



# FOCUSING ON QUÉBEC'S FUTURE

## SUMMARY

The Reform in Brief

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Final Report of the Québec Taxation Review Committee

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Summary . The Reform in Brief

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# INTRODUCTION

After eight months of deliberations, the Québec Taxation Review Committee is submitting its final report, entitled “Focusing on Québec’s Future.”

The report is comprised of a summary and six volumes.

The committee was chaired by Luc Godbout, Director of the Département de fiscalité at the Université de Sherbrooke.

The committee was also composed of the following members:

- Dana Ades-Landy, Vice-President, Scotia Bank
- Pierre-Carl Michaud, associate professor, Département des sciences économiques, Université du Québec à Montréal
- Danièle Milette, tax expert
- Yves St-Maurice, economist
- Jean-Pierre Vidal, CPA, CA, associate professor of taxation, HEC Montréal
- Luc Villeneuve, FCPA, FCA, Chairman, Deloitte – Québec
- Carole Vincent, economist, consultant and researcher in economics

## □ **The committee’s mandate**

The establishment of the Québec Taxation Review Committee to analyze, and propose the reform of, the Québec taxation system was announced by the Premier in his May 21, 2014 inaugural speech at the opening of the 41st Legislature of the National Assembly, and subsequently confirmed in Budget 2014-2015. The committee was officially created, and its mandate stipulated, in June 2014.<sup>1</sup>

The committee had to reflect upon reform that would make the Québec taxation system more competitive, more efficient and fairer, in order to better encourage people to work, better foster saving, better spur investment, better foster economic growth and enhance the standard of living.

At the same time, the committee had to contribute through its deliberations to a return to a balanced budget by pinpointing immediate tightening of tax expenditures in order to comply with the targets set in Budget 2014-2015.

Thus, the committee was assigned a very broad, demanding mandate by the government, requiring in-depth analysis of a particularly complex sector of government action within a limited period of time.

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1 Order in council of June 11, 2014.



# 1. THE COMMITTEE'S APPROACH

The committee responded to the second facet of its mandate in an interim report submitted to the government on October 31, 2014.<sup>2</sup>

The committee covers all of the facets of its mandate in this final report.

## □ Three sources of reflection

To carry out the mandate that the government assigned to it, the committee defined and implemented a demanding, strategic work approach, based on three sources of reflection:

- the briefs, comments and suggestions submitted or formulated during the public consultations;<sup>3</sup>
- external studies commissioned from Québec, Canadian and foreign experts on topics that the committee wished to examine in greater depth;<sup>4</sup>
- the analyses and studies conducted at its request by the committee secretariat and which mainly came from the Ministère des Finances du Québec.

## □ Zero cost reform

The Québec Taxation Review Committee is proposing a tax reform at zero cost for individuals and corporations taken separately. The committee therefore adopted a demanding guideline, to take into account the current level of taxation.

Due to that guideline, the tax reform would be neutral for public finances. It is therefore worth emphasizing that the tax reform targeted by the committee is not intended to generate new revenues for the government.

A reform that is neutral for public finances is one in which the objective is not to change the combined weight of taxation and user fees in the economy. Accordingly, the proposed changes must be self-financing and neither increase nor decrease the overall tax burden.

- Losses of government receipts stemming from the proposals would be offset by other measures that would increase government revenues by an equivalent amount.
- Conversely, additional receipts resulting from the abolishment or tightening of certain tax measures would reduce other government revenues by an equivalent amount.

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2 The full text of the interim report appears in Volume 4 of this report.

3 Appendix 2 of Volume 1 of this report provides a full list of the briefs submitted. Volume 6 assembles both the report produced by the Institut du Nouveau Monde, which reports to the committee on the contents of the exchanges that took place within the framework of the citizens' forums, and all of the 198 briefs received.

4 Appendix 3 of Volume 1 of this report provides a full list of the studies. Volume 5 comprises the 18 studies that the committee commissioned from experts and organizations.

