Compliance and Administration Issues Under the Tax Collection Agreements

Alan Macnaughton*

ABSTRACT
The federal and provincial governments have agreed that beginning in 2001 each province can choose to base its provincial personal income tax on taxable income rather than basic federal tax. A significant concern about this proposal is that it could lead to greater administrative and compliance burdens because of additional tax brackets, different tax credit systems, and more complex tax filing. In light of these concerns, this paper addresses the administration and compliance issues under the tax-on-income proposal.

The general conclusion of the paper is that concerns about administrative and compliance problems may not be justified. Since federal definitions of credits must be used if they are available, the opportunity for increased complexity is sharply limited. Also, the 1999 Alberta budget proposal for a tax on income beginning in 2002 raises no significant compliance cost issues; only the rate structure and the amounts of the basic personal and spousal credits are changed, and the existing surtax, flat tax on taxable income, and low-income tax reduction are abolished. Furthermore, the transparency of the tax system—the ability of taxpayers to understand their marginal tax rates and the amount of their tax liability imposed by each level of government—seems likely to be increased. If provinces adopt the tax-on-income approach, our personal income tax system is likely to be much more understandable to the non-expert.

INTRODUCTION
The current tax collection agreement (TCA) system for personal income tax is a remarkable achievement of the Canadian federation. Despite the existence of multiple levels of government, most Canadians have to fill out only one personal income tax return, and no income is taxable in more than one province or territory.

In 1962, when the present tax-on-tax system was created, provincial personal income tax in agreeing provinces (all provinces but Quebec) was

* KPMG Professor of Accounting, School of Accountancy, University of Waterloo.
a flat percentage of basic federal tax. No provincial tax system could be simpler to administer or less costly to comply with than that. However, this simple system has been complicated over time by the addition of a variety of refundable and non-refundable provincial tax credits and, in the case of the prairie provinces, provincial flat taxes.

Over the past decade, the provinces have become increasingly dissatisfied with the existing TCA system. Some provinces have expressed a strong preference for a tax-on-income approach to the assessment of provincial tax, along with increased flexibility in adjusting personal credits and deductions to changing provincial policy objectives. As discussed below, the federal government has yielded to provincial pressure, and a proposal has been drafted to amend the existing TCAs, effective in 2001, to include a tax-on-income option and to grant the provinces greater freedom in determining the amount and range of personal credits and deductions.

The provincial search for greater flexibility might perhaps have been expected. The provincial share of total personal income tax in Canada has risen greatly since the inception of the present TCA system, from 13.9 percent in 1962 to 30.7 percent in 1972 and 41.4 percent in 1982; currently, it is 38.2 percent. Residents of each province expect that the provincial government will respond to the economic and social needs of their province, and the personal income tax is one of the most significant policy levers. Also, the recent improvement in the fiscal position of the federal government has exacerbated the longstanding problem of the effect of federal tax changes on provincial revenues. According to Manitoba Finance Minister Eric Stefanson, if the federal government adopts the recommendations of the House of Commons finance committee for deep cuts in personal income tax, and maintains the tax-on-tax system, the provinces could lose as much as $600 million in annual revenue.

It has been argued that the movement to a tax-on-income system is probably inevitable if the TCA system is to be preserved. However, a significant concern with the tax-on-income option is the effect it could have on tax administration and compliance. A March 1998 survey of Canadian Federation of Independent Business members showed that 58

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2 Shawn McCarthy, “Manitoba, Alberta Leading Charge To Set Up Own Income Tax Systems,” The Globe and Mail, January 20, 1999. No figure is given for the comparable revenue loss if the provinces switch to a tax-on-income system.

3 Courchene and Stewart, supra footnote 1, at 299.
percent opposed replacing the current system with one “that would lead to additional tax brackets, different tax credit systems and more complex tax filing.”

In light of these concerns, this paper addresses the administration and compliance issues under the tax-on-income proposal. Particular attention is paid to the likely impact on transparency, particularly transparency of marginal tax rates. Reference is made to past empirical research and the likely direction of development of provincial personal income tax. Although the comments are inevitably speculative, some information is available from the 1999 Alberta budget and from a 1998 federal-provincial agreement that defines the terms of the tax-on-income proposal. The paper begins with a review of this background information and then considers transparency and other administration and compliance issues.

