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A Primer on Federal Corporate Taxes

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A Primer on Federal Corporate Taxes

(In Brief)

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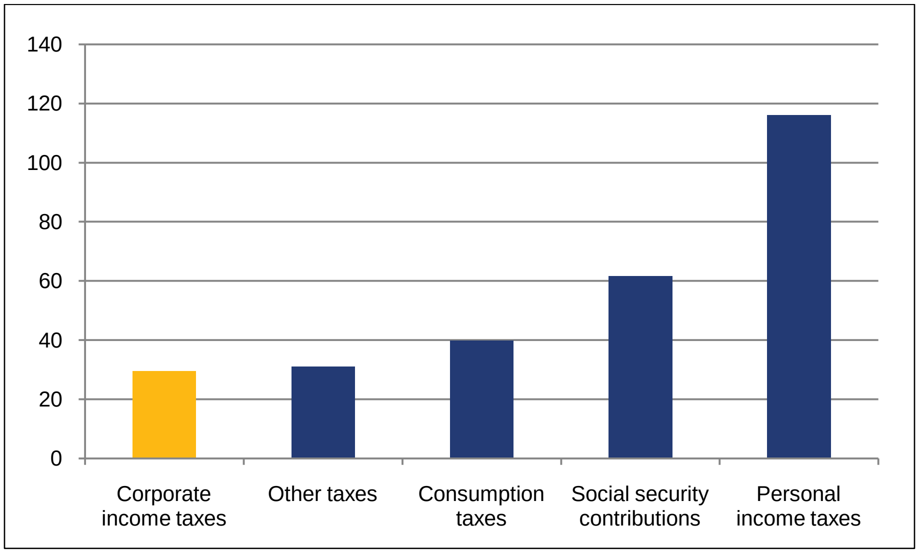
A PRIMER ON FEDERAL CORPORATE TAXES*

1 INTRODUCTION

Canada's federal government began taxing the income of corporations in 1917 and the capital of corporations in 1985. In 2008–2009, the federal government collected $31 billion in corporate income taxes. As shown in Figure 1, revenues from corporate income taxes[1] contribute less to federal tax revenues and social security contributions than do personal income taxes, consumption taxes or social security contributions.[2]

Figure 1 – Federal Tax Revenues and Social Security Contributions, Fiscal Year 2008–2009 ($ billions)



Note: "Social security contributions" refers to contributions to the Canada and Quebec Pension Plans (CPP and QPP) as well as Employment Insurance (EI) premiums. Capital taxes on financial institutions are included in corporate income taxes.

Source: Figure prepared by the authors using data obtained from Statistics Canada, CANSIM table 385-0006, and from Receiver General for Canada, *Public Accounts of Canada 2010*, *Volume I, Summary Report and Financial Statements*, October 2010.

2 OVERVIEW

Canadian corporations are obliged to pay tax on their taxable income earned worldwide, while foreign corporations pay corporate tax on their taxable income earned in Canada.[3] Companies may deduct, from their accrued revenues, the expenses incurred in producing goods and services, provided there is a reasonable expectation of profit. Expenses include, for example, current expenditures such as wages, fees, rents and energy costs, as well as costs associated with the purchase of capital goods such as buildings and machinery. Current expenditures are deductible in the year in which they are incurred, while the cost of capital goods can be deducted from revenue over a number of years, subject to prescribed rates of amortization. The rates of deduction, or capital cost allowance (CCA) rates, are defined in the *Income Tax Act* for different classes of depreciable assets and are designed to match the useful life of assets. In addition to the CCA, interest on borrowings for the purpose of earning income from a business is deductible, as are business losses.

Table 1 shows federal corporate income tax rates applied on a corporation’s taxable income. The corporate tax rate on general income is the rate applied on corporations that are not eligible for size- and/or sector-specific corporate income tax rate reductions. Two of the most prevalent reductions are the manufacturing and processing credit and the small business deduction.

