Government of Canada
Tax Expenditure Account

A conceptual analysis and account
of tax preferences in the federal
income and commodity tax systems

December 1979

Department of Finance
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I INTRODUCTION

The Canadian tax system contains a number of provisions that give preferential treatment to certain groups of individuals or businesses in the form of tax exemptions, deductions, reduced tax rates, or tax credits. The purpose of these provisions is to grant a subsidy or incentive for those engaging in a specific activity or for those in certain special circumstances by lowering or deferring their tax liabilities. In addition, the Canadian tax system contains provisions which reduce or eliminate tax in respect of certain activities carried on by other governments. Such tax forgiveness or postponement is equivalent to the government first collecting the sums involved by imposing tax on a more comprehensive base at uniform rates and then making a direct expenditure or loan in an amount equal to the revenue forgone due to the tax preferences. Such provisions have thus come to be called tax expenditures.

Tax expenditures are a means by which the government can pursue public policy objectives and, as such, they can be viewed in most cases as alternatives to direct budget outlays or other policy instruments. Indeed, both tax expenditures and direct budget outlays are used to meet many of the same objectives. Tax expenditures are used to encourage economic and social activities such as saving, investment, regional development, housing, resource exploration and development, and charitable giving. They have been used to aid taxpayers who suffer from special economic hardships such as the disabled, the elderly, or those with large medical expenses. They have also been used for effecting a fiscal transfer from the federal to provincial and municipal governments. Thus a full accounting of the government's fiscal effects on private sector and other governments' activities involves not only a catalogue of direct expenditures but also a listing of tax expenditures, the value of subsidies, implicit grants, or preferences delivered through the tax system in the form of forgone or postponed tax revenue. Also, because both tax and direct expenditures are used for many of the same objectives, it is desirable that information on both types of policy instruments be readily available for purposes of informed and rational policy formulation and decision making.

Information on direct spending is available annually from Main Estimates and the Public Accounts. With tax expenditures, information has been available in the Supplementary Budget Papers at the time of their introduction or on the occasion of significant changes. Also, information is available from Revenue Canada's annual publication, Taxation Statistics, and Statistics Canada's annual publication, Corporation Taxation Statistics. However, this information has not previously been collected in the more accessible form of a tax expenditure account.

This paper seeks to fill, at least partially, this information gap by introducing a Canadian federal tax expenditure account. This paper describes and analyses the concept of tax preferences or tax expenditures, provides a description of individual tax expenditure items, quantifies their magnitude where possible, and discusses in brief some of the considerations involved in the choice of providing an incentive through the tax system or by an expenditure program. While the data both in this tax expenditure account and in the Public Accounts give only the total amount of expenditure under each provision or program, as well as a brief description, these data provide the basis for assessing overall government priorities and the extent of government activity in various policy areas.

The concept of a tax expenditure account is not new. The United States has been publishing a tax expenditure account since 1969 and its publication became required by statute in 1974.(1) West Germany has also been publishing such an account biennially for more than a decade.(2) The U.K. Public Expenditure White Paper in January, 1979 released figures for the first time on the entire range of reliefs and allowances that underpin the United Kingdom's direct tax system.(3) Various private sector groups and academics have constructed partial listings and estimates of Canadian tax expenditures.(4)

In part, the reason a tax expenditure account for Canada has not been produced before this time has been a lack of adequate and appropriate data. While this problem continues, it is clear that the tax system and its tax expenditures have come to play a very important role in government policy. It was thus felt that an initial effort to prepare such an account should be made even though estimates of the values of all tax expenditure items are not yet available.

At the outset, it is important to emphasize that an accounting of tax expenditures is not an evaluation of government tax policy. The accounting does not question the desirability of the goals of the tax provisions nor their effectiveness in achieving the goals. It is not a list of tax loopholes or areas for tax reform. Its purpose is no more than to provide the basic information on which such evaluations can be based.

(1) Special Analyses, Budget of the United States Government; Part G; U.S. Government Printing Office; Washington, D.C. 20402; various years.

(2) A "subsidy report" is appended every other year as part of the annual budget forecast of the federal government of the Federal Republic of Germany.

(3) The Government's Expenditure Plans 1979-80 to 1982-83; London; HMSO Cmnd 7439; January 1979; pages 17-29.

(4) For example, published studies of Canadian tax expenditures include: Roger S. Smith: Tax Expenditures: An Examination of Tax Incentives and Tax Preferences in the Canadian Federal Income Tax System, Canadian Tax Foundation, 1979; Jonathan R. Kesselman: "Non-Business Deductions and Tax Expenditures in Canada: Aggregates and Distributions", Canadian Tax Journal, March-April 1977; National Council of Welfare: The Hidden Welfare System and The Hidden Welfare System Revisited, Ottawa, November 1976 and March 1979; and David B. Perry: "Corporation Tax Expenditures", Canadian Tax Journal, September-October 1976.

This paper is concerned with the tax expenditures provided through the federal individual and corporate income taxes and the sales and excise taxes. It does not cover any tax expenditures that may be embodied in other federal legislation such as the customs tariff, social security taxes under the Canada Pension Plan or the Unemployment Insurance program, or tax expenditures embodied in various Canadian tax treaties with other countries.

II GENERAL CRITERIA FOR DEFINING TAX EXPENDITURES

While tax expenditures take the form of deductions, exclusions, exemptions, lower tax rates, tax credits, etc., not all such provisions in the various tax statutes are tax expenditures. For example, deductions for expenditures incurred in earning income are necessary in order to properly define net income under any income tax. It is therefore necessary to define a benchmark tax structure, deviations from which are to be classified as tax expenditures. Without an explicit benchmark, or a set of criteria for defining the benchmark, any discussion of tax expenditures runs the risk of focussing on the merits or desirability of this or that tax provision which, as noted above, is not the purpose of a tax expenditure account. Rather, the purpose is simply to provide information in as clear and useful a form as possible.

The benchmark tax structure is not defined by legislation. It is, rather, a concept based on some notion of what the tax structure would be in the absence of tax expenditures. Since the benchmark tax structure is an abstraction, there will always be room for legitimate disagreement about its nature and, thus, about whether certain tax provisions are properly characterised as tax expenditures. However, even though reasonable people may differ as to which tax provisions are tax expenditures, this should not obscure the fact that for most provisions, there will be little dispute. Nor would any such disagreement diminish the usefulness of a tax expenditure account as a source of information. Indeed, the process of classifying tax expenditures is an ongoing one and, as circumstances change, certain items may be added to or removed from the account.

In order to be as rigorous and consistent as possible in delineating provisions that are tax expenditures, an explicit set of criteria will be used.

The main criterion to be used in this analysis is neutrality. Specifically, the benchmark tax structure is one that provides no preferential treatment to taxpayers on the basis of demographic characteristics, sources or uses of income, geographic location, or any other special circumstances applicable only to a given taxpayer or to a particular group of taxpayers.(5)

While this neutrality criterion will be the principal criterion used to identify tax expenditures, it may not provide sufficient guidance in some cases as to whether or not a given provision should be classified as a tax

(5) It should be noted that neutrality is not being used here in any technical sense. For example, it is not used in the sense of implying that the benchmark tax system should have no impact on relative prices. Rather, it is being used in a sense more akin to the concept of horizontal equity or the idea of being non-discriminatory.

expenditure. Also, a strict adherence to this criterion may lead to a benchmark tax structure that bears no resemblance to the actual tax structure in place. For these reasons, and in keeping with the informational purposes of this tax expenditure account, additional criteria will be used to modify or supplement the neutrality criterion:

(i) The definition of the benchmark tax structure should not depart dramatically from the public perception of the current tax system. This pragmatic criterion is dictated by the fact that the purpose of the tax expenditure account is to provide information and not to indulge in the academic exercise of defining an ideal tax system.

If the benchmark tax structure deviates too far from current perceptions, the tax expenditure information will not be useful in policy analysis. For example, it could be argued that the definition of income under an ideal, neutral tax structure should include the value of services provided by spouses and other individuals at home as well as the value of leisure time. Whatever the theoretical merit of characterizing these exclusions from income for tax purposes as tax expenditures, the suggestion that they should be included in a neutral tax structure is such an extreme departure from the actual Canadian tax system that their classification as tax expenditures is rejected on the grounds of pragmatism.

(ii) Whenever there is uncertainty or disagreement about the treatment of a given tax provision, the analysis should err on the side of comprehensiveness and include the provision in the tax expenditure account. This criterion is adopted because the purpose of the exercise is informational. The inclusion of borderline provisions is likely to best serve this purpose. Readers who do not wish to consider particular items in the account as tax expenditures are of course free to do so.

(iii) A tax provision which may be neutral for all taxpayers while at the same time clearly being functionally equivalent to a direct spending program should be classified as a tax expenditure. The main example here is the abatement of personal and corporate income taxes as a substitute for direct federal grants to provinces for cost-shared programs, specifically in the areas of post-secondary education, medicare, and hospital insurance. In such a case, where it is clear that the provisions have been designed as a direct substitute for a direct spending program, they will be considered as a tax expenditure.

(iv) Partial or ad hoc tax provisions should be viewed as tax expenditures despite the fact that the same provisions, comprehensively applied, could be part of the benchmark tax system. For example, the benchmark tax structure should, if it is to be neutral, be based on real income and therefore both the rate structure and the tax base should be indexed for price inflation. Thus, the current comprehensive indexing of the personal income tax rate structure (basic personal exemption and tax brackets) is not viewed as a tax expenditure. However, if indexing provisions are applied only partially (e.g. the 3-per-cent inventory allowance), they should be viewed as a tax expenditure.

It may be noted that the criteria listed above are not identical to those used in various other tax expenditure accounts or budgets. As a result, the respective tax expenditure lists are not comparable. For example, the primary criterion used in the preparation of the U.S. tax expenditure budget is the conformity of a given tax provision to "widely accepted definitions of income and standards of business accounting and ... the generally accepted structure of an income tax". Any deviations from "generally accepted" practices or standards are thus defined to be tax expenditures. While the neutrality and the "general acceptance" criteria would yield similar results in most cases (reflecting the fact that neutrality itself is a generally accepted criterion), they are not identical. For example, the general averaging provisions and the exemptions for dependent children may be generally accepted, but they are not necessarily neutral.(6)

(6) Two further examples of criteria used in the U.S. analysis but not here are the exclusion of provisions which are not quantifiable (though the U.K. list includes such provisions), and items "where the case for their inclusion in the income base stands on relatively technical or theoretical tax arguments". As a result of this latter criterion, the U.S. tax expenditure budget does not include the non-taxation of imputed income on equity in owner-occupied housing, while on the basis of the neutrality criterion, this analysis does. The quotations are from Exhibit 29. "The Tax Expenditure Budget: A Conceptual Analysis" in the Annual Report of the Secretary of the Treasury on the Finances for the Fiscal Year Ended June 30, 1968, pages 327 and 329.

III MAJOR CONCEPTUAL ISSUES IN DEFINING TAX EXPENDITURES

For purposes of identifying tax expenditures, both specific tax provisions and broader aspects of the tax structure must be examined. A number of fundamental issues arise in delineating the broad aspects of the benchmark tax structure, issues that affect whether or not groups of similar or related tax provisions give rise to tax expenditures. These basic conceptual issues are discussed in this section, making use of the criteria defined above. First, those issues that apply to more than one of the individual income tax, corporate income tax, and commodity taxes are discussed. Then issues specific to each of these taxes are discussed in turn. Finally, the appendix describes each tax expenditure item individually along with the reasons it has been classified as such.

A. GENERAL ISSUES

1. Tax Unit and Relation Between Individual and Corporate Income Taxes

It is necessary that tax expenditure accounting clearly address the relation between the individual and corporate income taxes under the benchmark tax structure. This issue is really an element of the general question of the definition of the tax unit, i.e. whether corporations and individuals are separate tax units. (The relationships among corporations within the corporate sector is discussed separately below.) It may be argued that application of the neutrality criterion implies that corporate source income should be taxed in the hands of individuals at the same rates as other sources of income. In other words, the benchmark tax structure should take the corporate and individual income taxes as integrated. In this way, there would be no difference in the taxation of business income whether or not the business itself was incorporated. Such benchmark treatment of the corporate and individual income taxes would imply that tax expenditures at the corporate level be allocated to shareholders and valued at their respective tax rates.(7)

(7) The argument that the neutrality criterion implies full corporate and individual income tax integration is most forceful in the case of small closely-held corporations. In these cases, it is particularly evident that it is individuals, not corporations, that ultimately bear tax and hence that it is necessary to "look through" the corporation to its owners in assessing the operation of various tax preferences. However, it should be noted that an alternative view is possible, particularly in the case of large public corporations. With these corporations, there is a significant divorce between ownership and control. As a result, they have come to be viewed as having a life of their own, distinct from their shareholders. According to this view, large corporations are indeed distinct entities and consequently their income provides a distinct tax base.

The present tax system, however, contains only limited integration between the corporate and individual income taxes. Corporations and individuals are treated as distinct entities in the law and each is taxed on its income at a different set of tax rates. This may be viewed as resulting in "double taxation" if a corporation first pays tax on its earnings and then these earnings are again taxed when they are paid out as dividends to individual shareholders. Such double taxation of earnings distributed to shareholders is reduced partially (but, in the case of small business, by more than the amount of potential corporate tax) by the current dividend gross-up and tax credit for individuals. Under the present system, individuals first "gross-up" their dividends to the notional "pre-corporate-income-tax" earnings on which they are based, compute their individual tax on this grossed-up amount, and then apply a tax credit equal to the assumed notional amount of corporate income tax paid on the earnings underlying the dividend. This system does not provide full or systematic integration of the corporate and individual income taxes for two reasons. First, the assumed notional amount of corporate income tax used in determining the amount of gross-up and tax credit is not the actual amount paid. In the case of small businesses, the assumed amount is typically larger than the actual amount resulting in "over-integration". Second, there is no integration with respect to undistributed corporate income. Individual income tax on such retained earnings may be deferred or realized as capital gains income which is accorded preferential treatment. Thus, a fully integrated income tax system would be fundamentally different from the actual Canadian income tax system. Such a structure would not provide a useful reference or benchmark for delineating tax expenditures.

As a result, on pragmatic grounds, the benchmark tax structure will be taken as one in which there is a separate income tax base at each of the corporate and individual levels. Distributions from corporations in the form of dividends out of tax-paid corporate profits are treated as income in the hands of individuals. Any special treatment of select corporations (e.g. fast write-offs in manufacturing) represents a tax expenditure benefitting corporations and the revenue forgone is determined by the applicable corporate income tax rate.

Under this strict separation, the whole of the dividend gross-up and tax credit at the individual level is logically a tax expenditure, even though it serves partly to alleviate the impact of double taxation on corporate-source income. Such separate treatment is equivalent to the way direct expenditures are generally viewed in that it treats corporations as entities with their own existence. For example, programs of grants to firms in particular industries or regions are generally viewed as grants to given corporations and not as benefits to those corporations' shareholders.

2. Tax Bases and Inflation Adjustment

Inflation distorts the calculation of individual and corporate income tax liabilities under an unindexed tax system in two ways. First, purely nominal increases in income which just keep up with inflation will push individual taxpayers into higher tax brackets, thereby causing their real tax liabilities to rise. Second, inflation distorts the measurement of business and investment income because the former is based on historical-cost-accounting concepts and because part of nominal investment income which is included in income for tax purposes (e.g. capital gains and interest income) represents a compensation for the decline in the real value of financial assets and does not add to the purchasing power, or ability to pay, of the individual recipient. For example, an increase in interest rates that exactly matched an increase in the rate of inflation would not increase the real income of the lender. However, it would increase his taxable income under a tax system that was not fully indexed, or under a tax system where only the tax brackets were indexed.

The tax base of the benchmark income tax system should ideally be real income. This implies two broad types of inflation adjustments. First, to the extent that rates of tax are progressive rather than proportional, the rate brackets should be indexed. Second, the business and investment income base would have to be defined in real terms. The current individual income tax indexing of the basic personal exemption and tax brackets, which is comprehensive and broadly based, provides the first type of adjustment and is thus treated as part of the benchmark tax structure. The tax savings from this indexing are distributed among all taxpayers, and no particular groups are given preferential treatment.

It may be noted that there are a number of other amounts in the income tax system which are not indexed, for example the limits on Registered Retirement Savings Plan (RRSP) contributions and on the small business deduction. However, since these limits serve to define the size of various tax expenditures, the fact that they are not indexed is not considered to be a separate departure from the benchmark tax structure.

The current income tax system does not include systematic inflation adjustment of business and investment income under the corporate and individual income tax systems, the second broad type of adjustment. To do so would involve special inflation adjustment deductions for inventories, and physical and financial assets. As well, it would be necessary to include in income any gains on taxpayers' outstanding net debt to reflect the fact that repayments are less in real terms in an inflationary environment.(8)

While it is possible, in theory, to design the nature of these comprehensive adjustments, the benchmark tax system proposed here does not contain inflation adjustment of investment or business income. This decision is based on the considerable degree of controversy among interested parties and the accounting profession as to the exact nature of the adjustments that would be appropriate under an inflation adjusted system. Indeed, some

(8) A comprehensive system of inflation accounting for income tax purposes would involve the following basic adjustments: changes to capital cost allowances to reflect differences between current and historical costs of depreciable assets, changes in costs of goods sold to reflect the impact of price changes on the value of inventories, a reduction in the amount of interest costs deductible to reflect real as opposed to nominal interest income, and changes to the cost base of capital assets to include only real as opposed to nominal capital gains in income.

have argued that these adjustments would be too complex to be feasible. In this environment, for pragmatic reasons, it does not seem appropriate for the federal tax expenditure account to presume the detailed nature of any such adjustments.

Measures such as the 3-per-cent inventory deduction and the $1,000 investment income deduction, which serve to offset the effects of inflation on business and investment income, are thus counted fully as tax expenditures. These are partial and ad hoc responses and their benefits are not distributed in a neutral fashion.

A large portion of the manufacturers' sales tax revenues is derived from ad valorem levies; that is, the tax is levied as a proportion of the sale price of the item. Such taxes are automatically and inherently indexed to the prices of the respective commodities. However, the portion of this tax applying to gasoline is derived from specific levies, so much per unit. These taxes are not indexed, so that in a period of inflation, their relative impact falls. Under the benchmark tax structure, these specific levies would be kept constant as a proportion of the value of the particular commodity.

3. Tax Rates and Treatment of Broad-Based Tax Cuts and Tax Increases

General broad-based tax cuts pose difficult problems in defining a benchmark tax structure. According to the neutrality criterion, any tax cuts available to all, without any reference to special circumstances, do not constitute tax expenditures. They can be regarded instead simply as adjustments to or changes in the rate structure of the benchmark tax system.

It is, however, not always clear to what extent such tax cuts can be said to be neutral or to provide preferential treatment to any individual or group of individuals. Analysis of any such favouritism in any particular case quickly leads to questions about whether a given cut favours, for example, income tax payers at the expense of sales tax payers. Also, to be non-discriminatory, should such a cut apply equally in dollar terms to all, or as an equal proportion of tax otherwise payable, or as an equal percentage of income?

To illustrate these difficulties, consider the recent 3 per cent federal sales tax cut, which did not apply to tobacco, alcohol or gasoline. As it is thus non-neutral it could be classified as a tax expenditure. However, given the limited nature of these exclusions, most would not view the cut as a tax expenditure. As another example, consider the federal individual income tax cut of 9 per cent, minimum $200, maximum $500. This cut may be seen as favouring lower- and middle-income taxpayers and could thus be viewed as a tax expenditure. However, to do so would imply conceptually that any deviation from a proportional tax system constituted a tax expenditure.

Thorny issues illustrated in these examples are not likely to be easily resolved. For reasons of pragmatism most broad-based tax changes will not be viewed as tax expenditures.

4. Tax Penalties and Negative Tax Expenditures

Government policies can be achieved both by levying lower taxes than usual for certain activities, i.e. tax expenditures, and by imposing tax penalties or higher than usual tax rates on specific items, activities, or transactions. The neutrality criterion implies that taxes at higher as well as at lower than normal rates should be identified as departures from the benchmark tax structure. The fact that these result in higher tax revenues than otherwise suggests that these provisions might be called negative tax expenditures or tax penalties. However, in these cases the analogy with direct budgetary outlays is not nearly as good as in the case of tax expenditures, since it is difficult to conceive of using direct expenditures to penalize any given activity.

Such negative tax expenditures or tax penalties serve a range of objectives. First, they may be used to penalize or discourage certain types of activities. In this regard they are analogous to regulations. If there is a policy to restrict a given activity, the alternatives open to the government include outright prohibition, licensing those who carry on the activity, or imposing a tax. While these alternatives differ in the specific manner of their impact, conceptually they all serve a similar purpose. Examples of such types of tax provisions include the excise tax on heavy fuel-inefficient automobiles, and the non-deductibility of advertising expenses in foreign media.

Second, such provisions may serve the purpose of raising revenues from specific groups to finance public services or benefits provided to those groups. In this case, the levies are analogous to fees or user charges. An example of such levies is the air transportation tax, designed to recoup from air travellers a portion of the federal costs of providing air transportation services.

Third, they may serve to increase the price to consumers of certain products whose production costs do not fully reflect the social costs of consuming the product. For example, smoking and alcohol consumption can produce adverse effects on health which have a wide range of social costs such as reduced labour force productivity and increased costs of health care. Higher levies on these products, at least in part, recognize these effects. They have also come to serve general revenue-raising purposes.

Fourth, such provisions may serve an administrative function. Often these provisions take the form of limitations or arbitrary rules relating to deductions which result in lower deductions than would be claimable under the benchmark tax system. The purpose of such rules is to provide certainty, clarity, simplicity, and administrative feasibility to the tax system in cases where the appropriate amount of any taxpayer's deduction would be exceedingly difficult to determine. An example is the prohibition of deductibility of certain employment expenses and the substitution of an amount equal to 3 per cent of employment income, maximum $500. In this case, some of the disallowed deductions would in fact be legitimate expenses to earn income. However, distinguishing the portions that were indeed legitimate would typically be difficult or impossible. As a result, a general rule is adopted as an approximation which in some cases results in insufficient deductions being allowed and may, in other cases, allow a greater deduction than would be warranted.

All such provisions in the nature of tax penalties and negative tax expenditures are listed separately as memorandum items. Such a separation is desirable for the reason, among others, that their revenue impact is opposite to that of provisions identified in the main part of the account.

5. Federal-Provincial Fiscal Relations

Both the provinces and the federal government levy individual and corporate income taxes. This is an area where policies have been and are continually evolving (along with the terminology). During the post-war period, the joint use of these tax bases has been accomplished via a series of tax rental or tax collection agreements. These agreements are part of a broader structure which includes federal equalization payments, cost-shared programs, and revenue guarantee programs. In a number of instances, federal direct expenditures on cost-shared programs have been partially replaced by federal income tax abatements, i.e. reductions in federal income taxes which are matched by increases in provincial income taxes (both individual and corporate). These are sometimes referred to as a transfer of tax points or "tax room" from the federal government to provincial governments.

As noted earlier, some of these tax abatements or "tax transfers" will be considered as tax expenditures, based on the criterion of functional equivalence. Specifically, the first item is the special federal income tax abatement for Quebec residents which is provided as a substitute for direct federal contributions under various shared-cost programs. This could also be classified as a tax expenditure based on the neutrality criterion since it applies only to a specific group of taxpayers. Second, in 1967 and 1977 transfers of tax points to all the provinces occurred, first in respect of federal payments for post-secondary education, and then for federal payments for hospital insurance and medical care. These reductions in tax rates to effect the transfers were general and could thus not be considered tax expenditures by virtue of favouring any particular group of taxpayers. Nevertheless, the tax point transfers are also functionally equivalent to direct spending being, in fact, direct substitutes for a portion of the original expenditures. It is also notable that the current value of the tax point transfers enters explicitly into the calculation of the total amounts of direct spending under the present formulae for payments to provinces in respect of post-secondary education, medicare, and hospital insurance, and is indeed one explicit component of the cost-sharing package. These tax point transfers have thus been included as tax expenditures. Their value in 1979 in terms of forgone income tax revenue is estimated to be about $4 billion.

During the 1941 to 1962 period, most provinces did not levy their own income taxes. Instead, the federal government generally made direct "tax rental" payments to the provinces for the use of their income tax room. In 1962, this system was replaced by a general federal abatement and tax collection agreements whereby Revenue Canada collected provincial income taxes on their behalf. While this change involves an apparent switch from direct spending to tax abatements and now tax transfers, it may be more appropriately viewed as a basic rearrangement of federal-provincial fiscal relations. Also, these abatements are not linked in any way to direct federal expenditures, nor are they contingent on the provinces undertaking any particular expenditures. For these reasons and on pragmatic grounds they are not considered to be tax expenditures.(9)

There is a further important aspect of the federal-provincial tax collection agreements. Provinces party to the agreements define their individual and corporate income tax in terms of federal income tax (more precisely, Basic Federal Tax in the individual income tax and Taxable Income in the corporate income tax), the exceptions being Quebec for both individual and corporate income tax and Ontario for corporate income tax. As a result, most federal income tax expenditures automatically result in revenue reductions for those provinces party to the tax collection agreements. (The respective Quebec and Ontario tax systems tend to parallel closely the federal tax system.) The dollar values of the various tax expenditures shown in this paper refer to federal revenue costs only. Because of assorted provincial revenue effects, the values to taxpayers of the tax expenditures shown will typically be from 40 to 60 per cent higher for individuals and about one-third higher for corporations, depending on the province of residence of the taxpayer or the province(s) to which his taxable income has been allocated.

