National Report Canada

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E National Report Canada

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I. Overview of the Lessons from Canada Relating to Compliance Costs

Interestingly, Canada has had relatively little recent experience with anything like the heated concerns expressed in American and EU tax policy circles regarding excessive compliance costs of corporate income taxes. The lack of debate regarding compliance costs cannot be attributed to a lackadaisical or uncritically accepting attitude toward personal and corporate income tax policy in Canada. On the contrary, there are issues in Canadian tax policy circles that are widely considered to be troubling. However, compliance costs are not one of our most contentious concerns. The conspicuous lack of heated debate relating to compliance costs can probably be attributed to early successes in fashioning an income tax system that has a relatively low overhead associated with compliance. Because of the perceived effectiveness of the Canadian system on the compliance cost front, those individuals in the EU who are interested in formulary apportionment of corporate income might well wish to examine the Canadian experience in more detail.

Indeed, a recent EU study examines the United States and Canada as possible models for EU formulary apportionment.1 The conclusion is that while the approach of the US is considered to be “chaos to be avoided,” the Canadian experience of a uniform sales-salaries allocation formula agreed to by the federal and provincial governments is regarded as “a good model for the EU to study.”2

Canada’s formulary apportionment system has been allocating corporate income to the ten Canadian provinces and the territories for almost 50 years. The system has worked well for the most part, albeit with some concerns regarding income-shifting among provinces.

A recently published manuscript that should prove to be of considerable interest by Joann Martens-Weiner, entitled Company Tax Reform in the European Union: Guidance from the United States and Canada on Implementing Formulary Apportionment in the EU, claims that there are two empirical results most worth highlighting from the Canadian experience with formulary apportionment:

First, provinces can compete for investment by cutting tax rates or by offering post-apportionment tax credits while still using a common formula and a common tax-base. Second, since consolidation is effectively optional, provincial income shifting possibilities arise through adjustments in corporate form.3

We agree, and would add that certain features of the Canadian system, elaborated upon in Part III of this report, suggest that the incentives for tax competition

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2 Ibid 51.
are probably mitigated to some extent. To the extent that the EU does not share the same features as Canada, consideration should be given to adopting anti-abuse measures to counteract income-shifting if it is decided that separate accounting is preferred over a consolidation approach.4

II. Canadian Tax Reform, Tax Administration, and Compliance Costs

2.1 Compliance Cost Considerations in Canadian Tax Reform Efforts

Canada’s federal income tax was introduced for the first time in Canada in 1917.5 The introduction of the federal income tax was motivated by the need for additional revenues to finance Canada’s participation in World War I. Several provinces had established income taxes prior to the introduction of the federal income tax for other, quite different, reasons. First, the provinces were constitutionally denied the power to impose indirect taxes. Second, other direct taxes, such as property taxes, were insufficient to meet provincial revenue needs. The federal government, on the other hand, from the time of confederation in 1867 has had the power constitutionally to impose both direct and indirect taxes.6

Currently there are income taxes at both the federal level and at the provincial level throughout Canada. The federal government has responsibility for administering the personal income tax for itself and for all but one of the provinces under the voluntary “tax collection agreements” (TCAs). Only Quebec administers its own personal income tax. With regard to corporate income taxes, the federal government administers and collects the corporate income tax for itself and also on behalf of seven of the ten provinces. Alberta, Ontario, and Quebec administer and collect their own corporate income taxes. These three provinces account for approximately 75% of corporate income.7 The government of Ontario has recently entered into a TCA with the federal government for corporate income tax administration and collection; however, as of this writing, the process has been begun, but is not complete.8

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4 Martens-Weiner makes a related point, *ibid* 97 et seq.
5 Several provinces had earlier introduced their own income taxes.
6 For the most detailed published treatment available of the allocation of taxing powers under the Canadian constitution, see Gerard La Forest, *The Allocation of Taxing Power Under the Canadian Constitution* (1981).
8 The federal government will not begin administering Ontario’s corporate income tax until 2008.
The Canadian federal income tax, like most income taxes, has been the subject of almost constant change since its introduction, with what is probably the usual mix of reforms involving at various times politically-motivated tinkering and policy improvement and refinement. Despite this constant change, compliance cost issues have time and again been a relatively minor consideration in most reform efforts. The predominant goal of income tax reform in Canada has been the promotion of fairness and, mostly indirectly, the promotion of economic efficiency. To a somewhat lesser extent, reform efforts have sought to make the income tax more difficult to avoid or evade (which in turn tends promote both fairness and efficiency) and easier to administer (through, for instance, withholding income taxes and payroll taxes from employment income at source).9

The relatively minor impact compliance cost issues have had in Canada can be seen most clearly by examining the 1972 reforms, the most significant that have been undertaken. The 1972 reforms grew out of the Report of the Royal Commission on Taxation.10 The Royal Commission on Taxation was struck in September 1962, with Kenneth Carter, a prominent Toronto accountant, as its chair. It was (and continues to be) widely known as the “Carter Commission.” The Carter Commission took more than four years to produce an extensive 2,700 page, six-volume report. The report was released publicly on 24 February 1967.11

Interestingly, the original Order in Council of the Privy Council establishing the Carter Commission, P.C. 1962-1334, made no mention of the need to study the costs of complying with the income tax, despite ordering that many other identifiable aspects of income taxes be considered and reported upon. The closest that the Order in Council came was in stating that the Carter Commission should “consider and report upon … (f) the changes that may be made to achieve greater clarity, simplicity and effectiveness in the tax laws or their administration.”12 In the introduction of the report, the Commission reports that, “In some tax fields, compliance and collection costs have been needlessly raised because of duplicate federal and provincial administrations.”13 In addition to this observation, however, the Commission reports in the conclusion to the introduction of the report that, “Preparing this Report has been a large undertaking, and the result is a long and complex document. Despite its length there are many questions with which we have not dealt. Despite its complexity we have often had to oversimplify and to ignore problems that we would like to have discussed.”14 Compliance costs,

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9 On the history of withholding in Canada, see Li, Withholding on Domestic Interest and Dividends, Canadian Tax Journal 1995, 553.
13 Supra note 10 at Vol 1, 1.
14 Ibid at Vol 1, 49.
apparently, were one of the areas that the Carter Commission probably would have liked to have addressed, but did not. It is telling that an extensive, 2,700 page report on income tax policy and reform in Canada did not regard compliance costs to be an area meriting specific attention.

