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Rationalizing the Canadian Income Tax System

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PRÉCIS

Le régime fiscal canadien repose sur des principes tirés du rapport Carter, et ces principes ont été contestés car les circonstances ont changé et les idées sur ce que doit être la politique fiscale ont évolué. Le régime d'imposition des particuliers adhère seulement en principe à l'idéal global de l'impôt sur le revenu, et l'impôt des sociétés est conçu comme un complément à un régime fiscal global qui n'existe pas. Les responsables des politiques canadiennes font face aux défis sans précédent que sont 1) la mondialisation, 2) une économie qui repose de plus en plus sur les services et la technologie, et 3) l'augmentation des inégalités en matière de revenu, de richesse et de possibilités. Les propositions récentes de réforme fiscale énoncées dans l'examen de Mirrlees au Royaume-Uni présentent les principes modernes de la conception fiscale. D'autres pays membres de l'Organisation de coopération et de développement économiques ont entrepris d'importantes réformes fiscales. Au Canada, des innovations dans le domaine de la politique fiscale ont été mises en œuvre par étape, tels les régimes enregistrés d'épargne-retraite, les comptes d'épargne libre d'impôt, la taxe sur les produits et services/la taxe de vente harmonisée, et les crédits d'impôt remboursables, mais il n'y a pas eu de coordination dans leur mise en œuvre. La structure fiscale des sociétés a très peu changé. Cet article explore les options de réforme du régime fiscal canadien qui pourraient améliorer l'équité et l'efficience.

ABSTRACT

The Canadian tax system is based on principles informed by the Carter report, and these principles have been challenged as circumstances have changed and ideas about tax policy have evolved. The personal tax system pays only lip service to the comprehensive income tax ideal, and the corporate tax is designed as a complement to a comprehensive tax system that does not exist. Canadian policy makers face the unprecedented challenges of (1) globalization, (2) an economy increasingly based on services and technology, and (3) growing inequality of income, wealth, and opportunity. Modern principles of tax design are reflected in recent tax reform proposals recommended by the Mirrlees review in the United Kingdom. Major tax reforms have been undertaken in other member countries of the Organisation for

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Economic Co-operation and Development. Some piecemeal innovations in tax policy have been implemented in Canada, such as registered retirement savings plans, tax-free savings accounts, the goods and services tax/harmonized sales tax, and refundable tax credits, but these measures have not been coordinated. The corporate tax structure has changed only modestly. This paper explores options for feasible reform of the Canadian tax system that might enhance equity and efficiency.

KEYWORDS: CANADIAN TAX SYSTEM ■ TAX REFORM ■ PERSONAL INCOME TAX ■ CORPORATE INCOME TAX

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INTRODUCTION

The Canadian tax system has undergone many piecemeal reforms since the landmark Carter report.[1] Notable changes include the introduction of various devices for sheltering capital income; the replacement of the federal manufacturing sales tax and some provincial retail sales taxes with a harmonized value-added tax system (that is, the harmonized sales tax [HST]); the changing of most tax deductions to tax credits, and the introduction of some refundable tax credits; the devolving of revenue-raising authority to provincial governments and the instituting of income tax collection agreements; and the streamlining of tax administration through the creation of the Canada Revenue Agency (CRA).

Each of these reforms has improved some aspect of the tax system. But, given the piecemeal introduction of the changes, the consequences for the system as a whole have been less than coherent. Although the income tax system pays lip service to the Carter-inspired ideal of the comprehensive income tax base, it deviates from it in

1 Canada, *Report of the Royal Commission on Taxation* (Ottawa: Queen's Printer, 1966-67) (herein referred to as "the Carter report").

significant ways. As the system as a whole moves from income- to consumption-based taxation, the corporate tax loses relevance as a backstop to the personal tax.

Moreover, circumstances have changed. The Canadian economy increasingly produces services rather than goods, and information- and knowledge-based industries have grown. Canada faces a more globalized setting, with capital and production becoming more mobile and domestic manufacturing industries increasingly facing challenges from emerging economies. Income and wealth inequality have increased as capital's share of national income has risen, and productivity has slowed. There has been growing recognition of the contribution of windfall gains (or rents) to inequality. At the same time, tax-transfer policies have become less effective at addressing market-driven inequality.

The principles and practices of tax policy have evolved, including views on the tax treatment of capital versus labour income and on the role of the tax-transfer system in mitigating inequality. This evolution has included a reassessment of the role of business taxation and its distortions. Complementary objectives of taxation have been emphasized in the process, including equality of opportunity and the addressing of behavioural anomalies. Much of the current thinking can be found in the Mirrlees review and its background studies.[2]

My purpose is to revisit the Canadian tax system with this background in mind, and to suggest some reforms that would improve the equity, efficiency, and coherence of the system. I begin by reviewing the inconsistencies in the existing system. I then summarize some tax reform suggestions that draw on current principles of public finance and best practices. Finally, I propose directions for reform that would address existing anomalies and shortcomings and that would be economically and administratively feasible.

ANOMALIES AND INCONSISTENCIES IN THE CANADIAN TAX SYSTEM

The current Canadian income and sales tax system has evolved through a series of discrete reforms. The consequence is a tax system that is sometimes incoherent and contradictory. In this section, I describe the ways in which irrational elements are embedded in the tax system. Of particular importance are the inconsistencies in the treatment of different forms of asset income, and this is where I begin the discussion.

Incoherent Sheltering of Asset Income

The income tax system—and the tax law that underlies it—is nominally based on the concept of "comprehensive income," as espoused by the Carter report, and this

2 James A. Mirrlees, Stuart Adam, Tim Besley, Richard Blundell, Stephen Bond, Robert Chote, Malcolm Gammie, Paul Johnson, Gareth Myles, and James Poterba, *Tax by Design: The Mirrlees Review* (Oxford: Oxford University Press, 2011) (herein referred to as "the Mirrlees review").

concept is reflected in the benchmark system used to define tax expenditures.[3] Gradually, as increasing amounts of capital income have been sheltered, the actual tax system has evolved toward a progressive consumption or expenditure tax system. The sheltering of capital income takes many forms, no two of which are identical. Four forms of sheltering can be identified.

First, the combination of income taxation, which includes capital income, with sales taxation, which is based on consumption, implicitly results in a lower tax on capital income relative to earnings. Consumption alone is subject to one of the goods and services tax (GST), the harmonized sales tax (HST), or the Quebec sales tax (QST), depending on the province of consumption, whereas income taxation applies to consumption plus saving (the sum of which equals income). Moreover, if we define "income" as including inheritances and gifts received, not even all income can be said to be included in the current income tax base (although bequests made are not deducted, either, and so, to the extent that such bequests are not regarded as consumption, consumption is overtaxed). Even if there were no explicit sheltering of capital income, the system would effectively tax capital income preferentially.

Through the second form of capital income sheltering, some assets are afforded registered or *tax-deferred* treatment. Such assets primarily include savings held in registered pension plan (RPP) or registered retirement savings plan (RRSP) accounts, both of which are intended to support savings for retirement. RPPs and RRSPs both have maximum contribution limits, but they differ in that RRSPs, unlike RPPs, allow full carryforward of unused deductions. The two differ in their limits, although the contribution limits of RRSPs depend on the size of the RPP contributions. RRSPs can be withdrawn at will and with no financial penalty; in that sense, they allow lifetime income averaging. RRSPs are based on defined contributions, whereas RPPs can be of the defined-benefit form. Compulsory contributory pension schemes such as the Canada or Quebec pension plans (CPP/QPP) also resemble tax-deferred savings vehicles. They are imperfect defined-benefit schemes, and contributions to them are not income-deductible. Thus, even within the tax-deferred category of assets, tax treatment of the two differs significantly. Note also that human capital investment is treated roughly as a tax-deferred asset. Much of the cost of education consists of forgone earnings, which are effectively tax-deductible. The increases in earnings that result from human capital investment are taxed when they accrue.