**BACKGROUND**

**History**

The basis for federal-provincial sharing of personal tax revenues is one of “hardest perennials” of federal-provincial fiscal relations. Under the original TCA, signed between Ontario and the federal government in 1936, Ontario basically adopted the Dominion definition of taxable income but applied a different schedule of rates. Subsequent agreements with other provinces in the late 1930s generally allowed each province belonging to the TCA (“agreeing province”) to have both a different rate structure and a different definition of taxable income. Quebec and Yukon Territory broke with this decentralized pattern by expressing provincial tax as a percentage of federal tax (the “tax-on-tax” approach) in their 1940 TCAs.

The issue disappeared with the move to a tax-rental/tax-sharing system from 1942 to 1961 but resurfaced in the negotiations leading up to the 1962 TCAs. The federal government’s position was that it could accept either a tax-on-tax or a tax-on-income system, but the system would have to be the same for all provinces. Since the provinces officially in favour of the tax-on-tax system (Nova Scotia, Ontario, and Saskatchewan) would account for more than half of the taxpayers in the nine provinces willing to enter into a TCA, the federal government withdrew the tax-on-income option and the 1962 agreements were based on tax on tax.

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6 Ibid., at 13-14.

7 Ibid., at 150.

8 Ibid., at 155. Despite the province’s official position, Ontario officials had indicated a preference for the greater flexibility inherent in a tax-on-income system. However, they did not press the issue because of the simplicity advantage of tax on tax.
the model for all TCAs ever since; each agreeing province has to calculate its provincial tax as a percentage of basic federal tax.

Although the 1962 agreements contemplated that the federally determined progressivity of the system was not to be altered by provinces, the federal government began to administer provincial tax credits in 1972 and provincial low-income tax reductions in 1975.9 In 1985, the federal government allowed provincial “flat taxes”—a percentage of net income or taxable income, rather than basic federal tax.10 Thus, the tax-on-tax system has lost much of the advantage of simplicity that it possessed in 1962.

Recent Federal-Provincial Developments

The present tax-on-income discussion originated with a 1991 federal discussion paper on the TCAs, which indicated the federal government’s willingness to allow provinces to base provincial tax on federally defined taxable income (the “tax-on-income” approach).11 For the next few years, the issue seemed to disappear, in part because of the federal government’s negotiating stance of tight restrictions on allowable provincial credits and a requirement that all provinces and territories must agree to adopt the tax-on-income system. However, provincial dissatisfaction continued, and Ontario’s 1997 budget delivered a strong warning: “Unless the federal government is prepared to address these inequities, Ontario will have to seriously consider withdrawing from the current arrangement.”12

A new round of discussions led to the December 1997 agreement among finance ministers that provinces would have the option of adopting a tax-on-tax system or a tax-on-income system, beginning in the year 2001. The details were discussed and agreed on by a federal-provincial working group of assistant deputy ministers, and a paper was issued (without any press release) in the fall of 1998.13 Although the detailed proposal has not yet been approved by the finance ministers, it appears to have general support among the provinces. It contains the following elements:

- Each province can choose between the existing tax-on-tax system and the tax-on-income system.

- Refundable credits, surtaxes, and low-income tax reductions can continue to be used, but all existing flat taxes must be folded into the new structure.
• Each province choosing the tax-on-income approach sets its own rate structure to apply to federally defined taxable income, including possibly a zero rate on a narrow first income bracket.

• From this is subtracted a distinct block of non-refundable tax credits to be multiplied by the lowest non-zero provincial tax rate (except for the charitable credit, to which the existing two-tier structure applies).

• The block has a federal component and, if desired by the province, also has a component consisting of additional provincial credits.

• The federal component contains all of the federal tax credits existing in 1997. For credits that are not directly based on taxpayer expenditures, the tax credit base used by the province can change over time as the base of the corresponding federal credit changes, but it cannot be less than the minimum of the 1997 federal base and the current federal base. Thus, each province has the option of adopting increases and decreases in the federal base after 1997.

