Learning to Live with an Imperfect Tax: A Defence of the Corporate Tax

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I. THE MOST RECENT ATTACK ON THE CORPORATE TAX

A proposal to eliminate the personal income tax on dividends was the major element in American President George W. Bush's budget plan, dubbed his "growth package", announced at the beginning of 2003. This aspect of his budget plan, which accounted for over one-half of the value of the tax cuts proposed in the plan, came as something of a surprise to most political observers since it had not been part of the President's campaign platform in 2000 nor had it been the subject of a recent study by the U.S. Treasury Department. Although, after much debate, Congress has decided to maintain taxes on dividends, but at a reduced rate, it seems likely that renewed attacks on dividend taxation will be forthcoming.

Following President Bush's lead, a number of Canadian financial commentators immediately called for the full removal of the tax on dividends in Canada. Jack Mintz, president and CEO of the C.D. Howe Institute and a professor of taxation at the J.L. Rotman School of Management at the University of Toronto, anticipated the U.S. proposals and urged the Canadian government to follow the U.S. lead on the same day that President Bush announced his budget plan. In his article in the National Post, Mintz gave five reasons for eliminating the double tax on corporate income in Canada: it would reduce the cost of capital, eliminate the preference for capital gains over dividends, eliminate the tax disincentive for corporations to pay dividends, remove the incentive for investors to arbitrage between corporate and other investment vehicles, and provide a tax break to middle-income Canadians. Jason Clemens, Director of Fiscal Studies at the Fraser Institute, echoed Mintz' call for a reduction in dividend taxes, citing the rationales given by President Bush— the tax cuts would spur investment, improve capital market efficiency, lower the cost of capital, and improve corporate
countries have moved away from their partially integrated corporate tax systems. In recent years some commentators have become more sceptical of the advantages of integration and a few countries have moved away from their partially integrated corporate tax systems.

The apparent rethinking of the role of corporate taxes began in the 1970s, encouraged by economic developments and by the reports of government committees in several countries. The difference between the Canadian system and President Bush's proposal is, in some ways, one of degree. Stated generally, President Bush's proposal would have exempted all recipients of dividends from tax provided those dividends were paid from taxed corporate income, while Canada's integration system provides a tax credit that amounts to only partial integration of the corporate tax, whether or not that tax was actually been paid. The most recent study of the Canadian corporate tax system was undertaken by the Technical Committee on Business Taxation (the Mintz Committee, named after its chair Jack Mintz), which was appointed in 1996 to review taxes paid by Canadian business and recommend ways of improving the business tax system. The Mintz Committee was asked to focus on the objectives of promoting job creation and economic growth, simplifying business taxation, and enhancing the fairness of the tax system to ensure that all businesses supported the costs of government services. Ultimately the Mintz Committee concluded there was no need to reform the relationship between Canada's corporate and personal tax systems since "the integration of corporate and personal income tax can only be partial, if a proper balance of [the] conflicting functions for the corporate tax is to be achieved.”

Although most of his arguments in the National Post in support of greater integration in Canada would appear to have been as relevant in 1998, the year the Mintz Committee report was published, as they might be today, presumably Jack Mintz changed his mind about the value of integration in Canada between the publication of the report and the publication of his article in 2003.

A separate corporate tax might seem anomalous to corporate law lawyers. Although natural entity theories of the corporation may have been popular in the late-19th and early-20th Centuries, making a separate corporate tax seem more defensible, modern financial theory and recent theoretical advancements in corporate law have been premised on the assumption that all forms of legal enterprise are simply a nexus of contracts among individuals such as shareholders, creditors, suppliers and employees. This paper argues that it is not necessary to subscribe to a belief that the corporation is an entity separate from these contracting individuals to recognize that the separate corporate tax plays a number of important, necessary, and irreplaceable roles in a modern tax system. Many scholars have reviewed the arguments for and against the corporate tax and little conceptual clarity can be added to those arguments; nevertheless, in light of the current interest in removing the double tax on corporate-source income, it seems an appropriate occasion to reexamine them. Instead of dealing narrowly with President Bush's dividend exclusion model, this paper will deal more broadly with the issues relating to the separate corporate and shareholder level taxes. It is suggested that the cumulative force of the arguments in favour of maintaining the separate corporate tax is often understated; the costs and disadvantages of the separate corporate tax are often exaggerated.

Attacks on the corporate tax are not new. Although it might be difficult to generalize about the precipitating events, such attacks have recurred at fairly regular intervals over the history of the corporate tax. The objections that businesspeople might have to the tax are obvious, but economists, who agree on little else, also have been almost unanimous in opposing the tax. Henry Simons, the founder of modern tax policy analysis, abhorred corporate taxes in any form. Richard Bird, one of Canada's most prolific tax scholars, has observed that "one important policy question on which most economists appear to agree... is that there is very little to be said in favour of taxing corporations". Tax law scholars have also generally opposed the separate corporate tax and have suggested that it should be replaced with a form of tax that integrates the corporate and shareholder level taxes. Over the past 40 years, government reports in several countries have also recommended integrating the corporate and shareholder level taxes. During the 1960s, 70s, and 80s, many countries, including France, the United Kingdom, Germany, and Australia adopted some form of integration.

In recent years some commentators have become more sceptical of the advantages of integration and a few countries have moved away from their partially integrated corporate tax systems. This apparent rethinking of the role...
of the separate corporate tax perhaps is reflected in the report of the Mintz Committee, which did not recommend any further integration of the corporate tax in Canada. Certainly, in recent years, perhaps due to the spectacular performance of the United States economy during most of the 1990s, there has been little suggestion of the need to reform the United States' classical corporate tax system. Only four years ago a law professor at the University of Chicago, David Weisbach, made the following prediction:

The two-tier corporate tax has been part of our income tax system since its founding. It taxes income from investment in corporate stock at a higher rate than income from other investments (in either corporations, through a different financial instrument, or in non-corporate businesses). Although academics, and more recently the Treasury Department, have long called for elimination of the two-tier tax system, there has never been a strong political push in the United States to reform it. The two-tier corporate tax will likely be with us for the indefinite future. n20

The fact that President Bush's dividend exemption proposal was supported with little analysis or evidence of its need or impact has led a number of critics to suggest that Bush's tax proposal was simply a way of giving a large tax break to the rich. Nobel prize winners Franco Modigliani and Robert Solow stated unequivocally "the real intent [of the 15 percent dividend tax rate plan] is a continuation of the old struggle to enrich the wealthy at the expense of ordinary people, including future generations." n21 This explanation for the proposed dividend exemption has been coupled with an expressed concern [*628] about its adverse economic and tax system effects. n22 Somewhat typical of the critical responses is that of Reuven Avi-Yonah and David Miller, a tax scholar and a tax practitioner respectively, in an article in the Washington Post. They argue that the dividend exclusion will not stimulate the economy, will add undue complexity to the tax system, is unlikely to address the preference for debt, may draw investors to more risky investments creating greater recession in the next stock downturn, will make it more difficult for states and cities to raise money by issuing tax-exempt municipal bonds, might be difficult to justify to residents of U.S. treaty partners, and will primarily benefit the wealthy. n23

One of the justifications for the American dividend exclusion proposal of special interest to corporate lawyers is the explicit link the administration made between the proposed tax change and corporate governance reform. Removing the tax on dividends, the administration argued in presenting the proposal, would improve corporate governance in two ways. First, it would encourage corporations to pay out more of their retained earnings as dividends hence removing large pools of capital from the hands of corporate managers. As a result agency costs for shareholders would be reduced and dividends would once again be able to perform their essential function of signalling to shareholders how efficiently the corporation is being operated. Second, removing the shareholder tax on dividends would remove the current incentive for corporations to borrow instead of issuing new stock to finance their operations. Thus, the leverage of companies would be reduced and the [*629] economy would be less fragile. n24 Vice President Cheney reiterated these rationales in stating that the proposal would:

... transform corporate behavior in America and encourage responsible practices. Without the current tax penalty, investors will demand higher cash dividends and companies will be motivated to share them. This should discourage companies from artificially inflating profits just to cause a temporary spike in stock prices.

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The rest of this paper is divided into two parts followed by a conclusion. Part II reviews a number of objectives of the corporate tax, arguing that they should carry more weight as arguments in favour of the corporate tax than they are often attributed. Furthermore, while it is conceded that the corporate tax is a second or even an nth best tax for achieving these objectives, there are simply no administratively feasible or politically acceptable alternatives to it. The arguments reviewed in the paper are as follows. First, by taxing income from capital, the corporate tax increases the comprehensiveness, progressivity, and fairness of the income tax. Second, since it falls, at least in part, on pure economic profits, the corporate tax, at least to this extent, raises revenue efficiently. Third, the corporate tax is a necessary support for the individual income tax since without it corporate-source income could accumulate tax-free. Of course, this familiar withholding function of the corporate tax would suggest that the corporate tax should then be refunded when corporate retained earnings are distributed and taxed in the hands of individual shareholders; however, the additional economic inefficiencies and administrative complexities created by all apparently politically acceptable systems of refunding the corporate tax make the effort not worth the costs. Fourth, the corporate tax is a justifiable, widely accepted and efficient method for source countries to levy tax on the business income earned by non-residents. Fifth, the tax serves as a benefit tax, requiring corporations to bear part of the cost of the government services from which their business operations clearly
benefit. Sixth, the tax serves the pragmatic purpose of collecting a good deal of revenue in an administratively efficient and politically acceptable way. Seventh, since the corporate tax is in place, and the economy has adjusted to it, any changes in the tax will cause inequities and windfall gains.

Economists and other critics have a long litany of complaints about the corporate tax. These arguments can be grouped under the traditional tax policy criteria of equity, efficiency, and administrative practicality. Part III of the paper argues that these arguments against the corporate tax are not as compelling as they might appear. The arguments addressed in this part of the paper are as follows. First, critics argue that the corporate tax amounts to double tax and therefore is inequitable. Second, they argue that the tax creates three types of distortions: distortions in corporate payout policies in favour of the retention of corporate earnings as compared with its distributions; distortions in the debt/equity ratios in favour of debt and against new share issues; and distortions in the legal forms of business organization in favour of non-corporate as compared with corporate forms. Third, they argue that the corporate tax is difficult to administer because it requires inherently arbitrary line drawing between legal concepts such as corporate and non-corporate business enterprises, and debt and equity.

The conclusion reviews and dismisses the arguments made in favour of adopting the American proposal to exempt dividends from taxation, or some variation of that proposal. Also, it presents an optimistic prediction about the future role of the corporate tax. Some critics of the separate corporate tax have maintained that even if policy makers do not abandon the tax because they are not persuaded by the tax policy arguments in favour of its abolition, increasing globalization will force its demise. Instead of this pessimistic diagnosis of the future role of the corporate tax, the paper concludes by suggesting that the same factors that are relied upon to predict its ultimate rejection may in fact be the factors that dictate the survival of the corporate tax.

II. THE CASE FOR THE CORPORATE TAX

A. THE CORPORATE TAX INCREASES THE COMPREHENSIVENESS, PROGRESSIVITY AND FAIRNESS OF THE TAX SYSTEM

The corporate tax is often justified by laypersons on the grounds that large corporations earn vast sums of income and, therefore, have ample ability to pay. But, although corporations clearly have ability to pay in the ordinary sense of that phrase, they do not have any ability to pay as that phrase is understood in the context of tax policy analysis. The phrase “ability to pay” in the tax policy context can only refer to the income of individuals. Income for tax purposes is defined broadly as the sum of the value of the goods and services that individuals personally consume in a year and the change in their net wealth. Corporations, being legal constructs, cannot engage in personal consumption nor, since all of their wealth belongs to their individual security holders, does it make any sense to attach significance to changes in their net wealth. Early tax policy analysts might have supported this justification for the corporate tax, but none do now.

However, simply because a corporation itself does not have any ability to pay, does not mean a normative justification for the corporate tax on the grounds of fairness does not exist. In a comprehensive income tax, all forms of income — including income from capital and income from labour — would be subject to the same level of tax. Income from labour is generally taxed relatively comprehensively under the income tax; however, it is notoriously difficult to subject all forms of income from capital to income tax.

Many forms of income from capital escape the income tax entirely, others receive favourable income tax treatment: if income from capital accrues in the form of capital gains, it is not recognized until the gain is realized and then it is subject to tax only at very favourable tax rates; income from capital earned in RRSPs, life insurance policies, and other tax-exempt investment vehicles is exempt entirely from tax; income from capital is often deferred through the use of excess interest deductions and other tax sheltering strategies; capital income earned through the ownership of homes, whether in the form of imputed rent or capital appreciation, is completely exempt from tax; and even fully taxable income from capital often escapes tax as a result of tax evasion. Studies have consistently shown that the overall rate of tax on income from capital is very low, if not negative. For example, because of the tax savings that can be realized by the ability to postpone realization of capital gains, it has been estimated that the so-called accrual equivalent rate of capital gains tax in Canada is anywhere from zero to 10 percent. Indeed it is so well known that income from capital is taxed lightly under the income tax that the tax itself has been referred to as a hybrid tax – part income tax and part consumption tax. In fact, in part because of the apparent difficulties of taxing income from capital comprehensively, many tax analysts have suggested that the income tax system should be converted to a tax on consumption alone.
be taxed as comprehensively as possible. Therefore, because of the difficulties of taxing income from capital in other ways, an important role of the corporate income tax is to impose some level of tax on income from capital, even if the corporate tax is an admittedly crude device.

This argument for the corporate tax, that it increases comprehensiveness, assumes that the tax falls on income from capital. In other words, it assumes that the corporate tax reduces the income earned by shareholders. Yet the incidence of the corporate tax, which is the empirical question of whose share of national income is reduced by the corporate tax, remains one of the most contentious issues in tax policy analysis. In theory, the tax might reduce the income of individuals in their roles as consumers, workers, or owners of capital. For example, corporate managers might be able to treat the cost of the corporate income tax like any other cost and pass it on to consumers in the form of higher prices. The tax might reduce the amount of capital employed in the economy and thus reduce the productivity and real wages of workers. Alternatively, the tax might fall on workers more directly, through negotiated wage settlements, simply because they are the least mobile factor of production in the economy.