A third form of asset income sheltering involves *tax-prepaid* treatment, such that asset income is not taxed and contributions are not deductible. There are two main forms of tax-prepaid assets. One is owner-occupied housing, whose return is imputed rent (including capital gains) and for which there is no maximum allowable size. The other is the tax-free savings account (TFSA), which carries an annual limit and allows unused limits to be carried forward. TFSAs can be withdrawn without penalty; thus, like RRSPs, they deviate from pure retirement-savings schemes. The absence

3 Canada, Department of Finance, *Report on Federal Tax Expenditures: Concepts, Estimates and Evaluations* (Ottawa: Department of Finance, 2018) (https://www.fin.gc.ca/taxexp-depfisc/2018/taxexp-depfisc18-eng.pdf).

of limits on housing investments implies that housing and TFSAs embed differential tax treatment. In addition, the limits on TFSAs and RPPs/RRSPs, respectively, are not comparable and are independent of contributions to one another, although limits on contributions to TFSAs are lower than limits on contributions to RPPs/RRSPs. Tax-deferred and tax-prepaid assets differ in one further respect. The tax savings obtained from RRSPs and TFSAs depend on the difference between the marginal income tax rates at the time of contribution and the rates at the time of withdrawal, and on the timing of contributions and withdrawals. These can differ considerably. In particular, the higher the tax rate at the time of contribution relative to the time of withdrawal, the greater the tax savings on RRSPs; whereas the opposite applies for TFSAs.

Finally, under the capital gains exemption, one-half of capital gains are tax-exempt. Two reasons are usually given for this. First, the exemption roughly offsets the fact that some capital gains are owing to the inflation of asset values, so they are not real gains. Second, the capital gains exemption, along with the dividend tax credit, is a component of the integration of the personal income tax (PIT) and the corporate income tax (CIT). Neither of these rationales is convincing. Although comprehensive income should ideally be measured on a real basis, consistency would require that all forms of taxable capital income be indexed, not just capital gains. Moreover, since capital gains are taxed on realization rather than accrual, taxpayers can shelter them by postponing realization and thereby offsetting the disadvantage that arises from the taxation of nominal gains. The integration argument is also unconvincing, for the reasons discussed below.

One further important observation poses a challenge to two of the forms of income sheltering—namely, the capital gains exemption and tax-prepaid assets. Capital income can include three components: (1) a risk-free return, (2) a return to risk, and (3) a windfall return representing unanticipated windfalls or rents. From a tax policy perspective, rents should be taxed even if the sheltering of normal capital income is desirable, because such taxation would be an efficient (and possibly equitable) source of tax revenue. Since one cannot distinguish rents from returns to risk, the exemption of one implies the exemption of the other. Rents and returns to risk are captured both in unsheltered capital income and in tax-deferred savings plans (including the GST/HST/QST), but they escape taxation with tax-prepaid assets. Given the evidence that rents constitute a significant share of capital income,[4] a compelling case can be made for limiting the use of tax-prepaid devices (capital gains exemption, TFSAs, and housing) in the sheltering of capital income from taxation. Of course, taxing all capital income in order to tax rents implies taxing returns

4 Andreas Fagereng, Luigi Guiso, Davide Malacrino, and Luigi Pistaferri, *Heterogeneity and Persistence in Returns to Wealth*, NBER Working Paper no. 22822 (Cambridge, MA: National Bureau of Economic Research, 2016); Marcin Kacperczyk, Stijn Van Nieuwerburgh, and Laura Veldkamp, "A Rational Theory of Mutual Funds' Attention Allocation" (2016) 84:2 *Econometrica* 571–626 (https://doi.org/10.3982/ECTA11412); Laura Power and Austin Frerick, "Have Excess Returns to Corporations Been Increasing Over Time?" (2016) 69:4 *National Tax Journal* 831-45.

to risk and could discourage risk taking. However, with generous loss-offsetting arrangements, taxing risk need not result in less risk taking, since the government effectively shares risk with taxpayers.

Not all assets can be sheltered. An important exception is assets in an unincorporated business. The returns to these assets are fully taxed as individual income, by the use of a tax base defined in the same way as for corporations.

The consequences of these varied and uncoordinated forms of asset-income tax treatment are many. Different forms of capital income are treated very differently. Housing equity is fully sheltered, while personal business income is unsheltered; and capital gains, interest, and dividends are treated differently. Assets that are sheltered to encourage saving for retirement are subject to different limits and rules, and they are not penalized for withdrawal prior to retirement. Some sheltering devices, such as TFSAs and housing, exempt all forms of capital income from taxation, while others, such as RRSPs, RPPs, and the GST/HST/QST systems, implicitly tax rents and all returns to risk. As we argue below, taxing capital income preferentially is desirable. However, it should be done in a coherent manner such that some forms of capital income are not unnecessarily favoured, and those that represent above-normal returns are appropriately taxed.

Imperfect and Unnecessary Integration of Corporate and Personal Taxes

As discussed below, the corporate income tax (CIT) is designed to withhold taxes on corporate-source income accruing to shareholders in order to prevent these shareholders from postponing personal tax liabilities by retaining and reinvesting income in the corporation. This backstop role may have been necessary in years past, but it is no longer warranted, for two reasons. First, most shareholder income is sheltered from personal taxation, so withholding taxes on shareholder income at source is not necessary. Most capital income of all but the wealthiest taxpayers can be sheltered, especially with the advent of TFSAs. Recent estimates by Milligan[5] and the Department of Finance[6] suggest that if all taxpayers took full advantage of RRSPs, RPPs, and TFSAs, 90 percent of them could shelter all of their capital income, and 70 percent of all capital income could be sheltered. This means that the need for integration is not compelling. Second, to the extent that personal capital income is taxable, the CIT would not be an effective withholding device. With highly open international capital markets, the incidence of the CIT is largely shifted to labour; empirical evidence bears this out. Recent studies estimate that between one-half and three-quarters of CIT changes are shifted to labour.[7]

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5 Kevin Milligan, "Policy Forum: The Tax-Free Savings Account: Introduction and Simulations of Potential Revenue Costs" (2012) 60:2 *Canadian Tax Journal* 355-60.

6 "Tax-Free Savings Accounts: A Profile of Account Holders," in Canada, Department of Finance, *Tax Expenditures and Evaluations 2012* (Ottawa: Department of Finance, 2013), 33-48.

7 Kevin A. Hassett and Aparna Mathur, "Spatial Tax Competition and Domestic Wages," December 2010 (https://dx.doi.org/10.2139/ssrn.2212975); George R. Zodrow, "Capital

In these circumstances, integration of the PIT and CIT is not warranted. Even if it were, the current instruments for integration—the dividend tax credit and the capital gains exemption—are highly imperfect. For one thing, these instruments apply uniformly to all taxable dividends and capital gains regardless of the extent to which corporate taxes have actually been paid. For another, no dividend tax credit applies to dividends received on sheltered asset returns. Moreover, the capital gains exemption has the additional disadvantage of giving rise to costly tax planning.

A further observation is that in the context of an open economy where the investment and savings sides of the market are separated, the dividend tax credit and the capital gains exemption effectively subsidize personal unsheltered savings.[8] They cannot be interpreted as a refund of corporate taxes paid on the shareholders' behalf. Some might argue that these arguments do not fully apply to small corporations that do not raise funds on international capital markets, but that argument is not convincing. Even though small corporations might raise all of their funds locally and, often, from owner-operators themselves, local rates of return must comply with rates of return that apply elsewhere in the economy, since creditors always have the option of buying assets whose rates of return are more directly influenced by international markets.

