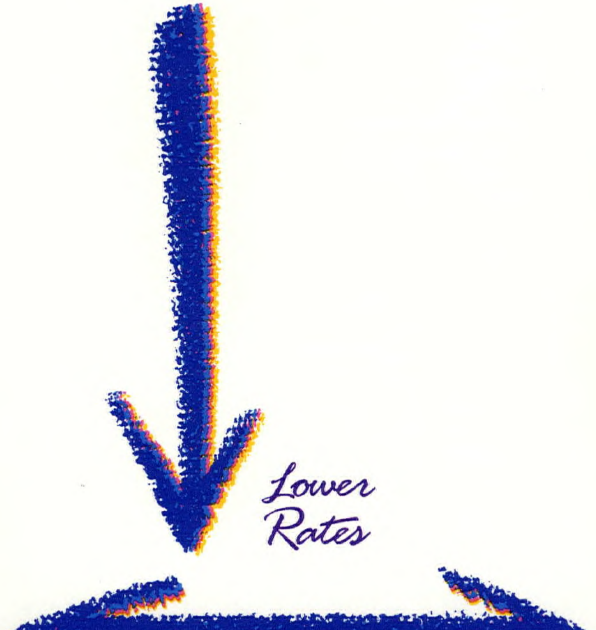
Tax Reform 1987

Corporate Income Tax

June 18, 1987



Canada

Preface

Canada needs a fairer, more effective tax system.

We need it to ensure equitable sharing of the costs of public services vital to our economic, social and cultural well-being; and to strengthen our capacity to create jobs, opportunities and a better life for Canadians in a competitive world.

That is why the government is making important, comprehensive reforms in the nation's tax system. The first stage of reform, to the personal and corporate income tax, will be implemented in 1988. In stage two, the federal sales tax will be replaced by a better system, following further consultation with provincial governments and interested Canadians.

The cornerstone of comprehensive tax reform is a fairer tax system with lower tax rates on a broader tax base. Lower tax rates are the best incentive for Canadians to create economic benefits for themselves and for the nation. A broader tax base with fewer special tax breaks provides the means to bring down tax rates, ensures that taxpayers in similar circumstances will be taxed more equitably, and strengthens the foundation for further measures to reinforce social justice.

This booklet summarizes the changes the government proposes to make to the corporate income tax system.

The Honourable Michael H. Wilson
Minister of Finance

Department of Finance Canada
Ministère des Finances Canada

Corporate Income Tax Reform

The Need for Reform

Over the past decade, the corporate tax system has failed to meet the needs and priorities of a growing Canada in an increasingly competitive world.

The corporate tax system's capacity to raise revenues has been eroded. Part of the problem is the multitude of special tax deductions and other incentives that have accumulated over the years. While each special preference was introduced to address a particular concern, the expanded array of preferences provide many opportunities for corporations to reduce their tax liability or pay no tax at all. This has reduced the stability of the government's revenue base. Special preferences also unduly influence the way corporations invest and plan.

A more competitive world economy has also focused the need for corporate tax reform in Canada. A number of our trading partners have recently overhauled their tax systems to reduce tax rates and improve efficiency. Canada's corporate tax rates are now much higher than those in the United States and the United Kingdom. If we do not narrow this gap, substantial income-earning activities would be shifted abroad. Canada would lose jobs and investment opportunities. Firms could also arrange their operations to pay their taxes at lower rates to other countries rather than to Canada.

Tax reform is needed now to correct these serious problems. Corporate tax rates will be reduced to keep our industries competitive. The corporate tax base will be broadened to ensure that substantially more revenues are collected from corporations and that profitable corporations pay their fair share.

The Basic Approach to Reform: A Fairer System, Lower Rates

The approach to corporate tâx reform is straightforward: The corporate tax base will be broadened significantly by eliminating or reducing many special preferences currently used by profitable corporations to reduce and sometimes eliminate their tax liability. At the same time, tax rates will be reduced to reward successful activities and to ensure the Canadian tax system remains competitive with those in other countries.

Total revenues from corporate income tax will increase by over $5 billion over the next five years. Most of this increase in revenue will come from sectors and firms that now pay less than average levels of tax.

Fewer Special Preferences

The key to improved tax fairness is fewer special tax preferences. Eliminating and modifying preferences will ensure that more profitable corporations pay tax. Over all, corporate taxes will increase significantly.

Not all incentives will be removed. The tax system will continue to recognize the importance of incentives for manufacturing, resource, R&D and small business investments. The incentives that remain will be fairer and more effective in supporting economic growth and regional development.

