Filling the government coffers

A submission to the House of Commons Standing Committee on Finance

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Executive summary

Canada's ledger is unbalanced. In an effort to recover from the global economic crisis the government's response since 2007 has been single-mindedly focussed on expenses. While austerity budgeting can be part of a short-term approach to balancing the ledger, in the medium to long term it is ineffective and potentially dangerous. True leadership requires looking at all possible solutions. It is therefore imperative that our leaders now turn their attention to ensuring this government is generating a fair tax revenue base.

As representatives of Canada's public sector financial officers, the Association of Canadian Financial Officers (ACFO) has an informed perspective on Canadian fiscal policy. ACFO submits two interrelated recommendations for the 2014 budget:

- A moderate and targeted reform to Canada's taxation laws to eliminate transfer mispricing, eliminate the stock option deductions and to introduce a Financial Transaction Tax; and
- A commitment to use the funds generated by these reforms to balance the budget and reinvest in quality public services to ensure fiscal and social sustainability for all.

Three of the most significant issues with the Canadian taxation regime are the tax revenue leaching stock option deduction, the rampant use of transfer mispricing to divert taxable corporate revenue and the absence of a modest Financial Transaction Tax.

The **stock option deduction** costs Canadian governments an estimated $8 billion annually with 90% of the benefit of this deduction going to the top 1% of income-earners[1].

The federal and provincial governments lose approximately $7.8 billion per year combined through tax avoidance schemes involving **transfer mispricing and tax havens**. Ten tax haven jurisdictions alone housed over $170 billion in 2013 - up $15 billion from 2012[2].

A fair and reasonable **Financial Transactions Tax** at 0.5% on shares traded on the TSX would generate an estimated $3.5 billion a year in revenues, assuming it led to a 50% decline in transaction volumes and values[3]. This is equivalent to a tax of $5 on a transaction worth $1,000.

Revenue from these taxation improvements would provide a sustainable source of revenue for the Canadian budget while eliminating any justification for austerity measures and cuts to public service that negatively affect all Canadians.

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[1] Statistics Canada (via Canadians for Tax Fairness)
[2] ibid
[3] Sanger, Toby, **Fair Shares, How Banks, Brokers and the Financial Industry Can Pay Fair Taxes**, Canadian Centre for Policy Alternatives, April 2011.

Introduction

As representatives of the financial stewards of Canada's public sector, the Association of Canadian Financial Officers (ACFO) will focus on two interrelated themes for the 2014 budget recommendation:

- improving Canada's taxation regime; and
- balancing the federal budget to ensure fiscal sustainability.

We believe that if the fair and reasonable tax reforms submitted are implemented that a balanced budget and significant reinvestment in innovation and public services can be realized without resorting to further austerity measures. Austerity measures and resulting cuts to publically-funded programs are becoming increasingly unsustainable and will only become more so; Statistics Canada projects that by the year 2051, 25% of the population will be over the age of 65. And our aging population will begin to rely heavily on public services even as soon as the next decade.

A balanced budget is one that considers both sides of the financial ledger. So far, focus has been on the expenditure side - austerity measures and resulting cuts to public services. These cuts affect most Canadians through lost services and, in many cases, lost jobs.

But a balanced budget doesn't just require cutting expenses; it also requires collecting the revenues that are due. Improving taxation laws, eliminating avoidance schemes and investigating tax evaders and holding them responsible will provide a significant, sustainable and hitherto-ignored source of revenue for the Canadian public purse.

This will result in a truly balanced budget that also supports the robust public services that Canadians need and deserve.

Recommendation 1: Eliminate stock option deductions

Context

One of the most significant taxation issues is the persistence of unfair and unsustainable tax deductions that disproportionately benefit the highest income-earners while providing no value to the majority of Canadians.

High earners with an income of $135,000 or greater are theoretically paying taxes at a rate of 29%, the average for an industrialized nation. However, thanks to the persistence of deductions in the Canadian taxation system, these individuals are effectively paying taxes at a rate of 19.7%. In fact the richest 1% of Canadians pay a smaller share of their income in taxes than anyone else, including the poorest 10%[4].

ACFO believes that Canada cannot hope to achieve a truly balanced budget unless these unfair and unsustainable deductions are eliminated. One of the most significant tax provisions contributing to this phenomenon is the stock option deduction.

The stock option deduction allows executives and CEOs whose compensation is partially comprised of stock options to pay taxes on only 50% of the income they receive from cashing in these company stocks. Meanwhile, the average Canadian pays taxes on all his/her income after the usual $11,000 exemption. This is not a tax law that provides a widespread benefit: over 95% of the benefit of this loophole goes to the top 2% of income earners.

Furthermore, while the stock option deduction doesn't provide any value to the majority of Canadians, it certainly does cost them a great deal: this deduction cost the federal and provincial governments combined an estimated $8 billion per year in revenue.

Not only is the stock option deduction expensive and of little value to most Canadians, it also economically dangerous. Top economists from across Canada have definitively stated that the stock option deduction should be eliminated. They have also stated that it encourages short-term thinking and risky, speculative behaviour - behaviour that former Bank of Canada governor Mark Carney has identified as one of the causes of unstable financial markets.

Recommendation

ACFO strongly recommends that the stock option deduction be eliminated; stock options earned as compensation for employment should be considered regular employment compensation and taxed accordingly.