We conclude, therefore, that CIT/PIT integration serves no useful role and this, in turn, has implications for the design of the CIT, to which we turn in the following section.

The Structure of the CIT Is Outdated

The design and rationale of the CIT have changed little since the Carter report, and the same rationale was adopted more recently by the Mintz report.[9] On the presumption that the intent of the PIT was to tax comprehensive income but that capital gains could be taxed only on realization rather than accrual, there was a perceived need to tax corporate equity income at source so that shareholders could

Mobility and Capital Tax Competition" (2010) 63:4 *National Tax Journal* 865-902; Wiji Arulampalam, Michael P. Devereux, and Giorgia Maffini, "The Direct Incidence of Corporation Tax on Wages" (2012) 56:6 *European Economic Review* 1038-54; Céline Azémar and R. Glenn Hubbard, "Country Characteristics and the Incidence of Capital Income Taxation on Wages: An Empirical Assessment" (2015) 48:5 *Canadian Journal of Economics* 1762-1802 (https://doi.org/10.1111/caje.12179); Kenneth J. McKenzie and Ergete Ferede, "Who Pays the Corporate Tax? Insights from the Literature and Evidence for Canadian Provinces" (2017) 10:6 *SPP Research Papers* [University of Calgary School of Public Policy] 1-21; Clemens Fuest, Andreas Peichl, and Sebastian Siegloch, "Do Higher Corporate Taxes Reduce Wages? Micro Evidence from Germany" (2018) 108:2 *American Economic Review* 393-418.

8 Robin Boadway and Neil Bruce, "Problems with Integrating Corporate and Personal Income Taxes in an Open Economy" (1992) 48:1 *Journal of Public Economics* 39-66 (https://doi.org/10.1016/0047-2727(92)90041-D).

9 Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, April 1998) (herein referred to as "the Mintz report").

not shelter income within the corporation by retaining and reinvesting it. That rationale dictated that the base of the CIT should be shareholder income, a principle that is consistent with the Income Tax Act.

Once the withholding rationale is discredited (as discussed above), the use of shareholder income as the CIT base not only is unwarranted but also leads to problematic distortions. Given the openness of international capital markets, domestic investment decisions are effectively segmented from domestic savings decisions. In these circumstances, the CIT serves to distort investment decisions, while integration measures subsidize saving.[10] Two important sources of such distortion are related to the fact that a CIT—if it is based on shareholder income—taxes that part of the normal return to investment that is financed by equity. First, investment is discouraged to the extent that a corporation relies on equity finance as opposed to debt, and that reliance varies across firms and types of capital. The many estimates of marginal effective corporate tax rates bear this out.[11] Second, firms are encouraged to use debt rather than equity finance, which increases the possibility of bankruptcies.

The distortions of investment and financing decisions are specific to a CIT that is based on shareholder income. Other CIT bases will give rise to other CIT distortions. For example, firms' decisions about location will depend on average CIT rates, which, unlike marginal ones, will generally be positive for any CIT system. Also, the incentive for profit shifting among countries depends on statutory CIT rates and not on the CIT base, although the ability to deduct interest provides an important vehicle for profit shifting. Finally, the CIT will discourage risk taking to the extent that loss offsetting is imperfect, although that effect might be greater when shareholder income is the CIT base rather than a narrower base that excludes competitive returns to investment, as discussed below.

Small Canadian-controlled private corporations (CCPCs) are liable for the CIT, but in preferential terms. The small business deduction (SBD) offers a reduced tax rate for CCPCs whose taxable income, investment income, and capital do not exceed prescribed upper limits. In addition, owners of CCPCs obtain the lifetime capital gains exemption (LCGE) of over $800,000. The SBD can be seen as a response to the fact that the income of new small businesses is risky. The tax system does not fully assign a cost to that risk: losses are not refundable and can be deducted against future income only if the firm becomes profitable. Because small firms are taxed on any

10 Boadway and Bruce, supra note 8.

11 For example, Robin Boadway, Neil Bruce, and Jack Mintz, "Taxation, Inflation and the Effective Marginal Tax Rate on Capital in Canada" (1984) 17:1 *Canadian Journal of Economics* 62-79; Mintz report, supra note 9; "Marginal Effective Tax Rates on Business Investment: Methodology and Estimates for Canadian and US Jurisdictions," in Canada, Department of Finance, *Tax Expenditures and Evaluations 2005* (Ottawa: Department of Finance, 2005); Duanjie Chen and Jack M. Mintz, "The 2014 Global Tax Competitiveness Report: A Proposed Business Tax Reform Agenda" (2015) 8:4 *SPP Research Papers* [University of Calgary School of Public Policy] 1-21.

profits that they earn but cannot fully recoup losses, especially if they go bankrupt, the CIT discriminates against them. The SBD is a partial response. The SBD may also address the difficulty that young, small firms have in obtaining access to credit markets; however, the SBD is of limited use in that regard, since firms that are credit-constrained may not be in a taxpaying position, and therefore lower tax rates provide no relief.

The SBD is not, however, restricted to small growing firms with risky prospects for success. It is available to all small firms, regardless of their riskiness, as long as they remain small. Incorporated professionals are an example of businesses that are eligible for the SBD although they are not particularly risky or credit-constrained and may undertake relatively little investment.

Small business owners also face some disadvantage in sheltering savings for retirement. Although they can invest in RRSPs and TFSAs, their business assets cannot be part of their RRSP or TFSA portfolios. The LCGE enables small business owners to shelter retirement income. In addition, some passive investment income can be sheltered within CCPCs and be subject to preferential rates. As with other devices used to shelter capital income, the limits of the LCGE and passive income sheltering are independent of limits on RRSPs, TFSAs, and other devices. The use of any one sheltering device is subject only to the limits prescribed for that device and is independent of the limits prescribed for sheltering through any other device.

The PIT Rate Structure Is Inconsistent and Inequitable

The progressivity of the PIT depends on (1) the structure of tax brackets and the tax rates, and (2) the various tax credits, both refundable and non-refundable. Progressivity also depends on differential treatment of various elements of the tax base and how such treatment applies at different income levels. Below, we highlight three anomalous features that affect the progressivity of the rate structure in questionable ways.

The first feature concerns the non-refundability of many tax credits, the so-called NRTCs. The concern applies mainly to tax credits that can be viewed as instruments for achieving vertical equity as opposed to tax credits that are intended to influence behaviour or to achieve horizontal equity. For example, deductions for charitable and political contributions arguably serve to encourage taxpayers to make such contributions. There may be some question about the precise design of these deductions, such as their size and how they vary according to the amount of contribution, but their existence can be justified. Similarly, deductions for medical expenses can be justified on the grounds of horizontal equity. Also, the cost-effectiveness of some smaller "boutique" tax credits, such as the one for public transit, can be questioned, but we are more concerned with those NRTCs that mainly affect tax progressivity.

The most important of these NRTCs is the basic personal amount. It is by far the largest NRTC and accounts for roughly two-thirds of the value of all NRTCs. The basic personal amount is equivalent to an equal per capita tax credit to all taxpayers that are eligible to claim it. However, it has less value for those with low taxable income, and it is of no value to those with no taxable income. The concept of the "basic personal amount"—which dates from the Carter report—recognizes that at least some minimal amount of income is necessary for non-discretionary consumption. Those with no taxable income also have non-discretionary consumption needs, and these could be met if the basic personal amount were refundable. As it stands, the non-refundability of the basic personal amount implies that income tax progressivity is very low at the bottom of the income distribution, contrary to what is recommended in the optimal income tax literature.[12] Similar arguments apply to other NRTCs, most of which are more progressive than the basic personal amount, since their amount declines with either individual or family income. Examples include the spousal exemption, the dependent exemption, and the age exemption.

