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C.D. Howe Institute COMMENTARY

FISCAL POLICY

Cleaning Up the Books:

A Proposal for Revamping Corporate Group Taxation in Canada

Alexandre Laurin

In this issue...

Providing a comprehensive group-taxation regime would bring fairness, simplicity and certainty of tax outcome for Canadian corporations.

The Study in Brief

Providing a comprehensive group taxation regime would bring fairness, simplicity and certainty of tax outcome for Canadian corporations. As it is, Canada's approach to corporate group taxation gives rise to a number of problems, including higher administrative and transaction costs, unfairness among different types of corporations, uncertainty, and weakened international competitiveness. Also, the web of intragroup transactions and structural changes needed to achieve some degree of tax consolidation adds complexity and artificiality to the tax system and the business environment since the sole purpose for these business activities is to gain a tax advantage.

These concerns point to the need to consider a statutory framework allowing for the transfer of profits and losses among domestic members of a corporate group for federal and provincial tax purposes. I propose a system in which each eligible subsidiary of a group would determine its own tax base separately, including taxable profits, current-year non-capital tax losses and federal credits. These amounts would then be transferred, on paper, from the subsidiaries to the parent company, which would then pay taxes for the entire group based on the aggregated transferred amounts and its own tax attributes. Provincial taxes payable could be computed based on the existing interprovincial allocation formula.

Such a comprehensive group taxation regime would improve the competitiveness of Canada's tax system with respect to the determination of the corporate tax base and would ensure that the tax system remains neutral with respect to business-structuring decisions, thereby contributing to a better environment for domestic and foreign investment in Canada.

The Author of This Issue

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INDEPENDENT • REASONED • RELEVANT

Canada's taxation system for groups of affiliated companies differs from that of most other developed countries. The difference stems from the absence, in Canada, of a formal system for allowing the transfer of corporate losses and profits among related companies for group-wide, tax-minimization purposes.

This *Commentary* argues for a new system whereby corporate groups would gain the ability to transfer profits and losses between a parent corporation and its subsidiaries.

Related corporations are generally permitted to transfer losses through some complex transactions, but these usually give rise to high administrative costs, additional risks or timing issues. For example, some intragroup loss transfers are possible through tax-planning techniques involving financial transactions among group members. Other methods include corporate reorganizations involving the merger of related companies or the winding up of a subsidiary by its parent. In all cases, however, the process consumes considerable time and resources.

The debate over group taxation arises primarily from the asymmetric tax treatment of losses and profits. While profits are fully taxed when they arise, tax losses are only given partial recognition – they are refundable only against current taxes or taxes paid in the prior three years. While unused losses may be carried forward, their real value diminishes with time, and in some cases may never be claimed. For example, losses cannot be claimed in the event of a business failure.

Given the global economic slowdown, issues related to the recognition of losses for tax purposes will gain profile. Incomplete tax refundability of losses leads to distortions in the tax system, particularly through its negative effect on risk-taking and business investment at early stages of development. One mechanism to improve loss utilization in general is to provide for the sharing of tax attributes among related corporations.

Background

The debate over group taxation has a long history. Back in the 1930s and 1940s, the federal government allowed groups of related companies to file corporate income tax returns on a consolidated basis, subject to a set of restrictive conditions.[1] Following the repeal of consolidated reporting in 1952, the Carter Royal Commission on Taxation (1966) recommended that the federal government adopt a system of consolidated taxation for corporate groups of wholly owned companies. The Standing Senate Committee on Banking, Trade and Commerce made a similar recommendation in 1971 (Brooks, 2008).

As well, the federal government studied the issue internally and proposed – as part of Finance Minister Michael Wilson's 1985 budget – a formal group tax-loss transfer system along with draft proposed amendments to the *Income Tax Act*. While Ottawa has not followed through on that proposal, both the Auditor General of Canada (1996) and the Technical Committee on Business Taxation (1998) recommended that the federal government review its 1985 proposal for a corporate tax-loss transfer system. More recently, the Advisory Panel on Canada's System of International Taxation (2008) urged the federal and provincial governments to collaborate in considering how a tax consolidation system could operate in Canada.

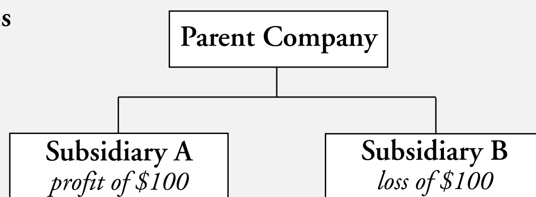
The debate around loss transfers is fundamentally linked to a theoretical discussion of who owns the loss. Is it the business as a legal entity, the company in a situation where it holds the majority of shares, or upstream individual shareholders? If one takes the view that business profits and losses ultimately belong to individual shareholders, one should not object to the transfer

The author is grateful to the members of the C.D. Howe Institute's Tax Competitiveness Council and other reviewers for their helpful comments.

1 For example, group tax consolidation was allowed only for wholly owned subsidiaries of a domestic parent company performing related and similar business activities. Group reporting was repealed in 1952 when Parliament introduced loss carry-over provisions. (see Brooks 2008).

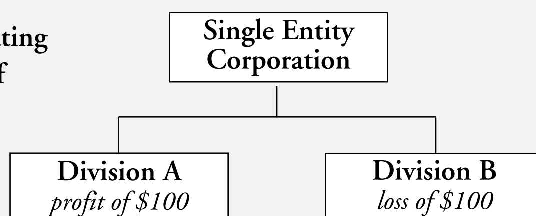
Box 1: Tax Treatment of Corporate Groups as Opposed to Businesses Operating Through Separate Divisions of One Single Legal Entity

Situation 1: Corporate Groups



Outcome: Subsidiary A pays corporate income tax of $100 times the corporate tax rate. Subsidiary B pays no tax and has a tax loss carry-over of $100. The corporate group pays corporate income tax.