Value

The financial value of eliminating the stock option deduction alone would be an additional $8 billion in the combined public purse.

[4] Canadians for Tax Fairness

Recommendation 2: Eliminate transfer mispricing

Context

Another significant source of public revenue that goes unrealized every year is billions of dollars lost to tax avoidance strategies involving the notional transfer of goods, intellectual property and services to corporate subsidiaries resident in tax havens.

Tax avoidance takes many forms but the most prevalent and expensive forms typically involve the use of subsidiary or shell companies with no or few employees whose funds are centered in low- or no-tax nations such as Switzerland, Ireland or the Bahamas.

Transfer mispricing operates in this fashion: essentially corporate subsidiaries are notionally assigned the goods, intellectual property and/or services produced by their Canadian parent or sister companies. The royalties and/or profits on the sale of those goods to a third party are fictionally realized in the tax haven and taxed at a lower rate. The goods and services are never actually transferred and Canada is denied all or part of the tax revenue from goods and services produced in Canada. It is a corporate shell game that persists because the tax regime does not clearly prohibit the behaviour and Canada chooses not to invest in enforcement of the tax laws that do exist.

Based on numbers provided by Statistics Canada, Canadians for Tax Fairness estimated that in 2013, 10 tax haven jurisdictions alone housed over $170 billion. They also estimated that federal and provincial governments combined lost approximately $7.8 billion through tax avoidance and evasion schemes involving tax havens in 2013. Even more concerning than these numbers is the rate at which they are growing. The $170 billion quoted above is a full $15 billion more than in 2012.

Approximately 60% of international trade happens within, rather than between, multinationals: that is, across national boundaries but within the same corporate group[5]. Suggestions have been made that this figure may be closer to 70%.

These profits that are unfairly sheltered overseas are the result of operating in a Canadian marketplace, using taxpayer-funded resources. The profits would not be earned without the use of Canadian infrastructure and a Canadian workforce whose heathcare and education is now disproportionately paid for by citizens who pay their fair share of income tax. In effect, these corporations and individuals are a drain on the economy, using taxpayer-funded resources but refusing to contribute their share. This is simply poor financial management.

[5] http://www.taxjustice.net/topics/corporate-tax/transfer-pricing/

Transfer mispricing needs to be dealt with decisively through legislative reform and investment in the government agents responsible for enforcing those laws and securing for Canada its fair share of revenue.

The federal government should adopt a system that requires combined reporting and formulary apportionment for corporate parents and their subsidiaries. Intra-subsidiary transactions would be ignored and licensing income would be allocated among tax jurisdictions where the IP is used. The corporate group would not be able to take the position that the licensing income belonged to a tax-haven-based holding company. A mandatory combined return would prevent multinationals from the current shell game that bleeds away $8 billion of legitimate and fair tax revenue annually.

Recommendation

ACFO strongly recommends that the government commit itself to reforming tax laws to end transfer mispricing and, again, that the funds collected from these investigations be directed towards strengthening public services that benefit all Canadians.

Value

As discussed above, tax avoidance involving tax havens cost the federal and provincial government approximately $7.8 billion per year. This is an additional $7.8 billion that could be in the public purse.

Recommendation 3: Introduce a Financial Transaction Tax

Context

A Financial Transaction Tax (FTT) mirrored on the EU model slated to be implemented January 1, 2016, would generate upwards of $3.5 billion in revenue without materially affecting economic growth.

An FTT would tax transactions between financial institutions charging 0.1% against the exchange of shares and bonds and 0.01% across derivative contracts.

To avoid an unwanted negative impact on the real economy, such a tax would not apply to normal financial activities of citizens and businesses (for example personal loans, payments, insurance and bank deposits); investment banking activities for the purpose of raising capital; transactions carried out for restructuring operations; or refinancing transactions with central banks.

In addition to generating tax revenue, an FTT would have the added benefit of serving as an effective curb on automated high frequency trading and highly-leveraged derivatives that contribute to market manipulation and instability.

Recommendation

ACFO recommends that Canada follow the lead of our EU trading partners and adopt a FTT similar to the EU model that is going to be implemented January 1, 2016.

Value

$3.5 billion annually could be generated through the establishment of an FTT, assuming it led to a 50% decline in transaction volumes and values[6]. This is equivalent to a tax of $5 on a transaction worth $1,000.

[6] Sanger, Toby, Fair Shares, How Banks, Brokers and the Financial Industry Can Pay Fair Taxes, Canadian Centre for Policy Alternatives, April 2011.

Conclusion

The current tax regime unfairly permits multinational corporations and the very wealthy to shelter their income and profits without justification while having full access to the human capital and infrastructure supported through tax revenue.

By implementing the recommendations above, an additional $19.5 billion in tax revenue could be collected annually and used to balance the budget, invest in quality public service, innovation, infrastructure, education and healthcare. We cannot afford to subsidized multi-national corporations and the super wealthy. It is only fair that together we all pay our share.

Some will argue that these advantages for multinational and the wealth are required to stimulate investment and create jobs when in fact our Canadian experience since 2007 has been the vast majority of increased profits have been spent on multinationals amassing fortress capital for mergers and acquisitions and investing manufacturing capital in other jurisdictions with poverty-level labour costs.

Canada needs to serve Canadians first. And everyone who benefits from living or operating a business in this great nation must pay a fair and equal share.