The second concern involves the structure of NRTCs. The number of NRTCs is large, and many of them are effectively redundant, given other elements of the tax system. The age exemption largely duplicates the pension exemption and the old age security (OAS) system. Similarly, the employment exemption accomplishes an objective similar to that of the Canada workers benefit (CWB). Both give tax credits on the basis of employment, albeit through different structures. Some NRTCs discriminate in favour of some groups for no good reason—for example, the age credit or the credits for volunteer firefighters and homebuyers. Different clawback rates apply to different NRTCs, and the clawbacks are not coordinated, with the result that more than one clawback applies to the same income, which leads to high implicit marginal income tax rates. Finally, some credits are intended to compensate taxpayers for costs incurred or for contributions made and should be deductions rather than credits. The CPP contribution is an example of this type of credit, as are education credits. The case for using credits is strongest when the objective is vertical equity as opposed to the reimbursement of taxpayers for contributions or expenses.

The third concern is that exemptions of some kinds of income are more beneficial to higher-income taxpayers than to other taxpayers. The importance of capital gains (including, notably, capital gains on owner-occupied housing) rises with income level, so the value of the capital gains exemption likewise rises with income. It is true that lower-income individuals can shelter most of their capital income by using RRSPs, RPPs, and TFSAs, but these vehicles are also available to higher-income individuals. The preferential tax treatment of capital gains also influences the choice of the rate structure. The tax rate at the top is constrained by the relatively high elasticity of taxable income at high income levels, part of which is attributable to tax-planning opportunities provided by the capital gains exemption.

As the foregoing has shown, the PIT is characterized by a distinct lack of progressivity at lower income levels, and a narrower base and lower rates than necessary at the top income levels.

12 Matti Tuomala, *Optimal Redistributive Taxation* (Oxford, UK: Oxford University Press, 2016).

The Exclusion of Inheritances from Taxation

One of the most conceptually challenging issues in tax design is the treatment of bequests and inheritances. There is no common international practice. Some countries tax bequests or estates, while others tax inheritances. Others, such as Canada, tax neither. Virtually no countries offer incentives for bequests, despite its being common to give tax credits or deductions for charitable donations. In Canada, bequests are largely ignored in the tax system, with the exception of the deemed realization of capital gains on estates at death, which triggers capital gains taxation that would otherwise be postponed until actual realization at some later date.

A number of key issues of principle arise with respect to the tax treatment of transfers of wealth, both at death and inter vivos. On equity grounds, inheritances are a form of income and ought to be taxed as such, especially given their windfall nature. The issue is whether a bequest given is analogous to consumption by the donors. If it is, a bequest would give simultaneous benefit to donors and recipients, so no credit would be given to donors, but recipients would be taxed. Many reject this form of double-counting,[13] arguing that taxation should occur only in the hands of the recipient. The Canadian case avoids double-counting, since no credit is given for forgone consumption by donors and no tax is paid by recipients; thus, the two roughly cancel. However, this view is complicated by a further consideration. In the case of large bequests, there is some likelihood that a significant amount of the value of the bequest represents a windfall gain or a rent accruing to the underlying assets. On these grounds, an argument can be made for taxing inheritances in their own right. As well, arguments for breaking up large estates can be made on the grounds of equality of opportunity and the dilution of the power that comes with wealth.[14] According to this view, a tax on inheritances with no relief for donors can be justified.[15]

There are also efficiency issues with inheritance taxation. If bequests benefit both the donor and the recipient, there is an externality: donors take into account the altruistic benefits that they obtain for themselves by making a bequest, but not the additional benefit to the recipients. This has led some authors to suggest the subsidizing of bequests on efficiency grounds.[16] In addition, even if there is

13 See Peter J. Hammond, "Altruism," in *The New Palgrave: A Dictionary of Economics*, 1st ed. (1987); and James A. Mirrlees, "Taxation of Gifts and Bequests," unpublished slides for a talk at the Centenary of James Meade Conference, 2007.

14 Thomas Piketty, *Capital in the Twenty-First Century* (Cambridge, MA: Belknap Press, 2014).

15 Robin Boadway, Emma Chamberlain, and Carl Emmerson, "Taxation of Wealth and Wealth Transfers," in Stuart Adam, Timothy Besley, Richard Blundell, Stephen Bond, Robert Chote, Malcolm Gammie, Paul Johnson, Gareth Myles, and James Poterba, eds., *Dimensions of Tax Design: The Mirrlees Review* (Oxford: Oxford University Press, 2010), 737-814.

16 Louis Kaplow, "A Framework for Assessing Estate and Gift Taxation," in William G. Gale, James R. Hines, and Joel Slemrod, eds., *Rethinking Estate and Gift Taxation* (Washington, DC: Brookings Institution, 2001), 164-204.

no double-counting, such that the benefits to donors are ignored, the taxation of inheritances will discourage donations, and this is something that must be taken into account in deciding on tax treatment.[17]

Clearly, difficult conceptual issues are involved in determining the tax treatment of bequests and inheritances, and these will apply to other voluntary transfers, too.

SOME PRINCIPLES FOR A MODERN TAX SYSTEM

The literature on the design of an optimal tax system has burgeoned in recent years. Much of it stems from the development of optimal income tax theory and its application to tax policy.[18] Optimal income tax analysis takes a utilitarian approach to tax design: it studies the tax system that optimizes final outcomes, using a social welfare function with standard properties.

The utilitarian approach contrasts with that of the Carter report, which dominated public finance for the first half of the 20th century and was summarized by Musgrave.[19] This approach emphasizes individuals' ability to pay (summarized as "comprehensive income") as the ideal tax base, and it uses the principle of equal sacrifice to guide tax progressivity. The ability-to-pay/equal-sacrifice approach, in contrast to the utilitarian one, emphasizes command over resources (or spending power), rather than utility, as the ideal base, and it takes into account both initial and final positions in determining progressivity.

More recently, the equality-of-opportunity approaches of Roemer[20] and of Fleurbaey and Maniquet[21] have offered another "command over resources" alternative to utilitarianism. These authors emphasize the heterogeneity of individuals, who may differ in characteristics over which they have no control, such as innate ability and family background, as well as in characteristics over which they may have control, such as preferences. The ideal tax-transfer system ought to compensate individuals for differences in given characteristics while letting these individuals assume

17 Helmuth Cremer and Pierre Pestieau, "Wealth Transfer Taxation: A Survey of the Theoretical Literature," in Serge-Christophe Kolm and Jean Mercier Ythier, eds., *Handbook of the Economics of Giving, Altruism and Reciprocity: Applications*, vol. 2 (Amsterdam: North-Holland, 2006), 1107-34.

18 James Banks and Peter Diamond, "The Base for Direct Taxation," in *Dimensions of Tax Design*, supra note 15, 548-648; Robin Boadway, *From Optimal Tax Theory to Tax Policy: Retrospective and Prospective Views* (Cambridge, MA: MIT Press, 2012); Thomas Piketty and Emmanuel Saez, "Optimal Labor Income Taxation," in Alan J. Auerbach, Raj Chetty, Martin Feldstein, and Emmanuel Saez, eds., *Handbook of Public Economics*, vol. 5 (Amsterdam: North-Holland, 2013), 392-474.