Although compliance and administrative concerns have been relatively unimportant to income tax reform in Canada, they have not been completely invisible. Four additional observations on the Canadian experience merit mention: (i) there is at least one reform post-Carter in which compliance costs were of paramount importance; (ii) the Canadian Department of Finance is aware of the problems associated with the informational burden of the income tax and has taken some steps (although relatively less systematically and perhaps with less sophistication than other OECD countries) to identify and quantify the costs of tax reforms; (iii) in a move that dramatically increased compliance costs by expanding the reach of indirect taxes at the federal level, the federal government abandoned its manufacturers sales tax, a form of retail sales tax that had applied to primarily large manufacturers, and replaced it with the GST, a value-added tax, in 1991; (iv) additional compliance costs were also consciously incurred in the 2000 and 2001 reforms to the TCAs as a tradeoff in favour of the benefits of additional flexibility for provincial tax policy. These are addressed in turn.

The primary reform effort in Canadian income tax where simplification and compliance costs were made a decisive factor was with regard to the taxation of small business in the early 1980s. Consultations were held across the country in order to determine how to make small business taxation more cost-effective. There was even a conference held by the Canadian Tax Foundation to address the issue of reforming the taxation of small businesses in Canada. Unfortunately, the proceedings of this conference were never published. The upshot of the conference and the consultations, however, was the elimination of the cumulative deduction account as of 31 December 1984. This reform has saved Canadian small businesses from the significant expense of maintaining a cumulative deduction account.

15 The index to the six-volume report has no mention of the terms “compliance costs”, “costs of collection” or any similar term.
17 The conference was entitled, “Symposium on the Simplification of the Small Business Provisions of the Income Tax Act” and was held in Toronto, 11 to 13 July 1983.
18 At least one paper presented at the conference was published, however; see Couzin, The Process of Simplification, Canadian Tax Journal 1984, 487.
19 Canada Department of Finance, Supplementary Information and Notice of Ways and Means Motions (8 November 1984).
The second relevant observation draws on the 1988 Report of the Auditor General of Canada, which devoted an entire chapter to the information burden of the Canadian income tax and how administrative and compliance costs should and do affect the design of proposed income tax provisions. As noted by Chris Evans and Michael Walpole in their study of tax impact studies in the OECD, there has subsequently been relatively little formal take up of the recommendation to systematize inquiries into administrative compliance costs. Indeed, in describing Canadian practice, Evans and Walpole identify a few generally applicable initiatives, some of which are mentioned by the Auditor General’s report, but then go on to state,

At first blush these mechanisms might suggest that Canada has some formal method of assessment of the compliance cost burden that is associated with tax changes. However this is not the case, as none of the mechanisms explicitly deals with the issue of compliance costs. Nonetheless compliance cost issues sometimes come up in the consultative process, and where this is the case, any advice and input on compliance costs, whether verbal or written, is taken into consideration by the Department of Finance in the development of tax policy changes. Moreover, although the Department of Finance has confirmed that tax impact statements are not currently being used, apparently some recent consideration has been given to the introduction of this type of reasoning.

Despite the suggestion at the end of this passage that tax impact statements may have been imminent in Canada, there has been no recent formal adoption of tax impact statements in Canada since the Evans and Walpole study was published in 1999.

Third, the federal government abandoned the manufacturers’ sales tax (MST) in 1991 with the GST. While the MST had been invisible to consumers, the GST is a 6% sales tax that is unusually transparent by VAT standards, since it is typically added to prices at the time of sale. At its introduction, the GST appeared alongside provincial retail sales taxes in all provinces except Alberta and Quebec. Alberta had no provincial retail sales tax with which the GST could be compared. For its part, the province of Quebec harmonized its retail sales tax with the federal GST, and agreed to collect the GST on behalf of the federal govern-

22 See Evans/Walpole, Compliance Cost Control: A Review of Tax Impact Statements in the OECD.
24 For an account of this transition, see Perry, Financing the Canadian Federation, 1867 to 1995: Setting the Stage for Change (1997) 98 et seq.
25 Ibid.
In 1997, three additional provinces – New Brunswick, Nova Scotia, and Newfoundland – agreed to harmonize their provincial retail sales taxes with the GST. Speaking generally, the MST was a much easier tax to administer and comply with because it applied to a much narrower range of taxpayers and did not involve the more extensive recordkeeping demands of a VAT. In addition, the GST, because of its visibility vis-à-vis the MST added difficult to quantify, though no less real, psychic compliance costs for Canadians.

The final observation is that the move to “tax on income” (also known as “tax on net income” or TONI) in the amendments to the various TCAs in 2000 and 2001 also increased (though perhaps only marginally) the compliance and administration costs of the income tax. Prior to 2000, the provinces were restricted by the tax collection agreements to impose provincial income taxes as a percentage of federal tax payable, in what is known as the “tax-on-tax” (TOT) approach. The TONI innovation was generally welcomed by commentators, despite the higher compliance and administrative costs, in large part because of the flexibility it accorded to provincial governments to choose tax rates and brackets independently from the federal government. One recent reform to the income tax where the distinction between the TONI and TOT approaches mattered was the new employee deduction in the 2006 budget, a measure which gives all employees an automatic credit equal to the lesser of tax at the lowest marginal rate on $1,000 or the total employment income earned. The reform could have been made a receipt-based credit but instead it was introduced as an automatic entitlement. By not requiring receipts, it is argued that the introduction of the employment expense credit was motivated by a desire to keep the paperwork simple in order to reduce administrative and compliance costs. This makes the new employee credit similar to an employment expense deduction that had been abolished in the 1987 budget, except that the new proposal is less limited since it is capped only by employment income rather than three percent of income. On the other hand, the 2006 budget also introduced two new receipt-based credits – (i) sporting activities for children; and (ii) and one for public transit passes.

