Report of the Advisory Committee on Federal-Provincial Tax Collection Agreements

Submitted to
The Honourable Don Mazankowski
Minister of Finance

January 1992

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January 15, 1992

The Honourable Donald Mazankowski
Minister of Finance
Government of Canada
140 O'Connor Street
Ottawa, Ontario
K1A 0G5

Dear Mr. Mazankowski

Re: Report of the Advisory Committee on Federal-Provincial Tax Collection Agreements

The advisory committee on federal-provincial tax collection agreements was appointed by yourself on June 25, 1991 to review certain aspects of the federal-provincial personal tax collection agreements.

Since then, the members of our committee have reviewed the issues relating to the possible modification of the federal-provincial tax collection agreements set out in the paper "Personal Income Tax Coordination", issued in June 1991 by the Department of Finance, Ottawa. The issues relate to proposed changes in the basis of imposition of provincial income tax now collected by the federal government so that it would be a tax on income, rather than a tax on federal tax. We have had the opportunity to receive substantial input and comments from the Tax Policy Unit of the Department of Finance, as well as from representatives of the provincial and territorial governments. We have also reviewed submissions to the Department of Finance of many interested parties and organizations across Canada. Our mandate has been to review the technical issues and complications which would arise from such a change, address the concept of transparency, and consider design constraints which any new system might have in order to continue to provide the benefits of a unified tax assessment and collection mechanism to Canadians.

We have considered the various matters referred to us under the terms of reference of our committee, with the overall objective of providing useful comments on the implications, to all Canadians, of the possible changes in the federal-provincial personal tax collection arrangements.

We have confirmed that the present federal-provincial personal tax collection arrangements provide substantial advantages to Canadians, and we have sought to identify the most important issues that should be addressed cooperatively by the federal and provincial governments in considering changes in the system, and its related design constraints.

We have now completed our mandate and we have the pleasure of submitting herewith our report on the aspects of the federal-provincial tax collection arrangements that were referred to our attention.

Yours very truly,

Edwin Harris François Lebel Risa Levine

Edwin Harris, QC	François Lebel, CA	Risa Levine, LLB	Robert Brown, FCA Chairman

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I Terms Of Reference

On June 25, 1991, The Honourable Don Mazankowski, Minister of Finance, appointed an advisory committee of tax professionals to review certain aspects of the federal-provincial personal tax collection arrangements. The members of the committee appointed by the Minister are:

Edwin Harris, QC
Daley, Black & Moreira
Halifax

Francois Lebel, CA
Informatrix 2000 Inc.
Sherbrooke

Risa Levine, LLB
Thorsteinssons
Vancouver

Robert D. Brown, FCA, Chairman
Price Waterhouse
Toronto

In conducting the study, the advisory committee's terms of reference, as set out by the Minister of Finance, were to provide advice on the implications of a move to tax on income, as requested by provinces, using the analytical framework set out in the paper Personal Income Tax Coordination, issued in June, 1991 by the Department of Finance, Ottawa and report its findings on the issues referred to its attention.

More specifically the advisory committee was asked to:

- review technical issues under a tax on income system which could affect national tax policies;
- consider constraints which might be necessary to achieve harmony, avoid interprovincial tax competition, and provide an overall efficient and effective system under a tax on income approach;
- identify complications which might arise under a tax on income system in the areas of compliance and judicial process;
- address the concept of transparency; and
- generally provide advice on the issues referred to the committee.

In the course of its work, the committee received useful assistance and comments from the Tax Policy Section of the Department of Finance, Ottawa, and from representatives of provincial and territorial governments.

The Department of Finance undertook a substantial program to obtain the views of Canadians on this important topic. Requests for submissions were sent to 250 organizations, including business, public policy, labour and consumer groups, regional organizations, tax professionals, academics and not for profit associations. Meetings were held with any interested individual or group, and submissions were also received from such groups and from individual Canadians. We had the benefit of reviewing the individual submissions of many interested organizations and groups, as well as reports on the process.

The committee is grateful for this assistance and input. The committee also gratefully acknowledges the contribution of Sue Pennal, a senior associate at Price Waterhouse, Toronto, in the preparation of this report.

II Executive Summary

The following is a summary of the major conclusions and recommendations in the full report of the advisory committee appointed by The Honourable Don Mazankowski, Minister of Finance. The committee's terms of reference were to provide advice on the implications of a move to tax on income, as requested by provinces, using the analytical framework set out in the paper Personal Income Tax Coordination issued in June, 1991.

Each of the conclusions contained herein is a summary of the discussions and conclusions contained in the related section of the report of the advisory committee. Reference to the report itself should be made to obtain a fuller understanding of the issues and of the conclusions reached.

Major Conclusions

It is not within our terms of reference or the purpose of this report to conclude on whether a change from a tax on tax approach to a tax on income system is desirable. Rather, the advisory committee has tried to fulfill its mandate by identifying the various issues to be considered, and the likely consequences to taxpayers, and to governments, of alternative approaches to this basic change in Canada's personal tax system.

In summary, a shift in the basis of provincial taxation from a tax on tax approach to a tax on income approach raises a surprisingly large number of issues that would have to be addressed, in considerable detail, both by the provinces in designing their own tax regimes, and by the federal government in deciding on the appropriate guidelines that it would ask the provinces to observe as a condition of continuing to collect the provincial income taxes under a joint federal/provincial system. In our report, we identify and comment on these issues without attempting to set the precise constraints that might be imposed on the provinces under a federal/provincial tax collection arrangement. However, it would appear that the agreeing provinces may wish to more fully consider the implications, and the technical ramifications and precise dimensions, of the tax flexibility which they seek, and it would also appear that it may require some time and the co-operative efforts of both levels of government, to design and put in place, if considered feasible, a mutually acceptable tax on income regime.

Overall, it is our conclusion that:

1. A change from a tax on tax approach to a tax on income system raises many technical and administrative issues. Purely technical issues usually have technical solutions. We note however that while virtually all of the technical issues considered in our report do have possible solutions, these solutions can involve

significant additional complexities in the system from the viewpoint of both taxation authorities and taxpayers.

2. A simple arithmetical shift to a tax on income from a tax on tax basis does not in itself necessarily result in an extraordinary increase in the complexity and compliance costs to taxpayers, or administrative costs to governments. Rather, the point is that the change in the system is basically desired by the provinces in order to permit them greater flexibility in the implementation of their policies through changes in tax brackets and rates and non-refundable personal credit amounts. In fact, it is this greater flexibility that gives rise to the danger that such a change would add new elements of complexity and administrative costs to taxpayers and governments alike, or unintended inequities or loopholes.

3. In a number of areas, the shift will inevitably be accompanied by a choice between a significant increase in compliance costs and complexity, and the acceptance of some measure of rough justice that could result in unfairness to some taxpayers, and undeserved benefits to others. If the provinces utilize the desired increase in flexibility to introduce significant new measures into their tax systems, there would appear to be no alternative but to address this difficult trade-off.

4. Ultimately, the issue is one of balance and compromise. A shift to a tax on income regime with more flexibility to the agreeing provinces is likely to involve significant costs to taxpayers, and to governments. But this increase in costs is likely substantially less than would be involved in any move of some or all of the provinces to establish and administer separate provincial personal income tax systems. On the other hand, the federal government should not be asked to administer provincial tax systems which contain measures which work against the Canadian economic union, which involve undue complexities for taxpayers and governments, or which contain measures involving obvious unfairness.

5. It will be the task of the two levels of government to consider jointly how, in light of the issues identified in this report, they can work together to further consider the feasibility and the features of the change.

We note below the following principal conclusions, on the details of a tax on income system, that arose as a result of our review.

1 Tax Brackets And Tax Rates

The principles adopted in the federal system - that the tax rate on the lowest tax bracket is used as a common denominator for several calculations and that the first tax bracket is wide enough to avoid problems in calculating the transfer of personal tax credits - offer advantages to taxpayers in ease of calculation and fairness. There are major benefits from preserving this system at the federal and provincial levels.

The replacement of provincial tax reductions by new and different tax brackets applicable to lower income taxpayers could result in either inappropriate and unfair results or more complex calculations than those required under the current system. The replacement of tax reductions by improved personal tax credits may not afford a better solution.

The integration of provincial surtaxes in the provincial tax bracket structure must take into account the fact that these tax rates would be applied before deduction of several frequently claimed credits whereas surtaxes are currently based on a "net of credits" number. If no adjustments are made, the move would result in substantial tax increases for numerous taxpayers. Such a result (intended or not) might be regarded as unfair by the taxpayers concerned.

2 Non-Refundable Credits And Transfer of Credits

The basis of non-refundable personal tax credits should remain defined at the federal level, without substantial variation by provinces. Moreover, although provinces should be allowed to vary the value of provincial personal amounts and the rate used to convert such amounts into personal tax credits, the value of provincial personal tax credits should be no less than what they are under the present system to ensure a continuance of the present level of provincial support for these credits.

To avoid potentially inappropriate and unfair results, provinces adopting different weightings for the provincial non-refundable personal amounts could be allowed to modify the income thresholds applied in determining certain of these credits. Such a modification of income thresholds would add significantly to the complexity of tax calculations for many taxpayers, but the alternative may be a system that produces inappropriate and unfair results.

Another important issue to be considered in a tax on income system would be whether the federal principle of using one common denominator for several calculations (lowest tax rate and non-refundable tax credit rate) should be maintained at the provincial level in order to achieve simplicity and ease of calculation. If this principle is departed from, there will be a difficult trade-off between a system with significant additional complexity and one that generates inappropriate and unfair results, with most of such unfairness falling on low-income taxpayers.

Some of the provinces have recognized the trade-off between complexity and inequity in this area and have suggested that they would live with the inequities or make ad hoc adjustments to offset them. This position is set forth on the basis that any such inequities would be relatively minor, and that there already are technical inequities in the system. This ad hoc compromise position compared with the alternative solutions which produce considerable complexity may be acceptable where the inequities produced are in fact minor.

However, we believe that this is an area which requires further study to ensure that there is good understanding of the full implications of possible adjustments. We have some concern that the provinces may not have had sufficient time to consider the extent of the possible inequities resulting from increased provincial flexibility and that such matters may in fact be, or eventually become, major and with particularly adverse effects on low income taxpayers.

3 Tax Deductions And Instalments

The adoption on a tax on income regime with flexible elements would raise the question of how appropriate payroll deductions and instalments of provincial tax should be determined. Taking into account the often conflicting elements of practicality, cost, and transparency, the following approach is suggested:

- Except where the federal government and a province agree that provincial variations from the federal system are sufficiently small to allow the use of combined tax deduction tables with reasonable accuracy, separate federal and provincial tax-deduction tables would be issued to employers, and employers would receive from their employees form TD1 with respect to federal taxes and an equivalent form with respect to provincial taxes. An employer would then determine for each employee the separate amounts to be withheld for federal tax and provincial tax respectively and would retain this determination in case of audit by Revenue Canada. The employer would be free, by way of payslips or otherwise, to notify the employees how much of the withheld income tax was intended to cover federal tax and how much provincial tax. However, for purposes of required reporting to Revenue Canada, only the combined amount would be accounted for. Thus, it would not be necessary, in the remittance forms to Revenue Canada or in the T4 slips, to segregate amounts withheld into federal and provincial components;

- Similarly, if relevant, separate federal and provincial guides would be provided for the determination of the amount that must be paid in tax instalments, but the instalment remittance form would only provide for a combined amount, and Revenue Canada would not need to keep a separate record of the federal and provincial components;

- In the tax returns themselves, separate areas, or parallel columns, would provide for a separate calculation of federal and provincial tax after deducting all credits, both refundable and non-refundable, but before taking into account payments by way of withholding or instalments. Refundable credits might leave either or both of these computations in a negative balance. The next step would be to combine these federal and provincial balances into a single figure and then to deduct total payments, including overpayments of Canada Pension Plan or unemployment insurance, to arrive at a single figure of net total tax payable or refund due.

- Advance payments by the federal government to the provincial governments on account of the latter's personal tax revenues for a year would be based, as now, on estimated tax revenues for the year. Final settlement with the provinces would also continue to be based on the actual amount of provincial personal tax for the year as assessed by Revenue Canada.

4 Dividend Tax Credit

The separate calculation of a provincial dividend tax credit is a matter that must be addressed if the provinces move to a tax on income. The primary advantage to the provinces of imposing tax on income, flexibility, does not appear to motivate changes to the fundamental concept of a dividend tax credit at the provincial level.

Some constraints to provide for a degree of harmonization of provincial systems with the federal system and with each other will better serve the policy objectives of all and the national economy. Accordingly, it is suggested that any revised "tax on income" agreements require the provinces to provide a dividend tax credit within a range of percentages of the federal credit.

The constraint suggested by the provinces; that is, a fixed provincial dividend tax credit of fifty percent of the federal credit, will actually increase the range of provincial personal tax rates on dividend income over that existing under the present system.

The constraint of a defined narrow range of provincial rates for the dividend tax credit appears to better satisfy both policy and technical objectives. Agreement by the provinces to establish a provincial dividend tax credit at an appropriate level within a minimum and maximum percentage of the federal credit and with changes in the rate linked to changes in the provincial tax rate, will permit provinces to set a rate that will not affect investment decisions to a greater degree than is the case under the present tax on tax system or, if they choose, that will result in closer integration of corporate income tax.

5 Alternative Minimum Tax Issues

In the case of a measure such as AMT which generates very limited revenue[1], moving to a tax on income system affects a great number of tax calculations. A simplified method such as that suggested by certain of the provinces' representatives seems to

[1]Approximately $232 million of net AMT (i.e., gross AMT collected less amounts subsequently refunded) was collected up to and including the 1989 taxation year. Approximately $93 million of AMT was assessed in respect of the 1989 taxation year and approximately $72 million of AMT was refunded in that year for a net revenue of $21 million.

provide a viable solution for all parties (federal, provinces and, not to be forgotten, taxpayers) assuming AMT is going to be maintained over a long period of time.

Other theoretically better "solutions" have been examined and have been found to be more accurate, especially in cases of taxpayers moving from one province to another and in cases of multiple jurisdiction returns. However, such "solutions" would be far more difficult to implement and would result in a significantly increased number of calculations.

Overall, and especially considering the modest amounts of revenue involved, the recommended solution would be to reach agreement between the federal and provincial governments such that all provincial AMT amounts would be applied as a percentage of federal amounts, and without regard to actual provincial taxes. This solution represents rough justice, since it does not take account of numerous individual circumstances, but it appears that it would not unduly disadvantage taxpayers, or for that matter governments, while continuing the policy objectives of the present federal AMT. (Even if Québec remained outside of such arrangements, this solution could provide substantial benefits in administrative simplicity with respect to the other provinces.) Another approach, which is beyond the scope of our report, would be to reconsider the need for an AMT at all in our present tax system with its sharply reduced "preferences".

6 Carryover Issues

Although there are few problems associated with carryover issues should a "tax on income" system come into force. provinces should ensure that provincial tax brackets and tax rates are set taking into account their impact on provincial forward averaging tax credits. The federal-provincial Tax Collection Agreements should reflect the indicated provincial position of allowing a provincial forward averaging credit at their top rate.

The application of ITAR 40(1) concerning certain pension and retirement payments would require modification: the federal rate applicable should be adjusted and then an appropriate portion of the tax collected allocated to the province of residence of the taxpayer.

7 Multijurisdictional Issues

In order to avoid undue complexity and compliance costs, it is recommended that:

- All business income (as well as other income) of individuals who are resident in Canada on December 31 of any year should be regarded as having been earned in the province of residence[2].

- An attempt should be made to obtain agreement from Québec to adopt a matching source rule for business income.

- Non-resident individuals who earn employment income in Canada or business income through a permanent establishment in Canada would only pay tax (including subsection 120(1) surtax) to the federal government, which would allocate the provincial share of such revenue under subsection 120(1) to the provinces of source.

8 Administration And Appeals

The present essentially single system for the creation, administration and adjudication of income tax laws serves both federal and provincial governments and taxpayers by limiting costs, complexity, conflicts and duplication.

To the extent that the provinces utilize the greater flexibility that will be allowed to them under a tax on income system to determine a greater range of components of the provincial tax calculation, the cost and complexity of administration of income tax laws will increase as will the necessity of appeals from reassessments to two separate courts, with resulting duplication, potential for conflicting interpretations and taxpayer confusion regarding the administration and appeals process. Administrative problems resulting from time lags in enacting new or amended income tax legislation may also increase.

Constraints on the flexibility allowed to provinces to separately define components of the tax calculation, and guidelines to define the parameters of Revenue Canada's ability and willingness to administer provincial measures will assist in maintaining the positive aspects of the present single system and in ensuring taxpayers effective rights of appeal.

The reasonable constraints and guidelines may include:

- limiting most provincially determined components in the tax calculation to a percentage or proportion of federally defined components;

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[2] If Québec does not adopt similar source rules, special adjustments for Québec income and residents would be required: these would diminish the simplicity of the overall approach.

- limiting provincial initiatives to those which Revenue Canada considers after careful review to be capable of being effectively administered;

- limiting Revenue Canada's obligation to administer changes to a provincial tax system to those changes that are "definitive" and requiring the provinces to bear any costs of a failure to enact proposed changes that have been acted upon by Revenue Canada;

- restricting the jurisdiction of the provincial courts to hearing purely provincial tax matters i.e., provincial tax issues not dependent on matters determined under federal law. Such matters may increase under a tax on income system and the jurisdiction of the provincial courts to hear such matters should be provided for in the provincial income tax acts, so that taxpayers are afforded effective rights of appeal. However, constraints on the creation of separately defined provincial components will limit the need to expand the effective jurisdiction of the provincial courts.

9 Interprovincial Considerations

One of the possible dangers that may arise from increased provincial flexibility relating to the design of provincial taxes is that such flexibility could be used to provide incentives for investment or economic activities in a province and possible disincentives for investments in activities elsewhere. Such provincially centred incentives could become so significant as to inhibit the free flow of capital between provinces, with the result that the allocation of capital within Canada would be less than the optimum.

We suggest that the federal government review and formalize their existing guidelines, in respect of special measures which will be administered on behalf of provinces, in conjunction with and as part of any new agreements based on tax on income. We note in our detailed commentary some guidelines that should be considered in this context.

III Tax Collection Agreements And The Basic Policy Issues

At present, nine of the ten provinces of Canada (all except Québec) and the two territories have entered into agreements with the federal government whereby the federal tax authorities administer and collect the provincial and territorial personal income taxes at rates determined by them, but under constraints set out in agreements between the two levels of government.

