Canada's Tax System: What's so Wrong and Why it Matters

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Introduction

Canada’s tax system is not delivering for Canadians

At Chartered Professional Accountants of Canada (CPA Canada), we’re worried about Canada’s tax system. At a time when income inequality is rising, labour force growth is slowing and our closest trading partners are shoring up their tax systems, Canada needs to ensure we continue to create jobs, attract investment and remain competitive. But, on these vital measures, our current tax system is falling short, and Canadians and their businesses risk falling ever more behind their global peers.

In this report, we present several real case studies that illustrate the problems Canada’s tax system creates for people and businesses.

We have reviewed key aspects of our current tax system to assess whether they promote or impede the prosperity of Canadians and Canadian businesses. What we found is troubling:

- Canada has lost its corporate tax advantage as the U.S. and other countries have reduced corporate taxes and improved their own tax competitiveness
- Top personal income tax rates and thresholds in Canada are uncompetitive

- Tax complexity makes it difficult for lower income and other vulnerable Canadians to access much-needed income supports through the tax system.
- Tax compliance is becoming exceedingly difficult for all Canadians, especially small business owners and their advisers, putting the integrity of the tax system in jeopardy
- Many Canadians have lost trust in the tax system, which may contribute to reduced compliance and increased underground economic activity.
- Canada's tax mix is out of sync with international trends and overly reliant on income taxes with high efficiency costs, putting a drain on Canada's economy.
- Benefits delivered through Canada's Scientific Research and Experimental Development (SR&ED) program are declining, indicating a need to improve the program's accessibility, certainty and ease of use
- Beyond SR&ED, the tax system does not adequately encourage innovation or attract investment in innovation to Canada
- Canada's income tax and GST/HST rules deliver a high number of tax expenditures that greatly complicate the tax system, but it is not known whether they are achieving their aims at an acceptable cost

Fixing our tax system is imperative. This can only be achieved through a tax system review. Until then, Canadians and their businesses will continue to shoulder unnecessary burdens and diminishing competitive prospects.

Tax system review: Our future prosperity depends on it

A tax system is fundamental to creating a competitive environment and a fair society. Canada needs a 21st-century tax system: a simple, predictable, fair, efficient and transparent tax system with internationally competitive tax rates, where everyone pays their share so that all Canadians prosper.

Yet our current system remains mired in the past. Canada has not undertaken a holistic review since the Carter Commission in the mid-1960s. Since then, all aspects of the domestic and global economies have changed dramatically, while incremental, ad hoc changes have obscured our tax system's underlying framework and its integrity. Canada's businesses, people and economy are suffering competitive setbacks as a result.

CPA Canada believes it's time for the federal government to consider all aspects of our tax system and answer four key questions:

- Does Canada's tax system align with international norms and promote global competitiveness?

- Does Canada's tax system help businesses grow and innovate?
- Do Canada's tax expenditures achieve their goals at the right cost?
- Does Canada's personal tax system promote compliance and deliver social benefits efficiently and effectively?

In this report, we explore each of these questions in detail.

CPA Canada counts many of the country's leading tax experts among our members. CPA Canada President and CEO Joy Thomas assembled a panel of these professionals to contribute their knowledge and ideas as part of an Advisory Committee on a Tax Review ("Advisory Committee"). The panel's discussions helped shape many of the views expressed in this report.

CPA Canada also conducted a broader survey of CPA members in the tax field to capture their views about and experiences with the tax system.[1] Their collective responses are summarized throughout this report, along with some snapshots of specific tax challenges and impacts on Canadian individuals, families and businesses. This report is also based on additional consultation with members, our own research and case studies that our members have shared with us.

CPA Canada is sharing its insights and recommendations for a tax review in this and two other reports. Our first report looked at how other countries have approached major tax reforms and reviews, and what Canada can learn from these experiences. This second report addresses why Canada's tax system needs an urgent overhaul. The final report in this series will explore how an independent tax system review can be designed to maximize the benefits.

With this series of research reports, CPA Canada aims to engage policy-makers, business and professional associations, think-tanks, academic experts and other key stakeholders in an in-depth discussion and debate about the future of Canada's tax system. It's time to tackle tax issues in the best interests of Canadians.

1 This survey was completed in August and September 2018, by 59 respondents who are experts in tax, and who are either on a CPA Canada tax committee, or volunteer for CPA Canada. An additional 43 individuals did not complete the survey, but provided responses to part of it. Their responses are included in this report. Due to the number of respondents, results in this report should be treated as directional in nature.

Tax and international competitiveness: Is Canada in step with global trends?

Canada has lost its corporate tax advantage

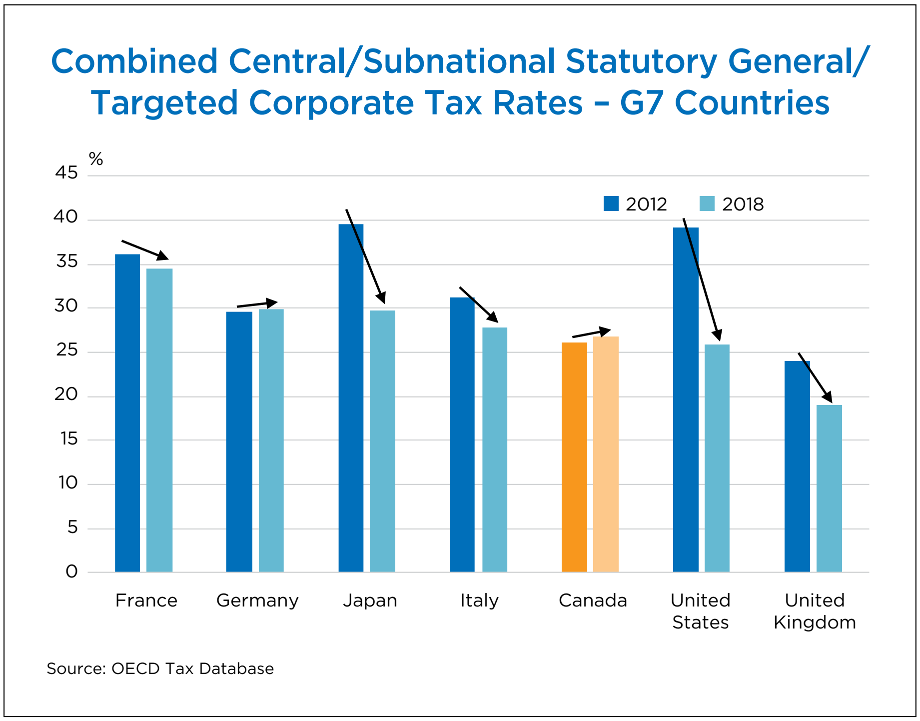
Until recently, Canada enjoyed a competitive tax advantage with its comparatively low corporate tax rate relative to other G7 countries and especially the U.S. But over the past six or so years, as Canada has maintained the status quo, other countries around the world have reduced corporate and personal tax rates while their take from consumption (sales) taxes has increased.

KEY FINDINGS:

- Canada has lost its corporate tax advantage as the U.S. and other countries have reduced corporate taxes and improved their own tax competitiveness.
- In particular, the lower U.S. corporate tax rate reduces Canada's relative appeal for more mobile investments and increases exposure to the shifting of profits to the U.S.

