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A Primer on Tax Expenditures

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A Primer on Tax Expenditures

(In Brief)

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A PRIMER ON TAX EXPENDITURES[*]

1 INTRODUCTION

In addition to its use as a means by which to raise revenue, the tax system may be used by the federal government as an instrument of public policy to achieve various economic and social objectives. To this end, the government has implemented a number of tax measures – such as exemptions, deductions, rebates, deferrals or credits – that are generally referred to as tax expenditures; they represent a cost to the federal treasury because they reduce government revenues. The Department of Finance publishes annual estimates in its publication entitled *Tax Expenditures and Evaluations*.

The use of tax expenditure estimates as a public policy tool has been criticized on several grounds. First, these estimates do not take into account the possibility that taxpayers may change their behaviour in response to a tax measure. For example, it is possible that taxpayers may give less to charity in the absence of the charitable donation tax credit. Second, it has been argued that determining which tax measures constitute tax expenditures involves a value judgment; for example, measures such as the basic personal amount or the foreign tax credit may be considered by some countries to be a tax expenditure while other countries may deem such measures to be part of the benchmark tax structure.[1]

Nevertheless, if the tax system is to be used as a public policy tool, policymakers should have information with which to assess the implications, costs and benefits of proposed tax measures. Since governments can use either tax measures or program spending to achieve their public policy goals, the value of tax measures may be assessed in light of the cost of programs that might achieve the same objective.[2]

Table 1 shows the projected value of selected federal tax expenditures for the 2010 taxation year. In total, more than 200 federal tax measures are considered as tax expenditures and are listed by the Department of Finance in *Tax Expenditures and Evaluations*.[3]

Table 1 – Projected Value of Selected Federal Tax Expenditures, 2010 ($ billions)

Personal Income Tax	
Registered pension plans (RPPs)	11.620
Registered retirement savings plans (RRSPs)	7.315
Non-taxation of capital gains on principal residences	3.930
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Zero-rated and exempted goods and services	7.875
Rebates for municipalities, hospitals, not-for-profit and charitable organizations, and academic institutions	3.650
Goods and Services Tax/Harmonized Sales Tax credit	3.850

Source: Department of Finance, *Tax Expenditures and Evaluations 2010*.

2 PERSONAL INCOME TAX

The personal income tax system provides a range of deductions, credits and other tax measures designed to achieve public policy objectives. Personal income tax measures sometimes take into account individual circumstances, such as disability or age, which could influence a taxpayer's ability to pay income tax. These measures can also provide incentives to engage in socially desirable activities, such as saving for retirement or donating to charity.

Registered pension plans (RPPs) and registered retirement savings plans (RRSPs): Contributions to RPPs[4] and RRSPs,[5] as well as investment income earned in these plans, are not subject to taxation until they are withdrawn. RPPs and RRSPs are designed to encourage Canadians to save for retirement, which may in turn reduce federal expenditures in support of older residents; general savings vehicles, such as Tax-Free Savings Accounts, can also be used to save for retirement.[6] Taxpayers can deduct RRSP contributions, from their taxable income, of up to 18% of their earned income in the preceding year, to a maximum of $22,450 for the 2011 taxation year; the contribution limit is lower if RPP contributions are made. Unused RRSP contribution room is carried forward to future years.

Non-taxation of capital gains on principal residences: Taxpayers are not required to include, in their taxable income, capital gains resulting from the sale, or deemed sale, as prescribed in the *Income Tax Act*, of their principal residence. This tax measure recognizes that principal residences are generally purchased to provide basic shelter and not as an investment.[7]

Non-taxation of employer-paid health and dental benefits: In general, the monetary value of "fringe benefits" provided by employers to their employees are to be included in employees' income as a taxable benefit, with some exceptions; in the *Income Tax Act*, certain benefits are specified as tax-free so as to encourage businesses to provide these benefits to their employees. One example is employer-paid benefits for private health and dental plans, the premiums of which are deductible business expenses for employers and are not classified as a taxable employee benefit.

Partial inclusion of capital gains: Taxpayers must include, in their taxable income, 50% of the amount of any capital gain resulting from the sale, or deemed sale, as prescribed in the *Income Tax Act*, of real property that is not their principal residence. The purpose of this reduced rate of inclusion for capital gains is to provide taxpayers with an incentive to invest in capital property, to account for the effect of inflation and to ensure tax treatment that is comparable to that of other countries. The value of the tax expenditure is the additional tax that would have been collected had the full amount of the capital gain been included in income.

3 CORPORATE TAX

Like the personal income tax system, the corporate tax system also includes tax measures designed to achieve public policy objectives, such as encouraging business investments, contributions to charitable organizations and the growth of small businesses.