The economic incidence of the corporate tax undoubtedly depends upon a wide range of factors and likely varies from industry to industry and even firm to firm. However, the traditional view is that the tax falls on individuals in their role as owners of capital. In the short term, it likely falls directly on corporate profits and thus reduces the rate of return of individuals owning corporate equity capital. In the longer term, however, it is likely shifted to all owners of capital as owners of corporate equity shift their capital to other forms of investments in response to the reduced rate of return they earn on their shares. The increase in demand for these non–corporate equity investments reduces their rates of return, and the reduced demand for corporate equity results in the bidding up of its rate of return. This movement of capital continues until the after-tax rate of return on corporate equity equals the rate of return of other investments of the same risk. Thus, the rate of return for all capital falls, and the corporate tax is effectively borne by all owners of capital.

Naturally, the precise effect of the corporate tax is infinitely more complicated than this simple story suggests, and every step in the real story of the incidence of the tax is contested. Although both the theory and the empirical evidence relating to the incidence of the corporate tax is still the subject of great debate and uncertainty, the prevailing view remains that at least a good portion of the tax falls on income from capital.

[*634] If those earning income from capital bear the corporate tax then, not only does the tax increase the comprehensiveness of the income tax, but also it greatly increases its progressivity. As an indication of the prevailing view of the incidence of the corporate tax, and of its progressive effect, applied incidence studies — studies applying theories of tax incidence to estimate the effect of the Canadian tax system on the distribution of income — invariably find that the corporate tax increases the redistributive effect of the tax system. In the most frequently relied upon Canadian study on tax incidence, the authors, Frank Vermaeten, Irwin Gillespie, and Arndt Vermaeten, assume that to the extent that the Canadian corporate tax rate is equal to the common world rate, which they assume is the U.S. rate, it is borne by owners of corporate shares. To the extent that Canadian corporate tax rates exceed the U.S. rate, they assume it is borne by immobile factors of production, such as workers, or passed forward to consumers. Since they find that the effective corporate tax rate in Canada is about equal to the U.S. rate, they assume (in their standard case) that the entire corporate tax is borne by owners of capital income. On this assumption, the corporate tax is by far the most progressive tax in the Canadian tax system since largely high-income individuals realize capital income. They find that Canadian families earning up to $150,000 pay a trivial amount of their income in corporate taxes: less than 1.3 percent. However, the effective tax rate increases sharply for higher income individuals and the richest 1 percent of families is found to pay about 12 percent of family income in corporate taxes. Without the corporate tax, the incidence of the tax system would be regressive over the highest income ranges.

In another applied incidence study, Ruggeri, Van Wart, and Howard assume in their standard case that half the corporate tax is borne by owners of capital and half is shifted forward to consumers. Even on this much less progressive assumption about the corporate tax, they find that while the tax is mildly regressive over the low end of the income scale it becomes mildly progressive over higher income ranges and sharply progressive for the highest income earners. The Fraser Institute, a Canadian economic think–tank, in its periodic assessment of the incidence of the Canadian tax system also assumes that the corporate tax is borne by owners of capital. On this assumption they find that over 62 percent of the corporate tax is paid by people in the upper 3 deciles of the income distribution.

There is little question that any assumption about the incidence of the corporate tax affects an analysis of the fairness of the tax. If the tax is passed on to consumers in the form of higher prices, like all sales taxes, it would be regressive, or proportional at best; if it results in lower wages for workers in the long run it is odd that it would be a tax that is

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normally championed by labour unions; if it is borne by corporate shareholders, or all owners of capital, it is steeply progressive. Sound theoretical reasons and empirical studies can be mustered to support each of these positions. Some have suggested that one reason that the tax is so politically popular is that no one knows for sure who pays it. Uncertainties over the incidence of the corporate tax led the Mintz Committee to conclude that it should not be used or supported as a redistributive tax. n45

[*636] Faced with these uncertainties, the question is what assumption about the incidence of the tax should be made to guide policymaking? An obvious answer is to adopt the prevailing view. Furthermore, it is difficult to reconcile the views of some economists on the question of who bears the tax with their stance on the economic inefficiencies caused by the tax. If, for example, the tax is shifted forward to consumers in the form of higher prices or backward directly to workers in the form of lower wages, and does not therefore reduce the return to equity capital, presumably it would have few of the distorting effects that economists attribute to it and that motivate them to want it repealed. Moreover, one might observe that most businesspeople and business lobbyists seem to feel that they and their clients pay the corporate tax. While there is no reason for believing that these people have any special expertise in judging the incidence of taxes generally, perhaps they have some tacit knowledge relating to the corporate tax based on their experience with the markets that the tax affects. In any event, they appear to be prepared to devote considerable resources to attempting to have the tax reduced.

B. BY TAXING PURE ECONOMIC PROFITS THE CORPORATE TAX RAISES REVENUE EFFICIENTLY

A second justification for the corporate tax is that it operates (admittedly somewhat crudely) as a tax on pure economic profits (or economic rents or pure profits or excess profits, as this type of profit is variously called). Pure economic profits are the earnings of an arm's length firm, and they are calculated by subtracting all costs of resources, both tangible and intangible, the costs of depreciation and inventory usage, and the full cost of financing the firm's operations (the real interest cost in the case of debt financing and the imputed or opportunity cost in the case of equity financing). The normative justification for imposing a tax on pure economic profits is that such a tax is neutral. Since pure economic profits are by definition the earnings that exceed the opportunity cost of a corporation's investment, corporations will have no incentive to change their investment behaviour if these profits are taxed at any rate less than 100 percent. There is likely a good deal of pure economic profit earned in the Canadian economy, n46 most of it by corporations. Opportunities [*637] to earn pure economic profits arise whenever a firm has a degree of monopoly power in a market, is exploiting natural resources, is operating in a regulated industry, or has some unique location or other business advantage.

The base of the current corporate tax might be described as normal economic profit not pure economic profit and, therefore, it is an imperfect instrument for taxing pure economic profit. However, the two concepts do overlap. On the revenue side, the two bases will yield about the same result for many corporations since, in most respects (other than for capital property), economic profit for tax purposes includes accrued revenues. However, in arriving at their respective concepts of profit the two bases require very different types of deductions. Most obviously, some of the deductions allowed under the income tax are less generous than those allowed under a tax on pure economic profits; most notably, the income tax does not allow a deduction for the opportunity cost of equity capital. However, in other cases the deductions permitted under the income tax are more generous than would be allowed under a tax on pure economic profits tax. For example, under an income tax, not only real, but nominal interest expenses are deductible and the allowance for depreciation often exceeds the economic depreciation of capital properties. Of course, it is highly unlikely that the economic profit of individual firms computed for income tax purposes would equal their pure economic profit. Nevertheless, in the absence of a tax on pure economic profit the corporate income tax serves the purpose of capturing some of the economic rents being earned in the Canadian economy.

From time to time, economists and government reports on tax reform have suggested that, to the extent that taxing pure economic profit is one of the purposes of the corporate income tax, it would make sense to replace the corporate tax with a properly designed pure economic profit tax. n47 The difficulty is that it would be impracticable to implement such a tax base directly since many of the revenue and expenditure items that would have to be calculated in arriving at the tax base depend upon unobservable amounts, such as the opportunity cost of equity capital. Nevertheless, it has been [*638] postulated that simply taxing corporations on their cash flow would result in the tax falling on a firm's pure economic profit in present value terms. There are various possible versions of a corporate cash-flow tax, however, the simplest one would allow firms to expense all capital outlays fully, report purchases and sales on a cash rather than an accrual basis, and remove all financial flows (dividends and interest received and paid) from the tax base. In theory, this tax base would result in a relatively accurate measure of the corporation's economic profits. However, as many of the proponents of the
corporate cash-flow tax have admitted, implementing it poses daunting administrative problems: other countries might not recognize it for the purposes of their foreign tax credits; a provision making negative taxes refundable, which would be required for the full benefits of the tax to be realized, would face enormous political resistance; in many industries even larger distortions would be created between incorporated and unincorporated firms; and rules would be required to address the strong incentives for individuals to incorporate their portfolio investments and personal service firms. As well as these and other administrative problems with attempting to implement a cash-flow corporate tax, such a tax would be anomalous and lead to all sorts of arbitrage opportunities as long as an income tax was levied at the individual level. A cash-flow corporate tax is only a realistic possibility if the individual income tax were changed to a personal consumption tax. n48 Finally, replacing the corporate income tax with a cash-flow tax would require the use of other policy instruments to achieve the other objectives now served by the corporate income tax. Thus, imperfect as it is, the corporate income tax is the only plausible way to levy a general tax on the economic rents earned in the Canadian economy.

C. THE CORPORATE TAX IS NECESSARY TO PREVENT THE UNLIMITED OPPORTUNITY FOR TAX DEFERRAL IN A REALIZATION-BASED INDIVIDUAL INCOME TAX

A comprehensive income tax base consists of the value of an individual's consumption plus accumulation. Accumulation in a year includes unrealized appreciation or in Henry Simons' words, "the change in the value of the store of property rights between the beginning and the end of the period in question." n49 Yet, largely for administrative reasons (such as the difficulty of valuing assets every year end and the hardship of requiring taxpayers to pay tax on gains that have not been converted to cash), no country taxes individuals on the accrued value of their capital assets. Instead, the gains on [*639] capital assets are taxed only when they are realized. Although the realization doctrine has been described as the "Achilles' heel" of a comprehensive income tax ideal, n50 and is a source of significant complexity, for most types of property the income tax system is able to cope reasonably well with taxing some gains only upon realization. The type of property that poses the most obvious danger to the individual income tax base under a realization-based regime is corporate shares. If the income earned in corporations was not taxed until individual shareholders sold their shares, the individual income tax base could be significantly eroded. Individuals would divert as many income sources as possible into corporations. Therefore, one of the most important and necessary purposes of the corporate tax is to prevent the undue deferral of tax on income earned in corporations. n51 This is often referred to as the withholding function of the corporate tax. n52

Few tax analysts would deny that the corporate tax is essential for the purpose of preventing the undue deferral of tax in a realization-based individual income tax system. The debate over the past 40 or so years has been over whether, if this withholding function of the corporate tax is its major purpose, the corporate tax should be refunded to shareholders when they pay tax on their corporate-source income and, if so, how such a refund should be structured. Many of those who think withholding is the primary purpose of the corporate tax argue that it can easily be integrated with the shareholder level tax on corporate-source income with great benefit. Others, who support the separate-level corporate tax, point out that withholding is only one function of the corporate tax and that, in any event, attempting to integrate it with the shareholder level tax leads to a great deal of complexity and creates more distortions than it resolves.

There are two obvious ways of completely integrating the corporate with the shareholder level tax, turning the corporate tax solely into a withholding tax. First, shareholders could be required to value their shares every year, paying tax on the accrued gain. This is what would be required under a truly comprehensive income tax base. The only purpose of the corporate tax would [*640] be to act as a withholding tax that would be credited against the tax liability of individual shareholders. There are four obvious problems with this approach to integrating the two taxes. First, it would require the annual valuation of shares. Particularly for those shares without an active market, annual valuation poses almost insurmountable difficulties. Second, this approach requires a method for allocating the corporate withholding tax to individual shareholders. This annual allocation would be a formidable task for large corporations with multiple classes of stock and millions of shares being traded daily. Not requiring the corporation to withhold tax and instead requiring individual shareholders to pay their own tax bills could avoid this problem, but the familiar liquidity problems and problems of enforcement and collection remain. Third, this approach would tax shareholders not only on their share of corporate profits, but also on other gains that would be reflected in the value of their shares including the unrealized appreciation of corporate assets and corporate goodwill. Thus, unless all assets were taxed on a realization basis, distortions and inequities would result. Fourth, this method of integration would not preserve the character of the corporate-level income and deductions. For these and other reasons, no country has attempted to refund the corporate tax using this approach. n53
Another method of fully integrating the shareholder and corporate tax is commonly referred to as the partnership or shareholder allocation approach. Under this approach, in its purest form, the corporation would simply act as a withholding tax in much the same way that employers withhold the tax to be paid by employees every year. In Canada, the Carter Commission proposed a variant of this type of integration. n54 Again, there is a long list of administrative and other reasons why no country has considered this proposal practicable. First, with large publicly held corporations that have often dozens of classes of different shares, where individual shares might be traded several times a year, and [*641] where financing instruments that have been issued may only look like shares, it is improbable that a method could be found of sensibly allocating corporate retained earnings to individual shareholders. This problem would be compounded where there were several levels of corporate holdings, each with different year-ends. Second, unless the corporate withholding tax was set at the top individual rate, shareholders might face liquidity problems. Third, this form of integration would make it impossible, or at least very difficult, to use the corporate tax as a policy instrument for providing incentives for activities to be favoured by the government, including small businesses — instead of targeting one taxpayer, the corporation, by imposing lower tax rates, for example, on a particular activity, the government would need to consider the effect of particular measures on the ultimate payees of the tax: individual shareholders, each of whom might face slightly different tax consequences of a particular incentive. Fourth, the revenue consequences, particularly if the tax was refunded to tax-exempt institutions and non-resident shareholders, would be extremely large. Fifth, if the corporate calculation of income was disputed by the revenue authorities, this method would require adjustments to be made to the tax liability of all shareholders years after the filing of their individual tax returns. The frequent trading of equity ownership would complicate this audit difficulty, as would the differing year-ends of the shareholders and corporation. n55 Sixth, the partnership approach might create excessive agency costs as investors, with different tax positions, might disagree about internal corporate decisions and may, therefore, feel the need to more closely monitor managers’ decisions. n56

In recognition of these and other problems, instead of implementing a system of full integration for the corporate and shareholder level taxes, those countries that refund part of the corporate tax have implemented only partial systems of integration. Most significantly, they have only attempted to refund the corporate tax paid on dividends, instead of that paid on retained earnings. Moreover, even on the payment of dividends, many refund only part of the corporate tax paid on the retained earnings out of which the dividends are paid.

