tax Rate Considerations

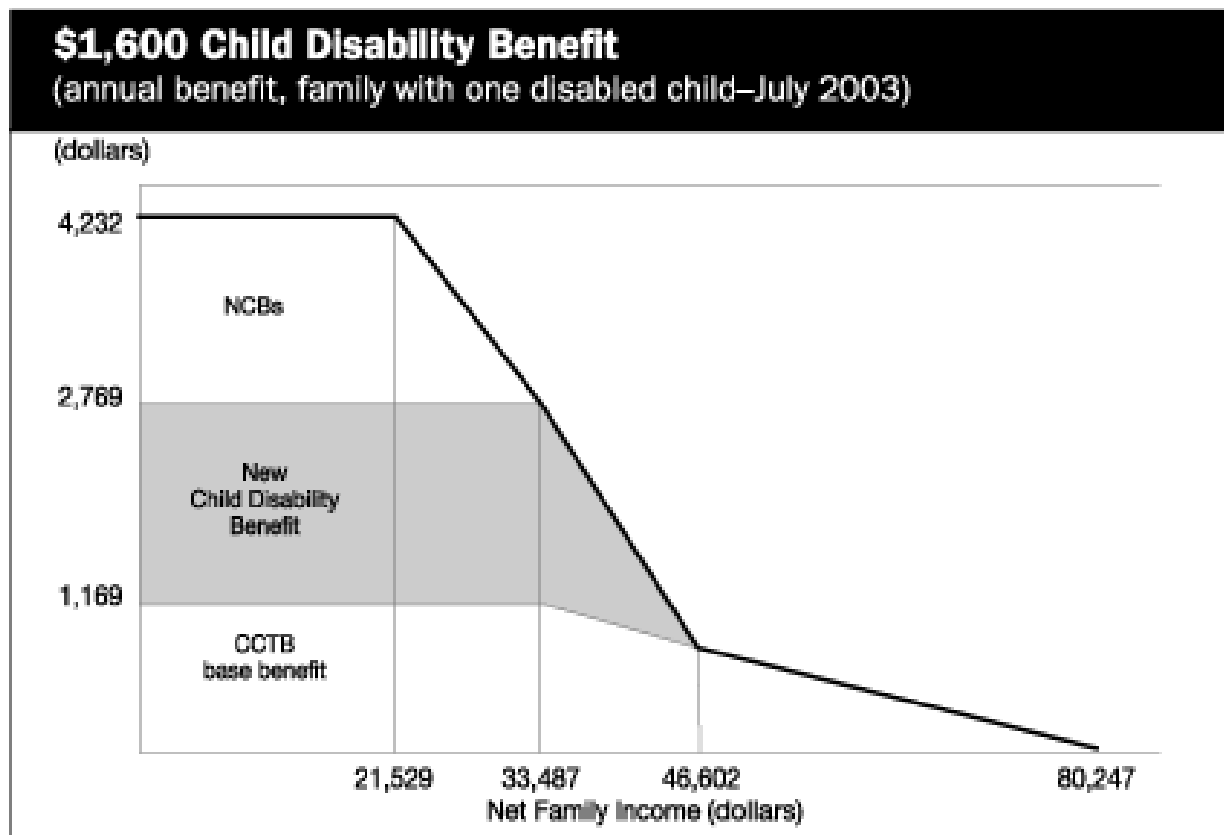
- Higher marginal tax rates on labour or capital cause reduced economic output and more excess burden by reduction of incentives to work or invest, and thus reduce economic efficiency.
- Tax rates, especially on more mobile factors of production like capital, which are not competitive with those in other jurisdictions can cause new economic activity to locate in, or existing activity to move to, those other jurisdictions.
- Tax rates that are regressive (or which are considered insufficiently progressive) cause a problem for vertical equity.
 - Taxes which are considered regressive can be made progressive by provision of refundable tax credits to lower income taxpayers– such as the GST/HST Credit (refer to Sales Tax below).

