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## FINANCES OF THE NATION

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### THE CORPORATE INCOME TAX IN CANADA— PAST, PRESENT, AND FUTURE

#### PRÉCIS

Cet article offre un survol général de l'impôt sur les sociétés (IS) au Canada. Il présente des données historiques relatives aux taux d'imposition prévus par la loi, aux parts des recettes, aux ratios impôts-produit intérieur brut, et à diverses mesures des taux d'imposition réels. Un des aspects qui ressort des données présentées est la réduction substantielle des taux d'imposition prévus par la loi et des taux d'imposition réels au cours des dernières décennies, sans que les recettes aient diminué de façon marquée, comme l'établissent diverses méthodes de mesure. L'article se termine par une brève analyse du rôle futur de l'IS au Canada.

#### ABSTRACT

This article presents a broad overview of the corporate income tax (CIT) in Canada. Historical data are presented relating to statutory tax rates, revenue shares, tax to gross domestic product ratios, and various effective tax rate measures. A notable feature of the data is the substantial reduction in statutory and effective tax rates over the last several decades, without a marked reduction in revenue, measured in several ways. The article concludes with a brief discussion of the future role of the CIT in Canada.

**KEYWORDS:** CORPORATE INCOME TAXES ■ EFFECTIVE INCOME TAX RATES ■ REVENUE ■ REFORMS

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## INTRODUCTION

In 1916, the government of Canada introduced the Business Profits War Tax Act,<sup>1</sup> the precursor to today's Income Tax Act.<sup>2</sup> While the birth of the corporate income tax (CIT) is often associated with the imposition of this "temporary" tax to finance the war debt, in point of fact Quebec introduced the first corporate income tax in Canada in 1884. Of course, the income tax turned out not to be temporary after all, and remains with us to this day.

This article provides a broad overview of the CIT in Canada. As readers of this journal are well aware, the devil is in the details, and the details in this case are exceedingly complex, with the devil popping up all over the place. It is not my intent in this article to undertake a microscopic discussion of the CIT in Canada; rather, my intention is to provide a "satellite view," focusing primarily on macro-level data.

The discussion that follows is divided into four sections. The first section presents a brief overview of the basic structure of the CIT. This is followed in the second section by a presentation of various data related to the CIT, including time series on statutory corporate tax rates and various measures of the effective tax rate. While the primary orientation of the article is descriptive as opposed to analytical, the third section offers some thoughts on the changing role of the CIT and where the tax may be headed in the future. The fourth section provides a brief summary and conclusion.

## OVERVIEW OF THE CORPORATE INCOME TAX IN CANADA

Notwithstanding the complexity of the CIT, it may be useful to begin by briefly describing the basic structure of the tax. The CIT is imposed on the taxable income of Canadian corporations and the taxable income of foreign corporations earned in Canada. In extremely broad terms, taxable income is determined by deducting various expenses from accrued revenue. These expenses fall into two broad categories: current expenses and capital expenses. Current expenses are, generally speaking, "reoccurring" expenditures and are deducted in the year in which they are incurred. They include things like wages, fees, energy costs, rents, the costs of purchasing intermediate inputs, etc. Capital expenditures are for "enduring" physical capital such as machinery and equipment, structures, and buildings. Capital expenditures are deducted over time according to prescribed capital cost allowance depreciation rates. Debt interest costs associated with the financing of capital expenditures are also deductible, while the imputed opportunity cost of equity finance is not.

Nominally Canadian corporations pay tax on their taxable income earned worldwide, and a foreign tax credit is granted for income taxes paid in other jurisdictions to prevent double taxation. However, in practice Canada follows a hybrid approach to

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1 Business Profits War Tax Act, 1916, SC 1916, c. 11.

2 RSC 1985, c. 1 (5th Supp.), as amended.

taxation, with much of the income of domestic corporations earned outside Canada being exempt from Canadian income tax under the so-called exempt surplus rules. Under this approach, exempt surplus dividends—that is, dividends received from the active business income of foreign affiliates—are tax-exempt in Canada. Foreign companies operating in Canada pay CIT on their taxable income earned in Canada.

Canada's federal, provincial, and territorial governments all levy a CIT. Under the tax collection agreements (TCAs), the Canada Revenue Agency (CRA) collects the CIT for the federal government and for all of the provinces<sup>3</sup> except Quebec and Alberta. Provinces subject to a TCA must use the federal definition of taxable income; however, they are allowed to offer their own tax credits, which lower provincial tax payable. While Quebec and Alberta are not obligated to use the federal tax base, and can use their own definition of taxable income, in practice these provinces do not deviate significantly from the federal base.

A corporation that has permanent establishments in more than one province must allocate its taxable income across the provinces according to an allocation formula. The formula is based on the proportion of the corporation's gross revenue for the year that is attributable to the permanent establishment in each province and the proportion of total salaries and wages paid by the corporation that was paid to the employees of each permanent establishment.

Taxable income, appropriately allocated, is then subject to taxation at the statutory CIT rates imposed by the federal government and the provinces. The statutory tax rate applied to taxable income has historically been determined by three things: the size and ownership of the corporation; whether it is a general enterprise or a manufacturing enterprise; and, of course, which province the income is earned in (or allocated to).