The different methods that countries have used to achieve some degree of partial integration, or that commentators have urged countries to adopt, are legion. n57 However, most methods are some variation on one of three [*642] systems. n58 Some partial integration systems allow corporations to deduct dividend payments, others provide a tax credit to shareholders who pay tax on dividends, and others apply one rate of corporate level tax to retained earnings and another to dividends. The point here is not to review the details of these schemes, but rather to note that all of them ultimately lead to enormous complexity in the tax system and appear to create as many distortions as they purport to remove. For example, any integration scheme poses numerous difficulties and opens up opportunities for tax avoidance. One of the most difficult issues has been how to relate a dividend tax credit to the actual corporate tax paid on the retained earnings out of which the dividend has been paid. Another difficulty is that the refund is seldom extended to charities and other tax-exempt institutions or to low-income shareholders. This greatly reduces the possible positive effects of integration, namely, the elimination of the disparate treatment between debt and equity. Yet another difficulty is that most schemes of partial integration do not extend relief to non-resident shareholders. n59 Again, this undoes much of the supposed benefits of integration. However, to extend it to foreign shareholders would invariably result in large revenue losses and would be contrary to another of the principal purposes of the corporate tax, namely to tax non-residents’ business income earned in the source country.

Most importantly, without complete harmonization between countries, there is no way that the international biases created by some form of partial integration can be removed. In theory, to have an efficient allocation of worldwide capital, investors should pay the same tax whether they invest in their own residence country or some other country. Moreover, the tax that investors pay in another country should be the same as that paid by resident investors in that country. However, by way of illustrating the distorting effects of some form of partial integration, if a non-resident investor is investing in a country that is providing dividend tax credits only to resident shareholders, investment biases will be present. n60 Even if non-resident investors receive a dividend tax credit in the foreign country, there still might be an investment [*643] bias since that might reduce the taxes they pay on foreign investments as compared to investment in their resident country. Reuven Avi-Yonah, a U.S. tax scholar, has argued that in general, "there seems to be no reason to assume that the
biases created by integration from an international perspective are less important than the biases created by the classical system from a domestic perspective.” n61 Indeed, a number of countries that have recently substantially reduced the corporate tax they refund to shareholders, such as Japan, Germany and the U.K., have done so largely because increased international investment has exacerbated the distortions caused by systems of partial integration.

In summary, an important, indeed vital, purpose of the corporate tax is to act as a back up for the individual income tax by preventing individuals from indefinitely deferring tax on corporate source income. n62 However, because of the complexity and additional distortions created by integration, n63 treating the tax as a separate tax and not refunding it to individual shareholders best achieves this withholding function of the corporate tax.

D. THE CORPORATE TAX PROVIDES A JUSTIFIABLE AND WIDELY ACCEPTED TAX ON NON-RESIDENTS

Non-residents control many Canadian corporations and foreign portfolio investors hold many shares of Canadian corporations. n64 Consequently, a good deal of the corporate tax falls on income that will be distributed to non-residents. For at least three reasons, the corporate tax acts as a justifiable tax on the income that non-residents earn in Canada. n65 First, while equity arguments in support of the international division of tax bases are always difficult to develop beyond assertion, it does seem equitable that the country in which business income is earned has a claim to impose the most substantial tax upon it. The taxpayer has derived a benefit from the provision of government services that made the earning of the income possible. In any event, it is a well-established international tax norm that the return to equity investment will be taxed primarily in the source country, while the return to debt instruments will be taxed primarily in the resident country. Or as Richard Bird stated in a slightly different context, "one reason most countries tax corporate profits is because most countries tax corporate profits.” n66 Once again, it might be argued that the corporate tax is an imperfect tax for performing this function and that this objective might be more fairly achieved by simply raising the withholding tax imposed on dividends paid to non-residents. However, raising the withholding tax would mean that the tax would only be collected when corporate profits were distributed. Furthermore, Canada's tax treaties would restrain increases in the withholding tax on dividends, at least for the time being. n67

A second justification commonly given by commentators for taxing the income that non-residents earn in Canada at the corporate level is that some percentage of that income is likely to be pure economic profit. As Peter Sorensen has suggested, "because of local factors, multinational corporations will sometimes be able to earn above-normal returns by investing in a particular country. The corporation tax enables the domestic government to capture some of these 'location-specific rents' without deterring investment.” n68 As discussed above, to the extent that the corporate tax is imposed on pure economic profit, it is both an equitable and a neutral tax.

Third, from a practical perspective, if non-residents are not subject to tax on their Canadian earnings, their country of residence will likely collect tax on that income. n69 The result is that revenue will simply have been transferred from the Canadian treasury to a foreign treasury. For example, U.S. corporations carrying on business in Canada will pay U.S. tax on their earnings when they repatriate them to the U.S. To the extent that those earnings have been taxed in Canada, the U.S. government normally allows that tax to be credited against these corporations' U.S. tax. Consequently, if the Canadian corporate tax is reduced, less Canadian corporate tax is collected, and more U.S. corporate tax is raised. This justification for the corporate tax was well understood almost 40 years ago by the Carter Commission:

A substantial proportion of the shares of Canadian corporations is held by non-residents. ...The revenues derived from taxing the corporate source income attributable to non-residents provide a major economic benefit to Canada. If Canada did not tax corporate income on an annual basis at a rate roughly equal to the rate other countries impose on the foreign corporate income generated by their residents, we would simply be transferring substantial revenue from the Canadian treasury to foreign treasuries with little reduction in taxes to the non-resident shareholder. This would provide a substantial windfall to foreign governments at Canada's expense... n70

E. THE CORPORATE TAX SERVES AS A GENERAL BUSINESS BENEFITS TAX

A long-standing approach to equitable taxation argues that taxpayers should be taxed in line with their demand for public services. For many specific goods and services this principle can be implemented through the use of fees, charges, and tolls. Where the imposition of a direct charge is impracticable, taxes can sometimes be used in lieu of a direct charge. Thus gasoline taxes are often justified as an indirect way of charging for highway usage.

Corporation shareholders derive substantial benefits from government regulations and expenditures. Hence the
corporate income tax is sometimes justified as a general business benefits tax. Corporate shareholders receive two types of benefits from the state. First, the shareholders, through the legal personality they are permitted to create, are granted a number of legal privileges: limited liability, free transferability of their interest in the corporation, ability to sue and be sued in the name of the corporation, perpetual existence of the corporation, and easy access to capital markets. Those who deride the corporate tax as a general benefit tax argue that granting these legal privileges to corporations and their shareholders cannot justify the separate corporate tax since benefit taxes will only promote efficiency if the taxes imposed equal the social cost of the benefit provided. The state incurs almost no costs in providing these benefits to corporations and shareholders. [*646] Moreover, they point out that many non-corporate legal forms that can be used to carry on a business enterprise, such as limited partnerships and trusts, now provide the same benefits as corporations and, therefore, a benefit tax justified on these grounds would have to be extended to all these business forms. Finally, they note that, at the very least, whatever the value of these legal privileges, they would appear to bear almost no relationship to the base of the corporate tax, namely economic profit.

In spite of these objections, an argument can be made that the corporate income tax can usefully serve as a general business benefits tax. The legal privileges that corporations are granted, such as limited liability and the ability of their shareholders to easily terminate their investments, undoubtedly provide a significant benefit to their shareholders. There is no reason for supposing that shareholders would not be prepared to pay a considerable amount for them. Thus taxing these benefits should not cause investors to change their behaviour. n71 Moreover, while the actual direct costs to the government of providing these benefits to businesses carried on in the corporate form may not be substantial, as a result of providing, for example, limited liability, the state is often left to bear other costs that it would not bear in the absence of granting such a legal privilege. It is true that other legal forms can sometimes be used to achieve the same legal advantages as incorporation; however, none would appear to provide those advantages as conveniently as the corporate form. If it were the case that non-corporate business forms received government benefits similar to traditional corporations, it could be argued that the corporate tax should be extended to such legal relationships. It is also true that the value of these privileges to particular shareholders would appear to bear only a loose relationship to corporate profit earned for the benefit of those shareholders; but it is difficult to imagine a method for determining the specific value of these legal privileges to individual shareholders. Once again, the corporate tax would appear to be an imperfect tool, but the only available tax for this purpose.

The second type of benefit that corporations receive from the state relate to the legal, social and economic infrastructure that enable corporations to earn their business profits. Corporations clearly benefit from the state's transportation and communication infrastructure, the state's public safety operations, the protection of property and contract rights, and a court system and law enforcement personnel. They also benefit from the state's school system's production of an educated workforce and its health care system's ability to keep that workforce healthy. n72 The fact that corporations attach a [*647] great value to these services is evidenced by the fact that numerous studies have shown that corporations attach a high significance to these types of public services when deciding where to locate their operations. Indeed, studies have shown that in making these decisions corporations attach more significance to the availability of these public services than they do to corporate tax levels. n73 It is true that businesses that are not incorporated also benefit from all of these services, but aside from a few industries such as agriculture and fishing, the amount of business conducted in unincorporated legal forms is trivial. Also, for these types of benefits in particular, it is plausible to argue that the actual benefits corporations and their shareholders receive from them are directly related to the profits they earn. It is hard to imagine a specific benefit tax that would be a better proxy.

F. THE CORPORATE TAX COLLECTS A GOOD DEAL OF REVENUE IN AN ADMINISTRATIVELY EFFICIENT AND POLITICALLY ACCEPTABLE MANNER

Modern governments have to collect huge amounts of revenues to finance their operations. A tax that yields a considerable amount of revenues, is relatively easy to administer, and is politically acceptable should not be disparaged. In 2001–02 the Canadian federal government estimated that it raised approximately $24 billion in corporate income tax revenues. n74 The [*648] corporate tax made up 13.9 percent of total federal government revenues, making the tax the third highest revenue raiser behind the personal income tax, which raised 48.3 percent of total revenues, and excise taxes and duties, which raised 21.1 percent of total revenues. n75 Federal government reliance on corporate tax revenues relative to other tax revenues has varied over time. Over the last forty years, it reached a high of 20.3 percent in 1964–65 and a low of 6.0 percent in 1992–93. n76 The amount of corporate tax collected by Canada as a percentage of gross domestic product in 2000 was 4 percent. n77 This ratio was slightly higher than the OECD average of 3.6 percent. n78 This amount of revenue could not be raised from other tax bases without creating major dislocations in the Canadian tax system.
Some deny that there would be any windfall in the transition in this case. They argue, for example, that individual moving from one tax system to another have been the subject of a large and sophisticated body of tax literature. n90 windfall to existing shareholders.

shares to increase. Hence, much of the benefit of the reduction in the taxes would be simply dissipated in an unjustified absence of the corporate tax. If the tax were removed, or substantially reduced, one would expect the price of all equity investment of equal risk. The result is that the price of equity securities is undoubtedly lower than it would be in the rate of return they could earn on their equity investment with the after-tax rate of return they could earn on any other investments. They would not, therefore, be willing to pay more for the share than an amount that equalized the after-tax rate of return on the dividends, or capital gains on distribution or realization would reduce their after-tax rate of return on corporate

in the price of shares. Investors who bought shares presumably were aware that both the corporate tax and the tax on dividends, or capital gains on distribution or realization would reduce their after-tax rate of return on corporate

any new investment. n89 This is because much of the existing corporate tax has likely been reflected or capitalized only dividend distributions, is that it would likely result in large windfall gains to all existing shareholders without creating any new investment. n89 This is because much of the existing corporate tax has likely been reflected or capitalized in the price of shares. Investors who bought shares presumebly were aware that both the corporate tax and the tax on the dividends, or capital gains on distribution or realization would reduce their after-tax rate of return on corporate investments. They would not, therefore, be willing to pay more for the share than an amount that equalized the after-tax rate of return they could earn on their equity investment with the after-tax rate of return they could earn on any other investment of equal risk. The result is that the price of equity securities is undoubtedly lower than it would be in the absence of the corporate tax. If the tax were removed, or substantially reduced, one would expect the price of all equity shares to increase. Hence, much of the benefit of the reduction in the taxes would be simply dissipated in an unjustified windfall to existing shareholders.

There are several responses to this windfall objection to changing the corporate tax. The difficulties generally of moving from one tax system to another have been the subject of a large and sophisticated body of tax literature. n90 Some deny that there would be any windfall in the transition in this case. They argue, for example, that individual
investors would have anticipated possible changes in the corporate tax system and that this uncertainty would have prevented the corporate tax from being completely discounted in the price of shares. Others note that this type of windfall argument could be made against any almost change in the tax laws and that in most cases the efficiency gains from reform will outweigh the inequity of providing windfall gains to some taxpayers. Nevertheless, the large potential windfall gains in the case of wholesale changes to the corporate tax should at least caution against changes unless the benefits to be achieved are substantial and certain.

One final consequence of abolishing or fundamentally revising the corporate tax is that governments would be left with one less governing instrument for pursuing their policy objectives. At present, the corporate tax is used to achieve a wide range of specific regulatory objectives; n91 for example, small businesses pay a lower rate of tax to compensate them for credit market biases, tax credits are available to encourage new capital investments, tax incentives abound for the conduct of scientific research and development, and there are a host of accelerated write-offs for assets whose use the government wishes to encourage. n92 Some commentators have argued that other regulatory instruments would be as or more effective than the corporate tax mechanism for delivery of these subsidies in most cases. n93 Although there may be some truth to that analysis, given that the corporate tax is in place, it may be sensible to use it to provide incentives in some cases. The corporate tax may provide a useful mechanism for delivering incentive programs because of the [*654] expertise of the revenue agency, n94 and in some cases it may provide a more politically acceptable mechanism for providing an incentive than the government cutting particular corporations cheques for direct payment. n95 In any event, if the corporate tax were abolished all the objectives now pursued through the use of corporate tax expenditures would have to be pursued using other, possibly more complex and distortionary, policy instruments.

III. THE CASE AGAINST A CORPORATE TAX

The arguments in support of the corporate tax outlined above do not rest upon the premise that the corporate tax in its current form is designed perfectly to meet each of its possible objectives. They do illustrate, however, that the corporate tax serves myriad different purposes reasonably well. The corporate tax increases the fairness of the tax system, exacts some portion of pure economic rents, prevents deferral of individual taxes, operates as an effective capital tax on non-residents, ensures that corporations internalize some of the social costs they create and that they pay for some of the benefits they receive from government, collects revenue in a politically acceptable fashion, and is embedded in the economy. It would be impossible to design a series of specific taxes that would serve these goals as effectively without incurring substantial administrative and transitional costs.