Table 1 – Federal Corporate Income Tax Rates, Selected Years, 1960 to 2012 (%)

	Corporate Tax Rate on General Income [4]	Corporate Tax Rate on Manufacturing and Processing Income	Corporate Tax Rate Including Small Business Deduction	Corporate Surtax Rate
1960	8%<$25,000 37%>$25,000	8%<$25,000 37%>$25,000	8%<$25,000 37%>$25,000	0
1970	8%<$35,000 37%>$35,000	8%<$35,000 37%>$35,000	8%<$35,000 37%>$35,000	1.50
1980	36.0	30.0	15.0	1.80
1990	28.0	24.5	12.0	0.84
2000	28.0	21.0	12.0	1.12
2001	27.0	21.0	12.0	1.12
2002	25.0	21.0	12.0	1.12
2003	23.0	21.0	12.0	1.12
2004	21.0	21.0	12.0	1.12
2005	21.0	21.0	12.0	1.12
2006	21.0	21.0	12.0	1.12
2007	21.0	21.0	12.0	1.12
2008	19.5	19.5	11.0	0
2009	19.0	19.0	11.0	0
2010	18.0	18.0	11.0	0
2011	16.5	16.5	11.0	0
2012	15.0	15.0	11.0	0

Source: Figure prepared by authors using data obtained from the *Income Tax Act*, R.S.C. 1985, c. 1, various years.

To determine the corporate income tax rate applied on a corporation, the basic corporate income tax rate is adjusted by any applicable reductions in the tax rate. Since 1988, the basic corporate income tax rate for all corporations has been 38%. Corporations that pay provincial/territorial corporate income tax are entitled to a 10 percentage-point reduction in the basic corporate income tax rate, called the provincial abatement in the *Income Tax Act*, which lowers the corporate income tax rate to 28%. The 28% rate has been, and is currently, further reduced by the general rate reduction, the manufacturing and processing credit or the small business deduction.

The general rate reduction was introduced in the October 2000 *Economic Statement and Budget Update* as a means of providing tax relief to sectors of the economy not already entitled to lowered corporate income tax rates; by 2012, the currently legislated general rate reduction percentage will increase to 13%, thus lowering the corporate tax rate on general income to 15%.

Corporate profits from manufacturing and processing activities have been eligible for a tax rate reduction since 1973. In 2006, the manufacturing and processing credit was amended to be the same percentage as the general rate reduction; thus, while this credit is still mentioned in the *Income Tax Act*, the preferential tax treatment for profits from manufacturing and processing activities has been eliminated.

Certain small Canadian-controlled private corporations (CCPCs) – basically, corporations not controlled by a non-resident or by a public corporation – are, at present, taxed at a lower corporate tax rate of 11% on their first $500,000 of taxable income, an amount that has increased over time since first being introduced in the early 1970s at a value of $50,000. The small business rate is applied to all CCPCs with capital not exceeding $10 million. For CCPCs whose capital exceeds $15 million, the corporate tax rate on general income is applied. 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 on taxable income below the lowered threshold.

Beginning in the 1970s, the federal government imposed a corporate surtax equal to 4% of the corporate income tax rate less the provincial/territorial abatement; this rate was equivalent to 1.12% in 2007. The corporate surtax was eliminated effective January 2008.

The federal government started to impose a levy on the capital of financial institutions in 1985 and on all businesses of a certain size in 1989.[5] The capital tax on large corporations was eliminated beginning in January 2006, but financial institutions continue to be subject to a tax of 1.25% applied on taxable capital exceeding $1 billion employed in Canada. Financial institutions can, however, reduce their federal capital tax payable by the amount of federal income tax payable and, consequently, pay capital taxes only to the extent that they do not have sufficient corporate income tax liability for the previous three years and the next seven years.