## □ Current level of taxation

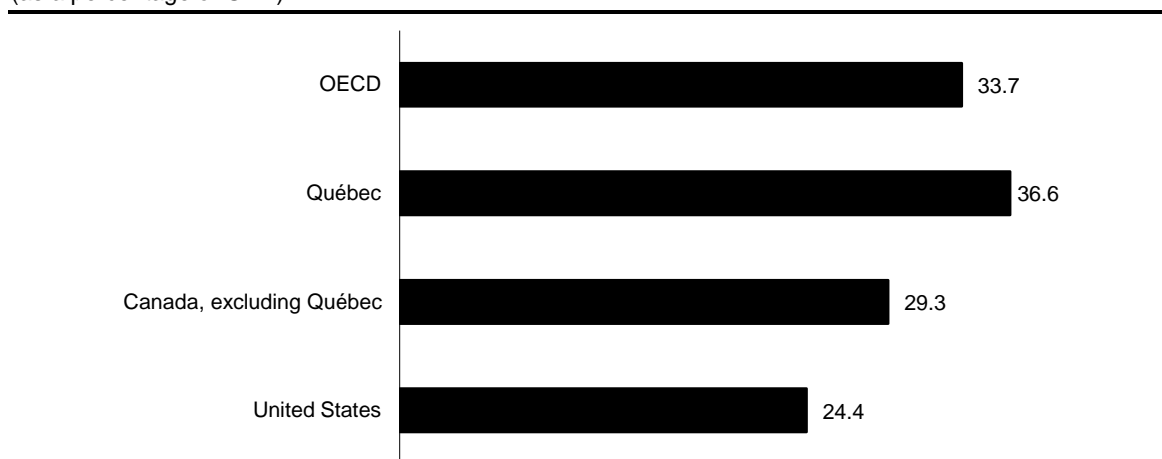
The guideline retained is explained by the current level of taxation, which singularly limits the latitude available to change the tax structure at zero cost, i.e. without having an impact on public finances.

The weight of taxation in the Québec economy is indeed significant. The ratio between tax revenues and GDP observed in Québec is higher than the average for the G7 countries and the member nations of the Organisation for Economic Co-operation and Development (OECD).<sup>5</sup>

Québec's taxation is higher than that applied by its main North American trading partners as regards personal income tax, corporate income tax, consumption taxes, payroll taxes, and wealth taxes. Electricity rates are the only important field in which levies in Québec are lower than in neighbouring jurisdictions.

CHART 1

### Overall weight of taxation – 2012 (as a percentage of GDP)



Sources: Organisation for Economic Co-operation and Development (OECD), central data warehouse as at January 30, 2015, and Institut de la statistique du Québec (ISQ), *Comptes économiques des revenus et dépenses du Québec, Édition 2014*.

5 For additional information, see Part 3 of Volume 3 of this report.

## □ Principles and objectives selected

Within this framework, the Québec Taxation Review Committee reflected on the challenges, principles and objectives that would guide it in the elaboration of tax reform.

### ■ Four challenges

Based on an analysis of the context of Québec's economic, demographic, social and fiscal environment, the committee identified four key challenges that must be considered in the tax reform:

- economic growth and the enhancement of the standard of living against a backdrop of demographic changes;
- public finances;
- competitiveness of the taxation system and the erosion of the tax base;
- attainment of certain social objectives.

### ■ Nine principles

Nine principles underpin the committee's elaboration of its proposals: the necessity of adopting a systemic approach, equity, neutrality, simplicity, transparency, predictability, minimization of costs, diversity and compliance.

### ■ Eight objectives

Based on the mandate that the government assigned to it, and on the above challenges and principles, the committee formulated eight objectives:

- foster economic growth and a higher standard of living;
- encourage business investment;
- encourage labour market participation;
- encourage personal savings;
- adhere to sustainable development;
- collect all tax revenues;
- adapt taxation to a changing society;
- ensure the equitable redistribution of collective wealth and adequate support for the most disadvantaged.



## 2. A REFORM FOR ALL TAXPAYERS

These eight objectives underpin the reform proposed by the Québec Taxation Review Committee. Three key points sum up the reform—adjustment of the methods of taxation, numerous fiscal enhancements, and forward-looking outlooks.

### 2.1 Adjustment of the methods of taxation

In the first place, the committee recommends that the government lay the foundations of a tax regime more conducive to economic growth, through an adjustment of the methods of taxation consisting in reducing personal income tax, corporate income tax and the payroll tax by **\$5.9 billion** annually.

The reduction would be funded through a **reduction in tax expenditures** and a **new tax mix**.

Québec could rapidly implement the reform without calling into question the very foundations of our taxation system.

#### □ A tax reduction of \$5.9 billion

The \$5.9-billion reduction would break down as follows:

- a **\$4.4-billion** reduction in personal income tax;
- a **\$1.1-billion** reduction in corporate income tax;
- a **\$430-million** reduction in the payroll tax.

#### ■ Personal income tax

In the case of personal income tax, the committee recommends the following:

- elimination of the healthcare contribution;
- increase in the basic personal amount;
- addition of tax brackets to enhance the system's progressivity;
- definition of the maximum marginal tax rate, including federal taxation, at 50%.

#### ■ Corporate income tax

In the case of corporate income tax, the committee recommends the following:

- a reduction from 11.9% to 10% of the corporate income tax rate;
- implementation of a “growth premium” for SMEs;
- a reduction in the payroll tax rate for SMEs.