Phase-Out Rates and Marginal Tax Rates

- Phase- out of tax and social benefits (sometimes referred to as “clawback”) results in potentially high marginal tax rates at lower income levels. The less gradual the phase out, the more the marginal tax rate shock; but the more gradual the phase-out, the poorer the targeting is for the particular tax measure and the higher the cost to government.
- Where multiple benefit clawbacks, including social assistance, are involved, this marginal rate effect is sometimes referred to as the “welfare wall”.
- Provisions such as the Working Income Tax Benefit (WITB) are designed to provide some substitute benefit to low income workers to cushion the potential marginal rate shock in such circumstances.

Example of Phase Out and Marginal Tax Rate Effect

This example from the 2003 Budget (Supplementary Information) indicates additions to marginal tax rates of 12 percentage points for the first phase-out (starting at \$21,529), but only about 2 percentage points for the later phase-out (starting at \$46,602).



Corporate Tax Rate Issues

- CIT generally should have a single rate for all corporations and all items in the base to avoid problems with non-neutralities, such as misallocation of economic resources and tax planning effects.
- Despite this, many jurisdictions provide special low CIT rates for “small business”, though there is not much theory or empirical evidence to support this practice as generally beneficial.
- Also contrary to sound theory, many jurisdictions have used tax incentives in the form of special low or zero rates of CIT or CIT “tax holidays” in an attempt to attract or maintain businesses.
- Non-refundability of business losses is asymmetrical tax treatment, which results in CIT tax system issues such as corporate loss trading.

Taxation of Corporations and their Shareholders

- There are two general approaches to dealing with the fact that corporations and their ultimate individual shareholders have an identity of economic interest.
- The “classical” approach to corporate taxation is to ignore this fact, and tax both the corporation and the shareholders as completely separate taxpayers, resulting in at least some double taxation of corporate earnings.
- The “integration” approach attempts to recognize the identity of economic interest for income tax purposes through special tax arrangements for corporations and their shareholders.
- Perfect integration would result in total shareholder PIT and corporate CIT being paid at the shareholder’s marginal tax rate (zero for non-residents and tax-exempts); and the flow through of corporate losses to shareholders for PIT purposes.

Taxation of Corporations and their Shareholders (continued)

- Various approaches to achieving integration include:
 - treating dividends paid to shareholders as a deductible expense;
 - imputing corporate income to shareholders directly;
 - use of a system of *precompte* and *avoir fiscal* sometimes called an Advance Corporation Tax ;
 - possibly combined with loss flow out to shareholders.
- All of these approaches pose serious questions of tax revenue loss, particularly vis-à-vis non-resident and domestic tax-exempt shareholders, together with other issues related to complexity and compliance.
- The most practical approach has been the Advance Corporation Tax, whereby a corporation paying a dividend must pay ACT equal to the CIT on related pre-tax corporate income (with a credit re CIT actually paid); with an equivalent dividend tax credit (refundable or not) to the shareholder.

International Taxation Issues

- Formulating tax policy for international circumstances according to a theoretical framework is more difficult than for domestic tax policy.
- International circumstances usually involve the interaction of the tax systems of two or more equally sovereign jurisdictions, which often have competing fiscal and economic policies and practices—for example:
 - where two developed states both seek to maximize tax revenue from a certain activity;
 - where a lesser developed state is less interested in tax revenue than in new economic activity coming from another state.
- This can lead to double or multiple taxation of income by more than one state where the income has a source in one state and the taxpayer is liable to tax in another state on the basis of its residence there or a similar criterion, or where the taxpayer is considered resident in both states.
- It can also result in reduced or zero taxation on income where a residence state does not currently tax all worldwide income.

International Taxation Issues (continued)

- There are two general principles related to economic efficiency that can be considered in these circumstances:
 - “capital export neutrality” (CEN) would tax income from outbound investment from a jurisdiction the same as equivalent income from domestic investment;
 - “capital import neutrality” (CIN) would tax income from inbound investment into a jurisdiction the same as equivalent income earned there by its residents.
- However, conflict between these principles arises in many cases.
- For example a residence state taxing income of outbound investment according to CEN will overlap jurisdiction with a source state taxing inbound investment using CIN.