6. Accounting Period

The choice of accounting period, as it applies to the individual and corporate income taxes, has two main aspects: how often is tax to be imposed, and what rules are to be used to allocate revenues and expenditures to particular time periods. Regarding the first aspect, tax liability is traditionally computed each year. Many have long considered that the annual accounting period is the most appropriate for measuring income for tax purposes. On the other hand, a case can be made that the current system based on annual income is discriminatory among individual taxpayers as no account is taken of lifetime income. Under the current system two persons with the same initial wealth endowments and lifetime earnings could well have significantly different tax liabilities depending upon their consumption and saving patterns and fluctuations in earnings over their lifetimes. One could argue that the application of the neutrality criterion would require minimization of such differences in lifetime tax liability. However, the theoretical literature on the requirements of neutrality in such situations is not very conclusive. Moreover, in the case of corporations, "lifetime income" has no real meaning because they are in principle immortal.

For purposes of this analysis, the accounting period is taken to be a year. Consequently, if a taxpayer realizes income in one year but is able to postpone paying tax on that income to a later year, this is assumed to give rise to a tax deferral benefit. This benefit is equivalent to an interest-

(9) It should be noted that abatements are distinct from other federal tax expenditures in their impact on the economy. They are simply one method of federal financing of certain expenditure programs. They would largely net out under a consolidated account of the federal and provincial governments, implying no net change in the size of the public sector.

free loan from the government to the taxpayer equal to the amount of additional tax that would have been paid had the income not been deferred. For example, a taxpayer who is in a 35-per-cent tax bracket and deducts from income $1,000 for contributions to a pension plan pays $350 less tax than he would if the taxation of this income could not be deferred. The benefit in this case is therefore an interest-free loan of $350. This benefit can be very significant. For example, at a 10-per-cent interest rate over 20 years the deferral is equivalent to an 85-per-cent reduction in tax on this income. In any one year, of course, taxpayers may have interest-free loans of taxes otherwise payable arising both in the current and from previous years. In addition, there is a further benefit in the form of a tax reduction that is often associated with tax deferrals. Continuing with the above example, when the taxpayer finally draws this pension income, he may be in a 25-per-cent rather than a 35-per-cent tax bracket, for example because he is retired and no longer has as much income. Thus, the taxpayer has benefitted from a $100 tax reduction as well as an interest-free loan of $250. In the case of pension plans and RRSPs, for example, these deferral and tax reduction benefits combined will amount to over $2 billion in 1979. As interest rates change so does the value of the deferral; higher interest rates imply greater benefits from such deferrals. In order to provide a more complete accounting, separate figures for the cumulated values of tax deferrals arising in the current and previous years are also presented.

Given an annual accounting period, further tax expenditures arise from the provision of forward averaging through the use of Income-Averaging Annuity Contracts (IAAC), five-year block averaging for farmers and fishermen, and general averaging. The first two of these are clearly departures from annual accounting and provide preferential treatment to certain sources of income. While the general averaging provisions are available on a broad basis, they favour individual taxpayers who experience rapid growth (as opposed to declines or fluctuations) in their incomes. These provisions are partial and ad hoc and are thus classified as tax expenditures.

The second aspect of the accounting period is specifying the rules determining when revenue and deduction items are to be brought into income for tax purposes. A comprehensive definition of income as well as generally accepted accounting principles clearly imply that income in any year is that which <u>accrues</u> in the year, and expenses are those which are incurred to earn that income in the year. Thus, accrued but unrealized income that is not taxed in the year of accrual gives rise to a tax expenditure in that it generates a deferral of tax and hence an interest-free loan from the government to the taxpayer. Correspondingly, expenditures and costs which are deductible but are not related to income earned in the year give rise to deferrals of tax. All such deferrals of tax may provide substantial benefits.

The current tax provisions in this area vary by source of income and type of expenditure. Business and professional income generally must be computed on an accrual basis as required by generally accepted accounting principles. However, tax expenditures arise, for example, in the case of farmers who can use cash basis accounting and have significant flexibility in the way they can treat inventories for tax purposes, professionals who can use billed-basis accounting, and the construction industry which is allowed to depart from accrual accounting in the case of holdbacks. Employment income and, to a large extent, investment income is taxable when received or realized. In the case of employment income, the differences between accrual and realization accounting are minimal, and can be ignored in this analysis. However, realization taxation can confer substantial benefits in the case of investment income, particularly in the case of deferral of tax on accrued but unrealized capital gains. On the expenditure side, deductions for pre-paid expenses and fast write-offs of exploration expenses in the resource sector and of depreciable assets generally give rise to substantial tax deferral benefits.

Practically, it would be impossible to provide for accrual taxation in all cases under the Canadian tax system. As well it is very difficult to estimate tax expenditures associated with accrued but unrealized income with any degree of accuracy. Nevertheless, any provisions giving rise to tax deferrals will be treated as tax expenditures.

7. Income Tax Treatment of Losses

In defining the benchmark tax structure, a fundamental question arises as to whether, and to what extent, government should share in losses.

Currently, the deductibility of certain losses from one activity to be offset against income from another, plus the provision for carry-forward and carry-back of unused losses to other years (for five years and one year respectively), imply some degree of sharing by government on an ongoing current basis. However, this treatment does not ensure neutrality among taxpayers. Taxpayers with the same net income will be subject to differential tax treatment depending on the source of any losses, the presence or absence of other income against which the losses may be offset, and the timing of past and future positive income against which current losses can be offset.

For pragmatic reasons, the benchmark tax system generally adopts the existing tax treatment of losses, even though this does not provide complete neutrality among taxpayers.(10) For example, the one-year carry-back and five-year carry-forward limits for unused losses will be taken as part of the benchmark tax system even though they violate both neutrality, as mentioned above, and the annual accounting period. Other loss provisions limit the extent to which losses in one area can be offset against income in another (e.g. capital losses and non-capital gains income). Such limits will in general either be treated as part of the particular tax expenditure that allows

(10) Full neutrality could be ensured by assuming, for example, complete sharing by government in all losses. This could in principle be accomplished by means of a grant or refundable tax credit equal to the basic corporate income tax rate times the amount of taxpayer's losses that could not be offset against any of his other income. The non-existence of this refundable tax credit for losses would then imply a very large negative tax expenditure. However, this approach is clearly unrealistic.

such losses to arise, as discussed more fully below, or they will be accepted as part of the benchmark structure. Any specific deviations from the general form of the loss provisions (such as the Multiple Unit Residential Building (MURB) provisions which allow a deduction of certain rental losses against non-rental income), however, will be considered to be tax expenditures.

8. Other Tax Bases

Until 1972, Canada levied an estate tax. Also, there have been discussions of value added and wealth as possible new tax bases. The fact that the federal government does not levy such taxes is not considered to give rise to any tax expenditures. To consider any such taxes as part of the benchmark tax structure would be the same as treating the non-existence of a possible or hypothetical tax base as a tax expenditure. It does not appear useful to consider such fundamental departures from the existing tax system as part of the tax expenditure account.

B. INDIVIDUAL INCOME TAX

This section describes the basic characteristics of the benchmark individual income tax system and some broad groups of tax expenditures. The concepts of appropriate tax base, tax unit, and rate structure are discussed. Detailed discussion of specific tax expenditure items is given in the appendix.

1. Tax Base

As the tax is a tax on income, the neutrality criterion for defining the benchmark tax structure leads to the use of a comprehensive definition of income. Any less-than-comprehensive tax base implies discrimination among persons with different sources of income. Such a comprehensive definition is often referred to as the Haig-Simons definition of income and was characterized during the Carter Commission debate as "a buck is a buck".(11)

At the time of the 1972 tax reform, the government stated that the tax system should be fair, that is "that people in similar circumstances should carry similar shares of the tax load". However, the government rejected the comprehensive definition of income as proposed by the Carter Royal Commission on Taxation as it felt that the income tax system should also be used to serve other goals. These included the pursuit of economic growth, the need to provide incentives to various kinds of activities, and the need to ensure simplicity.

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(11) The concept of comprehensive income is discussed, for example, in H.C. Simons, Personal Income Taxation, University of Chicago Press, 1938, and in the Carter Royal Commission on Taxation. This concept defines income broadly as the sum of consumption and change in net worth over a given period of time. It may be noted that this definition implies that gifts and bequests received as well as government transfer payments are part of income.

While these goals may or may not be desirable, and this paper is not advocating a move to a comprehensive definition of income, the purpose of a tax expenditure account is to shed more light on the amount of fiscal resources forgone to obtain these goals through preferential tax treatment. For this reason the comprehensive definition of income is generally adopted in defining the benchmark individual income tax structure. Departures from comprehensiveness are thus tax expenditures.

Some of the obvious tax expenditures resulting from the comprehensive definition of the benchmark tax base include: the exemption of one-half of capital gains; non-taxation of capital gains on principal residences; the exclusion of $500 of scholarship income and the first $1,000 of investment and pension income; exemption from tax of Guaranteed Income Supplements (GIS), Spouses Allowance (SPA), social assistance, and other welfare benefits; non-taxation of imputed income on an individual's equity in his home; deductibility of charitable and medical expenses and contributions to Registered Home Ownership Savings Plans (RHOSPs). Certain other deductions, such as those for union and professional dues and itemized employment expenses, are not identified as tax expenditures as they are legitimate costs incurred in earning income and thus should be recognized under a comprehensive definition of income.

One question that is usually viewed as relating to the tax unit rather than to the tax base is the benchmark tax treatment of exemptions in respect of dependants. However, the Carter Royal Commission argued first that comprehensively defined income should be used for tax purposes, and second that the tax base should be discretionary economic power. The commission defined discretionary economic power as comprehensively defined income adjusted by deductions or tax credits in recognition of differences in individual circumstances such as sickness and family status (e.g. single, married, number of children). Thus, it included the treatment of dependants in part under its discussion of the tax base. While allowance for such circumstances may well be a desirable policy goal, any preferential treatment can be made in many different ways, for example through family allowances, child exemptions, and tax credits. Also, given the individual as the basic tax paying unit, as discussed below, these deductions or tax credits are not neutral between taxpayers with different sized families. These tax provisions are thus functionally equivalent to direct expenditures and are non-neutral. Their classification as tax expenditures serves the informational purpose of bringing their magnitude to light.

Tax provisions where the appropriate treatment in a tax expenditure account is unclear include the treatment of benefits and contributions under the unemployment insurance program and the Canada and Quebec Pension Plans (CPP/QPPs) and the treatment of gifts and bequests. To illustrate the nature of the issues, consider first the case of the unemployment insurance program.

This program can be regarded as partly an insurance plan and partly a program of transfer payments. The insurance aspect of the program would suggest that under the benchmark tax system either contributions not be deductible and benefits not be taxable, or that contributions be deductible and benefits taxable. Any excess of benefits over the value of contributions could be regarded as a federal transfer payment to the unemployed. In line with the use of comprehensively defined income as the tax base this excess should properly be part of income for purposes of the benchmark tax system as are other transfer payments. The current taxation of benefits coupled with deductibility of contributions ensures this result and could thus be viewed as not giving rise to tax expenditures.

An alternative approach would be to regard unemployment insurance contributions as a payroll tax and all of the benefits as government transfer payments. This approach would require the benchmark tax system to include all of the benefits in the income base but not permit any deduction for the payroll tax or contributions, as is the case for other taxes. Given that participation in the program is mandatory and the link between contributions and program benefits is weak, this is the approach adopted in the analysis in this paper. Thus, the deduction for contributions is considered to be a tax expenditure.

Contributions and benefits under the C/QPP could be treated similarly to the unemployment insurance case, with a tax expenditure arising because of the deductibility of premiums. However, an alternative is to view the C/QPP as saving programs similar to Registered Pension Plans (RPPs), where tax expenditures arise because income tax liability is deferred. This paper adopts the latter view because, unlike unemployment insurance, the C/QPP do not now and are not expected to obtain any financing from general tax revenues.

Somewhat similar alternatives exist in the case of gifts and bequests (e.g. to children or to charity). A gift could be deductible from income for the donor and included in income for the recipient, treating it as essentially a transfer of income with no benefit occurring to the donor (as if the donor had never received that income in the first place). Alternatively, a gift could be neither deductible for the donor nor includable in income for the recipient, implying that gifts are conceptually distinct from exchange transactions that give rise to income. Finally, a gift could be includable in income for the recipient but not deductible for the donor. This last alternative is based on the assumption that the giving of a gift is like any other consumption expenditure for the donor, and like any other accretion to wealth for the donee. It is this alternative that is frequently advanced in the literature as the one implied by the comprehensive definition of income. However, for pragmatic reasons, it is the second alternative that is adopted in this paper; it is this alternative that is generally embodied in the current income tax system. This treatment implies that tax expenditures arise to the extent that gifts such as charitable donations are deductible from income.

2. Tax Unit

The major issue here is whether individual members of the family should be assessed separately or jointly on their incomes. The basic structure of the Income Tax Act contains provisions which generally ensure that individual members of the family are taxed separately. For example, two spouses each with $10,000 of income are taxed separately as individuals. Also, there are rules designed to prevent families avoiding tax by transferring income from higher- to lower-income spouses. On the other hand, certain other parts of the tax system recognize the family as the basic unit, for example through the structure of exemptions in respect of dependants, by relating the child tax credit benefits to family income, by allowing tax-free rollovers of capital property between spouses, and by allowing transfers between spouses of unused amounts of a number of exemptions and deductions. Nevertheless, while the Canadian tax system has elements of both individual and family taxation, it appears that provisions of the latter type are more in the nature of exceptions to the general principle which is to tax individuals, whether or not members of a family, separately on their own incomes.

The neutrality criterion for defining the benchmark tax structure is of little help in determining the appropriate unit for tax purposes. For reasons of pragmatism, and to preserve a point of reference to the current structure, the tax unit is taken to be the individual in this analysis. Given this choice of the individual as the benchmark tax unit, the neutrality criterion as well as the functional equivalence point above lead to the characterization of personal exemptions for spouses and other dependants, including those for the aged and disabled, as tax expenditures. The tax-free rollovers of property between spouses for capital gains tax purposes also give rise to tax expenditures. On the other hand, the tax saving from not aggregating spousal incomes is not viewed as a tax expenditure despite the fact that some may view our tax system as providing preferential treatment to two-earner families over one-earner families with the same total income.

3. Tax Rates and Credits

In considering tax rates, two considerations arise: the degree of progressivity under the benchmark tax structure and the treatment of various tax cuts and credits.

Consideration of progressivity under the benchmark structure is a somewhat arbitrary exercise. The neutrality criterion could be taken to suggest that the rate structure not discriminate among taxpayers. This in turn could imply that the rate structure under the benchmark tax system be taken to be simply proportional, with all income being taxed at the same flat rate. Progressivity in personal income tax would then constitute a departure from the benchmark. However, this would involve such an extreme departure from the current tax system that it is ruled out on grounds of pragmatism. Instead, the existing progressive structure of individual income tax rates is taken as part of the benchmark tax structure. In this regard, it is natural to consider the basic personal exemption as part of the rate structure, that is, to regard the exemption as an initial level of income which bears a zero rate of tax.

Any broad-based tax cuts and credits that do not discriminate among taxpayers except on the basis of income size are also assumed to form part of the benchmark tax rate structure. The general tax reduction of 9 per cent of tax otherwise payable, with a minimum of $200 and maximum of $500, falls in this category. The indexing of personal exemptions and tax brackets is also a form of general tax cut and thus falls in this category. On the other hand, the child tax credit and the political contribution credit, which apply only in select circumstances, are tax expenditures.

C. CORPORATE INCOME TAX

This section describes the basic characteristics of the benchmark corporate income tax system and identifies some broad groups of tax expenditures. The appropriate tax base, tax unit, tax rates and credits, and treatment of the resource allowance and provincial royalties are discussed. Detailed discussion of specific tax expenditure items is given in the appendix.

1. Tax Base

As with the benchmark individual income tax, the tax base under the benchmark corporate tax structure is comprehensive income. Following the generally accepted view, income, comprehensively defined, is the maximum value which a person could consume during a period and expect to be as well off at the end of the period as at the beginning. Applied to a corporation this would suggest that income is the maximum amount distributable to owners without impairing the capital of the corporation. This would lead to the following definition determining corporate income for purposes of the benchmark tax system:

- inclusion of the total value of receipts or receivables of the firm from sales of current output;
- inclusion in income of receipts not related to production such as government subsidies and investment income;
- subtraction of current costs associated with earning that income; and
- subtraction of an amount representing actual depreciation, the decline in the value of the corporation's productive assets due to wear and tear, obsolescence, and the like.

The current tax system departs from this benchmark in the following general respects:

(a) Tax allowances in respect of capital cost reflect in general a higher rate of wear and tear, obsolescence, etc. than actually occurs. In specific cases (e.g. machinery and equipment used in manufacturing and processing) the additional write-off is deliberately large as a matter of policy.

(b) Certain forms of income are excluded wholly or in part (e.g. one-half of capital gains).

(c) Some deductions are permitted for expenses unrelated to the business activity of the corporation (e.g. charitable contributions) and for deductions in excess of actual costs (e.g. the special 50-per-cent allowance for incremental R&D expenses and the depletion deduction for the resource industries).

(d) Some immediate deductions are permitted for expenses that relate to activity in a subsequent period (e.g. pre-paid expenses) and deferral of tax is allowed on certain income from work-in-progress.

The broad definition of income given above requires maintenance of capital in real terms. To ensure this, it would be necessary to make a variety of adjustments to the assets, liabilities, and the profit statement of corporations to reflect the effects of inflation. However, as noted earlier, there is a certain degree of controversy and disagreement about the method of making such adjustments. The benchmark tax system is thus defined on the basis of maintaining capital in nominal, as opposed to real terms. Consequently, the 3-per-cent inventory allowance, which is one example of an ad hoc adjustment, is treated as a tax expenditure.

The income tax system provides complete exemption from tax for certain types of non-profit public entities and federal, provincial and municipal corporations. Non-taxation of income from activities of an industrial or commercial nature or of investment income of such entities gives rise to tax expenditures.(12) Under the benchmark tax structure there is no logical reason to exempt income from tax merely because it accrues to a corporation owned by a government rather than by private sector shareholders. The result is an implicit tax subsidy from all taxpayers to the federal government in the case of non-taxable federal crown corporations and from the federal government to provincial and municipal governments in the case of corporations owned by these other governments. Of course, certain analogous transfers occur from the provinces to the federal government to the extent that the provinces do not tax federal crown corporations. These latter transfers do not form part of a federal tax expenditure account.

2. Tax Unit

The question of the appropriate unit for tax expenditure accounting purposes in the corporate sector is quite difficult. On pragmatic grounds, the tax unit will generally be taken to be the legal corporate entity. Nevertheless, the range of possibilities can be appreciated by considering four alternatives along a spectrum: at one extreme the establishment or activity unit within a corporation, the single legal corporate entity, a consolidated group of related corporations, and at the other extreme the whole of the Canadian corporate sector. The point to be noted is that the current system embodies elements of all four views.

In the first case, the establishment or activity unit would imply that a number of incentive provisions were clearly tax expenditures. For example, drilling-fund and MURB incentives, whereby tax losses in the resource sector and rental housing respectively can be offset against other income, would give rise to tax expenditures because tax losses would be flowing outside the benchmark sub-corporate tax unit. It would also imply that a number of other existing provisions were not negative tax expenditures. For example, losses for tax purposes on leased equipment now cannot be offset against other corporate income, and with this choice of benchmark tax unit, such a loss restriction would not appear to be a negative tax expenditure. However, other provisions such as

(12) Certain federal crown corporations are taxable, such as those on Schedule D of the Financial Administration Act. These tend to be crown corporations whose major purpose is industrial or commercial and who compete with private sector firms.

the ability to offset non-capital losses against other sources of income throughout the corporation, various rollover provisions, and the non-taxation of intercorporate dividends would appear as tax expenditures. Such a tax unit would thus clearly imply a fundamental departure from the existing tax structure.

Moving up a step in size, choosing the single legal corporate entity implies that the ability to offset losses from one part of the business against other business income is no longer a tax expenditure. However, the exemption from inclusion in income for tax purposes of intercorporate dividends would continue to appear as such, as would a range of rollover provisions applying to capital gains, losses, and recapture of capital cost allowance in the case of amalgamations, wind-ups, and other corporate reorganizations. In addition, a number of other provisions might be looked upon as negative tax expenditures. These include restrictions on the ability to offset either capital losses or leasing losses against other income within the corporation.(13)

If the tax unit were taken to be a consolidated group of related corporations, the third alternative, various rollover provisions in corporate reorganizations would no longer be tax expenditures. Nevertheless, the exemption from income of intercorporate dividends (more precisely, dividends between consolidated groups of corporations) would continue to be a tax expenditure, though of much smaller magnitude. On the other hand, the inability to use one corporation's losses against the income of another corporation, assuming both corporations were in the same consolidated group, might be viewed as a negative tax expenditure.

The fourth alternative, at the other extreme, would be to take the whole of the corporate sector as the tax unit. In this case, all gross flows of dividends, incomes, and losses would be consolidated to obtain a figure for net corporate sector profits, similar to the way corporate profits are calculated for National Accounts purposes. (Clearly such an alternative, particularly with respect to losses, could only be implemented indirectly.) Only from this viewpoint would the deductibility of intercorporate dividends not give rise to a tax expenditure, nor would various rollover provisions.

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(13) There is another way to view the restrictions on capital, leasing and some other losses. A part of these losses arise due to a variety of tax incentives, for example those that permit businesses to claim larger write-offs than would be permitted under a proper measure of business income. In such cases, a restriction on the ability to offset tax losses from one activity against income from another need not be viewed as a negative tax expenditure. Instead, it could be viewed as a part of the group of provisions that gave rise to the tax loss in the first place; it is a provision designed to limit the scope of a tax expenditure. For example, the restriction on the use of capital losses to offset income other than capital gains can be considered as a means of restricting the size of the tax expenditure arising from the taxation of capital gains on a realization rather than on an accrual basis. Thus, with this view, adopting the legal corporate entity as the benchmark corporate tax unit does not give rise to negative tax expenditures in cases where, for example, certain kinds of losses cannot be offset against other kinds of income.

While the four alternatives outlined above cover an extremely wide range, it can be seen that the current tax treatment of corporations embodies elements of all four views. The view closest to the current system is the second, the single corporation. For this reason, it is taken as the tax unit in the benchmark tax structure. In addition, on pragmatic grounds, the exemption for intercorporate dividends and the various rollover provisions as they apply to corporate reorganizations in the existing tax system will not be taken as giving rise to tax expenditures; the existing treatment in this area will be included in the benchmark structure. Finally, as noted above, restrictions on loss offsets where the losses are the result of other tax expenditure provisions will be considered as part of those related tax expenditures rather than as separate negative tax expenditures. On the other hand, as discussed above with regard to losses, any specific deviations from the general form of the current provisions will be treated as tax expenditures.

3. Tax Rates and Credits

The basic federal tax rate applicable to large non-manufacturing corporations is 36 per cent after all abatements. Reductions in this tax rate for manufacturing and processing income and for small Canadian-controlled private corporations are thus tax preferences. (The revenue costs of these two preferential tax rate reductions for 1979 are estimated to be about $400 million and $1 billion respectively.)(14)

Through the mechanism of a special refundable Part I tax and the dividend tax credit, the investment income (as opposed to business income or dividend income) earned by private corporations is exempted from taxation at the corporate level. Such income essentially bears tax at the rate that would be applicable if it were received directly by individuals. This preferential treatment of investment income as opposed to business income is considered to be a tax expenditure, given that the benchmark tax structure does not integrate the individual and corporate income taxes. Similar preferential tax treatment occurs in the case of investment corporations, mutual fund corporations, mortgage investment corporations, mutual fund trusts, co-operatives and other entities.(15)

The basic rate of withholding tax on gross interest and dividend payments to non-residents is 25 per cent. Where this rate is lowered as a result of provisions in tax treaties with other countries, this is not considered to

(14) Because the one percentage point of the abatement granted in 1966 in respect of post-secondary education is considered a tax expenditure, the basic corporate income tax rate under the benchmark tax structure is actually 37 per cent.

(15) Part IV tax which applies to dividend income of Canadian controlled private corporations and is refundable when dividends are in turn paid out is not considered to give rise to either positive or negative tax expenditures. This tax is imposed mainly to reduce the advantages to high-income individuals of accumulating income inside a corporation in order to defer tax.

give rise to tax expenditures. All such tax treaty provisions are treated as part of the benchmark tax structure. (The alternative of defining a benchmark tax treaty would require substantial further analysis that is beyond the scope of this paper.) However, any unilateral reduction in the withholding tax, for example the exemption of interest on long-term corporate debt, government and government-guaranteed debt, and foreign currency deposits, is assumed to give rise to a tax expenditure. Similarly, the lower rate of withholding tax on dividends paid to non-residents by a corporation with a degree of Canadian ownership is also a tax expenditure.

Tax credits such as the investment tax credit, the employment tax credit, and the political contribution tax credit are tax expenditures. The foreign tax credit is not treated as a tax preference as it is essentially a device to avoid international double taxation by providing a deduction against Canadian tax in respect of foreign taxes paid on foreign source income.

4. Resource Allowance and Deductibility of Provincial Royalties

Since 1974 provincial mining taxes and royalties on oil and gas have not been deductible from income for federal tax purposes. Initially, the federal government introduced a tax abatement to compensate for the non-deductibility of royalties. Since 1976 the federal system has instead allowed a resource allowance of 25 per cent of resource profits. The treatment of these provisions in a tax expenditure account poses difficult conceptual problems. There are four alternative approaches that could be followed.

First, provincial royalties could be regarded as essentially income taxes of one form or another and, like other income taxes, should not be deductible under the benchmark tax structure. In this case the resource allowance becomes a tax expenditure.