19 Richard A. Musgrave, *The Theory of Public Finance: A Study in Public Economy* (New York: McGraw-Hill, 1959).

20 John E. Roemer, *Equality of Opportunity* (Cambridge, MA: Harvard University Press, 2000).

21 Marc Fleurbaey and François Maniquet, *A Theory of Fairness and Social Welfare* (New York: Cambridge University Press, 2011).

responsibility for how they use the abilities and resources made available to them. A critique of utilitarianism as the sole basis for tax design is discussed in Boadway.[22]

The tax principles that I outline below combine the utilitarian approach with equality-of-opportunity approaches. I combine the principles that these approaches have in common with the principles that each brings separately to the table. The utilitarian principle dominates my approach, augmented by the equality-of-opportunity principle where the latter is useful. My focus is on tax design as it applies to individuals, though the complementary roles played by corporate and commodity taxation are relevant. The following subsections summarize the set of principles that I use to inform the subsequent suggestions about tax reform.

Individual Income Taxation

The key policy issue in the design of individual income tax is the treatment of capital income. Two alternative frameworks dominate the historical discussion: comprehensive income taxation and personal consumption taxation. The former is associated with the Carter report, while the latter has been advocated by the US Treasury,[23] the Meade report,[24] the Economic Council of Canada,[25] the president's panel in the United States,[26] and the Mirrlees review. An important innovation in the Mirrlees review was to stress the fact that some returns to capital are above the normal competitive return and ought to be taxed under both consumption and comprehensive income taxation. The Mirrlees review's rate-of-return allowance, which proposed taxing returns to shares in excess of a normal rate of return, was a means of imposing such taxation. The use of tax-deferred sheltering—by RRSPs and RPPs, for example—accomplishes the same thing.[27]

Although the Mirrlees review recognized the importance of including consumption finance by rents, it differed from the advice given to it by Banks and Diamond,[28] who argued for partial taxation, at least, of all capital income. Banks and Diamond argued, in particular, for retaining some progressive capital income taxation, but at

22 Boadway, supra note 18.

23 United States, Department of Treasury, *Blueprints for Basic Tax Reform* (Washington, DC: US Government Printing Office, 1977).

24 Institute for Fiscal Studies, *The Structure and Reform of Direct Taxation: Report of a Committee Chaired by Professor J. E. Meade* (London: Allen & Unwin, 1978) (herein referred to as "the Meade report").

25 Economic Council of Canada, *Road Map for Tax Reform: The Taxation of Savings and Investment* (Ottawa: Supply and Services, 1987).

26 President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals To Fix America's Tax System* (Washington, DC: US Government Printing Office, 2005).

27 An income tax with tax-deferred sheltering of capital income is equivalent, in present-value terms, to consumption expenditures. Tax-prepaid sheltering does not give the same equivalence. It would do so if above-normal returns to capital were included in the tax base, as in the Mirrlees review's rate-of-return allowance.

28 Banks and Diamond, supra note 18.

preferential rates compared with the taxation of earnings. Some of the principles discussed below include elements of both the Mirrlees review and Banks and Diamond, and these principles are augmented by a few others. First, given individuals' observable tendency to save too little for retirement and thereby to rely on government support, a case can be made for sheltering capital income in order to encourage saving for retirement. Such sheltering should apply as consistently and comprehensively as possible across various possible sheltering instruments. Second, I explicitly recognize both the importance of taxing above-normal asset returns and the implications that doing so has for sheltering by tax-prepaid vehicles (as opposed to tax-deferred ones). Rents are included as part of accumulated earnings that are taxed when tax-deferred accounts are drawn down, but they are exempt from taxation with tax-prepaid assets. Finally, because the sheltering of capital income is intended to encourage saving for retirement, some penalties for early withdrawal are warranted. These principles are mainly for the purposes of policy guidance. In practice, it will be difficult to achieve all of them fully.

Some other principles relate to personal income taxation more generally. The progressivity of the rate structure needs to be rationalized. This is particularly the case for those at the bottom of the income distribution. The existing system of NRTCs is of little use to the lowest-income persons, and this could be addressed by making NRTCs refundable. Such a reform would be a natural evolution of a system that was last changed in the 1980s, when most tax deductions were converted to credits. More generally, there is a case for rationalizing and simplifying the many existing NRTCs in order to make the PIT more fair and transparent.

A broadening of the tax base, so that all non-sheltered capital income is treated comparably, would enhance fairness at the top. In particular, given the weak case for integration of the CIT and PIT, the preferential treatment of dividends from Canadian corporations and capital gains is not warranted. Eliminating those tax preferences would not only enhance tax fairness but also reduce tax-planning opportunities.

Recent optimal income tax analysis has emphasized the role of participation incentives at the bottom of the income distribution.[29] In Canada, the CWB serves that purpose, but it is of limited size. An enhancement of the CWB, combined with the refundability and rationalization of NRTCs, would provide a reasonable basic income guarantee for those with no earnings, and it could be augmented by a larger transfer for those who engage in low-paid employment. As discussed in Boadway, Cuff, and Koebel[30] and in Koebel and Pohler,[31] such a measure could be

29 Emmanuel Saez, "Optimal Income Transfer Programs: Intensive Versus Extensive Labour Supply Responses" (2002) 117:3 *Quarterly Journal of Economics* 1039-73 (https://doi.org/10.1162/003355302760193959); Mike Brewer, Emmanuel Saez, and Andrew Shephard, "Means-Testing and Tax Rates on Earnings," in *Dimensions of Tax Design*, supra note 15, 90-173.

30 Robin Boadway, Katherine Cuff, and Kourtney Koebel, "Designing a Basic Income Guarantee for Canada," in Elizabeth Goodyear-Grant, Richard Johnston, Will Kymlicka, and John Myles,

(Notes 30 and 31 are continued on the next page.)

the prototype for a more substantial basic income guarantee that the federal government and the provinces could provide collaboratively. At the same time, the benefits of enhancing the CWB can be overstated. Encouraging the participation of the labour market is valuable to the extent that employment is actually achieved, and such achievement depends on the demand side of the labour market. Given the difficulties that low-skilled persons might have in obtaining employment, the premium paid by an enhanced CWB to those who succeed should not be excessively high compared with transfers received by those unable to land a job.

Finally, the tax treatment of unincorporated business income should be similar to that of corporations, a topic to which I turn in the next section. In anticipation, all real business income should be taxed on a cash-flow-equivalent basis so that normal returns are exempt. This implies that personal investments in unincorporated businesses would be fully sheltered unless they are passive investments.

Corporation Income Taxation

The CIT base is an accruals-based measure of shareholder income. Revenues are included, while current costs and accrued capital costs are deducted where the latter include, among other things, interest payments and capital cost allowances. This choice of shareholder income as the base follows from viewing the CIT as a backstop for the PIT. It withholds tax against shareholder income as the corporation earns it, in order to preclude the shareholder from using the corporation as a sheltering device. Given this withholding intent, shareholders are reimbursed by the dividend tax credit and capital gains exemption. I have argued that this rationale is dated. A significant proportion of shareholder income is sheltered at the individual level, and much of the incidence of the CIT is shifted to labour, with the result that withholding is ineffective and integration is unnecessary. Given the segmentation of investment and savings in international markets, the CIT distorts investment decisions regardless of any relief given by integration.

There is ample evidence that a substantial share of corporate income reflects rents or windfall profits.[32] Given that fact, a more cogent rationale for the corporate tax is that it is a tax on rents. This view was taken by the Meade report and by the

eds., *Federalism and the Welfare State in a Multicultural World* (Montreal and Kingston, ON: Queen's School of Policy Studies and McGill-Queen's University Press, 2018), 101-29; and Robin Boadway, Katherine Cuff, and Kourtney Koebel, "Can Self-Financing Redeem the Basic Income Guarantee? Disincentives, Efficiency Costs, Tax Burdens, and Attitudes: A Rejoinder" (2018) 44:4 *Canadian Public Policy* 447-57 (https://doi.org/10.3138/cpp.2018-044).