Situation 2: Businesses Operating Through Separate Divisions of One Single Legal Entity



Outcome: Loss of Division B offsets taxable profit of Division A. The corporation has no taxable income for the year and, therefore, no tax liability.

of losses and profits among commonly held members of a corporate group, provided that such transfers do not give rise to abusive tax planning.

In this paper, I propose a new system whereby corporate groups would gain the ability to transfer profits, losses and federal credits for tax purposes between the parent corporation and its subsidiaries. Federal and provincial taxes for the consolidated group would be payable by the parent company but each subsidiary would still be required to determine separately its own tax base. Provincial taxes payable would be determined on the basis of the existing interprovincial allocation formula.

This proposal would ensure that Canada's corporate tax system is: (1) internationally competitive with respect to the determination of the tax base, not only tax rates; (2) neutral with respect to corporate organizational decisions; and (3) limits unnecessary administrative costs and complexity for corporate groups wishing to enter into loss-consolidation arrangements.

The next section briefly describes tax-planning strategies adopted by some corporate groups in Canada to shift profits and losses among group members. The following section reviews the main concerns raised by the current system. The last section discusses the policy implications of the current system and suggests a viable new approach that could be adopted by both federal and provincial governments.

Consolidation of Profits and Losses in Corporate Groups: Current Practices

Under the *Income Tax Act,* each incorporated business – including a firm controlled by another corporation – is required to file and pay tax separately. Because some members of a corporate group may be in a loss position while others may be profitable, the group overall may have to pay taxes even though its consolidated taxable income could be zero or negative. This situation is illustrated in Box 1.

In this scenario, Subsidiary A has a profit of $100 while Subsidiary B has a loss of $100; the total tax liability of the group is $100 times the corporate tax rate even though on a consolidated basis the loss of Subsidiary B would wipe out the profit of Subsidiary A, leaving no taxes to be paid.

Although not formally recognized in legislation, a variety of tax-planning techniques enable corporate groups to achieve some degree of taxable income consolidation.[2] Most of these strategies involve the transfer of tax losses among related corporations, using transactions that are technically in compliance with the *Income Tax Act*.

The Canada Revenue Agency (CRA) has developed an internal policy to deal with the utilization of tax losses within a corporate group.[3] In practice, a corporate group is generally permitted to restructure or utilize various tax-planning strategies – as long as each transaction complies with existing laws and regulations – for sharing profits and losses among its member corporations to reduce overall tax liability. The federal government has taken the position that even though such transactions have been undertaken primarily to obtain a tax benefit, they would generally not fall under the application of the *Income Tax Act*'s anti-avoidance rule.[4]

This section provides an overview of currently permitted tax-planning strategies that may be used to transfer profits and losses within members of a corporate group to reduce group-wide tax liabilities.

1. RESTRUCTURING TECHNIQUES

Restructuring techniques involve the amalgamation of related companies or the winding-up – dissolution – of a subsidiary into its parent company. Losses and other tax attributes accumulated in a subsidiary may generally be rolled over to its parent company upon the winding up of a 90 percent owned subsidiary into its parent[5] (Brooks, 2008). The losses of the subsidiary in this situation may be utilized by the parent company to provide tax relief.

Similarly, when a business with losses merges with a related corporation, pre-existing losses may generally be carried over to the new amalgamated entity, provided that there is continuing control (generally 50 percent) and operation. The new entity may carry these losses forward[6] to reduce its taxes in the future.[7] It should be noted that while both techniques allow for the transfer of losses between related corporations, they are the result of a business reorganization that would have not otherwise occurred and that may be costly, time consuming and otherwise disturb normal business activities. In addition, following an amalgamation of related companies, a corporation is generally prohibited from carrying back the losses taken over to create a tax refund.

2. FINANCIAL AND OTHER ARRANGEMENTS AMONG RELATED COMPANIES

Corporate groups may use a variety of arrangements to generate income in loss-making subsidiaries and create expenses in profitable subsidiaries. One of the most popular techniques involves the artificial creation of an interest charge in one member of a corporate group with the corresponding interest income going to another member of the group.

For example, take a profitable parent company and its wholly owned subsidiary that has accumulated losses for tax purposes. The parent company acquires common shares of its subsidiary, which then lends the proceeds back to the parent

2 See Couzin (1991) for a review of the various provisions of the Canadian tax system that are most relevant to the transfer of losses among related corporations. Brooks (2008) also provides an overview of various aspects of corporate income tax legislation with respect to corporate groups.

3 The CRA (1990) determined that the "Explanatory Notes to Draft Legislation and Regulations Relating to Income Tax Reform issued by the Minister of Finance in June 1988 state that the transfer of income between related corporations that is accomplished using transactions that are legally effective would not usually result in a misuse of the provisions of the [*Income Tax*] *Act* or an abuse of the *Act* read as a whole."

4 The general anti-avoidance rule, introduced in 1987, is intended to deny tax benefits derived from abusive or artificial tax avoidance transactions. In other words, the rule prohibits transactions misusing provisions of the *Income Tax Act* to defeat the spirit of the *Act*.

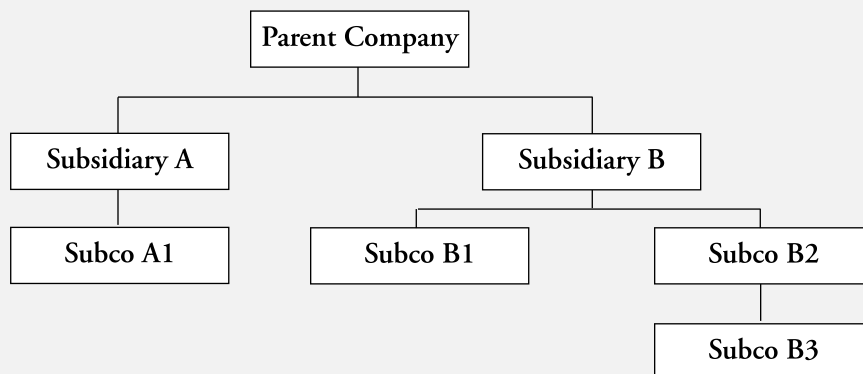
5 Section 88, the *Income Tax Act*.