Second, it could be argued that, while royalties are income taxes, the federal government is essentially providing an abatement to make room for the provinces' imposition of these levies. In line with the treatment of general abatements under the personal and corporate income taxes the resource allowance might not be treated as a tax expenditure. However, as the abatement is provided only for one sector, this reasoning might require it to be regarded as a tax expenditure analogous to the abatement for Quebec residents under the individual income tax system.

Third, royalties could be treated as a form of business or property income accruing to provinces as owners of the resources. If these amounts accrued to private sector owners they would be taxable to the recipient and deductible as a business expense by the paying corporations. Following this line of argument would suggest that, under the benchmark system, royalties would be taxable in the hands of provinces and fully deductible by resource companies. Under the current system, however, deductibility in the form of the resource allowance is not matched by taxation of royalties received by provinces and the resource allowance would thus be viewed as a tax expenditure.

Fourth, royalties could be regarded as a form of tax, other than an income tax. As such they would be deductible by the paying corporations as are property and capital taxes under the benchmark tax structure. However, as the receipts by provinces would be regarded as a tax and not as business or property income, the amounts would not be taxable in the hands of the provinces. Under this view the resource allowance is a tax expenditure only in those cases where it exceeds the amounts of royalties payable by companies; where it falls short of royalties paid, negative tax expenditures arise.

This paper does not take any firm position on the treatment of provincial royalties and the resource allowance in the tax expenditure account. However, the revenue impact of the resource allowance and the non-deductibility of provincial royalties are identified separately for the sake of comprehensiveness and to provide information on the operation of the current system. Similar issues arise in the treatment of the credit for provincial logging taxes that is allowed against federal tax. The value of this credit is also identified separately for the sake of comprehensiveness.

D. COMMODITY TAXES

Construction of a tax account for this part of the Canadian tax system again requires identification of a benchmark tax structure, deviations from which are tax expenditures. The following discussion is confined to sales and excise taxes and does not address any tax preferences inherent in the structure of import duties.

As with income-based taxes, the spirit of tax expenditure analysis implies that a benchmark commodity tax system provide no preferential treatment to taxpayers on the basis of consumption patterns.

Some may argue that income is the only appropriate base for taxation, and thus question the very existence of commodity taxes under the benchmark tax system. For purposes of this paper it is assumed that the existence of a commodity tax is part of the benchmark tax structure so as to preserve the usefulness of the analysis. If the opposite assumption were to be adopted, then the whole of the current commodity tax revenues would be viewed as comprising a large number of negative tax expenditures applicable to various goods. While a cataloguing of these would provide interesting information on the current tax base, such an analysis would shed little light on the perceived subsidies inherent in the base as a result of preferential tax rates, exemptions, and so forth.

The basic issues in defining the benchmark commodity tax structure concern the appropriate scope of these taxes and the trade level (manufacturing, wholesale or retail) at which the taxes are imposed. The main federal commodity tax is, of course, the manufacturers' sales tax. In its broadest possible scope this tax would apply to "final" consumption of all manufactured or produced goods (i.e. sales of manufactured or produced goods to wholesalers and retailers and to individual consumers, but not to sales of manufactured or produced goods to manufacturers or producers of other taxable products). Consumer expenditures on services (e.g. hospital and medical care, movie and theatre entertainment, services of a barber, laundromat, etc.) would not be subject to tax. The benchmark tax structure is taken to be this tax base. Such a tax is clearly non-neutral in that it favours consumption and production of services as opposed to tangible produced goods. While this non-neutrality is assumed to be part of the benchmark structure to maintain a point of reference to the current system, information is provided on the federal revenue forgone due to non-taxation of consumer expenditures on services.

In its present form the tax applies on the manufacturer's sale price of the good. The imposition of the tax at this level has been criticized as giving rise to non-neutralities and discrimination as the spread between the retail and the manufacturer's price varies from commodity to commodity. The effective rate of tax as a proportion of final sale price thus differs among various goods. Neutrality of this sort would require that the benchmark commodity tax be levied at the retail level. While recognizing the merit of this argument, the benchmark tax is assumed to be levied at the manufacturing level to maintain a point of reference to the current system.

Using this definition of the tax base, exemption of various manufactured goods from the sales tax results in tax expenditures. These include exemptions for food, clothing, drugs, heating fuels, transportation and construction equipment and a range of other commodities. The application of the tax at a lower rate on building materials also gives rise to a tax expenditure.(16)

The continued taxation of alcohol and tobacco products at a 12 per cent rate while the general tax rate has been lowered to 9 per cent could be viewed as a negative tax expenditure. However, this situation raises the further issue of the status of special excise taxes on alcohol, tobacco, motor gasoline for personal use, jewellery and a range of other goods under the benchmark commodity tax structure. These are each distinct taxes with no common tax base. Given the very specific nature of the structure of these taxes one could view each as a separate tax and thus not giving rise to any tax expenditures. On the other hand, looked at from the point of view of the appropriate commodity tax structure as a whole, these special excises are clearly non-neutral, and intentionally so. This would suggest that they are tax penalties or negative tax expenditures. In certain cases, such as energy conservation, these special taxes complement tax expenditures in other parts of the tax structure. Both views have merit and, for the sake of completeness, the revenues from these taxes are identified as separate memorandum items for information purposes.

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(16) A more consistent treatment of the construction industry would be to take as the tax base the manufacturer's sale price of the housing unit. The present tax base does not include the labour and profit content of the sales price. Thus it could be argued that the true value of tax expenditures in this sector is much larger than what is shown in Table 1 following this main text.

IV QUANTITATIVE ESTIMATES OF TAX EXPENDITURES

Table 1 provides quantitative estimates of federal tax expenditures in 1976 and 1979 for the individual, corporate and commodity taxes. The tax expenditure items have generally been grouped using the same functional categories that are used in the Public Accounts of Canada. The appendix describes each item in Table 1 individually. Before considering the amounts, a number of caveats need to be noted.

(i) The revenue impact of each provision is estimated by simulating the change in federal revenues as if that provision alone were eliminated, keeping all other provisions in place. (Thus, revenue impacts are measured relative to the existing rather than the benchmark tax structure.) Aggregate amounts cannot be obtained simply by adding together the revenue effects of individual items. Such mechanical adding up can impart a significant bias because of the interaction among individual tax preference items. For example, elimination of two deductions from income (e.g. the $1,000 investment income deduction and the RHOSP deduction) would push many more individuals into higher tax brackets than if just one deduction were eliminated; the combined revenue effect of eliminating two items would be greater than the sum of the two separate effects. A similar phenomenon exists in the corporate income tax as elimination of one tax expenditure moves some corporations from a tax loss position to being taxable.

(ii) Some of the items which have not been quantified are significant in value. For example, the value of tax preference in the form of non-taxation of various fringe benefits of employment cannot currently be estimated but is quite likely to be of the order of several hundred million dollars a year.

(iii) Taxpayer behaviour is assumed to remain unaffected by the assumed deletion of a tax expenditure provision. Generally, elimination of any tax expenditure provision would cause taxpayers to rearrange their affairs to minimize the impact of the change and thus result in smaller increases in revenue than is implied by the estimates given here. Similarly, the impact of eliminating tax expenditure provisions on the overall level of economic activity and the resultant feedback to government revenues is also ignored in the revenue estimates. (Of course, Public Accounts figures for direct program expenditures also take no account of such feedback effects.)

(iv) Many of the estimates are highly tentative in nature and are subject to wide margins of error. This is particularly true of the estimates of tax expenditures available to the business sector. Because of resource constraints and data limitations, it has not been possible to provide estimates for a number of important business incentives or to simulate others with a reasonable degree of accuracy. Moreover, the volatility of business conditions, including profit performance, precludes accurate forecasts of many provisions which are of a very specific nature.

No total or sub-total amounts are given in the table. This is because of the points outlined above. In particular, (i) the revenue impact of simultaneously eliminating two tax expenditures is generally not equal to the sum of their individual revenue impacts; (ii) estimates for some tax expenditure items are not yet available so totals that omitted those items could be misleading; (iii) actual or likely revenue consequences depend significantly on taxpayer behaviour; and (iv) uncertainty regarding the magnitudes of individual items could be even greater when comparing various totals or sub-totals (for example if the component estimates were all biased in the same direction).

<u>In considering the value of any particular tax expenditure item, it must be realized that the value to the taxpayer of a dollar of tax preference is often worth substantially more than a dollar of equivalent direct spending. This results from the fact that, while all tax expenditures directly increase after-tax incomes of taxpayers by the amount of revenue forgone, government grants are generally taxable to the recipients. Thus, the value to the taxpayer of a dollar's tax preference may be one and one-half to two times the value of a dollar of direct spending. (For example, for a family in a 33 1/3 per cent tax bracket, the $200 child tax credit is equivalent on a net of tax basis to a $300 taxable family allowance benefit.)</u> As well, while the figures show the <u>federal</u> values of various tax expenditures, there is typically an associated provincial tax expenditure in the case of individual and corporate income tax expenditures.

Given the above qualifications and caveats, it is nevertheless clear that the size of tax expenditures is significant. The expenditures are numerous; in many cases their values in terms of forgone tax revenues are large; and in some functional areas the amounts involved are comparable to or even larger than related direct spending programs.

It is also apparent that many tax expenditures have been growing in amount. This growth can be attributed in part to population and per capita income growth, and the extension and enrichment of existing provisions. As well, a number of new tax expenditures have been introduced in recent years. The bulk of these discretionary changes has occurred in the areas of economic development and support and fiscal transfers. In the case of fiscal transfers, the growth is explained directly by the new federal-provincial fiscal arrangements which resulted in a substitution of tax transfers for direct spending under various shared-cost programs. The growth in the economic development and support area reflects the decisions taken in recent years to stimulate the economy and improve the climate for business expansion and growth.

As a final point, it should be noted that changes in the tax system from 1976 to 1979 have affected the amounts of a number of tax expenditures. The recent federal sales tax reduction, being general in scope, is not counted as a tax expenditure. At the same time, it serves to reduce both the actual and benchmark rates of federal sales tax from 12 to 9 per cent. This, in turn, has the effect of reducing the value of existing tax preferences in the federal sales tax area. For example, the sales tax preference for building materials, currently taxed at a 5-per-cent rate, has been reduced from 7 percentage points to 4 percentage points. This phenomenon is particularly evident in the health and welfare area because of the number and value of tax expenditures there arising from various sales tax exemptions. A similar phenomenon occurred for individual income tax expenditures in 1977 because of the abatement of additional tax points to the provinces which served to reduce federal individual income tax rates.

V SOME CONSIDERATIONS FOR POLICY PURPOSES

It is evident that tax expenditures are a substitute, although imperfect, for direct spending. In addition, they have been growing more rapidly in recent years than direct spending in a number of areas. Both tax expenditures and direct spending lead either to increases in the budget deficit or require program cut-backs or general tax increases for their financing. It is also clear that tax expenditures are serving important policy objectives in a wide range of areas, particularly health and welfare and economic development and support.

The recent growth in tax expenditures may be related to the way fiscal matters are generally perceived. In a period of restraint, the indicators that are typically used to measure the impact of restraint policies are growth in direct spending and growth in government employment. Since tax expenditures can often be substituted for direct spending, there may have been a tendency to turn more to the expansion or creation of new tax expenditure provisions to meet important policy objectives. Such an approach avoids exceeding spending limits. However, financing new or expanded tax expenditures requires either a larger deficit, program cut-backs, or a higher general level of taxes.

A related consideration in the recent growth of tax expenditures may have been the perception that a general reduction in the size or rate of growth of the public sector is desirable policy in order to restore incentives and give the market portion of the economy greater scope. However, it may have been that, with this view, no distinction was made between a general reduction in levels of tax and a selective tax reduction taking the form of an increase in tax expenditures. While a general tax reduction clearly gives more scope to market activities, a specific or targetted tax reduction in the form of a new or expanded tax expenditure usually increases the government's intervention in the market.

The considerations outlined above may in part help explain the recent growth of tax expenditures. This is not meant to imply that their growth was necessarily undesirable. Depending on the specific circumstances, tax expenditures may be more or less effective than direct spending in meeting important policy objectives. Following are a number of points that bear on the relative desirability of direct spending programs and tax expenditure provisions.

(i) Delivery: The tax system is best suited for delivering and determining benefits annually, and then based on the taxpayer's characteristics during the previous year. It is not able to make more frequent determinations of eligibility nor to anticipate eligibility. Spending programs can be designed to cover a broader range of delivery needs. However, in those cases where the tax system does offer an adequate type of delivery of benefits, it may be less costly to deliver a program using the existing administrative machinery of the tax system rather than to set up a new administrative system.

(ii) Eligibility: The tax system is based on self-assessment. Thus, the use of very complex eligibility criteria for a tax expenditure program could place an undue burden on taxpayers who are intended beneficiaries. As a result, programs with very specific or difficult-to-define target groups are typically not well suited as tax expenditures. Instead, the tax expenditure approach is better suited to initiatives where the intended beneficiaries are clear well-defined groups, or where the information required to determine eligibility is related to income, demographic, or other data easily collected on a tax return.

(iii) Control: Spending programs are typically subject to expenditure ceilings. It is therefore possible that some eligible applicants would not receive benefits if all the funds have already been used. However, all taxpayers eligible for a given tax provision may benefit regardless of the total revenue cost. It is only after the fact that the revenue cost of a tax expenditure program can actually be determined and any alterations be made. Thus, incentives with very uncertain revenue implications may not be suitable candidates for delivery through the tax system.

(iv) Codification: Tax expenditure provisions must be very precisely defined. Who exactly is eligible in what specific circumstances must be fully spelled out. If the taxpayer and Revenue Canada disagree about eligibility for the benefit, the ultimate judgment rests with the courts' interpretation of the relevant statute. In contrast, the administrators of spending programs often have discretion as to who is eligible for benefits; and they typically operate under more general legislative direction. Thus, programs that are easily codified would be more suitable for tax expenditures.

(v) Take-Up: Because the tax system is very broad-based and affects virtually everyone in the economy, there is no stigma attached to benefits received in the form of tax expenditures. Thus, the take-up rate or utilization of some types of benefits would be greater if delivered as tax expenditures rather than as direct program expenditures. In areas such as sales tax exemptions, the take-up rate is automatically 100 per cent.

(vi) Tax Penalties: In some areas where it is desired to limit a particular activity, an outright prohibition may be too extreme while licensing or rationing may prove infeasible. In such cases, a tax penalty could prove the most effective option for regulating the activity.

VI RECAPITULATION

The Canadian tax system contains a significant number of provisions which give preferential treatment to certain groups of taxpayers or types of activities. Such provisions are often alternatives to direct spending and have thus come to be called tax expenditures. This paper has been mainly concerned with the way tax expenditures are identified, and with presenting a list of federal tax expenditures in the personal and corporate income taxes and in the commodity tax.

The presentation of this tax expenditure account partially fills a gap in the data available on the scope and nature of government policies and activities. It is not intended as an evaluation of their desirability or effectiveness. Rather, the intention is to provide more complete information on which such evaluations can be based.

The problem of determining which tax provisions are tax expenditures is not an easy one. In this analysis, a number of criteria were first defined so that tax expenditures could be identified in a reasonably systematic and logical manner. Nevertheless, important ambiguities are unavoidable. In such cases, the analysis has tended to be more comprehensive rather than restrictive - the assumption being that the reader may then select or reject specific items at his discretion.

Examination of the figures in Table 1 reveals that tax expenditures are numerous, sometimes large in value, and growing rapidly in certain areas. However, the numerical estimates should be treated with some caution. In particular, the values of individual items cannot simply be added together to get a combined revenue impact. Very often tax expenditures interact with one another so that such simple addition may produce inaccurate results.

While some may view this tax expenditure account as a catalogue of tax loopholes or tax breaks, it is important to emphasize that tax expenditures are a legitimate part of the tax system. It is often the intention, when a tax expenditure is introduced, that taxpayers rearrange their affairs in order to make maximum use of the tax provision. In a range of circumstances, the tax system, as opposed to a direct spending program, may provide the most effective means for fulfilling government objectives.

This accounting of tax expenditures will have served its main purpose if it sheds new light on the extent and impact of government tax policies, and permits a more informed public debate on how government can make efficient use of limited fiscal resources in attaining policy goals.

TABLE 1

VALUE OF GOVERNMENT OF CANADA TAX EXPENDITURES BY FUNCTIONAL CATEGORY, 1976 AND 1979

Functional Category and Item	1976 Personal Income Tax	1976 Corporate Income Tax	1976 Commodity Tax	1979 Personal Income Tax	1979 Corporate Income Tax	1979 Commodity Tax
	($ millions)					
I. GENERAL GOVERNMENT SERVICES						
A. Legislation and Administration						
1. Political Contribution Tax Credit	2.4	0.5	-	N/A	N/A	-
2. Non-taxability of income from the Office of Governor General	S	-	-	S	-	-
3. Exemption of goods purchased by the Office of the Governor General from sales tax	-	-	S	-	-	S
B. Protection of Persons and Property						
1. Non-taxation of R.C.M.P. pension or compensation for injury, disability or death	0.1	-	-	0.1	-	-
2. Non-taxation of up to $300 of allowances to volunteer firemen	1.5	-	-	2.0	-	-

Symbols: N/A: Estimates not available.
- : Not applicable.
S : Estimates not available; revenue impact is expected to be small, less than $5 million.
* : Value included elsewhere.

NOTE: The items in this table are described individually in the Appendix beginning on page 48.

TABLE 1 (Continued)

Functional Category and Item	1976 Tax Expenditures			1979 Tax Expenditures		
	Personal Income Tax	Corporate Income Tax	Commodity Tax	Personal Income Tax	Corporate Income Tax	Commodity Tax
				($ millions)		
II. FOREIGN AFFAIRS						
1. Tax sparing for developing countries	-	N/A	-	-	N/A	-
2. Non-taxation of Special Allowances for Diplomats and other government employees posted abroad	N/A	-	-	N/A	-	-
III. DEFENCE						
1. Non-taxation of Veterans Allowances, Civilian War Pensions and Allowances, and other Service Pensions	60.0	-	-	75.0	-	-
2. Non-taxation of Service Pensions from another country	S	-	-	S	-	-
3. Non-taxation of income from War Savings Certificates	S	-	-	S	-	-
4. Exclusion of the research and development component of defence purchases from sales tax	-	-	N/A	-	-	N/A
5. Exemption of defence memorials and monuments from sales tax	-	-	S	-	-	S
IV. TRANSPORTATION AND COMMUNICATION						
1. Exemption of transportation equipment from sales tax	-	-	175.0	-	-	170.0
2. Investment tax credit on transportation equipment	-	-	-	-	30.0	-

TABLE 1 (Continued)	1976 Tax Expenditures			1979 Tax Expenditures		
Functional Category and Item	Personal Income Tax	Corporate Income Tax	Commodity Tax	Personal Income Tax	Corporate Income Tax	Commodity Tax
			($ millions)			
3. Exemption from branch tax for transportation and communication companies	-	S	-	-	S	-
4. Exemption of foreign shipping and aircraft companies from Canadian income tax	-	N/A	-	-	N/A	-
5. Immediate deductibility of labour costs on capital projects undertaken by railways	-	N/A	-	-	N/A	-
6. Additional depreciation allowances on railway system assets	-	-	-	-	12.0	-
7. Fast write-offs for communication satellites	-	*	-	-	*	-
8. Excess of the tax depreciation over book depreciation, General	-	140.0	-	-	175.0	-
V. ECONOMIC DEVELOPMENT AND SUPPORT						
A. Farming and Fishing						
1. Five-year block averaging for farmers and fishermen	5.0	-	-	N/A	-	-
2. Cash basis accounting	N/A	N/A	-	N/A	N/A	-
3. Flexibility in Inventory Accounting	N/A	N/A	-	N/A	N/A	-
4. Deferral of tax on capital gains on inter-generational rollovers of family farms	N/A	-	-	N/A	-	-
5. Additional depreciation allowance on grain storage facilities	-	*	-	-	*	-
6. Excess of tax depreciation over book depreciation, General	16.0	1.3	-	21.0	2.0	-
7. Investment tax credit on farming and fishing investments	36.0	0.9	-	50.0	10.0	-
8. Deferral of income on grain sales and from destruction of livestock	N/A	N/A	-	N/A	N/A	-

TABLE 1 (Continued)

Functional Category and Item	1976 Tax Expenditures Personal Income Tax	1976 Corporate Income Tax	1976 Commodity Tax	1979 Tax Expenditures Personal Income Tax	1979 Corporate Income Tax	1979 Commodity Tax
	($ millions)					
B. Resource Sector						
1. Fast write-off for Canadian exploration expenses						
2. Fast write-off for Canadian development expenses	-	300.0	-	-	425.0	-
3. 33 1/3 per cent earned depletion allowance						
4. Additional earned depletion for heavy oil and tertiary recovery projects	-	-	-	-	N/A	-
5. Additional earned depletion on frontier oil and gas well exploration costs	-	-	-	30	70	-
6. Drilling funds	S	-	-	80	-	-
7. Accelerated depreciation for mining assets	-	52.5	-	-	70.0	-
8. Additional depreciation allowances on offshore drilling vessels	-	5.0	-	-	5.0	-
9. Excess of tax depreciation over book depreciation, General	-	165.0	-	-	215.0	-
10. Resource allowance and deductibility of provincial royalties for the Syncrude Project	-	0.0	-	-	0.0	-
11. Exemption of iron ore mining from branch tax	-	S	-	-	S	-
12. Taxation of sulphur production at manufacturing tax rates	-	-	-	-	N/A	-
13. Investment tax credit on resource investments	-	50.0	-	-	220.0	-
14. Non-adjustment of specific sales tax rate on gasoline	-	-	-	-	-	25.0
15. Capital gains treatment for prospectors and grubstakers	N/A	N/A	-	N/A	N/A	-
C. Regional Development						
1. Portion of investment tax credit	-	-	-	*	*	-
2. Portion of employment tax credit	-	-	-	*	*	-

TABLE 1 (Continued) Functional Category and Item	1976 Tax Expenditures Personal Income Tax	Corporate Income Tax	Commodity Tax	1979 Tax Expenditures Personal Income Tax	Corporate Income Tax	Commodity Tax
			($ millions)			
D. Energy Conservation						
1. Exemption of energy conservation goods and insulation materials from sales tax	-	-	20.0	-	-	10.0
2. Two-year write-off on energy conservation machinery and equipment	-	5.0	-	-	5.0	-
3. Non-taxation of Home Insulation Grants in Nova Scotia and Prince Edward Island	-	-	-	40.0	-	-
E. Manufacturing Sector						
1. Lower corporate income tax rates on manufacturing and processing profits	-	280.0	-	-	400.0	-
2. Investment tax credit on manufacturing investments	-	40.0	-	-	225.0	-
3. Two-year write-off on manufacturing and processing assets	-	320.0	-	-	425.0	-
4. Additional depreciation allowances on Canadian built ships	-	*	-	-	*	-
5. Excess of tax depreciation over book depreciation, General	-	70.0	-	-	100.0	-
F Research and Development						
1. Immediate write-off on R&D expenditures	S	40.0	-	S	65.0	-
2. Additional allowance of 50 per cent of incremental R&D expenditures	-	-	-	-	35.0	-
3. Investment tax credit on R&D expenditures	-	-	-	S	50.0	-
4. Non-taxation of non-profit scientific research corporations	-	N/A	-	-	N/A	-
5. Exemption of scientific apparatus from sales tax	-	-	N/A	-	-	N/A

TABLE 1 (Continued)

Functional Category and Item	1976 Tax Expenditures: Personal Income Tax	1976 Tax Expenditures: Corporate Income Tax	1976 Tax Expenditures: Commodity Tax	1979 Tax Expenditures: Personal Income Tax	1979 Tax Expenditures: Corporate Income Tax	1979 Tax Expenditures: Commodity Tax
	($ millions)					
G. Small Business						
1. Lower corporate income tax rate	-	738.0	-	-	1,000.0	-
2. Deferral of up to $200,000 of capital gains on inter-generational transfers of small businesses	-	-	-	N/A	-	-
3. Preferential income tax treatment of certain stock options issued to employees of private corporations	-	-	-	N/A	-	-
4. Full offset of capital losses on private company shares and debt obligations	-	-	-	N/A	N/A	-
5. Special investment tax credit on R&D expenditures by small businesses	-	-	-	-	5.0	-
6. Sales tax exemption on up to $50,000 of manufacturing sales ($10,000 in 1976)	-	-	5.0	-	-	30.0
7. Non-taxation of provincial assistance for venture investments	-	-	-	0.0	0.0	-
H. Labour Force						
1. Deductibility of employer contributions to Deferred Profit Sharing Plans	-	N/A	-	-	N/A	-
2. Employment tax credit	-	-	-	S	75.0	-
3. Non-taxation of employee benefits in the form of subsidized loans (including housing loans within prescribed limits)	N/A	-	-	N/A	-	-
4. Non-taxation of employer premiums on group term life insurance of up to $25,000	N/A	-	-	N/A	-	-
5. Non-taxation of other non-monetary benefits of employment (e.g. employee discounts)	N/A	-	-	N/A	-	-

TABLE 1 (Continued)