The agreeing jurisdictions[3] have proposed to shift the present provincial personal income tax system to a tax on income from the existing tax on tax basis. This shift in tax base is desired by the provinces to enhance their flexibility in the distribution of the provincial tax burden but, as they acknowledge, would occur within limits (constraints) imposed by the federal government as a condition of continuing to administer the personal income tax of the participating provinces.

It has been suggested that the adoption of the provincial tax on income approach would give the provinces valuable additional flexibility to implement their individual social, economic and other policies, including better integration of provincial welfare and tax regimes. In addition it might also provide a better indication to taxpayers as to how their taxes were divided between the two levels of government, thereby providing greater transparency and improved accountability of governments.

However, adoption of the tax on income approach would likely lead to greater variations in overall rates, tax reliefs and incentives across Canada which, carried to an extreme, could result in the fragmentation of our taxation system, and to some degree tax instability.

The shift would also give rise to a number of technical problems, relating to the alternative minimum tax, the dividend tax credit, forward averaging, non-refundable credits and other specific areas with the result that personal tax returns would be longer and the calculation of tax somewhat more difficult. The shift would almost certainly increase complexity for many taxpayers, and therefore the costs of administration and taxpayer compliance. These are serious issues in a self-assessment system and tax authorities would face difficult trade-offs between complexity and fairness in the design of more flexible provincial taxes.

The federal government currently administers the basic tax collection system for the provinces at no direct charge. The federal government keeps, in their entirety, all interest and penalty charges relating to personal income taxes. However, the federal government determines the share of personal income tax collections due to the provinces basically on the basis of personal income tax assessments, which means that

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[3]Throughout this document the phrase "agreeing provinces" and "provinces" will be used to refer to the nine provinces and two territories referred to above unless specifically noted otherwise.

the federal government bears all bad debts, including the portion of such bad debts that relates to provincial income taxes. Where the provinces have specialized provincial tax credits provided through their own personal income tax rules, the federal government charges a per capita fee to cover the administration of these separate items.

A new system in which the provinces would impose their taxes on the basis of income, instead of basic federal tax, could result in some additional features and additional length in the income tax returns, and therefore possibly increased administration, processing and other costs. The federal government and the provinces would have to evaluate whether such changes would give rise to any revision in the present system of allocating the costs of administering the personal tax system.

However, we also note that the increased compliance costs expected as a result of a tax on income approach within the Tax Collection Agreements are relatively minor when compared with those that would arise if the agreeing provinces decided, as is their constitutional right, to establish totally independent and separately administered provincial income tax systems. In comparison with separate provincially administered systems, a continuation of the Tax Collection Agreements, even with a relatively more complex tax on income approach, provides substantial harmonization in the tax base, simpler compliance for taxpayers and lower collection costs. Maintaining the federal collection of provincial taxes on a tax on income approach would still mean that the entire calculation of income and taxable income for individuals (with all of the detailed rules relating to inclusions, exclusions and deductions) and the allocation of that income amongst the provinces and territories in Canada would remain uniform under both the federal and provincial statutes. A continuation of the present tax collection arrangements, even in modified forms, would greatly simplify both tax planning and tax compliance by taxpayers, and would provide substantial advantages in terms of certainty, convenience and economy of administration, as compared to a system in which the provinces determined, assessed and collected their own provincial income tax. The fundamental features of the present federal/provincial personal income tax agreements have served Canada well and should be preserved if at all possible through a reconciliation of the views and priorities of the governments involved.

Total federal and provincial personal income tax revenue is estimated at $102 billion for 1990-1991, comprising approximately $63 billion collected under the federal Income Tax Act and $27 billion levied under provincial and territorial income tax acts within the Tax Collection Agreements. (A further $12 billion in personal tax revenue is estimated to be levied by Québec.) Personal income tax revenues are the single most important source of tax revenue for both the federal government and, in the aggregate, for the provinces, and both levels of government will continue to jointly occupy this revenue field for the foreseeable future.

The optimum position that the federal government and the agreeing provinces should strive for is one where they can continue to both raise substantial revenues and achieve other separate and varying policy objectives from the personal income tax field in a way that contributes to government accountability, keeps complexity and administrative burdens to a minimum and does not adversely impact national economic objectives. The central issue addressed in our report is the reasonable constraints the federal government should adopt as a condition of continuing its collection of provincial income taxes for the agreeing provinces. We have tried to set out a range of such conditions that would be consistent with the overall objectives for the income tax system outlined above. It will be the responsibility of the federal government to determine if the approaches suggested in our paper are consistent with its national objectives, and of the provinces to see if the suggested constraints can be reconciled with provincial objectives.

IV Background

1 Evolution Of Federal-Provincial Tax Collection

In assessing the current state of affairs in respect of federal-provincial relations in the personal income tax field and the potential direction future changes might take, a brief review of the 125 year history of federal-provincial tax co-ordination is instructive. Appendix A summarizes the major events in the course of these 125 years and indicates how the pendulum has swung from more provincial flexibility and power to more federal constraints, and now back again, and how this affected the overall co-ordination and efficiency of the tax system.

The past negotiations illustrate that obtaining unanimity on all personal tax policy issues amongst all provinces and the federal government is virtually impossible. To achieve the basic national objective of a co-ordinated and rational system, there must be flexibility on the part of all governments, and alternative options and exceptions built into the overall system. On the other hand if the federal government does not involve itself as the co-ordinator of fiscal policy objectives, or does not provide leadership as well as appropriate constraints on the provinces, history also indicates that inefficiencies and inequities will result.

Taking the long view of this dynamic relationship it can be concluded that in the past 30 years during which the Tax Collection Agreements have been in place the country has benefited from a period of relatively stable federal-provincial taxation arrangements. The current system provides a high degree of harmonization and administrative simplicity, and has provided benefits to all Canadians.

These arrangements are based on what is referred to as a tax on tax system whereby the provinces generally levy their personal income taxes by applying their rate to the basic federal tax owing. This system in its purest form allows provinces flexibility in determining the amount of revenue collected by allowing for higher or lower provincial percentages of federal tax to be applied but does not allow the provinces substantial flexibility in the determination of the tax base or (to a degree) the progressivity of the tax, since these matters are largely determined by the federal definition of taxable income and the federal marginal rate structure.

In recent years the provinces have attempted to influence to some degree these federally determined components by introducing provincial surtaxes, low income, economic and other credits and, in three provinces, "flat taxes" (supplementary taxes that are a flat percentage of income or taxable income). These measures have in fact given the provinces significant flexibility in determining the incidence of provincial tax, and additional flexibility has been obtained through grants and allowances outside of the tax system. However, some of the provinces now wish even greater freedom to support their specific provincial policies.

Table A on the following page summarizes the incidence of the 1991 provincial personal surtaxes and flat taxes. Chart A illustrates graphically the combined top marginal rate in each of the provinces and territories after all surtaxes including flat taxes and tax reductions are taken into account.

2 Federal And Provincial Objectives And Concerns

Against this long and varied history of federal-provincial fiscal arrangements, the current state of affairs since the introduction of the Tax Collection Agreements, nearly 30 years ago, has been relatively stable. The way that the co-ordinated approach has enabled both the federal government and the provinces to efficiently share the personal tax base has been viewed as a model for other federal states.

The stated federal objective in this round of discussion is tax co-ordination which the federal government views as involving the balancing of four factors:

- Harmonization
- Flexibility
- Simplicity
- Transparency

Harmonization implies tax regimes which complement each other and do not provide incentives which would inhibit the efficient allocation of capital or labour within Canada.

Flexibility recognizes that differences in regional preferences and in economic and social structures exist and that each jurisdiction must have the ability to generate its revenues in a way that suits its own situation.

Simplicity in terms of compliance and administration is a highly desirable objective that must be assessed in terms of taxpayers, employers and governments.

Transparency is a necessity in achieving government accountability. This term is used to refer to the need for taxpayers to easily identify who is taxing them and for how much.

The federal government wishes to maintain the greatest level of harmonization and simplicity possible while meeting higher provincial expectations in the area of flexibility and its own desire for greater transparency.

In the past, the provinces' flexibility has gone from an increasingly high degree in the first seventy years of Confederation (resulting in the extreme, in extraordinary complexity and inefficiencies), to being drastically reduced under the initial tax rental agreements, and then to evolving slowly again towards more flexibility and autonomy under the tax sharing and then the Tax Collection Agreements. The agreeing provinces now wish to

1991 Provincial Surtaxes

Table A

	Basis of surtax: Provincial tax		Basis of surtax: Income	Taxable income threshold (approximate level at which provincial surtax takes effect)	Maximum effect of surtax on marginal rate (% of taxable income)
	%	of provincial tax over			
Alberta			0.5 % of taxable income	$9,300	1.58%
	8%	$3,500		$43,000	
British Columbia	10%	$9,000		$79,000	1.49%
Manitoba			If net income is under $30,000: 2% of net income If net income is over $30,000: the amount by which 4% of net income exceeds $600 plus certain personal credits	$7,700	4%
New Brunswick	8%	$13,500		$96,000	1.39%
Nova Scotia	10%	$10,000		$77,000	1.73%
Ontario	12%*	$10,000		$84,000	1.84%
Prince Edward Island	10%	$12,500		$93,000	1.68%
Saskatchewan			2% of net income	$7,000	4.48%
	15%**	$4,000		$39,000	

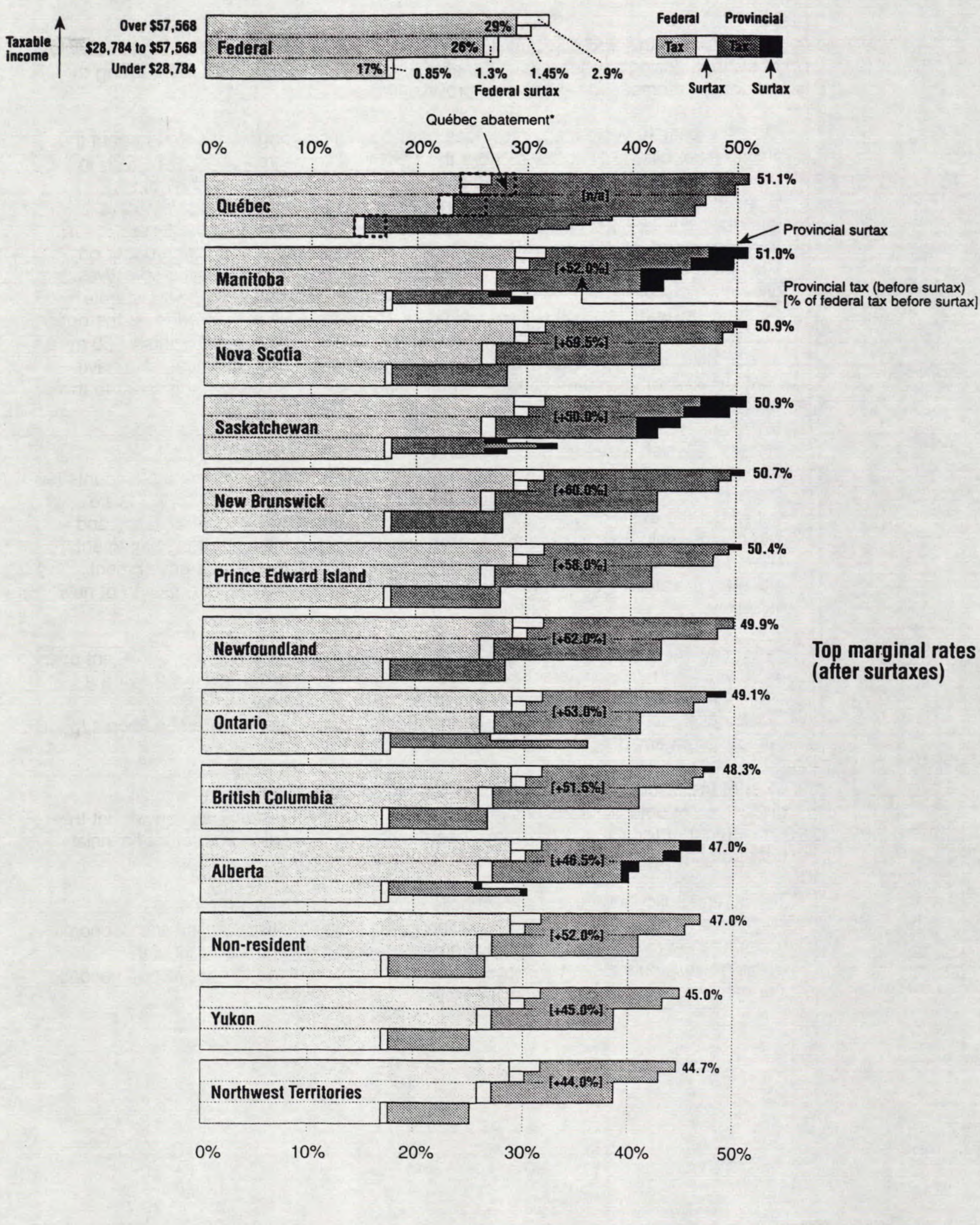
* Ontario's rate is to increase to 14% of provincial tax in 1992. That will raise the effect on top marginal rates to 2.15%.

** For Saskatchewan, provincial tax includes the 2% surtax.

*** Assuming only the basic personal tax credit is taken into account.

1991 Combined Income Tax – Federal and Provincial Components

Chart A



further extend this flexibility, in order to develop their own social and economic policies, but without losing the substantial benefits which they now obtain through having the federal government administer their provincial taxes.

Over the past 10 years many provinces have been increasingly concerned about the limits on flexibility allowed them under the Tax Collection Agreements, especially in the personal tax area, and have initiated studies of alternative taxing arrangements. Saskatchewan has been on the forefront of several initiatives - in the mid 1980's introducing a flat tax on personal net income to be collected under the federal agreement and in 1988 presenting in its budget documents a discussion paper on alternative tax arrangements to better meet its own social and economic objectives. An alternative discussed in Saskatchewan's paper is the adoption of its own separate personal tax administration system. Although this alternative is referred to as the option of last resort and the estimates given for additional costs were approximately $50 million a year after initial capital outlays, it remains a possibility. Other provinces also have considered their alternatives and undertaken independent studies with respect to this option of last resort.

Flat taxes, which were introduced on an experimental and temporary basis in Saskatchewan, followed by Alberta and Manitoba, produced large revenue amounts for these provinces but at the cost of introducing elements of provincial tax that were outside of the existing system, thereby complicating the calculation of total tax, and introducing major issues as to the appropriate flexibility that the federal government should permit in a federally administered system. In 1988 the federal government placed a moratorium on changes to existing flat taxes and on the introduction of new flat taxes.

In the interest of gaining further provincial flexibility without incurring the significant costs associated with a separate collection system the agreeing provinces put forward a consensus position paper, reproduced as Annex B in Personal Income Tax Coordination, to facilitate discussion with the federal government on amendments to the current arrangements.

Most of the discussion has focused on alternative taxing mechanisms with little discussion of potential trade-offs in other areas. However, history has shown that the tax element of fiscal policy has rarely been dealt with in isolation from other financial arrangements.

The central policy objective is to reconcile the conflict between the provinces' constitutional rights of identity and taxation powers, and the fiscal policy and economic harmonization role of the federal government. Within this central conflict is the additional tension caused by unequal provincial resources and the premise of national standards in certain areas of social policy.

V Tax Brackets And Tax Rates

1 Background

Under the present system, the provinces have been constrained by the tax brackets and rates established at the federal level since they can only levy tax by applying their tax rate to basic federal tax under the current system. To compensate for these constraints and to provide provinces with some flexibility to meet their objectives, the federal government has agreed to administer, over the last nineteen years, numerous provincial tax reductions, tax credits and surtaxes.

Under the provincially proposed tax on income system, the provinces would be able to establish tax brackets and rates independently from the federal government. The provinces suggest that this would enable them to achieve their objectives including more control of the progressivity of the tax burden and a greater ability to support provincial policies.

2 The Federal System

The federal government currently uses only three tax brackets and rates, together with two surtaxes. The first marginal tax rate of 17% is used as a common denominator in various calculations (lowest tax rate and non-refundable tax credit rate), which ensures a certain ease of calculation for taxpayers and an overall simplicity in the system. The fact that the first tax bracket is quite wide (i.e., from \$0 to \$28,785)[4] also ensures that the transfer of credits between spouses and between dependants and parents is done with as much simplicity and equity as possible. This broad initial bracket also assists in maintaining some basic tax policies as, for example, having the point at which an individual becomes taxable as his or her income increases the same as the point when that individual ceases to be a dependant to someone else. The benefits of this system flow through automatically to the agreeing provinces under the present tax on tax regime.

The Québec system, as an example of an independent provincial system where tax credits are calculated using a rate different from the lowest marginal tax rate and where there are many narrow tax brackets at the lower end, demonstrates how difficult the transfer of personal credits calculation can become in a system where the provinces move away from the present federal policies in this area.

The following example of a Québec tax situation involving transfers from a spouse demonstrates the complexity of the situation:

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[4]Here and elsewhere, reference to rates and brackets refer to those in effect for 1991.

Example

Lower income spouse's net income for Québec purposes:		$7,400
Lower income spouse's age:		67 years old
Lower income spouse's age amount (1991):		$2,200
Lower income spouse's basic amount (1991):		$5,530
Québec tax credit rate:		20%
Relevant Québec tax brackets	0-$ 7,000	16%
	$7,000-$14,000	19%

To determine the transferable age amount - the tax benefit which the lower income spouse can transfer to the other spouse because the former does not need to use it to reduce his or her tax to zero - the first spouse's entire return needs to be calculated under the Québec approach instead of using the much simpler approach in the federal return in which the correct transfer amount can be determined from taxable income instead of tax payable.

If the first spouse's return were not calculated and used for this purpose, and instead taxable income is compared with the non-refundable amounts, the value of the transferable amount would be incorrectly determined, as shown below:

Taxable Income		$7,400
Less: Basic amount	$5,530	
Age amount	2,200	
		7,730
Unused amount (transferable)		330
Rate of credit		x 20%
Value of the transferable amount		$ 66

If the first spouse's entire return is calculated and the result used to determine the transfer, the theoretically correct determination of the value of the transferable amount can be made:

Taxable Income (assumed equal to net income)				$7,400
Tax on taxable income	first $7,000 x 16%		$1,120	
	remaining $400 x 19%		76	$1,196
Less: Basic credit ($5,530 x 20%)		$1,106		
Age credit ($2,200 x 20%)		440		1,546
Value of the transferable amount				$ 350

The difference between the two results is due to the fact that under the Québec system the tax bracket rates are different from the rate used to convert personal amounts into personal tax credits. This requires a more complex approach to determine the correct transferable amount.

