FEI CANADA 2008 PRE-BUDGET CONSULTATION TO THE HOUSE OF COMMONS STANDING COMMITTEE ON FINANCE

AUGUST 15, 2008

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Mr. Rob Merrifield, MP
Chair, Standing Committee on Finance
House of Commons
Ottawa, Canada
K1A 0A6

Dear Mr. Merrifield,

Financial Executives International Canada (FEIC) is pleased to respond to the House of Commons Standing Committee on Finance (FINA) invitation to present a submission to FINA's 2008 fall pre-budget consultation. As an organization representing more than 2,100 senior Canadian financial executives, FEIC is acutely aware of the need to develop a taxation system which encourages savings and investment; fosters innovation, productivity and initiative; and enhances the economic and social well-being of all Canadians by eliminating unnecessary barriers to economic growth.

EXECUTIVE SUMMARY

Our submission addresses a fundamental concern of our members; the need for a thorough review of the tax system with the objective of eliminating anomalies and inconsistencies, undue complexity, and detailed provisions which no longer fulfill government policy objectives. A simple tax system increases compliance and fairness, reduces unnecessary compliance and administration costs, increases the certainty and predictability of the tax consequences of transactions, and enhances the efficiency of the Canadian economy. Three current issues (sales tax harmonization, the overly complex CCA system, and the inability to file group tax returns), and two potential issues (provincial carbon taxes and the conversion of financial reporting to international standards) are provided as examples of undue complexity. Reduced compliance costs will improve business productivity and reduce uncertainty, thus improving Canada's competitiveness and assisting in increased production and wealth creation.

THE NEED FOR SIMPLIFICATION

> *"Compliance costs draw resources from the economy that could otherwise be used for producing goods and services that are a benefit to Canadians. Efforts to reduce compliance costs can improve prospects for economic growth and job creation and can promote fairness in the tax system."* [1]

Canada introduced federal corporation income tax in 1916, and in 1917 enacted the Income War Tax Act. This "temporary war measure", which introduced federal personal income tax to Canada, was only eleven pages long, much shorter than the current Income Tax Act (the Act), which contains over 2,800 pages of legislation, notes and references.

Simplicity is a fundamental principle of a normative tax system. Simplicity refers to the degree of difficulty experienced by taxpayers in understanding and complying with the Act. In a simple system, the taxpayer is able to comprehend the basic principles and compliance requirements. The system is stable and predictable, both for government and the taxpayer, yet detailed enough to meet government objectives. Administration and compliance costs are as economical as is compatible with the objectives of the tax system. The tax is relatively easy to assess and collect. The timing and manner of filing are as convenient as possible for the taxpayer. The tax consequences of transactions and decisions are certain and predictable in advance. For each transaction, the taxpayer knows who is taxable, the tax base, the rate of tax, when tax is payable, and how the tax should be paid.

In spite of many attempts to simplify the Act, most notably in the small business area, one could not suggest that our present Act is a simple document. Indeed, the Act is now so complex that even seasoned and experienced tax professionals have great difficulty understanding its more obscure sections.

As noted in our April submission to this Committee[2]:

> *"Canada's tax system is overly complex. The current tax system is a patchwork quilt of overlapping tax measures, regulations and CRA administrative practices. All too frequently, tax practitioners and corporate tax managers*

[1] Canada: Department of Finance. "Report of the Technical Committee on Business Taxation". December 1997, p. 10.1.
[2] FEIC. (2008). "Submission to House of Commons Standing Committee on Finance: Study on Structure of Canada's Revenue-Raising System". (April)

> *resort to detailed technical notes to determine the meaning of many budget measures. Consequently, the costs of complying with the tax system are excessive. FEIC believes that Canada's economy will grow at a much faster rate if the talented individuals working on corporate and individual tax reduction strategies could turn their attention to business generation initiatives."*

Complexity puts compliance at risk. According to the OECD[3], "Less complexity … leads to an increase in tax compliance". Complexity creates compliance errors, a perception of unfairness, and disrespect for the law. A complex system cannot be certain, predictable, transparent, neutral or fair. Such a system wastes resources on compliance and administration.

Simplicity leads to greater certainty/predictability in determining the tax consequences of proposed transactions, enhances taxpayer awareness and acceptance of the tax system, provides a greater sense of fairness, and increases accountability.