3 PROS AND CONS OF THE TAXATION OF CORPORATE INCOME

The corporate income tax is sometimes described as performing a “withholding” function. Corporations are owned by individuals, whether domestic or foreign shareholders, and corporate income ultimately flows to these individual owners in the form of dividends or capital gains and is taxed at the personal level. However, foreign shareholders may have lower domestic taxes on income from dividends and capital gains, depending on where they reside and the applicable tax treaties, or corporations could choose to re-invest their income; in these cases, the withholding function is distorted. The corporate income tax ensures that corporate income is subject to a certain amount of immediate taxation. To offset this taxation, the dividend gross-up and dividend tax credit regime minimizes double taxation of corporate income that occurs when dividends are distributed by the corporation to Canadian shareholders.

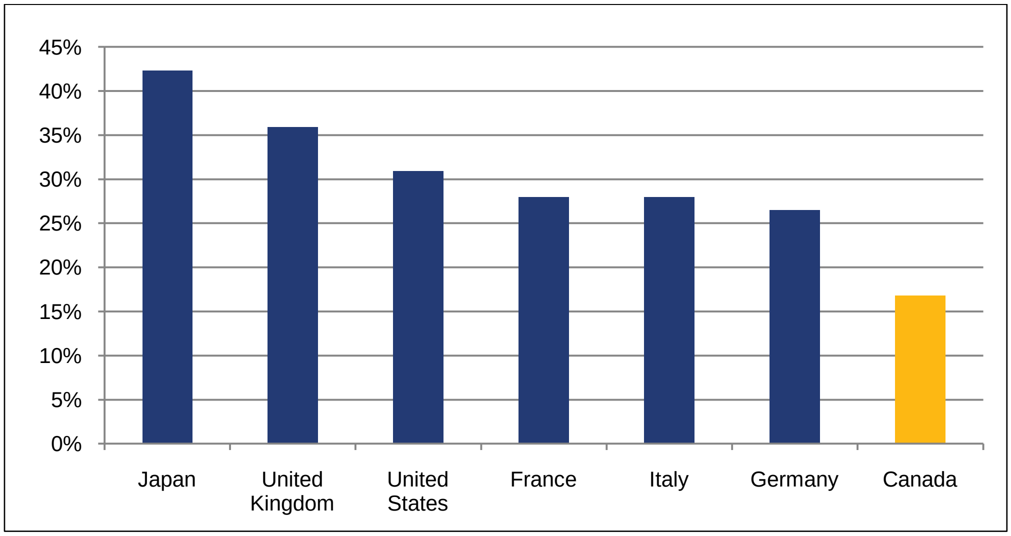
Corporate taxes affect the rate of return to corporate investors, and the burden of corporate taxes may be shifted to consumers through higher prices and/or to employees through lower compensation. The extent to which the corporate tax burden may be shifted from shareholders to consumers or employees is, however, affected by market forces, and varies across firms and industries as well as over time.

A factor to consider in assessing the pros and cons of the taxation of corporate income is the growing global competitive pressures faced by Canadian corporations. Given the international mobility of capital, Canadian corporations that do not provide a competitive after-tax rate of return on capital may experience difficulties in accessing capital. In addition, in countries with high corporate taxes, firms may be more inclined to finance investments through debt rather than through equity in the event that interest on debt financing is deductible for tax purposes.

Corporate income taxes may also affect investment, either discouraging or encouraging new investment. Economists sometimes rely on the notion of the marginal effective tax rate (METR) on business investment to assess the tax disincentive to invest. The METR represents the proportion of the rate of return on a marginal investment that accrues to governments. The calculation of METRs usually includes not only statutory corporate tax rates, but also retail sales taxes on business inputs, investment tax credits and other incentives, CCA rates, inventory accounting methods, capital taxes and the ability to deduct interest costs.

As shown in Figure 2, with the federal corporate income tax reductions fully implemented in 2011, Canada’s METR is considered to be the lowest among the Group of Seven (G7) countries.