Functional Category and Item	1976 Tax Expenditures: Personal Income Tax	1976 Tax Expenditures: Corporate Income Tax	1976 Tax Expenditures: Commodity Tax	1979 Tax Expenditures: Personal Income Tax	1979 Tax Expenditures: Corporate Income Tax	1979 Tax Expenditures: Commodity Tax
	($ millions)					
I. General Business and Investment Incentives						
1. Investment tax credit not included elsewhere	5.0	10.0	-	30.0	100.0	-
2. Non-taxation of one half capital gains income	170.0	130.0	-	280.0	225.0	-
3. Non-taxation of realized capital gains income accrued prior to 1972	N/A	N/A	-	N/A	N/A	-
4. Preferential treatment of distributions of pre-1972 corporate surplus	N/A	-	-	N/A	-	-
5. Flow through of capital gains for private corporations	N/A	-	-	N/A	-	-
6. Preferential treatment of stock dividends of public corporations	-	-	-	N/A	-	-
7. $1,000 capital gains exemption for personal use property transactions	N/A	-	-	N/A	-	-
8. $200 capital gains exemption on foreign exchange transactions	N/A	-	-	N/A	-	-
9. Deferral of capital gains income through various rollover provisions	N/A	N/A	-	N/A	N/A	-
a. involuntary dispositions						
b. voluntary dispositions						
c. transfer to a corporation for consideration including shares						
10. Accrued capital gains income not included elsewhere	N/A	N/A	-	N/A	N/A	-
11. Dividend gross-up & tax credit for individuals	170.0	-	-	350.0	-	-
12. Refunds of Part I tax on investment income of private corporations	-	56.4	-	-	65.0	-
13. Preferential treatment of investment and other special corporations	-	N/A	-	-	N/A	-
14. Lower tax rate for investment corporations	-	N/A	-	-	N/A	-
15. Deductibility of patronage dividends by credit unions and other cooperatives	-	60.4	-	-	70.0	-
16. Lower corporate income tax rate for credit unions and other co-operatives	-	N/A	-	-	N/A	-
17. $1,000 investment income deduction	425.0	-	-	650.0	-	-
18. Other accrued investment income not included elsewhere	N/A	N/A	-	N/A	N/A	-

TABLE 1 (Continued)

Functional Category and Item	1976 Tax Expenditures Personal Income Tax	1976 Tax Expenditures Corporate Income Tax	1976 Tax Expenditures Commodity Tax	1979 Tax Expenditures Personal Income Tax	1979 Tax Expenditures Corporate Income Tax	1979 Tax Expenditures Commodity Tax
			($ millions)			
19. Non-taxation of investment income on life insurance policies	N/A	-	-	N/A	-	-
20. Tax deferral from certain deductions for policy reserves of insurance companies	-	N/A	-	-	N/A	-
21. Non-taxation of life insurance companies' world income	-	N/A	-	-	N/A	-
22. Exemption from withholding tax for interest on long-term corporate securities	-	10.0	-	-	100.0	-
23. Exemption from withholding tax for interest on foreign currency deposits	-	70.0	-	-	95.0	-
24. Reduction in withholding tax for corporations having a degree of Canadian ownership	-	15.0	-	-	20.0	-
25. Two-year write-off on pollution control equipment	-	6.3	-	-	10.0	-
26. Excess of tax depreciation over book depreciation not included elsewhere	110.0	145.0	-	150.0	225.0	-
27. 3-per-cent inventory valuation adjustment	-	-	-	30.0	325.0	-
28. Exemption of banks from branch tax	-	N/A	-	-	N/A	-
29. Excess of doubtful debt reserves over expected amounts (mainly financial institutions)	-	N/A	-	-	N/A	-
30. Preferential tax treatment of income debentures and term preferred shares	-	40.0	-	-	400.0	-
31. Tax deferral on income of foreign affiliates of Canadian corporations	-	N/A	-	-	N/A	-
32. Exemption of metric scales and conversion kits from sales tax	-	-	S	-	-	S
33. Tax deferral available from Income Averaging Annuity Contracts (IAACs)	90.0	-	-	105.0	-	-
34. Deductibility of pre-paid expenses	N/A	N/A	-	N/A	N/A	-
35. Deferral of tax from use of holdbacks on progress payments by contractors	N/A	N/A	-	N/A	N/A	-
36. Deferral of tax from use of billed-basis accounting by professionals	N/A	N/A	-	N/A	N/A	-
37. Exemption of non-manufacturing commercial uses of fuel and electricity from sales tax	-	-	275.0	-	-	350.0

TABLE 1 (Continued)	1976 Tax Expenditures			1979 Tax Expenditures		
Functional Category and Item	Personal Income Tax	Corporate Income Tax	Commodity Tax	Personal Income Tax	Corporate Income Tax	Commodity Tax
			($ millions)			
38. Tax losses from fast write-offs of certain leased assets	N/A	N/A	-	N/A	N/A	-
VI. HEALTH AND WELFARE						
A. Health						
1. Deductibility of medical expenses	25.0	-	-	32.0	-	-
2. Portion of charitable deduction and non-taxation of registered charities	*	*	-	*	*	-
3. Exemption of drugs from sales tax	-	-	95.0	-	-	95.0
4. Exemption of purchases by hospitals, sanatoria, etc. from sales tax	-	-	140.0	-	-	145.0
5. Exemption of health appliances from sales tax	-	-	11.0	-	-	11.0
B. Income Maintenance						
1. $1,000 pension income deduction	78.0	-	-	100.0	-	-
2. Age exemption under the personal income tax	128.0	-	-	185.0	-	-
3. Non-taxation of Guaranteed Income Supplement and Spouses Allowance payments	S	-	-	S	-	-
4. Tax advantage on savings in Registered Pension Plans (RPPs) and Registered Retirement Savings Plans (RRSPs)	1,400.0	-	-	2,000.0	-	-
5. Portion of tax deferral available from Income Averaging Annuity Contracts (IAACs)	*	-	-	*	-	-
6. Tax advantage on savings in Canada and Quebec Pension Plans (CPP/QPP)	290.0	-	-	480.0	-	-
7. Rollovers into RRSPs	*	-	-	*	-	-
8. Deductibility of support payments	N/A	-	-	N/A	-	-
9. Income splitting through interest-free loans between family members	N/A	-	-	N/A	-	-

TABLE 1 (Continued)

Functional Category and Item	1976 Tax Expenditures: Personal Income Tax	1976 Tax Expenditures: Corporate Income Tax	1976 Tax Expenditures: Commodity Tax	1979 Tax Expenditures: Personal Income Tax	1979 Tax Expenditures: Corporate Income Tax	1979 Tax Expenditures: Commodity Tax
	($ millions)					
10. Marital exemption	930.0	-	-	1,355.0	-	-
11. Exemption for wholly-dependent children	609.0	-	-	870.0	-	-
12. Exemptions for other dependants	29.0	-	-	36.0	-	-
13. Child tax credit	-	-	-	810.0	-	-
14. Preferential Tax Treatment of Workmen's Compensation	198.0	230.0	-	265.0	300.0	-
15. Non-taxation of income from personal injury awards (including awards for Thalidomide injuries)	N/A	-	-	N/A	-	-
16. Non-taxation of strike pay	3.0	-	-	S	-	-
17. Non-taxation of up to $10,000 of death benefit	N/A	-	-	N/A	-	-
18. Exemption of food and non-alcoholic beverages from sales tax	-	-	2,120.0	-	-	2,200.0
19. Exemption of home-heating fuels and electricity from sales tax	-	-	400.0	-	-	400.0
20. Exemption of clothing and footwear from sales tax	-	-	465.0	-	-	440.0
21. Deductibility of unemployment insurance premiums	215.0	270.0	-	240.0	325.0	-
22. Preferential Tax treatment of registered supplementary unemployment insurance plans	-	N/A	-	-	N/A	-
23. Inter-spousal capital gains rollover	N/A	-	-	N/A	-	-
C. Social Assistance						
1. Non-taxation of means- and-needs tested and income-tested social assistance benefits	S	-	-	S	-	-
2. Exemption for the disabled and the blind	6.0	-	-	10.0	-	-
3. Exemption of goods manufactured by the handicapped from sales tax	-	-	N/A	-	-	N/A
D. Indians and Eskimos						
1. Non-taxation of income earned by Indians on reserves	N/A	-	-	N/A	-	-

TABLE 1 (Continued)	1976 Tax Expenditures			1979 Tax Expenditures		
Functional Category and Item	Personal Income Tax	Corporate Income Tax	Commodity Tax	Personal Income Tax	Corporate Income Tax	Commodity Tax
	($ millions)					
E. Housing and Urban Renewal						
1. Non-taxation of capital gains on principal residence	2,770.0	-	-	2,500.0	-	-
2. Non-taxation of imputed income on equity in owner-occupied residences	2,900.0	-	-	3,700.0	-	-
3. Registered Home Ownership Savings Plan (RHOSP) deduction	105.0	-	-	115.0	-	-
4. Multiple Unit Residential Buildings (MURB) provision	10.0	N/A	-	10.0	N/A	-
5. Deductibility of carrying charges on land	-	-	-	-	35.0	-
6. Non-taxation of income of corporations providing low-cost housing for the aged	-	N/A	-	-	N/A	-
7. Portion of charitable deduction	*	*	-	*	*	-
8. Non-taxation of first-time home buyer grants	8.0	-	-	-	-	-
9. Reduced rate of sales tax on building materials	-	-	470.0	-	-	395.0
10. Exemption of construction equipment from sales tax	-	-	80.0	-	-	80.0
11. Exemption of goods in competition with on-site construction from sales tax	-	-	N/A	-	-	N/A
12. Exemption of ready-mix concrete from sales tax	-	-	55.0	-	-	55.0
13. Reduced rate of sales tax on travel trailers used as homes	-	-	3.5	-	-	-
VII. EDUCATION ASSISTANCE						
1. Non-taxation of first $500 of scholarship and bursary income	4.0	-	-	6.0	-	-
2. $50 per month education deduction	39.0	-	-	42.0	-	-
3. Deduction of tuition fees	30.0	-	-	41.0	-	-
4. Deduction of contributions to teachers exchange fund	N/A	-	-	N/A	-	-
5. Preferential Tax Treatment of Registered Education Savings Plans (RESPs)	N/A	-	-	N/A	-	-
6. Exemption of construction materials & equipment bought by educational institutions from sales tax	-	-	57.0	-	-	52.0

TABLE 1 (Continued)

Functional Category and Item	1976 Tax Expenditures Personal Income Tax	1976 Corporate Income Tax	1976 Commodity Tax	1979 Tax Expenditures Personal Income Tax	1979 Corporate Income Tax	1979 Commodity Tax
			($ millions)			
7. Exemption of technical, educational, and other books from sales tax	-	-	28.0	-	-	28.0
8. Portion of charitable deduction and non-taxation of registered charities	*	*	-	*	*	-
VIII. CULTURE AND RECREATION						
1. Deductibility of itemized charitable donations and the $100 standard deduction	320.0	35.0	-	355.0	40.0	-
2. Non-taxation of registered charities	-	N/A	-	-	N/A	-
3. 100 per cent write-off for Canadian films	N/A	*	-	N/A	*	-
4. Non-taxation of capital gains on gifts of property under the Cultural Property Export and Import Act	N/A	-	-	N/A	-	-
5. Portion of tax deferral available from Income Averaging Annuity Contracts	*	-	-	*	-	-
6. Write-off on art work purchased by businesses	*	*	-	*	*	-
7. Non-taxation of lottery and gambling winnings	200.0	-	-	300.0	-	-
8. Deduction for clergymen's residence	N/A	-	-	N/A	-	-
9. Non-taxation of certain income of individuals who have taken vows of perpetual poverty	N/A	-	-	N/A	-	-
10. Exemption of newspaper and magazine production from sales tax	-	-	50.0	-	-	50.0
11. Exemption of a range of cultural and religious materials from sales tax	-	-	N/A	-	-	N/A
12. Exemption of imported antiques from sales tax	-	-	2.0	-	-	2.0
13. Exemption of amusement devices and equipment for use at exhibits or fairs from sales tax	-	-	N/A	-	-	N/A
14. Exemption of bicycles & tricycles from sales tax	-	-	13.0	-	-	11.0
15. Exemption of the outputs of craftsmen, artists, and sculptors from sales tax	-	-	7.0	-	-	7.0

TABLE 1 (Continued)	1976 Tax Expenditures			1979 Tax Expenditures		
Functional Category and Item	Personal Income Tax	Corporate Income Tax	Commodity Tax	Personal Income Tax	Corporate Income Tax	Commodity Tax
			($ millions)			
IX. FISCAL TRANSFER PAYMENTS						
1. Income tax abatement to Quebec for contracting out of the shared-cost programs	965.0	-	-	825.0	-	-
2. Transfers of income tax room to provinces in respect of shared-cost programs	750.0	170.0	-	3,000.0	270.0	-
3. Exemption from withholding tax for interest on provincial and municipal debt	-	160.0	-	-	270.0	-
4. Income tax exemption for provincial and municipal corporations	-	N/A	-	-	N/A	-
5. Exemption of a range of municipal purchases from sales tax	-	-	100.0	-	-	100.0
6. Exemption of provincial purchases from sales tax for provinces not party to the Reciprocal Taxation Agreements	-	-	90.0	-	-	30.0
X. PUBLIC DEBT						
1. Exemption from withholding tax for interest on Government of Canada debt	-	20.0	-	-	60.0	-
XI. OTHER TAX PREFERENCES						
1. General averaging for individuals	155.0	-	-	200.0	-	-
2. Non-taxation of certain federal Crown corporations	-	N/A	-	-	N/A	-
3. Non-taxation of income of various non-profit entities not included elsewhere	-	N/A	-	-	N/A	-

TABLE 1 (Continued)

Functional Category and Item	1976 Tax Expenditures			1979 Tax Expenditures		
	Personal Income Tax	Corporate Income Tax	Commodity Tax	Personal Income Tax	Corporate Income Tax	Commodity Tax
			($ millions)			
4. Exemption of goods imported in travellers' baggage from sales tax	-	-	N/A	-	-	N/A
5. Exemption of manufacture of coins from sales tax	-	-	N/A	-	-	N/A
XII. MEMORANDUM ITEMS						
A. Selected Totals						
1. Total tax expenditure value of Investment Tax Credit items listed above	40.0	100.0	-	85.0	625.0	-
2. Total tax expenditure value of items listed above for CCA claims in excess of book depreciation	135.0	910.0	-	175.0	1,250.0	-
3. Cumulative amount of federal corporate income taxes deferred per companies books	-	8,450.0	-	-	N/A	-
4. Cumulative amount of tax deferrals and reductions due to deductibility of contributions to RRSPs and RPPs	15,250.0	-	-	20,500.0	-	-
5. Cumulative amount of tax deferrals and reductions due to deductibility of CPP/QPP contributions	3,150.0	-	-	4,850.0	-	-
B. Commodity Tax						
1. Exemption of services from the sales tax base	-	-	4,480.0	-	-	4,600.0
2. Other commodity taxes in excess of manufacturers sales tax						
a. gasoline	-	-	634.0	-	-	435.0
b. tobacco	-	-	704.0	-	-	800.0
c. alcohol	-	-	555.0	-	-	665.0
d. jewelry	-	-	37.0	-	-	45.0
e. heavy cars, car air conditioners, private planes, motorcycles, boat motors	-	-	24.0	-	-	26.0
f. air transport	-	-	70.0	-	-	90.0
g. other	-	-	10.0	-	-	11.0

TABLE 1 (Continued)	1976 Tax Expenditures			1979 Tax Expenditures		
Functional Category and Item	Personal Income Tax	Corporate Income Tax	Commodity Tax	Personal Income Tax	Corporate Income Tax	Commodity Tax
			($ millions)			
3. Oil export charge	-	-	828.0	-	-	377.0
4. Special levy to provide international oil prices to Syncrude	-	-	-	-	-	285.0
5. Refunds of special excise tax on gasoline to commercial users	-	-	195.0	-	-	150.0
C. Resource Sector						
1. Revenue impact of 25 per cent resource allowance						
a. mining	-	130.0	-	-	N/A	-
b. petroleum, coal and gas	-	475.0	-	-	N/A	-
2. Revenue impact of non-deductibility of provincial royalties						
a. Mining	-	30.0	-	-	N/A	-
b. Petroleum, coal and gas	-	715.0	-	-	N/A	-
3. Logging tax credit	-	9.0	-	-	N/A	-
D. Other						
1. Childcare expense deduction	35.0	-	-	40.0	-	-
2. Employment expense deduction	250.0	-	-	500.0	-	-
3. $5,000 limit for deduction of hobby farm losses	50.0	0.2	-	60.0	S	-
4. Non-taxation of expense allowances of MPs, MPPs, Royal Commissioners, and certain municipal officials	S	-	-	S	-	-
5. $2,000 limit for deduction of capital losses against other income	20.0	-	-	N/A	-	-
6. Goodwill and expensing of advertising costs	N/A	N/A	-	N/A	N/A	-
7. Non-deductibility of advertising expenses in foreign media	-	N/A	-	-	N/A	-
8. Non-deductibility of salary paid to spouse by unincorporated business	125.0	-	-	150.0	-	-

APPENDIX

INTRODUCTION

This appendix provides a brief description of each of the provisions included in the tax expenditure account, and indicates the nature of the tax preference. In some cases, where a particular tax provision can be viewed in one of several ways with regard to defining the benchmark tax system, the alternative points of view that could be adopted are indicated. The description of the individual tax expenditure items follows the order of Table 1. However, before discussing each item individually, there is a general discussion of the procedures used to estimate and classify the tax expenditure items in the account. Also, a number of items that appear several times are first described in general terms.

GENERAL NOTES ON ESTIMATION METHODOLOGY

Estimates of tax expenditures in the area of income tax have been obtained from a number of sources. First, the values of many of the tax preferences to individuals (e.g. the age and disability exemptions, the marital and child exemptions, the $1,000 investment income deduction, the dividend tax credit) have been estimated by simulating the impact of a given provision on a sample of individual tax returns for 1976. To obtain the corresponding estimates for 1979, the information on the sample of tax returns was projected to 1979 by using various assumptions about economic and demographic trends. These estimates are generally of a high degree of reliability. Second, most of the corporate tax estimates (e.g. the value of the low corporate tax rates for small business and manufacturing, the accelerated capital cost allowances, the depletion allowance) are based on tax return data published by Statistics Canada. Certain other income tax items (e.g. the imputed income on equity in owner-occupied homes, capital gains on principal residences) are estimated on the basis of information from sources other than the individual and corporate tax returns. These estimates are subject to wider margin of error. In many cases, details of the estimation methodology are given with the descriptions of the items.

Commodity tax expenditure magnitudes are generally based on estimates of the sales volume of the goods that are exempt. These volumes have been estimated in three main ways. First, in some cases, the benchmark sales tax base is estimated from Statistics Canada data on sales of manufactured goods, duty-paid value of imports, and exports and re-exports. This estimation procedure is used for transportation equipment; food and non-alcoholic beverages; clothing and footwear; drugs; technical, educational, or other books; and newspapers and magazines. The tax base in these cases is generally projected using forecasts of National Accounts consumer expenditures by various commodity groups. Second, for another group of commodities, the benchmark sales tax base is estimated from Statistics Canada data on sales by retailers or data on consumer expenditures by various commodity groups. These amounts are adjusted for retail sales tax and both retail and wholesale gross margins, where applicable, to derive the appropriate manufacturer's tax base. This estimation procedure is used for home heating fuels and electricity; a range of goods used by the disabled; health appliances; purchases by hospitals, sanatoria, etc.; manufacture of ready mix concrete; education construction and equipment; service sector; and travel trailers used as homes. The tax base is projected by using industry selling price indices and various projections of real sales growth, or forecasts of National Accounts consumer expenditures by various commodity groups. Third, actual revenue collections data are available for a number of items. These include: the sales tax on building materials; refunds of special excise tax on gasoline to commercial users; and the special excise tax levies on a range of other commodities (e.g. jewelry, tobacco, alcohol). Also, some estimates have been provided by other government departments. They include the estimate of the Syncrude levy and the value of the tax expenditure associated with the four provinces which do not participate in the Reciprocal Taxation Agreement. Some external survey data are used in estimating the non-adjustment of the specific sales tax rates on gasoline and diesel fuel.

All estimates should be considered as the mid-point of a range of estimates.

The estimates assume that the particular tax provision was eliminated with everything else unchanged. (Thus, estimation is relative to the existing rather than to the benchmark tax system.) As a result of interaction among provisions, the revenue effect from elimination of two or more tax expenditures is not generally equal to the sum of the revenue effect of each provision as shown in the table. For example, if a deduction were eliminated from the individual income tax, some taxpayers would be pushed into higher tax brackets so that elimination of another deduction would raise taxes by more than is shown in the table. Thus, sums of the revenue effects of a number of tax expenditures should be taken as indicating a general magnitude rather than an exact revenue cost.

The estimates further assume that taxpayer behaviour would not be influenced by elimination of a tax provision. They neglect any revenue consequences resulting from changes in aggregate economic activity that would occur if particular tax expenditure provisions were eliminated. The estimates also take no account of any corresponding provincial tax expenditures.

CATEGORIZATION OF ITEMS BY FUNCTIONAL CATEGORY

The tax expenditures listed in Table 1 have generally been allocated to the same functional categories that are used in the Public Accounts of Canada. Of course, any such categorization encounters a number of ambiguities where one item could belong to several categories. The descriptions of the individual items will note any alternative categories where the item might have been allocated.

Fast Write-offs from the Capital Cost Allowance: The capital cost allowance (CCA) system provides taxpayers a deduction in determining their taxable income to take account of the wear and tear on fixed assets such as machinery and equipment that occurs in the course of carrying on productive activity. However, capital cost allowances that are determined for tax purposes differ in several fundamental ways from actual economic or physical depreciation. First, the rates at which assets can be written off against income are typically faster for tax purposes than actual depreciation or than the rates used in companies' financial accounts (which in turn represent the companies' own estimates of the useful lives of their assets). This is especially true in the case of incentive CCA classes such as the two-year write-off for manufacturing machinery and equipment. The fast write-off results in a deferral of tax. For example, in the case of an asset eligible for a fast write-off, the CCA system allows a larger deduction from income when the asset is new, hence lower taxable income and lower tax liability, than had the "actual" depreciation been claimed. Correspondingly, when the asset is nearing the end of its useful life, all or virtually all of the CCA will have been claimed even though there still was actual depreciation. Thus, income for tax purposes in these later years would be higher than otherwise. The net effect, then, is that income tax is deferred. However, in the case of a growing firm with many assets, the larger CCA claims on the newer assets (larger both because of the fast write-off and because the firm is growing) will always be sufficient to offset the smaller CCA claims on older assets, so that taxable income is continually lower than it otherwise would be. In this case, the tax deferral becomes indefinite and is equivalent to a tax reduction. In principle, a tax deferral is equivalent to an interest-free loan from the government to the taxpayer. The value of such a tax benefit equals the interest rate times the amount of loan - i.e. the amount of tax deferred.

The second main difference between CCA claimable and actual depreciation is that taxpayers have discretion in the rate at which they utilize their CCA. If a taxpayer has no taxable income even before claiming any CCA, he need not claim the CCA available to him in that year; he can wait to a future year. In this way, taxpayers can avoid having to create a loss for tax purposes which is subject to a five-year limit on carryforwards. There is no time limit on using CCA. Furthermore, the value of some other tax provisions such as the resource allowance can be enhanced by making use of the discretion available in the CCA system. By comparison, the benchmark tax system, since it uses actual depreciation, implies no discretion in the determination of net income. The revenue implications of this discretionary aspect of the CCA system are not fully captured in the estimates in Table 1, in particular to the extent that fewer losses would be available to be offset against income in other years.

The third basic difference between CCA claimable and actual depreciation arises from the grouping of assets into CCA classes. Actual depreciation is determined by reference to each asset individually. If an asset that had originally cost $100 had depreciated so that its current value was $50, and it was sold for $70, the $20 difference in principle should be brought into income. However, with the CCA system, this asset would typically be grouped with many other assets in a CCA class and the proceeds of sale serve simply to reduce the total undepreciated value of the class. The effect of this is that the $20 would be brought into income only gradually as claims on the CCA class were made over a period of years. Thus, the recapture of any "excess" depreciation claims is deferred well beyond the time of disposition of the assets. There is also a corresponding deferral in the recognition of losses when the asset is sold for less than its depreciated value.

Finally, CCA claims can exceed actual or book depreciation because the tax system allows CCA to be claimed at full annual rates even when the asset is bought at the end of the fiscal period.

The tax expenditure value of the CCA provisions has been estimated in reference to the depreciation claimed for book purposes in taxpayers' financial statements. An attempt has been made in Table 1 to disaggregate the tax expenditure value by functional category. Specifically, the estimation procedure involved several steps. First, the excess of 1976 CCA claims over 1976 book depreciation was estimated for three broad incentive groups of assets: the two-year write-off for manufacturing and processing equipment (Class 29), the fast write-off for new mines (Class 28), and the two-year write-off for air and water pollution control equipment (Classes 24 and 27). These estimates, drawing on Statistics Canada's annual series Corporation Taxation Statistics, were developed using historical data by industrial sector on the amounts of CCA claimed to infer the associated gross investments in these assets, and then to infer book depreciation on the assumption that it occurred on a 20-per-cent declining balance basis. The resulting estimates of the difference between CCA claimed and book depreciation by industrial sector were then subtracted from the total difference for each sector in 1976 to yield the remaining excess due to the overall generosity of the CCA system and other incentive classes not separately identified. The result was a set of differences between CCA claimed and book depreciation in 1976 by industrial groups for four groups of assets, three specific incentive groups and the residual group. (These differences may understate the difference between CCA claims and "actual" depreciation because smaller firms tend to use the CCA rates both for tax purposes and for their own financial statements.) The tax expenditure values were then estimated under the assumption that the differences involved simply deductions from income, rather than deferrals, by applying effective corporate income tax rates by sector in 1976. (The residual tax expenditure estimate, Item V.I.26 below, also excludes a number of other CCA items estimated separately.) In principle, it would have been more appropriate to estimate the value of these tax expenditures by applying an interest rate (e.g. the long-term government borrowing rate) to the cumulative value of deferred taxes (i.e. the effective tax rate times the cumulative value of CCA claims in excess of book depreciation). However, sufficiently detailed data are not available for this method of estimation. For information purposes, the memorandum items show the total value of deferred taxes as reported by companies in their financial statements, though it should be noted that these deferred taxes arise not only from the CCA system but also from a range of other provisions including, for example, fast write-offs of exploration and development expenditures in the resource sector and the deduction of pre-paid expenses.