• The additional provincial credits are limited to those that Revenue Canada can administer and may include former federal credits that have been eliminated (for example, the child tax credit). Where federal credit definitions exist, the additional provincial credits will use these definitions and just top up the amount.

The finance ministers also agreed in December 1997 that all provincial tax credits administered under the TCA system would have to satisfy certain requirements. These requirements further restrict provincial freedom in establishing new tax credits under the tax-on-income system. According to a draft version of the new guidelines, all provincial measures to be administered must

• be constitutional, be consistent with the Canadian Charter of Rights and Freedoms, be clearly authorized by statute, and not violate or impair the fulfilment of international obligations;

• be procedurally fair (for example, in redress mechanisms and confidentiality) and not impair the delivery of existing taxes and programs;

• not jeopardize the system of self-assessment and not lead to the taxation of the same income by more than one province; and

• not provide a locational incentive in a fashion that discriminates between provincial residents and non-residents.

The new guidelines also apply to the tax-on-tax system. In that capacity, they replace the 1981 “MacEachen guidelines” with less restrictive but more specific rules. For example, the old guidelines banned any measure that

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15 Courchene and Stewart, supra footnote 1, at 274.
“impede[d] the free flow of capital, goods, services and labour within Canada.” The new locational non-discrimination rule appears to be weaker; about all that it would ban is a tax credit that rewards taxpayers for migrating from another province. It appears that all existing provincial tax credits administered under the TCA system are considered to satisfy these guidelines.

1999 Provincial Budgets

The provinces that seem most eager to adopt the tax-on-income system are those that currently levy flat taxes under the existing TCAs—Alberta, Saskatchewan, and Manitoba. Manitoba’s interest was signalled in the “tax on income proposal” section of the 1998 Manitoba budget, while Saskatchewan’s 1999 budget contained a strong statement lauding the tax-on-income proposal. Yukon and Prince Edward Island also may be interested in this alternative approach.

The strongest response has come from Alberta. In its 1999 budget, the Alberta government, following the recommendation of the Alberta Tax Review Committee, proposed that beginning in 2002 the province will move to a tax-on-income system and impose a single tax rate of 11 percent on federally defined taxable income. The existing surtax, flat tax on taxable income, and low-income tax reduction will be eliminated. In addition, the basic personal amount will be increased by 60 percent from $7,131 to $11,620 and the spousal amount will be increased by 90 percent from $6,055 to $11,620. Both of these amounts will be fully indexed to inflation. Although this is not explicitly stated in the budget documents, it appears that non-refundable credits (both federal and provincial components) would be calculated using the same 11 percent tax rate. This supposition follows from the statement in the working group document that credits are to be converted at the lowest non-zero provincial tax rate.

Few precise details of the Alberta proposal are available. For example, since Alberta’s proposal provides for no higher-tier rate comparable to the federal rate of 29 percent, what rate will be used for charitable donations over $200? Similarly, what amount of dividend tax credit will Alberta allow? The dividend tax credit is perhaps the stickiest issue, since there are now a wide variety of corporate tax rates in different provinces,

16 Supra footnote 11, at 19.
including some very low rates for small businesses. The working group report does not discuss this issue, since its comments relate only to those credits that are currently calculated as a tax credit base multiplied by 17 percent. Possibly some sort of national-average rate could be used as an integration target.

**TRANSPARENCY**

In one sense, transparency refers to a taxpayer’s ability to understand the tax system and calculate his or her marginal tax rate. In another sense, transparency refers to a taxpayer’s ability to distinguish the tax measures of one level of government from those of another. The tax-on-income proposal could increase transparency in both senses, but particularly with respect to the calculation of the marginal tax rate.

For example, to calculate the 1999 top statutory marginal tax rate in Alberta, one must perform a certain multiplication and addition involving four quantities: the top federal rate (29 percent), the Alberta rate as a percentage of basic federal tax (44 percent), the Alberta surtax rate (8 percent), and the Alberta flat tax rate on taxable income (0.5 percent). The formula (which probably few taxpayers understand)\(^{21}\) is\(^{22}\)

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29\% \times 44\% + 29\% \times 44\% \times 8\% + 0.5\% = 14.28\%.
\]

If the tax-on-income proposal is implemented as proposed in the 1999 budget, in 2002, the top Alberta rate is to be simply 11 percent. No multiplication or addition is required.