6 Current-year, non-capital tax losses of a corporation may generally be transferred to future years (up to 20 years) or prior years (up to three years).

7 Section 87, the *Income Tax Act*.

Box 2: An Example of Consolidation of Profits and Losses Reported by the Auditor General of Canada*

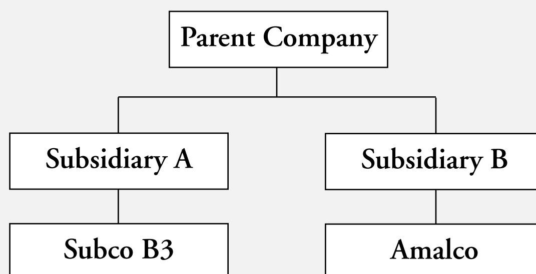
Initial Situation



Stage 1: Subsidiary A, which has tax losses carried forward largely in excess of $60 million, sells some of its holdings to Subco A1, a subsidiary incorporated for the purpose of this tax-avoidance scheme, in exchange for debt. The interest expenses on the debt create a large tax loss in Subco A1, while the interest income in Subsidiary A is offset by its large pool of tax losses. Subco A1 then sells all of its holdings back to Subsidiary A and is left with approximately $60 million in tax losses.

Stage 2: Subco B3, a profitable corporation which has paid taxes of approximately $100 million over the last three years, sells all of its operating assets to Subco B1, a subsidiary incorporated for the purpose of this tax-avoidance scheme, in exchange for preferred shares that are then redeemed. Subco B3 becomes a shell company that has paid taxes in the past, while Subco B1 is now the operating company. Subsidiary A and Subsidiary B then proceed to exchange their respective ownership interests in Subco A1 and Subco B2. Subco A1, now under the control of Subsidiary B, is amalgamated with Subco B1 to form Amalco. Subco B2 is wound up into Subsidiary A.

Resulting Situation



Stage 3: Amalco is now able to use the Subco A1 tax losses carried forward to offset future profits of Subco B1, the profitable operating company. Subsidiary A, on the other hand, transfers some of its investments on a tax-free basis to Subco B3 in exchange for debt and preferred shares. Subsidiary A uses its previously accumulated pool of tax losses to avoid paying tax on the interest income, while Subco B3 uses the interest expenses created to generate tax losses which are then carried back to claim a tax refund equal to approximately $100 million of taxes previously paid by Subco B3.

* This illustration is based on the Auditor General of Canada, November 1996 Report, Exhibit 37.5.

company at a commercial rate. The interest income generated in the subsidiary may be used against its losses, while the interest expense created in the parent company may be used to reduce its taxable income. In general, the CRA permits the use of such tax planning strategies that take advantage of deductible interest charges on inter-company loans (CRA, 1990).

Another, more straightforward method of shifting income is to arrange the activities of related firms so that the less profitable activities – or fixed charges – of the group are relocated in the most profitable corporations, and vice versa. A corporate group may also arrange to hold assets in a loss-making member of the group that could then lease them, on a commercial basis, to profitable members. Other methods for transferring losses among members of a corporate group include the sale of loss-making operations to related companies and the charging of intercompany fees for various administrative services located in the least profitable group member (Brooks 2008).

3. MIXTURE OF VARIOUS TECHNIQUES

Large corporations often use a combination of the above techniques to better achieve a desired tax outcome. The Auditor General of Canada, in his November 1996 report to Parliament, showed how a corporate group in Canada, using a web of intercompany transactions, is able to use tax losses incurred by one subsidiary to obtain a refund of taxes paid by another and, as well, to reduce its future tax liabilities without altering the basic structure of the corporate group. Details of this tax avoidance scheme are presented in Box 2.

Current Issues

Since Canadian corporate income tax legislation does not provide for group taxation, tax planners use a number of strategies, such as those found in Box 2, which produce partly similar results and give rise to a number of issues. Indeed, readers who found the transactions outlined in Box 2 difficult to follow will appreciate the efficiency loss to society involved in such complex, tax-driven activities. In this section, I discuss those issues, which also constitute the policy rationale for the adoption of a more formal system of group taxation in Canada.

1. CREATION OF ADMINISTRATIVE AND LEGAL COSTS

Current loss-utilization techniques involve complex transactions that may be costly to implement, not to mention difficult for authorities to trace. Other than management time and planning costs, tax-planning strategies often involve substantial accounting and administrative costs. Smaller businesses, in particular, may not find it economical to undertake such transactions because of these associated costs. In addition, the complexity of some of these tax-planning measures raises the issue of higher auditing costs for tax collectors.

2. GENERATION OF COMPLEXITIES

Large corporate groups may go to great lengths to set up the web of intragroup transactions necessary to shift profits and losses among related corporations with common ownership of at least 50 percent. The Auditor General of Canada (1996) found that some schemes involved more than 30 individual transactions to accomplish the desired loss consolidation. These transactions add complexity and artificiality to the tax system. Their artificial appearance may create difficulties for auditors – and corporate managers – in trying to establish the intent and determine the valid business purpose of such transactions.

3. UNCERTAINTY OF OUTCOME

The *Income Tax Act* contains no comprehensive system allowing for the consolidation of profits and losses within corporate groups. Tax planning is generally permitted to the extent that it is seen as consistent with CRA's administrative policy. The level of complexity sometimes required to achieve the transfer of tax losses leads to the question of whether it was the intent of Parliament to allow for corporate groups to pay tax on a consolidated basis (Auditor General of Canada, 1996). Because current loss-utilization techniques rely primarily on an administrative policy, the regime does not

provide corporate taxpayers with the same level of certainty as legislation.