Investment Tax Credit: As an incentive for taxpayers to invest in productive assets, the Income Tax Act provides for a credit against tax otherwise payable. The credit is available both to corporate taxpayers and unincorporated businesses under the individual income tax. Between June 23, 1975, when the provision was first introduced, and March 31, 1977, the credit was 5 per cent of investments in new plant and machinery and equipment used in manufacturing and processing, farming and fishing, logging, grain storage, and the resource sector. In the budget of March 31, 1977, the credit was differentiated by geographic region with a basic value of 5 per cent, 10 per cent in the Atlantic Provinces and the Gaspé, and 7.5 per cent in other designated regions (under the Regional Development Incentives Act, specifically the remainder of Québec excluding the Montréal-Hull corridor, Northern Ontario, Manitoba, Saskatchewan, Northern Alberta, Northern British Columbia, the Yukon and Northwest Territories). Also in March 1977, the credit was extended to expenditures on research and development. Effective November 16, 1978, the three credit rates were increased to 7 per cent, 10 per cent, and 20 per cent respectively. The basic 7-per-cent credit was also extended to investments in transportation equipment. The credit for expenditures on research and development was increased to 10 per cent generally, 20 per cent in the Atlantic Provinces and the Gaspé, and 25 per cent for small business corporations throughout Canada. The credit can be used in full against tax otherwise payable up to $15,000, and beyond that in amounts not exceeding half of tax otherwise payable. Any unused credits can be carried forward up to five years. The tax credit is considered a tax expenditure because it discriminates among taxpayers according to the way they use their income. The amounts of credit claimed must reduce the capital cost of assets that can be claimed in the CCA system.

Amounts of investment tax credit by sector for 1976 are reported by Statistics Canada in Corporation Taxation Statistics. The benefit of the credit to corporations, as noted above, is less than amounts claimed since the amount of the cost of the property, for purposes of claiming capital cost allowance, is reduced by the credit claims. The tax expenditure values shown in the account have been adjusted to account for this CCA offset. The amounts of credit for particular sectors (e.g. manufacturing, resource industries) are shown under separate headings and the remainder is shown under the heading General Business and Investment (Item V.I.1). Amounts of credit claimed for 1979 have been projected on the basis of estimates of investment by sector, taking account of changes in the rate of credit and the fact that amounts of credit unclaimed in prior years can be carried forward.

Capital Gains: In the benchmark tax system, capital gains are fully included in income on an accrual basis. The Income Tax Act provides for the inclusion of one-half of most capital gains, and then only when the gain is realized, that is when the asset is sold. Tax expenditures in this area therefore arise in several ways. First, some capital gains income is completely exempt, for example gains on a principal residence and gains on items of personal use property (such as automobiles, boats, and other consumer durables) sold for less than $1,000. Second, for most capital gains, one-half of the gains are not included in income for tax purposes. Third, even when gains are realized, there are a number of provisions that permit taxpayers to avoid realization for tax purposes, for example tax free rollovers between family members of farm assets or of small business shares up to a $200,000 limit. These rollover provisions are not necessarily separate tax expenditures, because they are special cases of departures from accrual taxation. However, they have been listed separately to provide more information. In addition, in intercorporate transactions, otherwise taxable capital gains can be converted to dividends which can flow freely between corporations. Finally, to the extent that capital gains income is accrued but not realized, there is a deferral of tax until the time when the gain is realized.

Withholding Tax on Payments to Non-Residents: Non-residents of Canada who receive Canadian income from employment, an unincorporated business, or realized capital gains pay income tax as if they were Canadian residents except that account is taken only of their Canadian rather than their world income. Canadian "property income" of non-residents (e.g. rent, royalties, dividends, interest, RRSP payments), however, is instead subject to withholding tax at a flat rate of 25 per cent. (Costs associated with generating this income are not deductible.)

On pragmatic grounds, the benchmark system is taken to include the current withholding tax at a flat 25-per-cent rate, or such other rate as is specified in Canadian tax treaties with other countries, for example a 15-per-cent rather than 25-per-cent rate for U.S. residents.

Tax expenditures arise in relation to the application of the withholding tax in that some forms of property income are unilaterally exempted from withholding tax altogether, for example interest on certain government bonds. These tax expenditures are preferences to non-resident individuals and corporations to the extent that their own countries do not tax them on their world income. Note that these tax expenditures as well as those relating to the branch tax have been included in Table 1 under the column for corporate income tax expenditures, though in principle they should appear under a separate column.

Branch Tax: Foreign corporations operating in Canada may do so either in a branch form, which is not a separate legal entity, or by incorporating a subsidiary. In order that the withholding tax is generally neutral between the two operating forms, a 25-per-cent tax is levied on the after-tax profits of a branch that are not reinvested in Canada, since these funds can be moved out to the foreign head office through an inter-branch transfer internal to the corporation. (Corporate income tax is levied on the branch as if it were incorporated.) The 25-per-cent branch tax therefore corresponds to the 25-per-cent withholding rate that applies to dividend payments to foreign parent corporations from incorporated Canadian subsidiaries. In the case of corporations resident in some countries with which Canada has a tax treaty, for example the U.S., rates of both the branch tax and withholding tax are lower. In a number of industries, however, businesses have been exempted from the branch tax, thereby giving rise to tax expenditures.

INDIVIDUAL ITEMS FROM TABLE 1

I GENERAL GOVERNMENT SERVICES

A. LEGISLATION AND ADMINISTRATION

1. Political Contribution Tax Credit: The Income Tax Act allows corporate and individual taxpayers a credit for donations to registered political parties at the federal level. The credit is 75 per cent of the first $100 of contributions, 50 per cent on the next $450 of contributions and 33 1/3 per cent on contributions exceeding $550. The maximum credit claimable is $500. This is a tax preference based on the uses to which taxpayers put their income.

2. Non-Taxability of Income from the Office of Governor General: This income is exempt from individual taxation. Since, under the benchmark tax structure no preferential treatment exists for income from particular sources, this provision is a tax expenditure.

3. Exemption of Goods Purchased by the Office of the Governor General from Sales Tax: Goods purchased by the Office of the Governor General are exempt from the federal sales tax. Under the benchmark commodity tax system no preferential treatment is provided to any taxpayers so that this exemption constitutes a tax expenditure.

B. PROTECTION OF PERSONS AND PROPERTY

1. Non-Taxation of RCMP Pension or Compensation for Injury, Disability or Death: Payments of these amounts are not includable in income for tax purposes. This is a tax preference based on income source.

2. Non-Taxation of up to $300 of Allowances to Volunteer Firemen: Volunteer firemen may receive up to $300 of allowances which are not includable in income for tax purposes. This is a tax preference based on income source.

II FOREIGN AFFAIRS

1. Tax Sparing For Developing Countries: As a general rule Canada provides a credit against Canadian income taxes for foreign income taxes only to the extent such taxes were actually paid. However, in certain developing countries, Canada gives a full credit even where domestic taxes have been reduced, provided the tax relief has been given for development reasons and not as an export promotion device.

2. Non-Taxation of Special Allowances for Diplomats and Other Government Employees Posted Abroad: Payments of these amounts are non-taxable. This is a tax preference based on income source.

III DEFENCE

1.,2. Non-Taxation of Veterans Allowances, Civilian War Pensions and Allowances, and Service Pensions from Another Country: These pension payments are not subject to individual income taxation. This is a tax preference based on income source. Included in the amounts are Canadian pensions and pensions received from countries that were allies of Canada. In the Public Accounts, corresponding pension expenditures are included under the heading Health and Welfare. The estimate is based on the amounts of payments under the various programs as reported in the Public Accounts and Main Estimates.

3. Non-Taxation of Income from War Savings Certificates: These payments are not subject to individual income taxation. This is a tax preference based on income source.

4. Exclusion of the Research and Development Component of Defence Purchases from Sales Tax: A remission order issued under the Financial Administration Act exempts from the federal sales tax the research and development portion of the sale price of manufactured goods, where the goods are procured for defence purposes. This constitutes a tax expenditure because, under the benchmark commodity tax system, the value of all inputs into the production of a good is reflected in the final value of the good and thus enters into the actual tax base. A precise estimate of the federal cost of this tax expenditure is not available at this time, but is expected to be fairly significant (between $30 and $100 million).

5. Exemption of Defence Memorials and Monuments from Sales Tax: This is considered a tax expenditure because, under the benchmark commodity tax system, the sales of all manufactured and produced goods are taxed.

IV. TRANSPORTATION AND COMMUNICATIONS

1. Exemption of Transportation Equipment from Sales Tax: This is considered a tax expenditure because, under the benchmark commodity tax system, the sales of all manufactured and produced goods are taxed. Insofar as this kind of equipment is used as an input to provide tax-free services, it should be reflected in the tax base. If, however, the benchmark tax base included the value of services, inputs such as transport equipment would be exempt as the associated services would be taxed instead. The coverage of the tax expenditure estimate includes: highway trucks with a gross vehicle weight rating of sixteen thousand pounds or more, trailers and semi-trailers, railway locomotives and railway rolling stock, ships and other marine vessels purchased or imported for use exclusively in marine activities, eligible aircraft, parts and equipment, refrigerator units and dollies. The tax expenditure also includes exemption of parts and equipment, in excess of $1,000 per unit, designed for permanent installation on the above tax exempt goods. However, all parts and equipment for aircraft purchased or imported for use exclusively in the provision of certain classes of air services are exempt. Not included in the 1979 estimate and added

to the provision after 1976 is the exemption for buses or vans specially equipped for transporting handicapped persons and school buses designed to carry twelve or more passengers. The estimate does involve some overestimation to the extent that transportation equipment is used in the production of other manufactured goods. A portion of this tax expenditure has been included under Item IX.5.

2. Investment Tax Credit on Transportation Equipment: As noted generally above, effective November, 1978, a 7-per-cent tax credit is available for purchases of transportation equipment including ships, aircraft, long-haul trucks, intercity buses, and railway assets. This is a tax preference based on the use of income.

3. Exemption from Branch Tax for Foreign Transportation and Communication Companies: Foreign transportation and communication companies are exempted from the branch tax. This is a tax preference as described generally above.

4. Exemption of Foreign Shipping and Aircraft Companies from Canadian Income Tax: Foreign-owned companies are generally subject to Canadian corporate income tax on their Canadian profits if they have a permanent establishment in Canada. Foreign-owned shipping and aircraft companies are, however, exempted from Canadian tax even though they have a permanent establishment in Canada.

5. Immediate Deductibility of Labour Costs on Capital Projects Undertaken by Railways: If a taxpayer uses his own employees to construct a capital asset, the whole cost of the asset including the labour cost must generally be depreciated at the applicable rate for the type of asset. This tax treatment puts capital projects constructed by a business itself on the same basis as projects constructed for it by other companies. Railways, however, are permitted an immediate deduction of the cost of labour they use to construct depreciable property, thereby allowing a faster write-off of expenses for capital services than is warranted on the basis of actual depreciation.

6. Additional Depreciation Allowances on Railway System Assets: Railway track and grading expenditures made between March 31, 1977, and April 1, 1980, are eligible to be written off at a rate of 8 per cent per year (declining balance basis) rather than the usual rate of 4 per cent. Railway system assets acquired after April 10, 1978, and before 1983 are eligible for additional allowance at a rate of 6 per cent per year in the year of acquisition and the following four years. This allowance covers railway track and grading, motive power, rolling stock, signaling equipment and certain other assets. These faster write-offs permit a deferral of tax. The amounts of additional CCA are estimated on the basis of data on qualifying investment from Statistics Canada series and from other sources such as company reports.

7. Fast Write-Offs for Communications Satellites (Class 30): Unmanned telecommunications spacecraft can be written off on a 40-per-cent declining balance basis, a faster rate than actual depreciation, giving rise to a deferral of tax.

8. Excess of Tax Depreciation over Book Depreciation, General: This item is the total tax expenditure arising from the fast write-offs in the CCA system, as discussed generally above, within the transportation and communications sectors excluding the amount under Item 6 above.

V. ECONOMIC DEVELOPMENT AND SUPPORT

A. FARMING AND FISHING

1. Five-Year Block Averaging For Farmers and Fishermen: Farmers and fishermen are allowed to average their incomes once every five years over the preceding five-year period and compute to tax as if their income in each year had equalled the five-year average. This is preferential treatment as the benchmark tax system would require tax to be paid annually on the income received in that year. Because of the progressive rate structure in the personal income tax, farmers and fishermen with fluctuating incomes benefit through the use of this averaging. (Farmers and fishermen are also eligible for general averaging, Item XI.1 below.) Such a provision could have been taken as part of the benchmark tax structure were it to apply to all taxpayers and not just to farmers and fishermen.

2. Cash Basis Accounting: Farmers and fishermen can elect to use the cash basis of accounting for tax purposes (except in respect of depreciable assets). Other taxpayers must generally use accrual accounting. Under the cash basis, receipts are included in income only when received and expenses are deductible when actually paid, regardless of when the income to which these costs relate arises. Under the benchmark tax structure, income is taxable when it accrues. Cash basis accounting may permit deferral of tax in that costs paid are immediately deductible despite the fact that the income to which they relate may not arise until a later year. For example, inventory costs can be deducted as a current expense unlike the case of most other taxpayers who must use accrual accounting methods. Moreover, accounts receivable (i.e. accrued) in the year but not yet paid are not taxable.

3. Flexibility in Inventory Accounting: Farmers who are using the cash basis method of accounting are allowed to depart from it with regard to their livestock inventory. Under cash basis accounting, net additions to inventory are a cost which is deducted in computing income. When a farmer's livestock inventory is growing from year to year, such costs could put him in a loss position for tax purposes. However, a discretionary amount can be added to income each year not exceeding the fair market value of livestock on hand at year end. This amount must then be deducted from income the following year. The effect of this provision is to allow farmers who are building up their herds to avoid the five-year carryforward limit on losses, or to make best use of the five-year block averaging provisions.

4. Deferral of Tax on Capital Gains on Inter-Generational Rollovers of Family Farms: Sales or gifts of business assets to children or grandchildren (on or before death of the taxpayer) would usually give

rise to taxable capital gains to the extent that the fair market value exceeded the cost base of the property under the existing tax system. On inter-generational transfers of farm property, or shares in a farm corporation after April 10, 1978, the taxation of capital gains is deferred until the property passes outside of the family. This is a tax preference both in that it is a departure from accrual taxation and in that it is a relaxation of the deemed realization provisions of the existing tax system.

5. Additional Depreciation Allowances on Grain Storage Facilities: Certain grain storage facilities acquired between April 1, 1972, and August 1, 1974, are eligible for additional CCA at rates from 14 to 22 per cent. These depreciation claims are in addition to the usual amounts claimable. As noted generally above, this is a preference in that it allows tax to be deferred.

6. Excess of Tax Depreciation over Book Depreciation, General: This item is the total tax expenditure arising from the fast write-offs in the CCA system, as discussed generally above, in the farming and fishing sectors.

7. Investment Tax Credit in Farming and Fishing Investments: This item is the value of the investment tax credit applicable to the farming and fishing sectors.

8. Deferral of Income on Grain Sales and from Destruction of Livestock: Under the deferred cash ticket program of the Canadian Wheat Board, farmers may make deliveries of grain before the year-end where payment takes the form of a ticket that may be cashed in the following year. The payment is included in income for tax purposes only when the ticket is cashed. (This is of benefit to farmers who have not elected cash basis accounting.) Also, on election of the taxpayer, where there has been forced statutory destruction of livestock (e.g. as a result of brucellosis) the income received as a result of the forced destruction can be deemed to be income in the following year. These measures are a departure from accrual accounting and result in a deferral of tax.

B. RESOURCE SECTOR

1. Fast Write-Off for Canadian Exploration Expenses: For purposes of these expenses, the Income Tax Act distinguishes between taxpayers that are or are not Principal Business Corporations (PBCs). A PBC is a corporation whose principal business is mining, production or refining of petroleum products, processing mineral ores, operating an oil or gas pipeline, or another prescribed activity. For such companies, Canadian Exploration Expenses must be deducted from any of their income as it is earned, though the deduction cannot exceed the amount of that income. (Unused Canadian Exploration Expenses are carried forward without limit.) Other taxpayers who are not PBCs can deduct

unclaimed Canadian Exploration Expenses on either a 30-per-cent declining balance basis or up to the amount of their resource income, whichever is greater. These provisions came into effect on May 5, 1974. Other preferential tax treatment applies to exploration (and development) expenditures made before that date. In addition, as a temporary provision, Canadian Exploration Expenses incurred by non-PBCs and individuals between May 25, 1976, and December 31, 1981, can be written off against any income up to 100 per cent in one year.

In principle, application of generally accepted accounting principles would require a matching of income and expenses incurred to earn that income, though in the case of exploration expenditures, the principle is somewhat difficult to apply. Exploration is a risky activity and any specific effort (e.g. an exploratory drilling well) may have a low probability of generating future income. Furthermore, even if an exploratory well is successful, it is often difficult to anticipate the total production that will result. Thus, the actual rate at which exploration expenditures depreciate is difficult to determine. Nevertheless, the benchmark tax system treats exploration expenses as a capital expenditure that can be written off only in relation to income subsequently generated. The existing tax provisions come nowhere near to even a rough approximation of this benchmark treatment. The existing provisions thus give rise to an accelerated write-off for exploration expenditures. In addition, the benefits of this tax expenditure are more widely available because for non-PBCs the tax losses caused by this accelerated write-off can be applied to non-resource income. The tax expenditure permits the deferral of tax.

Data limitations preclude separate estimates for this item. The combined tax expenditure value of this and the next two items can, however, be estimated from the excess of the sum of exploration expenses, development expenses, and depletion allowances claimed for corporate income tax purposes over the corresponding amounts claimed on company books, as reported in Statistics Canada's Corporation Taxation Statistics in 1976. This excess has been valued at effective corporate income tax rates to give the tax expenditure value shown. This estimation method treats the provision as a deduction rather than as a deferral. The temporary portion of this provision that allows Canadian exploration expenses to be claimed fully by anyone, particularly individual taxpayers, against any income is commonly referred to as the drilling fund incentive. An estimate of the revenue impact of this provision is shown separately in Item 6 below.

2. Fast Write-Off for Canadian Development Expenses: The write-off for Canadian development expenditures, in 1976, was 30 per cent per year declining balance. Effective November 16, 1978, the rate was raised to 100 per cent for development expenditures in mining (including tar sands projects) though it remained at 30 per cent for other resource activities (mainly oil and gas). These provisions give rise to a faster write-off of development expenditures for tax purposes than would be warranted under generally accepted accounting principles and

by the useful life of these expenditures, as reflected in company financial statements. This in turn gives rise to a deferral of tax.

3. <u>33 1/3-Per-Cent Earned Depletion Allowance</u>: Taxpayers with resource income and related resource investments are entitled to a special deduction called the earned depletion allowance. This allowance is equal to one-third of certain exploration and development expenditures plus the costs of assets used for new mines or for the processing of ores from new mines. The amounts that can be claimed for the allowance are accumulated in a special earned depletion account for tax purposes and are in turn deducted from income each year in an amount equal to 25 per cent of "resource profits." Any unused earned depletion is carried forward for use in future years. The effect of this provision is that costs that can be added to the earned depletion account are written off 1 1/3 times, once as Canadian exploration or development expenses or in the CCA system, and an additional one-third as an earned depletion allowance.

   The concept of economic depletion is that a resource property (for example, land whose main value is its resource content, or a right to explore for or mine minerals) is an asset whose value declines over time as the resources are extracted. This decline in value should therefore be set against revenue in computing net income. However, the cost of acquiring Canadian resource properties is included in Canadian development expenses, which can be written off at rates of 30 per cent or 100 per cent. Thus, economic depletion, which is allowable under the benchmark tax system, is already considered in the calculation of the tax expenditure value of the development expense write-off provisions. As a result, none of the earned depletion deduction can be said to be in respect of economic depletion. This provision provides a permanent reduction rather than a deferral of tax liability.

4. <u>Additional Earned Depletion for Heavy Oil and Tertiary Recovery Projects ("Supplementary Depletion")</u>: Purchases of machinery and equipment and other property after April 10, 1978, used for enhanced recovery can be accumulated in a separate earned depletion account at a rate of 50 per cent (rather than 33 1/3 per cent) of their costs. One-third of the cost of property acquired for mining the tar sands can also be added to this earned depletion account. Moreover, this type of earned depletion may be deducted up to one-half of resource income rather than the usual limitation of 25 per cent. Any unused supplementary depletion is carried forward for use in future years. This provision results in an additional 50 per cent write-off of certain costs and thus results in a permanent reduction rather than a deferral of tax liabilities.

5. <u>Additional Earned Depletion on Frontier Oil and Gas Well Exploration Costs ("Super Depletion")</u>: This provision allows a third type of earned depletion to be accumulated at the rate of 66 2/3 per cent of eligible expenditures. These eligible expenditures are exploratory oil and gas wells costing at least $5 million in Canada's frontier and

offshore regions. This is in addition to the usual earned depletion of 33 1/3 per cent, and the 100-per-cent write-off for exploration costs. This additional depletion may be deducted fully against any income rather than being limited to 25 per cent of resource income. This provision results in a permanent reduction in tax liabilities. In conjunction with the fast write-off on Canadian exploration expenses (Item 1) and 33 1/3-per-cent earned depletion (Item 3), this provision implies that up to 200 per cent of these frontier exploration costs can be deducted immediately. The exploration expenditures in the frontier which are eligible for these 66 2/3-per-cent depletion claims have been estimated on the basis of data collected by the Departments of Indian Affairs and Northern Development and Energy, Mines and Resources. The tax expenditure value of the deduction for individuals is calculated assuming individuals making the claims are on average in a 35-per-cent federal marginal tax rate bracket.

6. Drilling Funds: In the budget of May 25, 1976, the Income Tax Act was amended to permit individuals and others who are not Principal Business Corporations to write off Canadian exploration expenses fully against any other income, thereby allowing a deferral of tax. This temporary provision, commonly known as the drilling fund incentive, was extended in the November 16, 1978, budget to December 31, 1981. Data on individual taxpayers' contributions to drilling funds have been obtained from industry estimates. The value of the immediate deduction has been calculated assuming an average marginal tax rate of 35 per cent. (The amount of investments by non-resource companies cannot at present be reliably estimated.) In addition, actual drilling funds may be structured to allow individual taxpayers to take advantage of other tax incentives in the resource area such as super depletion. Thus, a $100 investment in a drilling fund can give rise to more than a $100 deduction for tax purposes. To some extent, these additional benefits are included in the estimate for Item 5 above.

7. Accelerated Depreciation of Mining Assets (Class 28): Expenditures on certain assets related to a new mine or a major expansion of an existing mine may be written off as rapidly as the income from the new or expanded mine permits or on a 30-per-cent declining balance basis, whichever is better for the taxpayer. The assets covered by this incentive include buildings, mining machinery and equipment, electrical equipment and related social infrastructure such as homes, schools, roads, and sewers. This faster write-off permits a deferral of tax.

8. Additional Depreciation Allowances on Offshore Drilling Vessels: Capital cost allowances not exceeding 15 per cent of undepreciated capital cost can be claimed in respect of offshore drilling vessels acquired after May 25, 1976, in addition to the usual CCA rate for ships.

9. Excess of Tax Depreciation over Book Depreciation, General: Aside from the fast write-offs noted in Items 7 and 8 above, this item is the total tax expenditure arising from the fast write-offs in the CCA system, as discussed generally above, in the resource sector.

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10. Resource Allowance and Deductibility of Provincial Royalties for the Syncrude Project: The tax system provides a resource allowance of 25 per cent of resource profits (before deduction of exploration expenses, development expenses, earned depletion, and interest expense). This allowance is in lieu of deductibility of provincial mining taxes and royalties. As noted in the main text, the precise treatment of the resource allowance and provincial royalties in the tax expenditure account is not clear. The Syncrude project, however, is permitted to deduct both the resource allowance and provincial royalties in computing income subject to tax. This provision is clearly a tax expenditure. There is no cost for this measure in 1976 nor is one forecast for 1979 since the project has not yet generated taxable income nor has it yet paid royalties. (See also Memorandum Items XII.C.1 and 2.)

11. Exemption of Iron Ore Mining from Branch Tax: Iron ore mining operations are exempt from the branch tax.

12. Taxation of Sulphur Production at Manufacturing Tax Rates: Sulphur production activity is not manufacturing and would thus normally pay federal tax at a rate of 36 per cent of taxable income. However, by virtue of being deemed to be manufacturing for tax years after 1976, this operation attracts the lower 30-per-cent federal tax rate on manufacturing and processing profits (see Item V.E.1). Assets used in sulphur production are also eligible for the Class 29 two-year write-off (see Item V.E.3).

13. Investment Tax Credit on Resource Investments: This item is the value of the investment tax credit claimed in the resource sector.

14. Non-Adjustment of the Specific Sales Tax Rate on Gasoline: The federal sales tax is generally levied at an ad valorem rate of 9 per cent (12 per cent in 1976) of the sale price of taxable goods. Under such an ad valorem levy, tax revenues increase as the price of the product increases. In 1977, for administrative reasons, the tax on gasoline and diesel fuel was converted from an ad valorem to a specific tax of varying amounts per litre depending on the product. Since that time, the price of these products has risen but the specific tax rate has not been adjusted. The effective tax on these products expressed as a percentage of sale price has thus been falling. The tax is now equivalent to somewhat less than an ad valorem levy of 9 per cent. As a result, gasoline and diesel fuel are more favourably treated under the sales tax than are other products. The difference is the amount shown as the tax expenditure value. (See also Memorandum Item XII.B,2.a and 5.)