More recently, the U.S. tax reform package and uncertainty over trade have raised concerns about our future prospects and cast doubt on Canada's ongoing tax competitiveness. Most notably, with the U.S. federal rate now at 21 per cent (from 35 per cent previously), Canada has lost that key benefit relative to its largest trading partner and competitor.

Canada's corporate tax rate is also now above the Organisation for Economic Co-operation and Development (OECD) average – and if planned changes proceed in France, Canada will lag behind the U.K., the U.S. and France in terms of G7 countries.



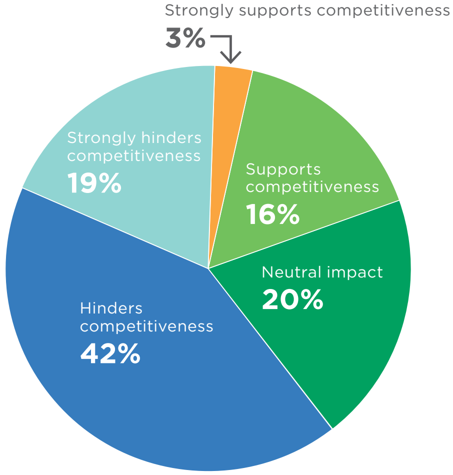
Our first report[2] in this series examined the implications of these changes for Canada in detail. Among other things, we noted that tax rates are just one of many factors contributing to a jurisdiction's competitiveness. CPA Canada's Advisory Committee suggested that Canada's previous tax advantage was so significant that it eclipsed other issues, including tax complexity and overregulation, that make it harder to do business in Canada than in the U.S. or elsewhere.

A majority of Canadian CPAs responding to our survey agree that Canada's current tax system hinders or strongly hinders competitiveness (61 per cent), while fewer than one in five CPAs (15.6 per cent) believes the system supports competitiveness.

When asked to identify the top barriers to competitiveness in Canada, uncompetitive personal and/or corporate tax rates ranked highest among CPA respondents, followed by the time and cost of tax compliance, and an ineffective system for supporting business investment.

2 CPA Canada, *International Trends in Tax Reform: Canada is Losing Ground*, October 2018.

What statement best reflects your view of the current tax system in Canada as it relates to the competitiveness of Canadian businesses?



Source: CPA Canada survey of CPA members in the tax field, 2018.

The International Monetary Fund (IMF) observed that the lower U.S. corporate tax rate reduces Canada's relative appeal for mobile investments and increases its exposure to the shifting of profits to the U.S.[3] As a result of the new tax rate differential, the IMF's analysis estimates that:

- real assets held in Canada by U.S. multinationals could fall by 6 per cent over the long term;
- less profit shifting into Canada by U.S. multinationals (which can be relatively easy for them to accomplish) could reduce the profits they report in Canada by around 15 per cent; and
- the overall amount of profits reported by U.S. multinationals in Canada -- which is 15 per cent of all corporate income tax revenue -- could drop by about 25 per cent.[4]

In a June 2018 statement, the IMF said: "The medium-term impact of lower tax rates in the U.S. could make Canada a less attractive destination for investment, leading to heightened uncertainty about Canada's medium-term growth prospects."[5]

3 International Monetary Fund, *Canada: Selected Issues,* IMF Country Report No. 18/222, 2018.
4 Ibid.
5 International Monetary Fund, "Canada: Staff Concluding Statement of the 2018 Article IV Mission," June 4, 2018 (https://www.imf.org/en/News/Articles/2018/06/04/ms060418-canada-staff-concluding-statement-of-the-2018-article-iv-mission)

Foreign direct investment in Canada is a concern

A PwC study commissioned by the Business Council of Canada found that US tax reform has put 635,000 Canadian jobs and $85 billion of Canada's GDP under threat.[6]

These threats are arising at a time when foreign direct investment (FDI) is an ongoing concern in Canada. Canadian FDI hit its lowest level since 2010 last year, and cross-border mergers and acquisitions resulted in a net withdrawal of funds from Canada for the first time since 2007.[7]

Canadian Manufacturers & Exporters (CME) identified similar trends, which show that businesses are struggling to compete globally while FDI has been passing Canada by.[8] CME cites data from the United Nations Conference on Trade and Development that shows FDI flows into Canada in 2016 were down by 50 per cent compared to the pre-recession average in 2005-2007, while global investment flows rose by 20 per cent over the same period.[9]

CME also points out that the majority of investment flows between the U.S. and Canada have changed direction. In 2013, U.S. businesses invested $40.6 billion in Canada, while Canadian businesses invested $25.7 billion of capital in the U.S. By 2017, U.S. investment in Canada dropped to $23.1 billion, while Canadian business investment in the United States has more than tripled to $81.9 billion in 2017.

More recent data for 2018 has shown a modest rebound. In addition, the recent changes introduced by the federal government in the 2018 Fall Economic Statement to increase capital cost allowances available to businesses provide some safeguard against concerns of an acceleration in FDI outflows by lowering the effective marginal tax rate on new investment. However, those same concerns tend to extend beyond depreciation rates, in isolation, given that competitiveness constitutes a much broader spectrum of issues. As a result, concern that Canada's competitive position is resulting in less foreign interest in investing in Canada remain.

6 PwC, *The Impacts of US Tax Reform on Canada's Economy*, September 2018.

7 Perrin Beatty and Joy Thomas, "It's time for Ottawa to look at implementing a 21st-century tax system," *The Globe and Mail*, October 7, 2018.

8 Mike Holden, "Restoring Canada's Tax Advantage: A Need for Tax Reform", BDO and Canadian Manufacturers & Exporters, June 2018, retrieved October 2018 (http://cme-mec.ca/wp-content/uploads/2018/11/Doc_QC_Restoring-Canadas-Advantage.pdf)

9 Ibid.

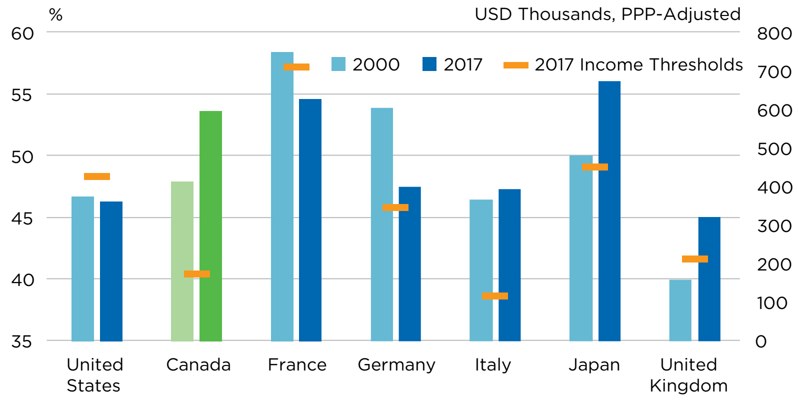
The IMF concludes: "It is time for a careful rethink of corporate taxation to improve efficiency and preserve Canada's position in a rapidly changing international tax environment."[10]

A recent academic study expressed this same message more starkly: "Put simply, Canada and other countries will face a drop in revenue while the U.S. gains revenue. Alarm bells should be ringing among public policy-makers in Canada and elsewhere, since research shows that taxes are a significant factor in multinationals' decisions on where to invest globally and how to finance it."[11]

Canada's top personal rate and threshold are not competitive

"High personal taxes disadvantage Canada in the competition for global talent," the C.D. Howe Institute says. "Lower personal income taxes in the U.S., in particular, hurt Canada's attractiveness to high earners and its appeal as a location for head offices."[12]

Top Statutory Combined National-Subnational Personal Income Tax Rates and Income Thresholds – G7 Countries



Source: OECD Tax Database

Note: Income thresholds are adjusted for purchasing power parity (PPP) for the purposes of drawing effective comparisons. PPP estimates how much one unit of currency in one country can purchase in goods and services in another. It differs from the exchange rate, which estimates how much it costs to purchase one unit of currency in another country.