Under the current federal system, the transfer of credits calculation can be completed correctly using only taxable income (as opposed to tax payable) and, as a result of the tax on tax system, requires no further computations at the provincial level for agreeing provinces. If the provincial tax was shifted to a tax on income approach, and the province did not utilize a broad initial rate bracket, then significant complexities or inequities would result.

3 Federal Surtax Issue

Before a solution can be arrived at in terms of provincial tax bracket and rate issues, the status of the present federal surtaxes must be determined. These surtaxes are not integrated in the federal marginal tax brackets. One implication of this is that they do not affect basic federal tax and, consequently the provincial tax base. The federal government may in the future maintain the surtaxes, remove them with a significant revenue loss, or replace them with appropriate adjustments to federal tax rates and brackets. The shift in provincial taxes to a tax on income base would provide the federal government with the opportunity to incorporate the surtaxes directly in the rates without affecting provincial revenues.

However, if the existing federal tax rates were to be revised, there could be an impact at both ends of the marginal tax bracket structure, unless adjustments were made to create the symmetry currently existing in the federal system. For example, if adjustments were not made in other sections of the Act, incorporating the regular 5% surtax could create differences between the lowest marginal tax rate and the non-refundable tax credits rate and, in addition, make the transfer of credits more difficult. Also, incorporating the 5% high income surtax could create differences between the highest marginal tax rate and the forward averaging tax credit rate.

It should be noted that both surtaxes are currently calculated on basic federal tax, i.e., the amount of federal tax after non-refundable tax credits, dividend tax credit, overseas employment tax credit and alternative minimum tax (AMT) carryover. If surtaxes were incorporated in the tax rate structure by simply grossing up the existing rates by 5% (and 10% for high income brackets), taxpayers claiming any of the above-mentioned credits would automatically suffer an increase in tax.

For example, assuming that the federal surtaxes were incorporated in the 1991 tax bracket structure without any adjustments, the old and new tax brackets would be:

Old (basic rates, before surtaxes)

$28,785 or less		17%		
$28,785 or more	$4,893 +	26%	on next	$28,785
$57,570 or more	$12,377 +	29%	on remainder	

New (rates including surtaxes, before rounding)

$28,785 or less		17.85%		
$28,785 or more	$5,138 +	27.30%	on next	$26,967
$55,752 or more	$12,500 +	28.60%	on next	$1,818
$57,570 or more	$13,020 +	31.90%	on remainder	

Incorporating surtaxes into tax brackets would also increase the amount of the refundable Québec abatement.

The question of whether the federal government chooses to incorporate the surtaxes into the basic rates is, of course, a separate matter: the above discussion merely points out the issues involved in such a change.

4 Provincial Issues

Under a tax on income system, six separate issues can be identified as requiring consideration:

- Symmetry Of Lowest Tax Rate With Other Provisions Of The Act
- Size Of The First Tax Bracket
- Ongoing Need For Provincial Tax Reductions
- Surtaxes Other Than Net Income Or Taxable Income Surtaxes
- Net Income Or Taxable Income Surtaxes
- Highest Tax Rate And Level Of The Top Marginal Tax Bracket

4A Symmetry Of Lowest Tax Rate With Other Provisions Of The Act

Under the current system, the lowest federal tax rate and consequently, the lowest provincial tax rate is a common denominator in several calculations. The benefits of consistency between these tax measures (tax rate, non-refundable credits rate) seem to have been widely accepted. There are major advantages to preserving this symmetry, even under the proposed tax on income system, at the provincial level.

However, if no constraints were imposed, the situation in a tax on income regime could be quite different since provinces might wish to use their new flexibility by adjusting provincial brackets and rates. Specifically they could replace existing low income tax reductions with a relatively narrow first tax bracket having a very low or possibly zero tax rate. The following example illustrates the difficulties of using a tax rate for the lowest tax bracket which is different from, for example, the non-refundable tax credit rate.

Example:

> Assuming a provincial tax rate of 4% for the lowest tax bracket and assuming a provincial non-refundable tax credit rate of 8% would mean that an amount of $6,280 (the basic personal amount for 1991) would eliminate taxes at the provincial level on an amount of $12,560 of taxable income (providing the first tax bracket is wide enough), while at the federal level tax would be payable.

This difference in the level of protection of taxable income is actually the same as that provided by the existing provincial reductions. However, the tax on income approach emphasizes the differences and thereby could add an element of confusion in the minds of taxpayers.

Much more importantly, the change from a provincial tax system involving tax on tax and separate provincial tax reductions, to a provincial system based on tax on income but with new and different provincial brackets and rates would tend to create inappropriate results in terms of the transfer of credits from one taxpayer to another. If the transfer of amounts which are "unused" by one taxpayer to a related taxpayer continues to be based on the present federal tests of transferability, there would be very inappropriate results generated, as for example by allowing two different related taxpayers to benefit from the same deduction (using it in effect twice) or in other situations preventing either of two related taxpayers from claiming any benefit in respect of an otherwise allowable credit. This situation emerges because the federal tests of transferability are in general based on determining an amount which one taxpayer does not need to "use" to reduce taxable income to nil, and then transferring that amount to a related taxpayer. If the provinces used different brackets and rates, particularly at the bottom of the income scale, then, as previously explained in relation to Québec income taxes, the correct amount that one taxpayer does not need to "use" requires a separate and more complex calculation of that taxpayer's tax liability, and further the correct break point - the point at which a taxpayer does not need to use a deduction for provincial tax purposes - will be different from the point at which he does not need to use the deduction for federal tax purposes. If the provincial transferable amounts are calculated by reference to the correct basis, then there will be substantial additional elements of calculation introduced into the returns, with particularly serious consideration because the taxpayers most affected will be those with the lowest incomes.

Accordingly, the change from the present system to a provincial system with different brackets and rates, and particularly variations in brackets and rates at the bottom of the income scale, may quite possibly lead either to a substantial increase in the complexity of the return, or in the use of inappropriate amounts of transferable credits.

4B Size Of The First Tax Bracket

The calculation of transferable non-refundable tax credits could also prove extremely difficult as a result of additional provincial tax brackets and differences between the tax rates applicable to these brackets and the non-refundable tax credit rate. These problems are discussed above in the context of the existing Québec regime.

A relatively wide first tax bracket in conjunction with a tax rate equal to the personal tax credit rate simplifies tax credit transfer calculations. Although constraints could be imposed by the federal government to preserve a wide tax bracket under the new system, the provinces may well find such a constraint difficult to accept in terms of their objectives.

4C Ongoing Need For Provincial Family Tax Reductions

The concept of tax reductions based on family situation, put forward as an objective by certain provinces, could still not be integrated by the provinces directly into the system unless - which is unlikely - the federal government modified the individual taxation concept to move to a joint return concept. Therefore, some provinces might wish to retain their special reductions under a tax on income regime.

As discussed above, targeted provincial tax reductions for low income taxpayers could only be integrated into a new provincial tax bracket structure at the cost of creating computational problems when calculating transfers of credits between spouses and between dependants and parents. Low-income tax reductions, if not maintained, could be replaced by increased non-refundable tax credit amounts (for example higher basic tax credits, dependant credits, disability credits, etc., should theoretically be granted in Manitoba if it wishes to maintain the same tax incidence, since the current tax reduction of that province is based on eligibility for these credits.) The problem with this option is that under such an approach such credits would be allowed to all taxpayers, not only to those with lower income.

4D Surtaxes Other Than Net Income Or Taxable Income Surtaxes

The present provincial surtaxes could and likely would be replaced by revisions to provincial tax rates under a tax on income approach. There is the relatively minor point that this would have an impact on the forward averaging tax credit since the provinces have committed to allow a forward averaging tax credit at their top marginal tax rate (refer to the section on "Carryover Issues"). Several provinces take the forward averaging tax credit into account when calculating provincial surtaxes, while other provinces do not. Replacing surtaxes by new tax brackets removes such an option.

In addition, current surtaxes are based on provincial tax which, in turn, is based on basic federal tax which is net of any non-refundable tax credits, dividend tax credit, AMT carryover and overseas employment tax credit. Creating new tax rates to replace surtaxes would no longer take these credits into account. This would have the same effect as discussed with respect to the federal surtax integration and would require special attention.

4E Net Income Or Taxable Income Surtaxes

Three provinces introduced surtaxes based on net income or taxable income, known as flat taxes, in 1987-1988. Such surtaxes represent the original tax on income inroads by the provinces. Moving to a complete tax on income system would call for the integration of such surtaxes in the tax bracket structure. It appears likely that a shift to the tax on income approach would be accompanied by the elimination of "flat taxes" in the three western provinces that now utilize those taxes. This integration, in the first tax bracket, might result in a tax rate higher than the rate used to calculate provincial personal tax credits under the current system. If, on the other hand, the flat taxes were maintained, the calculation of transferable non-refundable tax credits would be extremely difficult.

4F Highest Tax Rate And Level Of The Top Marginal Tax Bracket

Establishment of a top provincial tax bracket and rate higher than the existing bracket and/or rate for whatever reason has an impact on the forward averaging tax credit rate. Creating a tax bracket (and rate) incorporating high income surtaxes could result in unexpected tax savings for taxpayers with remaining forward averaged amounts.

5 Conclusion

The principles adopted in the federal system - that the tax rate on the lowest tax bracket is used as a common denominator for several calculations and that the first tax bracket is wide enough to avoid problems in calculating the transfer of personal tax credits - offer advantages to taxpayers in ease of calculation and fairness. There are therefore major benefits from preserving this system at the federal and provincial levels.

The replacement of provincial tax reductions by new and different tax brackets applicable to lower income taxpayers could result in either inappropriate and unfair results or more complex calculations than those required under the current system. The replacement of tax reductions by improved personal tax credits may not afford a better solution.

The integration of provincial surtaxes in the provincial tax bracket structure must take into account the fact that these tax rates would be applied before deduction of several frequently claimed credits whereas surtaxes are currently based on a "net of credits" number. If no adjustments are made, the move would result in substantial tax increases for numerous taxpayers. Such a result (intended or not) might be regarded as unfair by the taxpayers concerned.

VI Non-Refundable Credits And Transfer Of Credits

1 Background

Before 1988, personal exemptions were granted to taxpayers in the form of deductions in arriving at taxable income. Under the 1988 Tax Reform, these exemptions were replaced with tax credits deductible from federal tax in arriving at basic federal tax. The provinces automatically followed this federal initiative as the provinces based their provincial tax on a federal tax that reflected the elimination of income deductions for personal exemptions, CPP/QPP premiums and other amounts, and the allowance of federal credits for such items. It is this modification to the Act which now allows the provinces to suggest, as part of their proposal, that these non-refundable credits be used to achieve provincial social and economic objectives.

Under the provincially proposed tax on income system as outlined in Annex B of the document Personal Income Tax Coordination, the provinces' basic position is that first, a minimum level of support of the federal credits would be maintained under a tax on income system. The suggested minimum is 40%, i.e., the agreeing provinces would grant a provincial non-refundable credit of 40% of the federal credit.

This minimum provincial credit comprises two factors which are potentially variable: 1) the absolute amount of the credit value (i.e., if the basic personal amount is $6,000 federally, will this amount also be accepted for provincial purposes?) and 2) the tax credit rate applied (i.e., the federal rate is 17%, and to maintain the same result as under the tax on tax system the provincial factor would be equal to 17% times the provincial tax rate used in that system, for example, Ontario with a present tax rate of 53% would have a credit rate of 9%). The minimum level of support of 40% suggested by the provinces would however only provide for a minimum provincial credit - in the case of Ontario - of 6.8%, much less than the present 9%.

By suggesting a minimum support level of only 40% the provinces were allowing for a reduction of one of the two factors mentioned above and, therefore - all other things remaining unchanged - an appreciable increase in provincial taxes through lower credits for personal exemptions and related factors.

Secondly, the proposal also suggests that in addition to the basic level of support, the provinces would be able to augment their tax credit support by introducing additional tax credits for provincial purposes in six specific areas:

- basic personal
- spousal (and equivalent to married)
- dependent children
- age
- disability and,
- other dependents

It is not entirely clear whether these amounts, as proposed are intended to be separate new credits or increases in the value of the existing federal credits.

Some provinces have subsequently suggested that what they intend is to apply a factor (not less than 1) to the federally established values to determine the provincial tax credit base, and these provincial amounts would then be added together and the provincial credit rate applied. The provincial credit rate would be set at a percentage which would reflect the previous provincial tax on tax rate. Under this suggestion, the provincial support of the refundable credits would not be diminished or provincial revenue enhanced, as a result of this shift. (It is not clear to the committee whether these provinces intended to restrict the range of which federal values could be augmented.)

2 The Family Taxation Issue

Since Canadian tax is levied on the basis of individual income, using incremental marginal rates and non-refundable personal tax credits, the tax burden on a family depends upon the number of income earners. A Saskatchewan document ("A dialogue on Saskatchewan income tax reform") identifies a perceived bias against single-earner families in the current system which is not addressed under the current tax rules at the federal level nor, in many cases, at the provincial level.

Partly to compensate at the provincial level for this alleged bias, and partly for policy reasons, family tax reductions have been introduced in several provinces in the last few years. If the proposed tax on income system were to become a reality, additional measures would still be required to achieve a provincial solution to the perceived problem in all provinces. The issues surrounding the concept of family taxation appear to be a concern shared by several provinces, many Canadians and even the federal government: however, judging by the number of tax measures aimed at preventing income transfers between spouses, the perception of the "problem" is quite diverse.

It seems clear that those provinces concerned with the problem will continue to feel the need to add to the complexity of the taxation system through supplementary measures and will therefore also stretch the limits of feasibility of the Tax Collection Agreements. However, the introduction of a total family income approach by the federal and/or provincial governments would raise many other serious issues including substantial administrative complexity, higher marginal rates on "second-income" earners and, in some cases, a bias against single taxpayers. It is unlikely to be actively considered in Canada in the near future, and its review is far beyond the terms of reference of this committee.

3 Provincial Issues

Under a tax on income system, eight provincial issues have been identified as requiring consideration:

- Definition Of Personal Tax Credits
- Personal Tax Credits Involving Income Thresholds
- Personal Tax Credit Rates
- Personal Tax Credit Transfers To Spouse And/Or Supporting Persons
- Other Non-Refundable Provincial Tax Credits
- Multiple Jurisdiction Returns
- Impact On Free-Flow Of Resources Between Provinces
- Comparison With The Québec Taxation Act

3A Definition Of Personal Tax Credits

Personal non-refundable tax credits are currently federally defined amounts, both in terms of the credit amount and in terms of any relevant thresholds. The move to a tax on income system, would not, according to the provincial proposals contained in Personal Income Tax Coordination[5], result in provinces modifying parameters such as the income thresholds used in the calculation of dependant tax credits. Some provinces have indicated that they would grant additional new credits, others have indicated that they would augment certain existing credits.

3B Personal Tax Credits Involving Income Thresholds

The provinces have suggested at page 41 of the document, Personal Income Tax Coordination, that they be allowed to provide supplements to several federal personal tax credit amounts. However, the concept of providing a supplement to certain federal credits does not integrate with the present system very well, in the case of credits which involve income thresholds, since a dollar of income in excess of a threshold could then lead to a denial of more than a dollar of personal tax credit.

For example, assume that a province wishes to enhance (through a supplement) the dependant tax credit which is $69 at the federal level (being 17% of $406) in order to make it a $345 credit at the provincial level (a supplement of 400% at the provincial level but still representing only about 70% of the tax credit actually granted in Québec for the first dependant).

Each additional dollar of income earned by a dependant in excess of the threshold ($2,616 in 1991) would then - if federal income thresholds are still used - result in a reduction of $0.17 in the dependant tax credit at the federal level and would also result in a reduction of $0.85 in the dependant tax credit at the provincial level. The result is

[5]Annex B in Personal Income Tax Coordination.

astonishing; any dollar of income earned by a dependant in excess of a threshold set at the federal level would deny a total of $1.02 of personal tax credits. This would act as a disincentive for young Canadians to take summer or other employment.

If provinces are to offer non-refundable personal amounts different from those set at the federal level, they should be allowed to modify the personal amount and the income threshold of any personal tax credit in order to arrive at rational results which do not involve undeserved penalties to taxpayers. However, providing different income threshold amounts for provincial and federal tax purposes will substantially increase the length and complexity of personal tax returns, because it will require totally separate federal and provincial calculations of claims for dependents. Much of this complexity will again fall on lower income individuals.

3C Personal Tax Credit Rates

As mentioned at length in the previous section of this report and also in the section on the Alternative Minimum Tax, the federal principle of using the lowest marginal rate as a common denominator for many calculations, including the non-refundable tax credit rate, should be maintained at the provincial level to simplify tax calculations generally and to avoid undue complications with respect to the calculation of credits transferable to a spouse or supporting person. However, we again note that part of the provincial desire for increased flexibility is associated with a desire to use multiple rate brackets, and if such measures are adopted, there will again be a difficult trade-off between new complexity and a simpler solution with potentially unfair results.

3D Personal Tax Credit Transfer To Spouse And/Or Supporting Persons

As mentioned previously, the calculation of credits to be transferred to a spouse or supporting person would be more difficult should the tax credit rate be different from the lowest tax bracket rate since the calculation could no longer be done based on taxable income, but instead would require the calculation of taxes payable.

Provinces emphasized the fact that they wished to provide supplements to federally defined tax credits including several transferable credits. Any such supplement to a transferable credit would make the transfer calculations unduly complex, and accordingly would require consideration by the federal government as to whether it would be acceptable.

3E Other Non-Refundable Provincial Tax Credits

Provincial tax credits, such as stock savings plans tax credits, would presumably remain unchanged under a tax on income system. These tax credits are aimed at provincial social and economic objectives.

3F Multiple Jurisdiction Returns

Allowing provinces to modify provincial personal tax credit amounts and income thresholds would make multiple jurisdiction returns (if these are used) even more difficult since the same tax credit could have different values from province to province i.e., in the case of dependant tax credits:

- the rate could be different
- the base amount could be different
- the income threshold could be different

In the case of transferable credits, the tax credit rate could be different from the tax rate resulting in more difficult calculations in each province.

Multiple jurisdiction returns are one area where a move to tax on income could have totally unexpected results if the tax bracket rate is different from the non-refundable tax credit rate.