International Taxation Issues (continued)

- International taxation norms—particularly as set out by the OECD in its Model Bi-lateral Tax Convention and Commentary—generally contemplate reducing these tax conflicts among jurisdictions by:
 - allowing a residence state to tax worldwide income of its residents;
 - allowing a source state to tax income sourced in the state;
 - eliminating double taxation by having the residence state provide an exemption or tax credit regarding income from a source state.
- The same circumstances also arise indirectly where corporations that are not resident in a state but are owned by residents earn income in another state.
 - For business income, the residence state generally chooses to deal with double taxation in the same way: by providing an exemption or tax credit approach when income is repatriated as dividends.
 - For passive income, most states that tax on a worldwide basis utilize a back-up system of taxation of such income earned by non-resident corporations controlled by residents, usually on an imputation basis.
- Non-resident withholding taxes present additional issues.

International Taxation Issues--Example

Assume there is a taxpayer T which is a resident of state A and has \$100 of business income from carrying on business in State B; and that the rate of applicable income tax is 10% in State B and 30% in State A.

1. Applying CEN by State A and CIN by State B would result in \$40 of tax for T (30 paid to A and 10 to B), which achieves neither CEN nor CIN.
2. Adding relief for double taxation by State A –either unilaterally or by Tax Treaty between A and B--by giving T a tax credit in State A for State B tax-- results in \$30 of tax for T (20 paid to A and 10 to B) and achieves CEN for A, but not CIN for B.
3. Adding relief for double taxation by State A by exempting T's income outside State A results in \$10 of tax for T (paid only to B) and achieves CIN for B, but not CEN for A. Note that where State B is a tax haven levying zero tax, this result still reflects CIN.

Sales Tax and Other Consumption Taxes

- Properly structured consumption taxes are more economically efficient than income taxes (refer to Consumption Tax Base above).
- Tax on a consumption base can be levied by transactional sales type taxes, or on a more comprehensive periodic basis, say annually, by measuring total net income of a taxpayer, and adjusting for net increases and decreases in savings.
 - The more comprehensive approach (sometimes referred to as an “expenditure tax”) requires valuation of all assets and liabilities of each taxpayer on a periodic basis, which presents great practical difficulties.
- A more limited non-sales tax approach for taxing a consumption base that is sometime used involves tracking of only “registered” assets, such as is done in the Canadian income tax system for registered savings (RPP/RRSP/TFSA) and gains on “principal residence” (refer to Other Tax Base Characteristics above).

Sales Tax and Other Consumption Taxes (continued)

- A transactional sales tax can be levied at one or more different trade levels, and can be origin-based or destination-based.
- In order to tax only the consumption base and realize the full benefits of its economic efficiency, such tax should not apply to business inputs.
 - Traditional single stage retail sales taxes (such as RST/PST) have great practical difficulties in effectively exempting business inputs (and avoiding cascading tax) while containing tax evasion.
 - Turnover taxes, and single stage wholesale level taxes can be even worse.
- A multi-stage Value Added Tax (VAT), levied on a broad base of goods and services, using a destination base and an invoice/credit system, has proved to be the most practicable approach to an efficient sales tax on consumption .
 - The key mechanic is to tax purchasers on value at every trade level (including imports, but not exports) and to provide refundable input tax credits to businesses for all VAT paid.