10 International Monetary Fund, supra note 5.

11 Philip Bazel, Jack Mintz, and Austin Thompson, "2017 Tax Competitiveness Report: The Calm Before the Storm," *SPP Research Paper*, 11(7), 2018.

12 Alexandre Laurin, "Unhappy Returns: A Preliminary Estimate of Taxpayer Responsiveness to the 2016 Top Tax Rate Hike," C.D. Howe Institute *E-brief*, 2018.

Canada's top combined (federal and provincial) personal income tax rate is above 50 per cent in seven of 10 provinces and is one of the highest among the 35 OECD countries. Canada's top federal rate kicks in at an income threshold of just over $200,000 – well below the threshold of most other G7 countries.

For example, consider the overall personal income tax burden for an individual earning the same amount of income in Ontario versus California, one of the higher-taxing U.S. states for personal income. Ontario's top personal income tax rate is only 3 percentage points higher than California's, but the income threshold above which the top rate applies is much lower in Ontario than in California.

In Ontario, a person earning income of about $220,000 in Canadian dollars (or the equivalent of about $170,000 U.S. at the time of writing) would see any additional income earned taxed at a combined federal-provincial effective tax rate of about 53.5 per cent. In California, this person would pay combined federal and state income tax on additional income at an effective rate of about 41.3 per cent.

Further, since the top federal rate in Canada applies to income of just over $200,000, it may apply not only to the highest-paid senior executives but also to many highly skilled workers — the very workers Canada hopes to attract in the global competition for top talent. For a software engineer considering whether to work in Ontario or California, for example, the personal income tax differential might well be a deciding factor.

In response to the Canadian Employee Relocation Council's 2017 global survey of 10,000 mobile employees in 20 countries, 64 per cent of respondents said they would only relocate to a country with a low tax burden.[13] Taxes are more of a factor for those with higher levels of education.[14]

13 Canadian Employee Relocation Council, *Global Mobility Survey 2017*, June 2017.

14 Other top conditions for relocation include high-quality and accessible health care, a good social security system, and an innovative economy.

Canada does not have the right tax mix

> **KEY FINDINGS:**
> - Canada's tax mix is out of sync with international trends and relies too heavily on income taxes with high-efficiency costs.
> - The OECD and IMF have both indicated that rebalancing taxation toward consumption taxes could help improve resource allocation, thereby improving productivity.

While there is evidence that Canada's corporate and personal tax rates are no longer competitive, it has also been argued that Canada's tax mix is out of sync with international trends. Getting the right balance in the tax system is crucial. If one type of tax is too high, it may be harmful to the tax system as a whole and the government's goal should be to raise funds with minimal economic disruption.

In many other developed countries, there has been a clear trend over the past decade toward reducing income taxes and raising consumption taxes, usually in a revenue-neutral manner. Today, Canada and the U.S. are well out of step in their heavier reliance on personal and corporate taxes compared to their counterparts. Our first report[15] in this series discussed the implications of Canada's current tax mix in detail.

Consumption taxes are considered to have advantages over personal and corporate income taxes because consumption taxes tend not to change behaviours. If the GST/HST rate were increased, the evidence suggests Canadians would not change their consumption patterns significantly because of it.[16]

Conversely, raising income taxes tends to influence people's decisions to work or companies' intentions to invest, with spillover effects on the broader economy. For example, raising the corporate tax rate may discourage a company from investing in new machinery or equipment, which may have downstream impacts on employment, wages and broader economic growth.

That stated, consumption taxes are also more regressive than personal and corporate taxes because they hit lower-income families harder than higher-income families. Lower-income families already pay little income tax, but they feel the increases in the costs of basic groceries and other essentials more

15 CPA Canada, supra note 2.

16 Ergete Ferede and Bev Dahlby, "The Costliest Tax of All: Raising Revenue Through Corporate Tax Hikes Can Be Counter-Productive for the Provinces," *SPP Research Paper*, 9(11), 2016.

strongly than other consumers. However, governments can limit the burden that sales taxes impose by offering relief for lower-income earners (as we discuss in the next section).

Canada's income taxes come with high-efficiency costs in terms of how they alter relative prices and productivity, and how they influence decisions on savings, investment, effort and entrepreneurship.[17] The efficiency costs of the GST/HST are lower. The OECD observes that rebalancing taxation toward consumption taxes could help improve resource allocation, thereby improving productivity.[18] The IMF has also suggested that Canada consider relying more heavily on indirect taxation and, notably the GST/HST.[19]

In our first report, we pointed to estimates showing that for each dollar of revenue raised through corporate income taxes, the economy bears nearly four times that cost due to effects on business investment and hiring. The comparative figure for personal income taxes is $2.86 due to their effects on the labour supply, while that of sales taxes is just over $1.50.[20]

Canada's reliance on income taxes rather than consumption taxes is therefore costing our economy far more than if our tax mixes were more in line with those of other G7 and OECD countries. Value-added and sales taxes comprise only 13.4 per cent of Canada's total tax revenues, while the average for the other G7 countries (excluding the U.S.) is 30.7 per cent.

As the foregoing discussion shows, Canada's tax mix is out of step with international norms and the federal government should examine its level of reliance on various taxes as part of a tax system review.

17 Jason Clemens, Niels Veldhuis and Milagros Palicios, "Tax Efficiency: Not All Taxes Are Created Equal," *Studies in Economic Prosperity*, The Fraser Institute, January 2007.

18 OECD, *OECD Economic Surveys*: *Canada*, July 2018.

19 International Monetary Fund, supra note 3.

20 Ferede and Dahlby, supra note 16.

CASE STUDY

Stifling foreign investment

Foreign-owned companies employ two million Canadians and are responsible for about half of Canada's exports.[22] Wooing foreign investors is a high priority for every government in Canada, and the competition is intense.

Yet one of the federal government's tax policies — the withholding tax on dividends — may be hurting Canada's efforts to bring in new investment.

The tax usually applies at 25 per cent but is reduced for residents of countries having tax treaties with Canada. Thus, the rate drops to 5 per cent for a U.S. company that controls at least 10 per cent of its Canadian subsidiary.

How does the tax impede Canada's ability to compete? Take TradeX Canada, part of an Illinois-based advanced manufacturing group with operations in more than 30 countries, including facilities in Alberta and Ontario. Like other global companies, TradeX often uses a financial management technique known as cash pooling. This technique allows TradeX to transfer surplus funds seamlessly from an operation in one country to subsidiaries in others, fostering the group's global expansion.

The dividend withholding tax discourages cash pooling, making it more cumbersome and costly for a multinational to transfer funds among its subsidiaries. The tax has deterred TradeX from using a loan facility in Canada, putting a lid on its Canadian expansion.