For example, assume that a married taxpayer, with two dependants, earned income from five permanent establishments in five different provinces (i.e., professionals from national firms). Although the spouse and dependants do not need to complete more than one return each to establish their own tax liability, the taxpayer could be required to calculate tax returns for the spouse and dependants in each of five jurisdictions in order to establish transferable amounts in each jurisdiction. In the above situation, the taxpayer could be required to calculate a total of twenty (20) provincial tax returns (five for each household member).

3G Impact On Free-Flow Of Resources Between Provinces

A scenario where tax credits, tax credit rates and tax rates could be different from one province to another is comparable to the existing situation whereby provinces with lower tax rates might appear more attractive to taxpayers. Moving from one province to another only for tax considerations would still not be worth the costs of such a move for the average Canadian in terms of both monetary and non-monetary considerations. However, it conceivably could have some minor influence on interprovincial migration, as well as on the determination of residence by taxpayers who consider that they may have some flexibility in identifying the province in which they are resident.

3H Comparison With The Québec Taxation Act

The Québec Taxation Act does provide for tax credits at a rate other than the tax rate applied at the lowest tax bracket. For example, the 1991 basic personal amount of \$5,530 converted into a credit of \$1,106 (using the prescribed 20% rate) which allows the offset of taxes on an amount of \$6,912.50 (the lowest tax bracket in Québec is from 0 to \$7,000 and has a rate of 16%).

If the basic amount was just a little higher (i.e., in excess of $5,600), the calculation would be even more complex as it would involve more than one tax bracket.

If a transfer of credits is applicable in the Québec return, the calculation appears somewhat more difficult than it is now at the federal level. Additional calculations are required to determine the transferable amount for Québec purposes.

4 Conclusion

The basis of non-refundable personal tax credits should remain defined at the federal level, without substantial variation by provinces. Moreover, although provinces should be allowed to vary the value of provincial personal amounts and the rate used to convert such amounts into personal tax credits, the value of provincial personal tax credits should be no less than what they are under the present system to ensure a continuance of the present level of provincial support.

To avoid potentially inappropriate and unfair results, provinces adopting different weightings for the provincial non-refundable personal amounts could be allowed to modify the income thresholds applied in determining certain of these credits. Such a modification of income thresholds would add significantly to the complexity of tax calculations for many taxpayers, but the alternative may be a system that produces inappropriate and unfair results.

Another important issue to be considered in a tax on income system would be whether the federal principle of using one common denominator for several calculations (lowest tax rate and non-refundable tax credit rate) should be maintained at the provincial level in order to achieve simplicity and ease of calculation. If this principle is departed from, there will be a difficult trade-off between a system with significant additional complexity and one that generates inappropriate and unfair results, with most of such unfairness falling on low-income taxpayers.

Some of the provinces have recognized the trade-off between complexity and inequity in this area and have suggested that they would live with the inequities or make ad hoc adjustments to offset them. This position is set forth on the basis that any such inequities would be relatively minor, and that there already are technical inequities in the system. This ad hoc compromise position compared with the alternative solutions which produce considerable complexity may be acceptable where the inequities produced are in fact minor.

However, we believe that this is an area which requires further study to ensure that there is good understanding of the full implications of possible adjustments. We have some concern that the provinces may not have had sufficient time to consider the extent of the possible inequities resulting from increased provincial flexibility and that such matters may in fact be, or eventually become major, with particularly adverse effects on low income taxpayers.

VII Tax Deductions And Instalments

1 Implications Of Change To Tax On Income Regime

Under the proposed system of imposing provincial personal income taxes on taxable income, there is a likelihood that provincial tax brackets would differ from federal brackets and that various provincial credits that are not a fixed percentage of federal credits would need to be taken into account in determining the tax that is to be withheld from employment income. This situation will require certain changes in present procedures for determining withholdings and instalment payments. Thus, depending on the extent to which a province chooses to depart from the federal pattern of tax brackets and credits, accurate deduction tables or formulas that combine federal and provincial withholdings at any given income level may not be possible, and separate withholding tables could be required for federal and provincial taxes. Calculations of required instalment payments to be made by individuals subject to quarterly tax instalments may also need to be more sensitive to the separate federal and provincial components of the taxes that must be paid.

As well, the federal government has expressed a strong desire that the new system have a greater measure of "transparency" than the existing system, in the sense that taxpayers should be made better aware of the respective levels of taxes imposed by the provincial and federal governments. Thus, it has been suggested by some that transparency would be served by making it apparent, with respect to each paycheque received by an employee, each instalment payment, the annual T4 slip issued to employees, the tax return itself, and the ultimate obligation of the individual taxpayer to pay the final balance or to receive a refund for an overpayment, how much of the total tax is being paid to federal and provincial governments respectively.

It has been suggested by some provinces that rough and ready approaches to the calculation of tax withholdings and instalments could be used to produce a single combined federal-provincial amount that could be used for deductions and instalments. To the extent that the provinces based their tax liabilities on different criteria than used in the federal system, the provincial component of such a combined deduction must necessarily be less than totally accurate. However, it is argued that, at the end of the tax year, the taxpayer will only be required to bear the correct amount of provincial tax as determined on his return, and that if this differs from the implicit provincial share of tax withholdings or instalments, then any overpayment or underpayment will be adjusted on filing the return.

Where the differences between the basis for provincial tax and federal tax are relatively minor, the above approach does have practical merit. However, to the extent that the provinces introduce substantial variations in their tax calculations which are unrelated to the federal calculations, then the use of "rough and ready" combined deductions and withholdings is likely to result in significant under deductions or over deductions (or instalments) of provincial tax. This result seems generally undesirable: it could for example prevent low income taxpayers from receiving current credit, through lower deductions, for some provincial family related credits, and it could mean that other taxpayers were correspondingly under deducted for provincial purposes during the year, and would face substantial make-up payments when filing their returns. (Experience would indicate that Revenue Canada would incur additional costs in collecting such balances from taxpayers, as opposed to a system where the tax deducted was roughly equivalent to the tax owed.)

Both equity to taxpayers, and principles of administrative efficiency, require that current tax deductions and instalments should be relatively closely aligned with the taxpayer's actual obligations.

2 Complete Separation

If the transparency principle were to be carried through to the fullest extent, employers would segregate in their records, and in reporting on payslips to employees, the provincial tax and the federal tax withheld from each employee; these components would be shown separately in the remittance forms to Revenue Canada and in the T4 slips issued to the employees after the end of the year; payers of instalments would need to designate separately an instalment of provincial tax and an instalment of federal tax; and all individual taxpayers, taking this information into account, would need to calculate separately on their annual tax returns the net amount, if any, owing by them to the federal government and the provincial government and any net amount of refund due from the federal government or the provincial government or both.

The costs of making such a complete separation, especially for employers, could be substantial. Smaller businesses may in particular be expected to find the additional accounting obligations to be burdensome. Administrative problems would also be multiplied for Revenue Canada, which would need to record provincial and federal tax payments separately. Remitters of instalments would be exposed to having overpaid the tax payable to one level of government, with no interest benefit, while underpaying the tax payable to the other level of government, thereby incurring a nondeductible interest cost. To avoid unnecessary compliance costs and undue irritation to taxpayers, therefore, it appears desirable to combine federal and provincial taxes, refundable credits, and payments on account into a single number representing net tax owing or refund due, as is the case now.

While, in principle, greater transparency is desirable, there are practical limits to the extent to which individual taxpayers who are not sophisticated in tax matters can be made fully aware of the relative burdens of federal and provincial income taxes. Those who do not prepare their tax returns themselves may never know; and for many who do, the various components of the tax return, including federal and provincial taxes payable, are simply mathematical steps in arriving at the final result of net combined tax payable or refund due. The most important practical requirement for transparency, with respect to those taxpayers who are interested in the question, is to show the total federal and provincial tax burdens separately in the tax return.

Information on payslips showing separately the amount of federal and provincial tax withheld would also add to informing taxpayers as to the respective taxes imposed by each government, although the actual amounts of federal and provincial tax would be subject to year-end adjustments that do not affect withholdings.

One of the main gains in terms of transparency may come from the structure of the proposed system itself in that changes in provincial tax rates will only flow from provincial budget changes and not as an automatic flow through of federal rate changes.

3 A Middle Ground

Taking into account the often conflicting elements of practicality, cost, and transparency, the following approach is recommended:

- Except where the federal government and a province agree that provincial variations from the federal system are sufficiently small to allow the use of combined tax deduction tables with reasonable accuracy, separate federal and provincial tax-deduction tables would be issued to employers, and employers would receive from their employees form TD1 with respect to federal taxes and an equivalent form with respect to provincial taxes. An employer would then determine for each employee, at the beginning of the new arrangement and thereafter when there is a relevant change in pay, tax rates or credits, or family circumstances, the separate amounts to be withheld for federal tax and provincial tax respectively and would retain this determination in case of audit by Revenue Canada. Since this information would be available in the employer's records, the employer would be free, by way of payslips or otherwise, to notify the employees how much of the withheld income tax was intended to cover federal tax and how much provincial tax. For purposes of required reporting to Revenue Canada, only the combined amount would be accounted for. Thus, it would not be necessary, in the remittance forms to Revenue Canada or in the T4 slips, to segregate amounts withheld into federal and provincial components;

- Similarly, if relevant, separate federal and provincial guides would be provided for the determination of quarterly federal and provincial tax instalments, but the instalment remittance form would only provide for a combined amount, and Revenue Canada would not need to keep a separate record of federal and provincial components;

- In the tax returns themselves, separate areas, or parallel columns, would provide for a separate calculation of federal and provincial tax after deducting all credits, both refundable and non-refundable, but before taking into account payments by way of withholding or instalments. Refundable credits might leave either or both of these computations in a negative balance. The next step would be to combine these federal and provincial balances into a single figure and then to deduct total payments, including overpayments of Canada Pension Plan or unemployment insurance, to arrive at a single figure of net total tax payable or refund due.

  This would involve an arrangement somewhat different from that illustrated on page 49 or page 51 of Personal Income Tax Coordination. This arrangement would highlight to the greatest possible extent the separate federal and provincial tax computations, without imposing the undesirable burden on taxpayers of separately identifying amounts owing to or by the federal government and the provincial government respectively. It would also minimize compliance and administrative burdens to both the tax authorities and the taxpayers.

- Advance payments by the federal government to the provincial governments on account of the latter's personal tax revenues for a year would be based, as now, on estimated tax revenues for the year. Final settlement would also continue to be based on the actual amount of provincial personal tax for the year as ultimately assessed by Revenue Canada. Accordingly, the system of determining the timing and amount of provincial revenues would be unchanged.

We recognize that even this middle ground will impose additional costs on employers, particularly small business, but we do not see any way to avoid this in a situation where the provinces make substantial use of their desired flexibility.

VIII Dividend Tax Credit

1 Policy Reasons For The Dividend Tax Credit

The integration of corporate and personal taxes through the mechanism of the dividend tax credit is a key structural element of the Canadian tax system. In a totally integrated system, an individual will pay the same amount of tax whether the income is earned directly or earned by a corporation and distributed to the shareholder in the form of dividends. The level of the "gross-up" of the actual dividend included in computing an individual shareholder's income, and the credit allowed to be deducted in computing the federal taxes payable, take into account federal and provincial corporate and personal tax rates, with the objective of relieving from the double taxation of corporate income.

The present dividend tax credit in Canada is not, however, intended as a full offset for the corporation tax. The credit is available regardless of the level of tax imposed on the income out of which the dividend is paid, or even whether that income has borne corporate tax at all. For dividends paid by many public companies out of taxable income, the individual shareholder receives a credit that reflects only a small part of the corporate taxes paid. The present dividend tax credit is therefore in many cases simply a general incentive for Canadians to invest in Canadian equities combined with a partial and imperfect recognition of corporate tax.

However, under the existing levels of gross-up and dividend tax credit, integration is approximately achieved when a Canadian controlled private corporation has business income taxed at the small business rate or when a private corporation earns investment income (taxed under either Part I or Part IV) and is entitled to a dividend refund when it pays dividends to its shareholders. The present gross-up of twenty-five percent of the actual dividend received by a shareholder assumes a corporate tax rate of twenty percent and the dividend tax credit of two-thirds of the gross-up amount assumes a provincial personal tax rate of fifty percent of the federal tax rate. Both the corporate tax rate and the personal tax rate vary from province to province, resulting in a range of variations from perfect integration even at the level of these generally smaller corporations.

For the purposes of analyzing the options available if the "tax on income" proposals are adopted in some form, it is assumed that the policy reasons for the existence of the dividend tax credit remain valid to the federal and provincial governments. This is indicated by comments contained in Personal Income Tax Coordination at pages 35-36 and 42.

2 Dividend Tax Credit Mechanism

Under the present system, an individual's income is "grossed-up" by a fixed percentage of the actual dividend receipt. The amount added to income is intended to take into account the aggregate of the federal and provincial corporate income taxes paid on the profits out of which the dividend has been paid. The amount included in the individual's income in respect of a dividend receipt is thus intended to represent, to a greater or lesser degree depending upon the corporate tax rate, the pre-tax corporate income.

The federal Income Tax Act (the "Act") provides for a dividend tax credit to shareholders equal to two-thirds of the gross-up. Because under the present federal-provincial agreements and tax collection system, provincial taxes are calculated as a percentage of the basic federal tax, the reduction in tax at the federal level results automatically in a corresponding reduction of tax at the provincial level. If the provincial tax rate is fifty percent of the federal rate, the reduction in provincial taxes will equal the balance of one-third of the gross-up.

Because federal corporate tax rates vary with the kind of income earned, its source and the type of corporation earning the income, and provincial corporate tax rates vary from province to province, the gross-up does not necessarily equal the underlying corporate tax paid on the profits out of which the dividend was derived. If the combined corporate rate is not the assumed twenty percent, overintegration or underintegration occurs. Integration is achieved for dividend income of corporations subject to the refundable tax imposed under Part IV of the Act and is approximately achieved for the active business income of Canadian-controlled private corporations taxed at the small business rate and for the investment income of such corporations. Integration is not even approximately achieved for active business income not entitled to the small business deduction, business and investment income of corporations which do not qualify as Canadian-controlled private corporations or intercorporate dividend income subject to tax under provisions other than Part IV of the Act. Some of the corporate tax paid by other taxable Canadian corporations is offset, however, by the dividend tax credit, providing partial "integration" and a general incentive for Canadians to invest in such corporations.

Because of variations in the provincial personal tax rates, the reduction in provincial taxes may be more or less than the one-third of the gross-up not offset by the federal dividend tax credit. If the provincial personal tax rate is lower than fifty percent of basic federal tax, the implicit provincial tax credit is less than one-third of the gross-up. If the provincial tax rate is higher than the assumed fifty percent of federal tax, the resulting reduction in provincial tax will amount to more than one-third of the gross-up. Thus variations in provincial personal tax rates also contribute to overintegration or underintegration under the present system.

The integration objective of the dividend tax credit is further affected by the fact that individuals receive dividends and pay tax in the province of their residence, though the corporate income offset by the credit may have been taxed in another province. It is not possible, therefore, for a province to provide for perfect integration for its individual residents by setting its corporate and personal tax rates at levels that will mesh with the federal rates (for example, a small business corporate rate of eight percent and a personal rate of fifty percent of federal tax). All provinces would have to establish the same corporate rates and dividend gross up and credit for perfect integration to result for individuals in all provinces. This constraint is of course unrealistic.

3 Issues Presented By The Proposal To Move To Provincial Tax On Income

Because the individual shareholder's income as calculated under the Act will include the grossed-up dividend, provincial tax applied to federal taxable income will result in tax on the grossed-up amount, which is larger than the amount actually received by the individual. Without a separate provincial dividend tax credit, the integration and incentive policy reasons for the dividend tax credit will be significantly eroded, and in fact the provincial burden would be manifestly unfair.

If no agreement is reached with the provinces with respect to whether a dividend tax credit will be provided, and what level or range of levels would be acceptable, the modest under or overintegration which exists under the present system, because of varying corporate and personal tax rates, may be exacerbated. In addition, a province could use the dividend tax credit to enhance the investment by residents of the province in certain types of corporations, by providing greater dividend tax credits for corporations locating, investing, providing employment or otherwise benefiting the province. Provinces could attempt to attract investors to establish residence to take advantage of an enhanced dividend tax credit. Although individuals may be unlikely to change their residence merely to lower their tax rate on dividend income, the residence of trusts and corporations is more portable and enhanced provincial dividend tax credits could provide tax and investment planning opportunities for the use of such entities to shift income from one province to another. In addition, corporations could direct their financing activities to the residents of those provinces in which the dividend tax credit is more generous, thereby influencing the national capital markets and flow of investment capital.

4 Options

A myriad of options may be developed for structuring a provincial dividend tax credit under a tax on income approach. These include:

- Complete flexibility for provinces to design their own dividend tax credits. This proposal has the potential to create significant variations in provincial tax rates on dividend income and dislocation of national capital markets and investment decisions, although in practice these adverse results might be constrained by the following factors:

- "market" forces may lead to voluntary harmonization; that is, each province would want to avoid the negative effects of tax competition;

- lack of harmonization is inconsistent with the assumption that the policy reasons for the dividend tax credit are broadly accepted at the provincial level.

- Agreement by the provinces to establish a provincial tax credit at a rate that was a fixed proportion of the federal dividend tax credit. The provincial proposal set out in the provincial paper (Annex B in <u>Personal Income Tax Coordination</u>) suggests the provinces adopt a uniform provincial credit of fifty percent of the federal credit.

  The results of a fixed provincial credit at the rate of fifty percent are illustrated on Table B. (These calculations ignore variations in corporate tax rates and personal surtaxes.) This proposal has the advantages of a high degree of harmonization and some degree of simplicity. Assuming, however, that the provinces will not otherwise change their tax on dividend income, the range of provincial tax rate on dividend income as compared to that under the present system is broadened. If a province desired to set a dividend tax credit at a rate that would more closely approximate the present rates or full integration, taking into account its corporate and personal rates of tax, it would be constrained from doing so. Such a constraint on flexibility may not be warranted, assuming that the policy reasons for the dividend tax credit are broadly accepted and tax competition among the provinces is not an objective of the tax on income proposals.

- Agreement by the provinces to provide a dividend tax credit within a range of percentages of the federal credit. Table B illustrates the rates of provincial tax that would be imposed, assuming the present provincial personal tax rates, if the dividend tax credit was forty-five percent, fifty percent or fifty-five percent of the federal credit. A range of forty-five to sixty percent would allow each province either to set a rate that would maintain the present provincial tax burden on dividend income or, if it chose, to set a rate that would achieve even fuller integration in the limited situation of its own smaller corporations. Allowing a province to set its credit rate at an appropriate level within this range would not provide for such significant variations in the effective credit so as to substantially influence investment decisions. (Of course, the integration effect would vary if the province changed its own rate of tax, which it is free to do under the present system as well, but is unlikely to do only to affect the tax burden on dividend income.)