Benefits of Fewer Special Preferences

1. Fewer preferences will encourage productive economic activity. Investment and other business decisions will be made because of their economic merit and potential profitability, not because of tax benefits.

2. Fewer preferences will ensure that the tax burden on different sectors will be more evenly and fairly shared. Sectors which are now taxed much less than average and which have a higher proportion of profitable, but non-taxpaying, firms will be taxed more.

3. Fewer preferences will make corporate tax revenues more stable because there will be less scope for profitable corporations to practise aggressive tax avoidance. New anti-avoidance provisions will also reinforce revenue stability and increase fairness. A more stable revenue base, and higher corporate taxes, will lessen the reliance on personal income taxes to fund public programs.

Lower Rates

Starting in 1988, corporate tax rates will be reduced significantly:

- The general federal rate will drop from 36 per cent to 28 per cent.

- The rate for manufacturing will drop from 30 per cent to 23 per cent.

- The small business rate will drop from 15 per cent to 12 per cent.

Benefits of Lower Rates

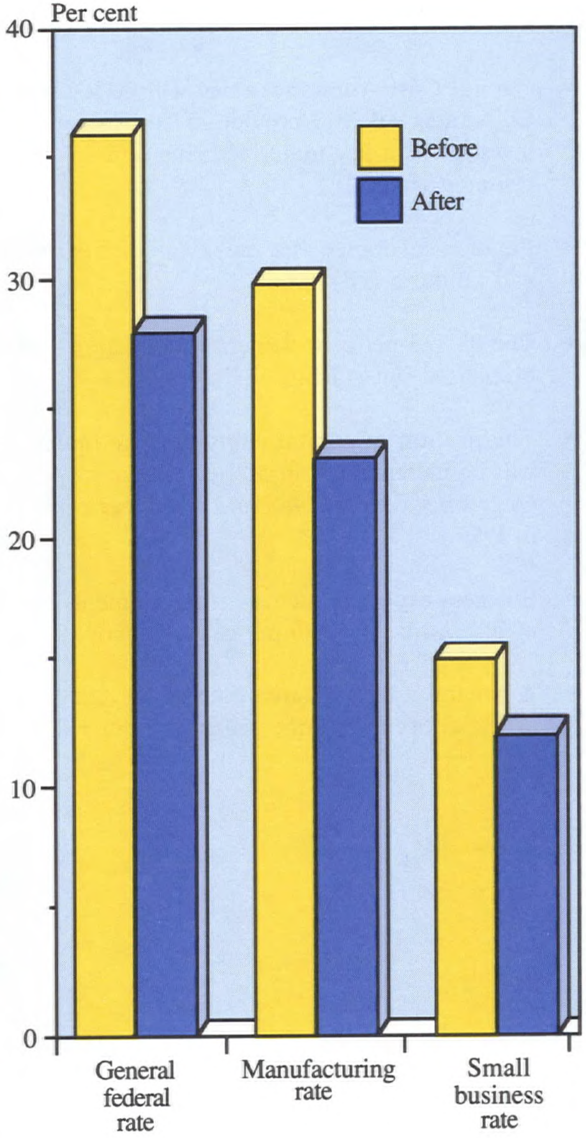
Lower rates will help Canada's economy grow stronger and be more competitive:

1. Lower rates are the best incentive for entrepreneurship, investment, economic growth and job creation. They reward profitable investment and business activity.

2. Lower rates will be competitive with rates in the United States and other countries. Canada will continue to be attractive for the domestic and foreign investment needed to generate growth and create jobs.

3. Lower rates mean less pressure to erode the corporate tax base through the use of special deductions and write-offs.

The Cut In Tax Rates

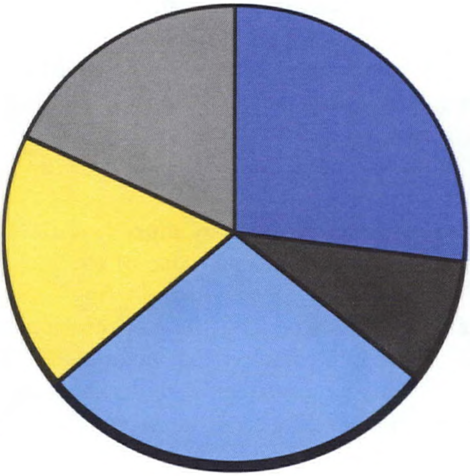


Changes to Broaden the Tax Base

The following are the main base-broadening changes under corporate tax reform:

- Capital Cost Allowance rates will be lowered. CCA rates will still provide incentives for investment in key manufacturing and resource sectors.
- Finance, insurance and real estate industries will be more fully taxed.
- The 33 1/3-per-cent depletion deduction will be phased out starting in July 1988.
- The portion of capital gains that are taxed will be increased from 50 per cent to 66 2/3 per cent in 1988 and to 75 per cent in 1990.
- Business expenses such as entertainment and meals will be only 80-per-cent deductible.
- A general anti-avoidance rule to prevent artificial tax avoidance will be introduced.