In 2016, the Conference Board of Canada estimated that the withholding tax cost Canada up to $2.6 billion in foreign investment each year. Reducing — or perhaps even, eliminating — the dividend withholding tax could encourage firms like TradeX to grow their operations in Canada and lower the cost of capital for Canadian businesses.

** This is a real case study received from a CPA member. Names and places have been changed to protect privacy and sensitive financial information.*

21 The Canadian Trade Commissioner Service, "Foreign-controlled firms in Canada making a big impact," last modified January 2018 (http://www.tradecommissioner.gc.ca/canadexport/0000017.aspx?lang=eng).

Tax and business: Does Canada's tax system encourage growth and innovation?

The tax system is too complex, especially for small and medium business owners

Stimulating business activity, job creation and growth are key policy objectives underpinning our tax system's design. For those reasons, the tax system offers a variety of tax incentives and concessions to support small and medium enterprises (SMEs). Among the most important of these tax expenditures are the small business deduction (SBD) and the related small business tax rate, which both depend on maintaining Canadian controlled corporation status.

Yet as with many other areas of the Income Tax Act, the taxation of SMEs has been subjected to layer upon layer of incremental changes over the years. As complexity rises, so do the costs of compliance for SMEs, given the extensive time and effort required by tax advisers to determine their clients' obligations under the new rules. The Joint Committee on Taxation of the Canadian Bar Association and CPA Canada ("Joint Tax Committee") and others fear that changes to the taxation of private corporations introduced

KEY FINDINGS:

- The taxation of SMEs has become unduly complex as layer upon layer of incremental changes have been implemented over the years – from anti-avoidance rules to association rules to the taxation of private corporations.
- Advisers to small businesses are having trouble keeping up with the complex rules that now apply and compliance costs are increasing.
- SMEs are a key source of new jobs. As part of a tax system review, the government needs to revisit the tax rules for small business to ensure they are effective, efficient and provide the right support to promote growth and innovation among SMEs.

in 2017 have magnified these challenges, raising concerns about taxpayers' ability to comply with the self-assessment system and the CRA's ability to administer it.[22]

When the private corporation tax rules were introduced, small business owners, their advisers and Canada Revenue Agency auditors were already challenged to deal with other recent and highly complex changes – such as the association rules and anti-avoidance rules that had been added to the small business deduction rules.

The new anti-avoidance rules are described by some tax practitioners as so overwhelmingly complex that they are simply unworkable in practice.[23] Many of our members are working with their clients to apply these and other recent changes. They have told us that time and compliance costs are increasing for their clients. Some members report having to call in tax specialists to help clients deal with transactions that used to be a matter of routine (e.g., paying dividends to active owner-managers or paying intercorporate dividends).

Despite the significant and growing complexity associated with the taxation of SMEs in Canada today, there are good arguments for providing tax support to SMEs. Government of Canada statistics show that SMEs contributed about

22 Joint Tax Committee, Letter to Department of Finance Canada re: "Tax Planning Using Private Corporations – Tax on Split Income and Limitation of Lifetime Capital Gains Deduction Proposals," October 2, 2017.

23 Lauchlin MacEachern, "The Small Business Deduction: Is Its Complexity Justified?" in *Tax for the Owner-Manager*, Vol. 17, No. 3, Canadian Tax Foundation, July 2017.

30 per cent to the GDP of their provinces in 2014.[24] They were responsible for creating 95.4 per cent of private sector jobs in Canada between 2005 and 2015[25] and, as of 2015, SMEs employed 10.5-million (90.3 per cent) of private sector workers across Canada.[26]

Tax support can help improve the success of this important sector of our economy in a number of ways. For example, it can provide SMEs with access to more capital and allow entrepreneurs to take more risks with their investments.[27] As one study observed, "The SBD amounts to an interest-free loan to finance capacity-expanding investment that is partially recovered when small firms begin distributing the income earned on this investment."[28]

But there are conflicting findings over the effectiveness of the small business deduction in supporting SMEs and improving competitiveness.[29] Given the importance of SMEs to Canada's economy and the SBD's complexity and high annual cost as a tax expenditure — estimated at over $6.3 billion for 2019[30] — Canada urgently needs a review to understand how well the tax rules are supporting small businesses and their owners.

24 Innovation, Science and Economic Development Canada, "*Key Small Business Statistics – June 2016*," last modified November 2016 (https://www.ic.gc.ca/eic/site/061.nsf/eng/h_03018.html#point7-1)

25 Ibid.

26 Ibid.

27 Robin Boadway, "The Canadian Corporate Income Tax at 100 Years of Age: Time for a Change?" in edited by Jinyan Li, Scott Wilkie and Larry F. Chapman, *Income Tax at 100 years: essays and reflections on the income war tax act*, Canadian Tax Foundation, 2017.

28 John Lester, "Policy Interventions Favouring Small Business: Rationales, Results and Recommendations," *SPP Research Paper*, 10(11), 2017.

29 See, for example, Ted Mallett, "Policy Forum: Mountains and Molehills --— Effects of the Small Business Deduction," *Canadian Tax Journal*, 63(3), 2015; Bazel, Mintz and Thompson, supra note 11; and Boadway, supra note 27.

30 Department of Finance Canada, "Report on Federal Tax Expenditures – Concepts, Estimates and Evaluations 2018," last modified March 2018 (https://www.fin.gc.ca/taxexp-depfisc/2018/taxexp1802-eng.asp#a3).

CASE STUDY

Losing out on tax credits while striving to compete

DB Tools* is based in Brandon, Manitoba, employs 160 people, and makes high-quality components for the mining industry. The company competes in this niche area with companies from around the world, especially the United States and Europe, and increasingly China.

DB's key U.S. competitor recently leveraged U.S. tax policy changes that allowed it to immediately write-off the full cost of investment in new equipment, speeding up production and improving its product quality.

To stay competitive, DB Tools wanted to expand its own investments in developing talent and acquiring new equipment. The company had looked to Canada's tax system for support in the past, but had little success:

The previous year, the company had invested in upgrading equipment but missed out on the Manitoba manufacturing investment tax credit. They hadn't realized they were eligible before the deadline had passed.

DB Tools has a good relationship with the local college, providing co-op and apprenticeship opportunities to its students. However, earning the credits for taking on apprentices and co-ops involves a lot of work to figure out which program applies to their students' roles and to complete all the forms correctly.

In the past, DB Tools succeeded in getting credits for research and development, but their last applications were refused after a time-consuming audit.

A small company like DB Tools has many ways to gain support through the tax system, and these can make a big difference. But identifying what provincial and federal credits they qualify for and submitting the right paperwork are significant impediments. When companies weigh the time and money they need to invest to claim these credits against the likelihood of success, it can be touch-and-go whether the investment is worthwhile.

** This is a real case study received from a CPA member. Names and places have been changed to protect privacy and sensitive financial information.*

The tax system does not encourage innovation sufficiently and effectively

In a rapidly changing and highly competitive global business environment, Canada needs to ensure that a competitive tax system and an efficient regulatory system are in place to enable Canadian businesses to adapt, innovate and succeed. Tax incentives are an important tool for encouraging innovation and attracting research and development (R&D) investment. In Canada, this indirect support is delivered primarily through the SR&ED program.

According to international consultancy PwC, research and development activity creates high-paying jobs and is essential to driving productivity growth.[31] However, CPA Canada's Advisory Committee has observed that Canada is lagging behind other jurisdictions in promoting innovation and that claims for SR&ED tax credits have fallen.