It should be noted from Table B that the provincial tax on dividend income will vary more from province to province as a result of varying provincial tax rates when there is a uniform dividend tax credit than under the present system. That is because the provincial tax on dividend income will be computed before application of the dividend tax credit at the federal level, as occurs under the present tax on tax system. If the provincial tax rate is applied to income, rather than to federal tax as reduced by the federal credit, and then a fixed provincial dividend tax credit is deducted, higher tax rate provinces will provide a lower effective credit and lower tax rate provinces will provide a higher effective credit, to a greater degree than is now the case.

The present levels of provincial dividend tax credits would be maintained, assuming no changes in federal or provincial tax rates, if the provincial tax credit was fixed at the same percentage of the federal credit as the present provincial tax rate is of federal tax. For example, if a province whose tax rate is now sixty percent of federal tax set its dividend tax credit under the new system at sixty percent of the federal credit, the same provincial credit as under the present system would be provided.

- It has been suggested that the opportunity might be taken by the prospect of a new federal-provincial agreement to set a provincial tax credit at a rate that will more closely achieve integration for corporate income taxed in that province at the small business rate.

This suggestion gives rise to a number of technical and policy problems. Because of variations in corporate and personal tax rates between provinces, it is not mathematically possible to ensure perfect integration even for income of a particular kind and source. Residents of one province earn dividend income from corporations which carry on business, and pay tax, in other provinces. Thus one province cannot, by fixing its own rates, determine the effect of the dividend tax credit on all of its residents.

This suggestion assumes that integration of small business income is the primary policy objective of the dividend tax credit. Although that is an important objective in the small business sector, particularly for owner-managed businesses, the incentive for investment in Canadian corporations affects all such corporations and their shareholders.

The option of providing a limited and defined range of dividend tax credits at the provincial level allows the provinces to attempt to achieve closer integration of certain income, if they choose, without constraining all provinces to emphasize that objective over the other policy reasons for providing the dividend tax credit.

5 Conclusion

The separate calculation of a provincial dividend tax credit is a technical matter that must be addressed if the provinces move to a tax on income. The primary advantage to the provinces of imposing tax on income, flexibility, does not appear to motivate changes to the fundamental concept of a dividend tax credit at the provincial level.

Some constraints to provide for a degree of harmonization of provincial systems with the federal system and with each other will better serve the policy objectives of all and the national economy. Accordingly, it is recommended that any revised "tax on income" agreements require the provinces to provide an appropriate dividend tax credit within a range of percentages of the federal credit, and with further changes in that rate linked to changes in provincial tax rates. (Issues noted elsewhere in the report may require some further adjustments to the dividend tax credit calculation.)

The constraint suggested by the provinces; that is, a fixed provincial dividend tax credit of fifty percent of the federal credit, will actually increase the range of provincial personal tax rates on dividend income over that existing under the present system.

The constraint of a defined narrow range of provincial rates for the dividend tax credit appears to better satisfy both policy and technical objectives. Agreement by the provinces to establish a provincial dividend tax credit to fit the policy objectives noted above within a minimum and maximum percentage of the federal credit and with changes in the rate linked to changes in provincial tax rates, will permit provinces to set a rate that will not affect investment decisions to a greater degree than is the case under the present tax on tax system or, if they choose, will result in closer integration of corporate income tax.

Tax On Dividend Income

Table B

	Present System		Provincial Tax under Tax On Income and Fixed Dividend Tax Credit			
	Provincial Tax Rate (1991) (% of federal basic tax)	Provincial Tax On Dividends (1991)(2)	Provincial Tax On Income(3)	Provincial Tax On Dividends(7) Dividend Tax Credit as % of Federal Credit 45%(4)	50%(5)	55%(6)
Newfoundland	62	9.72	17.98	11.98	11.31	10.65
Prince Edward Island	58(1)	9.09	16.82	10.82	10.15	9.49
Nova Scotia	59.5	9.32	17.26	11.26	10.59	9.93
New Brunswick	60	9.4	17.4	11.4	10.73	10.07
Ontario	53	8.3	15.37	9.37	8.7	8.04
Manitoba	52	8.15	15.08	9.08	8.41	7.75
Saskatchewan	50	7.83	14.5	8.5	7.83	7.17
Alberta	46.5	7.29	13.49	7.49	6.82	6.16
British Columbia	51.5	8.07	14.94	8.94	8.27	7.61
Yukon	45	7.05	13.05	7.05	6.38	5.72
Northwest Territory	44	6.89	12.76	6.76	6.09	5.43
Range of effective rates:						
Lowest		6.89		6.76	6.09	5.43
Highest		9.72		11.98	11.31	10.65

Notes:

(1) Prince Edward Island's rate increased from 57% to 59% on July 1, 1991.
(2) Calculated as provincial rate times net basic federal tax on dividend income at top marginal rate (29 - 13.33 = 15.67).
(3) Calculated as provincial rate times top federal marginal rate (e.g. 50% x 29): ignores surtaxes.
(4) 45% of federal dividend tax credit: (45% x 13.33 is 6.0)
(5) 50% of federal dividend tax credit: (50% x 13.33 is 6.67)
(6) 55% of federal dividend tax credit: (55% x 13.33 is 7.33)
(7) Calculated as provincial tax on income less fixed dividend tax credit.

IX Alternative Minimum Tax Issues

1 Background

Concern over the fairness of the Canadian income tax system paved the way to the introduction in 1986 of the alternative minimum tax mechanism designed to ensure that high-income earners pay an appropriate share of the total tax bill. Thus, Canadians must pay the higher of the following two amounts: the regular federal tax and a federal alternative minimum tax (AMT). Federal surtaxes are added to the higher amount. Provincial taxes are also applied on that higher amount and so are provincial surtaxes other than flat taxes: accordingly, the provinces also derive revenues from the AMT.

Excess federal AMT for a given year over regular tax for the same year is available as a credit against regular tax liability in excess of AMT in any of the seven subsequent taxation years and thus could serve to reduce basic federal tax. Consequently, such AMT carryovers have an impact on federal surtaxes, provincial taxes and provincial surtaxes other than flat taxes.

2 Federal Issues To Be Addressed

Over the years since AMT was introduced the federal government has amended on many occasions surtaxes that modify the effective AMT rate. This situation was not a disadvantage to Canadian taxpayers except possibly those who paid AMT in 1986.

For example, assuming a taxpayer was, throughout the period from 1987 to 1991, subject to all possible federal surtaxes, he would have been entitled to a higher or equal AMT carryover rate than that used in the prior year when he actually paid AMT.

Year	Maximum AMT Rate
1986	17.85%
1987	17.51%
1988	17.51%
1989	17.94%
1990	18.36%
1991	18.70%

If the federal government were to replace surtaxes by increased tax rates (incorporating surtaxes), the question would arise as to whether the federal AMT carryover should be adjusted to avoid any negative impact on Canadian taxpayers.

Understanding the implications of the above will help ascertain the various options available when dealing with provincial AMT carryover amounts since the change from a tax on tax system to a tax on income system will have similar implications.

3 Provincial Issues To Be Addressed

Under a tax on income system eleven separate provincial issues relating to the AMT have been identified and addressed in the following pages. These issues are:

- The Income Base
- The Tax Rate
- Non-Allowable Personal Tax Credits
- Foreign Tax Credits
- The Remaining Non-Refundable Credits
- Prior Year Carryovers
- Change In Province Of Residence
- Multiple Jurisdiction Returns
- Current Year Carryovers
- The Refundable Québec Abatement
- The Relationship With The Québec Taxation Act

3A The Income Base

As taxable income and adjusted taxable income are and would remain federally defined concepts, going from a tax on tax to a tax on income system would cause no additional problems and no additional calculations. Presumably the federally defined basic exemptions would also be retained by the provinces with no modifications.

3B The Tax Rate

Under a tax on income system, the provinces would be responsible for establishing a provincial AMT rate. That rate could be determined on a province by province basis or as a single rate applicable to all provinces. If each province is allowed to set its own AMT rate, that rate could be used to calculate prior year provincial carryover amounts but problems would be encountered with respect to taxpayers who moved from one province to another or who filed multiple jurisdiction returns.

A single AMT rate might be more practical in the case of multiple jurisdiction returns where the taxpayer would otherwise have to make as many additional calculations as there were provinces to which income was allocated. However, unusual results might be encountered under this alternative since regular provincial tax rates vary between provinces while the AMT rate would be identical for all provinces. AMT could be applicable for some provinces (those with low tax rates) while an AMT carryover could be applicable for other provinces (those with high tax rates). As a result, provinces might be reluctant to consider this idea, especially those provinces with lower regular tax rates such as Alberta. AMT would exceed regular tax more quickly in such provinces and AMT would also be more difficult to recover in such cases.

If a province chose not to apply a provincial AMT at all in future years, some constraint would be necessary to deal with AMT carryovers of individuals residing in the province at the transition date and also to carryover amounts of persons becoming residents of such provinces in future years. A notional AMT rate might be used to grant AMT carryover amounts in such circumstances. Provinces might, however, be reluctant to abandon the AMT because of possible adverse public reaction.

One constraint which might be considered would be the imposition of a floor and a ceiling on provincial AMT rates to ensure that taxpayers could move from one province to another without significant disadvantageous tax consequences. The floor and ceiling could be based on an analysis of the current effective provincial AMT rates.

Another possible alternative put forward for discussion by several provincial representatives would be to establish the provincial AMT liability as a percentage of the federal AMT liability. Although this alternative makes no reference to provincial taxes actually incurred and is thereby theoretically flawed, it is of the utmost simplicity. Such a "solution" would create no problems for future years under the new tax on income rules. However, problems would still remain with respect to prior years' carryover amounts (refer to the corresponding topic below).

3C Non-Refundable Personal Tax Credits And AMT

There are two aspects of this topic worth looking into; first, provinces would be responsible for establishing a provincial non-refundable tax credit rate for use in determining the provincial non-refundable credit against provincial tax. That rate could be determined on a province by province basis or as a single rate applicable to all provinces. Once again, the latter option could be more practical, especially in the case of multiple jurisdiction returns but the idea of a single rate applicable to all provinces causes other problems when calculating transfers between spouses or between dependants and parents. (Refer to the sections of the report dealing with "Non-Refundable Credits And Transfer Of Credits" and "Tax Brackets And Tax Rates".)

Secondly, provinces would be responsible for establishing the list of non-refundable tax credits not allowable for AMT purposes. Three options must be examined. The list could be determined on a province by province basis (likely a worst case scenario since it would involve a different AMT form and calculation for every province). The second option would be for the list to be identical for all provinces (in which case only one AMT form would be required under normal circumstances), or for even greater consistency, the list could be identical to the federal list. However, this option would constitute a horrendous task in the case of multiple jurisdiction returns since provinces would be allowed, under the new tax on income system, to provide for different amounts of credits for regular tax purposes. As a result, a separate calculation of non-refundable tax credits would then be required on a province by province basis for AMT purposes.

Once all the aspects of this problem are properly addressed, the most viable option is the third, which would be to allow all provincial non-refundable tax credits for provincial AMT purposes. (One could even argue that this should also be the federal approach.)

Should the tentative suggestion made by some of the provinces that provincial AMT be calculated as a percentage of federal AMT be proceeded with, the discussion on non-refundable personal tax credits for AMT purposes would become irrelevant.

3D Foreign Tax Credits

Under the current system provinces only calculate the provincial non-business foreign tax credit after provincial tax has been established, whether it be regular tax or AMT. Provinces should remain committed to preserving such a concept and not try to create a special provincial non-business foreign tax credit for AMT purposes.

3E The Remaining Non-Refundable Credits

Over the years (even before AMT was introduced) provinces introduced non-refundable tax credits such as stock savings plan credits, home ownership savings plan credits, venture capital credits (other than the refundable B.C. credit), political contributions tax credits, etc.

Under the current system, such credits are deducted after provincial tax has been established, whether it be regular tax or AMT. Provinces should presumably remain committed to preserving such a concept and not try to deny such credits for AMT purposes.

3F Prior Year Carryovers

Currently, where taxpayers have a federal AMT carryover which is claimed for federal purposes, it reduces basic federal tax and consequently, it reduces provincial tax. Creating a provincial AMT mechanism requires establishing provincial AMT carryover amounts for prior years in which there was no explicit provincial AMT.

It is essentially not feasible to calculate retroactively what should have been the provincial AMT carryover amount. This difficult task becomes virtually impossible if the taxpayer did not continuously (since 1986) reside in the same province or if, in a year where AMT (or an AMT carryover) applied, the taxpayer was required to file a multiple jurisdiction return. Therefore, a provincial rate should be applied to the amount of federal AMT carried over to arrive at provincial AMT carried over.

This provincial AMT rate should represent fairly the rate that was used under the current system to establish the provincial tax liability. For example, the 50% Saskatchewan rate (before surtax and flat tax) represents an 8.5% provincial AMT rate in the year of transition. Establishing fair provincial AMT rates on a province by province basis simplifies the provincial AMT carryover calculation.

Such carryover provincial AMT rates could take into account provincial surtaxes and flat taxes but taxpayers who were subject to provincial AMT in prior years were not necessarily subject to all surtaxes. The rate used for prior year carryover calculations would have to be consistent with the one used for current year AMT calculations.

However, the change from a tax on tax system to a tax on income system would mean that changes in provincial tax rates would no longer have an impact on provincial AMT carryover amounts. As mentioned in the section entitled "Federal Issues", this is also a result (intended or not) of the current federal system.

Any solution would have to be applied on a year by year basis to determine the expiry date of provincial carryover amounts. That calculation should cause no problem as the federal AMT carryover should also be set out on a year by year basis for the same reason.

3G Change In Province Of Residence

Moving from one province to another would still cause problems if the AMT rate varied from province to province. A taxpayer could end up with a remaining provincial AMT carryover but no federal AMT carryover if he moved from a province with a high AMT rate to a province with a lower AMT rate. On the other hand, if a taxpayer moved from a province with a low AMT rate to a province with a higher AMT rate he could end up with a provincial AMT carryover greater than the amount of provincial AMT paid originally. This result is no different from results that can be achieved under the current system.

3H Multiple Jurisdiction Returns

Problems similar to the one described in the "Change In Province Of Residence" topic above would be encountered in the case of multiple jurisdiction returns since the allocation to provinces would likely vary from year to year.

3I Current Year Carryovers

Very few additional calculations would be required if, upon moving to a tax on income system, the proposed provincial solution of a provincial AMT based on federal AMT described in the preceding pages were to be applied to regular (single province) returns. Establishing current year carryovers causes no problems if such amounts are based on the federal AMT amount for the year.

Examples could be drawn to show the complexity of AMT calculations in the case of multiple jurisdiction returns where the complexity results from the number of parameters that might be modified by the provinces (the rate, the non-allowable credits, etc.).

The solution to all provincial AMT problems must be developed bearing in mind that AMT affects only a limited number of Canadians. The question could even be raised as to whether the federal AMT concept is going to be maintained for a long period of time. If it is not, the provinces might be tempted to simply disregard the AMT issue.

3J The Relationship With The Québec Taxation Act

Québec levies its own AMT based on concepts similar to those applied at the federal level. However, the Québec Taxation Act reduces the practical impact of the Québec AMT by providing that tax shelter investments which qualify as Strategic Investments for the Québec Economy are used to reduce both regular tax and AMT. The result is that Québec taxpayers are less likely to be subject to provincial AMT. Although different in its application, this principle is similar to the one applied in other provinces where provincial tax credits are allowed as a reduction of both AMT and regular tax.

This situation means that taxpayers not subject to federal AMT are "never" (exceptions are always possible) subject to Québec AMT. In addition to the Strategic Investments for the Québec Economy issue, the fact that the Québec dividend tax credit is relatively smaller than the federal credit (while the dividend gross-up is the same) and the fact that Québec does not offer any overseas employment tax credit explain why there is a smaller number of taxpayers subject to Québec AMT, when compared with the number of Québec taxpayers subject to federal AMT.

A practical issue which would exist under the tax on income system is how to deal with those taxpayers who lose their provincial AMT carryover when moving to Québec and taxpayers moving out of Québec with a Québec AMT carryover amount and a refundable Québec abatement no longer repayable (see discussion below).

On the other hand, tax planning opportunities do exist under the current tax system when taxpayers move from one province to another. This is especially true for Québec residents, with a federal AMT carryover but no provincial (Québec) AMT carryover, who move away from Québec and inherit a provincial AMT carryover under the current tax system. Under the tax on income system this situation would not necessarily remain. The issues however might have to be dealt with in an interprovincial agreement.

3K The Refundable Québec Abatement

Currently, when AMT is paid at the federal level for a taxpayer resident in Québec, a 16.5% refundable Québec abatement is granted on that amount since it represents part of the federal tax payable in the year. This portion of the total abatement for the year is a negative provincial AMT carryover amount allocated to Québec. When a federal AMT refund is later obtained (reducing federal tax for the year), this refundable Québec abatement is recaptured.

The treatment of this negative AMT carryover is currently an issue when individuals move in or out of Québec and would continue to be an issue under the proposed changes to the other provinces personal tax systems.

For example, persons moving into Québec would "pay back" an abatement that they never received in a year where a federal AMT carryover is claimed. Those moving out of Québec would never pay it back (at least not under the current system). The abatement could be accounted for but the provincial AMT (Québec), if any, would also have to be accounted for to ensure the fairness of the system.

4 Conclusion

In the case of a measure such as AMT which generates very limited revenue[6], moving to a tax on income system affects a great number of tax calculations. A simplified method such as that suggested by certain of the provinces' representatives seems to provide a viable solution for all parties (federal, provinces and, not to be forgotten, taxpayers) assuming that AMT will be maintained for a long period of time.

Other theoretically better "solutions" have been examined and have been found to be more accurate, especially in cases of taxpayers moving from one province to another and in cases of multiple jurisdiction returns. However, such "solutions" would be far more difficult and complex to implement and would result in a significantly increased number of calculations.