## □ **Reduction in tax expenditures**

The reduction would first be funded through a **reduction in tax expenditures** based on the principle of a lower rate applied to a broader tax base.

## ■ **Problems stemming from tax expenditures**

Tax expenditures reduce the tax yield and impose a bigger tax burden on all taxpayers. The reduction lowers the revenues collected and implies, all things being otherwise equal, the application of higher rates.

The measures cause distortions in economic decision-making. They are an obstacle to the sound allocation of resources and hamper growth. Interaction between tax measures can also impede the incentive to work and to save. Moreover, the presence of numerous tax expenditures complicates the tax system.

In accordance with the mandate that the government assigned to it, the committee undertook a systematic, thorough examination of the tax expenditures related to personal income tax and corporate income tax. The examination revealed a number of tightening measures or existing measures to be abolished.<sup>6</sup>

Solely in the case of personal income tax, the Québec Taxation Review Committee is recommending the elimination of some 30 tax expenditures and the review of more than 20 others.

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6 The results of the analysis conducted are presented in detail in the first three parts of Volume 2 of this report.

■ **Revision of tax expenditures pertaining to personal income tax**

The committee recommends that the significant reduction in personal income tax be funded by means of a revision of tax expenditures that would achieve more than **\$1.0 billion** in net savings.

The committee is proposing an overall reduction in tax expenditures accompanied by the enhancement of a limited number of tax measures that satisfy the objectives adopted.

■ **Revision of tax expenditures pertaining to corporate income tax**

The committee recommends that the reduction in corporate tax be funded in part through a revision of tax expenditures from which businesses benefit, thus generating net savings of **\$1.1 billion**, namely:

- the elimination of the full refundability of tax credits for large businesses, which, in the long run, would generate recurring savings of **\$325 million**;
- the elimination of the existing small business deduction, representing a recurring saving of **\$550 million**, for a net saving of \$80 million bearing in mind the new “growth premium”;
- certain enhancements of tax measures concerning the cultural sector, estimated at **\$5 million**;
- the revision of other tax expenditures, which will generate additional savings of **\$205 million**.

## □ Tax mix

The \$5.9-billion income tax reduction would also, in the short term, be funded through a change in the relative weight of different methods of taxation, including user fees, which is called **the mixing of methods of taxation**, by defining a new mix more conducive to growth. The committee therefore recommends reduced reliance on certain methods of taxation and broader reliance on the others.

The new tax mix would be accompanied by the enhancement of support measures in favour of the most disadvantaged.

### ■ The impact of methods of taxation on economic growth

Extensive investigations have been conducted in recent years in the developed countries to analyze the impact of different methods of taxation on economic growth. Generally speaking, the studies reveal that direct taxes are more detrimental than indirect taxes.

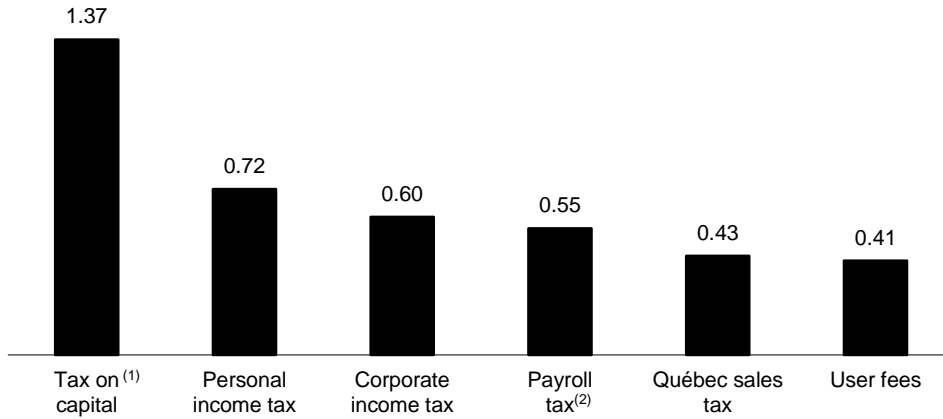
The committee wanted to pursue the matter further by asking the Ministère des Finances to quantify by means of its economic simulation tools the impact of different methods of taxation on economic growth.

Whether the tax burden is increased or decreased, the outcomes respecting the impact on economic growth are similar and lead to a clear division into two groups of different methods of taxation according to their impact on an increase in GDP.

- An increase in capital taxes, corporate income tax and personal income tax especially undermines growth. A reduction has a positive impact on growth.
- On the other hand, a change in consumption taxes or user fees has a much more limited impact on economic growth. An increase in taxes or user fees hampers growth less than an equivalent increase in other forms of levies. Their reduction fosters growth less than a similar reduction in other taxes.