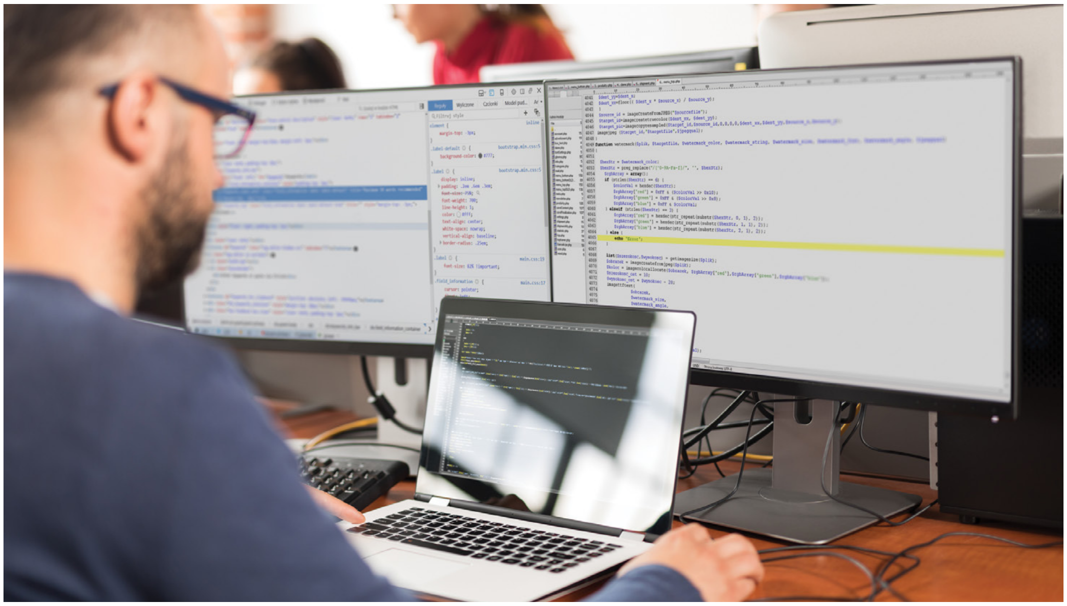
In its 2018 economic survey of Canada, the OECD recommended that "the substantially enhanced research and development (R&D) tax credit for small companies and heavy reliance on indirect R&D subsidies should be evaluated to determine whether they are efficient and adjusted accordingly."[32] Budget 2017 announced the federal government's intention to undertake such a review but the status of this initiative remains unknown.

Similarly, the Advisory Council on Economic Growth, chaired by Dominic Barton, recommended that the government should streamline existing programs, including SR&ED, and simplify the complex application and auditing processes. More broadly, the council called on the government to

KEY FINDINGS:

- R&D tax credit programs encourage more R&D spending among firms of all sizes.
- The SR&ED program is Canada's largest investment supporting R&D — but claimants and practitioners report problems including uncertainty on eligibility criteria, a complicated, labour-intensive process for claiming benefits and dealing with time-consuming audits.
- By one estimate, aggregate SR&ED tax credit payouts dropped by $5.3 billion between 2009 and 2016.
- With U.S. tax reform, the efficiency and effectiveness of the SR&ED program has become more urgent.

31 PwC, supra note 6.
32 OECD, supra note 18.



"conduct a targeted review of our tax system to ensure that the tax regime fosters the development and adoption of innovation, and secures Canada's position as a global magnet for investment and talent."[33]

Most recently, Canada's Economic Strategy Tables noted that the SR&ED program is Canada's largest investment supporting R&D but questioned whether the existing program is helping make Canadian firms more competitive.[34] The Economic Strategy Tables 2018 report on digital industries recommended streamlining existing programs, including SR&ED, and simplifying the complex application and auditing processes.[35]

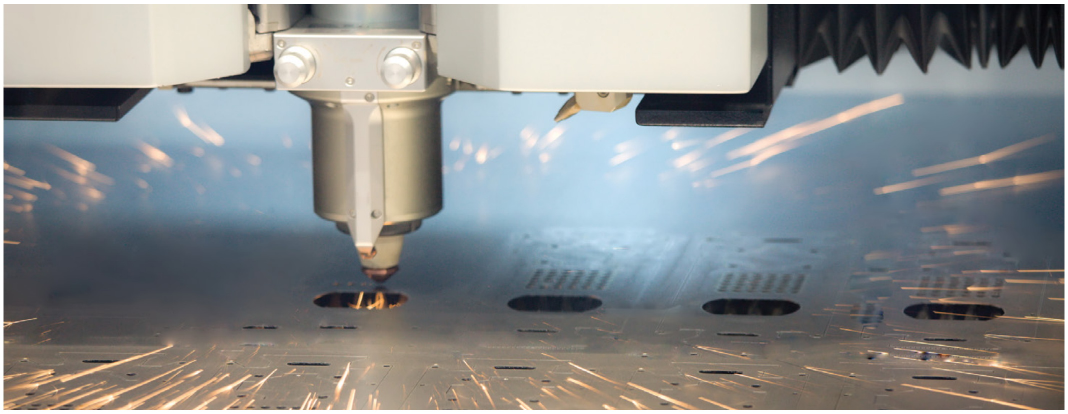
The report observes: "An increasing community of 'Walking SR&ED' firms (those that stay in business not because they're competitive but because they're surviving on SR&ED credits) tells us this tax incentive is not working."[36]

The report concludes that for Canada to remain competitive, "the government must modernize SR&ED to support both innovation and commercialization."

33 Advisory Council on Economic Growth, *The Path to Prosperity: Resetting Canada's Growth Trajectory,* 2017.
34 Canada's Economic Strategy Tables, *Digital Industries*, October 2018.
35 Ibid.
36 Ibid.

CASE STUDY

SR&ED process dampens ambitions



In today's world of intense global competition, many Canadian companies compete through continuous research and innovation. Coretech Engineering,* a small company based in Milton, Ontario, has carved out a lucrative niche in the energy sector, developing and manufacturing precision-made components that help squeeze more efficiency from renewable energy generation.

Initially the company relied on the federal Scientific Research and Experimental Development Program to supplement their investments in developing and commercializing technologies for sale in Ontario and around the world. The program lets companies deduct SR&ED costs from income for tax purposes, and provides an investment tax credit to reduce income tax bills. As Coretech constantly sought to enhance its technology by improving designs and using new materials, the extra money helped them stay on the technology's frontline.

Yet as time went on, a process that was once straightforward became increasingly complicated as the Canada Revenue Agency asked more questions about the work done. The CRA's interpretation of what it considers eligible for credit seemed to be much more restrictive, and Coretech's claims ultimately became bogged down in audits.

When the small company added up the staff time required, the back and forth during audits, and the costs of filing claims, applying for the credits no longer made any economic sense. Innovation remains part of the company's DNA, but they had to scale back their ambition, with a smaller budget and fewer employees focused on the research and testing needed to maintain a world-leading product.

** This is a real case study received from a CPA member. Names and places have been changed to protect privacy and sensitive financial information.*

"The current SR&ED compliance environment discourages use of the program at the very time companies need it most – commercialization and scale-up."
— A CPA in Ontario

Currently, SR&ED credits only encourage large Canadian Controlled Private Coporations and other corporations to perform SR&ED if they are taxable. Canada should stimulate all SR&ED activities, regardless if such taxpayer is currently in a taxable position or not (the current system is not aligned with the policy behind such incentives).
— A CPA in Quebec

Why are SR&ED claims declining?

