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# Policy Forum: Editor's Introduction— Reform of Corporate Taxation

Corporate taxation influences investment decisions as well as government revenues. The nature and extent of that influence reflect both purely domestic considerations and international capital flows.

Domestically, firms are continually measuring after-tax returns against costs to determine whether to make new investments. The resulting scale of corporate activity then has a direct impact on corporate tax revenues. So, independent of what is going on elsewhere, there is always a case for examining whether Canada's corporate tax system is delivering the appropriate levels of investment and tax revenue.

The international context also affects investment decisions and tax revenues. Firms may compare the Canadian investment climate, including Canadian tax rates and tax policy, with that in other countries when making capital allocation decisions. Moreover, firms can take advantage of opportunities to shift, and potentially reduce, their corporate tax burden through the use of a variety of cross-border arrangements, such as related-entity structures, transfer pricing, intercompany loans, and other transactions between members of a multinational group.

These international considerations became more pressing for Canada in 2017 with the passage of the Tax Cuts and Jobs Act in the United States.[1] The headline measure of cutting the US statutory federal corporate tax rate from 35 percent to 21 percent, in combination with structural changes such as immediate expensing for some asset classes, led to much debate about how Canada should respond to the US reforms.

In the fall economic statement of November 21, 2018,[2] the Canadian government responded to the US challenge. Rather than cutting Canada's statutory corporate tax rate, the government focused on depreciation measures for investments in new assets. All classes of assets are immediately eligible for triple the usual rate of depreciation in the first year, while investments in machinery and equipment for manufacturing along with some clean-energy assets are eligible for full expensing in the first year. These measures will be phased out starting in 2024, matching the timing of the temporary US depreciation measures.

1 Pub. L. no. 115-97, enacted on December 22, 2017.

2 Canada, Department of Finance, *Investing in Middle Class Jobs: Fall Economic Statement 2018* (Ottawa: Department of Finance, 2018).



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The purpose of this Policy Forum is to analyze Canada's response to the US corporate tax reform and provide direction for future reform of Canadian tax law and policy.

The first article provides an assessment of Canadian corporate taxes within the international context. Peter Harris, Michael Keen, and Li Liu begin by laying out how the US corporate tax changes may affect investment and government revenues in Canada—in particular, by providing estimates of the potential impact on revenues from base shifting. They go on to highlight several novel international aspects of the US tax reform that may have a substantial impact on Canada. As one example, the global intangible low-taxed income (GILTI) provisions impose a surtax on accruing income when the foreign tax rate is too low. Harris, Keen, and Li recognize that the full effects of the GILTI provisions cannot yet be determined, but they suggest that these measures could provide an incentive to locate tangible assets outside the United States.

In the second article, Philip Bazel and Jack Mintz provide an analysis and new simulations of the impact of the Canadian tax changes. They argue against narrowing the tax base through larger depreciation allowances, in part because this increases distortions for firms that do not pay tax. Moreover, without a change in Canada's statutory rates, there is the risk of additional revenue losses, to the benefit of the US Treasury, since tax-base shifting out of Canada may accelerate. In the simulations, Bazel and Mintz find that the Canadian reforms lead to large improvements, on average, in the marginal effective tax rates on new investment in Canada, but an increase in the disparity across industries. This non-neutrality in incentives to invest across industries, they argue, is a serious shortcoming of the Canadian government's approach. They close by pointing out the merits of a cut to corporate tax rates: a more even impact on investment incentives across industries, and a stronger defence against tax-base shifting.

In the third and last article, Ken McKenzie and Michael Smart deliver an alternative analysis of the Canadian tax reforms. They begin by noting some challenges for proposals to cut Canada's statutory tax rate. Not only are the fiscal costs heavy, but the GILTI provisions may limit the effectiveness of tax rate cuts in improving investment in Canada. McKenzie and Smart then move on to a more fundamental question: What should be the base of corporate taxation? Rather than broad corporate income, they argue for a switch to taxing above-normal returns and leaving the normal return to investment untaxed. This approach to taxing economic rent, they argue, can deliver marginal effective tax rates that are very close to zero across all industries, and still raise substantial revenue if tax rates on the remaining base are kept relatively high. The introduction of accelerated depreciation is seen as a step in this direction, but it is regarded as a partial and incomplete response to the US tax reform.

Looking at this collection of articles in total, it is clear that the main source of dispute about policy direction is a fundamental difference of opinion on the question of what should be taxed. The nature of the appropriate tax base is not a matter to be determined by reference to technical tax legislation, or ad hoc changes to tax

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parameters; instead, it is a question that should be addressed first, providing a framework that can then be used to build tax legislation and define tax policy.

An obvious way to clarify the fundamental question of what should be taxed is to undertake a thorough study of the tax system. A previous Policy Forum in this journal addressed different approaches to the conduct of such a study.[3] While a timely response to the pressures of the US tax reform likely called for action in advance of the advice of a comprehensive tax commission, it is clear that deeper reflection on the goals of our tax system could provide a robust and consistent framework within which future incremental tax reforms could be constructed.

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3 Policy Forum (2018) 66:2 *Canadian Tax Journal* 349-99.

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