15. Capital Gains Treatment for Prospectors and Grubstakers: Individuals and their financial backers who make a resource discovery can arrange their affairs such that the resulting income (the increase in value of the resource property) is treated as a capital gain for tax purposes, and the realization of that gain can be deferred at the discretion of

the owners of the discovery. This constitutes a departure from the benchmark tax system since half the income is never taxed and tax on the other half is deferred.

C. REGIONAL DEVELOPMENT

1. Portion of Investment Tax Credit: That portion of the revenue cost of the investment tax credit associated with higher rates in specific regions should properly be classified under regional development. These differentiated rates did not exist in 1976. Reliable disaggregated estimates are not yet available for 1979. Thus, the amount is included in the various sectoral figures.

2. Portion of Employment Tax Credit: That portion of the revenue cost of the employment tax credit associated with higher rates in specific regions should properly be classified under regional development (see Item V.H.2). Reliable disaggregated estimates are not available for 1979.

D. ENERGY CONSERVATION

1. Exemption of Energy Conservation Goods and Insulation Materials from Sales Tax: The Excise Tax Act provides for an exemption of a range of energy conservation goods. Since under the benchmark system the sales of all manufactured and produced goods are taxable, the above exemption is considered a tax expenditure. The 1976 estimate of this tax expenditure covers the exemptions for insulation materials (used for wall cavities and roofs), thermal insulation (used for heating and cooling systems), multipane windows, storm doors and storm windows. The 1979 estimate is lower than the revenue forgone in 1976 partly because after November 16, 1978, the exemption for multipane windows, storm doors and storm windows was removed. The range of exempt energy conservation goods also includes such items as solar furnaces and wind generating equipment which are not included in the estimate but whose revenue significance is probably small.

2. Two-year Write-Off on Energy Conservation Machinery and Equipment (Class 34): The capital cost of assets certified as being in this class can be written off up to 50 per cent in the first year and the remaining cost in the second year. This fast write-off gives rise to a deferral of tax. The approximate value of this fast write-off was estimated using information on amounts of expenditures certified as eligible for the measure.

3. Non-Taxation of Home Insulation Grants in Nova Scotia and Prince Edward Island: Under the benchmark individual income tax structure, all transfer payments to persons are part of income for tax purposes in order not to provide a tax preference to individuals based on the source of their income. Since December, 1976, and February, 1977, individuals in Prince Edward Island and Nova Scotia, respectively, have been eligible for home insulation grants of up to $500. Unlike

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the subsequent grant program which applies in other provinces, the grants in Nova Scotia and Prince Edward Island are not taxable.

E. MANUFACTURING SECTOR

1. Lower Corporate Tax Rates on Manufacturing and Processing Profits: Under the current tax structure, the usual rate of federal corporate income tax is 36 per cent. A preferential rate of 30 per cent is available on manufacturing and processing profits. In the case of small manufacturers (see Item G.1 below), the tax preference reduces the federal tax rate from 15 to 10 per cent.

2. Investment Tax Credit on Manufacturing Investments: This item is the total investment tax credit tax expenditure in the manufacturing sector (excluding research and development, see Item V.F.3 below).

3. Two-Year Write-Off of Manufacturing and Processing Assets (Class 29): Machinery and equipment used in manufacturing and processing, and purchased after May, 1972, can be written off for tax purposes up to 50 per cent in the first year and the remainder in the second year. This fast write-off gives rise to a deferral of tax.

4. Additional Depreciation Allowances on Canadian Built Ships: Ships constructed and registered in Canada can be written off at a 33 1/3-per-cent rate in addition to the usual rate. This fast write-off gives rise to a deferral of tax. Note that this tax expenditure might also have been classified under Category IV, Transport and Communication.

5. Excess of Tax Depreciation over Book Depreciation, General: Aside from the fast write-off noted in Item 3 above, this item is the remaining tax expenditure arising from the fast write-offs in the CCA system, as discussed generally above, in the manufacturing sector (including Item 4 above).

F. RESEARCH AND DEVELOPMENT (R&D)

1. Immediate Write-Off on R&D Expenditures: Current and capital expenses on R&D may be written off immediately in the year incurred despite the fact that these expenditures are capital in nature, designed to produce future income. The estimate assumes that under the benchmark tax structure these expenses would depreciate at 20 per cent per year.

2. Additional R&D Allowance: Since 1978 taxpayers have been permitted to deduct an additional allowance of 50 per cent of the increase in their R&D expenses over the average of the three previous years' expenditure levels. This is in addition to the 100-per-cent deduction for all R&D expenditures described in Item 1 above. This constitutes a tax preference based on a particular use of income.

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3. Investment Tax Credit on R&D Expenditures: In 1977 the investment tax credit was extended to cover current and capital expenditures on R&D. The rates of the credit were 10 per cent in the Atlantic Provinces and the Gaspé, 7.5 per cent in the other areas designated under the Regional Development Incentives Act, and 5 per cent in the rest of the country. Since November 16, 1978, the two lower rates of credit for R&D have been increased to 10 per cent and the top rate to 20 per cent. A 25-per-cent rate applies for R&D expenditures by small business corporations irrespective of their location. The estimate is based on credit claims at the rates of 10 and 20 per cent. The amounts claimable by small businesses are shown in Item G.5 below.

4. Non-Taxation of Non-Profit Scientific Research Corporations: Such entities are not subject to corporate tax despite the fact that they may have income that would otherwise be taxable.

5. Exemption of Scientific Apparatus from Sales Tax: As the sales of all manufactured and produced goods are taxed under the benchmark commodity tax system, the exemption of scientific apparatus constitutes a tax expenditure. Although an exact estimate of this tax expenditure is not available at this time, a very large portion of this amount is already included in the estimate of the tax expenditure for equipment, such as utensils and instruments for laboratory or scientific use, purchased by hospitals and educational institutions (see Items VI.A.3 and VII.6).

G. SMALL BUSINESS

1. Lower Corporate Tax Rate: Canadian-controlled private corporations are eligible for a Small Business Deduction which has the effect of lowering their federal corporate income tax rate to 15 per cent from the usual rate of 36 per cent. This lower tax rate applies on up to $150,000 of annual Canadian active business income as long as the cumulative retained income of the corporation is below $750,000.

2. Deferral of up to $200,000 of Capital Gains on Inter-Generational Transfers of Small Business: Sales or gifts of business assets to children or grandchildren (on or before death of the taxpayer) would usually give rise to taxable capital gains under the existing tax system to the extent that the fair market value exceeded the cost base of the property. On inter-generational transfers of shares in certain incorporated small businesses to a child or grandchild of the taxpayer after May 25, 1978, up to $200,000 of capital gains may be deferred until the business is finally transferred outside the family. This is a tax preference both in that it is a departure from accrual taxation in the benchmark system, and in that it is a relaxation of the deemed realization provisions in the existing tax system.

3. Preferential Income Tax Treatment of Certain Stock Options: Under the benchmark tax system, any benefits provided to employees in the form of shares issued at a price lower than their fair market value are

considered to be fully taxable just like ordinary wages and salaries. After March 31, 1977, the exercise of options by employees of Canadian-controlled private corporations (mostly small corporations) to buy shares in the corporation at a cost below their fair market value will not immediately give rise to any taxable income. Instead, any difference will be treated as a capital gain so that only one-half of the gain will be taken into income for tax purposes and then only when the shares are eventually sold by the employee. This is a tax preference for a particular income source.

4. Full Offset of Certain Capital Losses: In general, up to $2,000 of allowable capital losses (one-half of realized losses) can be offset against income other than capital gains by individuals. Corporations cannot offset any capital losses against income other than capital gains. (See Item XII.D.5.) Starting in 1978, however, both individuals and corporations can offset any amount of allowable capital losses incurred on arm's-length sales of shares or debt of Canadian-controlled private corporations (CCPCs) against any other income, not just capital gains income. While the general structure of the current loss provisions has been taken as part of the benchmark tax structure, this provision clearly gives preferential treatment to taxpayers investing in CCPCs, which are typically small businesses.

5. Special Investment Tax Credit of R&D Expenditures: As discussed generally above, expenditures after November 16, 1978, on R&D by small businesses are eligible for a 25-per-cent tax credit. The value of this part of the investment tax credit is in respect of amounts claimed by small businesses. (See also Item F.3 above.)

6. Small Firms' Sales Tax Exemption: In 1978, manufacturers with total sales of less than $50,000 (previously $10,000) were exempted from the federal sales tax. All production equipment purchased by such firms is also exempt from sales tax. This preferential treatment of the sales of small businesses constitutes a tax expenditure since, under the benchmark commodity tax system, the sales of all manufactured and produced goods are included in the tax base. The estimates are based on records of businesses licensed for sales tax purposes by Revenue Canada.

7. Non-Taxation of Provincial Assistance for Venture Investments: Normally when a taxpayer receives assistance in the form of a grant or tax credit in respect of purchase of a share, the cost of the share for purposes of computing any subsequent capital gain is reduced by the amount of the assistance. The Income Tax Act provides that such treatment will not apply in the case of assistance under prescribed provincial venture capital programs, thereby generating preferential tax treatment for such investments. To date no such provincial programs have been prescribed.

V (Continued)

H. LABOUR FORCE

1. Deferred Profit Sharing Plans: Employers may set up a plan for their employees under which the employers can make tax-deductible contributions. These amounts are taxable in the hands of the employees only later when the benefits are received. The employer's contribution must be at least partially linked to the firm's profitability, and cannot exceed $3,500 per employee (less any contributions by the employer to a Registered Pension Plan in respect of the employee) or 20 per cent of his earnings, whichever is less. Such deferred profit sharing plans constitute a tax expenditure because they allow individuals to defer recognition of income, and hence tax. Since some employers use these provisions as an alternative to a pension plan, this item might be included under Category VI.B, Income Maintenance.

2. Employment Tax Credit: Beginning in March, 1979, a program of employment tax credits was instituted. Employers who create new full-time jobs lasting at least three months and paying at least the minimum wage are eligible for a tax credit based on the number of new employees, the number of hours they work (to a maximum of 40 hours per week for up to 12 months), and the geographic region. The credit ranges from $1.50 to $2.00 per hour, depending on the region. The credits are non-refundable and serve to reduce deductible wage costs in respect of the employee. Unused credits can be carried forward up to five years. This is a tax preference for employers creating certain kinds of new jobs. A portion of the amount shown should in principle be allocated to Regional Development (see Item V.C.2).

3. Subsidized Loans: Prior to 1979, the benefit associated with certain interest-free or low-interest loans to an employee were not, as a result of administrative practice, specifically taxable. Starting in 1979, such benefits, calculated by reference to a prescribed rate of interest (9 per cent for 1979), are taxable with the exception of benefits related to a loan of up to $50,000 for purchasing a house as a result of a move or transfer, loans used to buy shares in the employer corporation, and a standard $500 exemption. Under the benchmark tax system, the benefit associated with any such subsidized loans would be included in income (including the extent to which the prescribed 9-per-cent interest rate for tax purposes is below the actual market rate).

4. Group Term Life Insurance: Employer payments of premiums for group term life insurance coverage of up to $25,000 per employee are a deductible expense for the employer but are not considered a taxable benefit for the employee. Under the benchmark tax system, such benefits would be taxable to the employee.

5. Non-Taxation of Other Non-Monetary Benefits: There are a range of benefits that an employer can provide his employees without giving rise to taxable income in the employees' hands. These include group sickness and accident insurance, private health insurance, discounts

on purchases of the employer's merchandise, subsidized meals in staff lunchrooms and canteens, subsidized school services for employees' families in remote areas, recreational facilities provided free or at a nominal charge, and transportation to work in vehicles supplied by the employer. The costs of these benefits can be deducted by the employer in determining his taxable income. Under the benchmark tax system, the value of all such benefits would be taxable to the employee. It should be noted that many such benefits are exempted as a matter of administrative practice, and not through any explicit provisions in the Income Tax Act.

I. GENERAL BUSINESS AND INVESTMENT

1. Investment Tax Credit Not Included Elsewhere: This is the tax expenditure value of the basic investment tax credit excluding those portions already included under the Transportation, Farming and Fishing, Resource Sector, Regional Development, Manufacturing Sector, Research and Development, and Small Business headings.

(Items 2 to 10 below all refer to capital gains and losses.)

2. Non-Taxation of One-Half of Capital Gains Income: Under the existing tax system, one-half of most capital gains realized since the beginning of 1972 (or "valuation day") need not be included in income for tax purposes for either individuals or corporations. Under the benchmark tax system, these gains would be fully taxable.

3. Non-Taxation of Capital Gains Income Accrued Prior to 1972: All capital gains realized after 1971 but accrued prior to 1972 (or "valuation day") need not be included in income for tax purposes. Under the benchmark tax system, these gains would be fully taxable.

4. Preferential Treatment of Distributions of Pre-1972 Corporate Surplus: With tax reform in 1972, there were major changes in the tax treatment of income received by corporations and distributed to shareholders. As a result, transitional arrangements were required with respect to corporations' pre-1972 income that had not yet been distributed (called corporate surplus). Essentially, retained earnings accumulated between 1950 and 1971 (excluding capital gains) could be distributed subject to a flat 15-per-cent tax. Any dividends from such tax-paid pre-1972 surplus were exempt from tax in the hands of shareholders. This resulted in a tax preference to the extent that the 15-per-cent tax was less than the income tax that would have otherwise been payable by individuals on these dividends. Pre-1950 surplus was granted even more preferential treatment in that not even the 15-per-cent tax applied. This system was repealed at the end of 1978; the above preferential treatment was largely ended and corporations were encouraged to distribute all their pre-1972 surplus before the end of 1978.

5. Flow-Through of Capital Gains: Private corporations (i.e. those not listed on a recognized stock exchange and not controlled by a public

corporation) can distribute the exempt one-half of any realized capital gains received (accumulated in their "capital dividend account") to their shareholders in the form of a special dividend that is completely exempt from tax in the shareholders' hands. Under the benchmark tax system, corporations and their shareholders are treated as separate taxpaying units, so that capital gains realized by corporations are fully taxable as corporate income, and any distributions to shareholders must be fully included in the shareholders' income.

6. <u>Preferential Treatment of Stock Dividends of Public Corporations</u>: Prior to March 31, 1977, stock dividends paid by public corporations were included (to the extent of the related increase in paid-up capital) in income by recipients like ordinary dividends. After that date, stock dividends are not included in income. Instead, their value when realized by sale is treated as a capital gain. Thus, tax is both deferred and reduced on such income in comparison to the former treatment and to the treatment under the benchmark tax.

7. <u>$1,000 Capital Gains Exemption for Personal Use Property Transactions</u>: Personal use property (such as automobiles and boats) is distinguished from other property by the fact that its primary use is for the enjoyment of the owner. Capital gains or losses arising from the sale of such property, to the extent that either the proceeds or cost were less than $1,000, are not included in income for tax purposes. Under the benchmark tax system the full amount of any gains would be included in income.

8. <u>$200 Capital Gains Exemption on Foreign Exchange Transactions</u>: Some foreign exchange gains or losses are treated as capital gains or losses, so that only half the amount is included in income. Furthermore, for individuals the first $200 of such gains or losses are not taken into account. Under the benchmark tax system, all such gains would be taken fully into income.

9. <u>Deferral of Capital Gains Income Through Various Rollover Provisions</u>: Some rollover provisions constitute a tax preference with respect to the existing tax system because they are an exemption from taxation of capital gains on a realization basis. Rollovers associated with amalgamations and other corporate reorganizations have been considered part of the benchmark tax structure. Since the benchmark tax system includes all accrued gains in the tax base, it is more for information purposes that the following rollover provisions have been separately identified. Had they not been identified separately, the associated tax expenditures would have fallen under the general heading "Accrued Capital Gains not Included Elsewhere" (Item 10 below). Following is a brief description of a number of these provisions:

   a. <u>Involuntary Dispositions</u>: Tax on any realized capital gains resulting from an involuntary disposition (for example, expropriation or insurance proceeds received for an asset destroyed in a fire) where the funds are reinvested in a replacement asset within a specified period may, at the option of the owner, be deferred until the replacement is disposed of.

b. Voluntary Dispositions: Tax on realized capital gains resulting from the voluntary disposition of land and buildings not used to generate rental income can be deferred if replacements are purchased soon thereafter (for example, a business changing location).

c. Transfers to a Corporation for Consideration Including Shares: A taxpayer can sell an asset to a corporation in exchange for cash and/or its shares (not only as part of a reorganization). No capital loss can be realized in such a transaction, but no capital gain need be realized, at the discretion of the parties to the transaction.

10. Accrued Capital Gains Income Not Included Elsewhere: This item represents the deferral of tax liability relative to the benchmark tax structure arising from the fact that accrued but unrealized capital gains are not taken into income each year. Estimates for this item are not available; however, it is likely to be of a substantial magnitude.

11. Dividend Gross-up and Tax Credit for Individuals: As a partial move toward an integrated personal and corporate income tax system, the current tax system treats dividends to individuals from Canadian corporations in a special way. Any such dividend income is first "grossed-up" for tax purpose to 150 per cent of its actual amount (133 1/3 per cent prior to 1978). Subsequently, a non-refundable credit against tax otherwise payable may be claimed equal to 37.5 per cent of the actual dividends or 25 per cent of the grossed-up dividend (25 per cent of actual dividends prior to 1978). The value of this item at the federal level is estimated as the amount of dividend tax credit claimed less the extra federal tax levied on the grossed-up portion of dividends received.

12. Refunds of Part I Tax on Investment Income of Private Corporations: As a method of integrating the personal and corporate income taxes, a portion of the income taxes paid on investment income received by a private corporation (excluding inter-corporate dividends) is refunded to the corporation when this income is paid to shareholders as dividends. Since corporations and individuals are treated as separate tax units under the benchmark tax system, such refunds are a tax expenditure.

13. Preferential Treatment of Investment and Other Special Corporations: The current income tax system gives special treatment to investment corporations, mortgage investment corporations, mutual fund corporations, mutual fund trusts, and non-resident-owned investment corporations (NROs). In all these cases, the corporation or trust typically invests its shareholders' (or unit owners') funds in certain kinds of financial assets. These corporations are treated essentially as conduits with their income flowing through to the ultimate owners to

be taxed in their hands. For example, except for NROs, capital gains income paid out as dividends gives rise to a refund of the Part I tax paid on that income, while recipients treat such dividends as capital gains. Also, for mortgage investment corporations, dividends paid are treated as interest payments and thus are deductible. Except in the case of mortgage investment corporations and NROs, dividends received are not taxable as a result of the general provision for inter-corporate dividends. NROs are subject to a flat 25-per-cent tax on most of their income but this tax is refundable when the income is distributed. Since corporations and individuals are treated as separate tax units under the benchmark tax system, such conduit treatment is a tax expenditure. An estimate of this item is not available at this time.

14. <u>Lower Corporate Income Tax Rate for Investment Corporations</u>: Investment corporations are allowed a 16 2/3-per-cent deduction in computing their tax (25 per cent prior to 1978), so that their effective federal tax rate is 19 1/3 per cent (except on capital gains income). Thus, corporate income tax is lower than it would be under the benchmark tax structure. This is a preference for a certain type of taxpayer.

15. <u>Deduction of Patronage Dividends</u>: Credit unions and other co-operatives typically offer their products or services at close to market prices and interest rates. Then after the year end, any excess of revenues over costs is returned to members in the form of patronage dividends (or "allocations in respect of borrowings" for credit unions) based on their contribution to total revenues. These patronage dividends are deductible in computing the corporate income tax liability of credit unions and other co-operatives. They are not taxable to the recipients provided they are in respect of consumer goods and services (i.e. goods or interest costs that were not deductible by a taxpayer in computing his taxable income from a business or property). The appropriate tax treatment of patronage dividends for tax expenditure purposes is not entirely clear. From one viewpoint, they are simply an accounting adjustment for members of co-operatives because of the difficulties of setting prices in advance to exactly match costs. According to this view, the current treatment gives rise to no tax expenditures since the dividend or allocation is being thought of as a return of excess payments. Alternatively, the co-operative can be viewed as a distinct corporate entity where the payment of dividends to members should have no particular significance, and thus should not be deductible. From this viewpoint, co-operatives and credit unions perform essentially identical roles as retailing, wholesaling, or banking corporations all of which are taxable. Also, the payment of patronage dividends is not pursuant to any contractual arrangements. Both views have some merit. The item has therefore been included based on the comprehensiveness criterion. The amount shown is the revenue impact of allowing patronage dividends to be deducted from corporate taxable income. (Deductions for allocations in respect of borrowing, however, are not included in the estimate.)

V (Continued)

16. Lower Corporate Income Tax Rate for Credit Unions and Other Co-operatives: Credit unions and co-operatives are taxed essentially as if they were eligible for the Small Business Deduction (see Item V.G.1). Thus, their tax rate is basically 15 per cent rather than 36 per cent on up to a cumulative total of $750,000 of income. In addition, this lower tax rate is extended to credit unions in respect of income used to build up certain statutory reserves.

17. $1,000 Investment Income Deduction: In recognition of the impact of inflation on the taxation of interest, dividends, and taxable capital gains income of individuals, up to $1,000 of such income need not be included in income for tax purposes. This provision is a tax expenditure because it is partial, ad hoc, and non-neutral. Any unused portion of this deduction is transferable between spouses.

18. Other Accrued Investment Income Not Included Elsewhere: Taxpayers have the option of reporting certain types of investment income (for example interest on Canada Savings Bonds, deferred annuities, and loans where interest is accumulated over more than one year) on an accrual or on a realization basis. This permits a deferral of tax.

19. Life Insurance Companies, Investment Income: Life insurance beneficiaries, when they receive benefits from a life insurance policy, typically receive an amount that is greater than the premiums that were paid for the policy. This difference is attributable to the return earned on the premiums when they are invested by the life insurance company. When, for example, a bank invests its depositors' funds and then pays interest, this interest is included in the depositors' income for tax purposes. However, in the case of life insurance benefits, the component that is accrued investment income is not taxable (except for policyholders who surrender their policies before their death). Up to March, 1977, life insurance companies paid a flat 15-per-cent tax on this income (over and above any corporate income tax liability) as an arbitrary approximation to the tax that would have been collected had the investment income been allocated to policyholders and taxed in their hands. Under the benchmark tax system, all such investment income would be allocated to policyholders as it accrued for inclusion in their income. The present system therefore provides a tax exemption for taxpayers investing in life insurance.

20. Insurance Companies, Policy Reserves: A portion of premiums paid to insurance companies by policyholders is set aside in policy reserves to cover future liabilities. Insurance companies in turn are allowed deductions for corporate income tax purposes for certain amounts set aside in policy reserves and unearned premium reserves. In principle, these reserves are purely in respect of liabilities expected in future years. In practice, these tax deductible reserves typically exceed amounts determined in accord with generally accepted accounting principles. Reserves for tax purposes are generally based on the reserve calculations required by the Department of Insurance, which may be viewed as being on the conservative side because their major concern

is with the solvency of insurance companies. This results in a deferral of tax and hence a tax expenditure. The allowable amounts of these reserves were materially reduced in 1977. While the precise specification of appropriate reserve amounts under the benchmark tax system is very difficult, it is generally believed to be less than the amounts currently allowed.

21. Life Insurance Companies, World Income: All corporations under the benchmark tax system are taxable on their world income, with tax credits available in respect of foreign income taxes paid on foreign source income. Because of the nature of the industry, multinational insurers typically do not operate through incorporated national subsidiaries. The current tax system generally taxes only the domestic income of such multinational life insurers. Thus, the non-taxation of foreign source income in excess of foreign taxes paid of resident multinational life insurers constitutes a tax expenditure.

22. Exemption from Withholding Tax for Interest on Long-Term Corporate Securities: Interest paid to non-residents acting at arm's length on securities issued after June 23, 1975, and before 1983 with a term to maturity of at least five years is exempt from withholding tax.

23. Exemption from Withholding Tax for Interest on Foreign Currency Deposits: Interest paid to non-residents on such deposits is exempt from withholding tax.

24. Reduction in Withholding Tax for Corporations Having a Degree of Canadian Ownership: Generally, the withholding tax rate on dividends paid to non-residents is reduced by 5 per cent (e.g. from 25 to 20 per cent) if the paying corporation is resident in Canada, has at least a quarter of its voting shares Canadian-owned, and has at least a quarter of its directors resident in Canada.

25. Two-Year Write-Off on Pollution Control Equipment (Classes 24 and 27): Up to 50 per cent of the cost of equipment acquired to control or limit air and water pollution can be deducted from income in the first year and the remaining cost in the second year. This fast write-off gives rise to a deferral of tax.

26. Depreciation Generally: This item is the tax expenditure arising from the excess of tax over actual depreciation not considered explicitly under any other heading.

27. 3-Per-Cent Inventory Valuation Adjustment: In recognition of the impact of inflation on inventory costs, corporations may claim a deduction equal to 3 per cent of their tangible opening inventories (other than real estate). Since this is an ad hoc, partial, and non-neutral allowance for the effects of inflation on business income, this provision is a tax expenditure.

V (Continued)

28. Exemption of Banks from Branch Tax: Canadian branches of foreign banks are exempt from branch tax.

29. Excess Doubtful Debt Reserves: Corporations may deduct a reasonable amount from income for purposes of creating a reserve for the possibility that some debts owed to the corporation will not be repaid. However, in the case of certain kinds of financial institutions, these reserves are determined by specific regulations. Such reserves may be conservative, thereby causing income to be understated. Any such excess deductions for reserves for doubtful debts, over amounts based on actual experience, constitute a tax expenditure.