In spite of the purposes that the corporate tax serves, there are a number of familiar arguments that have been made against its retention. Taxes are traditionally evaluated using the criteria of equity, neutrality, and simplicity. Opponents of the corporate tax allege that it violates each of these criteria. It is inequitable because it results in the double taxation of corporate-source income. It creates three major economic distortions: it causes firms to reduce dividend payments; it causes firms to become too heavily leveraged; and it distorts the allocation of resources between the corporate and non-corporate sectors. It also requires a number of administratively difficult distinctions to be made between, for example, corporate and non-corporate business forms, and debt and equity. All of the arguments against the corporate tax can be categorized under one of these three types of criticisms. After setting out each of these criticisms, this part of the paper argues that they are not nearly as serious as opponents of the corporate tax have suggested.

[*655] A. THE CORPORATE TAX AND THE TAX ON DIVIDENDS IMPOSE AN INEQUITABLE DOUBLE TAX ON CORPORATE-SOURCE INCOME

The equity case against the corporate tax — the so-called double taxation argument — is easy to illustrate. Assume that a corporation earns $100 of profits and the corporate tax rate is 35 percent. The corporation will have after-tax earnings of $(100 - $35) $65. If these after-tax corporate earnings are distributed to shareholders whose individual tax rate is 40 percent, the shareholders will pay tax of (40 percent of $65) $26 and be left with ($65 - $26) $39 after-tax. Consequently, the shareholders will have paid an effective rate of tax of 61 percent on $100 of corporate-source income, even though their individual marginal rate is only 40 percent. This inequity is compounded since the corporate tax is a flat rate and thus imposes the same basic tax rate on low- and high-income shareholders.

This equity argument against the corporate tax is misleading for a number of reasons. First, characterizing the tax on corporate-source income as a double tax to invoke an obvious moral objection to the tax is conceptually misleading. n96 Most forms of income are subject to double tax and even triple or quadruple tax. Labour income, for example, is often subject to the income tax plus two or three different payroll taxes. When income is consumed it is likely subject
to another series of taxes in the form of excise, import and sales taxes. If one’s concern were income that was subject to more than one tax, corporate-source capital income would not be the place to start. In fact, as long as each separate tax can be justified, there can be little objection on the grounds of equity to multiple taxation. As argued in Part II, the corporate-level tax has a number of separate justifications. Moreover, it seems worth noting that even if two taxes do not have separate justifications, presumably what individual taxpayers care about is not the number of taxes they pay but the overall rate of tax. One might assume that income subject to four different taxes each with a rate of 5 percent would be more acceptable to most taxpayers than the same income being subject to one level of tax with a rate of 40 percent.

Second, the standard example illustrating the inequity of the corporate tax is misleading because it assumes that the statutory rate of tax on corporate-source income is also the effective rate and that corporate retained earnings are always immediately distributed. Few, if any, corporations pay tax at the statutory rate. In fact, the Mintz Committee found that the average federal \[^{656}\] effective tax rate for corporations operating in all industries was 16 percent. \[^{97}\] Many profitable corporations pay no income tax at all because they are able to take advantage of corporate tax incentives and credits. Moreover, many shareholders similarly do not pay tax on dividends, either because they are tax-exempt, such as charities and pension plans, or because they are other corporations (and able to pass intercorporate dividends tax-free). \[^{98}\] Given the high number of non-taxable corporations and investors, instead of a slogan against double taxation, in many instances it would be more appropriate for tax reformers to be concerned about collecting at least one level of tax. Furthermore, because of the small business credit, the system of refundable taxes for investment income earned by private corporations, and the dividend tax credit mechanism, business income earned by Canadian-controlled private corporations and investment income earned by private corporations is not subject to any form of double tax in the Canadian tax system.

An even more significant factor resulting in the reduction of the total amount of tax paid on corporate-source income is that corporate profits often are not distributed to shareholders but instead are reinvested by the corporation. Individual shareholders do not pay tax on retained earnings until they sell their shares. In this case, if the corporate tax rate is significantly less than the rate of tax paid by the individual shareholder, the overall tax paid on corporate-source income often will be much less than if the shareholder had earned the business income directly. \[^{99}\] Providing a simple illustration of the time value of the deferral in the corporation is complicated; however, Samuel \[^{657}\] C. Thompson Jr., a professor at the University of Miami, has provided a relatively straightforward example based on the U.S. tax rates and the payout history of American corporations. The Canadian rates do not deviate significantly from those used by Thompson, and his example provides a useful illustration of the interaction of the value of deferral with other aspects of the taxation of corporate-source income. Assume that the effective corporate tax rate is 22 percent, the marginal rate of tax for an individual shareholder on dividends is 35 percent, and the effective capital gains rate is 15 percent. Assume also that corporations distribute 60 percent of their after-tax earnings to shareholders — 60 percent of that amount as dividends, and 40 percent as share repurchases that qualify for capital gains treatment. Finally, assume that shareholders generally sell their shares after 10 years and that the discount rate is 10 percent. Given these assumptions, Thompson calculated that the present value of the aggregate tax burden from the corporate tax, shareholder tax on dividends and repurchases, and capital gains tax on disposition result in a tax rate of 35.5 percent. \[^{100}\] This rate is lower than the top personal rate on ordinary income.

Finally, the example illustrating the inequity of the corporate tax is misleading because it assumes that the incidence of the corporate-level tax falls fully on shareholders and that no market adjustment occurs to the price of shares to account for the tax. If the corporate tax is shifted forward to consumers in the form of higher prices or back to workers in the form of lower wages then profits available to shareholders will be unaffected by the tax. \[^{101}\] If this is the case, an argument can be made that consumers or workers should be receiving the tax relief that shareholders argue they are entitled to because of double tax. However, even assuming that part of the tax falls on profits and, therefore, the return that is available to shareholders, the price of shares should adjust to completely remove any inequity potentially caused by the tax. This is the familiar point about the capitalization of taxes discussed in the section of the paper that addressed the transition effects of a move from the corporate tax. In the example above, purporting to illustrate the inequity of the corporate tax, taxpayers would have paid a price for the shares that would result in them earning the same after-tax rate of return that they could earn on any equivalent \[^{658}\] investment. That is, market adjustments would ensure that the tax levied on the corporate-earned income was completely discounted in the price of the shares. This point can be seen intuitively by thinking about how strange it is that investors who bought equity shares instead of other investments, knowing how much tax had to be paid on each type of investment, would then think they had standing to complain on the grounds of equity about the taxes they paid in relation to that paid on other investments. The capitalization of corporate taxes in the price of shares is, of course, an illustration of a more general tax policy theorem, made well known in the tax literature in a classic article by...
Boris Bittker back in 1979, namely, that often because of market forces, inefficiencies will drive out inequities. n102 This brings the paper to the next criticism of the corporate tax, the alleged inefficiencies caused by it.

B. THE CORPORATE TAX DISTORTS CORPORATE FINANCIAL DECISIONS AND INVESTMENT DECISIONS AND THUS THE ECONOMIC WELL BEING OF TAXPAYERS

All taxes involve a transfer of resources from individual taxpayers to the government. They impose compliance costs on taxpayers and administrative costs on the government. These costs of taxation are unavoidable. However, all taxes also cause taxpayers to substitute preferred but taxed activities for less preferred but less taxed activities. To the extent that taxes cause taxpayers to substitute a preferred transaction or activity for a less preferred transaction or activity they reduce the efficiency of the economy. Although all taxes affect behaviour to some extent, corporate taxes are alleged to have particularly adverse affects on business decisions and, therefore, the efficiency with which resources are allocated in the economy. These alleged effects of the corporate tax include effects on financial decisions such as the choice between debt and equity, the decision to retain earnings or distribute them as dividends, and effects on investment decisions such as the decision of whether to invest in the corporate or non-corporate sector. n103 This section will examine these possible distortionary effects of the corporate tax and argue that they are not likely as serious as they are often alleged to be.

[*659] 1. THE CORPORATE TAX CREATES A BIAS IN FAVOUR OF RETENTIONS

One of the important financial decisions that corporate managers must make is whether to retain and reinvest corporate earnings or whether to distribute them to shareholders as dividends. Conscientious corporate managers endeavour to establish a dividend policy that will maximize shareholder wealth. One of the criticisms of the corporate tax is that it biases management financial decisions in favour of retaining corporate earnings and, therefore, reduces shareholder wealth. Whether the corporate tax has this effect depends upon the answer to a series of questions: whether the payment of cash dividends can affect shareholder wealth; if it can, what dividend-payout ratio will maximize shareholder wealth; and whether the corporate tax affects that ratio?

Over the last 50 years, the prevailing finance theory view of dividend policy has shifted. Prior to 1960, to the extent that analysts turned their attention to dividend policy at all, they simply described it, assuming that shareholders had some unquantifiable preference for dividends over retentions because dividends were seen to remove an element of uncertainty about shareholders' wealth position by giving them cash in hand. Then, in their classic contribution in 1961, Miller and Modigliani hypothesized that the value of a firm should be unaffected by its dividend policy and, therefore, a matter of indifference to its shareholders. n104 The essence of their proof of this proposition rested upon the assumption that shareholders could by their own actions achieve whatever dividend-payout ratio they wished for a particular firm: they could sell shares of the firm to achieve the same results as a dividend payment, and they could purchase more issued stock to offset the effect of a dividend payment — in essence, investors could manufacture a home-made payout ratio through the purchase or sale of shares. Basically, they theorized that the firm, through its financial decisions, is unable to do something for the shareholders that they cannot do for themselves and, therefore, given the investment decisions of the firm, the firm's payout decisions are irrelevant to the shareholders. The value of a firm is determined solely by the rate of return it earns on its investments and is independent of how those returns are split between dividends and retentions.

The Miller and Modigliani hypothesis rested upon a number of assumptions: that investors had perfect information about the firm's investment policy and the conduct of the corporate managers, that individuals could buy and sell shares of the firm without cost, that dividends served no purpose other than to distribute the firm's cash, and that there were no taxes or that the taxes that were imposed were perfectly neutral in their effect on the firm's payout ratio. Following publication of Miller and Modigliani's article, [*660] research relating to dividend policy has consisted essentially of testing the implications of varying these assumptions.

What is now widely referred to as the traditional view of dividend policy assumes that, contrary to Miller and Modigliani's assumption, there are a number of reasons why shareholders might value the payment of dividends (even though they could replicate the cash flow results by selling shares): dividends might reduce agency costs, that is, the cost shareholders incur in monitoring management; in the absence of perfect information about the corporation's prospects, dividends might signal the corporation's profitability, or at least reduce uncertainty about the firm's prospects; and, dividends might assist shareholders in planning their own consumption patterns, particularly since the purchase and sale of securities is costly. n105 This traditional view also assumes, contrary to Miller and Modigliani's assumption in their initial article, that there are tax costs to the payment of dividends, since dividends are taxed in the shareholders' hands upon distribution, while retained earnings do not bear the shareholder level tax until the shareholders sell their shares and
then they are taxed at preferential capital gains rates.

Thus, so the traditional argument goes, corporate managers will only pay dividends when the non-tax benefits of paying dividends exceed the extra tax cost. Under this view, taxes on dividends clearly affect corporate financial decisions. They reduce dividend payouts. Moreover, they increase the cost of capital to corporations. Corporations cannot finance new investments out of retained earnings since corporations must pay out a portion of their earnings in dividends (to satisfy shareholder demands for dividends). The marginal source of equity funds is assumed to be new issues of stock. Thus corporate investments must earn a rate of return that will cover both the corporate tax and the tax on dividends. Those who take this traditional view are likely to favour some form of integration of corporation and shareholder taxes in order to remove the bias of the separate level tax on payout ratios.

Over the past 25 years, a new view of dividend policy has developed. This view, which is more consistent with Miller and Modigliani's initial assumptions, argues that dividend payments offer no benefits to investors relative to retained earnings. They do not perform a signalling function nor do they reduce shareholder agency costs. Dividends, under this view, are simply the funds left over after the firm has satisfied all of its other obligations and exhausted its investment opportunities. Thus, if firms need funds for capital investment, they will find themselves under no compulsion to pay out dividends. They will be able to finance their new investments out of retained earnings and need not go to the market for new funds. Furthermore, this new view holds that there is no tax disadvantage to paying out dividends as opposed to retaining earnings. The reason for this is that earned income must be paid out as dividends eventually (equity is "trapped" in the firm) and when it is paid out (along with all of the income it has earned from being reinvested at the corporate level) it will bear the shareholder level tax. Thus reinvesting corporate level earnings cannot reduce the present value of the individual tax on dividends. Furthermore, shares will be priced to discount the tax liability that will be imposed upon the eventual distribution of earnings. The tax on dividends is assumed to have no effect on the cost of capital to the corporation since the marginal source of equity is retained earnings. Thus a change in the tax on dividends will have no effect on the user cost of capital and thus no impact on investment decisions or shareholder wealth.

There have been countless theoretical and empirical studies of dividend policy over the past forty years and there is still no consensus on the effect of taxes on dividend policy or even the significance of dividend policy on firm value. Certainly, no one claims to have a firm view of the optimal dividend payout ratio. After an exhaustive review of the studies, McKenzie and Thompson, in a background study prepared for the Mintz Committee, concluded "the current 'state of the art' gives a slight edge to the view that dividend taxes act to dampen both investment and dividend payouts, at least for some firms, although the results are by no means conclusive." n107

Altogether aside from the importance of a theory of dividend policy relating to individual taxable shareholders, the fact is that there is some likelihood that in today's security markets the marginal investor in corporate equity has a zero rate of tax and, therefore, the rate of individual tax on dividends is completely irrelevant both for investment decisions and the determination of equity prices. Many shareholders are tax exempt, such as charities and pension plans, including RRSPs. One would expect these shareholders to migrate to those shares that paid significant dividends, and tax exempt individual shareholders to migrate towards those shares that yielded most of their return in the form of capital gains. Thus, the corporate tax should have no effect on the cost of capital and therefore investments and no effect on the dividend-payout ratio. Whatever the effect the corporate tax might have on payout ratios in a world of taxable individuals, it is clearly mitigated by the presence of so many tax-exempt shareholders, including other corporate and non-resident shareholders. Moreover, the effect of the corporate tax would be further reduced where the corporate tax rate is much lower than the top individual marginal tax rate, as it is now in Canada; the fact that corporations can distribute earnings at capital gains rates by redeeming shares; and the likelihood that at least some part of the tax on dividends is capitalized into the price of shares and, therefore, any retention bias only applies to new equity, and new equity is unlikely to pay dividends for non-tax reasons.