There is also a strong possibility that the move to a tax-on-income system could make the federal tax system more transparent in this sense. Computing the 1999 top federal marginal tax rate requires the multiplication of three numbers: the 29 percent rate and two surtax rates. The formula is

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29\% + 29\% \times 1.5\% + 29\% \times 5\% = 30.89\%.
\]

Clearly, the surtax rates reduce the transparency of the system.

One reason for the federal government to use surtaxes rather than to change the basic schedule of marginal rates in section 117 is to prevent having the federal government’s changing needs for funds from affecting provincial revenues. A federal surtax, because it does not affect basic federal tax, has no direct effect on provincial revenues. Under a tax-on-income system, the federal government might alter the section 117 rates instead of imposing surtaxes. The 5 percent surtax on basic federal tax exceeding $12,500 could easily be dealt with in this manner since it falls

\(^{21}\)Unfortunately, there is no Canadian empirical research on misperception of marginal tax rates. One US study is Timothy J. Rupert and Carol M. Fischer, “An Empirical Investigation of Taxpayer Awareness of Marginal Tax Rates” (September 1995), 17 (Supplement) *Journal of the American Taxation Association* 36-59.

\(^{22}\)Since the top federal rate is 30.89 percent (see below), the top federal-provincial rate in Alberta in 1999 is 45.17 percent (14.28% + 30.89%).
almost exclusively on taxpayers who are in the 29 percent section 117 bracket.\(^{23}\) If the 5 percent surtax were folded into this rate bracket, the new rate brackets would be 17 percent, 26 percent, and 30.5 percent (since \(29\% \times 1.05 = 30.45\%\)). Hence, an individual’s federal-provincial statutory marginal tax rate could be calculated simply by adding the federal rate to the provincial rate. For example, in Alberta in 2002, the top rate might be

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30.5\% + 11\% = 41.5\%.
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Such a system would provide for both an easy calculation of marginal tax rates and an easy determination of the federal and provincial components. Thus, transparency in both senses would be served.

This system is so simple that Canadians may at last understand the difference between the tax impacts of deductions and those of credits—a confusion that has bedevilled our tax system since 1987. Currently, the tax impact of an addition to the credit base is confused by all of the same elements that confuse the determination of the marginal tax rate. With tax on income and abolition of federal surtaxes, the tax impact is simply the sum of the lowest brackets of the federal government and the relevant province. For Alberta in 2002, it would be

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17\% + 11\% = 28\%.
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Thus, for example, the tax saving from $100 of additional tuition would be $28.

The above analysis assumes that all provinces will move to the tax-on-income system. However, some provinces, particularly those with simpler tax systems, might retain the tax-on-tax system. If this occurred, provincial rates might not be so transparent because of confusion created by the existence of different provincial tax systems. It would also be more difficult, politically, to eliminate the federal surtaxes in this situation. However, I would expect that if a few provinces switched to the tax-on-income system, others would follow suit because of the appeal of seemingly lower rates. For example, could Ontario continue its current 40.5 percent tax-on-tax rate when Alberta moves to an 11 percent tax-on-income system? The 11 percent rate sounds a lot better, even though it is applied to a different base.

The situation also might not be quite as simple in a province that opts for a schedule of progressive rates rather than a flat rate. In that case, a taxpayer who was not subject to the top federal-provincial marginal rate

\[^{23}\text{Alan Macnaughton, Thomas Matthews, and Jeffrey Pittman, “‘Stealth Tax Rates’: Effective Versus Statutory Personal Marginal Tax Rates” (1998), vol. 46, no. 5 Canadian Tax Journal 1029-66, at 1038. The rate could be set somewhat lower than 30.5 percent to account for the fact that the increase in the section 117 rate ( unlike the surtax) is not reduced by non-refundable credits. On the other hand, there is a loss of revenue owing to the increase in the 16.5 percent Quebec abatement. See Canada, Department of Finance, Report of the Advisory Committee on Federal-Provincial Tax Collection Agreements, submitted to the minister of finance, January 15, 1992 (Ottawa: Supply and Services, 1992), 21.}\]
would have to know which federal bracket and which provincial bracket applied to him or her. The breakpoints of the brackets would not be expected to be the same federally and provincially. Also, if provinces tried to mimic the progressivity of the present system created by surtaxes and low-income tax reductions, there could be many more provincial brackets than the present three federal brackets.