30. Preferential Tax Treatment Income Debentures and Term Preferred Shares: Income from these financial instruments issued prior to November 16, 1978, is treated as dividends for tax purposes even though it is similar to interest. Because inter-corporate dividends are tax-exempt to the recipient and non-deductible for the payor, these financial instruments have allowed loss corporations to obtain financing at much lower cost. If the borrowing corporation was in a loss position for tax purposes, perhaps as a result of claiming fast write-offs on its assets, the deductibility of interest costs on borrowed funds was of virtually no value. Thus, paying non-deductible dividends made little difference. On the other hand, the lending agency (typically a bank) could receive tax-free inter-corporate dividends instead of taxable interest payments. As a result, the lender could afford to charge the borrower a much lower rate of interest if the amount were taken in the form of income debentures or term preferred shares.

31. Tax Defrral on Income of Foreign Affiliates of Canadian Corporations: Canada currently exempts certain dividend income from controlled foreign affiliates from Canadian corporate income tax, and provides no tax credit for foreign taxes paid. As a result, the tax on distributed profits can be lower than what would be payable had the business activity occurred in Canada. This occurs whenever foreign tax rates are lower than those in Canada. As well, on certain undistributed profits a tax deferral occurs to the extent that foreign tax rates are lower or this income is not subject to the "foreign accrual property income" (FAPI) provision.

32. Exemption of Metric Scales and Conversion Kits from Sales Tax: Under the benchmark tax system, the sales of all manufactured and produced goods are taxed. The exemption from sales tax for metric scales and conversion kits is therefore a tax expenditure. Although an estimate of the revenue forgone is not available at this time, the amount is expected to be small.

33. Tax Deferral Available from Income Averaging Annuity Contracts: The recognition for tax purposes of certain types of income of individuals can be deferred through the purchase of an Income Averaging Annuity Contract (IAAC). IAACs involve an initial lump sum premium and a

subsequent stream of annuity payments. These periodic payments can either be for a fixed term of up to 15 years or for life. The premium is deductible provided it does not exceed the amount of the taxpayer's income from certain specific sources, for example, taxable capital gains, recaptured depreciation on disposal of depreciable property, the taxable portion of the sale of goodwill or other "eligible capital property", sale of inventory upon ceasing or disposing of a business, and stock option benefits. The subsequent annuity payments are included fully in income only as they are received. Because of the difficulty in segregating the component amounts, the whole of the tax expenditure value of IAACs is included here despite the fact that for a range of other allowed income sources, the IAAC provision is more appropriately classified under the headings of Income Maintenance (see Item VI.B.5) or Culture and Recreation (see Item VIII.5). The tax expenditure value of this provision is estimated as the current-year value of the deduction of IAAC premiums.

34. Deductibility of Pre-Paid Expenses: Under the benchmark tax system, expenses are only deductible in a year to the extent they were associated with income in that year. However, current administrative practice is to allow certain pre-paid expenses as deductions as well. For example, a rental or insurance payment covering more than the current tax year may be deducted in full in computing income for tax purposes in the year in which the payment was made. Under the benchmark tax system, only that portion of the payments applicable to the current tax year would be deductible in the year, the remainder being deductible in the subsequent years to which the costs relate. Thus, current practice in this area allows a deferral of tax.

35. Holdbacks on Progress Payments by Contractors: In the construction industry, contractors are typically given progress payments as their construction progresses. However, a portion of these progress payments (e.g. 10 to 15 per cent) is often held back until the entire project is satisfactorily completed. This holdback need not be brought into the income of a contractor until the construction to which it applies is certified as complete. However, a contractor can often fully write off his expenses under the construction contract as they are incurred. The contractor, therefore, has an optional faster write-off of expenses than would be allowed under the strict accrual accounting of the benchmark tax structure. This gives rise to a deferral of tax.

36. Billed-Basis Accounting by Professionals: Under accrual accounting, costs must be matched with their associated revenues. Professionals in computing their income for tax purposes, however, are allowed to elect either an accrual or a billed-basis accounting method. This implies that costs of work in progress under the latter method can be written off as incurred even though the associated revenues are not brought into income until the bill was paid or became receivable. This gives rise to a deferral of tax.

37. <u>Exemption of Non-Manufacturing Commercial Uses of Fuel and Electricity from Sales Tax</u>: Under the benchmark commodity tax structure, non-manufacturing commercial uses of fuel and electricity (e.g. in the retail, wholesale and service sectors) would be taxable, given that the services of this sector are exempt. Of course, if the benchmark commodity tax base did include the outputs of the non-manufacturing commercial sector, this exemption would not be a tax expenditure. Included in the estimates are such commercial uses of fuels as oil and gas, and electricity.

38. <u>Tax Losses from Fast Write-Offs of Leased Assets</u>: For leasing contracts written prior to May 25, 1976, losses for tax purposes from accelerated depreciation claims on movable assets leased to others can be offset against any income source. Since that time, tax losses from such leasing can only be offset against other leasing income. The earlier treatment is considered a tax expenditure.

VI. HEALTH AND WELFARE

A. HEALTH

1. <u>Deductibility of Medical Expenses</u>: In computing income for tax purposes, taxpayers may deduct specified medical expenses to the extent that they exceed 3 per cent of net income. This is a deduction based on special circumstances and thus, by virtue of the neutrality criterion, is not allowed under the benchmark tax structure.

2. <u>Portion of Charitable Deduction and Non-Taxation of Registered Charities</u>: The deductibility of charitable donations includes donations in respect of medical research and the operation of medical facilities and hospitals. It is not possible to provide estimates by type of charitable donation so that the whole amount of this tax expenditure is shown under Item VIII.1. Correspondingly, the non-taxation of registered charities (see Item VIII.2) includes charities supporting health-related activities.

3. <u>Exemption of Drugs from Sales Tax</u>: This exemption gives rise to a tax expenditure since, under the benchmark commodity tax structure, the sales of all manufactured and produced goods are taxable. The estimate excludes the sales of drugs to hospitals which are included in the tax expenditure estimate on purchases by hospitals, sanatoria, etc., Item 4 below.

4. <u>Exemption of Purchases by Hospitals, Sanatoria, etc. from Sales Tax</u>: Under the benchmark commodity tax system, the manufactured and produced inputs used in providing tax-free services are taxable. The estimated tax expenditure in this case includes the purchases of building materials, machinery and equipment, medical and surgical supplies and drugs used by hospitals, sanatoria, etc.

5. <u>Exemption of Health Appliances from Sales Tax</u>: The estimate of this tax expenditure includes the federal costs of exempting health appliances such as hearing aids, eyeglasses, health equipment, wheelchairs, trusses and artificial limbs, and the like.

B. INCOME MAINTENANCE

1. <u>$1,000 Pension Income Deduction</u>: A deduction in respect of up to $1,000 of private pension income (excluding Old Age Security pensions and Canada or Quebec Pension Plan benefits) can be claimed in computing income for tax purposes. The range of pension income qualifying for the deduction is restricted if the taxpayer is under age 65. Unused portions of the deduction may be transferred between spouses. This is a tax preference based on income source.

2. <u>Age Exemption</u>: Individual taxpayers age 65 or over are entitled to claim an exemption of $1,660 in 1979 ($1,310 in 1976), thereby allowing them to reduce their taxable income. This is a form of preferential treatment for the elderly. Unused portions of the exemption may be transferred between spouses.

3. <u>Non-Taxation of Guaranteed Income Supplement (GIS) and Spouses Allowance Payments</u>: Payments under these programs are not included in income for tax purposes. (There is an exception in the case of the marital exemption and the transferable amounts of the age and disability exemptions which are reduced by the amount of GIS income received by the spouse.) This is a departure from comprehensive income as the tax base under the benchmark tax system. It may be noted that the structure of these programs is very close to that of the refundable child tax credit. If these payments were instead made as refundable tax credits, the whole amount would be a tax expenditure, and they would then not be taxable under the benchmark tax structure.

4. <u>Tax Advantage on Savings in Registered Pension Plans (RPPs) and Registered Retirement Savings Plans (RRSPs)</u>: Both individuals and employers on their behalf can make tax deductible contributions to RPPs. In addition, employees can make deductible contributions to RRSPs. All such deductions are subject to annual limits, and the contributions must be to approved plans. Subsequently, when the individual retires or matures his RRSP, all payments out of the plans are fully included in his income, or in the income of a surviving spouse or orphaned children. Under the benchmark tax system, employer contributions to RPPs are a taxable benefit to employees, and employees' contributions to RRPs and RRSPs are not deductible. As a result, these provisions allow a significant deferral of tax, in some cases extending beyond the lifetime of the taxpayer. Such a deferral amounts to an interest-free loan to the taxpayer. Under the benchmark tax structure, no such deferral is allowed.

The value of this tax expenditure as shown in Table 1 is based on the total value of assets accumulated in RPPs and RRSPs, being equal to the interest that would be accruing on the tax liability outstanding on these accumulated contributions. More precisely, estimates were made of the amounts of assets in pension plans and RRSPs in 1976, including assets of government-sponsored pension plans accumulated on behalf of their employees. These amounts, which represent accumulated employer plus employee contributions plus investment income, were estimated to be some $54.6 billion for RPPs and $7.5 billion for RRSPs. Under the benchmark tax structure, all of these amounts would have been subject to tax in the hands of employees, which at assumed marginal rates is estimated to amount to some $15.2 billion. This is the amount of interest-free loan implied by the tax deferral in these plans. The cost of the loan to the federal government, and thus the value to taxpayers, at an interest rate equal to the 1976 yield on long-term Government of Canada bonds (9.2 per cent) amounts to some $1.4 billion. A similar method was employed for 1979 taking account of growth in assets in the plans resulting from forecast increases in contributions, investment income and an assumed pattern of withdrawals.

The estimate does not take account of the fact that, in addition to tax deferrals, contributors to these plans benefit to the extent that their tax rate at the time of withdrawal is generally less than at the time of contribution. Thus, while tax is deferred, some tax is in fact never repaid. Examination of 1976 average marginal tax rates on contributors and those receiving private pension income suggests a difference of some 10 percentage points. Thus, on the basis of assets in the plans in 1976, some $6.2 billion of the deferred tax of $15.2 billion will in fact not be repaid. By 1979 this amount is estimated to have grown to $8.5 billion.

5. <u>Portion of Tax Deferral Available from Income Averaging Annuity Contracts (IAACs)</u>: Incomes from a range of sources including a "refund of premiums" from an RRSP, death benefits, a withdrawal from a Deferred Profit Sharing Plan (DPSP, see Item V.H.1), or a lump sum payment from a Registered Pension Plan are eligible for preferential treatment under the IAAC provisions. These allow a deferral of tax. The tax expenditures involved are included and described under Item V.I.33 because the amounts cannot be estimated separately.

6. <u>Tax Advantage on Savings in Canada and Quebec Pension Plans (CPP/QPP)</u>: The current tax treatment of CPP/QPP is analogous to that for RPPs and RRSPs described above. Employee and employer contributions are deductible while benefits are fully included in individuals' incomes for tax purposes when subsequently paid. This treatment gives rise to both a tax deferral and tax reduction, as described in the case of RPPs and RRSPs above and as discussed in the main text. The figures in Table 1 capture only the deferral aspect. Further information is given under Memorandum Items. The method of estimation is analogous to that used for RPPs/RRSPs (described above under Item 4) based on assets in these plans in 1976.

7. Rollovers Into RRSPs: Taxpayers can at their discretion defer recognition of certain sources of income for tax purposes. Old Age Security pension payments, Canada and Quebec Pension Plan benefits, and benefits from Registered Pension Plans can be rolled over into an RRSP. This gives rise to a tax expenditure in the form of additional deferrals. The estimating methodology results in the value of this item being included in Item 4 above.

8. Deductibility of Support Payments: Payments by a taxpayer to a divorced or separated spouse for support based on a written separation agreement are deductible in computing income for tax purposes. These payments are not a consequence of a court order and are typically in respect of personal expenses for children and the former spouse. Under the benchmark tax structure, deductions for personal expenses are not permitted. More generally, any payments that are not court-ordered may be viewed as gifts. Thus, under the benchmark tax structure, they would be neither deductible for the donor nor includable in income for the recipient. It should be recognized, however, that three alternatives in the treatment of gifts were discussed in the main text, choice among which is somewhat arbitrary. The current treatment is not a tax expenditure under one of the alternative treatments.

9. Income Splitting Through Interest-Free Loans Between Family Members: Normally, the attribution rules prevent income splitting when a taxpayer gives an income-producing asset to his spouse or child. These rules act to attribute the income for tax purposes back to the person who made the gift. However, these rules can be circumvented by use of an interest-free loan. If a taxpayer gives an interest-free loan to his spouse and she invests the funds, the resulting investment return is taxable in her hands, typically at a lower marginal rate. Under the benchmark tax structure, loans between family members would be deemed to be at market rates of interest.

10. Marital Exemption: A married taxpayer who supports his or her spouse is entitled to an exemption of $2,320 in 1979 less the amount of his or her spouse's income in excess of $430 ($1,830 and $360 in 1976). This exemption is considered a tax expenditure since the tax unit in the benchmark tax system, as discussed in the main text, is taken to be the individual.

11. Exemption for Wholly-Dependent Children: Children and grandchildren of a taxpayer who were wholly-dependent and either under age 21 or were mentally or physically infirm or in full-time attendence at a school or university entitle the taxpayer to claim an exemption. The amount of the exemption is $500 for children under age 17 and $910 for children 17 or over in 1979 ($390 for children under age 16, $720 for those 16 or over in 1976). These exemptions provide preferential treatment to taxpayers with dependents. Note that a portion of this tax expenditure could be classified under Category VII, Educational Assistance.

12. Exemptions for Other Dependents: Other relatives of the taxpayer (sisters, brothers, nieces, nephews, aunts, uncles, grandparents), who were either under age 21 or were physically or mentally infirm or in full-time attendance at a school or university can be claimed as dependents. The amount of the exemption is $500 for other dependents under age 18 and $910 for other dependents age 18 or over in 1979 ($390 and $720 in 1976). The amount of the exemption (except for nieces and nephews) is also limited to amounts actually spent by the taxpayer for support. These exemptions provide preferential treatment to taxpayers with dependents. Note that a portion of this tax expenditure could be classified under Category VII, Educational Assistance.

13. Child Tax Credit: Starting in 1978, families with children on whose behalf they are receiving family allowances (basically children under age 18) are entitled to a refundable tax credit of $200 per child ($218 in 1979) less 5 per cent of the amount of the parents' combined net income in excess of $18,000 ($19,620 in 1979). The whole amount of this tax credit is a tax expenditure since it provides preferential treatment to taxpayers with children. It can also be considered a tax expenditure on the basis of the functional equivalence criterion, since its introduction was coupled with a reduction in direct spending under the family allowance program.

14. Preferential Tax Treatment of Workmen's Compensation: Benefits under provincial workmen's compensation programs are not included in income for tax purposes. This is a departure from the comprehensive income base of the benchmark tax structure. Also, employers' contributions to these programs are deductible. Such contributions are in the nature of a payroll tax and are not deductible under the benchmark tax system. Thus, the benchmark tax treatment of workmen's compensation is analogous to that of unemployment insurance (see Item 21 below).

15. Non-Taxation of Certain Income from Personal Injury Awards: Interest or other income (including accrued capital gains) earned on certain capital amounts that were received as personal injury awards, for example the awards to Thalidomide children, is not included in income for tax purposes provided the recipient is under age 21. This constitutes preferential treatment for a certain group of taxpayers and a particular income source.

16. Non-Taxation of Strike Pay: Strike pay is not included in income for tax purposes. This is a departure from the comprehensive income base of the benchmark tax structure.

17. Non-Taxation of up to $10,000 of Death Benefit: Typically where an amount is paid by an employer to an employee's widow upon the employee's death, the lesser of $10,000, an amount equal to the employee's remuneration over the past year, or the amount of the death benefit need not be included in income for tax purposes. This is a departure from the comprehensive income base of the benchmark tax structure.

18. Exemption of Food and Non-Alcoholic Beverages from Sales Tax: The sales of all manufactured and produced goods are taxed under the benchmark tax system. The exemption of these goods thus constitutes a tax preference. Included in the estimate are purchases of food and non-alcoholic beverages by all groups, including consumers, restaurants, hotels, and hospitals. Also included in this estimate are home-produced food, confectionery and near foods, fresh fruits and vegetables, canned and packaged foods, and pet food.

19. Exemption of Home Heating Fuels and Electricity from Sales Tax: This is considered a tax expenditure because the sales of all manufactured and produced goods are taxable under the benchmark tax system. The estimates are based on consumer expenditures on fuel and electricity.

20. Exemption of Clothing and Footwear from Sales Tax: The estimate of this tax expenditure includes exemptions for both adults' and childrens' clothing, footwear, and accessories.

21. Deductibility of Unemployment Insurance Premiums: Contributions to the federal unemployment insurance program by both employees and employers are deductible in computing income for tax purposes. As discussed in the main text, this gives rise to a tax expenditure. The estimate is based on the amounts of deductible premiums valued at the employees' and employers' average tax rates.

22. Preferential Tax Treatment of Registered Supplementary Unemployment Insurance Plans (RSUP): Employers may set up an RSUP to which they can make tax-deductible contributions. On termination resulting from a layoff, the employee receives a taxable benefit. Any investment return within the plan is not taxable. Under the benchmark tax structure, the employee benefit would be deductible to the employer only when it was paid. RSUPs therefore allow a deferral of tax for employers.

23. Inter-Spousal Capital Gains Rollover: Usually, the death of a taxpayer gives rise to a deemed realization of any accrued capital gains. An exception is allowed, however, for property passing to a taxpayer's surviving spouse either directly or by way of a spousal trust. This treatment permits a deferral of tax.

C. SOCIAL ASSISTANCE

1. Non-Taxation of Social Assistance Benefits: Means- and needs-tested social assistance benefits are not included in income for tax purposes. (There is an exception in the case of certain means-tested benefits which serve to reduce the amount of the marital exemption and the transferable amounts of the age and disability exemptions.) This is a departure from the comprehensive income base of the benchmark tax structure.

2. Exemption for Blind and Disabled: Blind and disabled taxpayers are entitled to an additional tax exemption of $1,660 in 1979 ($1,310 in

1976). Unused portions of this exemption may be transferred between spouses. This exemption provides preferential treatment to a particular group of taxpayers.

3. Exemption of Goods Manufactured by the Handicapped from Sales Tax: Under the commodity benchmark tax system, the sales of all manufactured and produced goods are taxable, making this exemption a tax expenditure.

D. INDIANS AND ESKIMOS

1. Income Earned on Reserves: Income earned by Indians on reserves is not included in income for tax purposes. This is a departure from the comprehensive income base of the benchmark tax structure.

E. HOUSING AND URBAN RENEWAL

1. Non-Taxation of Capital Gains on Principal Residence: Capital gains associated with an owner-occupied residence are completely exempt from tax. This is a departure from the comprehensive income base of the benchmark tax structure under which these gains would be taxed in full. The estimated tax expenditure value was obtained as follows. Data on the average value and number of owner-occupied houses was taken from the 1971 and 1976 census respectively. Changes in average values of houses, for purposes of computing accrued capital gains in any year, were taken to be equal to the changes in average value of all houses sold through the multiple listing service (MLS). After examination of census data on period of occupancy, it was assumed that on average one-fifth of the housing stock was sold each year and that, of houses sold, one-quarter had been held for an average of 7.5 years, one-half had been held for an average of five years, and one-quarter were held for an average of 2.5 years. An adjustment was made to reflect commissions on sale and to reflect repair expenditures during the holding period. These assumptions permitted estimation of the capital gains accrued on all houses during the year. It was assumed that the average federal marginal tax rate applicable was 20 per cent.

2. Non-Taxation of Imputed Income on Equity in Owner-Occupied Residences: Any imputed income on equity in an owner-occupied house is exempt from tax. This is a departure from the comprehensive definition of income and is non-neutral between renters and owners of housing. For example, a taxpayer who has $50,000 in a savings account which pays $4,500 in interest and who pays $6,000 per year rent for a house must include the $4,500 of interest in his income for tax purposes. On the other hand, a taxpayer who has accumulated $50,000 of equity in an owner-occupied house of otherwise identical quality pays no rent, has no interest income, but may have expenses of $1,500 per year on insurance, property taxes, and upkeep. In both cases, the $50,000 is yielding a net benefit of $4,500. However, this benefit is taxable for the renter but not for the owner. The estimated revenue cost of not including the imputed return on equity in an owner-occupied house is based on data on the value of owner-occupied houses and average mortgage

debt from a Statistics Canada survey of 1976 assets and debt. Equity in houses (equal to the market value of the house less mortgage debt outstanding) is calculated directly from the publication. Owner's equity is assumed to earn a net imputed return of 9.2 per cent thus yielding the estimate of income subject to tax. It is assumed that the marginal tax rate on this income source would be 20 per cent. This estimate is projected to 1979 on the basis of changes in the housing stock, house prices and average mortgage debt.

3. Registered Home Ownership Savings Plan (RHOSP) Deduction: A taxpayer can deduct up to $1,000 per year to a cumulative maximum of $10,000 of contributions to a Registered Home Ownership Savings Plan. Any investment income earned within the plan is not taxable. The savings can then be used to purchase a house. This is a tax preference based on the use to which a taxpayer's income is put. It generally gives rise to a tax reduction. If, however, assets accumulated in the plan are not used to purchase a house, they are taxable when withdrawn. The taxpayer in this case has enjoyed a tax deferral while the amounts accumulated tax-free within the plan. The estimated value of this tax expenditure is the revenue cost of all RHOSP deductions made in the year, under the assumption that all funds accumulated will eventually be used for house purchases.

4. Multiple Unit Residential Building (MURB) Provision: This provision is an exception to the general provision that losses for tax purposes arising from the application of capital cost allowances to rental property income cannot be offset against other non-rental income. The capital cost allowances (CCA) on MURBs can be offset against any other income as an incentive for taxpayers to invest in these types of dwelling units. Thus, tax deferral benefits from faster write-offs are more widely available. The estimate of the tax value of CCA which is written off against other income, as a result of the provision, is based on information on housing starts by type, average value per unit, and fragmentary data from personal tax returns on the incidence of taxpayers claiming CCA on rental buildings against other income.

5. Deductibility of Carrying Charges on Land: The current tax system allows the immediate write-off of interest costs, property taxes, and other expenses associated with holding undeveloped land in the course of a taxpayer's business. (During the period from June 23, 1975, to November 16, 1978, these carrying charges were not allowed as a deduction.) Such land holding is a form of inventory. Thus, under generally accepted accounting principles regarding inventory, and under the benchmark tax system, such carrying charges would be costs associated with the acquisition of inventory that can be deducted as a cost of sales only when the land is finally sold. The current tax treatment therefore allows a tax deferral insofar as costs are recognized before the associated revenue.

6. Non-Profit Housing Corporations: Certain non-profit corporations providing low cost housing for the aged are exempt from tax, whether

or not they have taxable income in a given year. This constitutes preferential treatment for a certain type of taxpayer.

7. Portion of the Charitable Deduction: The deductibility of charitable donations includes donations to certain non-profit housing corporations, as in Item 6 above. It is not possible to provide estimates by type of charitable donation so that the whole amount of this tax expenditure is shown under Item VIII.1.

8. First-Time Home Buyer Grants: The federal government and several provinces offered grants in 1976 to first-time home buyers which were not included in income for tax purposes. This is a departure from the comprehensive income base of the benchmark tax structure.

9. Reduced Rate of Sales Tax on Building Materials: The sales of all manufactured and produced goods are subject to the full tax rate under the benchmark commodity tax structure. Building materials under the existing tax system, however, are subject to a preferential low rate of tax of 5 per cent. The value of the tax expenditure is estimated using data on actual collections of tax on building materials. However, it is an over-estimate to the extent that the building materials were used to construct manufacturing facilities used as inputs in the production of other taxable products. As noted in the main text, a more consistent treatment of the construction industry under the benchmark commodity tax would be to take the sale price of housing units (but not plant and factory buildings) as the tax base. In this case, inputs to such construction would be exempt (Items 10 to 12 and building materials), but the total tax expenditure would be larger because the labour and profit content of the sale price would bear tax.

10. Exemption of Construction Equipment from Sales Tax: Since the output of the construction sector is exempt from sales tax under the benchmark tax structure, any machinery, equipment, and materials used as inputs in the sector must be fully taxable. This exemption thus constitutes a tax expenditure. The estimate of the tax expenditure includes all sales of tractors, excavator cranes, trenchers and ditchers, graders, compactors and rollers, concrete machinery, asphalt equipment, and all other construction type machinery and attachments. It is an over-estimate to the extent that the construction equipment was used to construct manufacturing facilities. A portion of this tax expenditure is included under Item IX.5.

11. Exemption of Goods in Competition with On-Site Construction from Sales Tax: Under the current federal sales tax, manufactured goods which could alternatively have been fabricated on a construction site are taxable only to the extent of the input of materials and not on their sale price. This constitutes a tax expenditure since any value added in the manufacture of these goods is effectively exempted from tax. Some manufactured goods affected by this provision are pre-cast concrete structures, steel structures, cement blocks, and septic

tanks. Although an estimate of this tax expenditure is not available at this time, it is expected to be quite substantial.

12. <u>Exemption of Ready-Mix Concrete from Sales Tax</u>: This exemption is really a special case of the tax expenditure available under Item 11 above. Ready-mix concrete is itself exempt from tax. All the inputs used in the production of ready-mix concrete, except for the mortar, are also exempt. The estimate of this tax expenditure thus equals the tax that would be payable on the sale price of ready-mix concrete less any tax currently collected on mortar.

13. <u>Reduced Rate of Sales Tax on Travel Trailers Used as Homes</u>: Prior to November 16, 1978, trailers for use as homes were permitted a 25-per-cent exemption on a tax of 12 per cent, which effectively resulted in a 9-per-cent sales tax rate. The general federal sales tax rate, however, was lowered to 9 per cent in November, 1978, thus making this effective rate on trailer homes the same as the general rate. This treatment of trailer homes constituted a tax expenditure for the years in which the exemption was applicable.