CHART 2

**Long-term gain in real GDP per dollar of reduction in the tax burden (\$)**



Note: The impact consists in a \$1-billion tax reduction or increase in subsidies. The government's loss of revenue is offset through a fixed levy that has a neutral impact on the results.

(1) The tax on capital was abolished on January 1, 2011 and its impact at the time it was still levied is presented here for illustrative purposes.

(2) The impact of the tax reduction applied solely to the private sector.

Source: The calculable general equilibrium model of the Ministère des Finances du Québec.

## ■ A new tax mix with respect to individuals

The Québec Taxation Review Committee therefore recommends that the significant reduction in personal income tax be funded by means of:

- broader recourse to consumption taxes, namely:
  - an increase in the rates that would generate **\$2.665 billion** in additional tax revenues,
  - a revision of tax expenditures related to consumption taxes, representing savings of **\$201 million**;
- additional reliance on user fees, namely:
  - **\$101 million** in additional savings through the fiscalization of reduced-contribution childcare rates,
  - an increase in the price of heritage pool electricity and a new tax on the overconsumption of electricity in the household sector, thereby generating **\$705 million**.

The committee recommends, for example, a 1.025-percentage-point increase in the rate of the QST, from 9.975% to 11%. Combined with the GST, the rate would rise from 14.975% to 16%.

The committee also recommends an increase in the rate of the tax on insurance premiums, the rate of the specific tax on tobacco products, the rate of the tax on alcoholic beverages and the fuel tax rate with respect to gasoline and diesel, as well as the additional registration fee applied to luxury vehicles.

The committee further recommends a series of measures to protect the poorest members of society against the deterioration of their financial situation that may stem from the new tax mix.

## ■ A new tax mix with respect to corporations

In the case of corporations, the tax cut would be partly funded through broader recourse to user fees, which would generate **\$500 million** annually.

With respect to corporations, the committee's recommendation to resort more extensively to user fees concerns Hydro-Québec's electricity rates.

The committee's recommendation concerning the cost of heritage pool electricity formulated earlier would also affect corporations, except for Hydro-Québec's large industrial clients under the L rate.

## □ Impact on economic growth and the standard of living

The committee had assessed the impact of the proposed reform on economic growth and on Quebecers' standard of living. Such impact would be significant.

The committee asked the Ministère des Finances to use its general equilibrium model to simulate the short-term economic impact of the proposed reform, i.e. a **\$5.9-billion** adjustment in the methods of taxation.

According to the Ministère des Finances evaluation, the committee's proposed reform would increase GDP by **\$2 billion** and personal disposable income by nearly **\$600 million**.

TABLE 1

### Economic impact of the committee's proposed reform – Estimates based on the general equilibrium model of the Ministère des Finances

(in millions of 2013 dollars, unless otherwise indicated)

	Impact of the proposed new tax mix
Cost of the reform for the government	0
Impact on GDP	1 924
Impact on disposable income	592
Impact on private non-residential investment	584
Impact on employment (number)	20 505

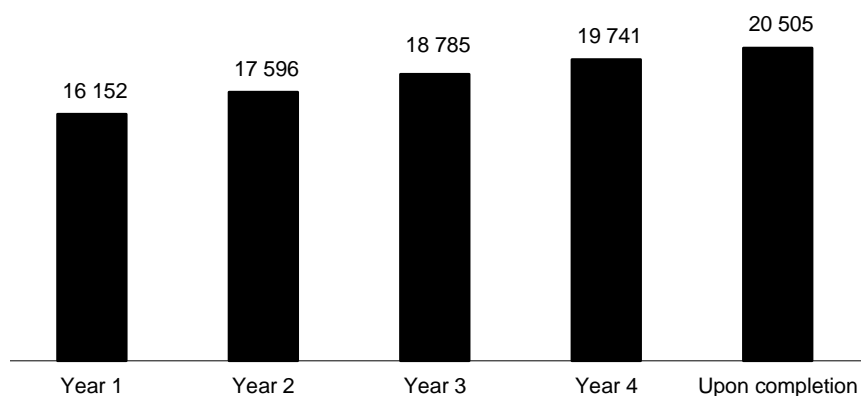
Source: The calculable general equilibrium model of the Ministère des Finances du Québec.

The reform would, in the long run, support the creation of 20 505 jobs. Based on the guidelines that the committee adopted, the reform would have a zero cost for the government.

CHART 3

### Increase in employment resulting from the committee's proposed reform

(number)



Source: The calculable general equilibrium model of the Ministère des Finances du Québec.

## □ **Anticipated impact for individuals**

In the case of personal income tax, the reorganization of the methods of taxation proposed by the committee would benefit all taxpayers, especially middle-class taxpayers.