4. NON-NEUTRALITY WITH RESPECT TO CORPORATE STRUCTURE

The current regime is also economically inefficient because corporations are taxed differently depending on whether they segregate their business operations based on divisions within a single corporation or based on subsidiaries within a corporate group. Hence, the system is not neutral with respect to the legal structure of corporations. Currently, the tax system generally discriminates against firms operating through distinct corporations within a group, as opposed to divisions within a single corporation, because only the latter can file income taxes on a consolidated basis.

Some techniques for consolidating losses, such as mergers and windups, directly involve the restructuring of business operations. The Department of Finance (1985), among others, has identified many valid business, non-tax reasons for a corporation to choose to operate through a group of subsidiaries.

But the tax system should not be an important consideration in the determination of a corporation's legal structure. From an efficient management viewpoint, for instance, it may be desirable to maintain the separate operational independence, track records and corporate marketing identities achieved by the segregation of businesses in distinct but related companies. There may also be labour and management issues arising when corporations with distinct cultures and unions merge into one conglomerate, or financial considerations when subsidiaries within a group have different costs of capital.

From a risk-management perspective, the legal structure of a corporation is an important factor in determining the liability of investors. Corporations with risky start-ups or projects may wish to conduct such activities in separate corporations to limit their financial liability and overall exposure to risk. In addition, corporate investors setting up new uncertain ventures may find it desirable to co-invest with minority shareholders who may contribute their own expertise and networking to the success of innovative projects. Finally, in some industries, there are regulatory or legislative barriers to the amalgamation of different business lines in a single corporate entity. Such business decisions should be based on merit, rather than tax implications.

5. CREATION OF OPPORTUNITIES FOR INTERPROVINCIAL TAX PLANNING

Corporate tax rates vary among provinces. Combined federal and provincial/territorial statutory corporate tax rates for 2008 varied from a low of 29.5 percent in Alberta to a high of 35.5 percent in Nova Scotia and Prince Edward Island. The current policy governing the transfer of profits and losses among related companies offers some opportunities for interprovincial tax planning to take advantage of these tax rate differences (Mintz and Smart, 2004).

For example, in a closely related group of corporations, the group may be in a position to have losses or expenses reflected in provinces that have higher corporate tax rates, and income in provinces with lower rates of tax. Mintz and Smart (2004) have shown that large corporations, operating through subsidiaries incorporated in various Canadian provinces, respond to variations in provincial corporate tax rates by making use of income-shifting to reduce the group's overall provincial tax burden. They estimated that a one percentage point reduction in a provincial corporate tax rate would result in an 8.5 percent increase in the taxable income of corporate groups in that province (Mintz and Smart, 2004).

6. UNFAIRNESS

The ways in which different corporations are generally able to use tax-planning strategies raises an issue of fairness among different types of corporations. Larger corporations will generally have more options and be better equipped to absorb the administrative and legal costs required to plan and enter into complex intercompany transactions. Also, some corporations within corporate groups may be exposed to legislative, regulatory, financial or other constraints that may

Table 1: Group Taxation Around the World, Selected Countries

Countries Providing a System of Group Tax Consolidation or Relief	Countries With No Statutory System of Group Taxation
Australia	Belgium
Austria	Canada
Cyprus	China
Denmark	Czech Republic
France	Greece
Germany	Hong Kong
Ireland	Hungary
Italy	Korea
Japan	Switzerland
Latvia	Turkey
Luxembourg	
Malaysia	
Malta	
Netherlands	
New Zealand	
Portugal	
Singapore	
Spain	
Sweden	
United Kingdom	
United States	

Source: Various

be limiting their ability to use amalgamations and windups to consolidate losses. Clearly, this situation is inequitable to the extent that corporations facing similar economic conditions have different effective access to loss-sharing provisions.

7. WEAKENING OF INTERNATIONAL COMPETITIVENESS

With respect to the international competitiveness of Canada's tax system, the federal government made progress in recent years by gradually reducing the federal statutory corporate tax rate from 28 percent in 2000 to a scheduled 15 percent by 2012. A more complete framework for measuring the competitiveness of a tax system is based on the calculation of marginal effective tax rates (METRs) on capital. This measurement assesses how the corporate tax system as a whole affects new investment. In particular, all measurable factors affecting the federal and provincial determination of taxable income and tax liabilities, such as investment tax credits, cost allowances and sales taxes on business inputs, are recognized in the computation of METRs on business investment. The latest measurement of Canada's marginal effective tax rate on capital (Chen and Mintz, 2008) shows that Canada's tax burden on business investment still ranks 11th highest among 80 countries – notably behind the United States, the United Kingdom and Mexico – and that more progress is required.

It is important to recognize that the impact of taxation is dependent upon the tax base as much as tax rates. Many developed countries offer some form of group reporting systems (Table 1). Canada is the only country within the Group of Seven (G7) without a statutory group tax relief

mechanism. To make Canada's corporate tax system more internationally competitive with respect to the determination of the tax base, Ottawa should follow suit when it comes to group corporate taxation. Such a measure has the added benefit of being an alternative to further statutory tax-rate reductions (Donnelly and Young 2002).

Doing so would also have the effect of lowering the marginal expected effective tax rate on capital in Canada.[8] A lower cost of capital benefits Canadian companies competing with firms internationally. It also makes Canada more attractive to foreign investors, resulting in gains in domestic economic activity, productivity and labour compensation growth.

Policy Implications

Instituting a system of group taxation provides an opportunity to improve the tax system by addressing the concerns described in the previous section. A number of stakeholders – including tax practitioners, academics, government-appointed bodies and the Auditor General – have recommended reforming the Canadian policy with respect to group taxation. This section briefly looks at how other countries have chosen to implement group taxation and then suggests the policy implications of such a regime for Canada.