Lower tax rate for small businesses: Small corporations are entitled to a relatively lower tax rate, a measure that is designed to provide them with more after-tax income for reinvestment and expansion. Certain small Canadian-controlled private corporations (CCPCs) – basically, corporations not controlled by a non-resident or by a public corporation and with capital not exceeding $10 million – are, at present, taxed at a lower corporate tax rate of 11% on their first $500,000 of taxable income. For CCPCs with capital exceeding $15 million, the corporate tax rate on general income is applicable. For CCPCs whose capital is between $10 million and $15 million, the small business deduction threshold of $500,000 is reduced at a rate of $1 per $10 of capital exceeding $10 million; the small business deduction is applicable to taxable income below the lowered threshold.

Non-capital loss carry-overs: Non-capital losses, which are ordinary business losses that are not related to the sale of capital property, can be carried backward or forward a certain number of years to reduce business income. In particular:

- non-capital losses that arise in taxation years ending after 31 December 2005 may be carried backward 3 years and forward 20 years;
- non-capital losses incurred in a taxation year that ended after 22 March 2004 and before 31 December 2005 may be carried backward 3 years and forward 10 years; and
- non-capital losses incurred in a taxation year that ended before 23 March 2004 were permitted to be carried backward 3 years and forward 7 years.

The objective of these carry-over provisions is to reduce investment risk and provide tax relief to cyclical businesses.

Scientific Research and Experimental Development (SR&ED) Investment Tax Credit: The SR&ED investment tax credit is the largest single source of support from the federal government for research and development, and is intended to encourage firms to undertake research and development activities in Canada; the economic benefits of SR&ED activities are not limited to the private interests of the firms undertaking the research, since the economy also benefits from technological advances, resulting in productivity growth. The basic SR&ED tax credit, which is available to all Canadian corporations, proprietorships, partnerships and trusts, has a value of 20% of qualified expenditures, is non-refundable and may be carried backward 3 years or forward 20 years to reduce the corporation's tax liability. Small Canadian-controlled private corporations benefit from a more generous refundable investment tax credit of 35% on the first $3 million of SR&ED expenditures and 20% on any additional SR&ED expenditures, up to an expenditure limit of $2 million.

Partial inclusion of capital gains: Like individuals, corporations include 50% of the amount of any capital gain resulting from the sale, or deemed sale, as prescribed in the *Income Tax Act*, of real property in their taxable income. This tax measure provides an incentive to invest in capital property, ensures comparable tax treatment of capital gains internationally and takes into account the effect of inflation. The tax measure has a value that is equal to the additional tax that would have been collected had the full amount of the capital gain been included in income.

Exemptions from non-resident withholding tax: Generally, non-residents who receive certain income from a Canadian source must pay a non-refundable withholding tax of 25%; the tax is submitted by the Canadian source and is applied on the gross value of the payment to the non-resident. The types of income subject to non-resident withholding tax include interest payments, dividends, rents and royalties; management and administration fees; and certain pension, annuity and other payments.

There are a number of exemptions from withholding tax for corporations under the *Income Tax Act*. For example, exemptions are available for certain dividend payments made by foreign companies operating in Canada. There are also exemptions for interest payments from corporations to unrelated non-residents. These exemptions are in addition to any reductions or exemptions negotiated by the federal government through bilateral tax treaties.

4 GOODS AND SERVICES TAX/HARMONIZED SALES TAX

The Goods and Services Tax/Harmonized Sales Tax (GST/HST) is a value-added tax collected at every stage of the production process on most goods and services sold in Canada. Since businesses can generally recover the GST/HST paid on purchased inputs, the final customer bears the full cost of the tax.

Some goods and services are zero-rated: suppliers do not have to collect GST/HST and can claim the GST/HST paid on their purchased inputs. Others are exempt:

suppliers do not have to collect GST/HST but cannot claim the GST/HST paid on their purchased inputs. The zero-rated or exempt status of some goods and services is intended to achieve public policy objectives. For example, the zero-rating of basic groceries is designed to improve the fairness of the sales tax system, since low-income households tend to spend a larger share of their income on such items. Moreover, some agricultural and fishing equipment is zero-rated in order to improve the cash flow of farmers and fishers. Other zero-rated goods and services include prescription drugs and medical devices. Exempt goods and services include health care and education services.

A number of specific sectors or services benefit from GST/HST rebates on their purchased inputs. Municipalities, universities, colleges, elementary and secondary schools, and hospitals receive full or partial rebates on the GST/HST paid on their purchased inputs. The rates of the rebates were initially set at a level that ensured that the sales tax burden did not increase for these sectors as a result of moving from the previous federal manufacturers' sales tax to the GST in 1991. Registered charities and not-for-profit organizations also benefit from a partial GST/HST rebate to compensate them for the GST/HST paid on their purchased inputs. Furthermore, low-income individuals and families can benefit from a GST/HST credit to offset all or part of the GST/HST that they pay.