VII. <u>EDUCATION ASSISTANCE</u>

1. <u>Non-Taxation of First $500 of Scholarship and Bursary Income</u>: The first $500 of scholarship and bursary income are exempt from tax. This is a departure from the comprehensive income base of the benchmark tax structure.

2. <u>$50 per Month Education Deduction</u>: Students who are enrolled at a "designated educational institution", mainly universities and colleges, are entitled to claim a deduction from income for tax purposes of $50 for every month of full-time attendance. Unused portions of this deduction may be used by a taxpayer (typically a parent of the student) who claimed a dependent's exemption in respect of the student. This deduction provides preferential treatment to a particular group of taxpayers.

3. <u>Deduction of Tuition Fees</u>: Students may deduct their tuition fees for courses or full-time enrolment at a college or university in computing their income for tax purposes. This deduction provides preferential treatment to a particular group of taxpayers for a specific use of their income under the assumption that education is a form of personal consumption. If, instead, education is viewed as an investment, then the immediate deduction of tuition costs allows a fast write-off of a capital cost.

4. <u>Deduction of Contributions to Teachers' Exchange Fund Contributions</u>: Teachers are allowed a deduction for up to $250 in contributions per year to a fund established by the Canadian Education Association for the benefit of teachers from Commonwealth countries present in Canada under a teacher's exchange agreement. This is a tax preference for a particular use of income.

5. Preferential Tax Treatment of Registered Education Saving Plans: A taxpayer can set aside funds to pay the educational expenses of a designated beneficiary (usually a child) in a registered education savings plan. The investment return on these funds is not taxable until the funds are drawn upon by the beneficiary for educational purposes, and then in his hands. Thus, preferential treatment arises both in the deferral of tax on the investment return and in having this return taxed at the beneficiary/student's typically lower marginal rate of tax.

6. Exemption of Construction Materials and Equipment Bought by Educational Institutions from Sales Tax: The present federal sales tax exempts from tax equipment and materials used in the construction of buildings used by educational institutions. The estimates of the tax expenditure include all capital and repair expenditures for schools and universities. Note that this item might in part be viewed as more appropriately placed under Category IX, Fiscal Transfers. (See also Item IX.6.)

7. Exemption of Technical, Educational and Other Books from Sales Tax: This tax expenditure includes the full range of hard cover and soft cover books such as encyclopedias, educational text books, fiction and non-fiction books which are currently exempt from federal sales tax.

8. Portion of Charitable Deduction: The deductibility of charitable donations includes donations to certain educational institutions. It is not possible to provide separate estimates by the type of charitable donation so that the whole amount of this tax expenditure is shown under Item VIII.1. (See also Item VIII.2.)

VIII. Culture and Recreation

1. Deductibility of Itemized Charitable Donations and the $100 Standard Deduction: Taxpayers, both individuals and corporations, who make donations to registered charities may claim a deduction in computing their income for tax purposes equal to the amount of their donations, provided this amount does not exceed 20 per cent of their net income. Any excess donations over this 20-per-cent limit can be carried forward one year. If an individual taxpayer's donations plus medical expenses over the 3-per-cent floor (see Item VI.A.1) were less than $100, he can claim a standard deduction of $100. For tax purposes, donations must be to registered Canadian charities, which include religious, educational, medical, and cultural institutions, as well as to registered Canadian athletic associations, certain non-profit housing corporations, Canadian municipalities, United Nations agencies, certain foreign universities, and foreign charities that have also been supported by the Canadian government. This is a tax preference based on the use to which income is put. Portions of the tax expenditure shown here should in principle be included under the headings of Health, Social Assistance, Housing and Urban Renewal, Educational Assistance, and Foreign Affairs. However, such a breakdown is not feasible at present.

2. Non-Taxation of Registered Charities: Otherwise taxable income of registered charities, mainly investment income, is exempt from tax.

This is a tax preference for a specific group of taxpayers/legal entities.

3. <u>100-Per-Cent Write-Off for Canadian Films</u>: Investments in films meeting a set of Canadian content criteria can be depreciated at up to a 100-per-cent rate for tax purposes. (Other feature films can be depreciated on a 30 or 60-per-cent declining balance basis.) Under the benchmark tax structure, accrual accounting requires that costs be matched against revenues so that costs of investing in a film would be spread over the income-generating life of the film. This fast write-off thus gives rise to a deferral of tax.

4. <u>Cultural Property Import and Export Act</u>: Certain objects certified as being of cultural importance to Canada under the Cultural Property Import and Export Act after September 6, 1977, may, if donated to a designated museum or art gallery, be exempt from capital gains tax. At the same time, the whole of the fair market value of the property may be claimed for purposes of the deduction for charitable donations (without the 20-per-cent limit noted in Item 1 above). Capital gains on the disposition are also exempt from tax if the object is sold rather than given to the museum or art gallery. This constitutes preferential treatment for taxpayers engaged in particular kinds of transaction.

5. <u>Portion of Tax Deferral Available from Income Averaging Annuity Contracts (IAACs)</u>: Incomes from production of literary, musical, or artistic works and from activities as an athlete, musician, or public entertainer are eligible for preferential treatment under the IAAC provisions. These allow a deferral of tax. The tax expenditures involved are included and described under Item V.I.33 because the amounts cannot be estimated separately.

6. <u>Write-Off on Art Work</u>: Art work acquired by a business (not necessarily incorporated), for example to be displayed in an office, can be depreciated for tax purposes on a 20-per-cent declining balance basis (Class 8). However, it is not clear that works of art depreciate; in many cases their value appreciates and their durability is such that they may last for centuries. Thus, under the benchmark tax structure, works of art owned by a business are not considered depreciable assets. Depreciation claims on such works of art therefore give rise to a deferral of tax, assuming the work is eventually sold; otherwise there is a permanent reduction in tax. (Works of art owned by individuals are not depreciable.)

7. <u>Non-Taxation of Lottery and Gambling Winnings</u>: Net lottery and gambling winnings are not now included in income for tax purposes. (Costs of tickets or wagers during the year would be deductible from gambling gains under the benchmark system. Losses could not be offset against other income sources or gambling gains in other years.) The estimate is based on prizes paid under Loto Canada, and provincial lotteries as reported by the various agencies, on winnings from horse racing as reflected in provincial taxes on betting, and on winnings under bingos estimated on the basis of expenditures on bingos reported by Statistics

Canada in expenditure surveys. It is assumed that the average marginal tax rate on taxable income would apply to these winnings if they were to be taxable.

8. Deduction for Clergyman's Residence: A taxpayer who is a full-time member of the clergy or regular minister of a religious denomination may deduct his housing costs from his income for tax purposes. This is a tax preference for a particular group of taxpayers.

9. Non-Taxation of Certain Income of Individuals Who Have Taken Vows of Perpetual Poverty: Where an individual has taken a vow of perpetual poverty as a member of a religious order, he may deduct donations to the order up to the total amount of his pension and employment income (but not investment or other income) in lieu of the deduction of charitable donations. (See Item 1 above.)

10. Exemption of Newspaper and Magazine Production from Sales Tax: The value of this tax expenditure is estimated on the basis of the retail sales value of the printing and production of a range of magazines, newspapers and pamphlets adjusted for retail and wholesale markups.

11. Exemption of a Range of Cultural and Religious Materials from Sales Tax: Although a separate estimate for these items (e.g. church organs, church bells, reproduction statues, hymn books, pamphlets) is not provided, the bulk of this tax expenditure is included in the figure for the sales tax exemptions for: technical, educational, and other books, and newspaper and magazine production (Items VII.7 and VIII.10 above).

12. Exemption of Imported Antiques from Sales Tax: Included in the estimate are the federal cost of exempting antiques over 100 years old. Domestic antiques are not included in the estimate because they were initially taxed when purchased or because prior to the late 1920s the commodity tax was non-existent in Canada and thus was not part of the benchmark tax system.

13. Exemption of Amusement Devices and Equipment for Use at Exhibits or Fairs from Sales Tax: Under the benchmark tax system, all goods used in providing tax free services such as entertainment are taxable. The revenue estimates of this tax expenditure are not available at this time.

14. Exemption of Bicycles and Tricycles from Sales Tax: The estimate includes both replacement parts for bicycles or tricycles and the complete units.

15. Exemption of the Outputs of Craftsmen, Artists, and Sculptors from Sales Tax: Included in the estimate are paintings, sculptures, carving, handicrafts and other art objects. An adjustment to the sales tax base was made in order to account for the taxation of some of the inputs such as paints, canvas and other art supplies used in the production of the tax-exempt goods.

IX. FISCAL TRANSFER PAYMENTS

1. Quebec Abatement: Individuals resident in Quebec were entitled to an abatement which reduced their 1976 federal basic tax (federal tax before deduction of federal tax cuts and credits) by 24 percentage points. This abatement provided the province extra "tax room" instead of direct federal transfers in respect of certain federal-provincial cost-shared programs. With the change in fiscal arrangements in 1977 (see next item), the general abatement to all provinces was increased; consequently, the special abatement for Quebec residents was reduced to 16.5 per cent for 1979. This is a tax preference for a particular group of taxpayers and is functionally equivalent to a direct spending program. (See discussion in main text.)

2. Transfers of Income Tax Room to Provinces: In 1967, federal-provincial fiscal arrangements were altered such that the federal government substituted a transfer of individual and corporate income tax points for direct transfers to provinces under the cost-shared program for post-secondary education. The tax changes involved were an increase in the corporate income tax abatement from 9 to 10 percentage points, effectively reducing the current federal corporate income tax rate from 37 per cent to 36 per cent (46 per cent is the rate before any abatements), and a four percentage point increase in the personal income tax abatement. (The general personal income tax abatements were embodied in a revised rate schedule in 1972.) In 1977, there was a further change in fiscal arrangements wherein the federal and provincial governments agreed to substitute an abatement of 13.5 points of individual income tax and one point of corporate income tax for direct federal transfer payments in respect of post-secondary education, hospital insurance, and medicare programs. These new abatements were inclusive of the abatements provided earlier in 1967. As noted in the main text, these transfers of tax room are considered tax expenditures based on the functional equivalence criterion; they have in fact been substitutes for direct spending programs.

3. Exemption from Withholding Tax for Interest on Provincial and Municipal Debt: Interest paid to non-residents on provincial and municipal debt, on debt issued by provincially or municipally owned corporations, or on debt of hospitals or educational institutions which is guaranteed by a province is exempt from the withholding tax if issued after April 15, 1966.

4. Provincial and Municipal Corporations: Under the current income tax system, provincial crown corporations and municipal corporations are exempt from tax. Under the benchmark tax structure, such corporations would be taxable to the extent they had taxable income. While the amount of this tax expenditure is not known, it is expected to be substantial.

5. Exemption of a Range of Municipal Purchases from Sales Tax: Under the benchmark commodity tax system, the sales of all manufactured and

produced goods are taxable. Since the goods purchased by municipalities are used either as inputs in order to provide tax-free services or are directly consumed, they are included in the benchmark commodity tax base. The estimate of this tax expenditure covers a range of construction materials and equipment such as those used in water and sewage treatment plants, municipal transit equipment, fire-fighting equipment, and road-making and water distribution equipment. (See also Items IV.1 and VI.E.10.)

6. Exemption of Certain Provincial Purchases from Sales Tax: Certain provinces not party to the Reciprocal Taxation Agreement are exempted from federal sales taxes on their purchases. Prior to October 1, 1977, all provinces were exempted from federal sales tax on their purchases. This constitutes a tax expenditure since, under the benchmark commodity tax system, the sales of all manufactured and produced goods whether for private or public use are included in the sales tax base. Manitoba, Saskatchewan, Alberta and British Columbia are not now participating in the Reciprocal Taxation Agreement whereby one level of government bears the sales or similar taxes imposed by the other level of government.

X. PUBLIC DEBT

1. Exemption from Withholding Tax for Interest on Government of Canada Debt: Interest paid to non-residents on Government of Canada bonds or on bonds guaranteed by the Government of Canada is exempt from the withholding tax.

XI. OTHER TAX PREFERENCES

1. General Averaging for Individuals: The current income tax system provides a reduction in tax for taxpayers who experience relatively sharp increases in income. If their net income in a year has increased more than 10 per cent over the previous year and has increased more than 20 per cent over the average of the last four years' incomes, then the income above these thresholds is not subject to progressively higher rates of tax. This constitutes a tax expenditure since it is a departure from the annual accounting period in the benchmark tax system and because it provides preferential treatment to a particular group of taxpayers.

2. Non-Taxation of Certain Federal Crown Corporations: Federal Crown corporations listed under Schedule D of the Financial Administration Act are taxable. However, a number of other federal Crown corporations, while not so listed, carry on commercial activities and thus could have income which would otherwise be subject to tax. This represents a tax preference for a particular group of taxpayers.

3. Non-Taxation of Income of Various Non-Profit Entities Not Included Elsewhere: Certain organizations -- including boards of trade or chambers of commerce, labour organizations, mutual insurance corporations providing insurance solely to churches, schools or other charitable

organizations, clubs or societies organized and operating exclusively for social welfare, civic improvement, pleasure, recreation, amateur athletics, etc., and insurers doing the bulk of their business in respect of farming and fishing -- are completely exempt from tax. Under the benchmark tax structure, these organizations would be taxable to the extent that they had taxable income. (See also Items V.F.4 and VI.E.6.)

4. <u>Exemption of Goods Imported in Travellers' Baggage from the Sales Tax:</u> Residents returning from visits abroad are allowed to bring back gifts and articles within various limits, depending on the length of their absence without any payment of sales tax (or customs duty). An estimate of this tax expenditure is not available at this time.

5. <u>Exemption of Coins from Sales Tax:</u> Coins are considered a manufactured and produced good and are thus included in the benchmark commodity tax base. An estimate of the revenue cost of this tax expenditure is not available at this time. (It may be noted that bank notes, i.e. the production of dollar bills etc., are currently taxable under the federal sales tax.)

XII. MEMORANDUM ITEMS

A. SELECTED TOTALS

1. <u>Total Tax Expenditure Value of Investment Tax Credit:</u> This is the total of amounts shown under Items IV.2, V.A.7, V.B.13, V.C.1, V.E.2, V.F.3, V.G.5, and V.I.1. (The individual items may not add to totals due to rounding.)

2. <u>Total Tax Expenditure Value of CCA Claims in Excess of Book Depreciation:</u> This is the total of amounts shown under Items IV.6, 7, and 8, V.A.5 and 6, V.B.7, 8, and 9, V.D.2, V.E.3, 4, and 5, V.I.25, 26, and 38, VI.E.4, and VIII.3 and 6. (The individual items may not add to totals due to rounding.)

3. <u>Cumulative Amount of Federal Corporate Income Taxes Deferred per Companies' Books:</u> This item is the estimated federal portion of the amount shown in <u>Corporation Taxation Statistics</u> as "Reserve for Future Income Taxes". This item reflects not only tax deferrals arising from the CCA system but also items such as fast write-offs of exploration and development expenses. It is an indication of the total amount of deferred corporate income tax revenue outstanding.

4. <u>Cumulative Amount of Tax Deferrals and Reductions due to Deductibility of Contributions to RPPs and RRSPs:</u> These amounts are described under Item VI.B.4 above.

5. <u>Cumulative Amount of Tax Deferrals and Reductions due to Deductibility of CPP/QPP Contributions:</u> These amounts are analogous to those given in Item 4 above. They represent the total amounts of tax forgone from

the deductibility of CPP/QPP contributions, based on the total amount of assets in the two plans.

B. COMMODITY TAXES

1. Exemption of Services from Sales Tax Base: On pragmatic grounds, the benchmark sales tax structure accepted the exclusion of services from the sales tax base. However, such a tax is clearly non-neutral in its treatment of goods and services. If services were included in the tax base, it would then be inappropriate to tax materials and machinery and equipment used directly to provide the services. The net tax expenditure in this case would then become the excess of the value of non-taxation of services over and above the revenue collected from the taxation of materials and machinery and equipment used to produce the services. For instance, the net tax expenditure in favour of repair services would become the excess of the total value of repair services times the sales tax rate less the revenue collected from parts used in making repairs. Included in the estimate of this possible tax expenditure are: housing services (gross paid and imputed rent); lodging at schools, hotels, etc.; communication services; child care expenses and household help; cleaning services; repairs; insurance premiums; moving, storage, garage rental and parking expenditures; personal care services; medical services; other professional services; rentals; amusement and recreation services; personal instruction services; membership dues in organizations and clubs; tuition fees; and funeral services. For purposes of the estimate, it is assumed that services would be taxed at the federal sales tax rate applicable in the year.

2. Other Commodity Taxes in Excess of Manufacturers' Sales Tax: The federal government levies a range of taxes on commodities in addition to the sales tax. For tax expenditure accounting purposes, it is possible to treat each of these taxes as being levied on a separate tax base and thus as part of the benchmark tax structure, so that no tax expenditures arise. Alternatively, these taxes can be considered negative tax expenditures insofar as they cause more revenue to be collected than would be collected under the sales tax alone. In either case, they are included here as memorandum items for information purposes.

   a. Gasoline: In 1976, the special excise tax on gasoline was 10¢ per gallon. It was subsequently reduced to 7¢ per gallon or 1.5¢ per litre in August 1978. (See also Item V.B.14.)

   b. Tobacco: Cigars, cigarettes, and manufactured tobacco are subject to a combination of excise duties (under the Excise Act) and excise taxes (under the Excise Tax Act).

   c. Alcohol: Beer, wine, sparkling wine, brandy, liquor and medicinal spirits are subject to a combination of excise duties (under the Excise Act) and excise taxes (under the Excise Tax Act).

   d. Jewellry: Jewellry is subject to a 10 per cent excise tax.

e. Heavy Cars, Automobile Air Conditioners, Private Planes, Motorcycles, and Boat Motors: These items have been subject to a range of excise taxes. After November 16, 1978, these additional taxes were repealed for private planes, motorcycles, and boat motors.

f. Air Transportation Tax: The proceeds of this tax are earmarked for the air transportation program of the Department of Transport. It is levied on airline tickets as a percentage of the ticket price for flights within Canada, the U.S., and the islands of St. Pierre and Miquelon, and as a flat amount on other international flights.

g. Other: Clocks, watches, lighters, playing cards, and smokers' accessories are all subject to excise tax at various rates.

3. Oil Export Charge: This charge, under the Petroleum Administration Act is levied on exports of Canadian crude oil and oil products. It is set so that the export price including the charge is generally equal to the international price of crude oil and oil products.

4. Syncrude Levy: This item is an earmarked tax levied on petroleum products, in particular the receipts of refineries for outputs manufactured from domestic and imported crude oil, and on imports of foreign-produced petroleum products. The revenues are used to bring the prices paid for the tar sands output of the Syncrude project and the Suncor Inc. (formerly Great Canadian Oil Sands Limited) plant up to world levels.

5. Refunds of Special Excise Tax on Gasoline for Commercial Users: The special excise tax on gasoline (Item 2.a above) is levied only on non-commercial users, though commercial users pay the tax when purchasing gasoline and then apply to Revenue Canada for refunds. The amount shown is the additional revenue that would be collected if commercial uses of gasoline were also subject to the special excise tax. (They are subject to the specific excise levy under the manufacturers' sales tax, though note Item V.B.14 above.)

C. RESOURCE SECTOR

1, 2, 3. Resource Allowance, Provincial Royalties, and the Logging Tax Credit: The resource allowance is a deduction of 25 per cent of "resource profits". This deduction is commonly viewed as being in lieu of deductibility of provincial resource royalties. The logging tax credit is based on a fraction of provincial logging taxes paid and income from logging operations. As noted in the main text, the appropriate benchmark treatment of these items is not clear. Thus, for purposes of providing more comprehensive information, the federal revenue impact of the resource allowance deduction, the federal revenue impact if instead of the resource allowance a deduction were allowed for provincial royalties, and the federal revenue impact of the logging tax credit, are shown separately. The amounts are based on data in Corporation Taxation Statistics and effective corporate income tax rates by sector. The figures in Table 2 indicate that in the mining sector, the value of the resource allowance is greater than deductibility of provincial royalties would be, while the opposite is the case in the petroleum, coal, and gas industries.

D. OTHER

1. Childcare Expense Deduction: Under the current income tax system, expenses in respect of dependent children under age 14 such as baby sitting fees and nursery costs are deductible in computing income for tax purpose. The maximum amount of the deduction is limited to $1,000 per child up to a total of $4,000, or two-thirds of "earned income". In most cases, the deduction must be claimed by the mother. It is not entirely clear that this provision is a tax expenditure. One view is that childcare expenses are a legitimate expense in earning income. However, if this view is accepted, the maxima on the amounts claimable and the general restriction to women being able to claim the deduction imply negative tax expenditures. An alternative is to view the entire measure as a tax expenditure. Such treatment is suggested most broadly in terms of the functional equivalence criterion. For example, the Royal Commission on the Status of Women, in commenting on the proposal in 1970 before it was implemented, suggested that a better alternative would be to increase family allowance benefits. More recently, there have been suggestions that the provision would be better structured as a tax credit rather than a deduction. It is apparent from the discussion surrounding the introduction of the measure that it was widely viewed as a matter of social as well as economic policy, and as a measure directed toward the general question of the appropriate tax burden on two-earner relative to one-earner couples. In any case, for purposes of providing a more complete picture of the tax system, the provision has been included in the tax expenditure account as a memorandum item.

2. Employment Expense Deduction: Individuals with employment income are allowed a 3-per-cent deduction to a maximum of $500 ($250 in 1976) from this income as an arbitrary allowance in respect of certain expenses incurred in earning that income. Such expenses are not themselves deductible. While in principle the actual expenses should be deductible, practical considerations would make such a provision impossible to administer. Thus, a tax expenditure (or tax penalty) could be viewed as arising to the extent the arbitrary 3-per-cent deduction exceeded (or was less than) actual employment expenses. It is not possible to estimate these amounts. Instead, the figures in Table 1 show the federal revenue impact if the employment expense deduction were simply abolished.

3. $5,000 Limit for Deduction of Hobby Farm Losses: Individuals whose major source of income is not farming are allowed to deduct up to $5,000 of losses on a farm operation against other income. Costs giving rise to these losses may be in the nature of personal expenses and therefore should not be deductible. Alternatively, it could be argued that this provision is not a tax expenditure in that legitimate expenses of any business should be deductible. However, insofar as the tax losses arise from other tax expenditures (see section V.A),

the $5,000 limit can be viewed as a limit on the size of these other tax expenditures. In any case, the amounts shown in Table 1 reflect the alternative of allowing no hobby farm losses to be offset against other income.

4. Non-Taxation of Expense Allowances of MPs, MPPs, Royal Commissioners, and Certain Municipal Officials: Individuals in these positions are generally given a flat amount per annum in addition to their salaries to cover a variety of expenses they typically incur, or additional amounts to cover certain living and travelling expenses. These amounts are not included in income for tax purposes. However, in principle it could be argued that these amounts should be included in income and the associated expenses, other than personal expenses, allowed as deductions. The net revenue impact of such alternative treatment cannot be readily estimated.

5. $2,000 Limit for Deduction of Capital Losses: Individual taxpayers are allowed to deduct up to $2,000 ($1,000 in 1976) of allowable capital losses (one-half of realized capital losses) against income other than capital gains. As noted in the general discussion in the main text, this is not considered to be a tax expenditure. Rather, the limit in this case is viewed as a limit on the size of the tax expenditure arising from the taxation of capital gains on a realization rather than on an accrual basis. Nevertheless, the amounts shown in Table 1 reflect the alternative of allowing no capital losses to be offset against other income.

6. Goodwill and Expensing of Advertising Costs: The current tax system allows advertising costs to be treated as current expenditures. At the same time, one-half of the value of intangible assets (referred to as "eligible capital property") such as goodwill, if purchased, can be depreciated on a 10-per-cent declining balance basis. In turn, goodwill may be the result, in substantial part, of earlier expenditures on advertising, for example those devoted to enhancing "brand image". Thus, the current tax treatment of advertising is somewhat ambivalent; in some forms it is a current expense while in others it is only partly depreciable at relatively low rates. Some advertising, such as that of super markets in local newspapers, almost certainly has a useful life less than a year. Other advertising, however, such as that oriented to enhancing a brand's image, could well have a useful life greater than a year. The benchmark tax system should in principle require advertising to be depreciated over its useful life. Thus, expensing of those advertising expenditures with useful lives greater than a year would be equivalent to a fast write-off and would give rise to a deferral of tax. In the case of goodwill, a positive or negative tax expenditure would arise to the extent that its actual rate of depreciation was greater or less than 10 per cent on half the amount. However, because of the difficulties of reasonably determining the useful life of advertising expenditures, no estimates of these items have been attempted.

7. Non-Deductibility of Advertising Expenses in Foreign Media: Expenses for advertising in non-Canadian newspapers or periodicals and on non-

Canadian broadcast media (mainly U.S. border radio and TV stations) cannot be deducted in computing income for tax purposes. Under the benchmark tax system, no preferential treatment would be given to Canadian versus other advertising media (though advertising expenses should be depreciated over their useful lives). This provision therefore gives rise to a negative tax expenditure.

8. <u>Non-deductibility of Salary Paid to Spouse by Unincorporated Business:</u> Salaries paid by businesses, both incorporated and unincorporated, are generally allowed as a deductible expense. An exception, however, is made in the case of an unincorporated business proprietor paying a salary to his or her spouse. In this case, the salary is not deductible. This provision is a tax penalty or negative tax expenditure to the extent that legitimate expenses are not allowed as deductions. This restriction has been imposed because of the administrative difficulty of determining when such salaries are legitimate business expenses as opposed to means of artificially reducing individual income tax liabilities by income splitting. The amounts shown are rough estimates.