Overall, and especially considering the modest amounts of revenue involved, the recommended solution would be to reach agreement between the federal and provincial governments such that all provincial AMT amounts would be applied as a percentage of federal amounts, and without regard to actual provincial taxes. This

[6]Approximately $232 million of net AMT (i.e., gross AMT collected less amounts subsequently refunded) was collected up to and including the 1989 taxation year. However, with a general reduction in tax "preferences" that has occurred, AMT revenue is decreasing. Approximately $93 million of AMT was assessed in respect of the 1989 taxation year and approximately $72 million of AMT was refunded in that year for net revenues of $21 million.

solution represents rough justice, since it does not take account of numerous individual circumstances, but it appears that it would not unduly disadvantage taxpayers, or for that matter governments, while continuing the policy objectives of the present federal AMT. (Even if Québec remained outside of such arrangements, this solution could provide substantial benefits in administrative simplicity with respect to the other provinces.)

Another approach, which is beyond the scope of our report, would be to reconsider the need for an AMT at all in our present tax system with its sharply reduced "preferences".

X Carryover Issues

Aside from the AMT carryover issue discussed at length in the AMT section of this report, other current measures with carryover provisions involving tax credits granted at the federal and provincial levels are limited to donations and forward averaging.

1 Forward Averaging

Since the addition of previously forward averaged amounts is made before arriving at taxable income level, moving to a tax on income system creates no new problems; a credit rate would be applied on a taxable income amount while, under the current tax system, a provincial rate (only one per province) is applied on the amount of the federal credit. In their discussion paper, the provinces have agreed to allow a credit at their top marginal rate as long as this remains the federal policy.

The only possible issue remaining would be to let the provinces determine whether the provincial forward averaging tax credit should have an impact on provincial surtaxes as it does for some provinces under the current tax system. That decision also depends on whether provinces would maintain high-income surtaxes or create new tax brackets and, if new brackets were created, whether they would apply at income levels higher than the beginning of the top federal marginal tax bracket. Using provincial tax brackets higher than the top federal marginal tax bracket could lead to provincial tax savings not available under the current system, at least for the portion of the amount added to taxable income that would under the current system not be subject to a surtax. (Refer to the Tax Brackets And Tax Rates section of the report for more detailed explanations.)

As far as the taxpayer's ability to move from one province to another is concerned, that issue exists under the current tax system and it will continue to exist under any revised Tax Collection Agreements.

Provinces should not be allowed to withdraw from that aspect (forward averaging) of the Tax Collection Agreements which, by the time the new agreements come into force, will likely be more than ten years old with only a few possible years of carryover left. Provinces accepted the concept and benefit of forward averaging in the past, and accordingly should provide for appropriate adjustments in the future, at the time taxpayers would be entitled to savings. As far as new tax credits are concerned, if the federal government were to introduce new national tax credits with carryover provisions and if it wanted provinces to share in such tax initiatives, an agreement would have to be reached with the provinces and the provincial carryovers would have to be maintained separately.

Other provincial tax credits aimed at provincial social and economic objectives are not relevant to the discussion since the objectives are provincial ones (not national objectives).

2 Other Issues

Carryover of amounts related to charitable donations, unused RRSP deductions, loss carryovers and reserves present no particular problems should a move from a tax on tax system to tax on income system be agreed upon.

One unusual situation which will require consideration on a change to a tax on income regime is the application of ITAR 40(1) with respect to certain payments pursuant to certain registered plans (i.e., RPP's, EPSP's and DPSP's) and certain other payments in respect of loss of office or on death. In effect, the current rule is that these payments (to the extent they are eligible) can be excluded from taxable income and instead be taxed separately at an average of the prior three years' rates. This amount is then deemed to be Part 1 tax which is the base upon which provincial tax is then levied.

Under a tax on income regime any amount excluded in this manner from taxable income would escape provincial tax entirely unless a specific new provision was enacted. There are two possible methods of addressing the provincial tax component:

- specific provisions enacted in each province to mirror the rules in ITAR 40(1) to allow for a special average provincial tax rate to apply to any amount excluded form taxable income; or

- amendments to the federal rules to provide for the tax rate to be applied to be equal to the average prior three years federal rate plus the surtax provided for in subsection 120(1). The surtax component collected could then be allocated to the appropriate province of residence of the taxpayer.

Given the fairly limited application of these provisions it is recommended that the second alternative described above be applied.

3 Conclusion

Although there are few problems associated with carryover issues should a "tax on income" system come into force, provinces should ensure that provincial tax brackets and tax rates are set bearing in mind their impact on provincial forward averaging tax credits. The federal-provincial Tax Collection Agreements should reflect the indicated provincial position of having the provinces allow a provincial forward averaging credit at their top rate.

The application of ITAR 40(1) concerning certain pension and retirement payments would require modification: the federal rate applicable should be adjusted and then an appropriate portion of the tax collected allocated to the province of residence of the taxpayer.

XI Multijurisdictional Issues

1 Present Rules Regarding Deemed Source Of Income

The tax-collection agreements incorporate by reference the rules in Part XXVI of the federal Income Tax Regulations.

Under those provisions:

- Individuals resident in a province of Canada on December 31 of a particular year who do not have business income for that year from a "permanent establishment" outside that province are deemed to have earned all their income for that year from sources in the province. This rule has many arbitrary elements and may lead to a selection (or declaration) of a province of residence that is tax-influenced. The rule has been long accepted, however, and appears to create little difficulty in practice. The current federal and provincial proposals indicate a consensus that this rule should not be changed.

  The arbitrariness of the rule is particularly apparent where a taxpayer who has moved from one province to another claims or includes, for purposes of computing federal tax and therefore for purposes of computing tax payable to the province of current residence, carryovers that relate to a period of residence in another province. These carryovers might relate to such matters as forward averaging, minimum taxes, unused R.R.S.P. deductions, loss carryovers, carryovers of charitable donations, or "reserves". Again, however, the simplicity and ease of application of the general rule are such that this provision should remain unchanged.

- Where an individual has income for the year from a business that has a permanent establishment outside the province of residence, that income is allocated amongst all of such jurisdictions. The formula used to divide the income is an arbitrary one, based in general on the average of employee compensation in the jurisdiction to total compensation and gross revenue from the jurisdiction to total gross revenues. "Basic federal tax" is then prorated to each such province in proportion to its deemed share of total income, and each province's tax rate, expressed as a percentage of federal tax, is applied to its prorated portion.

  While this quasi-unitary method of determining the source of business income is again arbitrary in several respects and while it creates some compliance burdens for the relatively small number of individuals affected (for example, partners of national professional firms), these persons tend to be sophisticated taxpayers, and only modest problems of application seem to have emerged in practice. The provinces also appear content to retain this rule as an element of the new tax-sharing structure. Under this rule, the province of residence is, in effect, treated as the source of all employment and investment income earned by the taxpayer as well as all business income not attributed to a permanent establishment outside the province of residence, even though some or all of the employment income or investment income may have originated outside that province.

- Special rules apply to an individual who resides in Canada for only part of the year in question.

- An individual who does not reside in Canada at any time during the year in question is deemed to earn in any particular province any employment income reasonably attributable to duties performed in that province (in other words, using familiar international-source rules rather than the place-of-residence rule) and to earn business income in any province on the basis of the same permanent-establishment rules as are applicable to residents. The provinces do not receive any tax on Canadian-source investment income earned by non-residents.

Presumably the present rules, with all their theoretical defects, are generally accepted because:

(i) for the great majority of individual taxpayers they are easy to apply and do not give rise to dispute;

(ii) correspondingly, the rules are relatively easy to administer by Revenue Canada. (It is noted that, in areas where disputes might arise, such as a question of multiple residence under section 2607 of the Income Tax Regulations, there seems to be little incentive for Revenue Canada to challenge the taxpayer's designation);

(iii) there is a feeling that the benefits and detriments to a particular province of not adopting a more accurate method of determining the geographic source of income will more or less balance;

(iv) the federal government is unlikely to accept responsibility for administering a significantly more complex system, even one that is demonstrated to be technically preferable.

2 Changes Required If Provinces Impose Tax On Taxable Income

The present rules respecting multijurisdictional income will need some revision if, as is proposed, the agreeing provinces commence to impose their personal income taxes on the basis of taxable income, as determined under the federal Income Tax Act.

2A Canadian Resident Taxpayers

Where an individual is resident in a province on December 31 and did not have a permanent establishment outside that province in the year in question, the existing rules should continue to apply: all taxable income for the year should be deemed to have been earned in the province of residence, and the only provincial income tax for the year should be payable to that province based on its tax rates and tax credits. The arbitrariness of the current rules does not seem to be aggravated by a change in the basis of calculating provincial tax.

Difficulties would arise where an individual who is resident in a province on December 31 has business income for the year that is attributed to a permanent establishment outside the province. A simple allocation of the basic federal tax to the provinces or countries affected would no longer suffice; and an allocation of taxable income, without additional provisions, would give an individual who has income attributed to more than one province under the present rules the benefits of income splitting by the use of the lower rate brackets in each such province and by multiple use of full provincial non-refundable tax credits.

A suggested solution was developed in a federal study and is referred to favourably in the provincial discussion paper: see Personal Income Tax Coordination, page 43, note 6. Under this proposal, the individual would prepare a tax return for each province to which his or her income is allocated (under the existing rules) on the basis that all the individual's income for the year was taxable in that province, and the provincial tax on that total income, after all applicable provincial tax credits, would be calculated. Each such province would then be entitled to receive tax in an amount equal to the proportion of its notional total tax that the income allocated to it is of the taxpayer's total income for the year. This would avoid any income-splitting effect.

This proposal has all the disadvantages of arbitrariness from which the existing rules for allocating business income suffer. The province of residence would still tax all non-business income, as well as any business income not attributed to a permanent establishment outside the province. Jurisdiction shopping would still be possible in the choice of place of residence and location of permanent establishments. As well, new problems may emerge - for example, if one province does not recognize carryover rights that arose in another province or restricts certain tax credits to its own residents. An individual who receives taxable dividends from taxable Canadian corporations may find that a province other than the province of residence can influence the tax payable to itself by the manner in which it chooses to allow dividend tax credits, even though only the province of residence is supposed to tax those dividends. Again, income and deductions that are allocated only to the province of residence may affect the computation of minimum tax in another province to which business income is allocated. The benefits of special tax credits granted by the province of residence may be reduced by the allocation of income to other provinces.

In addition to these disadvantages, substantial further compliance burdens would be imposed on those affected by the allocation rules - with corresponding increased administrative burdens on Revenue Canada. For example, a member of a partnership that has offices in all provinces and territories would need to complete 12 full provincial tax return calculations, with computations of alternative minimum tax where applicable and computations of all applicable carryovers and tax credits. Further full tax calculations might be required for each province with respect to each dependent child of the taxpayer who earns income (refer to page 31 for an example). If the proposal had strong justification in principle, perhaps the additional compliance and enforcement costs could be accepted. In the circumstances, however, the interests of simplification and practical convenience strongly suggest that this proposal should not be followed.

Another option considered by the same federal study would involve an approach having some resemblance to the present system of basing the provincial tax on the federal tax. The federal government would impose a surcharge on all business income allocated under the present rules to provinces other than the province of residence, at a flat rate equal to an assumed ratio between present average provincial tax rates and basic federal tax. The revenue from the surcharge would be paid to those other provinces in proportion to the business income allocated to them. The arbitrariness of the choice of average rates would create a problem here; and this system might be regarded as being in concept contrary to the desire of the provinces to control the progressivity of their tax systems, although the differences involved would not likely be large. However, the approach has the substantial benefit of simplicity.

The most attractive solution to the problem (subject to the concerns that will be raised regarding nonresident individuals and individuals resident in Québec) would appear to be to apply the province-of-residence rule to all income earned in Canada and not to have a separate rule with respect to business income. This rule would be no more arbitrary than the others that have been proposed and would substantially simplify compliance by those affected and the administrative burden faced by Revenue Canada. Each province would both gain and lose some revenue in comparison with the current system but since relatively few taxpayers are involved, the overall effect of this change on the revenues of any given province should not be material. This issue is further discussed later under the heading "Overall Impact". If a particular province has uncompetitive rates so that individuals avoid residing in that province, it faces a substantial problem under existing rules, and the proposed change would not aggravate that problem materially. Provinces cannot, and probably should not, be insulated from the competitive effects of choosing to impose comparatively high tax rates.

The allocation of business income to the province of residence in the case of individuals would not require a change in the method now used to allocate corporate income. In the case of corporate income, revenue considerations can be much more substantial, and the pressure for the provinces to render the rates progressive and to multiply tax credits is far less.

2B Non-Resident Taxpayers

Taxing all business income in the province of residence would not resolve the case of a non-resident individual who is employed or carries on business in Canada. If employment or business income is earned in only one province, the non-resident could be required to file a tax return and pay tax to that province on "taxable income earned in Canada" as defined in the federal Income Tax Act, which in turn should be calculated consistently with any applicable tax treaty. Where employment income or business income, or both, would be attributed to more than one province under the present rules in section 2602 of the Income Tax Regulations, there would still be a problem. If present rules are applied to determine taxable income earned in any of those provinces, the concern previously raised about splitting income would arise here as well. Income splitting already occurs to some extent, because normally only part of the non-resident individual's total income for a year is attributed to Canadian sources; but the problem would be aggravated if that portion of the non-resident's income were further subdivided and allocated to two or more provinces. Presumably the number of cases in which this problem would occur - for example, international partnerships with offices in more than one province - would be quite small.

Three options seem worth considering:-

(i) Accept having the business income derived from a province taxable only in that province, with the consequent income splitting, on the basis that it is a further application of existing rules and that not much revenue is involved;

(ii) Apply, but only for this case, the proposal previously discussed of requiring tax returns to be prepared for each province affected in which provincial tax is calculated based on the non-resident's total employment and business income from Canadian sources, determining business income in accordance with present allocation rules; then reduce the tax for each province to its proportion of that total income. While the compliance burdens imposed on affected non-residents might be unwelcome, relatively few persons would be involved. Here, as well, the provinces would need to agree to accept any modification to the tax base required by an applicable tax treaty to which Canada is a party.

(iii) Have non-resident individuals pay tax only to the federal government, including the surtax provided for in subsection 120(1) of the federal Income Tax Act, with respect to all employment and business income deemed to be earned in Canada. The tax collected under subsection 120(1) from any non-resident would be divided among the provinces in proportion to the employment and business income deemed earned by him or her in each such province under present source rules. Tax returns filed by non-residents, of course, would need to provide for disclosure of the necessary information.

In the interests of simplification and to avoid having a complex procedure and formula applicable only to a small number of non-resident individuals, the first option has some merit. However, the third option is more equitable but at the expense of some slight loss of provincial flexibility in the taxation of this income, and overall seems preferable. (If it was decided to use the more complex procedure and formula for taxing business income of Canadian resident individuals, analogous rules would apply to non-resident individuals with respect to business and employment income deemed earned in more than one province.)

2C Overall Impact

Tables C and D at the end of this chapter show figures provided by Revenue Canada, Taxation for 1988 and 1989 illustrating how basic federal tax allocated to the provinces would shift if (a) all business income of Canadian resident individuals was allocated to the province of residence and (b) Canadian-source employment and business income of non-resident individuals was taxed and retained only by the federal government, including the surtax under subsection 120(1) of the Income Tax Act. The revenue effect of this shift on individual provinces would only be the provincial rate applied to the gain or loss in basic federal tax allocated to that province.

If the subsection 120(1) federal revenue were allocated to the provinces as suggested under the heading "Non-Resident Taxpayers", the possible losses to certain provinces would be further reduced. Overall, the changes in provincial tax revenues resulting from such a shift would appear to be immaterial.

2D Tax Planning Issues

Some question may be raised whether taxing all business income in the province of residence would pave the way to further manipulation of the source rules by individuals resident in high-tax provinces who choose to form a corporation or a trust in a low-tax province.

Many individuals affected are members of professional partnerships who under most present rules could not transfer their business activities to a corporation or to a trust. For those who can incorporate, the existing rules regarding allocation of corporate income would apply. The number of individuals who are now carrying on an unincorporated business that earns income that is taxed in one or more provinces other than the province of residence and who can and will incorporate that business to avoid having all that income taxed in the province of residence is likely to be insignificant.

Trusts are a difficult vehicle to use for carrying on a business, though they are sometimes used for this purpose. If the proposal to tax the business income of individuals in the province of residence were adopted, a trust could be formed in a low-tax province, carry on business in one or more high-tax provinces, and (being treated as an individual for tax purposes), by accumulating its current income, benefit from the low tax rate in its province of residence. Apart from the inability of many affected individuals to use trusts for this purpose and the unwieldy nature of the trust as a vehicle for carrying on an interprovincial business, persons who choose to use this device would face some uncertainty concerning the place of residence of a trust that has substantial business interests outside the province in which it is formed and where its principal beneficiary and chief decision maker resides outside that province. (See also the later discussion in Section XIII, parts 2 and 3).

3 Coordination With Québec Taxation

If Québec continues to use the existing source rules for purposes of its personal income taxation, some coordination problems would arise should the other provinces attribute all income to the province of residence. Where an individual resides in a province other than Québec and has business income that is taxed in Québec under the present source rules, it would appear necessary for the province of residence to grant the equivalent of a foreign-tax credit for the Québec tax. As well, the individual will presumably have lost the benefit of the existing refundable abatement of federal taxes applicable to income earned in Québec under the current source rules, which may or may not be offset by any credit for Québec tax granted by the province of residence.

In the reverse situation there would be a problem of undertaxation: if an individual who is resident in Québec has business income attributable to a permanent establishment in one or more other provinces, there might be no provincial tax on that business income. As well, that individual would benefit more than now from the Québec tax abatement. Such a change would presumably be objectionable in a static situation; in addition, however, it might induce individuals who have income from permanent establishments in one or more provinces other than Québec to move to Québec - for example, for Ottawa-based partners of a national accounting firm to decide to move their residence to Hull. Clearly, this result would not be acceptable.

Two approaches to address this problem, in order of preference, would be:

- Persuade Québec to adopt a source rule attributing all income of an individual to the province of residence. Overlapping taxation would then be avoided unless there is a disagreement as to the province of residence. Any such disagreement might be resolved, by prior agreement between the federal and Québec tax authorities, under a "competent authority" type of procedure;

- Provide that an individual who is resident in Québec and has business income attributed, under Québec tax rules, to a permanent establishment in one or more of the other provinces will be subject to tax payable to Revenue Canada on that income in the same incremental amount as if all that income had been taxed in Québec, and the tax revenue so received would be divided among the other provinces in proportion to their respective shares of individual tax revenues for the year in question. Individuals resident outside of Québec but with business income in Québec, would be provided with the appropriate abatement of federal tax, along with a credit from the province of residence for the Québec tax rate offset by the federal abatement.