### ■ **Elimination of the healthcare contribution**

The committee recommends the elimination of the healthcare contribution, which would remove the inconsistencies observed in the marginal tax rates under the current system. The abolition of the healthcare contribution alone would represent a **\$734-million** personal income tax reduction.

### ■ **Increase in the basic personal amount**

The increase in the basic personal amount that the committee is recommending would raise from \$14 281 to \$18 000 the threshold below which a taxpayer does not pay tax. The increase would benefit all taxable taxpayers and represent for them an annual gain of **\$225 million**.

### ■ **Increase in the number of brackets in the tax rate schedule**

The committee recommends that the number of brackets in the Québec tax rate schedule be increased to enhance the progressivity of personal income tax.

The number of rates in the tax rate schedule would increase from four to nine.

— Lower marginal rates would be reduced.

— The upper marginal rate would remain unchanged at 25.75% but would apply to a higher income.

The changes would represent an overall personal income tax cut of **\$3.4 billion**.

### ■ **Maximum marginal tax rate capped at 50%**

The committee recommends that the maximum marginal tax rate of the personal income tax rate schedule, including federal taxation, not exceed 50%. Instead of proposing a maximum marginal tax rate higher than 50%, the committee has preferred to reduce the tax measures that often benefit the well-to-do. By limiting the application of a maximum marginal tax rate of 50%, we will ensure that taxpayers keep at least half of their additional income.

## ■ **An estimate of the impact of the reform on certain groups of individuals**

At the committee's request, the Ministère des Finances used simulation tools to quantify the impacts for taxpayers of the key recommendations formulated.

### ■ **The changes to the tax rules whose impacts were simulated**

The estimated impacts of the committee's proposed reform take into account the changes that would, when applied, have the biggest repercussions on the disposable income of different types of households.

The changes are indicated below:

- the modification of the tax rate schedule from four to nine tax brackets, the increase in the basic personal amount, and the abolition of the healthcare contribution;
- the abolition of the deduction for workers;
- the enhancement of the tax credit for the work premium;
- the introduction of a new premium for experienced workers to replace the existing refundable tax credit for experienced workers;
- changes in the provisions respecting the splitting of retirement income and the transfer between spouses of unused tax credits;
- changes to the refundable tax credit for child assistance;
- changes to the user fees for reduced-contribution childcare services;
- the enhancement of the solidarity tax credit;
- the increase in the QST rate.

The simulations did not take into account the other recommendations since their impact can vary considerably from one household to the next depending on individuals' circumstances and the choices that they make concerning the goods and services that they consume or their work or saving habits.

This is true, in particular, of the increase in the price of heritage pool electricity that the committee is recommending. With this increase, the average annual electricity bill would increase by \$108 for a five-and-a-half room dwelling unit and by \$664 for a large house.

### ■ **Couples with preschool-aged children**

Without taking into account the committee's recommendations concerning user fees for childcare services, all couples with two preschool-aged children and income under \$200 000 would come out ahead. Households with work income between \$60 000 and \$100 000 would be the biggest beneficiaries, with gains ranging from \$1 274 to \$1 887.

Bearing in mind the committee's recommendation concerning childcare services user fees, households with work income between \$40 000 and \$100 000 would be the biggest beneficiaries, with gains ranging from \$2 656 to \$4 343.

In the case of families with work income between \$40 000 and \$60 000, the gain represents between 6.99% and 10.86% of work income.

### ■ **Couples with school-aged children**

The proposed reform would have a positive impact on couples with two school-aged children in all income brackets, except for couples that earn work income of \$200 000 or more.

As a proportion of income, the main beneficiaries would be couples with work income between \$40 000 and \$100 000, with gains ranging from \$853 to \$1 971.

### ■ **Single-parent families**

Without taking into account the committee's recommendation concerning reduced-contribution childcare services user fees, all single-parent families with one preschool-aged child would come out ahead. The gains would be highest for families with work income between \$60 000 and \$80 000, with gains ranging from \$980 to \$1 026.

Taking into account the committee's recommendations concerning user fees for childcare services, a single-parent family with one child in a reduced-contribution childcare service and work income between \$40 000 and \$60 000 would obtain a tax cut, higher child assistance and a reduction in the net cost of childcare services such that disposable income would increase between \$2 243 and \$2 412.

As a proportion of income, the value of the proposed changes would have greater impact on lower incomes. On work income of \$20 000, the gain would represent a 7.52% increase in work income.

In the case of single-parent families with a school-aged child, no family would have less disposable income following the implementation of the reform.

## ■ **Single individuals**

The proposed reform would have a positive impact on single individuals in all income brackets.

Taxpayers with the highest incomes would enjoy the biggest gain. On work income between \$20 000 and \$100 000, the gain would range from \$520 to \$834. On earnings of \$150 000, it would rise to \$1 601. However, as a proportion of work income, the gains would be fairly uniform and even slightly greater among individuals with lower incomes.