Thus, with some contrary observations littered among the historical annals of Canadian income taxes, it seems that compliance costs have been and continue to be of relatively minor importance in Canadian income tax reform. If history is a reliable guide, then prospectively it does not appear that the reduction of comp-

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26 Ibid.
27 For a discussion of the changes brought about by the new approach, see Macnaughton, Compliance and Administration Issues Under the Tax Collection Agreements, Canadian Tax Journal 1999, 890.
Compliance costs will play a predominant role in income tax reform debates in Canada, though, of course, as mentioned by the Auditor General’s report and the Evans and Walpole study, administrative and compliance costs are not wholly ignored by the Department of Finance in framing new income tax measures.

2.2 Canadian Compliance Rules and their Enforcement

2.2.1 Enforcement of Canadian Income Tax Law

Canada’s income tax is a self-assessing and self-reporting system. All individuals who are required to pay income tax for a given year must file an income tax return with the CRA, most usually by 30 April (or the first business day following 30 April). A corporation is generally required to file a tax return within six months of the end of the corporation’s fiscal period regardless of whether it has any tax liability. Tax returns are completed on forms provided by the CRA. Ordinarily, supporting documentation does not have to be submitted to the CRA at the time a tax return is filed. If a tax return shows that the taxpayer owes additional tax, that additional tax is expected to be submitted to the CRA along with the return.

Tax returns filed by taxpayers are assessed by the CRA. A basic check for arithmetical consistency and documentary completeness is done at the outset. At this point, the CRA will send to taxpayers a “notice of assessment” which, in addition to reporting on the CRA’s basic check of the return, may: (i) ask for documentation substantiating any aspect of the return; (ii) reassess the return (i.e. alter the substance of the return to be consistent with information the CRA believes to be accurate); and/or (iii) inform that taxpayer that additional tax is due or that a refund of tax previously remitted is forthcoming. A taxpayer who disagrees with an assessment by the CRA may informally attempt to resolve the matter with a local taxation office or, failing the informal approach, may launch a formal appeal. If negotiations with the CRA are unsatisfactory to the taxpayer, the taxpayer may appeal under the “informal procedure” or the “formal procedure” at the Tax Court of Canada. Under either process, the CRA benefits from a presumption that the facts it relies on in its assessment are accurate. As such, the taxpayer must adduce evidence to satisfy the Tax Court of Canada on a balance of probabilities of the probity of any fact that is inconsistent with the facts relied upon by the CRA.

It bears mentioning that the CRA may only reassess taxpayers with regard to the preceding three tax years. Beyond this three-year window, the CRA may only reassess if the taxpayer has been guilty of misrepresentation or fraud. In such cases, the CRA must first establish that the taxpayer is guilty of misrepresentation or fraud before being able to reassess the taxpayer for the tax year outside the three-year window. Once the CRA has established misrepresentation or fraud, however, at trial the CRA still benefits from the conventional presumption that its assessment is valid.
2.2.2 Withholding Taxes in Canada

The Canadian income tax system has two main types of withholding, both of which are conventional in comparative terms. The first is non-resident withholding. The second is resident withholding. With regard to non-resident withholding, the established Canadian practice with residents of our treaty partners is essentially consistent (with some minor variations, such as withholding taxes on royalty income) with international practice as embodied in the OECD Model Convention. Insofar as residents of non-treaty countries are concerned, the Canadian practice is to impose non-resident withholding taxes on a broader range of payments, and typically at higher rates than under treaties.

With regard to resident withholding, the federal Income Tax Act does provide for withholding at source with regard to salaries and wages paid to employees. Approximately 76% of total income assessed on Canadian personal income tax – including employment income, employment insurance benefits and income from registered pension plans – is subject to withholding at source for personal income tax and, in the case of employment income, there is also withholding at source for mandatory Canada Pension Plan (CPP) contributions and Employment Insurance (EI) premiums. If an employer does not withhold taxes at source, the employer is responsible for the amount that should have been withheld, as well as for any applicable penalties or interest on the amount. Investment income and self-employment income are generally not subject to withholding at source. There has been some discussion in Canada about a proposal for the expansion of source withholding to cover these income sources, but the issue has not had any traction. Directors of a corporation that has not withheld at source can be held personally responsible for any shortfall.

We are not aware of any constitutional requirements in Canadian law ensuring that there is a minimal prospect of effectively enforcing tax provisions. Indeed, there are some practically unenforceable provisions in the Canadian income tax system. For example, probably the most difficult to administer provision relates to the taxation of the value of frequent flyer points that were earned while travelling in the course of employment, but redeemed for personal travel. The US has sensibly decided that it will not tax the value of points redeemed for personal travel, but the CRA has taken the position that these benefits are taxable benefits under sec. 6 (1)(a) of the Income Tax Act. The central enforcement problem is, of course,

30 Sec. 153 (1).
31 For details of amounts subject to personal income tax withholding, see the definition of “remuneration” in Reg. 100 (1).
32 Sec. 227.
33 See Li, Withholding on Domestic Interest and Dividends, Canadian Tax Journal 1995, 553.
34 Sec. 227.1.
35 See Canada Revenue Agency, IT-470R (Consolidated) Employees’ Fringe Benefits, para. 14. The CRA states in that paragraph that, “Under [a frequent flyer] program, which is usually
that there is no information reporting from the airlines to employers, employees, or government, which, given the difficult issues associated with the identification and valuation of benefits, renders the imposition of income tax on such amounts virtually impossible.