31 Kourtney Koebel and Dionne Pohler, "Expanding the Canada Workers Benefit to Design a Guaranteed Basic Income," *Canadian Public Policy* (forthcoming).

32 Ruud A. de Mooij, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, IMF Staff Discussion Note SDN 11/11 (Washington, DC: International Monetary Fund, May 3, 2011); Robin Boadway and Jean-François Tremblay, *Corporate Tax Reform: Issues and Prospects for Canada*, Mowat Research no. 88 (Toronto: University of Toronto, School of Public Policy and Governance, Mowat Centre, April 2014); Power and Frerick, supra note 4.

Mirrlees review. The Institute for Fiscal Studies[33] recommended this approach for the European Union, and Boadway and Tremblay[34] and McKenzie and Smart[35] have advocated it for Canada.

The classic design of a rent tax is a cash flow tax, following Brown.[36] The cash flow tax base is total cash receipts less total cash outlays, with no distinction between current and capital expenditures. In particular, investment is expensed, and no further deductions are given for interest or depreciation. Provided that positive and negative cash flows are treated symmetrically—by refundability or carryforward of tax losses with interest—such a tax is neutral with respect to both investment and financing. The Meade report proposed that the cash flow tax should either apply only to real transactions (the R base) or apply to both real and financial transactions (the R+F base) in order to tax the rents earned by financial institutions.

The cash flow tax is the simplest form of rent tax; however, by deducting all costs before revenues are earned, it results in negative tax liabilities for firms that engage in large investments, and it results in the postponement of tax revenues for others. If governments are reluctant to refund tax losses, other options are available that are equivalent to cash flow taxation in present-value terms. Any tax base for which the present value of future deductions from an investment equals the value of investment will be equivalent to cash flow taxation.[37] An example of a cash flow-equivalent tax base is the allowance for corporate equity (ACE) tax proposed by the Institute for Fiscal Studies.[38] It allows firms to deduct from their corporate tax base a normal rate of return to equity times the amount of their investment that was financed by equity. Assuming that the existing corporate tax base measures shareholder income relatively accurately (so that CCA deductions approximate actual capital depreciation), the allowing of a deduction for the cost of equity financing converts the tax base from shareholder income to above-normal profits, which include both rents and returns to risk. To the extent that the corporation is risk-neutral, because shareholders can diversify their risk, the ACE tax is neutral with respect to investment and financing. The ACE tax has the additional advantage that it is relatively easy to phase

33 Institute for Fiscal Studies, *Equity for Companies: A Corporation Tax for the 1990s*, *Report of the IFS Capital Taxes Group* (London: Institute for Fiscal Studies, 1991).

34 Boadway and Tremblay, supra note 32.

35 Ken McKenzie and Michael Smart, *Tax Policy Next to the Elephant: Business Tax Reform in the Wake of the Tax Cuts and Jobs Act*, C.D. Howe Institute Commentary no. 537 (Toronto: C.D. Howe Institute, March 2019).

36 E. Cary Brown, "Business-Income Taxation and Investment Incentives," in *Income*, *Employment and Public Policy: Essay in Honor of Alvin H. Hansen* (New York: Norton, 1948), 300-16.

37 Robin Boadway and Neil Bruce, "A General Proposition on the Design of a Neutral Business Tax" (1984) 24:2 *Journal of Public Economics* 231-39 (https://doi.org/10.1016/0047-2727(84)90026-4).

38 Supra note 33.

in, beginning with the existing CIT.[39] It can be applied to both real and financial corporate incomes in order to capture rents from financial intermediation.

A problem with both a cash flow equivalent tax and the existing CIT is that losses that are carried forward are not refunded for firms that go out of business. This is a particular problem for small, growing firms that undertake risky investments and may face credit barriers. Ideally, refundability of tax losses would address the problem, but since refundability is problematic, preferential corporate rates for small corporations is a next-best response. The rate reductions should be targeted to young firms engaged in risky investments rather than to established small firms. One way to ensure this would be to restrict eligibility by a cumulative limit on taxable income (as opposed to the annual taxable income limits that exist currently). Preferential treatment should not be extended to the passive investment income of small firms, whose owners may be high-income persons whose capital income is fully taxable.

An implication of taxing corporations on a rent tax basis is that unincorporated businesses should receive the same treatment as is recommended by the Mirrlees review. This turns small personal businesses into tax-sheltering vehicles that are akin to tax-deferred instruments. There would then be no need for special provisions to shelter family business incomes. Of course, unless there were limits on the ability to shelter income in personal businesses, these businesses would have an advantage over other tax-sheltering devices such as RRSPs, RPPs and TFSAs. Imposing comparable limits on the sheltering of normal capital income via rent tax treatment of family businesses would be administratively complicated.

A final issue is the treatment of foreign-source corporate income. Recently, it was proposed that the US corporate tax be changed into a destination-based cash flow tax.[40] The destination base would be achieved by deducting the value of exports from a firm's tax base and including imports—a model analogous to that of a destination-based value-added tax. This would effectively transfer a corporation's tax on rents from the countries where the rents originate to those where the final output of the corporation is purchased. The argument for doing this is administrative, since the destination base largely eliminates the incentive for corporations to shift profits to low-tax countries. This would allow the tail to wag the dog. There is no compelling economic or fairness case for allocating rent tax revenues to countries of final consumption. On the contrary, since rents arise from conditions in origin countries, such as resource endowments or legal and market institutions, it makes more sense for the rents to be taxed where they originate. A territorial approach to corporate

39 Other forms of cash flow equivalent taxes exist. One is the resource rent tax implemented temporarily in the Australian mining industry by the Commonwealth. See Boadway and Tremblay, supra note 32, for a description of this tax.

40 Alan Auerbach, Michael P. Devereux, Michael Keen, and John Vella, *Destination-Based Cash Flow Taxation*, Oxford University Centre for Business Taxation Working Paper no. 17/01 (Oxford: University of Oxford, Said Business School, Centre for Business Taxation, January 2017).

tax liability is reasonable, and it is the one that I propose. Of course, enforcement of the territorial approach is challenging, given the ability of firms to shift profits, and this approach remains a work in progress.

Sales Taxation

The GST/HST/QST system is a major component of the tax mix. The federal GST is, roughly speaking, a proportional tax on consumption. The HST is an imperfect consumption tax, since many provinces have not opted into it. For those that have not, business inputs are taxed, which leads to production inefficiency.[41] The main consequence of sales taxation for tax policy results from its taxing of consumption rather than income. As mentioned above, this implies that the tax system favours normal capital income over labour income. (Rents are implicitly taxed under general sales taxation.) This is consistent with the optimal income tax suggestion that capital income be taxed preferentially. Given this preferential treatment, there is no further need—apart from a desire to encourage saving for retirement—to treat capital income preferentially through the income tax system. To the extent that capital income is still taxed too heavily relative to earnings, the mix between the GST/HST/QST and the income tax could be changed.

The tax system relies on the income tax to achieve progressivity. There is no compelling reason to make sales taxation more progressive by favouring goods consumed by low-income persons. Progressivity is more efficiently achieved through the income tax system, by the use of both the rate structure and refundable tax credits.[42]

Inheritance Taxation?