Transparency also will be affected by the degree to which provinces use their newfound flexibility to create income-tested credits. Such credits have an impact on the taxpayer’s effective marginal tax rate—the rate that reflects the effect of a change in an individual’s income on his or her family’s net payments to government. For example, if a $100 increase in income causes a taxpayer’s child tax benefit to decrease by $20, the effective marginal tax rate is 20 percent plus the normal statutory marginal tax rate. To the extent that provinces extend their use of such credits, transparency of marginal tax rates could decline. Evidence suggests that Quebec, which is now the only province that has unfettered access to income-tested credits and other such measures, has used that freedom extensively. In Quebec in 1999, 79 percent of the population has at least some divergence between statutory and effective marginal tax rates, while the proportion for all Canada is a lower (but still high) 56 percent.\textsuperscript{24} However, if the use of income-tested credits is limited to replacing the highly non-transparent low-income tax reduction provisions currently used by six provinces, no new problems with transparency will occur.

**ADMINISTRATION AND COMPLIANCE**

The spectre that troubles all parties to the existing TCAs is the possibility that one or more provinces will decide to pull out of the agreement and set up a separate personal income tax, with a separate provincial collection agency. If such a situation arose, it would be hard to return to a more centralized collection system, as the US experience with the “piggybacking” proposals of 1972 and 1976 suggests.\textsuperscript{25}

Until recently, the issues of a separate tax and a separate collection agency were intertwined. With the advent of the Canada Customs and Revenue Agency, it is possible to separate the two, although for political reasons it is doubtful that the new agency would be assigned the job of collecting the personal income tax of a province that had just opted out of the TCA system. Studies suggest that the separate provincial collection agency is almost as important as, or more important than, the separate

\textsuperscript{24} Macnaughton, Matthews, and Pittman, supra footnote 23, at 1051-52.

personal income tax with respect to administrative and taxpayer compliance costs. In particular, Plamondon estimates that 40 percent of Quebec’s actual administrative costs of $158 million arise from using Revenu Québec rather than Revenue Canada. He argues that centralized collection provides substantial cost savings because provincial income tax is similar to federal income tax and federal tax administrators are already dealing with the same taxpayers. In another study, Erard and Vaillancourt estimate annual taxpayer compliance costs of $373 million for a separate Ontario personal income tax similar in structure and complexity to the Quebec personal income tax system, $245 million for a provincially administered tax-on-income system, and just $38 million for a federally administered tax-on-income system. The main reason for the reduction from $245 million to $38 million for centralized collection is that dealing with one tax agency would greatly reduce compliance costs for employers and financial institutions, although there would also be a slightly lower taxpayer compliance burden. The $38 million estimate breaks down to just $5.19 per taxpayer.

The precision of these figures is perhaps misleading, since the compliance and administrative costs of a tax-on-income system depend very much on the degree to which the provincial system departs from the federal. The proposed Alberta model is quite comforting in this respect, in that there are no aspects of the proposal that raise significant compliance cost issues; as described earlier, only the rate structure and the amounts of the basic and spousal credits are changed, and the existing surtax, flat tax on taxable income, and low-income tax reduction are abolished. (This appears to be the main reason why the Canadian Federation of Independent Business favours the Alberta proposal even though it has generally opposed the tax-on-income proposal.) In fact, the principal compliance cost problem might be the need for employees to fill out a separate employer-withholding (TD1) form for Alberta provincial tax.

The working group document does not state how provinces are to treat increases in credits after 1997 resulting from the automatic federal indexing system. If these increases are not considered to be part of the 1997 value, a province could choose whether or not to utilize them. This flexibility has significant implications for the ease of taxpayer compliance. If all federal indexing increases are followed provincially, the federal component of provincial credits can be calculated by simply multiplying the

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total federal credit base by the relevant lowest-bracket provincial tax rate. On the other hand, if such increases are not matched, each federal credit will have to appear separately on the provincial-tax component of the tax form and the amounts allowed will be different from those for federal tax.