5 INTERNATIONAL CONTEXT

Countries vary widely in their use of tax expenditures. Anglo-Saxon democracies tend to use tax expenditures extensively for social purposes; some countries, such as Australia and Norway, use tax expenditures primarily for retirement savings. However, others, such as Sweden, tend not to use tax expenditures but rely more on direct spending to achieve social policy goals.[8]

In 2010, the Organisation for Economic Co-operation and Development (OECD) reported on the use of tax expenditures by 10 OECD member countries.[9] The report indicated that comparing tax expenditures internationally is a difficult exercise with limited results, due to differences in how countries define their benchmark tax structure and in how tax expenditures are identified.[10] Countries with elaborate benchmark tax structures might include certain tax measures within their structure that other countries with less detailed benchmark tax structures might identify as tax expenditures.

Generally, the OECD found that countries with a greater number of tax expenditures tended to have larger overall values of tax expenditures. Regarding the distribution of tax expenditures, using the latest data available for each country, the OECD determined that Canada, the United Kingdom and the United States had allocated relatively significant shares of their tax expenditures to retirement savings, while Germany, the United Kingdom and the United States had designated relatively large shares of tax expenditures for housing; Canada, the United Kingdom, the United States and Germany had also provided significant tax relief for income from capital, such as capital gains, interest and dividends.

In general, differences were also observed across countries regarding the value of tax expenditures as a percentage of income tax revenues, with 59.3% in Canada and

58.0% in the United States, compared to 8.8% in Germany and 9.6% in the Netherlands.[11] Some suggest that such differences across countries reflect institutional design: countries with several levels of government find it relatively more difficult to introduce direct spending programs and thus rely on tax expenditures to promote social policy objectives. Others argue that the political culture of the country is the reason for the use of tax expenditures: countries that face demands for improved social benefits without increases in taxes collected tend to use tax expenditures to meet these demands rather than engage in direct spending on social programs.[12]

NOTES

* This publication is an updated and revised version of *A Primer on Tax Expenditures*, prepared on 27 August 2007 by Philippe Bergevin and Alexandre Laurin, formerly of the Library of Parliament.

1. The benchmark tax structure of a country refers to the basic structural elements of its tax system. It includes the rate structure, accounting conventions, the deductibility of compulsory payments, provisions related to administration and international fiscal obligations. As the benchmark tax structure is defined by each country, it can differ – at times greatly – among countries.
2. In the Department of Finance's *Tax Expenditures and Evaluations* annual publication, the term "value" is used to describe the tax revenue foregone as a consequence of the tax measure.
3. The estimated value of individual tax expenditures should not be added together to determine the estimated overall value since, due to the progressive nature of the personal tax system and interactions among individual tax expenditures, the sum would not accurately reflect the combined effect of related tax measures.
4. A registered pension plan, or RPP, is an arrangement by an employer or a union to provide pensions to retired employees in the form of periodic payments. Normally, employers and employees make contributions to the plan, although there are RPPs to which only the employer contributes.
5. A registered retirement savings plan, or RRSP, is a savings vehicle into which tax-deductible contributions are made by individuals up to a maximum age of 71. Investment earnings that are maintained in the RRSP are tax-free, although payments from the plan, whether they are out of contributions or investment earnings, are taxable.
6. Canadian residents aged 18 or older can contribute up to a specified annual limit to their Tax-Free Savings Account, which is permitted to earn tax-free investment income. The limit was $5,000 in 2009 when the measure was introduced, and is indexed to inflation and rounded to the nearest $500 in later years. Unused contribution room can be carried forward to future years.
7. Edgar J. Benson, *Summary of 1971 Tax Reform Legislation*, Department of Finance, Ottawa, 1971.
8. Christopher Howard, "The Politics of Tax Expenditures in Wealthy Democracies," in *Tax Expenditures: State of the Art*, ed. Lisa Philipps, Neil Brooks and Jinyan Li, Canadian Tax Foundation, Toronto, 2011, pp. 7:1–7:20.

9. Organisation for Economic Co-operation and Development, *Tax Expenditures in OECD Countries*, Paris, 2010. The countries that were analyzed were Canada, France, Germany, Japan, Korea, the Netherlands, Spain, Sweden, the United Kingdom and the United States. The OECD compared tax expenditures for those years in which final tax expenditure figures were available: 2004 for Canada, 2006 for Germany, 2006 for the Netherlands and 2008 for the United States.

10. As mentioned in an earlier note, in the Department of Finance's *Tax Expenditures and Evaluations* annual publication, the term "value" is used to describe the tax revenue foregone as a consequence of the tax measure.

11. The OECD compared tax expenditures for those years in which final tax expenditure figures were available: 2004 for Canada, 2006 for Germany, 2006 for the Netherlands and 2008 for the United States.

12. Howard (2011), p. 7:6.