2.3 The Operational Burden of Compliance Rules in Canada

2.3.1 Overview
A number of studies of compliance costs have been conducted in Canada, though compliance cost issues, as explained above, have had a relatively low profile. To a significant extent, this low profile and small number of studies is probably due to the finding that compliance costs are reasonably low in Canada. There are a number of reasons to believe this is the case. For example, since 1949 Canada’s income tax has dealt with depreciation through a pooling mechanism, which does not require taxpayers to do asset-by-asset calculations. Also, the Canadian income tax does not permit consolidated returns, which reduces complexity and compliance costs significantly. Finally, the federal and provincial income tax bases are very similar, which again reduces significantly the compliance burden on taxpayers. This section presents a chronological summary of the work that has been done. The conclusion of the section attempts to synthesize the findings of these studies, including what has been found to be the major causes of compliance costs for various categories of taxpayers, the explanations given by the authors, and the reasons motivating the studies.

2.3.2 François Vaillancourt (1989) 40
In this study, Vaillancourt examined data relating to individual taxpayers and their employers in 1986, concentrating on personal income taxes and payroll taxes.
Data on the compliance costs incurred by individual taxpayers were collected through 2,040 face-to-face interviews conducted from May to June 1986 with Canadians over the age of 18. Of the 2,040 individuals interviewed, 1,673 had filed a tax return for the 1985 taxation year. According to Vaillancourt, the taxpayers were a representative sample of the 15,926,804 Canadian taxpayers in 1985.\textsuperscript{41} The study found that considering all the costs, including time costs and out-of-pocket expenses, compliance costs: (i) were higher for men than for women; (ii) initially increase and then decrease with age; (iii) are lower for single individuals than for married persons; (iv) do not vary predictably with geographical location, but do increase with income; and (v) are highest when a paid preparer is used.\textsuperscript{42} In addition, Vaillancourt found (i) that taxpayers who prepared their own returns spent 5.5 hours on average on the task for the 1985 tax year; (ii) that those who paid a tax return preparer paid an average of $69 for their 1985 returns; (iii) that an increase in the complexity of a return increased the time and money spent on it; and (iv) the total average time and money cost for all Canadians of complying with the personal income tax for the 1985 tax year was $117.20 – approximately EUR 135 in current terms.\textsuperscript{43} Employers were canvassed through a postal survey. Surveys were sent to 4,196 employers. Of these, 385 were returned, reflecting a relatively low response rate of 9.2%.\textsuperscript{44} The study found that the costs to employers of retaining and remitting personal income and payroll taxes to the government (i) were approximately 0.1% of gross business income on average; (ii) that this percentage decreased as the size of the firm increased; and (iii) that this relationship was robust, remaining consistent for a variety of proxies for firm size.\textsuperscript{45} Overall, Vaillancourt estimated the total costs of compliance and administration of personal income taxes and payroll taxes to individual taxpayers, employers, and the government to be approximately 6.9% of the revenue yield.\textsuperscript{46} Of this cost, 2.5% was borne by individual taxpayers, 3.5% by employers, and 1% by the government.\textsuperscript{47}

\textsuperscript{41} Ibid 21.
\textsuperscript{42} Ibid 37 et seq.
\textsuperscript{43} According to Statistics Canada, the CPI for 1985 is 75.0 and for 2004 is 124.6 (1992 = 100). See Statistics Canada, \textit{Consumer Price Index—Historical Summary}, available at http://www 40.statcan.ca/l01/cst01/econ46.htm. This suggests that in current Canadian dollars, the total compliance cost found by Vaillancourt would be equal to approximately $194.71. Converted into Euros at an exchange rate of EUR 1.44 per dollar yields an estimate of EUR 135 as the average compliance costs.
\textsuperscript{44} Vaillancourt, \textit{The Administrative and Compliance Costs of the Personal Income Tax and Payroll Tax System in Canada}, 47.
\textsuperscript{45} Ibid 53.
\textsuperscript{46} Ibid 83.
\textsuperscript{47} Ibid 84.
2.3.3 Sally Gunz, Alan Macnaughton, and Karen Wensley (1995)\textsuperscript{48}

This study attempted to quantify the compliance costs of tax expenditures on scientific research and experimental development (SRED) initiatives. To do so, individual interviews were conducted either in person or over the telephone with 51 participating companies during the spring and summer of 1994. The sample size was small because the interviews required a lengthy period of time – from 4–6 hours – to complete,\textsuperscript{49} but nevertheless cumulatively represented the companies claiming 30\% of the SRED credits in Canada.\textsuperscript{50} The overall participation rate was about 46\% of those who were approached. The authors found that the compliance costs of SRED initiatives were quite low in aggregate, representing approximately 0.7\% of the credits claimed. For firms with small claims, however, the costs of compliance were found to reach 15\% of the credits claimed (and sometimes more).\textsuperscript{51} The authors identified two interesting findings of the study that could of broader interest. First, the study found that it was the size of the claim that was most important, rather than corporate size, in dictating the proportionate level of compliance costs. Second, technical and scientific employees’ salaries represented about 2/3 of the compliance costs of the SRED credit, rather than accounting employees, because of the nature of the credit.\textsuperscript{52}

2.3.4 Brian Erard (1997a)\textsuperscript{53}

In this study, Erard conducted a postal survey of 250 large Canadian corporations. The survey asked questions regarding federal and provincial corporate income and capital taxes. Out of the 250 surveys, 59 were returned, an effective response rate of 24\%. Erard found that compliance costs amounted to between 4.6\% and 4.9\% of the tax revenues collected,\textsuperscript{54} with significant variation depending on certain firm characteristics. Total compliance costs were distributed as follows: 56.9\% to in-house personnel expenses, 20.6\% to in-house non-personnel expenses, and 22.5\% to external assistance. With regard to variation relating to corporate characteristics, Erard found (i) that the compliance cost burden increased with firm size, but less than proportionately; (ii) that corporations with foreign operations faced higher compliance costs; and (iii) that a corporation’s involvement in the mining, oil and gas industries led to relatively higher compliance costs.\textsuperscript{55}