At a recent SR&ED symposium sponsored by the Chartered Professional Accountants of British Columbia, participants observed:

- When multinationals are deciding where to conduct R&D, the risk of not securing a SR&ED credit in Canada and/or the cost are significant factors
- Many companies delay the actual deployment of SR&ED incentives in the business because they do not want to invest in assets while there is a risk they may have to pay the incentives back to the Canada Revenue Agency (CRA)
- Many companies – large and small – do not bother to claim their SR&ED entitlements due to uncertainty over benefit entitlements, the high cost of preparing claims and difficulties with the CRA's audit processes for SR&ED claims

With U.S. tax reform, the efficiency and effectiveness of the SR&ED program has become more urgent. While the U.S. R&D credits remain lower than Canada's, other aspects of the reforms deny full foreign tax credits to U.S. companies, including SR&ED credits. Furthermore, intellectual property developed in Canada by U.S. companies will now bear more U.S. tax on its commercialization than it would if developed in the U.S., creating an incentive for U.S. companies to do their R&D south of the border.

What will be the impact of these tax changes in the U.S.? According to PwC, "overall, the U.S. tax reform has decreased the net effectiveness of Canada's SRED credits for U.S.-based companies and increased the net effectiveness of U.S. R&D credits. This is likely to lead to a reduction in R&D activity by U.S.-based companies in Canada, including the spillover benefits that such activity creates. Currently, R&D conducted by U.S. companies in Canada accounts for at least 11 per cent of total private R&D spending in Canada."[37]

Now that the U.S. tax environment has become more favourable for U.S. companies conducting R&D, it is important to determine whether Canada is doing enough to support innovation through the tax system and to weigh alternative mechanisms for encouraging R&D and the exploitation of its results here at home.

37 PwC, supra note 6.

CASE STUDY

An HST shock for a long-term care home

Canadians are living longer, and as they get older they need more care. Over 400,000 elderly people live in long-term or residential care in Canada. It is a growing challenge for governments to find resources to provide a home and round-the-clock care for the people who need it most. And the tax system sometimes makes that task even harder.

Consider Ottawa's Hemlock Manor* home for seniors, which cares for over 100 residents. In 2014, after operating for four years, the charity running the home got an unexpected surprise. The Canada Revenue Agency advised the charity that it owed $1 million in Harmonized Sales Tax (HST) arrears, plus $350,000 in penalties and interest.

Without seeking access to specialist advice upfront, Hemlock had become tangled in an obscure Excise Tax Act rule that says anyone who puts up a residential building and then lets someone else live there is deemed to have sold the building to themselves at fair market value. The charity thus became liable for 13 per cent HST as soon as the first resident moved in.

Faced with a crippling tax bill and personal liability, Hemlock's volunteer board was forced to make some hard decisions that affected the lives of residents and staff. In an effort to keep providing care, the board delayed upgrading residents' beds and fell behind on wages for nurses and other staff.

The board spent two years appealing the CRA's ruling. The agency eventually allowed an HST rebate at a blended rate of 85 per cent and reduced the penalties. Even so, Hemlock took a hit of about $150,000 — not to mention the emotional strain on staff and residents, and the stress on their families.

** This is a real case study received from a CPA member. Names and places have been changed to protect privacy and sensitive financial information.*

Tax expenditures: Do they achieve their goals for the right cost?

Canada has many tax expenditures, both federal and provincial, which are designed to achieve various purposes, such as enhancing social policy or driving business growth. From the lifetime capital gains exemption, to various tax credits for students, caregivers, teachers and volunteer firefighters, to the SR&ED tax credit and the small business deduction we discussed earlier in this report, there have been questions as to whether these expenditures are achieving their stated aims and whether those aims could be achieved in more efficient and effective ways.

What's not in question is that all these tax expenditures, large and small, combine to vastly complicate the tax system, reduce tax revenues and diminish Canada's tax competitiveness.

In response to our survey, 71 per cent of CPAs said that Canada's system of tax expenditures is too complicated and in need of major reform.[38]

KEY FINDINGS:

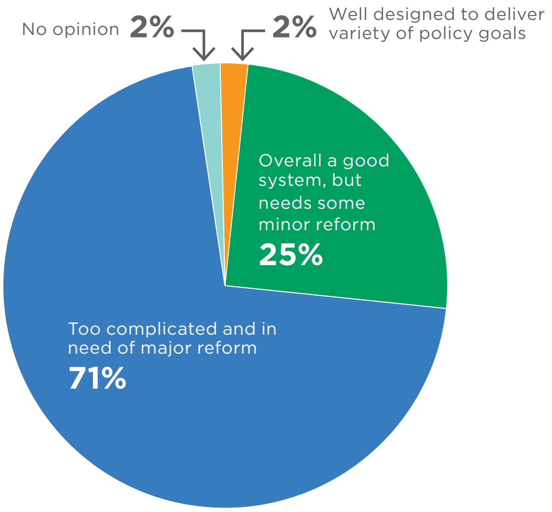
- Canada's income tax and GST/HST rules deliver a high number of tax concessions and preferences, but it is not known whether and to what extent they are achieving their aims at an acceptable cost or whether there are preferable alternatives.
- In response to CPA Canada's survey, 71 per cent of CPAs said that Canada's system of tax expenditures is too complicated and in need of major reform.
- Going forward, Canada's income tax and GST/HST expenditures need to be examined as part of a comprehensive tax review.

38 For purposes of this survey question, a tax expenditure was defined as any government spending through the Income Tax Act. As classified by the federal government, they include: exemptions; exemptions and zero-rating under the GST; deductions; credits; rebates and refunds; preferential tax rates; surtaxes; and timing preferences.

The preponderance of "tax benefits" makes our system more cumbersome. Many Canadians miss out on the benefits because they either do not know the rules, or do not wish to spend the time required to maintain records and deal with CRA scrutiny of these claims. We also need to better define "tax expenditures" — many of these are integral to the tax system itself. Disguised program spending is the problematic item.

— A CPA in Alberta

What statement do you think most accurately reflects the system of tax expenditures in Canada?



Source: CPA Canada survey of CPA members in the tax field, 2018.

Many expenditures add complexity and are inefficient

In Budget 2016, the federal government announced it would undertake a review of federal tax expenditures in 2016-17. The review was conducted internally by the Department of Finance ("Finance Canada") and the process, data and detailed analysis were not made public.

In Budget 2017, the government announced that the review was complete and that it would be adjusting some personal tax credits, combining some (credits for caregivers) and cancelling others as a result. While this expenditure review may have been a step in the right direction, an enormous number of tax expenditures are still in place, making for what one tax expert has called "a veritable Swiss cheese of a tax system."[39]

Although the expenditures may have been designed to achieve social or economic policy objectives, this tax expert observed, "These measures often entail unintended costs in terms of economic efficiency and they are not necessarily good substitutes for direct expenditure programs, which could achieve the same objectives more transparently, with more public scrutiny and accountability. Those tax expenditures that have been analyzed have often been found ineffective in achieving their stated objectives."[40]

Without transparency over the government's tax expenditure review data and analysis relating to tax expenditures, it is difficult to understand whether those tax expenditures still in place are meeting their objectives. It is also not known whether Finance Canada considered key elements such as compliance costs for taxpayers and administration costs for the government as part of the review. Much unfinished business remains from that review, and its findings should be made public.