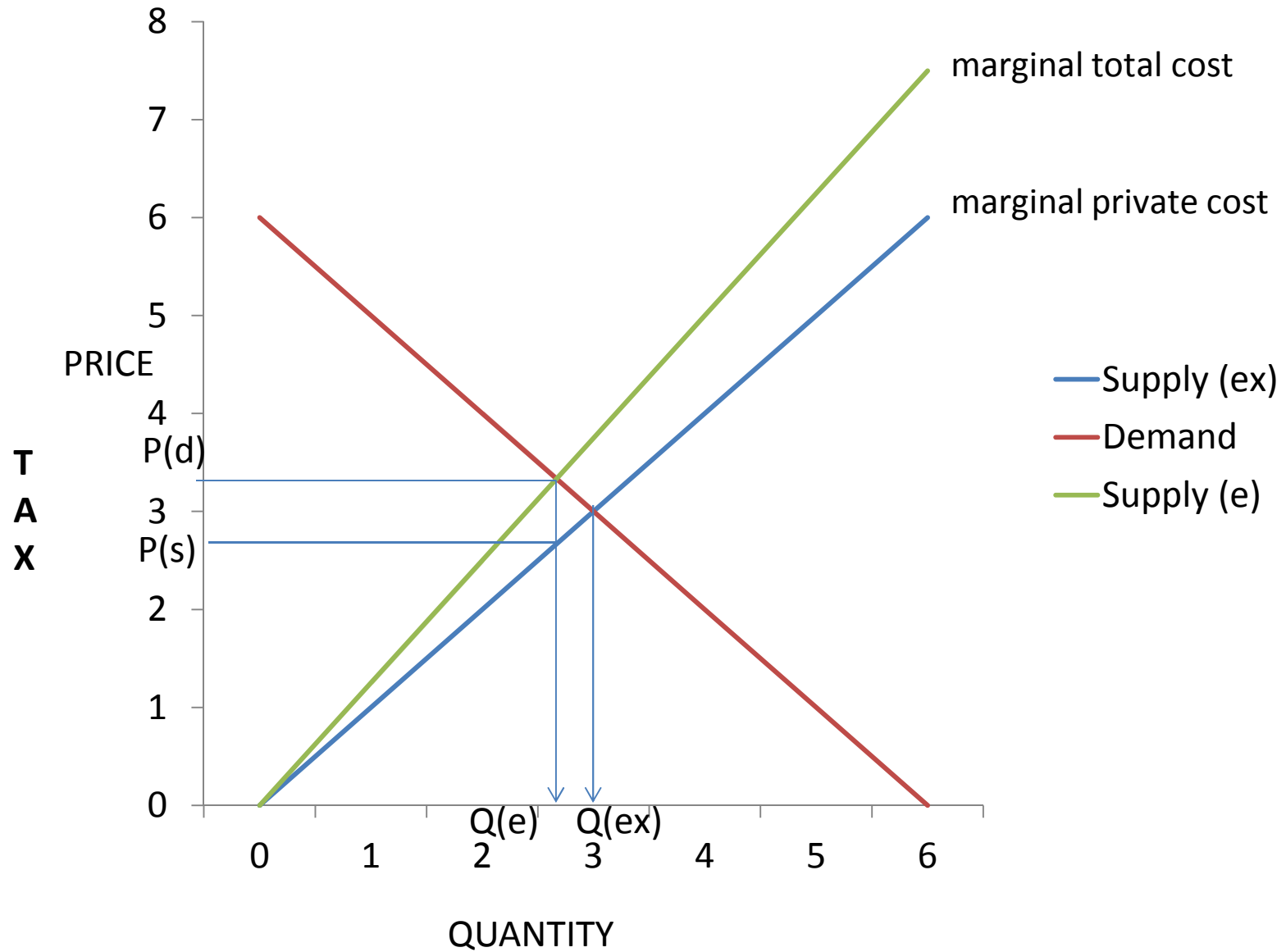
Sales Tax and Other Consumption Taxes (continued)

- VAT is used as a major tax in over 100 countries, including the GST/HST in Canada, with the notable exception of the U.S.
- Other consumption taxes that are used widely (with or without a VAT) include excise taxes, which are sales taxes levied on specific goods-- often motor fuels, tobacco and alcohol—either to raise revenues or also to account for negative externalities of product use.
- The economic efficiency of the consumption tax base, for example as effected through a VAT, is sometimes thought to clash with the equity concerns that arise from the regressive nature of sales taxes.
- Progressivity can be dealt with (separately from the question of base) by providing income-tested refundable tax credits to consumers with less income—as is done in Canada with the GST/HST credits.