Finally, if the tax system were to bias corporate financial decisions in favour of retentions, it is not clear whether or not that bias might be efficiency enhancing since it might simply be correcting for other biases in the tax system and in the economy more generally. One the one hand, a bias in favour of retentions could mean that corporate managers are investing funds that could be invested more efficiently by shareholders; it could mean that corporate managers are provided with more opportunity for misconduct; and it could result in less funds being available for small and medium size firms because larger firms are financing their investments out of retained earnings instead of distributing funds and competing on the new issue equity market. On the other hand, many economists argue that for numerous reasons the rate of savings in the Canadian economy is much below the optimal level. A tax bias in favour of corporate retentions might
increase the amount of savings in the economy. If earnings are distributed, shareholders will consume some portion of them instead of reinvesting. Finally, using retained earnings to finance new investment should reduce the transaction costs involved in issuing new securities.

2. THE CORPORATE TAX CREATES A BIAS IN FAVOUR OF DEBT FINANCING

In addition to the decision of whether to retain or distribute earnings, corporate managers must decide what capital structure of the firm will maximize shareholder value and minimize the cost of capital. The traditional approach to the question of a firm's appropriate ratio of debt to equity assumes that there is an optimal capital structure. As a firm becomes more leveraged, the rate of return demanded by equity holders will increase to compensate equity holders for the increased riskiness of their investment. Firms can lower their cost of capital and maximize shareholder value by issuing debt instruments, but only to the point where the required rate of return on the increasingly risky equity capital exactly offsets the benefit of the cheaper debt funds.

In the same way that they challenged the traditional thinking on payout ratios, in a classic article published in 1958, Merton Miller and Franco Modigliani, who earned the Nobel prize in economics for their early work on capital structure theory, argued that (in the absence of taxes and other costs) there is no optimal capital structure for a firm: a firm's value and its cost of capital remain constant no matter what its ratio of debt to equity. Put another way, the overall value of a pizza is dependent on its ingredients and is unaffected by how it is sliced; similarly, a firm's value is dependent on its profitability and the risk of its investments and is unaffected by how its capitalization is divided between debt and equity. In the same way that their hypothesis about the irrelevance of a firm's payout ratio rests upon an assumption that shareholders can create their own desired payout ratio by purchasing or selling the firm's shares (shareholders can create a home-made payout ratio), Miller and Modigliani's hypothesis about the irrelevance of a firm's capital structure rests upon an assumption that shareholders can replicate any capital structure a firm structure a firm might undertake by borrowing to purchase shares or by buying the firm's debt (shareholders can create home-made leverage). If a firm is not making optimal use of leverage, arbitrage opportunities develop for investors that result in changes in the firm's rate of capitalization so that it will exactly equal the rate of capitalization of an identical firm, but with a different capital structure.

In a revision to their theorem, published in 1963, Miller and Modigliani acknowledged that their original paper had not properly accounted for taxes. Interest paid on corporate debt is deductible and thus shields some income from taxation while dividends paid on shares do not. They revised their theorem to account for the value of the tax savings available from deducting interest on debt.

The arbitrage process that Miller and Modigliani assume will result in the irrelevance of a firm's capital structure will never operate perfectly. Subsequent research has explored in depth the consequences for the theorem of numerous market imperfections. The most obvious imperfection is the risk of bankruptcy. The possibility of bankruptcy imposes both direct and indirect costs on firms and thus severely limits the extent to which firms can increase their leverage. The direct costs of bankruptcy include the extensive legal and accounting costs of going through a bankruptcy and the fact that the value of its assets upon liquidation are likely to be considerably less than their value to the firm as a going concern. The indirect costs of bankruptcy include all the additional costs that a firm on the brink of bankruptcy must bear including the cost of more expensive financing, the loss of customers and key employees, and the increased costs of completing transactions and dealing with reluctant parties. Another cost that limits the extent of leverage is the increased agency cost that must be incurred by security holders as the debt/equity ratio increases. For example, bondholders might incur few costs monitoring management if the amount of debt outstanding is small relative to equity capital. However, as the firm increases its leverage, bondholders will take a greater interest in management decisions in an attempt to ensure that their interests are being protected. In addition to demanding higher interest rates to cover these greater monitoring costs, bondholders may even insist that the borrowing firm sign covenants that restrict corporate decision-making. High debt/equity ratios also impose a cost by restricting a firm's flexibility in taking advantage of new opportunities and in dealing with temporary setbacks.

In establishing their debt/equity ratio, firms trade off the tax advantages of debt against the bankruptcy, agency, and other costs of increased leverage. The optimal capital structure is achieved at the point at which the tax shield advantages of debt financing are exactly offset by the costs of using more debt. In this model, corporate taxes clearly matter and could result in a firm being more heavily leveraged than it might be in the absence of taxes.

Although the tax shield offered by the interest paid on debt would seem to suggest that the corporate tax has a significant effect on debt/equity ratios, aside from the non-tax costs of debt, there are other reasons for doubting whether
its effect is particularly significant. The tax shield offered by debt is subject to a good deal of uncertainty. Corporations may suffer business losses or take advantage of tax deductions and credits that reduce or completely eliminate the interest tax shield. More importantly, the concern over the effect of the corporate tax on debt/equity ratios ignores the personal level tax. n114 If the corporate tax is lower than the individual tax, as it has been throughout most of the history of the income tax, and if corporations retain part of their earnings, and if capital gains are taxed at preferential tax rates, under a set of reasonable assumptions, the tax system — even with the separate corporate tax — can be shown to favour equity over debt. The deferral advantage offered by the corporation for the individual shareholder, which arises because the yield on the income retained in the corporation will initially only be taxed at the lower corporate tax rate, and the lower rate of tax on capital gains that the individual shareholder will pay on disposition, will more than offset the tax advantage to an individual bondholder of not paying the corporate tax on interest distributions.

There is still a good deal of uncertainly surrounding the question of what an optimal capital structure should be, even in theory. In practice, a multiple set of somewhat indeterminate considerations confront a corporate manager who must decide on a firm's debt/equity ratio. There is clearly no algorithm that can assist corporate managers in reaching this decision. Therefore, it is not surprising that observed debt/equity ratios vary widely across firms, even within the same industry, and that the market value of firms appears to be fairly insensitive to the choice of capital structures. Therefore, also not surprisingly, the empirical studies have not generally found any link between debt/equity ratios and the corporate income tax. n115 Most recently, Jeffrey [*666] Pittman concluded a review of the studies by noting "most empirical capital structure studies do not find that taxes matter to firms' financing and investment policies.” n116

Even if the corporate tax is found to affect debt/equity ratios, it is not obvious whether or not this bias reduces or enhances efficiency. On the one hand, increased leverage due to taxes might be assumed to carry a number of costs including making firms less willing to engage in risky activity and more susceptible to bankruptcy. On the other hand, increased leverage might perform the useful function of creating incentives for management to be more efficient, since they will have to meet the fixed interest charges each quarter.

3. THE CORPORATE TAX CREATES A BIAS IN FAVOUR OF INVESTMENTS IN THE NON-CORPORATE SECTOR

Since the corporate tax is a tax on the return to corporate equity capital, it can be avoided simply by making equity investments in non-corporate business enterprises. This might result in an over-investment in industries where firms are traditionally not incorporated, such as agriculture and fishing, and could result in business being carried on in non-corporate forms even though it might be more efficiently organized in corporate form.

A number of considerations would suggest, however, that these possible distortions of the corporate tax are not likely to be serious. First, as argued above, when the corporate tax rate is significantly lower than the top individual rate, and business income is being reinvested, the corporate form can act as a tax shelter for individual investors. Second, in Canada the bias in favour of the non-corporate form is removed altogether for firms that qualify for the small business credit. The ability to reduce the corporate tax rate to below 20 percent, plus a host of other tax rules that often favour incorporation, mean that there are substantial tax savings to be realized in incorporating small firms in every industry. Third, for large firms, the non-tax reasons for incorporating, including the centralization of and increased control over management, the increased access to capital markets, and the assurance of limited liability, will almost always dominate any tax disadvantage of incorporation. n117 Fourth, the plethora of tax expenditures, in many cases that [*667] are available only to corporations, means that the effective tax rate of corporate-source income is often quite low.

C. THE CORPORATE TAX COMPLICATES THE TAX SYSTEM BY REQUIRING ARBITRARY AND DIFFICULT DISTINCTIONS TO BE DRAWN BY TAX ADMINISTRATORS

The corporate tax is a tax on the return to corporate equity capital. Therefore, it necessarily requires a distinction to be drawn between corporate and other forms of equity and between corporate equity and corporate debt. The shareholder level tax on dividends also requires distinctions to be drawn between dividends and retentions and between dividends and the return of capital. The problem of drawing lines between these legal concepts is unquestionably difficult, consumes a considerable amount of resources, and provides opportunities for tax arbitrage. However, the legal line drawing that needs to be done is no more difficult than it is in many areas of law. Indeed, these precise legal distinctions have to be drawn in several areas of law, including corporate and commercial law.

Ideally, the distinction between corporations and other legal entities used for the purpose of carrying on business enterprises would be drawn based upon the justifications for imposing the separate corporate tax. Thus, for purposes of
Moreover, reducing the tax on dividends only creates additional opportunities for tax planning. This provides opportunities for arbitrage, this approach could be readily modified to remove these tax planning opportunities.

Approach for distinguishing between corporate and non-corporate equity and between corporate equity and corporate debt, which is financed mainly by borrowing or retained earnings, not issuances of new shares. Although the present Canadian system is weak. To the extent that such a tax cut did increase stock prices, it would at best have a minimal impact on investment, the financial decisions of corporate managers. Both the theory and the empirical evidence in support of such contentions shareholder value, reduce the cost of capital, and improve corporate responsibility, assume that the corporate tax affects the top 1 percent of Canadians. Assertions that the exemption of dividends from individual income tax would increase Canadians — rest upon a conceptual misunderstanding of the incidence of the corporate tax and a mis-description of the top 1 percent of Canadians. Assertions that the exemption of dividends from individual income tax would increase shareholder value, reduce the cost of capital, and improve corporate responsibility, assume that the corporate tax affects the financial decisions of corporate managers. Both the theory and the empirical evidence in support of such contentions are weak. To the extent that such a tax cut did increase stock prices, it would at best have a minimal impact on investment, which is financed mainly by borrowing or retained earnings, not issuances of new shares. Although the present Canadian approach for distinguishing between corporate and non-corporate equity and between corporate equity and corporate debt provides opportunities for arbitrage, this approach could be readily modified to remove these tax planning opportunities. Moreover, reducing the tax on dividends only creates additional opportunities for tax planning.

Distinguishing between debt and equity for the purposes of imposing the corporate tax is admittedly more difficult and has given rise to considerable tax planning and administrative costs. The problem is that in a business relationship every element and degree of the fundamental attributes of the business that are reflected in a debt or equity financing instrument — such as risk of loss, the nature of the return, the allocation of control, and the duration of the relationship — are subject to negotiation. Based upon the totality of factors present in their contracts, one type of investor is labelled an owner and another a creditor, but there is clearly a undifferentiated continuum of financial contracts that can be created and no normative basis for distinguishing between them in terms of tax principles.

The Canadian tax system has dealt with this problem by relying upon the legal label attached by the parties to the financing instruments used by them and then has attempted to deal with the classification of so-called hybrid instruments on an ad hoc basis as significant tax arbitrage opportunities arise. Arguably, this approach has not fared badly. However, once again, if the government felt that the problem was serious enough, and had the political will, it could adopt other approaches for distinguishing between debt and equity that would go along way to solving the problem. For example, Tim Edgar has suggested that a list of indeterminate factors could be used to classify instruments. David Weisbach has argued that a line should be drawn between debt and equity based on efficiency criteria.

Even though the Canadian government could likely do a better job of distinguishing between debt and equity for the purposes of the corporation tax, the administrative problem of drawing a distinction between debt and equity is unquestionably difficult and any solution not completely satisfactory. However, it is important to note that this problem transcends issues of the corporate tax. On the one hand, no country has integrated its corporate and shareholder tax in a way that makes the distinction irrelevant. The most commonly suggested method of integration that would solve this problem is to provide a deduction for dividends at the corporate level, instead of an exclusion or credit at the shareholder level, but this solution has its own problems. In particular, it removes any Canadian tax on tax-exempt shareholders and non-residents. On the other hand, even if a method of integration were adopted that would make the distinction between debt and equity irrelevant for corporate tax purposes, unless a comprehensive solution to the problem of financial instruments were enacted at the individual level, the distinction would still be relevant for tax purposes.