For single individuals with incomes between \$150 000 and \$200 000, the elimination of the healthcare contribution would represent 56% to 60% of the gains stemming from the recommendations.

## ■ **Childless couples**

Childless couples would enjoy positive gains in all income brackets.

Couples with work income between \$60 000 and \$150 000 would obtain the highest gains, ranging from \$1 207 to \$1 590.

## ■ **Seniors**

The proposed reform would have a positive impact on couples in which both spouses are 60 years of age with work income, in all income brackets.

The increases in disposable income would range from \$1 649 to \$4 252 for couples with work income between \$20 000 and \$80 000. As a percentage of work income, the gain would be especially significant for couples with work income between \$20 000 and \$60 000. The gains would represent between 7.09% and 9.44% of work income.

The new tax rate schedule would be favourable. Such seniors would pay less tax and the healthcare contribution would be abolished. Above all, the benefits stemming from the new premium for experienced workers would largely offset the abolition of the deduction for workers.

The impact of the proposed reform on couples in which both spouses are 65 years of age would be especially significant for those whose work income is between \$20 000 and \$80 000, with gains ranging from \$2 370 to \$4 985.

As a percentage of work income, the gain would be significant for couples with work income between \$20 000 and \$60 000. The gains would represent between 8.31% and 11.85% of earnings.

In the case of couples with work income between \$20 000 and \$80 000, the effect of the new premium for experienced workers would be especially significant, explaining a good portion of the gains obtained.

In the case of couples in which both spouses are 65 years of age who have left the labour force and in which only one spouse receives pension income, the estimated gains stemming from the committee's recommendations would be positive but fairly modest for those with total income of \$100 000 or less. The gains would range from \$62 to \$995.

## □ Anticipated impact for corporations

The various corporate taxation measures proposed by the committee would improve the competitiveness of businesses.

### ■ Corporate income tax rate

The committee recommends reducing from 11.9% to 10% the corporate income tax rate.

The reduction of nearly 2 percentage points in the tax rate corresponds to a reduction of nearly 16% in the tax rate. The tax rate combined with the federal rate would, accordingly, stand at 25%.

The tax reduction would represent a **\$675-million** gain for corporations.

Québec would thus offer, with Alberta, the most competitive tax rate in Canada and the rate would be nearly 3 percentage points below the Canadian average.

The reduction in the tax rate would benefit roughly 90 000 enterprises.

Such a reduction in the tax rate would promote business investment in Québec by increasing the return on such investments in all sectors of the economy.

### ■ Growth premiums for SMEs

The committee recommends the introduction of a “growth premium” for SMEs to replace the existing small business deduction.

Such a premium would cost the government **\$470 million**.

The new “growth premium” would replace the existing small business deduction, which defines a reduced income-tax rate for SMEs, at a cost of \$550 million. The new premium would cost \$80 million less than the existing small business deduction.

The new premium would encourage small enterprises to grow in order to reach levels of income that benefit from favourable tax treatment.

Eligibility for the new premium would be limited to Canadian-controlled private corporations with paid-up capital of less than \$15 million, as is the case for the existing small business deduction.

What is more, access to the rate would be limited to corporations with at least five employees.

## ■ Impact for SMEs

On taxable income between \$100 000 and \$500 000, SMEs would pay a marginal rate of 4%.

- The reduction in the tax rate for SMEs would benefit nearly 20 000 enterprises.
- The marginal tax rate would be lower than the current 8% rate, lower than the 4.5% rate in force in Ontario and near the 3% average rate applied by the Canadian provinces, excluding Québec.

## ■ Payroll tax rate

The committee recommends reducing from 2.7% to 1.6% the rate of the payroll tax for SMEs, which would reduce their tax burden by **\$450 million annually**.

Currently, the Québec taxation system is noteworthy for its heavy payroll tax in relation to the other three provinces in which such a tax exists. The payroll tax is a fixed charge that is more of a burden for SMEs than for large businesses.

The committee is proposing to substantially reduce the tax for SMEs—by nearly 40%—and thereby significantly narrow the gap in relation to the other provinces for all sectors of the economy.

By reducing the tax burden of SMEs, the lower payroll tax would both foster job creation and enhance the competitiveness of such enterprises on external markets by reducing their production costs.

The reduced payroll tax would benefit more than 200 000 enterprises.