\textsuperscript{49} Ibid 2014.
\textsuperscript{50} Ibid 2009.
\textsuperscript{51} Ibid 2009.
\textsuperscript{52} Ibid 2010.
\textsuperscript{54} Ibid 5.
\textsuperscript{55} Ibid 11 et seq.
This study, prepared at the same time as the one just discussed, was also prepared for the Technical Committee on Business Taxation. Instead of focusing on large Canadian corporations, however, this study focused on small and medium-sized enterprises. The study contacted members of the Canadian Federation for Independent Business – a group of more than 85,000 small and medium-sized Canadian enterprises. A survey was distributed to the entire membership of the CFIB. In total, 8,823 completed surveys were returned. As such, the response rate was approximately 10%. The survey concentrated on assessing perceptions of compliance costs on a qualitative basis only. In other words, no attempt was made to measure or quantify the level of compliance costs faced by the firms. The survey used a scale of 1 to 4, where 1 represented “very high” compliance costs, and 4 represented “low” compliance costs. According to Erard, “It is important to recognize that respondents may differ in their views about what constitutes a high compliance cost. Some might evaluate their compliance burden for a given tax in relation to their compliance burden for the other taxes they face. Others may consider their compliance costs in relation to the total amount of taxes paid. Still others may compare their burden to what they perceive that similar businesses in other jurisdictions are experiencing. As a result, one needs to be very careful in interpreting the statistics on reported compliance costs. These statistics provide a useful indication of how high respondents perceive their compliance burdens to be, but they do not provide an objective measure of the actual compliance costs faced by the respondents.” Federal corporate income and capital taxes were reported as imposing in-house compliance costs of 2.81 and outside compliance costs of 2.43 on the 1 to 4 scale. Provincial corporate income and capital taxes were perceived to have higher compliance costs on the 1 to 4 scale of 2.88 for in-house costs and 2.51 for outside costs. Erard examined the firms to determine if any firm characteristics were systematically associated with high perceived compliance costs. Firm size and the number of years in business were both found, perhaps surprisingly, to be unrelated to perceived compliance costs. On the other hand, firms in construction, retail, and other personal service industries tended to perceive that their compliance costs were higher than firms in other industries.
The survey also attempted to determine the causes of high compliance costs. The most frequently cited sources of high compliance costs were (i) the cost of professional services (58.8% of respondents); (ii) the complexity of information requested (32.4% of respondents); and (iii) the lack of coordination among governments (28.9% of respondents).64

2.3.6 Robert Plamondon and David Zussman (1998)65

In this study, Plamondon and Zussman estimated the costs of complying with a variety of federal, provincial and territorial taxes. They estimate that the total compliance costs ranged from $2.3 billion to $4.5 billion, with a midpoint of $3.4 billion.66 The authors contend that the midpoint estimate equates to approximately 0.4% of GDP or 1.5% of total tax revenues.67 Plamondon and Zussman then attempted to estimate the savings associated with ridding Canada of duplicate tax administrations at the federal and provincial levels. To do so, they used a mixed methodology involving three elements: (i) a panel discussion with six accountants from firms dealing with thousands of small business annually; (ii) a telephone survey of 1,507 small and medium-sized businesses out of a pool of 3,082 calls – a 49% response rate; and (iii) a panel discussion with nine financial executives from some of Canada’s largest companies.68 After analyzing all the data gathered from this mixed methodology, Plamondon and Zussman estimate that moving to a single tax administration would reduce annual compliance costs by an amount between $171 million and $285 million – a savings of about 6.7% of current compliance costs.69 It should be highlighted that the authors of this study strike a cautionary note at the outset of the paper, remarking that, “It should be noted that the measurement of compliance costs is imprecise in the best of circumstances, let alone for an administrative regime that does not yet exist. As a consequence, the estimates presented in this article are based on a series of assumptions, extrapolations, and judgments that the authors consider to be reasonable. These estimates are offered as a useful benchmark for those considering the potential of single tax administration for Canada.”70

None of these studies has found that compliance costs were troublingly high. On the other hand, however, there was considerable variance in the quantification of compliance costs. Estimates for complying with corporate income taxes ranged up to 4.9% of taxes paid in Erard (1997a). Vaillancourt (1989) estimated the compliance costs associated with personal income taxes at 6.9% of taxes collected.

64 Ibid 7.
66 Ibid 763.
67 Ibid 763.
68 Ibid 770 et seq.
69 Ibid 763.
70 Ibid 763.
It is relatively difficult to square these estimates with those of Plamondon and Zussman (1998), who estimated that the costs of complying with a variety of federal, provincial and territorial taxes to be 1.5% of total tax revenues, especially when one considers that personal and corporate income taxes are the most significant sources of government revenue in Canada. Nevertheless, it is important that not too much is made of the consistency of the results. A finding common to Vaillancourt (1989) and Erard (1997a) is that although the costs of compliance do increase as corporate size increases, costs rise less than proportionally. Interestingly, however, Erard (1997b) found that for small and medium-sized companies, the perceived costs of compliance do not exhibit a similar scale effect. Gunz, Macnaughton and Wensley (1995) found that corporate scale effects also do not come into play when the focus is a given tax expenditure; however, there was a scale effect, but it was restricted to the size of the claim being made, rather than to corporate size.