The federal government has at times imposed lower CIT rates on so-called manufacturing and processing (M & P) income. Since 2004, however, all corporate income in Canada earned by large corporations has been taxed at the same general rate at the federal level. Historically, many of the provinces have also imposed lower tax rates on M & P income; however, most of the provinces no longer distinguish between general and M & P income (the current exceptions being Ontario and Newfoundland and Labrador).

With respect to size and ownership, the federal government and all of the provinces distinguish between so-called large and small corporations. Large corporations are subject to the general tax rate (or M & P rate if appropriate), while small Canadian-controlled private corporations (CCPCs), with income and capital below defined thresholds, are subject to a lower rate up to the income threshold, and the general rate after that. CCPCs are corporations that are not controlled by a non-resident or by a public corporation. In 2015, the federal tax rate on large corporations (general

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3 Unless otherwise noted, for the purposes of this article, the term “provinces” used in a general context should be understood to include the three Canadian territories.

and M & P) is 15 percent. Small CCPCs with taxable capital (basically the sum of retained earnings, share capital, and long-term debt) less than \$10 million are subject to a federal tax rate of 11 percent on taxable income up to \$500,000.<sup>4</sup>

Provincial statutory CIT rates vary. In 2015, general rates vary between 11 percent in British Columbia and 16 percent in Nova Scotia and Prince Edward Island. As noted above, currently only Ontario and Newfoundland and Labrador impose lower rates on M & P income—in the case of Ontario, 10 percent (versus the 12 percent general rate), and for Newfoundland and Labrador, 5 percent (versus the 14 percent general rate). The small business tax rates (and thresholds) also vary by province, with current tax rates on small CCPCs ranging from 0 percent in Manitoba to 8 percent in Quebec, with most provinces falling between 2 percent and 4.5 percent.

Taxes payable can be reduced by various credits, applied at either the federal or the provincial level. Historically, several federal tax credits have been provided, with the intention of encouraging various types of investment; these incentive credits have largely been phased out. A notable exception is the scientific research and experimental development (SR & ED) credit, which is applied to qualifying research and development (R & D) expenditures. As noted above, provinces may also provide tax credits for various types of expenditures, and they have historically done so. For example, currently most provinces grant a credit for R & D expenditures that largely mirrors the federal SR & ED credit.

With this broad sketch of the structure of the CIT in Canada as a general framework, I now turn to the data.

## THE DATA

For the most part, the data are presented here as a series of graphs.<sup>5</sup> Figure 1 shows changes in the general statutory federal CIT rate applicable to large corporations, including adjustments for surtaxes when appropriate,<sup>6</sup> from 1981 to 2015. It illustrates a general downward trend, in stepwise fashion, in the tax rate over this 34-year period. As shown in the figure, the rate fell from 37.8 percent in 1981 to 15 percent in 2012 (which is where it currently stands), representing a rather remarkable 55 percent reduction in the CIT rate over this period. Three rate-reduction periods are noteworthy in this regard: the first starting in 1987, the second in 2001, and the third in 2008.

In 1987, the federal government initiated a phased-in reduction in the general CIT rate in conjunction with a modest base-broadening exercise. This resulted in a reduction in the federal general CIT rate from 37.8 percent in 1986 to 28.84 percent

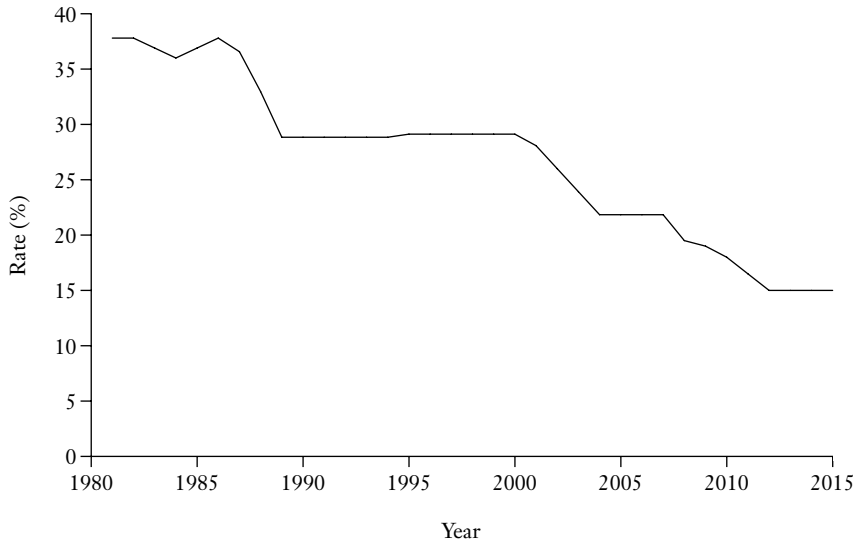
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4 The federal small business tax rate is scheduled to undergo a phased-in reduction to 9 percent by 2019.

5 The data underlying the figures are available from the author on request.

6 A surtax is “a tax on a tax.” It effectively increases the statutory tax rate. The figures reported here roll the surtax into the CIT rate. Surtaxes are typically intended to be temporary, and have been imposed, raised, lowered, and eliminated from time to time for decades.