1. GROUP TAXATION: WHAT ARE THE POLICY OPTIONS?

France, Germany, the United States, Australia, Italy and Japan operate one kind or another of group tax consolidation regimes (KPMG 2007). Most of these systems are legislatively complex, leading to relatively high administration and compliance costs. For example, group tax consolidation typically involves the elimination of intragroup transactions such as intragroup sales, gains on transfer of assets and payments of interest or dividends. At the group level, there are special rules to deal with members upon leaving the group, separate anti-tax avoidance provisions and other requirements with respect to the eligibility and length of agreements (Jones Day 2003).

In France and the United States, the parent company aggregates all group members' profits and losses, eliminates intragroup transactions, makes other adjustments and files a tax return for the entire group. In France, as well, each group member is required to file a separate tax return, although it is not required to pay the tax shown on the return. In both countries, the parent is required to pay the consolidated tax owed, even though US group members are jointly and severally liable for the entire group tax liability while French group members are only liable for their share of the consolidated tax bill.

In the United States, only a domestic corporation may be the parent of a consolidated group, while in France permanent establishments of foreign companies are also allowed to head a corporate tax group. In the United States, the parent company must own at least 80 percent of each subsidiary's voting rights. In France, the group definition requires the parent company to own at least 95 percent of the share capital of each subsidiary.

In the United States as well, each of the qualifying group members must be part of the consolidated tax group and may not voluntarily leave the group. In France, each eligible group member is free to be outside of the consolidated tax group and continue to pay tax separately. Conversely, a French subsidiary in the consolidated tax group may leave the group at any time.

Germany, Sweden, Finland and Norway take a different approach, sometimes labelled as profit-transfer systems (Lockwood and Pantaleo 2002), than the French and the Americans. Sweden, for example, permits the transfer of taxable income on an annual basis between profitable and loss-making group members. In Germany, the so-called "Organschaft" approach is a give and take between the consolidation of profits and losses on the one hand and group-loss transfer models on the other.

8 Although not readily measurable, the ability of firms to use tax losses more effectively in Canada would reduce the expected tax burdens and improve expected after-tax rates of return on capital investments.

In other countries, only losses may be transferred among the eligible related companies. In practice, these types of group taxation – commonly known as "group relief" or "group-loss transfer systems" – are designed to achieve a similar result to that of full tax consolidation systems, but are usually less complex and easier to administer.[9] Ireland, Singapore and the United Kingdom, for example, operate loss-transfer systems. The UK group-relief system allows for non-capital losses to be transferred on a current-year basis between profitable and loss-making related corporations that are at least 75 percent owned by their parent company.

As part of the 1985 federal budget, the Department of Finance released a discussion paper that would have allowed for the transfer of non-capital losses within a commonly owned group of corporations. Officials put forward three basic approaches to group reporting: full consolidation, refundability of losses and intercorporate transfer of losses. They favoured the group-loss transfer system because it was considered the least disruptive to the tax system and less complex to administer, while minimizing federal budgetary cost implications (Department of Finance Canada 1985).

Under the federal proposal, members of a corporate group would have been able to transfer current non-capital losses, on an annual elective basis, subject to a 95 percent common ownership requirement. Certain group members – investment corporations, mortgage investment corporations, mutual fund corporations, cooperative corporations, credit unions and deposit insurance corporations – would have been excluded from the proposed loss-transfer regime. Other group members, such as farm corporations and insurance companies, would have been allowed only to transfer losses to another corporation within the same class of business (Department of Finance Canada 1985).

2. TAX POLICY IMPLICATIONS AT THE PROVINCIAL AND TERRITORIAL LEVELS

The main advantages of the proposed 1985 federal tax-loss transfer system were its relatively low levels of complexity and fiscal and compliance costs. In addition, the proposal received the general support of the business and tax-practitioner communities. The main drawback of the federal proposal, however, was its potential asymmetric effect on provincial tax revenues, which limited its acceptance among provincial governments. Under a loss-transfer regime, provincial tax revenues in a province where corporate losses are being transferred would diminish, while future tax revenues in the loss-originating province would increase through reduced losses carried forward. As the Department of Finance (1985) pointed out, the result would be an interprovincial transfer of fiscal revenues.

Although interprovincial transfers of losses would typically cancel out at an aggregate level, there are, nevertheless, reasons to believe that the proposed loss-transfer regime would lead to a permanent interprovincial shifting of tax revenues. First, there is the obvious fear that corporations would organize their affairs so as to recognize losses in provinces with a higher corporate income tax rate and income in provinces with a lower tax rate. As well, the Department of Finance (1985) identified several structural and regional economic differences – such as the location of industries with access to high levels of tax incentives, the location of cyclical industries and the relative predominance of mature or start-up industries – which could cause an enduring shift in provincial tax revenues.

In light of issues raised with respect to provincial corporate income taxation, the adoption of a federal-only, group-taxation system has been proposed on a few occasions (Tax Executive Institute 2003). However, adopting a federal-only regime of group taxation is clearly unattractive as it would only partially address the issues from which the need for group taxation originates in the first place. Indeed, some significant provincial tax benefits could still be gained from continuing to use the current, indirect methods of transferring losses among related corporations. In addition, it would create an undesirable division between federal and provincial corporate-income-tax bases, wiping out the private and public benefits obtained from harmonization.

9 There are significant differences between group-loss transfers and consolidated returns. For example, group-loss transfer systems do not generally allow for eliminating inter-company sales or profits in inventories or other assets.

3. A VIABLE APPROACH FOR CANADA

Any viable Canadian group-taxation solution would have to address implications for provincial tax revenue. An appropriate approach would lead to similar tax burdens for similar business activities whether those activities are conducted in multiple provincial/territorial jurisdictions through various branches of a single legal entity or through various members of a corporate group.