Environmental Taxation

- Pollution, and other environmental degradation, often represent a negative externality in markets, because, in determining equilibrium price, the market fails to add costs of the general negative effects of production or consumption caused by it.
- These externalities result in economic inefficiency in the form of overproduction by producers not paying the full marginal cost of production and overconsumption by consumers not paying full price for the utility of the product.
- Arthur Pigou, in 1920, developed the idea that economic efficiency could, in theory, be increased by correcting such market failures using taxation which properly prices in the additional cost element (now referred to as a “Pigouvian tax”).
 - For example, a proportionate tax on all releases of GHG into the atmosphere, or a tax on goods that are hazardous to dispose of.
 - Pigou and others since have also recognized that government regulation of the activity is another form of solution for this problem (e.g. cap and trade system).
- Environmental Pigouvian taxes have a number of major potential shortcomings, and can be controversial. Issues include: measurement, implementation, reciprocity and scope of jurisdiction.

Figure 5: Pigouvian Tax and Economic Efficiency



Payroll Taxes

- Taxes levied as a percentage of remuneration from employment or income from self-employment are often identified as funding certain government social benefits, such as retirement benefits, unemployment insurance and workers compensation benefits—whether or not revenue is actually “ear-marked”.
 - For, example, in Canada, CPP/QPP premiums (and investment income on funding) are held separately and will fund benefits well into the future; while EI premiums go into general government revenue.
- Payroll taxes are often levied on both the employee, through withholding from remuneration, and on the employer.
- However, it is generally thought that elasticities of labour supply and demand are often such that a substantial portion of the employer cost of these taxes is borne by workers in the form of lower wages.

Property Taxes

- Property tax usually refers to a tax on real property (land and improvements), but could be levied on personal property as well (refer to Death and Wealth Taxes below).
- Real property tax in North America is usually a municipal or provincial/state tax levied on owners as a constant proportion of the value (often based on market value) using a percentage or mill rate.
- There are differing views of the nature of property tax:
 - The “old View” is that the tax is largely capitalized into market value of the real property according to the level of service provided; location is then tax neutral and the tax is economically efficient.
 - The “new view” is that property tax is more of a tax on capital, especially as modern taxes become less tied to specific direct services (often dealt with by user fees), and differential rates are used; this creates economic distortions regarding location.
- Owners can, by contract, shift the liability for the tax to users such as lessees. But, as elasticity of supply of real property appears most often to be substantially less than elasticity of demand, it is thought that in many cases real property tax is borne more by owners than by users such as lessees, though there still may be some regressive effects.

Death and Wealth Taxes

- These taxes are usually the result of concerns about long term vertical equity, and can take the form of transactional inheritance or succession taxes (with related gift taxes) or annual net asset taxes.
- There are currently no estate, succession or gift taxes in Canada.
- Death and wealth taxes are generally difficult and costly to enforce, and produce very modest amounts of revenue because of large exemptions and sophisticated tax planning.
 - For example, in 2013, U.S. Estate and Gift tax was projected to raise only $\frac{1}{2}$ of 1% of total revenues.
- To the extent that this type of tax represents double taxation, it can be quite economically inefficient.
- Taxes on corporate capital could be viewed as some form of tax on wealth, though because they are highly inefficient economically their use has generally been declining.

User Fees

- “User fees” are not taxes to the extent that they are structured to recover from the specific consumers of public goods or services the full cost of those to government; this would make them very economically efficient, though the use of government monopolies detracts from this effect.
- In many areas where user fees are common, such as highways, public transit, and water and waste disposal services, only partial cost recovery is effected by the fee.
- As many governments become more concerned about the negative effects of increasing economically inefficient taxes, the greater efficiency of user fees makes them a desirable choice for some public goods and services.
- A major policy challenge for government is to determine when and to what extent it is fair to put the cost of certain goods and services on consumers, and how to deal with lower income consumers.