**FIGURE 1** Statutory General Corporate Income Tax Rate, Federal Government, 1981-2015



Sources: Sean A. Cahill, *Corporate Income Tax Rate Database: Canada and the Provinces, 1960-2005* (Ottawa: Agriculture and Agri-Food Canada, March 2007); *Finances of the Nation* (Toronto: Canadian Tax Foundation, various years); and various federal and provincial government websites.

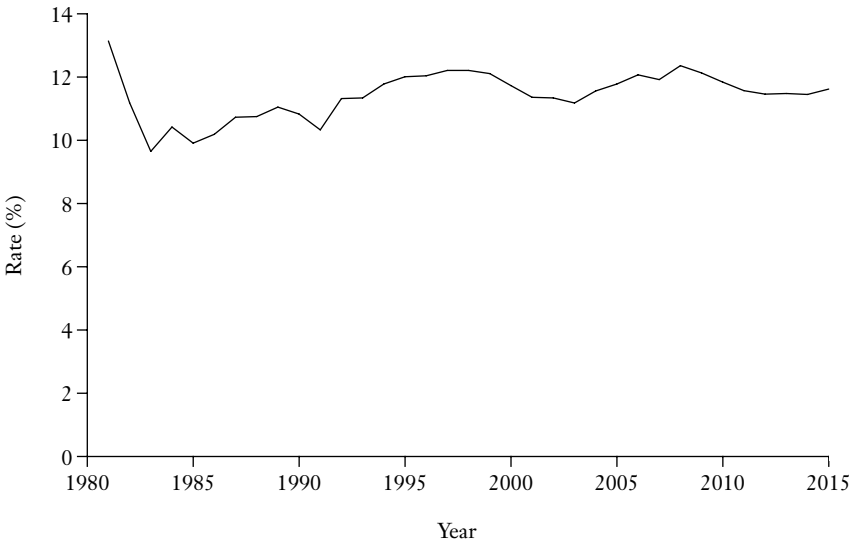
in 1989 (both inclusive of the surtax). The second tranche of major rate reductions started in 2001, resulting in a decline in the federal general rate from 29.12 percent in 2000 to 21.84 percent in 2004. The third rate reduction at the federal level started in 2008, with the rate falling from 21.84 percent in 2007 to 15 percent in 2012.

The 34-year period from 1981 to 2015 also saw some modest reductions in statutory CIT rates at the provincial level. Rather than presenting these on a province-by-province basis, figure 2 shows the weighted average general statutory provincial CIT rate applicable to large corporations, weighted by each province's share of aggregate provincial corporate tax revenue.<sup>7</sup> In 1981, the weighted average provincial CIT rate was just over 13 percent; by 2015, it had fallen to just over 11.5 percent, with some fluctuations along the way.

Figure 3 shows changes in the weighted average general statutory CIT rate applicable to large corporations, for the federal and provincial governments combined, from 1981 to 2015. Again, we see a stepwise downward trend, from almost 51 percent in 1981 to 26.6 percent in 2015, a reduction of almost 50 percent over this

<sup>7</sup> Statutory CIT rates on a province-by-province basis are available from the author on request.

**FIGURE 2 Weighted Average General Corporate Income Tax Rate, Provinces, 1981-2015**



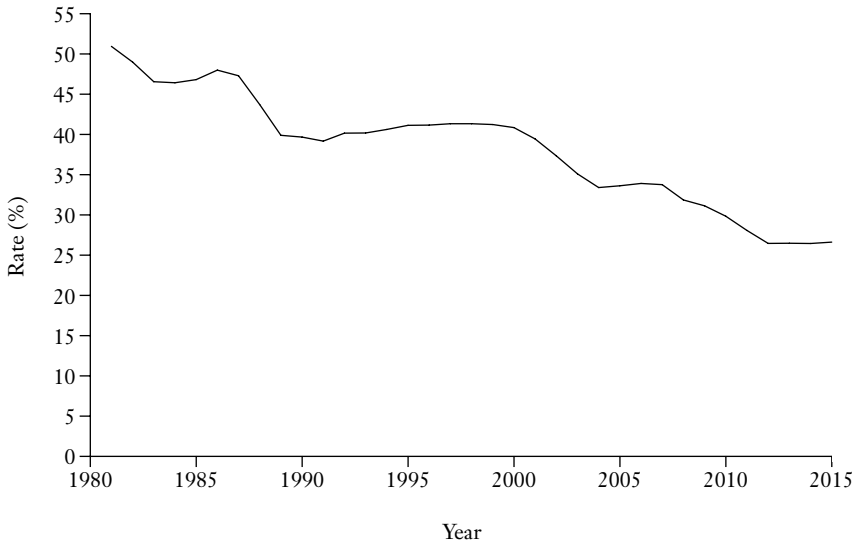
Sources: Sean A. Cahill, *Corporate Income Tax Rate Database: Canada and the Provinces, 1960-2005* (Ottawa: Agriculture and Agri-Food Canada, March 2007); *Finances of the Nation* (Toronto: Canadian Tax Foundation, various years); and various federal and provincial government websites. Weights are author's calculations based on data from Ron Kneebone and Margarita Wilkins, "Canadian Provincial Government Budget Data, 1980-81 to 2013-14" (University of Calgary, School of Public Policy, forthcoming).

period. To a large extent, the decline can be attributed to the substantial cuts in the federal rate.