How Base-Broadening Measures are Distributed



Capital cost allowances 27%

Other up-front incentives 9%

Financial institutions 28%

Anti-avoidance and preferred shares 18%

Other changes 18%

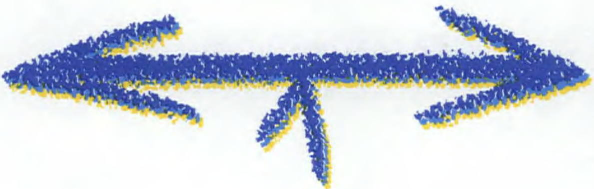
The Impact of Reform on Corporations

Corporate tax revenues rise. Total corporate tax revenues will increase by 10 per cent or more than $5 billion over the next five years.

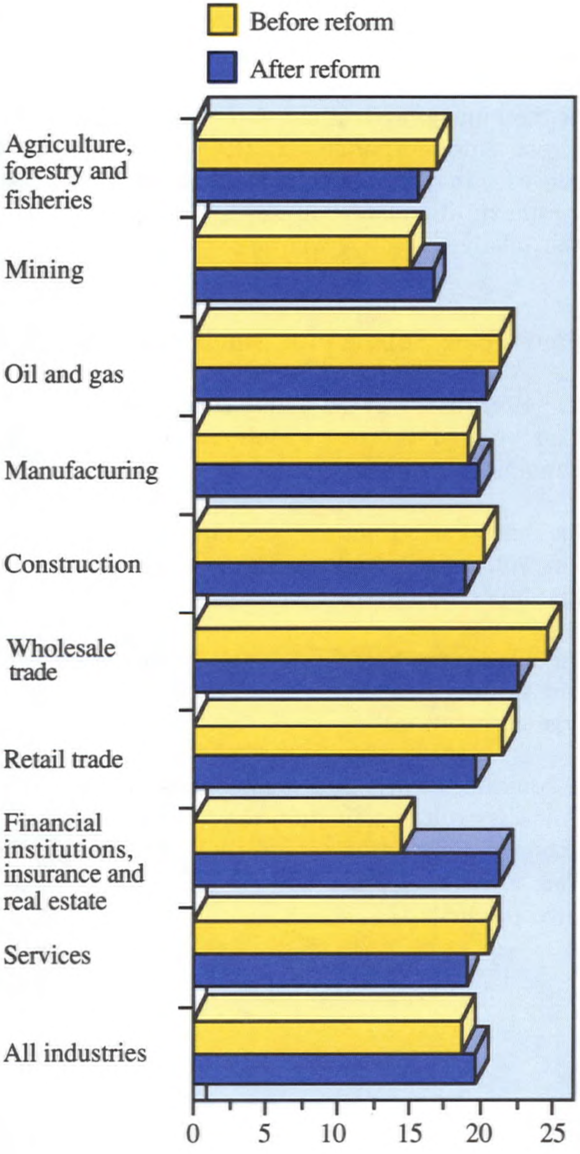
More profitable corporations pay tax. The number of profitable corporations not paying tax will be reduced by more than 50 per cent. Those which will still pay no tax are mainly companies which have experienced losses in previous years or use the incentives still remaining in the system.

Profitable corporations pay more tax. Before reform, only about 70 per cent of the income that companies reported on their financial statements was taxable. After tax reform, more than 84 per cent of reported income will be taxable. This gap between taxable and actual income will be reduced in all sectors of the economy.

Less variation in tax paid by different sectors. Sectors which formerly paid below-average taxes, such as finance and life insurance, will pay higher effective tax rates. Sectors which paid higher-than-average taxes, such as wholesale and retail trade, oil and gas, services and construction, will pay lower effective tax rates.



Average Federal Tax Rates For Profitable Corporations



Respect for Regional Needs

Tax reform will continue to reflect regional priorities by retaining the regional tax credits now in place for investment in Atlantic Canada, Cape Breton and certain slower growth regions and by maintaining lower-than-average tax rates for the mining, agriculture, forestry and fishing sectors. Since corporate tax rates will be reduced, the rate of the regional credits for investment after 1988 will also be reduced, but their relative incentive will be maintained.