4 Conclusion

Taking account of all of the considerations, the most appropriate solution to the multijurisdiction issues discussed would be:

- All business income of individuals who are resident in Canada on December 31 of any year should be regarded as having been earned in the province of residence[7].
- An attempt should be made to obtain agreement from Québec to adopt a matching source rule for business income.
- Non-resident individuals who earn employment income in Canada or business income through a permanent establishment in Canada would only pay tax (including subsection 120(1) surtax) to the federal government, which would allocate the provincial share of such revenue under subsection 120(1) to the provinces of source.

[7] If Québec does not adopt similar source rules, special adjustments for Québec income and residents would be required: these would diminish the simplicity of the overall approach.

1988 Taxation Year
Multijurisdictional Taxfilers

Table C

Province of Residence	Number Of Taxfilers	Basic Federal Tax: Current Allocation	Basic Federal Tax: Allocation By Residence	Basic Federal Tax: Increase (Decrease)
Newfoundland	59	$ 1,184,079	$ 1,090,520	$ (93,559)
Prince Edward Island	29	263,141	352,090	88,949
Nova Scotia	203	3,470,406	3,878,683	408,277
New Brunswick	130	2,059,818	2,469,406	409,588
Québec	1,056	25,520,816	21,732,569	(3,788,247)
Ontario	2,483	55,223,568	53,586,545	(1,637,023)
Manitoba	297	4,408,147	4,531,589	123,442
Saskatchewan	275	4,132,907	3,067,313	(1,065,594)
Alberta	1,356	17,355,725	16,869,800	(485,925)
British Columbia	1,674	19,912,068	23,525,774	3,613,706
Northwest Territories	28	272,003	179,184	(92,819)
Yukon	14	784,030	691,247	(92,783)
Non-Residents	2,133	7,239,940	9,851,928	2,611,988

1989 Taxation Year
Multijurisdictional Taxfilers

Table D

Province of Residence	Number Of Taxfilers	Basic Federal Tax: Current Allocation	Basic Federal Tax: Allocation By Residence	Basic Federal Tax: Increase (Decrease)
Newfoundland	58	$ 1,484,507	$ 1,126,777	$ (357,730)
Prince Edward Islands	26	415,791	443,534	27,743
Nova Scotia	257	5,610,894	6,390,304	779,410
New Brunswick	174	2,816,315	3,078,014	261,699
Québec	1,115	30,965,238	28,004,042	(2,961,196)
Ontario	2,535	86,709,500	82,438,967	(4,270,533)
Manitoba	319	4,862,266	4,708,272	(153,994)
Saskatchewan	298	5,656,805	3,753,099	(1,903,706)
Alberta	1,371	23,392,960	23,248,617	(144,343)
British Columbia	1,856	27,126,033	31,864,440	4,738,407
Northwest Territories	20	259,086	158,528	(100,558)
Yukon	16	511,553	462,371	49,182
Non-Residents	3,151	10,230,464	14,364,448	4,133,984

XII Administration And Appeals

1 Introduction

Under the present tax on tax system for the calculation of provincial income taxes, most of the components of the provincial tax calculation are determined in accordance with rules set out in the federal Income Tax Act. The administration of the tax system, including the collection of taxes, the issuing of assessments and reassessments and the administrative appeals procedure are handled by Revenue Canada, Taxation for the nine agreeing provinces, and two territories (the agreeing provinces). Uniformity of income tax legislation among these agreeing provinces is obtained by federal drafters preparing amendments to the provincial income tax acts which are necessary to implement the Tax Collection Agreements.

Thus there exists essentially a single system for the creation of much provincial tax legislation and for the determination of questions and disputes relating to the computation of income, taxes, credits, interest, penalties, and other relevant components of federal and provincial tax calculation, both at the administrative and at the judicial level. Reassessments that are resolved through the administrative appeals process within Revenue Canada, in respect of matters arising under the federal Act, generally result in a corresponding adjustment to provincial taxes. Similarly, disputes that are resolved through the courts will normally result in similar adjustments to federal and provincial taxes.

Under the present system, however, problems can arise where federal and provincial tax questions are not completely harmonized. The federal courts do not have jurisdiction to hear appeals in respect of purely provincial matters and the jurisdiction of the provincial courts in relation to income tax matters is restricted to certain specific provincial issues. These restrictions limit the areas in which conflicting interpretations of tax laws may arise between provinces, but on the other hand may confuse and limit the taxpayer's rights of appeal in those cases where federal and provincial laws are inconsistent. For example, a nil assessment for federal taxes may not always result in a nil assessment of provincial taxes; however, under the present system, the taxpayer may be precluded from challenging the assessment for provincial taxes if a component of the federal system (such as the computation of taxable income) is involved in the calculation of provincial tax. Another example is a case involving a provincially-defined tax credit that does not have a counterpart in the federal system but is not within the list of specific provincial issues over which the provincial courts have jurisdiction. In these cases, the taxpayer may find himself or herself in the wrong court or without any avenue of appeal.

As the variations among the federal and provincial tax systems increase both between the federal and each provincial system and between each province, the cost and complexity of administration by Revenue Canada and the potential for appeals in respect of the computation of provincial taxes increase. If, as may be expected under a tax on income system, the provinces increase the number of provincially defined components of the provincial tax calculation, an assessment of federal tax will not necessarily result in a corresponding provincial assessment and vice versa. Nor will the determination of an assessment in respect of tax at one level necessarily determine the outcome of an assessment at the other level.

The determination of tax appeals in thirteen separate jurisdictions (federal, ten provinces and two territories), both administratively and by different court systems, has the potential to fracture the consistency of tax administration and interpretation in Canada and to increase the cost and complexity of administration and appeals to both governments and taxpayers. However, if the appeals system does not allow provincially defined tax issues to be determined through a judicial appeals process taxpayers' rights to appeal from assessments of tax will be seriously affected.

2 The Present System

Under the present system, taxpayers generally have access to one administrative system and one court system which has jurisdiction to hear most appeals in respect of federal and provincial tax matters. Under the present Tax Collection Agreements, the provinces have delegated to Revenue Canada, Taxation, the powers to administer the provincial income tax acts. Thus the federal Minister of National Revenue is authorized to employ all powers to assess both federal and provincial taxes, to administer the non-judicial appeals process in respect of such assessments, and to defend such assessments in court.

A taxpayer who wishes to dispute an assessment files one notice of objection with Revenue Canada, and the review of that notice of objection by officials of Revenue Canada relates to both federal and provincial taxes.

A taxpayer's appeal from a notice of confirmation or reassessment after review of a notice of objection is heard in the Tax Court of Canada, the Federal Court of Appeal[8] and, with leave, by the Supreme Court of Canada. The superior courts of each province have jurisdiction to hear tax appeals only in respect of purely provincial matters such as residence, allocation of income to the province or some alleged error in the computation of provincial taxes. In practice, because the provincial tax computation relies so heavily, under the tax on tax system, on the federally determined components, virtually all tax disputes are resolved in the federal courts, and

[8]The Trial Division of the Federal Court will continue to hear tax appeals commenced before the effective date -- January 1, 1991 -- of the amendments to the Tax Court Act which established the Tax Court of Canada as the sole court to hear tax appeals at first instance, with appeals from decisions of the Tax Court directly to the Federal Court of Appeal.

corresponding adjustments to provincial taxes, usually necessitated by any change in the computation of federal tax, are made administratively by Revenue Canada.

The federal courts have no jurisdiction over purely provincial tax matters and assessments of provincial taxes only cannot be challenged by a taxpayer in the federal courts (The Queen v. Bowater Mersey Paper Company Limited (87 D.T.C. 5382; [1987] 2 C.T.C. 159, Federal Court of Appeal,) at page 5384; Stiege v. Minister of National Revenue (91 D.T.C. 808; [1991] 2 C.T.C. 2005, Tax Court of Canada)). A taxpayer who receives a nil assessment for federal tax purposes but is liable for provincial taxes (because of the deduction of credits, such as investment tax credits, allowed in computing federal tax payable but excluded for purposes of defining the provincial tax base) may not be allowed any appeal, since the provincial courts are precluded by the provincial income tax acts from hearing appeals relating to the computation of federal tax, upon which the provincial tax is computed (for example, see section 25 of the British Columbia Income Tax Act). A taxpayer may find himself or herself in the wrong court where a notice of objection is filed with and confirmed by Revenue Canada but the matter in dispute is purely provincial and only the provincial courts have jurisdiction. A taxpayer may be precluded by the restrictions on the jurisdiction of the federal courts to hear provincial matters and the restrictions on the provincial courts to hear only certain specified income tax matters from appealing to any court with respect to a provincial matter, if the specific jurisdiction of the provincial court does not extend to the particular issue in dispute.

Such restrictions serve the objectives of the single administrative and appeals system which is a significant advantage of the present arrangements. They limit the duplication of appeals and the resulting cost, complexity and potential for conflicting interpretations. However, they also limit taxpayers' rights. The possibility of additional variations in provincial rules which will result from a tax on income system increases the need for additional provisions in provincial statutes to provide for appeals and the possibility that taxpayer appeals will have to be taken under two separate appeal and judicial systems, thereby increasing complexity and costs.

3 Implications Of The Tax On Income System

As the potential for the provinces to separately define the components of the provincial tax calculation increases, so does the potential for duplication of the appeal process and conflicting case law in different jurisdictions. To the extent that provinces add provincially-defined credits and other components to the provincial tax calculation, the existing problems relating to nil assessments and lack of an appeal mechanism for provincially defined components will increase.

3A Duplication And Conflicting Case Law

As the provinces implement provincially defined tax credits and other components of the tax calculation which do not parallel the federal system or those of the other provinces, a taxpayer may find that two appeals must be instituted in respect of an assessment of federal and provincial taxes, involving two separate procedures in two separate court systems. For example, to the extent that provincial credits are determined as a percentage of federal credits, the existing system may still operate: Revenue Canada, the administrator of both systems, will assess both levels of tax, and the determination of the provincial credit will turn on the determination of the corresponding federal credit. An appeal in respect of the federal credit would result in a corresponding adjustment to the provincial credit, and an appeal only to the federal courts would be sufficient.

If, however, the provincial credit includes separately determined components, administration by Revenue Canada is more difficult. Assuming that Revenue Canada agrees to continue to administer such provincial credits, the federal courts would have no jurisdiction to hear an appeal in respect of a component of the provincial credit which has no counterpart in the federal system. An appeal would thus have to be instituted in the provincial courts, assuming the provincial courts were given jurisdiction under the provincial income tax acts to hear such appeals.

Appeals from tax assessments at two levels of courts will obviously increase not only the number of appeals, but also the cost and complexity to a taxpayer of exercising rights of appeal. The potential for differing and conflicting interpretation of similar tax legislation, when tax appeals are heard in federal and provincial courts, is also obvious.

As a non-agreeing province, Québec provides an example of a system where appeals must be instituted separately in respect of federal and provincial taxes, in two separate court systems. It is understood that in practice Revenu Québec and the Québec courts are influenced by the outcome of federally determined appeals where the issues involved are similar and the two tax systems have similar rules or wording. The Québec courts will refer to court decisions of the other provinces and the federal courts, which are persuasive though not binding on the Québec courts. The Québec courts are of course bound by decisions of the Supreme Court of Canada, as are all the provincial and federal courts.

Whether such administrative and judicial practice would continue where eleven or more court systems are involved in tax appeals can only be speculated upon. It is obvious that the potential for conflicting case law increases as the number of courts involved in determining tax matters increases.

3B Nil Assessments And Absence Of An Appeal Mechanism For Certain Provincial Tax Components

Under the tax on income proposal, the possibility of a nil assessment at the federal level but positive tax payable at the provincial level increases. To the extent that the provinces have more flexibility to define and determine the components of their own taxes (for example, defining separate credits as opposed to providing credits determined as a percentage of federally defined credits) the likelihood of nil assessments federally and positive assessments provincially or of provincial tax being influenced by special provincial credits or adjustments is greater.

If the provinces move to separately define provincial tax components, the provincial tax acts will have to provide for appeals in respect of all such provincially defined components in order to avoid prejudice to and discrimination against taxpayers. However, an increase in appeals in the provincial courts increases the cost and complexity of the appeals process, the hearing of tax appeals by judges with less experience, and probably less expertise in tax matters, than judges in the Tax Court and Federal Court, and the potential for conflicting interpretations. Thus increased access to appeals for taxpayers could result in less satisfactory processes and legal interpretations than is the case under the present system.

4 Options

4A Duplication Of Appeals Process And Conflicting Case Law

It is reasonable to assume that a tax on income system will provide definitional flexibility to the provinces in respect of provincial credits and certain other components of the provincial tax system, increasing the potential for duplication of appeals and conflicting case law. There appear to be three options, none of which may effectively solve all the attendant problems:

(i) Preserve the existing system. Under the present system, appeals are available at the federal level in respect of disputes involving federal tax and, indirectly, disputes concerning provincial tax matters that are defined in relation to federal rules. Provincial courts have the jurisdiction to hear disputes involving purely provincial matters. Provided that the jurisdiction of the provincial courts clearly extended to all matters determined solely under the provincial income tax act in question, duplication and the potential for conflicting case law would be limited to those areas not paralleled at both levels, which would remain limited even under the tax on income system. The administration of both systems by Revenue Canada, including the requirement to file only one notice of objection to appeal from an assessment, would continue to provide for coordination of adjustments.

This "status quo" option would be aided if any new agreement with the provinces were to limit provincial credits to those defined under the federal Income Tax Act (allowing the provinces to determine the rates at which such credits would apply for provincial tax purposes). The restrictions on the jurisdiction of the provincial courts could be extended to such federally defined credits, so that the federal definitions would be interpreted only in the federal courts. Only the computation of the credit at the provincial level - a largely arithmetic exercise - would be a purely provincial matter for the provincial courts.

As an alternative, any new provincial credits could be required to be reviewed and approved by Revenue Canada, in advance of their enactment, to ensure that they could be effectively administered by Revenue Canada (as is required under the "MacEachen Guidelines"). The use of federal legislative drafters, to ensure uniformity of provincial legislation, where possible, would also help to continue the advantages of the present system.

Where a reassessment or confirmation of an assessment resulting from a review of a notice of objection required an appeal to a provincial court, Revenue Canada could aid taxpayers by so advising them in the reassessment or confirmation. To the extent that the appeals process must, for constitutional and jurisdictional reasons, include rights to appeal to the provincial courts on some issues, taxpayers' access to the proper court would be enhanced.

(ii) Single federal court jurisdiction. If jurisdiction were transferred to the federal courts to deal with all federal and provincial tax matters, the potential duplication and conflicting case law problems could be avoided. It is not clear, however, that such a transfer can be made constitutionally. Under the Constitution Act, 1867 the federal government's power to create courts at the federal level is for the "better administration" of federal laws, while the provinces have the exclusive power to establish courts in the province for the application of all federal and provincial laws. Thus it is not clear that parliament could validly invest the federal courts with jurisdiction in respect of provincial tax laws, and similarly whether a transfer by the provinces of matters exclusively within the jurisdiction of the provincial courts would be valid.

(iii) Single provincial court jurisdiction. It would be constitutionally possible for the provincial courts to take sole jurisdiction in all federal and provincial tax matters. However, provincial courts are inexperienced and lack expertise in tax matters and the potential for duplication and conflicting case law is further exacerbated, not limited, by such a move.

4B Nil Assessments

The problem relating to nil assessments may be resolved without a major change in the appeals system. For example, the law may be amended to provide for an appeal from a nil assessment, or a "determination" procedure similar to that available in respect of losses could be implemented. The granting of appeal rights in general in respect of nil assessments may, however, open the appeals process wider than necessary to deal with the specific problem, both as it now exists and as it may be presented if the tax on income proposal goes forward. For example, appeals in respect of matters which have no bearing on any tax payable for the year assessed should probably continue to be excluded.

A "determination" process would allow a taxpayer to request a determination of taxable income in circumstances where the federal tax is nil but provincial tax is payable. Such determination could then be the subject of an appeal to the federal courts, providing the taxpayer with appropriate rights of appeal in respect of provincial taxes where the issue involves a federally defined component of the tax computation.

4C Appeals Mechanism

Appeals should be provided for under the provincial income tax acts to the provincial courts on all provincially determined tax components of the system to ensure that taxpayers are provided rights of appeal to the courts in respect of their taxes payable. However, the flexibility of the provinces to separately define the components of the calculation of provincial tax should be constrained to confine the necessary jurisdiction of the provincial courts to a narrow range of purely provincial matters, as is now the case. The potential for conflicting interpretations by courts in different provinces and duplication of appeals, with the attendant increased cost and complexity, can thus be held to a minimum.

5 Administration Of Provincial Changes

Amendments to provincial income tax acts are necessitated by changes to the federal Act under the present system, as well as by purely provincial initiatives allowed under the present Tax Collection Agreements. Such changes are often delayed by legislative backlogs in the provincial legislatures, differing legislative priorities in the provinces, changes in provincial governments and so on.

These delays complicate Revenue Canada's role in administering the provincial income tax systems. Revenue Canada cannot legally collect taxes until the laws are enacted which impose them, and where changes are enacted retroactively, it is often impractical or impossible to collect taxes that apply to previous periods.

The change to a tax on income system will require numerous amendments to the provincial income tax statutes, and the greater flexibility available to the provinces under such a system to define the components of provincial income taxes may lead to more frequent and complex amendments. Some constraints will be necessary to allow for effective administration by Revenue Canada of provincially-initiated changes.

Firstly, no provincial change should be made unless Revenue Canada can administer it effectively. Secondly, Revenue Canada should not administer any provincially-initiated change until it is definitive, which may mean that it has to be announced in a provincial budget, and it has to be in draft statutory form or enacted. Thirdly, whatever form is accepted as definitive, the province should be contractually liable to bear any costs incurred by Revenue Canada if the change is administered by it before enactment and is subsequently not enacted by the province.

6 Conclusion

The present essentially single system for the creation, administration and adjudication of income tax laws serves both federal and provincial governments and taxpayers by limiting the costs, complexity, conflicts and duplication that would result if two levels of administration and two levels of courts had to become involved in determining a taxpayer's liability for tax.

Under a tax on income system, increased flexibility may be allowed to the provinces to determine a greater range of components of the provincial tax calculation. Some of the inevitable results of more provincial involvement in legislating in the income tax area include greater differences between federal and provincial income tax laws and therefore assessments of tax, more separate provincially-defined issues to be administered by Revenue Canada and more purely provincial matters that fall only within the jurisdiction of the provincial courts. To the extent that the federal and provincial income tax systems diverge, and the provincial systems diverge from each other, the cost and complexity of administration of all of the income tax laws increases as does the necessity of appeals from reassessments to two separate courts, with resulting duplication, potential for conflicting interpretations and taxpayer confusion regarding the administration and appeals process. Administrative problems resulting from time lags in enacting new or amended income tax legislation may also increase.