■ **The tax burden differential with Ontario**

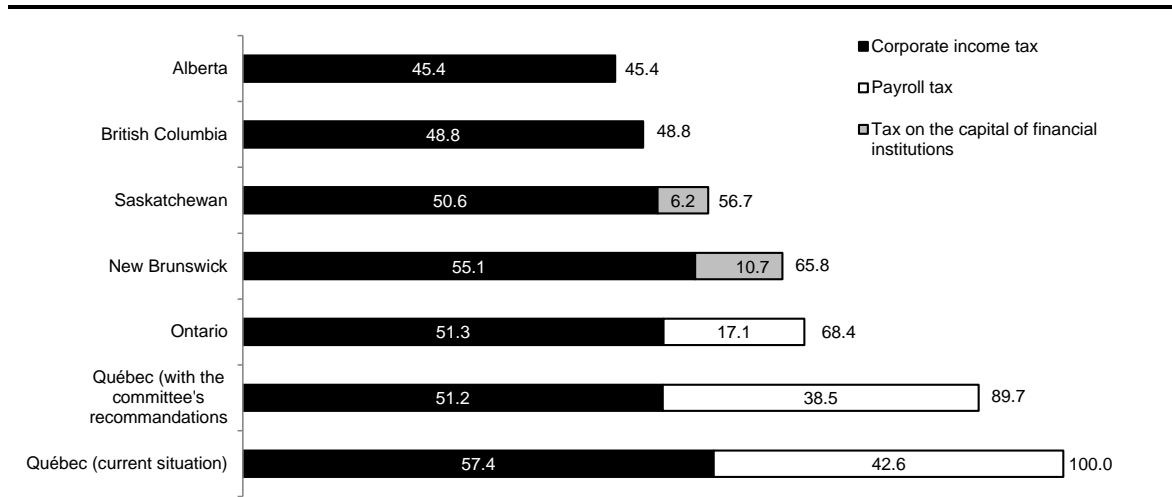
In total, Québec’s tax burden differential with Ontario, its main economic partner, would be reduced by one third.

The current difference represents a tax burden in excess of \$2.8 billion in relation to the application in Québec of the Ontario tax regime. The difference stems by and large from the payroll tax.

The tax burden differential respecting corporate income tax, one of the taxes that is the most detrimental to economic growth, would be completely eliminated.

CHART 4

**Tax burden differential – All corporations, 2014**  
(current Québec =100)



## 2.2 Numerous fiscal enhancements

The reform proposed by the committee also includes numerous fiscal enhancements aimed, in particular, at remedying anomalies or responding to specific challenges.

### ❑ Transfer of businesses

A series of recommendations seeks to foster investments by facilitating transfers of businesses between persons dealing on a non-arm's length basis.

Current tax rules favour the sale of businesses to purchasers with whom the vendors have an arm's length relationship, which can affect family business successions.

The committee has analyzed this problem in order to facilitate transfers of the ownership of businesses between generations in a given family.

The committee has identified three solutions that it recommends the government contemplate. In all of the solutions identified, the committee is insisting on the importance of defining the specific tax rules for transactions genuinely related to family business successions.

### ❑ Encouraging labour market participation: the “tax shield”

In the current and future demographic context in Québec, the work incentive is a strategic objective.

Québec's population is ageing rapidly, which is directly affecting economic growth, because of changes in the labour force. It is crucial for Québec to counteract the decline in the labour force by encouraging Quebecers to enter, remain on or return to the labour market.

To tackle the problem of high implicit marginal tax rates, the committee recommends the establishment of a “tax shield” intended to reduce the implicit marginal tax rate tied to an annual increase in income.

The “tax shield” would take the form of a deduction of 50% of the increase in work income up to a maximum increase of \$5 000 per household and would apply to net income, thus creating a “net adjusted income,” used to calculate the following socio-fiscal tax credits:

- the work premium, including its enhancement and the new premium for experienced workers that the committee is recommending;
- the solidarity tax credit;
- the tax credit for childcare expenses.

The “tax shield” would thus allow households that increase their work income to protect themselves from a marked increase in their tax burden by limiting the loss of the refundable tax credits reducible according to income. It could apply each year to the increase in work income in relation to the preceding year.

The measure would cost **\$90 million**.

We estimate that nearly 790 000 households could benefit from the measure, representing a total gain of nearly \$90 million a year for them. The measure would apply essentially to taxpayers with family incomes under \$75 000.

If we take the example of a couple with two children and family income of \$41 000 that receives the work premium, the solidarity tax credit and the tax credit for childcare expenses, in the absence of the “tax shield” and in the wake of a \$1 000 increase in work income, the couple’s implicit marginal tax rate would reach 61.3% without taking into account federal taxation.

By limiting the reduction of the socio-fiscal transfers from which the couple benefits, the “tax shield” would avoid unduly penalizing individuals who succeed in increasing their work income. Accordingly, under the “tax shield,” the same couple’s implicit marginal tax rate would fall from 61.3% to 43.0%, a reduction of 18.3 percentage points.