Corporations operating as a single entity with divisions located in various provinces and territories currently allocate their consolidated taxable income according to the general interprovincial allocation formula, which has served Canada well since 1946.[10] The formula is based on the average share of gross revenues and total salaries earned or paid in various provinces and territories in which the corporation has a permanent presence.

Therefore, adopting a group tax-reporting regime in which the parent company pays provincial/territorial tax for the entire group based on current allocation rules would accomplish interprovincial tax neutrality with respect to corporate organiza-tional structuring. Such an approach would facilitate reaching provincial cooperation with respect to group taxation as it would ensure that the provincial/ territorial fiscal cost is shared on the basis of currently accepted allocation principles, while limiting opportunities for interprovincial tax planning based on corporate organizational structuring.

It should be possible to develop such a group-taxation regime partly based on the German model. In Germany, transfers of profits are only allowed between a parent and a subsidiary; each group member must sign a profit-and-loss transfer agreement with its group parent, effective for a minimum of five years. Under the agreement, group subsidiaries are obligated to transfer their profits to the parent company which, in return, must reimburse the losses of its subsidiaries.

Actual cash payments are not required, but intercompany transfers must be booked in the financial records. All group members must determine their own taxable income separately and then the taxable profits and tax losses of group members are aggregated at the parent company level (European Commission 2006).

The German profit-transfer system does not require the elimination of intragroup transactions at the consolidated level. A transfer agreement may be signed between a parent and a 50 percent-owned subsidiary, providing flexibility for minority interests within the corporate group. Since all profits of a subsidiary must be remitted to the parent, minority shareholders are entitled to compensating payments, which are taxed in the hands of the subsidiary and deducted from the subsidiary's profits being transferred (Lockwood and Pantaleo 2002).

For Canada, I propose a model that would allow domestic subsidiaries of corporate groups to transfer, on paper, their taxable income, net of deductions, to their Canadian-incorporated parent company along with current-year, non-capital losses and federal credits. Once transferred, unclaimed tax losses and credits would carry forward and accumulate at the parent company level. Although each subsidiary would still be required to compute a separate tax return, taxes for the entire group would be payable by the parent company without requiring the elimination of intragroup transactions.

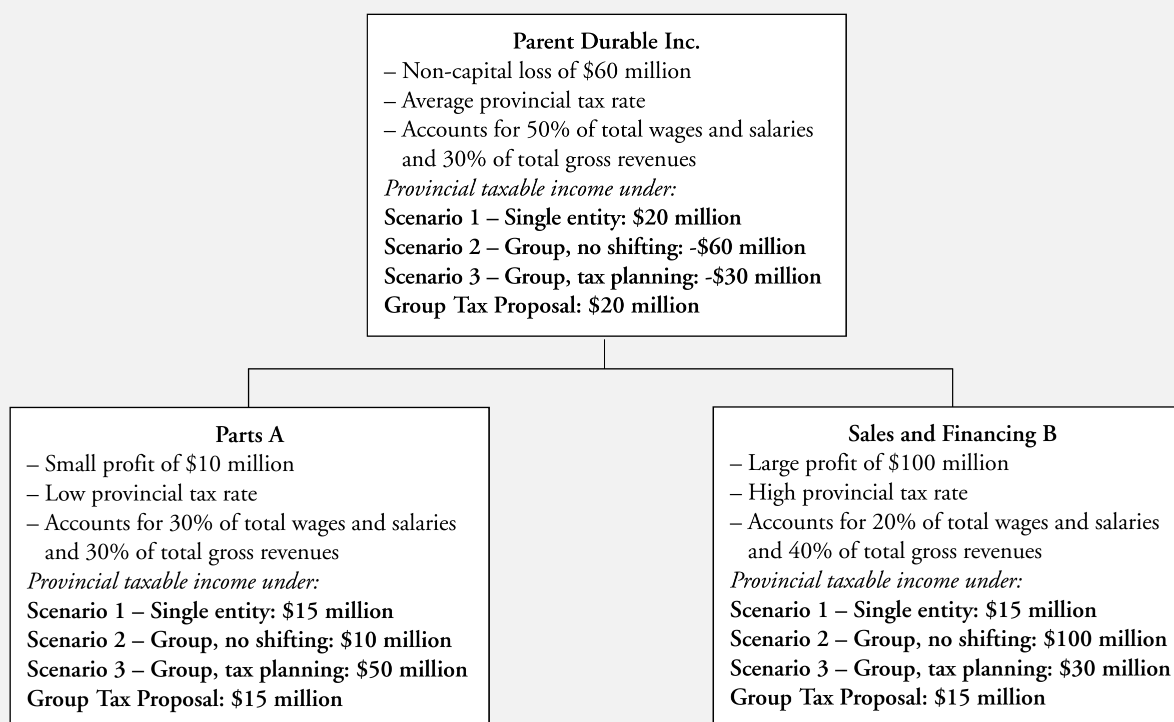
To effectively address concerns with respect to provincial/territorial tax revenues, all eligible members of the corporate group should be compelled to participate in the tax group. Mandatory participation is necessary to ensure that group taxation does not simply create more opportunity for tax planning and avoidance on the part of corporate groups.

Provincial/territorial taxes would be computed in each jurisdiction based on the current interprovincial allocation rules for taxable income.[11] An illustration of how this model could work is shown in Box 3. Under this proposal, provincial taxes are paid based on a corporate

10 Finance and insurance, transportation and other specific activities use a different formula (Technical Committee on Business Taxation, 1998).

11 The allocation rules would have to be amended to eliminate intragroup sales to avoid distortions.

Box 3: Comparison of Hypothetical Taxable Income Calculations under the Proposed Group Taxation Regime and Various Scenarios



Scenario 1 – Single Legal Entity: Parts A and Sales and Financing B are operating divisions of Parent Durable Inc. The corporation pays tax at the federal level on its consolidated taxable income of $50 million. At the provincial level, taxable income is allocated among provinces based on the allocation formula – i.e., the average of the share of gross revenues attributable to each province and the share of wages and salaries paid in each province.