IV. THE FUTURE OF CANADA’S SEPARATE CORPORATE TAX

In the light of this overview of the case for and against the separate corporate tax, none of the arguments for abolishing the tax on dividends made by Canadian financial commentators in response to President Bush’s dividend plan seem convincing. The equity arguments they made — namely, that the double taxation of corporate-source income is anathema to the notion of fairness and that the exclusion of dividends from income would provide a tax break for middle-income Canadians — rest upon a conceptual misunderstanding of the incidence of the corporate tax and a mis-description of the top 1 percent of Canadians. Assertions that the exemption of dividends from individual income tax would increase shareholder value, reduce the cost of capital, and improve corporate responsibility, assume that the corporate tax affects the financial decisions of corporate managers. Both the theory and the empirical evidence in support of such contentions are weak. To the extent that such a tax cut did increase stock prices, it would at best have a minimal impact on investment, which is financed mainly by borrowing or retained earnings, not issuances of new shares. Although the present Canadian approach for distinguishing between corporate and non-corporate equity and between corporate equity and corporate debt provides opportunities for arbitrage, this approach could be readily modified to remove these tax planning opportunities. Moreover, reducing the tax on dividends only creates additional opportunities for tax planning.
Canada, at present, provides a tax credit for dividend income that compensates shareholders for about 20 percentage points of corporate tax. Instead of enriching this credit, or completely exempting dividends from tax, a strong case can be made for repealing the existing dividend tax credit and using the increased tax revenue to reduce the corporate tax rate. The Canadian dividend tax credit is anomalous. It benefits primarily high-income individuals. It is completely unrelated to corporate tax paid: shareholders receive the credit, ostensibly to compensate them for the corporate tax paid on their dividends, even though the corporation might have paid no tax on the income. It is not extended to tax exempt organizations such as charities and pension plans, nor is it refunded to individual taxpayers whose tax liability is less than the credit. Non-residents do not receive the credit. If the costs of finance that Canadian firms must pay are set in international capital markets because of the openness of the Canadian economy, then providing domestic shareholders with a dividend tax credit can do nothing to reduce the cost of capital in Canada. Domestic shareholders will simply replace foreign shareholders in Canadian firms, with no beneficial investment incentive effects. For these reasons, it is hard to imagine that the credit operates to mitigate any of the distortions that the corporate tax might impose. Its only useful function is to provide, in effect, for the pass-through treatment of income earned in small businesses. This function could be better served by allowing small corporations to elect to be taxed as partnerships.

A number of economists have argued that, regardless of the strength of the traditional arguments supporting a corporate tax, with increased globalization, countries will be unable to sustain the tax. As investment capital becomes increasingly mobile, firms will be able to locate their assets in the most tax-advantaged jurisdictions. The corporate tax will be a victim of the resulting race to the bottom to attract investment capital. It is also argued that the development of e-commerce and the increasingly sophisticated use of financial instruments will make administering and enforcing the corporate tax impossible. This is not the place to deal with these arguments, except to note that to date, despite the predictions of the commentators, the corporate tax has remained remarkably resilient. Although the corporate tax rates in a number of OECD countries have been reduced in recent years, the corporate tax collected relative to GDP has remained constant or even risen. Perhaps the resilience of the corporate tax can be attributed to the many functions it performs in a modern tax system. The justifications for the tax remain as important today as they have been throughout the history of the tax. However, what the arguments in this paper would suggest is that if the corporate tax is to be reformed, or its predictions of the commentators, the corporate tax has remained remarkably resilient. Although the corporate tax rates in a number of OECD countries have been reduced in recent years, the corporate tax collected relative to GDP has remained constant or even risen. Perhaps the resilience of the corporate tax can be attributed to the many functions it performs in a modern tax system. The justifications for the tax remain as important today as they have been throughout the history of the tax. However, what the arguments in this paper would suggest is that if the corporate tax is to be reformed, or its role diminished, in spite of the strong case if favour of it, the most inappropriate way of doing that would be the approach adopted in the Bush proposal, namely, by refunding it, in effect, to individual shareholders.

FOOTNOTES:


of Economic Advisers Chairman Glann Hubbard was only too glad to dust off the 1992 plan for dividend relief he had toiled on when he was Deputy Assistant Treasury Secretary for Tax Policy in the first Bush administration).

n3 On May 28, 2003 President Bush signed the Jobs and Growth Relief Reconciliation Act of 2003. The plan, approved by the House (231 votes to 200) and the Senate (51 votes to 50, with Vice President Dick Cheney casting the tie-breaking vote) on May 23, 2003, reduces the capital gains tax rate from 20 to 15 percent and reduces the dividend tax rate to 15 percent. These new rates come with a sunset date, December 31, 2008, presumably to ensure that the cost of the tax cut package was within the agreed-upon limit. Lower-income taxpayers’ rates are set at 10 percent for capital gains, and 5 percent for dividend income.

n4 The majority of Canadian business leaders were also of the opinion that Canada should follow the U.S. lead. Answering the question, "should Canada also cut dividend taxes?", 28 percent of business leaders answered "definitely", 48 percent answered "probably", 12 percent answered "probably not", and 2 percent answered "definitely not" (the remaining 11 percent did not know or refused to answer): Compas Opinion and Market Research, Poll, "Bush Dividend Tax Cut Earns Strong Endorsement While Business Divided About Trust Conversion as Tax Device" (20 January 2003), online: Compas Opinion and Market Research <http://www.compas.ca/html/archivesdocument.asp?compasID=382> (last accessed 20 August 2003). See also "Canada May be Forced to Match" Edmonton Sun (8 January 2003) 40 (where John Drummond, chief economist with the TD Bank Group was quoted as stating, "At the very least, Manley may have to consider changing dividend laws to keep pace with the U.S. changes. Canada will have to match the Americans to stay competitive").

n5 Jack Mintz, "We need relief, too" Financial Post (7 January 2003) FP11.


n8 Partial integration was initially introduced by the Honourable D.C. Abbott’s 1949 budget. The dividend tax credit was set at 10%. The Hon. D.C. Abbott, as Minister of Finance, presented two reasons for the introduction of the credit — both of which are still given as justifications for increasing the credit. First, the credit was expected to increase the flow of venture capital, otherwise hindered by the double tax on corporate-source income. Second, the credit was expected to increase dividend payments by corporations. This second reason for the credit was presented explicitly as a corporate governance rationale: "It seems to me that under a system of private enterprise which depends for its existence on a steady flow of venture capital we cannot afford to neglect the implication of this defect [double taxation] in our tax system... The fact is...that if the corporation distributes more than about one-half of its profits after tax in dividends [once the credit is implemented]...there will have been a net decrease in the tax burden": House of Commons Debates, v. 2 (22 March 1949) at 1799 (Hon. D.C. Abbott). The dividend credit was increased to 20% in the 1953 budget. In his 1953 Budget, Mr. Abbott added a third reason for the credit, to encourage increased Canadian participation in share ownership: "...it would seem to be a good thing if Canadians were encouraged, where they can safely do so, to join in a wider participation of equity ownership in the expanding industrial wealth of our country. This dividend credit of 20 per cent should, I think, be of considerable assistance in encouraging our people to increase their stake in Canada’s future": House of Commons Debates, v. 3 (19 February 1953) at 2218 (Hon. D.C. Abbott). Finally, as part of the 1972 income tax reforms the dividend tax credit was given its current form.


n10 This paragraph begins by suggesting that the immediate response of Canadian commentators imploring the Canadian government to follow the U.S. lead was surprising, particularly given that Canada already has enacted
partial integration. Perhaps surprise is unwarranted. Canadian tax authorities often seem to feel compelled to follow the American lead. See Arthur J. Cockfield, "Tax Integration Under NAFTA: Resolving the Conflict Between Economic and Sovereignty Interests" (1998) 34 Stan. J. Int'l L. 39 at 45 ("The norm in North America is regulatory emulation. In certain circumstances, Canadian and Mexican regulators change their tax policies to ensure that they do not impose burdens on mobile factors dissimilar to those imposed by the United States. Indeed, there is evidence that both Canada and Mexico have felt pressure to conform parts of their tax regimes with that of the United States. For example, Canada's effective tax rates on corporate capital income have been gradually reduced over the last twenty years. Now the Canadian tax system imposes a tax burden on capital activity similar to that imposed by the United States. Further, Canadian tax reform in 1987 was influenced in part by the tax reform undertaken in the United States in 1986"). See also John Bossons, "The Impact of the 1986 Tax Reform Act on Tax Reform in Canada" (1987) 40 Nat'l Tax J. 331.

n11 The taxation of corporations has been described as "the epitome of entity theory in action": William A. Klein, "Income Taxation and Legal Entities" (1972) 20 U.C.L.A. L. Rev. 13 at 43.


n14 Henry C. Simons, "Federal Tax Reform" (1946) 14 U. Chicago L. Rev. 20 at 56 ("There should be no taxation of business as such and certainly no such taxes confined to incorporated business").


n18 For a survey of the model of corporation tax imposed by different jurisdictions see Sijbren Cnossen, "The Role of the Corporation Tax in OECD Member Countries" in John Head & Richard Krever, eds., Company Tax Systems (Burwood, Victoria: Deakin Printery, 1997). The Treasury Assistant Secretary Pam Olson used the contrast between the classical corporate tax system in the United States, and the partial forms of integration used in most other jurisdictions as a justification for the dividend exemption: "Our double tax on corporate earnings also sets us apart from our foreign competitors. Of OECD countries, only Ireland and Switzerland afford no relief from the double tax": U.S., Department of the Treasury, News Release KD-3803, "Remarks by Treasury Assistant Secretary Pam Olson to the ABA Tax Section on January 25, 2003" (25 January 2003), online: U.S. Department of the Treasury <http://www.ustreas.gov/press/releases/kd3803.htm> (last accessed 20 August 2003).

n19 See the analysis of this trend in Reuven S. Avi-Yonah, "Back to the 1930s? The Shaky Case for Exempting Dividends" (2002) 97 Tax Notes 1599 [Avi-Yonah, "The Shaky Case"] ("The recent trend, in fact, has been to move away from integration") at 1600. See also Howell H. Zee, "Taxing Capital Income in a Globalized World" (2002) 27 Tax Notes International 1185 [Zee, "Taxing Income"] ("There has been no movement toward greater integration of the CIT [corporate income tax] with the PIT [personal income tax] among OECD countries in recent years. If anything, the reverse seems to be the case, with corporate income being taxed increasingly separately from personal income") at 1192.

n20 David Weisbach, "Line Drawing, Doctrine, and Efficiency in the Tax Law" (1999) 84 Cornell L. Rev. 1627 at 1637 [Weisbach, "Line Drawing"].


n22 See e.g. Charlotte Denny, "Bush goes to war with America's poor: U.S. president's tax plan is divisive and dangerous" The Observer (16 January 2003) 12 ("to judge by last week's much-hyped $674 billion tax cut plan, it is the rich toward whom President Bush feels most compassion"); William G. Gale & Peter R. Orszag, "The Administration's Proposal to Cut Dividend and Capital Gains Taxes" (2003) 98 Tax Notes 415 (in which they argue that the proposal will not remove the incentives to shelter corporate income from taxation or to retain earnings); Paul Krugman, "Stimulus for Lawyers" The New York Times (14 January 2003) A27 ("the plan has nothing to do with stimulus. ... Its benefits are almost ludicrously tilted toward the very, very affluent"); Jeff Madrick, "Bush wants $670 in tax cuts, but where's the bang for the buck?" The New York Times (23 January 2003) C2 ("...this plan, more than half of which is made up of tax cuts on dividends, would have far less stimulative impact than has been promised in both the short run and the long run. What we have here is a huge tax cut for the rich without a commensurate bang for the buck for the economy"); Linda McQuaig, "Bush tax break boosts 'regal class'" The Toronto Star (12 January 2003) A13 (in which she argues that the dividend exemption will largely benefit the rich with little stimulus for the economy); Michael Den Tandt, "U.S. tax-cut plan simply Bush league" The Globe and Mail (9 May 2003) B2 (in which he argues that the proposed tax cuts would have little stimulative effect and quotes Warren Buffet as a critic of the proposal who reportedly alleged that "the main beneficiaries will be people like me...giving a lesser percentage of our incomes to Washington than the people working in our shoe factories").


n27 See e.g. Thomas S. Adams, "The Taxation of Business" in *National Tax Association: Proceedings of the Eleventh Annual Conference 1917* (New Haven, CT: National Tax Association, 1918) 185 at 191 (in which he argues that applying the ability to pay principle only to individuals is a shallow and narrow interpretation of the concept).

n28 See e.g. Richard Abel Musgrave & Peggy B. Musgrave, *Public Finance in Theory and Practice*, 5th ed. (New York: McGraw-Hill, 1989) at 373, n. 2 ("One may, of course, speak of the ability of a corporation to pay a certain tax without going bankrupt or without curtailing its operations. The concept of capacity to pay as used in this sense, however, relates to the economic effects of the tax rather than to ability to pay as used in the context of equity considerations").

n29 Indeed it has been argued that on the grounds of equity that income from labour should bear a lower tax rate than income from capital since taxpayers have to sacrifice leisure to earn income from labour, income from labour tends to be more precarious than income from capital, and many expenses in earning income from labour are not deductible since they cannot administratively be distinguished from personal expenses.


n33 Those analysts who support a consumption over an income tax make a number of other arguments in support of a consumption tax, but the difficulties of taxing income from capital is usually a significant one. See e.g. Robin W. Boadway & Harry M. Kitchen, *Canadian Tax Policy*, 3d ed., Canadian Tax Papers No. 103 (Toronto: Canadian Tax Foundation, 1999) at 97 [Boadway & Kitchen, *Canadian Tax Policy*] ("A third argument for a consumption tax, and in some respects the most compelling, is that it is easier on the whole to administer an ideal consumption tax than it is to administer an ideal comprehensive income tax").


n36 Boadway & Kitchen, *Canadian Tax Policy, supra* note 33 at 217:

A tax imposed on corporate income initially reduces the rate of return on capital employed in the corporate sector of the economy. If capital markets are operating competitively, capital will move out of the corporate sector and into the unincorporated sector. Because of the assumed property of diminishing marginal returns to capital, the return to capital will initially fall in the unincorporated sector and rise in the corporate sector. The reallocation of capital will continue until the economy
reaches a new equilibrium in which the after-tax returns to capital in the corporate and unincorporated sectors are identical. In this way, the burden of the tax will be shifted in part to capital owners in the unincorporated sector. This result implies that the corporate tax does not discriminate against owners of corporations in favour of owners of unincorporated business. The workings of the capital market spread any part of the tax that falls upon capital across all capital owners.

n37 See U.S. Congressional Budget Office, *The Incidence of the Corporate Income Tax* (Washington, D.C.: Congressional Budget Office, March 1996) at 27 ("Most evidence from closed-economy, general equilibrium models suggests that given reasonable parameters, the long-term incidence of the corporate tax falls on capital in general"). See also U.S. Congressional Budget Office, *Effective Federal Tax Rates, 1979-1997* (Washington, D.C.: Congress of the United States, 2001). In the United States analysts frequently model the economy as essentially a closed one because of its size. Canada has a small and reasonably open economy and therefore the same results might not hold. However, since the Canadian economy is so integrated with the American economy, it would seem sensible to treat it for these purposes as essentially part of that economy and since the United States has a corporate tax very similar to the Canadian tax, the corporate tax cannot be avoided by shifting investments to the United States. For a comprehensive review of the Canadian studies on the incidence of the Canadian corporate tax see Boadway & Kitchen, *Canadian Tax Policy*, supra note 33 at 212-20.

n38 In Canada, statistics for the 2000 tax year reveal that approximately 17% of tax filers reported taxable dividends. Of those filers, approximately 67% reported incomes under $50,000 compared with 2% who reported incomes in excess of $250,000. While it is clear that more low than high income earners receive dividends, only 14% of earners earning under $50,000 receive dividends versus 66% of earners who reported over $250,000. Further, those with incomes under $50,000 received only 22% of the total value of dividends distributed, while those with incomes in excess of $250,000 received 37% of the total value of the dividends distributed. The average value of dividends received by filers under $50,000 was $1,421, compared to $86,615 for filers with incomes in excess of $250,000. Canada Customs and Revenue Agency, *Income Statistics 2002 -- 2000 Tax Year*, Table 2, online: Canada Customs and Revenue Agency <http://www.ccra-adrc.gc.ca/tax/individuals/stats/gb00pst/final/pdf/table2-e.pdf> (last accessed 20 August 2003) [Income Statistics].


n40 Ibid. at 375.


n42 Ibid. at 439.


n44 Ibid. at 79.

n45 *Report of the Technical Committee*, supra note 9 at 3.22:

Because there is a great deal of uncertainty regarding the incidence of the corporate income tax, and because individuals at the same income levels can have different patterns of consumption, savings and capital ownership, the Committee concludes that business taxes should not be used as a means of pursuing one important aspect of fairness — vertical equity — that is, that individuals in different circumstances should bear appropriately different levels of tax. Rather, in the Committee's view, the prime tax instrument for achieving vertical equity should be the personal tax system.