Inheritance taxation has emerged as an area of policy interest. Recent evidence has emphasized the growth in wealth inequality and the extent to which inequality is transmitted across generations. Piketty[43] has argued that the growth in asset wealth relative to earnings is a natural consequence of growth, given the tendency for the return on capital to exceed the economy's rate of growth. This disparity is exacerbated by the fact that larger wealth holdings tend to have especially high rates of

41 Michael Smart and Richard M. Bird, "The Impact on Investment of Replacing a Retail Sales Tax with a Value-Added Tax: Evidence from Canadian Experience" (2009) 62:4 *National Tax Journal* 591-609 (http://dx.doi.org/10.17310/ntj.2009.4.01).

42 The Atkinson-Stiglitz theorem says that income taxation is more efficient, for redistributive purposes, than differential commodity taxes if goods are weakly separable from leisure in individual utility functions. Although weak separability may not strictly apply, the administrative costs of adopting differential commodity tax rates likely outweighs any redistributional advantage. See A.B. Atkinson and J.E. Stiglitz, "The Design of Tax Structure: Direct Versus Indirect Taxation" (1976) 6:1-2 *Journal of Public Economics* 55-75 (https://doi.org/10.1016/0047-2727(76)90041-4).

43 Piketty, supra note 14.

return, a phenomenon that may well reflect the importance of windfall gains or special advantages. On equality-of-opportunity grounds, the Mirrlees review recommended a progressive lifetime inheritance tax separate from income taxation. Although Piketty proposed an annual wealth tax to address inequality, annual inheritance taxation—which applies to an intergenerational transfer only once—seems a more appropriate instrument, as discussed in Boadway and Pestieau.[44]

The case for a tax on cumulative lifetime inheritances, with a moderately high threshold, is applicable to Canada. Taxing inheritances that are above a certain threshold would recognize that some large estates reflect windfall gains. It would also recognize that power and influence accrue to holders of significant wealth.

IMPLICATIONS FOR REFORM OF THE CANADIAN TAX SYSTEM

The discussion above suggests an agenda for tax reform that would lead to a fairer and more efficient tax system, would address the international circumstances that Canada faces, and would correspond with the principles and practices of modern tax policy. I focus on general directions for tax reform without providing the full details.

I propose that the overall personal tax base should include both labour and capital income but that capital income should be taxed more favourably than labour income. This would be analogous to the dual tax systems in the Nordic countries, except that the tax on capital income would be progressive. The Nordic dual income tax system is progressive with respect to earnings, but capital income is taxed at a low linear rate.[45] A progressive tax on capital income is fairer and captures some associated rents that accrue especially to higher-income taxpayers.

Differential taxation of capital and labour income differs from the comprehensive income taxation of the Carter report, but it would not represent a fundamental change in current practice. The mix of broad-based income taxation with a consumption-based GST/HST/QST implies lower tax rates on normal capital income versus labour income, taxation of above-normal returns on capital, and progressive taxation of capital income. Since neither the capital income tax nor the sales tax systems are completely broad-based, further reform is needed.

In the case of sales taxation, the HST is effectively a tax-deferred sheltering device that exempts normal capital income but includes unexpected or windfall returns to assets. The system does not fully apply in five provinces, four of which maintain inefficient retail sales taxes. A priority for federal tax policy is to continue to pursue HST agreements for provinces that have yet to join.

44 Robin Boadway and Pierre Pestieau, *Over the Top: Why an Annual Wealth Tax for Canada Is Unnecessary*, C.D. Howe Institute Commentary no. 546 (Toronto: C.D. Howe Institute, June 2019).

45 Robin Boadway, "The Dual Income Tax System—An Overview" (2004) 2:3 *CESifo DICE Report* 3-8.

Important exceptions to the uniform capital taxation are exemptions due to either tax sheltering or special treatment of particular types of capital income. Tax sheltering is warranted to the extent that it encourages saving for retirement, but the system of RRSPs, RPPs, and TFSAs has structural deficiencies. Contributions to RRSPs and RPPs together are limited, but their limit is independent of contributions to TFSAs, and vice versa. It is important to recognize that tax-prepaid instruments such as TFSAs and housing differ from tax-deferred instruments such as RRSPs and RPPs. The latter shelter only normal capital income, while the former shelter all capital income, including windfalls; therefore, there is a case for favouring tax-deferred devices over tax-prepaid ones. This suggests that significantly lower limits should be imposed on TFSA contributions than on RPPs and RRSPs. Moreover, given that the rationale for tax sheltering is to encourage saving for retirement on the basis that individuals do not save enough if left to their own devices, some penalty should apply on early withdrawals.

An anomalous form of tax-prepaid sheltering is housing. Returns to housing, which can include windfall capital gains, are fully sheltered without limit. Housing is an important component of intergenerational transfers. It is also an asset that households use to save for retirement. Given this fact, sheltering of housing, like other asset sheltering, should be limited. Since measuring the full imputed returns to housing is difficult, and since housing is to some extent taxed already through the property tax, a pragmatic approach would be to tax capital gains in excess of some threshold. As with other capital gains, deemed realization would apply on death, although this would have to be coordinated with an inheritance tax, which I propose below as a longer-run tax reform.

Three further reforms to individual capital income taxation follow from our proposal that business taxation be reformed into a tax on rents, as discussed below. First, the case for integrating the PIT and CIT is weak, given the estimated shifting of the CIT to labour income earners and the fact that much capital income is sheltered from the PIT. The case becomes even weaker in the light of our proposal to reform the CIT into a rent-based tax. The dividend tax credit largely serves to shelter equity income and encourage saving, so it should be eliminated. In addition, no strong case exists for the capital gains exemption, and it too should be abolished. Although nominal capital gains are taxed, this taxation is offset, at least in part, by the benefits of sheltering, given that accrued capital gains are not taxed until they are realized. This is also consistent with our proposal to tax capital gains from housing above some exemption level. Second, personal unincorporated businesses would be taxed on a rent tax basis, through an approach similar to the one used for corporations (discussed below). This implies that these businesses are sheltered on a tax-deferred basis. Third, the LCGE could be abolished, since its main purpose is to be a tax-sheltering device, which is no longer necessary if business income taxation takes the form of a tax on rents.

Now consider the tax treatment of business income. The intention of the current CIT system is to tax at source income earned by the corporation on behalf of shareholders, in order to preclude the postponing of personal taxation. The tax base of unincorporated business income accords with the same withholding aspiration. As more shareholder income becomes sheltered at the personal level, and as evidence mounts that much of the CIT is shifted to labour, the withholding rationale loses force. At the same time, the evidence (cited above) indicates that a substantial share of corporate income consists of above-normal returns. This suggests that although the CIT is not needed as a withholding device against shareholder income, it is useful as a device for taxing rents at source. A tax on rents represents an efficient source of tax revenues. A cash flow corporate tax or its present-value equivalent is analogous to a rent tax, where annual cash flows include annual revenues less annual expenditures, including actual investment spending. No further deductions would be given for either the depreciation of assets or the costs of financing, and accounting could be in cash rather than in accrual terms, which would simplify the tax system. Ideally, negative and positive cash flows should be treated symmetrically in order to maintain the neutrality of the CIT, either by the offer of refundability or, more likely, by the carryforward of tax losses indefinitely, with interest. To the extent that corporations are risk-averse, the cash flow tax applies to the risk premium. This cannot be avoided, but its effects can be mitigated by full loss-offsetting.

A tax that is analogous to cash flow taxation in present-value terms is the ACE tax discussed above. It differs from the current system by allowing a cost-of-finance deduction using a normal cost of finance for all equity-financed investments, as well as by allowing tax losses to be carried forward with interest. It has the advantage of being a fairly straightforward reform of the existing system, but it has two disadvantages. It retains accrual accounting, and it requires the choice of a normal cost of finance for the cost-of-equity deduction.