Scenario 2 – Corporate Group of Subsidiaries, No Loss or Profit Shifting: Parts A and Sales and Financing B are wholly owned subsidiaries of Parent Durable Inc. Each corporation within the group is required to pay tax individually based on its own assessment of taxable income. In total, the group pays tax on $110 million of taxable income and carries forward a loss of $60 million that may be used to reduce future tax liabilities.

Scenario 3 – Corporate Group of Subsidiaries, Tax Planning Arrangements: Parts A and Sales and Financing B are wholly owned subsidiaries of Parent Durable Inc. Each corporation within the group is required to pay tax individually. However, through intragroup tax-planning strategies such as those described in Section B and Box 2, Parent Durable Inc. is able to transfer $30 million of its $60 million current-year loss to Sales and Financing B, while Sales and Financing B, located in the high-tax province, is able to shift $40 million of its large profit to Parts B, located in the low-tax province. In effect, the group pays tax on $80 million of taxable income and carries forward a loss of $30 million that may be used to reduce future tax liabilities.

Proposed Group Taxation Regime: Parts A and Sales and Financing B are wholly owned subsidiaries of Parent Durable Inc. Under the proposed approach, both Parts A and Sales and Financing B would transfer, on paper, their profits to Parent Durable Inc., which would then pay taxes on the aggregated net taxable income of $50 million. At the provincial level, taxable income would be allocated among provinces based on the current allocation formula applying for single entity corporation; i.e., the average of the share of gross revenues attributable to each province and the share of wages and salaries paid in each province.

Outcome: Both federal and provincial tax burdens under the proposed group taxation regime would be similar to those that would have been obtained had the group operated under a single legal entity. The corporate group is able to utilize tax losses more effectively and more quickly.

Source: Various

group's contribution to employment and sales, which would remove incentives for interprovincial tax planning based solely on financial transactions.

Although the illustration in Box 3 shows a significant shift of income from one jurisdiction to others, there would likely be compensating movements. Ultimately, aggregate provincial tax revenues would be a function of the economic activity generated in each province.

One possibility would be to require that a common parent company holds, directly or indirectly, at least 95 percent of a subsidiary's voting rights. This option would limit the need to provide adjustments for minority interests in a subsidiary.[12] Another possibility would be to facilitate corporate financing through subsidiaries by adopting a lower ownership threshold of 50 percent along with new rules providing for compensating deductible payments to minority shareholders – based on the German model – and other necessary adjustments.

A low common ownership threshold would be preferable because it would ensure that related corporations with significant minority interests would be provided with an incentive to discontinue their use of existing loss-sharing methods. The necessity to develop special rules to protect and compensate minority shareholders for the transfer of losses from one entity to another, however, would add complexity to the system.

This transfer proposal would not yield the same tax result as full consolidation – for example, elimination of intragroup transactions would not be required – and would be more complex to design and implement than would the federal loss-transfer proposal. However, the manner in which members of corporate groups currently arrive at loss consolidation is also complex and certainly more opaque and difficult to administer than if loss consolidation would be achieved through a more transparent legislated process.

4. Budgetary Revenue Considerations

Providing a transparent legislated process for group taxation in Canada could lead to an immediate reduction of federal and provincial government revenues, as it would extend the benefits of tax consolidation to corporations currently unable to transfer losses. However, many corporations do currently engage in sharing of tax losses and shifting of income through other, indirect, means. Therefore, the relative revenue cost to governments in the longer term could be less than a static analysis would suggest.

Another important consideration is one of timing of loss recognition. Under a group-taxation regime, firms would be able to use losses more rapidly and more cost-effectively. Therefore, if one supposes that all losses and tax credits carried forward into future years will eventually be monetized,[13] the real fiscal cost to governments of group taxation would be narrowed to the time value of taking advantage of tax attributes more quickly.

5. Economic Benefits

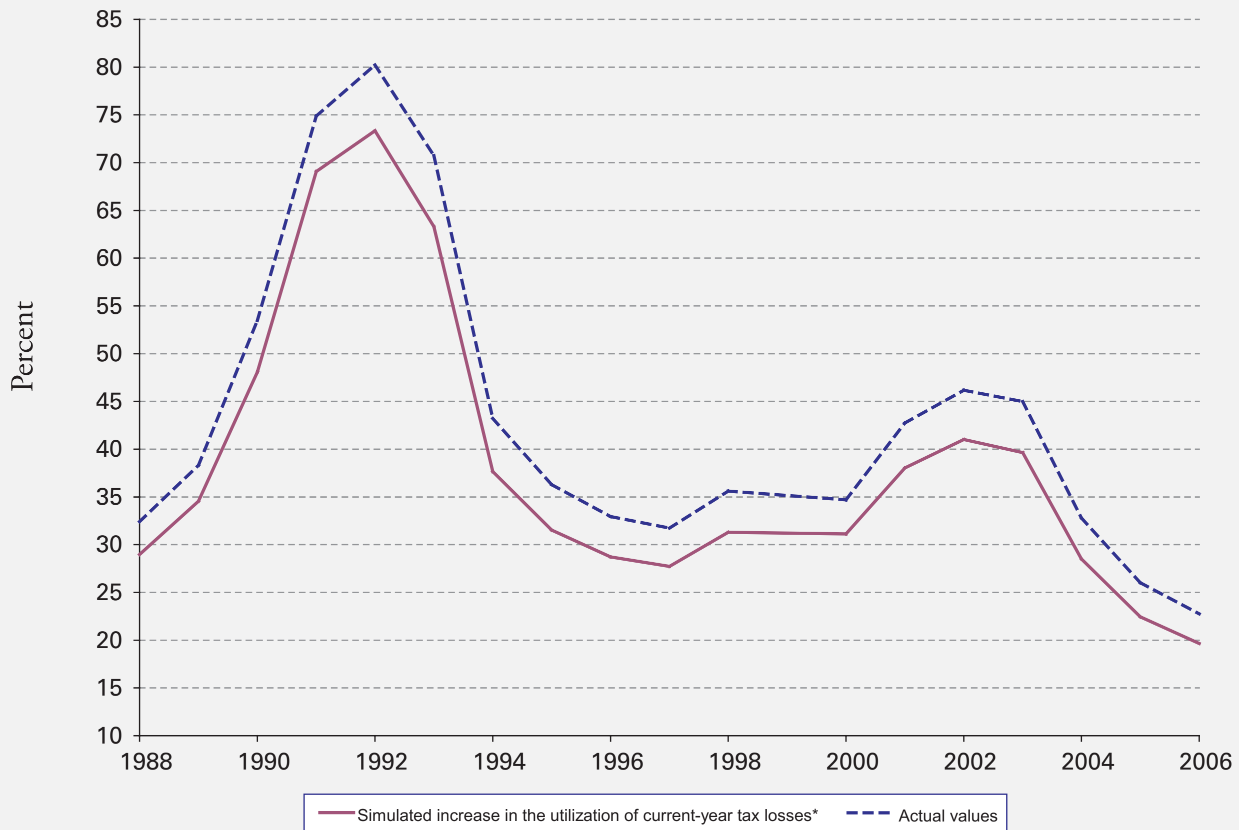
Currently, the treatment of taxable profits differs from that of tax losses in that profits are fully taxed when they arise, while tax losses are only partially refundable. Tax refunds with respect to losses are limited by the amount of taxes paid in the prior three years. The remaining losses must be carried forward in anticipation that they will be used to offset future profits. This asymmetric treatment of tax loss penalizes investors because losses carried forward may never be used, while their real value diminishes substantially over time due to inflation and forgone investment return. Cooper and Knittel (2006) have shown that the US tax system leads to "substantial delays between the generation and utilization of the tax loss."