The emergence of new information technologies, such as the availability of computer software and electronic filing of returns, probably means that, pragmatically, compliance costs will be even less of an issue in the future than they have been in the past. The Canada Revenue Agency (CRA) allows individuals to file income tax returns electronically over the Internet through NETFILE. To file using NETFILE, taxpayers must use software that has passed through a rigorous testing protocol designed to ensure that the software output is compatible with the CRA’s system. The market is competitive for software. At last count, the CRA certified ten separate software packages for the 2005 taxation year. Many of the software providers make their tax filing software available for free under certain circumstances for students and to those who have earned less than $25,000 in taxable income. In describing NETFILE, the CRA states,

NETFILE is an easy-to-use, convenient option for filing your personal tax return. It streamlines the tax-filing process and offers the following benefits:

• secure and confidential;
• faster refunds (in as quick as eight business days);
• greater accuracy (with the use of software, we don’t re-key the information, and there is less chance of errors);
• no paper return to mail;
• no receipts to send in, unless we ask for them at a later date; and
• immediate confirmation that we’ve received your tax return.72

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71 Nine of these software packages are for Microsoft Windows and one is for Macintosh computers. In addition to these software packages, nine companies offered online applications that operated entirely through the web. For more detail, see CRA, Software: Certified software for the 2006 NETFILE Program (2005 tax return), available at http://www.netfile.gc.ca/software-e.html.

A columnist in a recent article appearing in one of Canada’s national newspapers had this to say while reviewing two offerings in the latest generation of tax software available to Canadians:

One of the impressive aspects to both these products is that your lack of knowledge for tax codes and all the financial wizardry that comes with ‘getting it all’ doesn’t really matter because the software holds your hand the whole way through. For someone like myself who much prefers words over numbers, I had a relatively easy experience working with these. To say that it was exciting or enjoyable would be a stretch, but it certainly had an educational element to it. Rather than having an accountant find loopholes and explain how they can help me, I was able to see for myself how I can make the most of what I had. Can you ask any more from tax software?73

Professional tax preparers are not permitted to use NETFILE, though another option, called EFILE, is available to them. For the 2003 tax year, the CRA reports that 4.9 million of the approximately 23 million returns were filed electronically.74 More recent figures have not been reported by the CRA, but it is reasonable to expect that figures for the 2005 tax year will be significantly higher as software becomes easier to use and as computer use and the Internet become more widely used by Canadians.

III. Allocating the Corporate Income Tax Base: Limited Lessons from Canada

3.1 Separate Accounting versus CCCTB

Unlike the US, which has a “highly developed system of consolidated taxation,”75 the Canadian corporate income tax mandates separate filing on an entity basis, and under no circumstances makes formal provision for consolidated taxation.76 As a formal matter, each individual corporation, regardless of whether it is private or

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76 AultArnold, *ibid* 322, report that despite the insistence on entity level corporate income taxation, “informal consolidation has been recognized both administratively and legislatively. Most of the anti-avoidance and anti-loss-trading rules do not apply to transactions between related corporations; transactions which are structured to transfer profits and losses among the members of a group and generally effective.” On this informal consolidation point, see Donnelly/Young, *Policy Options for Tax Loss Treatment*, Canadian Tax Journal 2002, 429 (471), who state that with respect to loss consolidation, Canada has “an ad hoc system … in place which operates by administrative decree of the … [CRA] as sanctioned by the explanatory notes provided by the Department of Finance.”
public, controlled or widely held, is regarded as a separately taxable legal entity and must file its own return. Unfortunately then, there are few, if any, lessons to be gleaned from the Canadian approach with regard to the manner in which to consolidation ought to be effected for tax purposes.

With regard to Canadian cross-border transactions, the arm’s length principle applies. Although the text of the transfer pricing provision of the federal Income Tax Act provides minimal guidance, the CRA reports that it interprets the relevant income tax provision in a manner consistent with the arm’s length principle laid down by OECD transfer pricing guidelines. Advance Pricing Agreements (APAs), when they occur, are perceived to contribute to a small reduction of compliance costs, primarily in the sense that uncertainty regarding the application of the relevant legislative provision is resolved. Although the CRA introduced an APA program in 1993, to date, APAs are not prevalent in Canada, though a number of unilateral and bilateral APAs have been entered into with taxpayers. However, recent developments suggest that APAs may soon be increasing in popularity. On 18 March 2005, the CRA announced that it was introducing a unilateral small business APA programme. Under the terms of the programme, the CRA focuses on two conditions in determining whether to proceed with considering an APA with a small business. The first condition is that the taxpayer’s revenue in the preceding tax year must have been less than $50 million or the non-arm’s length transaction must have a value of less than $10 million. The second condition is that the transaction must involve tangibles or routine services (i.e. not intangibles). For small business APAs, the CRA charges a non-refundable fee of $5,000. Under the programme, the taxpayer gets the benefit of certainty going forward, and is relieved from the task of producing for the CRA extensive information regarding the consummated transactions. Instead, it is usually sufficient to indicate to the CRA that none of the assumptions in the unilateral small business APA has been violated.

The pricing methods used in current APAs, regardless of whether the APA is a traditional one or a unilateral small business APA, more or less mirror the approach the CRA would apply ex post in a typical transfer pricing context. As such, the comparable uncontrolled price methods are favoured, with considerable reluctance – mirroring the expressed “last resort” idea in the OECD Transfer

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77 This is consistent with the legacy of the Canadian income tax’s primary focus on juridical form and legal relationships rather than on economic substance. This focus on legal form places Canadian income tax law much closer to the tradition of the UK than the US in terms of the judicial approach taken to the ever-present issue of tax avoidance. For an illuminating discussion of the ways in which the UK and US tax systems diverged in their approaches to tax avoidance, see Likhovski, The Duke and the Lady: Helvering v. Gregory and the History of Tax Avoidance Adjudication, Cardozo Law Review 2004, 953.

78 For an extended treatment of transfer pricing in Canada, see generally, Vincent, Transfer Pricing in Canada (2004).

Pricing Guidelines in this regard – to use profit-splitting methods. It is unclear to what to attribute the increase in the popularity of APAs, but it can probably be attributed at least partly to taxpayers learning from their own hard-won experience, and the experience of others, that the costs of litigating transfer pricing disputes and the gains associated with business certainty can easily exceed the gains associated with setting aggressive transfer prices.  