Blind pursuit of simplicity for its own sake is not our objective. We understand a certain degree of complexity is necessary to facilitate the computation of taxable income or taxes payable, to counteract or mitigate abuses, and to deliver incentives, which necessitates detailed rules to determine eligibility.

Compliance costs are determined by the complexity of the tax system and the language of the Act. Financial, time and economic costs are incurred in complying with the Act. The time taxpayers devote to preparing tax returns, keeping records, and planning and implementing tax strategies is time that is not spent managing the business.

Ease of computation is essential in reducing complexity. Whereas the intent of current tax law is generally well understood by tax professionals, the significant number of ordinary Canadians who resort to external tax preparers suggests they encounter great difficulty unraveling the complexities of the Act.

Certainty or predictability of the tax consequences of a proposed transaction is essential to tax planning. Even simple tax planning requires that the amount of tax payable on a given transaction be readily determinable. However, this is not the current situation. For example, the tax cost of many capital transactions cannot be precisely computed because of, for instance, the availability of losses and progressive tax rates. Certainty and predictability not only aid the taxpayer, but as the tax yield should be relatively certain, government budgeting can be more accurate.

Compliance costs can be reduced if a tax measure is implemented through an existing tax structure and/or the number of collection points is kept to a minimum. Where collection costs are lower on one taxpaying unit than another, the tax should be directed there. The personal and corporation income tax systems are relatively straightforward on this count. However, the various sales tax systems create an endless paper burden problem for businesses, especially smaller firms.

By improving the efficiency of the assessment process and tax reporting, by simplifying the language of the tax code, or by improving the perceived fairness of a self-assessment system, cost reduction can be achieved, compliance increased and additional revenues generated.

FEIC recommends that the Act be thoroughly reviewed with the objective of eliminating complexity. In particular, this is directed to those aspects of the Act which (a) do not lead to economic efficiency, growth and/or increased competiveness, (b) create excessive compliance costs vis-à-vis their policy objectives, and/or (c) are inconsistent with the above noted characteristics of a simple tax system.

The remainder of this submission outlines three current tax issues, the proliferation of CCA classes and their related rules, the inability of Canadian corporations to file group tax returns, and the non-harmonization of sales taxes, and two potential issues, the introduction of carbon taxes and adoption of International Financial Reporting Standards (IFRS) by Canadian public corporations, where complexity can be reduced.

CURRENT ISSUES

1. Sales Tax Harmonization

FEIC recommends that the federal government work with its provincial partners to achieve a national Harmonized Sales Tax.

3 OECD. Centre for Tax Policy and Administration. "Tax Policy Conclusions", p. 6. (undated)

Sales tax harmonization is the leading issue on which virtually all Canadian corporate executives agree. A harmonized sales tax makes for a more efficient tax system, is less susceptible to avoidance, and simple to achieve. Numerous Finance announcements and international organizations have also called for greater harmonization. Harmonization will decrease compliance and administration costs. Corporations which operate in more than one province will have one set of rules, one filing requirement, and one audit obligation. Harmonization streamlines the cost of auditing sales tax registrants. Experience in the now harmonized provinces indicates that consumers benefit, businesses achieved greater efficiency, and compliance costs have been reduced.

2. Classes of Capital Cost Allowance (CCA)

Because of their impact on after-tax cash flows, CCA rules are critically important to corporate management.

FEIC recommends that the CCA classes be reduced to 10 comprehensive classes, as in numerous European countries, and that inconsistencies and anomalies which no longer serve a public policy purpose, be eliminated. Two or three of these classes could be accelerated classes on selected asset acquisitions.

The CCA system has been an area of frequent government tinkering, made easier because it is governed by Regulations. Finance has established a standard system, albeit arbitrary and heavily policy influenced, for writing-off depreciable assets. Subsection 13(21) (definition of “undepreciated capital cost”), an inordinately complex provision, outlines the framework of the CCA system.

Detailed rules in Schedule II of the Regulations are required to define depreciable property included in each CCA class. There are currently 38 declining balance classes, approximately 10 straight-line classes, and numerous “additional allowance” provisions, outlined in approximately 24 pages. Many similar assets appear in two or more classes. The placing of similar assets into different classes reflects changes in government policy over time. To encourage the acquisition of certain assets, new classes have been created with a higher CCA rate than prior acquisitions of that asset. When changes in government policy have resulted in acceleration or reduction in the annual deduction, current acquisitions are assigned to a class with a higher or lower rate.