The proposed group-taxation regime would increase the ability of firms to use tax losses and use them more quickly, thereby reducing the economic

12 However, one can make an argument that minority shareholders would still demand to be protected and compensated for tax losses transferred elsewhere in the group.

13 This assumption is a simplification as a portion of losses carried forward will most likely never be used. A recent study of the utilization of tax losses in the United States showed that approximately 25 to 30 percent of tax losses carried forward over a 10-year period never get utilized due to business failures (Cooper and Knittel, 2006).

Figure 1: Current-Year Tax Losses as a Percentage of Taxable Income



*Assumes a purely hypothetical 15% increase in the utilization of tax losses.
Source: Statistics Canada.

costs associated with partial refundability. Figure 1 shows the ratio of current-year tax losses as a percentage of taxable income over the 1988-to-2006 period. Figure 1 also shows a simulation of the possible impact of corporate groups being able to use current-year tax losses more quickly to offset taxable income.[14]

Mintz (1988, 1996) has shown that the current asymmetric treatment of tax losses discriminates against risk-taking and entrepreneurship since expected taxes disproportionately reduce the rate of return expected on risky investments when compared to riskless investments – that is, the after-tax risk premium on investments. Therefore, by improving the after-tax return on risky investments for corporate taxpayers, the proposed group-reporting regime would likely lead to greater risk-taking and investment in the economy.

Moreover, the ability to use tax losses more effectively may also enable corporate groups to maintain loss-making operations in certain subsidiaries during cyclical downturns for a longer period of time than would otherwise have been possible. In a way, it may help firms stabilize their operations by reducing the incidence of temporary disruptions in production or hiring plans due to cyclical slowdowns (Cooper and Knittel 2006). Indeed, the ratio of tax losses to taxable income increased significantly in the last two cyclical downturns in Canada (Figure 1).

14 Assuming that 15 percent of current-year tax losses are being used in the current year instead of being carried forward to future years. This assumption is purely hypothetical.

Group taxation may also improve the responsiveness of loss-making firms to various tax-incentive measures. To be effective in the short term, tax measures such as accelerated depreciation schemes and non-refundable tax credits require that benefiting corporations be in a tax-paying position. The proposed group-tax reporting regime, for example, may enable firms within corporate groups to make better use of investment tax credits.

Conclusion

Corporate groups in Canada are generally able to use various intragroup transactions to consolidate – although imperfectly – the profits and losses of group members and thus reduce tax liabilities at the group level. The federal government has generally allowed the use of such tax-planning strategies so long as each transaction employed in the process complies with existing laws and regulations.

Canada's position with respect to group taxation gives rise to a number of issues. For example, large corporations are likely to engage in complex intragroup transactions, leading to higher administrative costs and uncertainty. Furthermore, a number of regulatory or financial constraints may preclude some corporations from using the same tax-planning strategies as those available to their counterparts, leading to unfairness in the tax system.

An ideal tax system should not interfere with the organizational decisions of corporations. It should not provide incentives to restructure to reap tax benefits. Moreover, many countries have a legislative framework in place providing for some types of group taxation, putting Canadian corporations at a competitive disadvantage.

These concerns point to the need to consider a comprehensive legislative framework, allowing for the transfer of profits and losses of corporate groups for federal and provincial tax purposes. A workable approach would be to establish a system in which each eligible subsidiary of a group would determine its own tax base separately, including taxable profits, current-year tax losses and federal credits. These amounts would then be transferred, on paper, from the subsidiaries to the parent company, which would then pay taxes for the entire group based on the aggregated transferred amounts and its own tax attributes. Provincial taxes payable could be computed based on the existing allocation formula.

Providing a comprehensive group-taxation regime would bring fairness, simplicity and certainty of tax outcome for Canadian corporations. It would improve the competitiveness of Canada's tax system with respect to the determination of the corporate tax base and would ensure that the tax system remains neutral with respect to business-structuring decisions, thereby contributing to a better environment for domestic and foreign investment in Canada.

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