Interestingly, the significant reduction in statutory CIT rates is not associated with a discernible downward trend in revenue generated by the CIT. Figure 4 shows combined federal and provincial revenue from the CIT expressed as a percentage of gross domestic product (GDP). From 1981 to 1990, CIT revenue as a percentage of GDP fluctuated between just under 3 percent and just over 4 percent. The period from 1991 to 1994 witnessed a fairly significant reduction in CIT revenue as a share of GDP, reaching a low of 2.25 percent in 1993. This, of course, was the period marked by a significant worldwide recession. CIT revenues are quite sensitive to business cycles, the effects of which can show up in revenue figures for several years owing to the carryforward of corporate tax losses generated during recessions. From its nadir in 1993, combined federal and provincial CIT revenue as a percentage of GDP recovered to fluctuate between 3.5 percent and 4.5 percent, levelling off in 2013-2014 at just above 3.5 percent.

The fact that a virtual halving of the combined statutory CIT rate over this period is not associated with a sizable reduction in the amount of CIT collected as a

**FIGURE 3 Weighted Average General Corporate Income Tax Rate, Federal and Provincial Combined, 1981-2015**

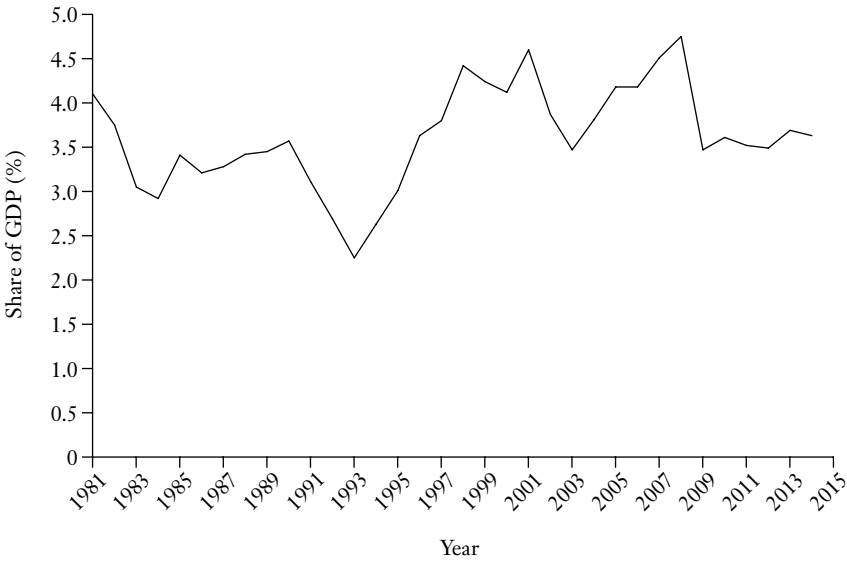


Sources: Sean A. Cahill, *Corporate Income Tax Rate Database: Canada and the Provinces, 1960-2005* (Ottawa: Agriculture and Agri-Food Canada, March 2007); *Finances of the Nation* (Toronto: Canadian Tax Foundation, various years); and various federal and provincial government websites. Weights are author's calculations based on data from Ron Kneebone and Margarita Wilkins, "Canadian Provincial Government Budget Data, 1980-81 to 2013-14" (University of Calgary, School of Public Policy, forthcoming).

share of GDP suggests that other changes in the CIT, perhaps an expansion of the tax base, may have generated more revenue. While some base broadening did indeed occur, particularly in 1987 and to a lesser extent in 2001 and 2008, it was not nearly sufficient to have offset the effect of the 50 percent reduction in statutory CIT rates.

While it is well beyond the scope of this article to investigate this question in more detail, and in particular one must be cautious about inferring causal relationships from simple graphs, it is clear from the raw data that significant reductions in the CIT rate were not associated with significant reductions in CIT revenue as a share of the economy over the period displayed. Many other things were going on during this period that may have affected CIT revenue, and a rigorous statistical investigation that sought to generate a counterfactual would need to control for these factors; but it is evident from the raw data that there has not been a marked reduction in the CIT/GDP ratio despite the significant reductions in the statutory CIT rate. It is worth mentioning, however, that some studies suggest that the size of the corporate income tax base is quite sensitive to changes in the statutory tax rate. For example, Dahlby and Ferede, in a study for the C.D. Howe Institute, have estimated that a 1 percentage point reduction in the CIT rate leads to a 2.3 percent increase in the

**FIGURE 4 Combined Federal and Provincial Corporate Income Tax Revenue as a Share of Gross Domestic Product (GDP), 1981-2014**



Sources: Author's calculations based on Canada, Department of Finance, "Fiscal Reference Tables" ([www.fin.gc.ca/pub/frt-trf/index-eng.asp](http://www.fin.gc.ca/pub/frt-trf/index-eng.asp)); and Ron Kneebone and Margarita Wilkins, "Canadian Provincial Government Budget Data, 1980-81 to 2013-14" (University of Calgary, School of Public Policy, forthcoming).

tax base in the short run, and a 15.5 percent increase in the long run.<sup>8</sup> This suggests that reductions in the CIT rate can give rise to behavioural responses that lead to an expansion of the CIT base, partially offsetting potential revenue reductions.