Maintaining Support for Small Business

Tax reform respects the major contribution made by small business to job creation and economic growth.

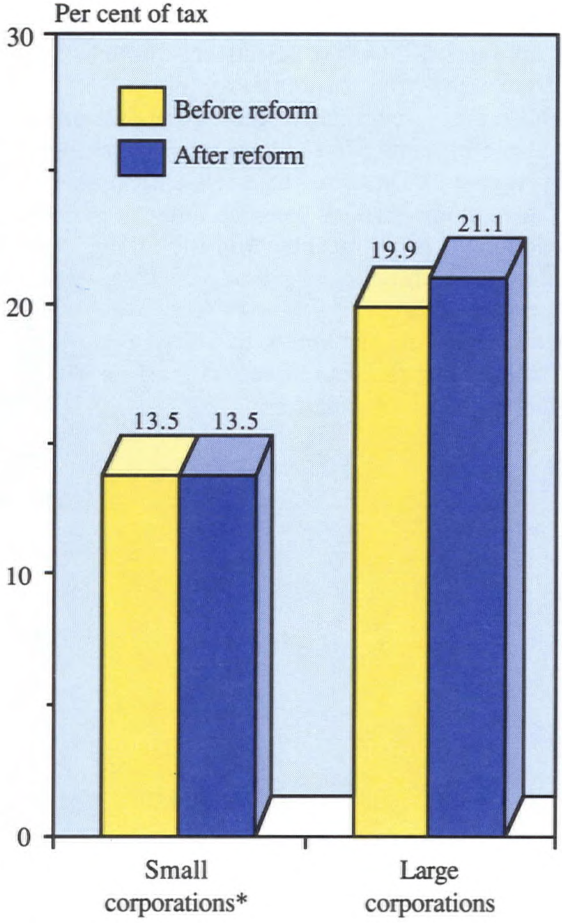
The federal small business tax rate of 12 per cent will continue to be less than one-half of that imposed on large businesses.

The relative tax burden on small firms will not increase, and will remain well below that of large corporations.

In addition, owners and shareholders of small businesses will benefit from the full $500,000 lifetime exemption on capital gains, beginning in 1988, to reward success and private entrepreneurship.

Average Corporate Tax Rates

Small Firms Pay Less Than Large Ones



* Total tax burden is unchanged after tax reform, as the lower tax rate offsets measures to broaden the tax base.

Maintaining Incentives to Invest

Tax reform will reduce tax rates on the return from new investment. This will strengthen the incentive for firms to invest in profitable ventures.

By encouraging investment generally through low tax rates rather than selectively through up-front write-offs, corporate tax reform will establish a tax environment that fosters sound, broader economic growth. Investment incentives will, however, be retained to assist critical areas of the economy such as research and development, small business and the mining and oil and gas sectors.

After tax reform, our ability to attract investment and compete in export markets will be maintained and enhanced.

Stage Two – Sales Tax Reform

The changes described in this booklet, along with important changes to the personal income tax system, make up stage one of comprehensive tax reform. In stage two, the existing federal sales tax will be replaced by a new system.

Canada needs a better sales tax system. The present federal sales tax is a narrowly-based, single-stage tax that weighs heavily on a limited range of manufactured goods. It is also biased against exports and in favour of imports; it discriminates against certain sectors and products; and its price impact pyramids through to the consumer in a hidden and unfair way. The system has become increasingly complicated and more difficult to comply with and administer. It is hurting Canada's ability to grow and create jobs.

The government is committed to replacing the current system with a broadly-based, multi-stage tax similar to those in more than 30 other countries. Three variants have been put forward: a national sales tax system which would combine the federal and provincial sales tax systems into one; and two federal-only systems, one that requires sale invoices and one that does not but which requires a more comprehensive base. Each of these three variants will eliminate the distortions of the present system. The national sales tax system will be the subject of federal-provincial consultations.

The tax reform proposals are designed as an integrated set of measures. When a new sales tax system is implemented, further important changes will be made to the personal and corporate income tax systems. To protect lower-income Canadians, the refundable sales tax credit will be significantly enriched and extended to more families. Tax brackets will be adjusted to provide relief to middle-income earners. And the personal and corporate income surtaxes will be removed.

Sales tax reform will also reinforce the positive economic benefits of corporate tax reform. A reformed sales tax system will remove the existing biases that inhibit competitiveness and the hidden production costs imposed by the current sales tax. The combined effect will be a fairer, more progressive personal and sales tax system that will help promote a better, more efficient and more productive economy, one that will produce many more jobs.

For additional copies of this booklet:

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