Regulation 1100(1)(a) sets out the maximum annual write-off rate (from 4% to 100%) for each class. Conceptually, these rates establish annual temporary allowances, which are adjusted when the asset is disposed of. Although from a purely economic perspective CCA is intended to reflect the reduction in value of a depreciable asset through use or obsolescence over time, overall the CCA rates generally have little relation to economic life.

There are approximately 40 pages of detailed rules in Regulations 1100 to 1106 related to the half-year and available-for-use rules, leasing and rental properties, separate class requirements, and specific sectors such as the film industry and natural resources.

Each budget adds additional complexity as Finance fine-tunes certain regulations or provides incentives for specific investments by creating new classes or amending the rules related to existing classes. While there are policy reasons for the constant juggling of the CCA system, the present system is excessively costly in compliance cost terms. Thus, a thorough review is required to simplify the CCA system as has been done in several European countries which have reduced the number of classes.

3. Group Reporting

FEIC recommends that FINA urge the government to implement either group tax consolidation or a loss transfer system.

Our competitors in the U.S., Britain, the European Union and Mexico are permitted to file either a consolidated group tax return or transfer losses within a corporate group. Of the two systems, a loss transfer system is much simpler to implement than tax consolidation. FEIC research[4] has shown that some Canadian companies spend more than $500,000, and consume over 1,000 person years, devising strategies to accomplish the same objective as group reporting, essentially a revenue neutral policy over time. Implementing group reporting would increase the competitiveness of Canadian corporations, decrease their compliance costs, and allow corporate tax managers to spend more time advancing the corporate objectives of economic growth and profitability.

[4] Gorman, F. Barry. (2002). “Corporate Group Reporting: An Old Chestnut Worth Revisiting?” FEIC Submission to the House of Commons Standing Committee on Finance. (September)

While we anticipate some objection from the provinces, our recommendation would make Canada's tax system more efficient. If the provinces do not accept group reporting, it would be worthwhile implementing this measure on a federal only basis.

EMERGING ISSUES

1. Carbon Taxes

FEIC recommends that the government create a consistent framework for provinces which adopt a carbon tax.

British Columbia and Quebec have recently introduced carbon taxes. Other provinces have commenced studies on some form of carbon taxation. In a worst case scenario, Canada could end up with differential carbon taxes in each province, which, similar to the provincial sales tax regimes, would result in inconsistent application bases, rules, and administration provisions. If we are to have a carbon tax, national consistency in its implementation is essential.

2. International Financial Reporting Standards

FEIC recommends that the government review International Financial Reporting Standards to ensure that their adoption does not increase the complexity of the tax system.

Canadian public corporations are required to adopt IFRS on January 1, 2011. Although primarily a financial reporting issue, adopting IFRS, especially the transition rules, will have significant consequences for the income tax system. Although only a few tax provisions directly incorporate generally accepted accounting principles, they are indirectly the default authority for determining net income from a business in the absence of a specific tax rule.

Previous experience with the introduction of new regulatory standards indicates that compliance and administration costs tend to exceed those anticipated by the drafters of the new regulations. For example, FEIC research[5] indicated that the costs of implementing MI 52-111, the proposed regulations intended to impose internal control regulations on Canadian listed corporations, were excessive vis-à-vis the policy objectives of the proposals. Eventually, the Regulations were relaxed to achieve greater balance between cost and policy objectives. Given the immense cost of implementing IFRS, any tax-related distortions and anomalies must be resolved before IFRS become mandatory. Taxpayers will be well served if Finance provides tax-related transition rules well in advance of the 2011 conversion.

CONCLUSION

In summary, this submission has advocated a thorough review of the tax system with the view to simplifying the system, in particular, by eliminating tax provisions which are unduly complex and/or no longer fulfill their policy objective. More specifically, we have provided three current and two potential examples of undue complexity in the tax system. Simplification will result in lower compliance and administration costs, greater certainty/predictability, and fairness, and will lead to a more efficient and growth-oriented Canadian economy.

We thank FINA for the opportunity to contribute to the 2008 fall pre-budget consultation process. We look forward to continuing to work with the Committee and the government in order to ensure that Canada maintains a tax system which ensures the highest levels of competitiveness and economic growth from which all Canadian will benefit.

Respectfully submitted,

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Barry Gorman

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5 FEIC. (2005). "Costs of Internal Control Certification in Canada".