Figures 5, 6, and 7 show the share of government revenue accounted for by the CIT from 1981 to 2014 for, respectively, the federal government, the aggregate of all provincial governments, and the federal and provincial governments combined. As seen in figure 5, corporate income taxes have accounted for 6 percent to 17 percent of federal revenue over this period, with a "normal" range appearing to be between 10 percent and 14 percent. There are significant fluctuations, primarily associated with the business cycle; in particular, the effect of the deep recession of the early 1990s is again clearly evident, with CIT collections as a share of total revenue sinking to 5.7 percent in 1993, after which they climbed to a high of 17.2 percent just prior to the financial crisis of 2008, before levelling off at about 13.5 percent in 2013 and 2014.

8 Bev Dahlby and Ergete Ferede, *What Does It Cost Society To Raise a Dollar of Tax Revenue? The Marginal Cost of Public Funds*, C.D. Howe Institute Commentary no. 324 (Toronto: C.D. Howe Institute, March 2011).



**FIGURE 5 Corporate Income Tax Revenue as a Share of Total Revenue, Federal Government, 1981-2014**



Source: Author's calculations based on Canada, Department of Finance, "Fiscal Reference Tables" ([www.fin.gc.ca/pub/frt-trf/index-eng.asp](http://www.fin.gc.ca/pub/frt-trf/index-eng.asp)).

Corporate income taxes are less important to the provincial governments, as figure 6 shows, with CIT revenue accounting for 7 percent to 12 percent of total provincial revenue in aggregate. Business cycle effects are again evident, but are not as marked given the lower statutory provincial rates. Interestingly, there has been a general upward drift in the share of provincial revenue accounted for by the CIT. As discussed above, and illustrated in figure 2, this has occurred during a period when the weighted average provincial statutory CIT rate has remained relatively flat. One possible explanation for this is that the behavioural base expansion effects discussed above in association with the federal rate reductions have benefited provinces to some extent.

Combined federal and provincial CIT revenue as a share of total revenue is shown in figure 7. In aggregate, from 1981 to 2014 CIT revenue accounted for 6 percent to 14 percent of total government revenue. The low point (6.3 percent) was again in 1993, and the high point (14.3 percent) in 2008. Since 2009, combined federal and provincial CIT revenue as a percentage of total revenue has hovered around 12 percent. As with the GDP share numbers, there does not appear to have been a marked reduction in the share of total revenue accounted for by the CIT associated with the significant reduction in statutory rates.

Figure 8 shows a comparison of effective CIT rates from 1999 to 2013 for three statistical measures. The first measure is the effective weighted average general

**FIGURE 6 Corporate Income Tax Revenue as a Share of Total Revenue, Aggregate Provincial Government, 1981-2014**



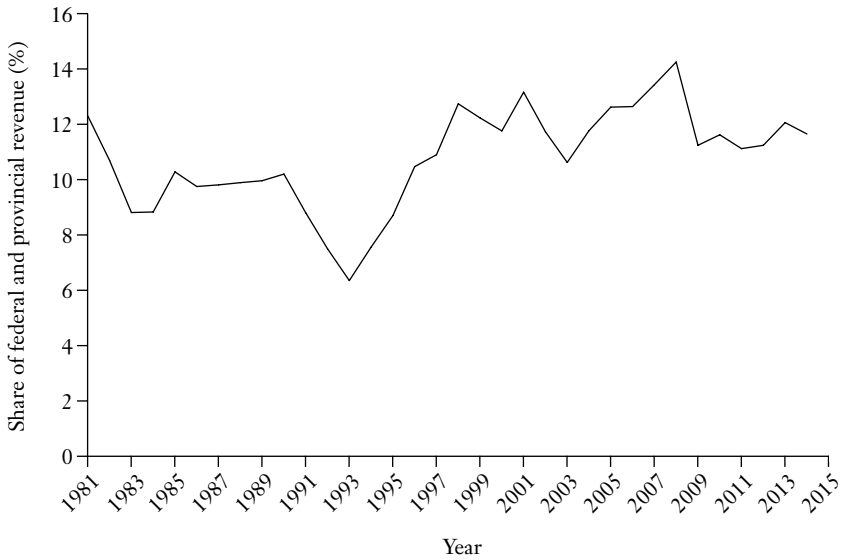
Source: Author's calculations based on Ron Kneebone and Margarita Wilkins, "Canadian Provincial Government Budget Data, 1980-81 to 2013-14" (University of Calgary, School of Public Policy, forthcoming).

statutory rate for the federal and provincial governments combined (calculated from the rates shown in figure 3). The second is the effective CIT rate as a percentage of taxable income, using aggregate Statistics Canada data for all industries in Canada. The third is the effective CIT rate as a percentage of financial income, again using aggregate data from Statistics Canada.

The first and most obvious thing to note about this figure is that all three rates trended downward over the 14-year period. Also, both CIT revenue as a percentage of taxable income (the average effective tax rate on taxable income) and CIT revenue as a percentage of financial income (the average effective tax rate on financial income) were less than the statutory tax rate. In 2013, for example, the effective weighted average combined statutory CIT rate was 26.5 percent, while the average effective tax rate on taxable income was 22.9 percent and the average effective tax rate on financial income was 18.2 percent.