Figure 2 – Marginal Effective Tax Rate on Business Investment, Various Countries, 2011



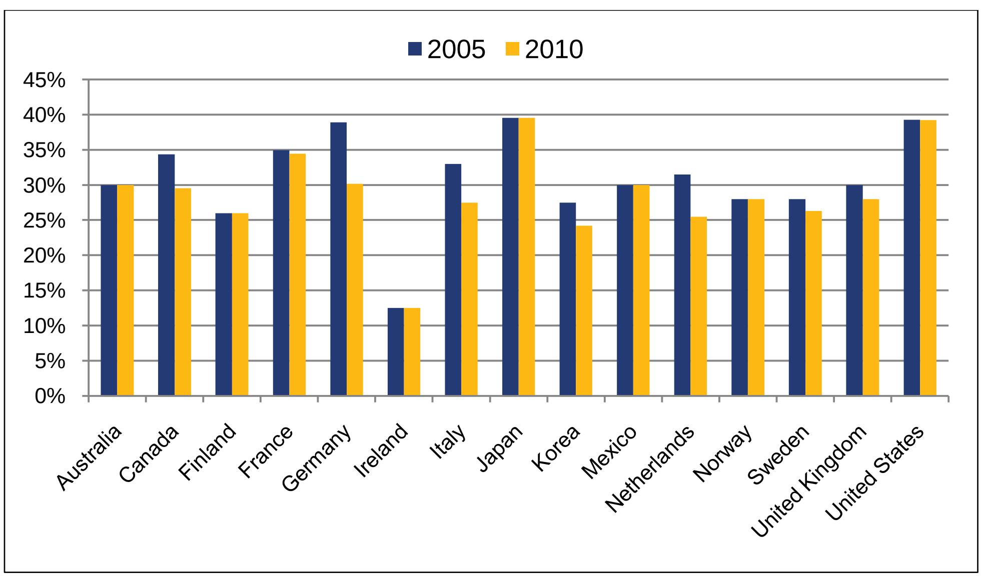
Note: The calculation of marginal effective tax rates by Canada's Department of Finance includes all legislated policy initiatives announced as of 1 January 2011. The calculation excludes the resource and financial sectors as well as research and development assets.

Source: Department of Finance, *Canada's Economic Action Plan: A Seventh Report to Canadians*, January 2011, p. 44.

4 INTERNATIONAL CONTEXT

Recent federal corporate income tax rate reductions in Canada are consistent with a global trend. As shown in Figure 3, 9 of 15 selected Organisation for Economic Co-operation and Development countries lowered their statutory corporate tax rate from 2005 to 2010.

Figure 3 – Statutory Corporate Income Tax Rates, Selected Countries, 2005 and 2010



Source: Organisation for Economic Co-operation and Development, *Revenue Statistics 1965–2009*, 2010.

NOTES

* This publication is an updated and revised version of *A Primer on Federal Corporate Taxes*, prepared on 27 August 2007 by Alexandre Laurin, formerly of the Library of Parliament.

1. For the purposes of this paper, “corporate income taxes” includes both income taxes paid by corporations and capital taxes paid by financial institutions.

2. “Social security contributions” includes Employment Insurance premiums as well as contributions to the Canada and Quebec Pension Plans.

3. Since Canadian corporations pay Canadian income tax on worldwide taxable income, foreign tax credits can be used to offset any tax paid in foreign jurisdictions.

4. The corporate tax rate on general income is calculated by subtracting the abatement rate for any provincial/territorial corporate taxes paid and any other general reduction in the corporate tax rate from the basic corporate tax rate. For example, in 2011, the basic corporate tax rate is 38%, the provincial/territorial abatement rate is 10 percentage points and the general rate reduction is 11.5 percentage points, which results in a corporate tax rate on general income of 16.5%.

5. The taxable capital of a corporation may be described as the aggregate of shareholders’ equity, retained earnings and indebtedness (bonds, debentures, mortgages and other similar obligations) minus investments in shares or debts in other corporations. The taxable capital of financial institutions excludes deposits.