Constraints on the flexibility allowed to provinces to separately define components of the tax calculation, and guidelines to define the parameters of Revenue Canada's ability and willingness to administer provincial measures will assist in maintaining the positive aspects of the present single system and in ensuring taxpayers effective rights of appeal.

The reasonable constraints and guidelines may include:

- limiting most provincially determined components in the tax calculation to a percentage or proportion of federally defined components;

- limiting provincial initiatives to those which Revenue Canada considers after careful review to be capable of being effectively administered;

- limiting Revenue Canada's obligation to administer changes to a provincial tax system to those changes that are "definitive" and requiring the provinces to bear any costs of a failure to enact proposed changes that have been acted upon by Revenue Canada;

- restricting the jurisdiction of the provincial courts to hearing purely provincial tax matters i.e., provincial tax issues not dependent on matters determined under federal law. Such matters may increase under a tax on income system and the jurisdiction of the provincial courts to hear such matters should be provided for in the provincial income tax acts, so that taxpayers are afforded effective rights of appeal. However, constraints on the creation of separately defined provincial components will limit the need to expand the effective jurisdiction of the provincial courts.

XIII Interprovincial Considerations

The shift of the provincial personal tax base from a tax on tax to a tax on income is basically desired by the provinces in order to allow them more flexibility in the use of the tax system as an instrument for the implementation of social, and possibly economic policies. It is only reasonable to suppose that, if this flexibility were permitted, the provinces would in fact show substantially greater variances than at present with respect to their tax systems, including rates. Of course, and as previously noted, the likely variations in provincial personal tax regimes would take place, for those provinces which agree to have the federal government continue to collect their personal tax revenues, within the bounds of whatever constraints may be imposed by the federal government as a condition of continuing these agreements. If a province chose to withdraw from the agreements, and impose and administer its own personal income tax system, it would be free of such constraints, but would face the practical limitation that unduly high rates and variations in structure, in relation to other provinces, could impose a significant detriment to its own interests.

1 Tax Induced Change In Residence

If a tax on income regime is adopted, then the first question that arises is whether the greater variation in provincial tax rates - not only the top marginal rate but also in the underlying rates - would have practical considerations for the provinces, and indeed for the country. If, as we have suggested elsewhere, personal taxable income is generally taxed only in the province in which the individual is resident at December 31, then individual taxpayers, in order to obtain some perceived advantage from such differences, would have to be prepared to move their residence. It is supposed that the number of Canadians who are prepared to move solely or principally because of tax differences between the provinces would be relatively small. However, it must be remembered that a number of Canadians may choose, particularly in their retirement years when they are not linked to particular employment, to change their residence, and it may be assumed that if there are larger tax differences between the provinces, these tax differences would become a consideration in certain circumstances in choosing a retirement home.

The possibility exists of course that one province may seek to adjust its tax system so as to attract taxpayers from other provinces, such as by reducing its top marginal personal rate, by granting special concessions in respect of retirement income, or through other mechanisms. The possibility of such interprovincial competition exists not only at the top end of the rate scale - for highly paid individuals, entrepreneurs (particularly those with substantial inherent capital gains where a shift to another province would potentially save significant tax) and retired individuals with high income, but may also exist at the other end of the scale - for a province that offered very substantial advantages, relative to others, for low income individuals.

There are so many considerations that enter into a personal choice of residence that it seems unlikely that even a moderately greater range of rates and tax incentives would significantly influence a material number of individuals to change the province of their residence. The only exception to this might be the case of a province which chose to attract retired individuals from outside the province through targeted tax benefits. If any province did adopt such a strategy, of course it would have to recognize that it would have to bear increased health and other costs that would be related to an increased number of retired taxpayers.

All in all, the possibility of rate competition and interprovincial arbitrage for individuals does not seems large, within any reasonable potential range of tax systems, and whatever tax induced movement does occur would seem to be part of the price that would have to be paid, by the country and by the individual provinces, for the additional flexibility that the provinces are seeking.

2 Choice Of Residence

There are an appreciable number of individuals who, because of their personal lifestyles, may consider that they have a choice as to which province they establish or claim as their province of residence at December 31. These individuals may include some students, certain workers with mobile lifestyles, and a number of others. Residence is of course a question of fact to be determined on the principles developed in a number of court cases and set out in Revenue Canada Interpretation Bulletins. While individuals may not, in the strict application of law, have a choice as to where they are resident for tax purposes, in practice this may be a difficult area for Revenue Canada to monitor. There are areas in Canada - Hull Québec and Ottawa Ontario, and the Alberta and Saskatchewan sides of Lloydminister - where such a personal shift may be particularly easy. Provinces imposing relatively higher rates or more onerous regimes, even in limited areas, may therefore find that they lose revenue as a result of such arbitrage.

3 Interprovincial Shifts Of Investment Income

There is an additional point in connection with individuals who have substantial investment income - either current interest income or potential capital gains. It is difficult to move employment income from the tax regime of one province to that of another without physical movement of the individual. However, there are a variety of tax planning mechanisms that will enable individuals with substantial current or potential investment income to shift that income elsewhere in Canada. One possible mechanism might involve the use of personal trusts, whose residence might be established in a low-tax province in order that individuals escape the higher taxes that would be imposed in their own province of residence.

Again, such tax planning opportunities are available now, with respect to the present variation in provincial tax burdens, and while some interprovincial tax planning is undoubtedly occurring we have found no evidence that it is substantial. If tax differences between the provinces increase - particularly in the top marginal rates - we would anticipate some increase, possibly modest, in such interprovincial shifting of income. We have concluded however that this is simply part of the price the provinces must pay for the flexibility that they are seeking, and that provinces which impose a more onerous tax regime than others must anticipate some revenue loss as a part of the cost of this particular change. Preventing such interprovincial shifting would require complex anti-avoidance provisions in the law, which could be ineffectual unless backed up by substantially expanded enforcement and administration. In view of the heavy costs of any such effort to prevent interprovincial shifting, and of our belief that this is a natural part of the evolution towards flexibility, we recommend no change in legislation in this area.

4 Interprovincial Barriers Harm Canada

A larger issue is the possibility that the increased flexibility offered to the provinces could result in the creation of new interprovincial barriers to trade and capital, to the detriment of the Canadian economic union. Already, some provinces have offered incentives which are linked to investment only within the province, largely to residents of that province. If such incentives became more widespread and more important, the free flow of capital between provinces could be inhibited, with the result that the allocation of capital within Canada would be less than the optimum.

As a matter of judgement, we have concluded that present and past provincial incentives do not appear to have been so large as to result in material distortions in the capital flows within the country. But we regard the possible increase in such incentives, through new provincial incentives to attract (or restrict) investment to a particular province, as being potentially damaging to the broad interests of the country as a whole.

5 Conclusion

Based on informal discussions with representatives of certain provinces, it seems likely that at least some provinces would want the flexibility to introduce new provincial incentives, as part of their policies to encourage local investment or local economic activities. The federal government announced in 1981 that it would only administer special measures on behalf of the provinces if they:

- respected the common tax base;

- did not impede the free flow of capital, goods, services and labour within Canada; and

- could be administered effectively.

We therefore suggest that the federal government review and formalize these existing guidelines in conjunction with and as part of any new agreements based on tax on income with agreeing provinces.

We suggest that the existing guidelines be adhered to with possibly some further guidance given such as the following:

- the incentives must respect the common tax base;

- only provincial incentives based on specified provincial investments, clearly defined, would be permitted;

- any such new incentives could not impede the free flow of capital, goods, services and labour, as for example, providing that no province could offer a tax benefit to any individual in excess of a stated maximum;

- the incentives would be restricted to simple direct provisions capable of being readily administered, through some reporting system, by Revenue Canada; and

- the provinces would agree to pay the additional costs of administration resulting from such programs.

We recognize that provinces who wish to provide larger or more extensive incentives can do so outside of the tax system, but this opportunity is already available to them.

XIV Conclusion

Our terms of reference did not call upon us to make any judgement as to whether a shift from a tax on tax to a tax income regime should be adopted. Rather, we were asked to analyze and comment upon the various implications that such a change could involve and advise on the approach that should be followed if such a change takes place.

The change is basically desired by the provinces in order to permit them greater flexibility in the implementation of their policies. But it is this greater flexibility that gives rise to the danger that such a change would add new elements of complexity, administrative costs to taxpayers and tax collectors alike, unintended unfairness or loopholes, and dangers to the efficiency of our economic union and interprovincial trade and capital flows. It is important to note that the dangers largely come from the increased flexibility that might be achieved by the provinces, and which the provinces are indeed seeking as part of the change: the dangers are only marginally associated with the shift in the tax base itself.

For example, it is quite possible to envisage a shift from a tax on tax system to a tax on income system, in which the federal government would require the provinces to simply impose their taxes, in the existing federal tax brackets, and at rates which parallel federal rates on federal taxable income and grant a flat specified percentage credit on the entire amount of the federal non-refundable credit block, without any other adjustment. Such a system would likely be no more complicated, after transition, for either taxpayers or tax collectors than the present system - indeed it could be less complicated - but it certainly would not satisfy the provinces' desire for increased flexibility.

On the other hand, a tax system which allowed the provinces substantial elements of flexibility in adjusting provincial income tax burdens relative to provincial priorities, through introducing new provincially determined parameters and complex adjustments in relation to federal credits, would clearly result in substantial additional complexities and compliance costs if the provinces used this flexibility to the ultimate. In some areas, it would be possible to reduce the complexity that would flow from provincial flexibility through adopting ad hoc or arbitrary rules - but the rules themselves would introduce elements of unfairness to the system.

The real issue in the debate on the shift to tax on income is the appropriate constraints that the federal government might impose on the provinces as a condition of continuing to collect their personal tax revenues. Such constraints should be reasonable, adopted for articulated reasons, and responsive to both provincial concerns and to the welfare of all Canadians.

The issue is obviously one of balance and compromise. If the federal government were to impose unreasonably strict constraints, then the provinces would have no answer to their request for increased flexibility and the danger of additional federal-provincial confrontation would arise. Some provinces could in such a situation move to exercise their clear constitutional right to impose and collect their own personal tax revenues, under whatever tax regime they felt appropriate. In doing so, they would of course have to face both the significant administrative costs - to the province and to its taxpayers alike - of setting up a separate regime involving separate deductions, information slips, tax returns, assessments and enforcement, and the political cost of imposing perceived additional burdensome requirements on their residents. If the federal government does not come forward with reasonable proposals that appear at least partially responsive to provincial concerns, there is the danger that some provinces will accept these costs of setting up their own tax systems. The harm and costs to taxpayers, and to the economy, of such separately administered provincial systems are potentially substantially more than the costs that are associated with permitting some reasonable range of provincial flexibility within a federally administered system.

On the other hand, the federal government must adhere to certain basic policies if it continues to administer the income tax systems of the agreeing provinces. There are definite limits beyond which the federal government should not go in extending greater flexibility to the provinces, such as in allowing the federal administration to be used to administer discriminatory features that adversely affect the national economy, that require overly complex adjustments that would stress the overall tax system, or that involve unfairness to individual taxpayers.

In our view, a change from a tax on tax to a tax on income regime with substantial elements of provincial flexibility will result in significant additional complexities and costs, largely falling on individual taxpayers. Tax returns will be more complex, payroll deduction requirements could be more onerous, and the entire tax system, from the viewpoint of taxpayers, would be even more difficult to understand than it is at present. Such costs and complexities are serious, but as noted above, are likely less than the costs and complexities that would be imposed if the provinces levied and administered their own tax systems if this were the alternative.

In addition to the additional costs and complexities, a shift in the tax base would give rise to a number of technical problems; some of them of considerable complexity. While these technical issues will be of concern to some taxpayers, and may cause them some problems, we believe that there is a range of sensible and reasonable solutions - some admittedly involving compromise - for most of these issues.

We have suggested in this report what we perceive to be a range of practical solutions to the technical issues that would arise in the shift of the tax base. We have also suggested a range of constraints that might reasonably be imposed by the federal government as a condition of continuing to administer the provincial personal tax systems.

We have concluded that the essential issue is the conflict between the request of the provinces for flexibility to meet provincial objectives, and the desirability of maintaining a large degree of common features in a federally-administered federal and provincial personal income tax system. If the Tax Collection Agreements are changed to allow the provinces to impose personal income taxes on taxable income, with very substantial flexibility in terms of the design of the provincial system, then the total federal-provincial tax regime is likely to be made significantly more complex from the point of view of taxpayers, and is likely to include some arbitrary elements providing unfair results. If, on the other hand, the shift to a tax on income regime proceeds with virtually no enhancement of provincial flexibility, then the result, while administratively acceptable and providing some advantage in transparency, may not satisfy provincial objectives. Reconciling these two conflicting scenarios will require compromise and understanding.

A shift in the basis of provincial tax from a tax on tax regime to a tax on income with real flexibility is not likely to be greeted with enthusiasm by individual taxpayers, as inevitably such a shift will be accompanied by some additional elements of complexity and compliance difficulty, and by some degree of arbitrariness to offset such difficulties. However, such a shift in tax base is responsive to clearly articulated provincial objectives, and broad trends of providing additional flexibility and autonomy to the provinces.

With goodwill and direct negotiations relating to the issues summarized in this paper, it may be possible to achieve a regime that represents a reasonable compromise between the conflicting policy and technical issues that we have identified. However, we have observed that the two levels of government have not yet had a full opportunity to develop a position with respect to the various technical and practical issues that will arise in such negotiations, and in particular that the provinces may require additional time to examine the trade-offs that we have identified. An overall acceptable solution can only be developed in direct discussions between the federal government and the agreeing provinces after a review of the relevant issues and their underlying implications.

Appendix A

Evolution Of Federal-Provincial Tax Collection

A brief history of the route to this tax collection arrangement gives some idea of the trade-offs and considerations which enter into the negotiation of changes to the system.

- At Confederation the federal government was given unlimited powers of taxation reflecting the costly responsibilities assigned to the central government such as the development of roads and railways for the new nation. From 1867 onward "the tariff" which previously raised the majority of the original provinces' revenues was assigned entirely to the federal government.

- Provinces were assigned limited responsibilities and were restricted to direct taxation within the provinces. This was done chiefly to restrict taxing powers only to residents of the particular province and also since, other than property taxes, it was such a poorly accepted concept that it was felt it would not get extensive use.

- As a result of this re-balancing of revenues and costs, the provinces were not able to balance their budgets and therefore the concept of federal subsidies emerged.

- From the beginning, issues of provincial disparities had to be balanced with even-handedness and a national standard.

- Despite these efforts, minor variations were given and used as precedents for each new province entering Confederation.

- A long period of depression in the last quarter of the 1800's pushed the provinces to look for new revenue sources. Provinces began to experiment with expanded forms of direct taxation including land transfer taxes, corporate place of business taxes and succession duties. Personal income taxes were imposed in two provinces.

- Although there was a renegotiation of the subsidy amounts in 1907, the original financial arrangements remained in place. There grew throughout the years since Confederation an implied understanding that the federal government would not impose direct taxes which was ended with the announcement in 1917 that the federal government would impose both personal and corporate income tax.

- The next major changes occurred as a result of the 1930's depression. As provinces and the federal government strived to remain solvent, each raised existing taxes and imposed new taxes. The result was an administrative hodge-podge. In addition, further provincial subsidies were paid and other mechanisms for transfer of funds to needy regions were developed.

- The 2nd World War and a report generated in 1940 by a special commission (The Rowell-Sirois Commission) established in 1937 to study Dominion-Provincial relations resulted ultimately in two major changes:

  (i) the transfer of responsibility for relief of the unemployed to the federal government, and

  (ii) the agreement by the provinces to abstain from taxing corporation and personal income in return for compensation payments referred to at first as the Wartime Tax Agreements and then as Tax Rental Agreements.

- Further negotiations in 1945 resulted finally in 1947 in significant sharing of responsibilities previously assigned to the provinces such as health insurance and old age pensions.

- The agreements involved many trade-offs in terms of revenue sources and were only finalized with the majority of the provinces by providing three options to choose from in terms of their compensation payments. Even so Ontario and Québec, rejected the arrangements and imposed their own corporate and inheritance taxes.

- The agreements were not long term commitments since they were renegotiable at periods varying from three to five years.

- Over the years provinces negotiated new indirect taxing powers (i.e., sales tax at the retail level) and Ontario became an agreeing province. Some of the changes in powers and responsibilities required changes in the Constitution.

- In 1957 the agreements were renegotiated as Tax Sharing Agreements which gave the provinces the choice of receiving abatements from federal taxes and levying their own tax or simply sharing the revenue collected by the federal government. They also provided for Equalization payments to bring all provinces' per capita yield from the three taxation fields (personal, corporate and succession) up to the average of the two highest provinces yield and also Stabilization payments to ensure that the yield from the tax collected plus Equalization did not fall below a minimum level.

- All provinces except Ontario and Québec opted for the sharing of federal tax collections - Québec continued to impose all three types of taxes and Ontario imposed a corporate tax.

- In 1962, in recognition of continuing pressure to recognize provincial autonomy and needs, the sharing arrangements terminated and were replaced with Tax Collection Agreements. Under the agreements, provinces imposed their own taxes in the major tax fields of corporate and personal income taxation while still benefitting from federal collection and administration. Although the provinces enjoyed new freedom to set their own rates, the limiting factor was the political pressure to have uniform rates amongst the provinces. In fact most chose to increase other taxes, such as sales or gasoline taxes, rather than changing corporate or personal rates.

- The federal government imposed conditions on the new arrangements in that it was prepared to collect provincial taxes free of charge providing that the provincial tax base was identical with that of the similar federal tax.

- A new era of negotiation commenced in 1963 whereby some provinces , led by Québec, negotiated opting out of joint programs in return for further tax room provided by abatements to federal taxes.

- At the same time the Tax Structure Committee was established to conduct a complete and fundamental re-examination of federal-provincial fiscal arrangements.

This tax on tax basis of provincial personal taxation administered by the federal government is the fundamental structure which has continued since 1962 with the notable exception of Québec. In the corporate tax area, the federal government continues to administer the corporate tax systems (based on tax on income) of all provinces except Ontario, Québec and Alberta.

Negotiations have continued over the past 30 years on the existing personal tax arrangements. However, through the period the basic tax on tax system has not fundamentally changed but has been substantially modified by provincial initiatives implemented through tax credits and surtaxes and more recently flat taxes.