Foundation, 1982) 171 at 172 (“We are accustomed to thinking of rents as a phenomenon unique to extractive industries. Indeed, these industries have their share of rents; and for this reason, the capture of such rents is important in the Canadian economy. But rents and pure profits are generated from many sources and in many industries”); Roger H. Gordon & Jeffrey K. MacKie-Mason, “Why is There Corporate Taxation in a Small Open Economy? The Role of Transfer Pricing and Income Shifting” in Martin Feldstein, James R. Hines, Jr. & R. Glenn Hubbard, eds., The Effects of Taxation on Multinational Corporations (Chicago: University of Chicago Press, 1995) 67 at 70 [Gordon & MacKie-Mason, “Corporate Taxation”] (“While existing corporate taxes do distort capital investment decisions, much of the revenue seems to be collected from the taxation of pure profits, which we interpret to represent the return to entrepreneurial ideas and effort”).


n49 Simons, Personal Income Taxation, supra note 26 at 50.


n51 This function of the corporate tax applies to labour as well as capital income. Indeed, in attempting to explain why so many small open economies impose corporate taxes, MacKie-Mason and Gordon (“Corporate Taxation,” supra note 46 at 88) hypothesize that the corporate tax acts as "primarily a backstop to the personal tax on labor income, rather than as primarily a tax on capital income".


n54 Canada's Carter Commission concluded that "equity and neutrality would best be achieved under a tax system in which there were no taxes on organizations as such, and all individuals and families holding interests in organizations were taxed on the accrued net gains from such interests on the same basis as all other net gains": Carter Report, supra note 17 v. 4 at 4.

n55 Polito, supra note 16 at 1044.

n56 For a discussion of the circumstances under which the separate corporate tax may actually reduce agency costs see also Joseph A. Snoe, "The Entity Tax and Corporate Integration: An Agency Cost Analysis and a Call for a Deferred Distributions Tax" (1993) 48 U. Miami L. Rev. 1.


n59 There are cases where this may be desirable from an efficiency standpoint. See Neil Bruce, "A Note on the Taxation of International Capital Income Flows" (1992) 68 Econ. Record 217 at 220 ("If economic profit is not fully taxed, a realistic assumption, then a positive tax on foreign capital income is desirable").

n60 Boadway, Bruce & Mintz, supra note 46 at 61-62.

n61 Avi-Yonah, "The Shaky Case," supra note 19 at 1602.

n62 Incidentally, it also reduces the incentive to convert labour income into income from capital.

n63 As stated by Boadway in "Economic Rationale," supra note 15 at 21:11 ("an ideal integration system is not attainable. It is simply not possible to give full credit to appropriate shareholders for corporate taxes that have been withheld. The implication is that there will inevitably be some elements of distortion imposed on capital markets, as well as a deviation from principles of fairness or equity").

n64 In 1999, approximately 21.7% of Canadian assets were foreign-controlled. This proportion rises to 25.4% for non-financial assets: See Canada, Statistics Canada, Corporations Returns Act 1999, Catalogue No. 61-220-XIE (Ottawa: Minister of Industry, 2002) at 7.

n65 Richard Bird suggests that "at least seven [international] arguments may be found in the literature for taxing corporate profits": Bird, "Corporations," supra note 15 at 8.

n66 Bird, "Corporations", ibid. at 7.

n67 Jack M. Mintz, "Alternative Views," supra note 32 at 230 ("It may be in Canada's interest to increase the withholding tax rate up to the level of foreign tax rates (such as 33 per cent in the United States) but this requires a renegotiation of treaties. It is thus simpler to withhold using a corporate tax").

n68 Peter Sorensen, "Changing Views of the Corporate Income Tax" (1995) 48 Nat'l Tax J. 279 at 290. See also Bird, "Corporations," supra note 15 at 6 ("An important aspect of the argument for taxing rents relates to the taxation of foreign investment. Foreign firms would seem to be at an inherent disadvantage relative to domestic firms. One reason why they may nevertheless be able to compete successfully is because they have some special advantage, in terms of know-how, skill, access to finance or markets and so on, that they can exploit to offset their 'foreignness.' In other words, they have some firm-specific assets that generate rents for them. In this view, the mere existence of direct foreign investment may be taken to imply that the profits accruing to such operations must contain a rent element").

n69 The difficulties of granting integration internationally are reviewed in Hugh J. Ault, "International Issues in Corporate Tax Integration" (1978) 10 Law & Pol'y Int'l Bus. 461.

n70 Carter Report, supra note 17 v. 4 at 5. See also Bird, "Corporations," supra note 15 at 14 ("If [the corporate tax rate] is much lower [than the U.S. rate], some revenues may...be unnecessarily lost, though ... to the U.S. Treasury"); Boadway & Kitchen, Canadian Tax Policy, supra note 36 at 241 ("As long as Canadian corporate tax rates do not exceed the rates of foreign tax-crediting regimes, they will be offset by a tax credit, and thus the tax withheld becomes a 'free' sources of tax revenue for the Canadian treasury").
n71 See Rebecca S. Rudnick, "Corporate Tax Integration: Liquidity of Investment" (27 February 1989) 42 Tax Notes 1107.

n72 For a discussion of the relationship between the amount of property taxes paid and the expenditure benefits businesses receive see Harry M. Kitchen & Enid Slack, Business Property Taxation (Government and Competitiveness Discussion Paper Series 93-24) (Kingston: School of Policy Studies, Queen's University, 1993) at 23-30 (Kitchen and Slack calculate that approximately 40 percent of non-education municipal expenditures benefited commercial and industrial activities in either Ontario cities).

n73 See e.g. Timothy J. Bartik, Who Benefits from State and Local Economic Development Policies? (Kalamazoo, Mich.: W.E. Upjohn Institute for Employment Research, 1991) at 57 ("The most important conclusion from this chapter is that a wide variety of state and local policies can significantly affect the long-run level of business activity in a local economy. Business tax reductions may increase an area's business activities. But so may tax increases, if they are used to finance infrastructure and public services used by business"); Kitchen & Slack, ibid. at 51 ("Given that the influence of taxes on location is not known with any degree of certainty and given that tax competition is unlikely to lead to an efficient allocation of businesses between communities, it does not seem appropriate to recommend that municipalities use tax subsidies to attract business. Rather, the provision of services that, at the same time, provide direct benefits to existing residents and firms is preferable to tax competition. In particular, the provision of infrastructure would influence firms to locate but it would also provide a tangible resource to the community"); Robert Lynch, Do State & Local Tax Incentives Work? (Washington, D.C.: Economic Policy Institute, 1996) at 9 ("Factors such as the cost and quality of labor, the quality of public services (schools, roads and highways, sewer systems, recreational facilities, higher education, health services), the proximity of markets, and the access to raw materials and supplies are more important than tax incentives in business-location decisions").


n75 Ibid. at Table 5.

n76 Ibid.


n78 Ibid.

n79 The Mintz Committee commissioned a number of studies to look at compliance costs arising from the corporate tax system. See Brian Erard, "The Income Tax Compliance Burden on Canadian Big Business," (Working Paper 97-2) (Ottawa: Department of Finance, April 1997) at 1 ("In the case of the 500 largest non-financial Canadian corporations, the estimated annual cost of keeping tax records, researching the tax laws, filing returns, responding to audits and launching appeals represents about 5 percent of taxes paid." This cost was found to be lower than the corporate cost for big companies conducting business in the United States). See also Brian Erard, "The Income Tax Compliance Burden on Small and Medium-sized Canadian Businesses," (Working Paper 97-12) (Ottawa: Department of Finance, October 1997) (a study that reports on a survey of small and medium-sized businesses perception of their compliance costs). See also the Technical Committee on Business Taxation, "Compliance Issues: Small-Business and the Corporate Income Tax System," (Working Paper 96-9) by Plamondon & Associates (Ottawa: Department of Finance, December 1996) at 1 ("The corporate income tax system is functioning reasonably well for small business [revenues under $2 million] in Canada, with no dramatic flaws or overwhelming irritants").

n80 See e.g. Canadian Labour Congress, policy statement, "Workers Demand Social and Economic Justice" (May
The Ontario Federal of Labour equates cuts to corporate taxes with cuts to the taxes of the rich in their comment on Ontario's 2003 economic statement, stating "the government's March 27th economic statement ... delivered big corporate tax cuts for the rich," *Focus* (Newsletter of the OFL) (9 April 2003), online: OFL <http://www.ofl-fto.on.ca/ftp/focus/APRIL92003.pdf> (last accessed 20 August 2003). Andrew Jackson, then the senior economist for the Canadian Labour Congress, put the sentiment of many centre or left-of-centre Canadians accurately, perhaps, when he testified before the finance committee of the House of Commons in 1996 that Canadians in general are concerned about the fact that corporate income tax revenues are falling as a share of federal revenues: See Canada, Standing Committee on Finance, *Evidence: Standing Committee on Finance*, 35th Parl., 2d Sess., No. 22 (29 July 1996), online: Parliament of Canada <http://www.parl.gc.ca/committees352/fine/evidence/22_96-07-29/fine22_blk101.htm> (last accessed 20 August 2003):

I would maintain that even when we look at the share of business taxes, corporate income tax, as a share of corporate profits, there has been a decline over time. I think Canadians continue to be concerned about the fact that there are many profitable companies, highly profitable companies, paying no tax, or effectively very low rates of tax. That lost revenue is of concern in terms of financing not just services but also potential public investments, which can create jobs.

The New Democratic Party has also, at times, made increasing or preserving the corporate tax part of its campaign platform. See "Fair taxes for you, no more unfair tax breaks for the wealthy", online: ICAN <http://home.ican.net/edtoth/ndpfairtax.html> (last accessed 20 August 2003) (It was stated that the NDP want to, "bring Canada's corporate tax revenues up to the average for industrialized countries"). Of course, not all advocates on the left support corporate taxes or denounce corporate tax cuts unqualifiedly. See e.g. Canadian Auto Workers Union, "Federal Budget 2000 Highlights and Analysis", online: CAW <http://www.caw.ca/whatwedo/research/federalbud.asp> (last accessed 20 August 2003) (after Canada's 2000 federal budget announced cuts to the corporate tax rate, the Canadian Auto Workers' Union released its analysis of its contents, noting that "in general, we will want to focus most of our fire on the larger personal income tax cuts (which will cost about $15 billion per year by 2004) rather than on the corporate income tax cuts (which will cost $3 billion per year by 2004). In the case of corporate taxes, a certain argument can be made that lower taxes will result in larger profits and hence higher business investment. We would prefer to see targeted performance-linked measures (such as an investment tax credit system), rather than a general corporate tax cut. But nevertheless the argument can be made that there will be a (small) positive impact on growth and job-creation").

n81 This phenomenon has been widely noted in the U.S. See e.g. Martin Sullivan, "Dividend Deja Vu: Will Double Tax Relief Get Canned — Again" (3 February 2003) 98 Tax Notes 645 at 648 ("...former Assistant Treasury Secretary (during both the Carter and Clinton administrations) Donald Lubrich said that in the 1970s, corporate integration was ultimately killed by big business, which wanted rate reduction instead").

n82 Economic Council of Canada, *Political Economy of Tax Reform: Six Case Studies* (Discussion Paper no. 290) by Douglas G. Hartle at 137 ("The managers of corporations do not have the same interests as the owner–shareholders. Yet they control the resources of the corporation and increased corporate reliance on capital markets that would result from a tax system that encouraged high payouts of corporate profits which would weaken that control. Therefore, even though the shareholders of INCO might have gained by the proposals, INCO officially opposed the proposals").


n84 Arlen & Weiss, *ibid.* at 341 ("Most managers...have much to gain from incentives for new investment, and
little to gain from windfalls to existing equity. Most managers thus support stimulus measures, such as integration, that provide subsidies to both new and old capital, but general prefer incentives...that subsidize only new capital. ... Indeed, to protect existing tax preferences for new capital, some managers may actively oppose integration").

n85 Ibid. at 344–46.

n86 See e.g. arguments made by Arlen & Weiss, ibid. at 327–28 ("The separation of ownership and control may have an even more surprising consequence. Some managers, we argue, may actively oppose integration because the double tax serves their interests. These managers may support the double tax for one of the very reasons that reformers oppose it: Double taxation traps earnings in the corporation. This retained earnings trap enable managers to pursue investments from which they benefit at the expense of shareholders").