Cash flow taxation or its equivalent removes the distortions that the existing tax system imposes on the extent of investment and the form of financing of the firm. However, it does not eliminate the effect of the CIT on corporate location or on the shifting of profits. These depend on the average tax rate and the statutory tax rate, respectively. The recent proposal by Auerbach, Devereux, Keen, and Vella[46] for a destination-based cash flow tax was intended to remove the incentive for corporations to locate their profits in a tax-favoured country. However, the destination principle would entail that rents generated by the attributes and institutions of one country would accrue to countries where final sales happen to be made, and this violates reasonable tax principles. Our preference would be the territorial taxation of corporate profits, with tax compliance and enforcement being pursued by other means. This would be consistent with the system toward which the United States is moving.

The cash flow principle would also apply to small businesses, both corporations and unincorporated businesses. A convincing case can be made for the preferential treatment of CCPCs, with targeted provisions. Small corporations that are new and

46 Supra note 40.

growing are typically highly risky. They have significant probabilities of being unsuccessful, and they face credit constraints. The CIT can exacerbate these problems to the extent that loss-offsetting is imperfect. If governments are willing to allow tax losses to be carried forward and offset only against future income, unsuccessful firms that go out of business with tax losses on their books will face a disadvantage. The tax system will tax positive gains but may not refund losses, so the tax system increases riskiness. In these circumstances, taxing small businesses at preferential rates reduces the disadvantage in ways that other incentives, such as faster investment writeoffs, do not. Thus, the SBD is a useful instrument, but it should be designed to target small, growing firms and not established ones that face little risk. To achieve this, eligibility for the SBD should be subject to a cumulative income limit rather than simply an annual one. As well, the carryforward of losses should be with interest, and of long duration. To further address the financing and riskiness issues faced by small firms, consideration could be given to allowing refundability of at least some of the costs of hiring labour by firms eligible for the SBD.

Other details of corporate tax design have been discussed elsewhere—for example, the taxation of natural resource rents and the harmonization of natural resource taxes and the CIT; tax incentives for research and development; and the tax treatment of patent income.[47]

Now consider PIT progressivity. Despite the progressive rate structure, overall progressivity is undermined at the top by exemptions from the tax base and by an absence of progressivity at the bottom. The proposals above for reforming the taxation of capital income—especially the elimination of the capital gains exemption and dividend tax credit, and the taxation of large housing capital gains—would significantly improve progressivity at the top. At the bottom, I would propose a three-pronged reform of NRTCs. First, consolidate those credits that serve mainly a redistributive role, such as the age and pension credits, the employment credit, and several minor credits. Some of these credits are redundant, and others are discriminatory. Second, make them refundable so that they benefit those who need them most. Finally, make them conditional on income. This reform of the NRTCs would represent the beginning of a basic income guarantee, which, if combined with the reform of provincial social assistance systems as proposed by Boadway, Cuff, and Koebel,[48] would result in a federal-provincial income guarantee of substantial

47 Boadway and Tremblay, supra note 32; Robin Boadway and Benjamin Dachis, *Drilling Down on Royalties: How Canadian Provinces Can Improve Non-Renewable Resource Taxes*, C.D. Howe Institute Commentary no. 435 (Toronto: C.D. Howe Institute, September 2015); Robin Boadway, "The Canadian Corporate Income Tax at 100 Years of Age: Time for a Change?" in Jinyan Li, J. Scott Wilkie, and Larry F. Chapman, eds., *Income Tax at 100 Years: Essays and Reflection on the Income War Tax Act* (Toronto: Canadian Tax Foundation, 2017), 9:1-27; and Robin Boadway and Jean-François Tremblay, "Policy Forum: The Uneasy Case for a Canadian Patent Box" (2017) 65:1 *Canadian Tax Journal* 61-72.

48 Boadway, Cuff, and Koebel, "Designing a Basic Income Guarantee for Canada," supra note 30.

size. This would combine a basic income guarantee with a tax-back rate, and it would be superimposed on the PIT system.

For those economists, such as Kesselman[49] and Osberg,[50] who worry that a basic income guarantee would focus too much on providing income for those who choose not to work, the CWB could be enhanced and integrated with refundable tax credits, as described by Koebel and Pohler.[51] As I stressed above, however, the success of the CWB depends on those who choose to participate in the labour force actually finding jobs, so it cannot displace the need for an income guarantee for those who are not employed.

To further improve fairness, general income averaging could be re-instituted. The case for this is apparent, given the recent finding by Garcia-Medina and Wen[52] that since the mid-1990s, the Canadian tax-transfer system has become less effective at reducing market-induced income volatility. A design feature of income averaging that would have to be chosen would be the number of tax years over which averaging should apply. Since this would be less than a lifetime, self-averaging through the mix of tax-prepaid and tax-deferred sheltering devices would be a useful supplement.

In the long term, inheritance taxation could be revisited. The case for the inheritance tax is partly based on equality of opportunity, especially the extent to which wealth inequality is transmitted across generations. Moreover, a significant proportion of the returns on large estates represent past rents. Introducing an inheritance tax would be a major reform, and it would probably face political obstacles. The Mirrlees review recommended a cumulative lifetime inheritance tax with a sizable exemption level.

SUMMARY

The reforms suggested above are best thought of as reform ideas, in the sense that the full details remain to be worked out. Despite the lack of detailed proposals, I regard these reforms as feasible from an administrative and compliance point of view. To recapitulate, my main ideas for reform are as follows:

- Maintain the system of preferential taxation of capital relative to labour income that is achieved by the combination of comprehensive income and the GST/HST/QST system, and pursue HST adoption by those provinces that retain retail sales taxation.

49 Jonathan Rhys Kesselman, "Can 'Self-Financing' Redeem the Basic Income Guarantee? Disincentives, Efficiency Cost, Tax Burdens, and Attitudes" (2018) 44:4 *Canadian Public Policy* 423-37 (https://doi.org/10.3138/cpp.2017-064).

50 Lars Osberg, *The Age of Increasing Inequality: The Astonishing Rise of Canada's 1%* (Toronto: Lorimer, 2018).

51 Koebel and Pohler, supra note 31.

52 B. Cecilia Garcia-Medina and Jean-François Wen, "Income Instability and Fiscal Progression" (2018) 51:2 *Canadian Journal of Economics* 419-51 (https://doi.org/10.1111/caje.12326).

- Tax all capital income except tax sheltering that encourages saving for retirement.
- Maintain lower contribution limits on TFSAs relative to RPPs and RRSPs.
- Penalize withdrawals from sheltered savings plans before retirement.
- Tax capital gains on owner-occupied housing beyond some threshold.
- Eliminate the integration of the PIT and CIT by abolishing the dividend tax credit and the capital gains exemption, as well as the LCGE.
- Use the territorial principle to tax all business income based on rents, and allow the carryforward of losses with interest.
- Retain the SBD, but impose a cumulative income limit.
- Combine NRTCs that serve vertical equity into a single refundable and income-tested credit.
- Enhance the CWB and integrate it into the reformed system of refundable tax credits.
- Institute general income averaging.
- In the long run, contemplate a cumulative lifetime tax on inheritances.

The revenue consequences of these proposals are ambiguous. In previous studies, partial implementation of some of these reforms was found to be roughly revenue-neutral. For example, Boadway and Tremblay[53] found that the combination of a move to a rent-based CIT and the elimination of integration measures was roughly revenue-neutral. In addition, Boadway, Cuff, and Koebel[54] showed that a basic income guarantee could be financed by making NRTCs both refundable and income-contingent and by using revenues from provincial welfare systems.

53 Boadway and Tremblay, supra note 32.

54 Boadway, Cuff, and Koebel, "Designing a Basic Income Guarantee for Canada," supra note 30.