There are several possible explanations for these differences. In the case of the average effective tax rate on taxable income, which on average was less than the statutory CIT rate by about 4.3 percentage points, the difference is primarily related to loss carryovers and tax credits. In the case of the average effective tax rate on financial income, which on average was less than the statutory CIT rate by about 8.7 percentage points, the explanation relates to the fact that the base for the CIT, taxable income,

**FIGURE 7 Corporate Income Tax Revenue as a Share of Total Revenue, Aggregate Federal and Provincial Government, 1981-2014**

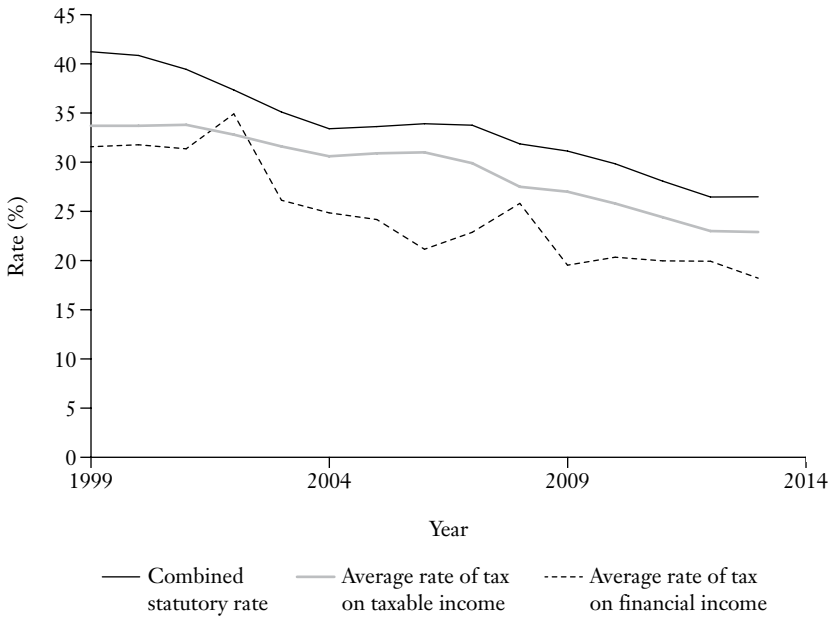


Sources: Author's calculations based on Canada, Department of Finance, "Fiscal Reference Tables" ([www.fin.gc.ca/pub/frt-trf/index-eng.asp](http://www.fin.gc.ca/pub/frt-trf/index-eng.asp)); and Ron Kneebone and Margarita Wilkins, "Canadian Provincial Government Budget Data, 1980-81 to 2013-14" (University of Calgary, School of Public Policy, forthcoming).

differs from profits reported on financial statements. Timing differences in the reporting of income, differences between tax and book depreciation, exempt income under the CIT, claimable versus non-claimable expenses, loss carryovers, etc., all account for differences between income for tax purposes and income for financial purposes. Typically, taxable income is less than financial income, and as a result the average effective tax rate on financial income is lower than both the statutory tax rate and the average effective tax rate on taxable income.

The average effective tax rates reported above are informative, but do not tell the whole story. In particular, they do not provide a complete picture of the potential distortionary effects of the corporate tax, most particularly with respect to investment. To investigate this, an alternative type of effective tax rate is required. Economists summarize the key elements of the business tax system with respect to investment in a measure called the marginal effective tax rate (METR) on capital. The METR is a summary measure of the *effective* rate of tax imposed on the rate of return generated by the last, or *marginal*, unit of capital in which a firm invests. The METR is therefore a summary measure of the total distortion in the rate of return to capital imposed by the business tax system.

**FIGURE 8 Statutory and Average Effective Corporate Income Tax Rates, Aggregate Federal and Provincial Government, 1999-2013**



Source: Author’s calculations based on Statistics Canada, CANSIM table 180-0003, “Financial and Taxation Statistics for Enterprises, by North American Industry Classification System (NAICS).”

The calculation of METRs can be quite complicated, but the idea can be conveyed in a simple example. Assume that the hurdle rate of return on an investment—that is, the minimum rate of return (ROR) required by the shareholders after the payment of all business taxes—is 4 percent. Also assume that the CIT system, with all its complexity, is such that in order to earn an ROR of 4 percent *after* the payment of CIT and other taxes on business income or capital, an investment must earn a *before-tax* ROR of 6 percent. The METR is then 33.33 percent (determined as  $[0.06 - 0.04]/0.06$ ). The METR therefore measures the share of the investment’s pre-tax required ROR needed to cover the tax costs associated with the investment. The higher the METR, the greater is the distortion in the ROR caused by the CIT and the larger the disincentive to undertake investment.

A comprehensive model developed by the School of Public Policy (SPP) at the University of Calgary produces METR calculations for 95 countries, which are released and analyzed in the SPP’s annual tax competitiveness report. The 2014 version of the report provides METR data for the past 10 years. Table 1 shows the calculations for Canada and several aggregate averages for different groups of countries.