For the most part, both private and publicly traded Canadian companies abide by the generally accepted accounting principles (GAAP) promulgated by the Accounting Standards Board of Canada. Canadian GAAP has traditionally been independently developed albeit with international influences, most notably from the Federal Accounting Standards Board (FASB) of the US. The influence of FASB standards has been most strong because of the integrated nature of the North American economy and its capital markets; many of the largest publicly traded Canadian companies are cross-listed on both US and Canadian exchanges. Despite this strong US influence, however, on 30 March 2006, the Accounting Standards Board of Canada announced its commitment to adopt standards consistent with the IFRS over the next five years. 

A backgrounder regarding the many changes that will be required by Canadian companies has been published by the Accounting Standards Board of Canada to explain the shift and to help companies prepare for the transition.

Historically, the Accounting Standards Board of Canada and its predecessors have strongly resisted any attempt to link its accounting standards to defining the tax base for income tax purposes. There are a variety of reasons for this resistance, not least of which is the fear that the accounting standards could become artificially distorted by attempts to alter the standards so as to reduce reported income in order to economize on income tax liabilities, rather than to modify the rules to more accurately reflect a business’s operating results. These efforts at resisting a link with the corporate income tax base have been for the most part successful. For the purposes of Canadian income tax, there is no decisive link between accounting income and income for tax purposes, though the courts have taken the position that accounting standards are one relevant factor in assessing whether a given approach is lawful.

According to Hugh Ault and Brian Arnold,

For a more general discussion comparing Canada and other countries on the reliance on financial accounting, see Ault/Arnold, Comparative Income Taxation: A Structural Analysis (2004) 243 et seq.
While the tax accounting rules are based on financial accounting principles, they have developed into an independent body of law. There are a number of special tax rules which specifically displace financial accounting rules. In addition, courts have sometimes rejected financial accounting rules as inconsistent with more basic tax law principles.84

Indeed, the Supreme Court of Canada has emphasized that what is important for determining taxable income under sec. 9 of the Act is “well accepted principles of business practice,” which are distinct from “generally accepted accounting principles,” as the term is understood and used by accountants.85 Thus, although one can frequently use the approach suggested by Canadian GAAP as a helpful suggestion in determining the appropriate approach for the purposes of Canadian income tax law, there is no necessary connection and caution must be exercised to ensure that there has been compliance with the provisions of the legislation.

3.2 Formulary Apportionment

The costs of complying with 25 corporate tax regimes within the EU, with the separate accounting principle and the arm’s length standard applying to transfer pricing, is obviously an expensive and cumbersome approach to corporate income taxation. The Canadian approach involves two systems. First, within Canada there is formulary apportionment of corporate income among provinces. Second, as between Canada and the rest of the world, the arm’s length standard is used. The experience in Canada shows that this two-pronged approach works reasonably well and is a relatively robust method of coping with competing jurisdictional claims to tax. It should be noted in passing that there were some early proposals that formulary apportionment be extended within NAFTA, but these proposals have gone nowhere.86

Despite the emphasis being on legal form insofar as filing obligations are concerned, each corporation’s income is allocated to the provincial jurisdictions in which the corporation has a permanent establishment through the use of a formula prescribed by regulation.87 The formula assigns equal weight to (i) sales; and (ii) salaries and wages. Unlike the most common formulas used in the US, there is no weight given to the value of corporate property (i.e. capital) situated in each

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84 Ibid 247.
85 See, for example, Symes v. Canada, [1993] 4 S.C.R. 695 at para. 37 per Iacobucci J.
87 Formally, this formulary apportionment is accomplished through the provisions of Part IV of the Income Tax Regulations.
province. The formula seems to work relatively well in allocating income in a tolerably fair way, although it should be emphasized that the conjunction of separate accounting and formulary apportionment facilitates income-shifting and, hence, tax avoidance, among the provinces.88 Because Canada does not consolidate corporate groups for tax purposes, subsidiaries can be established in low corporate tax rate provinces and income shifted through, for example, intercorporate transfer prices or various financing techniques to obtain sometimes substantial relief from the higher corporate tax rates of certain provinces.

The Canadian approach emerged through years of negotiation among a series of federal and provincial governments.89 The conflict between federal and provincial corporate income taxes dates back to the inception of income taxes at the federal level in Canada. Throughout the early decades of the concurrent income tax jurisdiction, various approaches were tried, including (i) tax rental agreements pursuant to which the federal government solely occupied the income taxation field in exchange for guaranteed “rental payments” to the agreeing provinces;90 and (ii) tax collection agreements for corporate income taxes, first entered into by Prince Edward Island and Manitoba with the federal government in 1939,91 but not in general use until 1962,92 pursuant to which the federal government simply administered and collected provincial income taxes. Even as early as the 1930s, insofar as province-to-province coordination was concerned, various measures were taken to avoid double taxation, including credits and formulary apportionment (though not for some time in the harmonized manner that currently prevails).93 In the negotiations leading to the 1962 TCAs, it appears that the formula for apportioning corporate income among the provinces emerged almost spontaneously from the measures that had been taken by various provinces and by the federal government under the tax rental agreements previously. The last holdout was the province of Quebec, which preferred to have the formula place greater weight on sales than on salaries. However, even Quebec eventually agreed to the equally weighted sales and salaries formula in the late 1950s in the lead-up to the 1962 TCAs.94 From 1958 forward, the same formula has been in

89 For an excellent and detailed treatment of the details of the emergence of the current approach to interprovincial formulary apportionment, see Smith, Federal-Provincial Tax Sharing and Centralized Tax Collection in Canada (1998). Another treatment of the history of Canadian income taxes is given by Perry, Perry, Financing the Canadian Federation, 1867 to 1995: Setting the Stage for Change, 98 et seq.
90 See Smith, ibid 30 et seq.
91 Ibid 15.
92 Ibid 119 et seq.
93 Ibid 14 et seq.
94 Ibid 150.
place, although at times various provinces have expressed concern about its effects.95