GST/HST expenditures add unwarranted complexity

The GST/HST system is complicated, with many exemptions and concessions that make these rules time-consuming and costly to deal with. Many commentators have argued that the GST/HST could be both simplified and broadened by eliminating many of these preferences.

For example, Finance Canada estimates that, for 2018, the cost of zero-rating of groceries will amount to some $4.76 billion.[41] As Frances Woolley, a professor of economics at Carleton University in Ottawa, argued in *The Globe and Mail* this is positioned as a measure that benefits lower-income Canadians, but higher-income Canadians are also subsidized. In fact, this concession actually delivers more dollar benefits, on average to wealthy families than to lower-income ones.[42] Lower-income Canadians spend a higher portion of income on food but some say tax fairness could be improved by increasing the GST tax credit benefit specifically for those who need it.[43]

39 Fred O'Riordan, "Policy Forum: Why Canada Needs a Comprehensive Tax Review," *Canadian Tax Journal / Revue fiscale Canadienne*, 66(2), 2018, pp 351-362.

40 Ibid.

41 Department of Finance Canada, supra note 29.

42 Frances Woolley, "Taxes, tampons and Canada's fiscal future," *The Globe and Mail*, June 29, 2015.

43 The Canadian Press, "Ending GST exemptions could raise $39 billion, economists say," *Investment Executive*, February 24, 2012.

CPA Canada's Advisory Committee observes that, as part of an overall review, all of Canada's income tax and GST/HST expenditures need a closer look to see whether they are meeting their aims for an acceptable cost and whether there are preferable alternatives. As one study concluded, "Eliminating unneeded tax expenditures would increase efficiency and economic competitiveness. It would allow a tax system that is fairer across income groups and also fairer in its treatment of different types of income recipients at the same income level."[44]

44 Peter S. Spiro, "Tax Exemptions for Investment Income: Boon or Bane?" *Mowat Research* #143, Mowat Centre, Toronto, 2017.

Tax and individuals: Does the tax system promote compliance and deliver social benefits efficiently and effectively?

The personal tax system impedes compliance

Both in Canada and worldwide, leading tax administrations have struggled to determine ways to reduce complexity and increase fairness and effectiveness through tax policy and administration.

In a self-assessment system, complexity in tax legislation can make it more difficult for taxpayers to comply, lead to errors that are costly for governments and taxpayers to correct, and diminish trust in the tax system. Internationally, many leading tax authorities have made concerted efforts to simplify their tax system's administration, especially for individuals, families and smaller businesses.[45]

Tax simplification can lead to important benefits in:

- enhancing taxpayer compliance;
- increasing tax revenues; and
- easing enforcement and associated costs.

KEY FINDINGS:

- Many Canadians have lost trust in the tax system, which may contribute to reduced compliance and increased underground economic activity.
- For individuals, the federal tax gap — the difference between the amount of tax it should have collected and how much it actually received — stood at $8.7 billion in 2014.
- The CRA's enforcement efforts to close the tax gap would be more effective if combined with steps to significantly simplify and improve trust in the tax system.

45 CPA Canada, supra note 2.

The personal tax system appears to function well for Canadians with relatively straightforward tax affairs, such as employees who earn salary income with simple deductions (e.g., RRSP contributions) and basic tax credits (e.g., spousal credit), and little scope for tax planning. The CRA's focus on improving its electronic filing (including the ability to download tax data) and payment services and on refining its secure tax portals (e.g., My Account) is helping to make compliance for these taxpayers even easier.

However, CPA Canada's Advisory Committee notes that some tax administration processes are needlessly burdensome, even in relatively straightforward tax situations. For example, many taxpayers filing simple returns have become frustrated with the CRA's inefficient verification practices, as CRA auditors often request receipts for simple claims such as charitable donation and medical expense credits within tight deadlines, even where claims in previous years were verified and accepted for the same taxpayer.

Taxpayers with questions about how to comply or about the status of their tax filings, payments and other information, have had difficulty getting answers through the CRA's telephone helplines. In 2017, the Auditor General of Canada observed that call centres are a key source of information for taxpayers. In its report, the Auditor General said, "If taxpayers cannot get timely access to accurate information, they may file incorrect returns, miss filing deadlines, pay too little or too much tax (and later be subject to reassessment), or miss out on benefits they are eligible to receive."[46]

However, the Auditor General found that, between March 2016 and March 2017, the CRA's call centres failed to answer 64 per cent of all calls, because the calls were either blocked due to high call volumes or because the caller reached automated service options and hung up.[47] The Auditor General also found that call-centre agents gave wrong information to callers 30 per cent of the time.[48]

46 Auditor General of Canada, *Report 2 – Call Centres,* 2017 Fall Reports of the Auditor General of Canada to the Parliament of Canada, November 2017.

47 Ibid.

48 Ibid. In the report, the CRA acknowledged problems with its call-centre technology and committed to migrate to a new telephony platform as part of the Government of Canada's Contact Centre Transformation Initiative. The CRA also said it would examine how it manages caller wait times and continue to enhance self-service options.

Tax-rate increases may also lead to a lack of trust and there is evidence that they are likely to change the behaviour of those affected. In response to personal tax-rate increases, some people may reduce the amount they work, while others could engage in more extensive tax planning. Based on feedback from manyCPAs, this concern is more acute when the combined marginal personal tax rate exceeds 50 per cent -- which it currently does in seven provinces in Canada.

The C.D. Howe Institute concluded, "The bottom line is that high tax rates may discourage earning additional income, and may encourage shifting taxable income to different forms, times and jurisdictions, so they may not only negatively affect the economy, but add little to, or even reduce, government revenues."[49]

Finally, as the C.D. Howe Institute has noted, lack of trust in the tax system has the behavioural effect of encouraging tax evasion and underground-economy activity. Indeed, according to the CRA, Canada is losing considerable tax revenue to taxpayer errors or tax evasion and the underground economy.

The CRA estimated that, for individuals, the federal tax gap – the difference between the amount of tax it should have collected and how much it actually received – stood at $8.7 billion or 6.4 per cent of personal income tax revenues in 2014, with unreported income earned in key underground economy activities comprising about $6.5 billion of that amount.[50] For GST/HST, the tax gap for that year was estimated to be $4.9 billion,[51] while the tax gap for offshore investment income for 2014 was expected to be between $800 million and $3 billion.

The federal government is committed to combating tax evasion and CPA Canada supports the CRA's efforts to enforce the tax law. In view of the high amount of forgone tax revenue, however, we also believe these efforts to close the tax gap would be more effective in combination with steps to significantly simplify the tax system and improve trust.

49 Laurin, supra note 12.
50 Canada Revenue Agency, "Minister Lebouthillier releases a study on individual income tax gap in Canada, June 6, 2017 (https://www.newswire.ca/news-releases/minister-lebouthillier-releases-a-study-on-individual-income-tax-gap-in-canada-626777491.html).
51 Canada Revenue Agency, "Estimating and Analyzing the Tax Gap Related to the Goods and Services Tax/Harmonized Sales Tax," last modified August 2017. (https://www.canada.ca/en/revenue-agency/corporate/about-canada-revenue-agency-cra/tax-canada-a-conceptual-study/estimating-analyzing.html).