**TABLE 1 Marginal Effective Tax Rates on Capital (Percent), Canada, Group of Seven, and OECD Member Countries, 2005-2014**

	2014	2013	2012	2011	2010	2009	2008	2007	2006	2005
Canada . . . . .	19.0	18.8	17.5	18.8	19.9	27.3	28.0	30.9	36.2	38.8
G7 . . . . .	27.4	27.7	27.9	28.6	28.9	30.1	30.2	32.9	36.2	34.2
OECD average . . . . .	19.4	19.6	19.5	19.7	19.6	19.8	20.1	21.0	21.6	22.3

Source: Duanjie Chen and Jack M. Mintz, “The 2014 Global Tax Competitiveness Report: A Proposed Business Tax Reform Agenda” (2015) 8:4 *SPP Research Papers* 1-22.

As shown in the table, there has been a marked and significant reduction in the METR in Canada over the last 10 years. In 2005, Canada’s METR was 38.8 percent, higher than the Group of Seven (G7) average, at 34.2 percent, and substantially higher than the average of 22.3 percent for member countries of the Organisation for Economic Co-operation and Development (OECD). Ten years ago, Canada’s corporate tax system was quite distortionary by international standards. In 2014, Canada’s METR had fallen to 19.0 percent, compared to a G7 average of 27.4 percent and an OECD average of 19.4 percent. As documented above, a key element of this change has been the significant statutory CIT reductions in Canada, primarily at the federal level. It bears repeating that these significant reductions in both the statutory CIT rate and the METR have not been accompanied by substantial reductions in either the ratio of CIT revenue to GDP or the share of total revenue accounted for by the CIT.

## THE ROLE AND FUTURE OF THE CIT

As documented above, the CIT currently accounts for around 12 percent of total revenue collected by the federal and provincial governments combined. It might well be argued that the time and resources devoted to discussion, debate, and analysis related to the CIT is disproportionate to the amount of revenue collected. No doubt there are several reasons for the attention it attracts, not the least of which is the complexity of the tax, and indeed the underlying complexity of the modern economy itself. But in my opinion one of the key factors behind the debate is different views regarding the role of the CIT.

As noted at the outset, it is not the purpose of this article to go into great detail regarding that role;<sup>9</sup> however, it is useful to conclude with a brief discussion of the prevalent views on the role of the CIT, and some speculation as to what the future may hold in this regard.

Perhaps the most common view of the CIT, which has arguably driven much of the policy discussion in Canada over the last several decades, concerns its role as a

9 For a more detailed discussion, see Ken McKenzie and Charles Taylor, “Business Income Taxation,” in Heather Kerr, Ken McKenzie, and Jack Mintz, eds., *Tax Policy in Canada* (Toronto: Canadian Tax Foundation, 2012), 7:1-51.

withholding tax and backstop to the personal tax system. One of the most difficult problems to address in income tax systems is the measurement of accrued capital gains. The taxation of comprehensive income at the personal level requires accrued capital gains to be included in income on a periodic basis. But most actual tax systems, including Canada's, include only realized capital gains, largely for practical reasons.

Absent the ability to tax accrued capital gains at the personal level, one way of dealing with the problem is to impose a tax on income at the corporate level, so that individuals cannot avoid, or defer, paying taxes by retaining income within corporations. According to this view, the CIT acts as a withholding tax so that, in effect, a corporation pays taxes on behalf of its shareholders as income accrues. When the income is ultimately paid out to shareholders, by way of dividends and/or through realized capital gains on retained earnings, those shareholders are then given "credit" for the taxes paid on their behalf under the CIT. The treatment of income from corporations in Canada largely reflects this view, as reflected in the integration of the corporate and personal tax systems through features such as the gross-up and credit approach to dividend taxation and the preferential taxation of realized capital gains.

This view is consistent with the so-called comprehensive income tax view put forward in the *Report of the Royal Commission on Taxation* in 1966,<sup>10</sup> widely known as "the Carter report" (after the commission's chair, Kenneth Carter). The Carter report endorsed the comprehensive income approach to taxation—that "a buck is a buck," and therefore all additions to personal wealth (command over goods and services) are income and should be taxed as such. Consistent with the view of the CIT as a withholding tax and backstop to the personal income tax system, the report also recommended the complete integration of personal and corporate income, so that income earned by companies would be taxed at the personal rates of its shareholders. While many of the precise recommendations of the Carter report were not enacted, the report provided much of the intellectual basis for discussions of tax policy in Canada for several decades.

The comprehensive income tax view, and in particular the idea that the CIT should be viewed as a withholding tax on dividends and capital gains earned by shareholders, implicitly assumes that the burden of the CIT ultimately falls on the owners of capital (the shareholders). Indeed, this was the prevailing view at the time of the Carter report. While the incidence of the CIT remains a matter of some controversy, many have questioned this view. Recent theoretical, simulation, and empirical studies of the incidence of the CIT suggest that in the long term labour bears much of the incidence of the corporate tax, especially if capital is relatively mobile internationally.<sup>11</sup>

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10 Canada, *Report of the Royal Commission on Taxation* (Ottawa: Queen's Printer, 1966).