n87 See Edward McCaffery, "Cognitive Theory and Tax" (1994) 41 UCLA L. Rev. 1861 at 1884 ("Cognitive theory...helps to explain at least the political appeal of the corporate income tax. The corporate income tax is attractive precisely because it is hidden by its uncertain incidence. ...cognitive theory suggests an advantage to the actual, apparently senseless, way of doing things. This is not the same thing as saying that old taxes are good ones — although that familiar proposition has interesting psychological dimensions as well. It is, rather, a statement that fully hidden taxes have a systematic advantage over more transparent ones. A cognitive perspective therefore casts some doubt on the political possibilities of the corporate tax integration projects").

n88 In Canada, even business leaders do not appear to strongly support cutting corporate taxes. In four separate polls between 12 November 2001 and 20 December 2002 approximately 9 percent of business leaders thought that any new spending should go to cutting taxes (as opposed to spending on health (roughly 20 percent), paying down the debt (roughly 25 percent), military (roughly 12 percent), infrastructure (roughly 12 percent), cutting personal taxes (roughly 14 percent), and border controls (roughly 11 percent)). Not surprisingly, when asked where new federal money should not be allocated, the same group were most strongly against allocating new money to corporate tax cuts (roughly 19%) relative to the other possible priorities: Compas Opinion and Market Research, Poll, "Four Unchanging Priorities for New Federal Money: Military/Home Security, Tax Cuts, Debt Pay-down, Healthcare" (6 January 2003), online: Compas Opinion & Market Research <http://www.compas.ca/html/archivesdocument.asp?compasSection=Money&Go=Go&compasID=379> (last accessed 20 August 2003). See also Arlen & Weiss, supra note 83 at 333–34 (Arlen and Weiss present interesting arguments about the public support in the United States for the corporate tax, distinguishing support for the corporate tax from support for the corporate tax coupled with a dividend tax. Based on U.S. public opinion polls, they note that the public supports the imposition of a tax on corporations (citing polls that range between 65% to 80% support), but that only 29% - 37% of the public support "double taxation" of dividend income).

n89 Other transitional problems, for example, the difficulty of restricting tax avoidance opportunities in the transition period, are reviewed in William Vickrey, "The Corporate Income Tax and How to Get Rid of It" in Lorraine Eden, ed., Retrospectives on Public Finance (Durham: Duke University Press, 1991) 118 at 131–32.


n91 Some commentators accept that the regulatory use of the corporate tax is a legitimate objective for the corporate tax that helps to justify its imposition, despite the lack of normative justification. See e.g. Vijay Jog & Jack Mintz, "Corporate Tax Reform and Its Economic Impact: An Evaluation of the Phase 1 Proposals" in

n92 For a list of the corporate income tax expenditures and an estimate of their values see Canada, Department of Finance, Tax Expenditures and Evaluations 2002 (Ottawa: Department of Finance, 2002), online: Department of Finance <http://dsp-psd.communication.gc.ca/Collection/F1-27-2002E.pdf> (last accessed 20 August 2003).

n93 See e.g. Richard M. Bird, Tax Incentives for Investment: The State of the Art, Canadian Tax Paper No. 64 (Toronto: Canadian Tax Foundation, 1980) at 2 (Bird concluded that "(1) we know amazingly little about the efficiency and effectiveness of the investment incentives we employ so profligately; (2) what little we do know suggests that these incentives are neither efficient nor effective in achieving most of the objectives for which they were supposedly introduced....").

n94 See Boadway, "Economic Rationale," supra note 15 at 21:8 ("Given the administrative expertise built up in Revenue Canada, it would seem to be sensible to rely on it for delivering corporate tax preferences").

n95 See Mintz, "Capital Income," supra note 13 at 1487.

n96 It is surprising how many commentators find the equity argument against the double taxation of corporate income compelling, given that it is likely the weakest argument against the corporate tax. See e.g. Krishna, supra note 7; "Ending Double Tax Trouble" Wall Street Journal (26 December 2002) A14 (arguing that the double taxation of dividend income should be ended because it is inequitable).

n97 Report of the Technical Committee, supra note 9 at 4.2.

n98 For U.S. information see e.g. William Gale, "About Half of Dividend Payments Do Not Face Double Taxation" (11 November 2002) 97 Tax Notes 839 at 839 ("...just under half — 46 percent ... - of dividends paid out of the corporate sector were subject to double taxation in 2000"). See also William Gale & Peter Orszag, "The President's Tax Proposal: Second Thoughts" (2003) 98 Tax Notes 605 at 609 (Gale & Orszag cite evidence suggesting that only about 50% of corporations pay corporate tax, and only about 50% of shareholders pay tax on the dividends they receive). In Canada, Avery Shenfeld, an economist with CIBC World Markets, has reported that 30 percent of the income trust units are held within RRSPs or tax sheltered pension plans. This probably slightly understates the participation of tax exempt entities holding equity in the broader market, given the more specific clientele of income trusts: See Avery Shenfeld, "The Economic Benefits of Income Trusts" Economic Perspectives (7 March 2003) at 6, online: CIBC World Markets <http://research.cibcwm.com/economic_public/download/incometrust.pdf> (last accessed 20 August 2003).

n99 See John W. Lee, "A Populist Political Perspective of the Business Tax Entities Universe: 'Hey the Stars Might Lie But the Numbers Never Do'" (2000) 78 Tex. L. Rev. 885 (Lee argues that at least in some cases the corporation can act as a very effective shelter). See also Myron S. Scholes & Mark A. Wolfson, Taxes and Business Strategy: A Planning Approach (New Jersey: Prentice-Hall Inc., 1992) at 59–61 (reviewing the relationship between the tax on individuals and corporations and the possible deferral value where the investment horizon is long).

n100 Thompson, supra note 2 at 393-94.

n101 See Richards Petrie, The Taxation of Corporate Income in Canada (Toronto: University of Toronto Press, 1952) at 144-45, n. 3 ("Despite the wide disagreement on the incidence of tax, there is a curious unanimity in popular opinion regarding double taxation. Not infrequently those who argue that the tax is a cost and is included in price will argue that the tax results in double taxation. This is arrant nonsense. If the tax does not reduce the amount of profit available for dividends, the shareholder will pay only one tax — the tax on individual income. The point to be stressed is that double taxation exists if any part of the corporate tax is not shifted").

n102 Boris I. Bittker, "Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?"
n103 For a review of the economic effects of the corporate tax on firms, which includes a review of some of these problems see Boadway & Kitchen, *Canadian Tax Policy*, supra note 33 at 220-35 (Boadway and Kitchen's review includes effects of the corporate tax on resource allocation that are not explained by the different treatment of debt and equity, for example, interprovincial distortions that might be explained by different corporate tax rates in different provinces).


n106 For good surveys of the competing theories, see Rafael La Porta et al., "Agency Problems and Dividend Policies Around the World" (2000) 55 J. Finance 1; Sorensen, "Changing Views," supra note 61. There is no definitive evidence of the correctness of either the new or old theories of dividend taxation. As summarized by the OECD, "the evidence does not unequivocally favour one view over the other, and it is likely that both views contain important elements of the truth: OECD, *Taxing Profits in a Global Economy: Domestic and International Issues* (Paris: OECD, 1991) at 29.

n107 Technical Committee on Business Taxation, "The Economic Effects of Dividend Taxation" (Working Paper 96-7) by Kenneth J. McKenzie & Aileen J. Thompson (Ottawa: Department of Finance, 1996) at 1 (McKenzie and Thompson's conclusion, stated in more detail, is that "based upon a perusal of the literature of dividend taxation and its effects on investment, firm financial policy and equity values, we find ourselves in general agreement ... that 'the current state of empirical knowledge gives the edge to the traditional ... view of dividend taxation.' We would stress, however, that this conclusion is very much a tentative one, and that additional research is required to increase our comfort level") at 19.


n109 Emil Sunley, "Corporate Integration: An Economic Perspective" (1992) 47 Tax L. Rev. 621 at 636:

Despite theoretical justifications, however, one reason why the United States has not adopted corporate integration is that there is considerable uncertainty as to whether the benefits of corporate integration are worth the costs. For example, a revenue neutral tax change that eliminated the distortion between distributed and retained earnings would increase the pressure on corporations to pay out dividends. This by itself would reduce business savings. Unless individuals increased personal savings, dollar for dollar, total savings in the economy would decrease. Indeed, it was just this concern over the impact of corporate integration on corporate distributions that led the United Kingdom to flip flop on integration in 1965 and France to impose a higher tax on distributed profits than retained profits in 1989...


n113 See OECD, supra note 106 at 25 ("The tax incentive for debt finance has caused some concern that corporations may be tempted to rely excessively on debt. If this were the case, it could threaten the financial
stability of the corporate sector and make corporations too vulnerable to downturns of the business cycle, thereby destabilizing the national economy. In several countries the debt-equity ratio of the corporate sector does seem to have increased during the 1980s... it is ... not quite clear whether the vulnerability of the corporate sector has in fact increased in recent years ...

n114 See generally William D. Andrews, "Tax Neutrality Between Equity and Capital and Debt" (1984) 30 Wayne L. Rev. 1057 (Andrews does not deny the preference for debt, but he does argue that there are compensating advantages to equity capital, including deferral advantages and the use of retained earnings to finance new projects).

n115 For a good review of the depth of studies on this topic see Jeffrey A. Pittman & Kenneth J. Klassen, "The Influence of Firm Maturation on Firms' Rate of Adjustment to Their Optimal Capital Structures" (2001) 23 J. Amer. Tax'n Assoc'n 70.

n116 Stating that the studies have been inconclusive may actually understake the case. See Jeffrey A. Pittman, "The Influence of Firm Maturation on Tax-Induced Financing and Investment Decisions" (2002) 24 J. Amer. Tax Assoc. 35 at 35 ("Most empirical capital structure studies do not find that taxes matter to firms' financing and investment policies").


n118 See Report on Integration, supra note 2 at 146-50. For a similar suggestion, see Cooper & Gordon supra note 58 at 822 ("...including all legal persons and entities engaged in business or profit-making activities (depending on how such organizations are defined under the applicable law), unless they have a very small number of owners, may be preferable to providing flow-through treatment for all partnerships").

n119 See Rudnick, supra note 71 at 1123 ("A liquidity-based standard could solve many of the difficult line-drawing efficiency concerns which accompany any form of profits taxation").


of Canadian corporations is likely a non-resident who does not receive the credit. In making this recommendation, Hartle critiques the approach taken by the Carter Commission, stating that the Commission did not adequately deal with the difficulties that would arise from the form of integration it proposed).

n126 For a good review of the debate about whether the dividend tax credit is an effective tax expenditure or a technical rule designed to achieve some integration see Tim Edgar, "Integration Canadian Style: Comments on the Dividend Tax Credit and the Recommendation of the Ontario Fair Tax Commission" (1994) 9 Tax Notes 1231. It might be noted that Canada's dividend tax credit has always been justified as a tax expenditure targeted to Canadian residents and not as a provision required as part of the technical tax rules. This justification has been important as a defence to claims by treaty partners that the credit should be extended to nonresident investors.

n127 See Income Statistics, supra note 38 and accompanying text.


n129 Peter Birch Sorensen, "Changing Views of the Corporate Income Tax" (1995) 48 Nat'l Tax J. 279 at 290-91 (Sorensen concedes that there may be some positive effects to integration where a company is small enough that all of the shares of a particular class of companies become domestically owned, so the cost of capital is set domestically. As he states, "there may be cases where double tax relief aimed at domestic shareholders will succeed in stimulating domestic corporate investment. For instance, the tax discrimination in favor of domestic shareholders may become so strong that all shares in domestic companies end up being held domestically. In that case, the 'marginal' shareholder is no longer a foreign investor, and domestic share prices will then be bid up by policy measures that make shareholding more attractive for domestic investors").

n130 There is no shortage of tax analysts who take the position that at a minimum corporate taxes will need to be reduced to negligible amounts in a globalized economy. See e.g. Eric Engen & Kevin Hassett, "Does the U.S. Corporate Tax Have a Future?" Special Report, Tax Notes 30th Anniversary Issue (2002); Gordon, "Open Economies," supra note 30; Jack M. Mintz & Duanjie Chen, "Will the Corporate Income Tax Wither?" in World Tax Conference Report (Toronto: Canadian Tax Foundation, 2000) 45:1; Assaf Razin & Efraim Sadka, "International Tax Competition and Gains from Tax Harmonization" (1991) 37 Econ. Letters 69-76.

n131 For example, in Canada taxes on corporate income as a percentage of GDP increased from 2.5 percent in 1995 to 3.6 percent in 1998 and 1999 and to 4.0 percent in 2000. OECD, Revenue Statistics, supra note 77 at Table 12. For comments on this trend more generally see Arthur John Cockfield, "Transforming the Internet into a Taxable Forum: A Case Study in E-Commerce Taxation" (2001) 85 Minn. L. Rev. 1171 at 1232-1234; Zee, "Taxing Income," supra note 19 at 1195.

n132 Numerous commentators have raised the point. See e.g. William Gale, "The President's Tax Proposal: First Impressions" (2003) 98 Tax Notes 265 at 265:

President Bush's new tax plan is an answer in search of a question. It would provide little short-term stimulus. It seems unlikely to provide much of a long-term boost to growth or jobs. It is an incomplete way to reform corporate taxes. It would not boost investor confidence. It would provide windfall gains for previous actions, rather than encouraging new activity. It would make taxes more complex. ... It is fiscally irresponsible and unduly weighted toward high-income households.

See also Dodge, supra note 53 at 292 ("Even if the individual income tax were a flat rate tax, the dividend exclusion approach would avoid basic canons of fairness: Shareholders would avoid tax on clear accessions to wealth in a context where there is no assurance that they would indirectly bear the full burden of the corporate level tax. Given these fundamental problems of the dividend exclusion approach, there is no need to examine the technical issues raised by it"). See also McLure, supra note 16 at 5 ("Finally, such inherently defective schemes as excluding dividends from personal taxable income...are not called either integration or dividend relief (unless preceded by the term 'unacceptable' in the latter case) in order to avoid confusing them with legitimate schemes for providing
integration or dividend relief").