We’ve had many challenges with the CRA audit initiative related to the deduction for spousal support paid. In many cases, sending response after response to the CRA case officer to explain the eligibility criteria for the client only to have new requests sent back for information that was not included on the original request, or to have information that was previously accepted subsequently denied.
— A CPA in New Brunswick

The tax system does not deliver all social benefits efficiently and effectively

Excessive tax complexity has important implications for the effectiveness of Canada’s various transfer and incentive programs. When lower-income and other vulnerable Canadians do not understand their entitlements and how to access them, they may miss out on vital economic benefits. We have also heard that complexity makes it difficult for this taxpayer group to comply with the CRA’s verification and administration activities. It is therefore important to ensure that Canada is using the right vehicle(s) to deliver social benefits efficiently.

KEY FINDINGS:

- Tax complexity makes it difficult for lower-income and other vulnerable Canadians to access much-needed income supports through the tax system.
- According to cautious estimates, more than $1.2 billion in federal benefits for low income households goes unclaimed each year (including the Guaranteed Income Supplement, Canada Learning Bond and Canada Child Benefit by Indigenous families)[52]
- Simpler rules and better guidance on how to follow them could greatly increase the prospects of social benefits being received by their intended recipients.

Many entitlements are delivered by the tax system through a complex mix of federal and provincial programs with similar goals but different rules. Many tax credits and benefits, such as the spousal, age and caregiver credits, are income-tested and subject to thresholds and clawbacks based on family net income, which complicates tax credit claims.

> *"The complexity of the old age security system, with its annual income thresholds and clawbacks, creates undue stress and complexity for seniors and encourages behaviour to minimize taxable income."*
> — A CPA in British Columbia

> *"The complexity of the medical expense tax credit has created an environment where no one understands the exact expenses that may be claimed."*
> — A CPA in Alberta

We have heard from some CPAs taking part in Community Volunteer Income Tax Program clinics that preparing tax returns for people with significant benefit entitlements can be a complex exercise, and that CPAs themselves would have difficulty preparing these returns without the assistance of tax preparation software and guidance.

52 Remarks by Elizabeth Mulholland, Prosper Canada, *Canada 2020 Tax Summit,* Ottawa, October 22, 2018.

For example, eligibility for the disability tax credit (DTC) depends not only on filing a personal income tax return and meeting income thresholds. It generally also requires meeting specific definitions of qualifying conditions – which have been subject to a considerable number of disputes in the tax courts – and the filing of a form certified by a medical professional. Higher credits are allowed for children under 18 with severe disabilities but the amount of credit depends on amounts claimed for other tax concessions (e.g., childcare and medical expenses).

A study on the take-up of social benefits delivered through the tax system found that "many more people are eligible for the [DTC] than actually received it."[53] Key findings from a June 2018 study by the Standing Senate Committee on Social Affairs, Science and Technology include:

- Fewer than 40 per cent of the more than 1.8 million adults who report qualifying disabilities claimed the credit in 2012
- One important reason for the low take-up is that the DTC is non-refundable
- The current DTC application process contains too many barriers for people living with severe disabilities to access the credits to which they are entitled, especially in view of the need to periodically reapply for the credit
- The appeals process is needlessly costly, complicated and stressful to navigate for people with disabilities[54]

Similarly, in Budget 2018, the federal government acknowledged that many eligible taxpayers do not claim the Working Income Tax Benefit (now called the Canada Workers Benefit), and the government plans to streamline those rules. Among other things, when people entitled to that benefit do not claim it on their tax return, the government will allow the CRA to assess their tax returns as if the benefit had been claimed.

There may be more tax incentives and credits for which this type of direct administrative assistance would be welcome. Even without direct assistance, providing simpler rules and better guidance on how to follow them could greatly increase the likelihood that social benefits will be received by the lower-income or otherwise vulnerable people for whom they are intended.

53 Alan Mcnaughton, "Takeup of Social Benefits Delivered Through the Personal Income Tax System: Evidence-Based Analysis," in edited by Jinyan Li, Scott Wilkie and Larry F. Chapman, *Income Tax at 100 years: essays and reflections on the income war tax act*, Canadian Tax Foundation, 2017.

54 Standing Senate Committee on Social Affairs, Science and Technology, *Breaking Down Barriers: A critical analysis of the Disability Tax Credit and the Registered Disability Savings Plan*, June 2018.

CASE STUDY

Kevin's story

At a time when governments are looking to make life easier for the four million people in Canada living with disabilities, Kevin Turney's* story is discouraging.

Kevin lives in Cape Breton, Nova Scotia. After he was diagnosed with Alzheimer's in his early 80s, his son Dan advised him to apply for the federal government's disability tax credit.

Now 90 and increasingly frail, Kevin has moved to a long-term care home but has yet to see a nickel of the tax credit, worth up to $8,235 for the 2018 tax year. In fact, Dan and his spouse Susan, who live almost five hours away in Halifax, gave up even trying to apply for the credit — all because of the system's complexity.

To qualify for the credit, Kevin would need to obtain a doctor's certificate and complete a lengthy self-assessment questionnaire. He would then have to submit the forms to the Canada Revenue Agency, which considers each application case-by-case. The approval process typically takes about four months.

Even when Kevin lived independently, the intricacies of applying for the credit were beyond him. "He never got the disability credit because he could never remember to get the form back from his doctor," says Susan. Making things worse, the doctor took three months to fill in the form after mislaying it.

Susan, herself a tax specialist, feels that the tax system has let her family down, and she worries about the impact on other families. "Anything like this is difficult for disabled or elderly people, and it puts more strain on families who are trying to take care of their loved ones," she says. "It feels like there should be an easier process."[55]

** This is a real case study received from a CPA member. Names and places have been changed to protect privacy and sensitive financial information.*

55 Note that the Disability Advisory Committee provides advice to the Minister of National Revenue and the Commissioner of the CRA on the administration and interpretation of the laws and programs related to disability tax measures, among other matters.

Conclusion

At the outset of this report, we posed four questions about the state of Canada's tax system. Based on the evidence examined in these pages, the answers to our questions reinforce our longstanding view that our tax system is in disrepair, with adverse impacts on Canadians, Canadian businesses and our economy overall.

In short, the evidence presented in these pages shows:

- Canada's tax system does not align with international norms or do enough to promote global competitiveness
- Canada's tax system needs to do more to help businesses grow and innovate
- Whether Canada's tax expenditures achieve their goals at the right cost is unknown, yet there is no doubt that they greatly complicate the tax system
- Canada's personal tax system discourages compliance in many cases, and there may be ways to deliver social benefits more efficiently and effectively

This report highlights only the most important concerns that we've heard about the deteriorating state of Canada's tax system. It is by no means exhaustive. For all these reasons, CPA Canada believes that a tax system review should be a priority for the Government of Canada.

Nationally and internationally, a growing range of stakeholders agree. As this movement continues to gather steam, CPA Canada believes it's time to deepen the conversation. Whether a large-scale review is needed is no longer in question: It's time to move the debate from whether to how.

CPA Canada and the business and accounting professionals we serve welcome the opportunity to contribute our knowledge and experience to help build an effective framework for achieving a tax system review that will benefit people across Canada.

To help advance this discussion, CPA Canada invites you to visit cpacanada.ca/taxreform. Also, you are welcome to watch for our next report in this series, which will set out key principles and practical considerations to help guide a federal tax system review.

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