11 For recent empirical evidence, see Wiji Arulampalam, Michael P. Devereux, and Giorgia Maffini, "The Direct Incidence of the Corporate Income Tax on Wages" (2012) 56:6 *European Economic Review* 1038-54; Mihir Desai, C. Fritz Foley, and James R. Hines Jr., "Labor and Capital Shares of the Corporate Tax Burden: International Evidence," paper presented at the

This is particularly relevant in small open economies like Canada's. The idea is simple: mobile capital will leave jurisdictions that impose higher taxes on capital by way of the CIT, putting downward pressure on wages over time. If, as suggested, the burden of the CIT falls largely on labour in the long term, the role of the CIT as a withholding tax on capital income, and the associated integration of corporate and personal taxes, become questionable.

This suggests an alternative view of the role of the CIT, one that focuses on the associated distortions to investment discussed above in the context of the METR data. This view argues that the corporate tax can, in principle, be designed to be an efficient, non-distortionary method of collecting taxes; more specifically, the corporate tax, if designed properly, can act as a non-distortionary tax on pure economic profits. This view of corporate taxation was reflected, for example, in the recent Mirrlees review of the tax system in the United Kingdom<sup>12</sup> and has been endorsed in general terms by many public finance economists. This view calls for a complete and substantial redesign of the CIT, with the objective of eliminating, or substantially reducing, investment distortions.

As documented above, it is evident from the METR calculations in table 1 that the CIT in Canada has become substantially less distortionary over the last decade. This incremental reform has taken place within the context and design of the existing CIT, focusing on things like changes in tax depreciation rates, the elimination of investment tax credits, reductions in the statutory CIT rate, the removal of taxes on capital through sales tax reform, etc. It could be argued that further changes along these lines are not likely to have a marked effect on METRs and the associated investment distortions.

The alternative view of the corporate tax, which focuses on its distortionary effects rather than its role as a withholding tax on shareholder income, suggests a complete rethink and redesign of the CIT. This can be accomplished in various ways, which differ in the details but have the overall objective of reducing the METR to zero. The simplest approach, for example, would be to turn the corporate tax into a simple

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International Tax Policy Form and Urban-Brookings Tax Policy Center seminar, Who Pays the Corporate Tax in an Open Economy? held in December 2007; R. Alison Felix, *Passing the Burden: Corporate Tax Incidence in Open Economies*, Regional Working Paper RRWP 07-01 (Kansas City: Federal Reserve Bank of Kansas City, October 2007); and Kevin A. Hassett and Apama Mathur, *Taxes and Wages*, AEI Working Paper no. 128 (Washington, DC: American Enterprise Institute for Public Policy Research, June 2006). Jane G. Gravelle and Thomas L. Hungerford, *Corporate Tax Reform: Issues for Congress*, CRS Report for Congress (Washington, DC: Congressional Research Service, 2012), provide a critique of this evidence. An overview of the literature is provided by Alan J. Auerbach, "Who Bears the Corporate Tax? A Review of What We Know," paper presented at the International Tax Policy Form and Urban-Brookings Tax Policy Center seminar, *supra*.

12 James Mirrlees, Stuart Adam, Timothy Besley, Richard Blundell, Stephen Bond, Robert Chote, Malcolm Gammie, Paul Johnson, Gareth Myles, and James Poterba, *Tax by Design: The Mirrlees Review* (Oxford: Oxford University Press, 2011).

cash flow tax. As discussed above, the current design of the CIT requires capital expenditures to be depreciated over time and provides for the deductibility of debt interest, but not of the opportunity cost of equity finance. A simple cash flow tax would write off capital expenditures immediately, rather than depreciating them over time, and eliminate deductions for debt interest altogether. There are many issues that arise with respect to a simple cash flow tax, including revenue volatility and the treatment of the tax under international tax systems, which render it an unlikely practical substitute for the CIT; however, other approaches are equivalent in their distortionary effects (or lack thereof). These include the “capital account allowance” tax, which is equivalent to a simple cash flow tax in present-value terms, and the “allowance for corporate equity” tax, which is similar to the current system except that it allows a deduction for the imputed cost of equity finance. It is beyond the scope of this article to go into the details of how these various approaches would work, and they have been discussed elsewhere.<sup>13</sup> However, an argument can be made that future discussions regarding the role of the CIT and possible alternatives to the current system will be more reflective of the view of the corporate tax as an efficient and non-distortionary revenue source.

## CONCLUSION

In this article, I have provided a broad overview of the CIT in Canada, presenting and discussing historical data related to statutory tax rates, average and marginal effective tax rates, revenue shares, revenue to GDP, and other indicators of its impact. One of the noteworthy elements of the data is that despite significant reductions in both statutory and effective tax rates over time, there has not been a marked erosion of the CIT as a percentage of GDP. This no doubt merits further investigation.

I have also noted that views of the role and nature of the CIT have changed over time. In this respect, I argue that future reforms associated with the CIT should focus on the distortionary aspects of the tax, with a view to redesigning the current system so as to reduce the associated distortions, if not eliminate them altogether.

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13 See, for example, Robin Boadway and Jean-François Tremblay, *Corporate Tax Reform: Issues and Prospects for Canada*, Mowat Research Paper no. 88 (Toronto: University of Toronto, School of Public Policy & Governance, Mowat Centre, April 2014).