The Alberta proposal presents particular problems with indexing in a different direction. Alberta has proposed to fully index the newly increased amounts of the basic personal and spousal credits, while the federal government currently indexes only to the extent that inflation exceeds 3 percent. Unless the federal government moves to full indexing by the time the new Alberta tax system comes into effect in 2002, almost immediately these two credits will have different values for federal and Alberta purposes.

The working group document also does not deal with another potential source of complexity—the possibility that provinces will create their own separate dividend tax credits. Not only could the rates differ by province (possibly in line with provincial variation in corporate tax rates), but conceivably some provinces could offer a larger credit for companies headquartered in the province. As discussed above, the 1999 Alberta budget proposal did not deal with this issue. It is to be hoped that this divergence does not occur and that some sort of national-average dividend tax credit is agreed upon by the TCA provinces.

Another source of concern is that although federal credits are still to be used, they are to be converted at the lowest non-zero provincial rate; if that rate were very low—say, 5 percent—the importance of the federal credits would be much diminished. This would leave more room for the provinces to create their own credits. Also, only credits existing in 1997 must be used; there is no provision for adopting new federal credits. Provincial governments are free to adopt different definitions of credits where no federal credit exists or the credit has been abolished. Thus, for example, provinces could create tax credits for dependants that differed across provinces. 29

Still, the restrictions limit provincial action. In particular, federal definitions of credits must be used if they are available. This requirement is very important since it implies, for example, that a province could not move on its own to extend the tuition tax credit to cover secondary-school tuition. Also, the discussion of tax credits relating to taxpayer expenditures appears to suggest that changes in eligible expenditures must be adopted by provincial governments. 30 Thus, it appears that most provincial credits are likely to be simply top-ups of federal credits, as proposed by Alberta.

It is also important to remember that the tax-on-tax system being replaced is not the simple 1962 model, which had only one component—

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29 However, the working group report claims that the definition of a child would be the same for both provincial and federal purposes: see supra footnote 13, at 4.

30 Ibid., at 4.
provincial tax as a percentage of basic federal tax. Instead, the current tax-on-tax system is rife with complexities such as low-income tax reductions, surtaxes, flat taxes, and refundable and non-refundable tax credits. As the working group report states, provinces have been forced to “pyramid tax measures in order to use the tax system to achieve their social and economic policy objectives.”31

The area in which there is the greatest potential for compliance problems is increased use of “province-building” initiatives, such as stock savings plans and venture capital tax credits, which discriminate in favour of residents of the particular province. Complex rules that vary across provinces could create confusion. However, since such programs have been allowed in recent years under the tax-on-tax system, even though they appear to violate the MacEachen guidelines, there seems to be little to fear from the tax-on-income initiative.32 Also, such policies can be implemented through subsidy programs and corporate income tax measures (which have been extensively employed in the research and development area).

CONCLUSION

The tax-on-income proposal is a halfway house between the tax-on-tax system and a separate personal income tax for each province. However, it appears to be much closer to the former than to the latter.

This paper has addressed concerns that the tax-on-income option will lead to increased complexity and higher administrative and compliance costs. There is evidence that these concerns may be overstated. The requirement that agreeing provinces adopt the federal definition of taxable income has foreclosed most of the potential for provincial versus federal differences. Also, since the federal-provincial working group report states that federal definitions of credits must be used if they are available, the opportunity for provinces to increase complexity through the extension or proliferation of credits is sharply limited. It is noteworthy that the 1999 Alberta budget proposal for a tax on income beginning in 2002 appears to raise no serious problems with respect to compliance or administrative costs (although questions remain about the dividend tax credit and indexing of personal tax credit amounts). Furthermore, the transparency of the tax system—the ability of taxpayers to understand their marginal tax rates and the amount of their tax liability that is imposed by each level of government—seems likely to be increased by the tax-on-income approach. This is surely a good thing. It is about time that our federal and provincial governments made our personal income tax system more understandable to the non-expert.

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31 Ibid., at 3.
32 Courchene and Stewart, supra footnote 1, at 275-80.