Jack Mintz and Michael Smart have analyzed the elasticities of the corporate income tax base with respect to corporate income tax rates in Canadian provinces. They find that the strategies available to Canadian corporation groups with operations in multiple provinces are generally effective.96 They argue that tax planning strategies that shift income to relatively low tax rate provinces from high tax rate provinces clearly occur, but that they may have ambiguous welfare effects. On the one hand, they acknowledge that income-shifting possibilities can result in interprovincial tax competition, as each province attempts to attract a shift of income towards itself from the other provinces.97 On the other hand, they claim that to the extent that income can be shifted nominally (i.e. without shifting actual income-generating activity) through selective incorporation and creative financing arrangements, real investment decisions might not respond strongly to lower tax rates. This leads to an ambiguous welfare effect if, as they suggest, provinces care about real investment in addition to tax revenues (e.g. provinces want to increase provincial employment and economic output). Interestingly, their empirical analysis shows that,

taxable income of corporate subsidiaries that do not allocate income is significantly more elastic with respect to tax rates than income of other, comparable firms that do allocate income by formula and those that are not corporate subsidiaries. These results are suggestive of the role of income shifting in the investment decisions of large, multijurisdictional firms, and of its implications for tax policy choices of affected governments.98

Mintz and Smart reached this conclusion by comparing Canadian corporations with a permanent establishment in only one province (not subject to formulary apportionment) with Canadian corporations with permanent establishments in more than one province (subject to formulary apportionment). For the purposes of the discussion in the EU, it should be highlighted that unfortunately the authors caution that their “reduced form estimates, which ignore the organizational decision, do not permit us to conduct policy-relevant simulations of the impact of changes in statutory tax rates or in the rules for consolidating income of corporate groups.”99

Unlike the US, Canada uses a consistent approach across all the provinces for allocating the corporate tax base to provinces. Although there are special rules used for businesses in several specific industries (such as various financial inter-

95 Ibid 380.
97 Ibid 1150.
98 Ibid 1166.
99 Ibid 1167.
mediaries, railways, airlines, grain elevators, bus and trucking companies, and pipelines)\textsuperscript{100} these tend to be quite specialized and represent a small proportion of Canadian business activity. With regard to businesses in other industries, the same formula applies universally in all provinces. The formula used gives equal weight to sales and salaries and wages in the provinces in allocating the corporate tax base. It is worth noting, however, that a majority of the provinces have provincial capital taxes which apply regardless of corporate income and its allocation.\textsuperscript{101} The province of Saskatchewan has been concerned for some time about the shifting of corporate income away from the province on the basis of its relatively high corporate tax rates. More revenue has been raised recently by the Saskatchewan corporation capital tax than the province’s corporate income tax, even though the corporation capital tax is paid by only 1,400 corporations.\textsuperscript{102} In its 2006 provincial budget, however, Saskatchewan has committed to abolishing the corporation capital tax and making its corporate income tax rates significantly more competitive with neighbouring provinces.\textsuperscript{103}

There seem to be several factors that account for the significant difference in approach to formulary apportionment in the US and Canada. Among the strongest is the tradition of harmonization of taxes between federal and provincial jurisdictions in Canada. This tradition is much stronger in Canada than the US. Thus, the corporate income allocation rules are only part of a broader pattern of cooperation on income tax issues. This is not unrelated to the tradition of the federal government running things in the income tax field, which dates back at least to World War II, at which point the provinces ceded the income tax field to the federal government. Tax politics in the US did not play out the same way. The TCAs play a role, too, but cannot on their own explain adherence to the federal allocation formula among all the provinces, because two provinces do not have TCAs for corporate income tax (Quebec and Alberta). One possible explanation is that Alberta and Quebec are content with the allocation formula since these provinces are among the most populous and host a significant proportion of head offices and therefore tend to pay a greater proportion of salaries than other provinces. Quebec only questioned the formula later on, when the province began

\textsuperscript{100} For a list of the nine industries that are subject to differing formulas for apportionment, see Martens-Weiner, \textit{Company Tax Reform in the European Union: Guidance from the United States and Canada on Implementing Formulary Apportionment in the EU}, 57.

\textsuperscript{101} Six provinces have corporation capital taxes: Saskatchewan, Manitoba, Ontario, Quebec, New Brunswick and Nova Scotia.


to realize that almost all of the oil refineries in eastern Canada were located in Quebec. At least some observers, such as David Perry, believe that this is why Quebec lowered its corporate tax rates in the 1980s and raised payroll and capital taxes, through others differ on what motivated the reduction in provincial corporate tax rates. Alberta and Saskatchewan have also questioned the formula from time to time, though it remains solidly in place.

In the article by Jack Mintz and Michael Smart discussed above, the authors identify three ways in which provincial incentives to engage in corporate tax competition may be affected by peculiarly Canadian factors: (i) equalization payments – transfers from the federal government to provincial governments – are based in part on provincial corporate tax revenues, so an increase in corporate tax revenue will result in a partly offsetting decrease; (ii) provincial corporate income taxes cannot be deducted from federal corporate income taxes, so there is less incentive to increase provincial corporate income tax rates than there would be if the federal government gave credits for taxes paid subnationally; and (iii) since there is no corporate consolidation for tax purposes, income-shifting is, with some caveats, not very difficult. To the extent that the EU departs from these peculiarly Canadian environmental conditions, it would be reasonable to expect different results.

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105 Mintz, *Canadian Tax Journal* 1994, 1469 (1502) attributes the reduction in the Quebec corporate income rate to a desire on the part of Jacques Parizeau, then Minister of Finance, to reduce the practice of aggressive transfer pricing to shift income out of the province.
107 Ibid at 1158.