The gains would be mainly attributable to compensation for the loss of transfers in respect of the work premium or the solidarity tax credit.

The problem of implicit marginal tax rates is not confined to Québec alone. A significant part of the problem stems from the loss of socio-fiscal transfers under the federal taxation system. Accordingly, federal government participation in the “tax shield” would allow eligible households to benefit from higher compensation.

#### **□ Premium for experienced workers**

The second way to counteract the dwindling labour force is to promote the maintenance on or a return to the labour market by workers approaching retirement or who have already retired, called experienced workers.

To this end, the committee recommends the replacement of the tax credit for experienced workers by a premium for experienced workers to be added to the work premium.

The premium would apply to work income exceeding \$5 000, to a maximum excess income of \$10 000.

The premium would be available at the age of 60. The rate of the tax credit would be 15% starting at the age of 60 and up to the age of 64 for a maximum tax credit of \$1 500. The rate would increase to 25% starting at the age of 65, for a maximum tax credit of \$2 500.

Starting with work income of \$30 000, the maximum amount would be reduced by 10% for each additional dollar of work income.

The measure would have a total annual cost of **\$335 million**. Bearing in mind the cost of the tax credit for experienced workers that it is replacing, the net cost of the measure would be \$275 million.

## 2.3 Forward-looking outlooks

Third, the committee's proposed reform is forward-looking and offers suggestions that should sustain reflection in the years ahead.

### ❑ **Revision of the method of capital gains taxation**

In the medium term, the committee recommends that the government undertake a **revision of the method of taxation in respect of capital gains**.

In 2013, the partial inclusion of capital gains in the case of individuals represented a tax expenditure of nearly \$740 million. Also in 2013, the non-taxation of the capital gain on principal residences resulted in a tax expenditure of nearly \$1.2 billion. The same year, the cumulative capital gains exemption in respect of farm property or fishing property and in respect of the sale of a business cost \$156 million. At the same time, the tax treatment of stock options represented a tax expenditure of \$45 million.

In total, tax expenditures stemming from the treatment of capital gains in the case of individuals thus reached close to \$2.5 billion.

The changes that the committee is proposing cover the four tax expenditures identified.

The revision would seek to treat more fairly capital gains compared with other sources of income.

This is a medium-term change that would require coordination between the other provinces and the federal government to avoid capital gains realization simply shifting outside Québec were Québec to act alone.

### ■ **Partial inclusion of capital gains**

The committee recommends the elimination of the partial inclusion of capital gains and its replacement by the recognition of the real capital gain, i.e. the capital gain that takes into account inflation.

In the case of capital gains realized at the time of disposition of property owned for less than one year, the capital gain must be taxed like any other income.

— Beyond the one-year time limit, the capital gain realized would be adjusted to take into account inflation.

### ■ **Other changes to capital gains taxation**

The revision would lead to the modification of the current rules that allow for the non-taxation of capital gains on the principal residence. It would include a proposal aimed at transforming the cumulative capital gains exemption into an additional RRSP contribution. It would also lead to changes in the tax treatment of stock options granted to employees.

## □ Reflection on a dual income tax system

In the third stage, in the long term, the committee recommends that **thorough reflection occur on the very foundations of income tax by examining the implementation of a dual income tax system.**

The current personal income tax and corporate income tax systems hinge essentially on ideas developed in the 1960s.

The economic setting and knowledge of tax-related questions have changed vastly since then. In particular, we now have a much deeper understanding of the impact of methods of taxation and improper resource allocation that each method of taxation can engender.

The committee believes that the time has come to initiate thorough reflection on the relevance of maintaining the current paradigm or gradually shifting to a new income tax system.

The committee is proposing the examination of what it regards as a promising avenue—**the implementation, in the long run, of a dual income tax system**—similar to the one that prevails with some success in the Scandinavian countries.

The dual income tax system consists in applying a progressive, relatively high tax scale on work income and a single, low rate on capital income and corporate income, combined with the broadening of the tax base.

The committee wishes to emphasize that more detailed analyses should be conducted to determine whether this avenue is the one that should indeed be emphasized in the long term.

The collaboration of the other Canadian jurisdictions would, moreover, be essential.

### 3. A REFORM THAT ADDRESSES A NUMBER OF CONCERNS

The committee's recommendations point to a number of concerns.

#### 3.1 Equity and redistribution of wealth

Within the context of its analysis of taxation, the committee was to **ensure the equitable redistribution of collective wealth and adequate support for the most disadvantaged.**

The committee believes that this objective must be regarded as a condition for the implementation of the objectives it set for itself.

The committee has ensured that the initiatives proposed in respect of the tax reform do not call into question the equitable redistribution of collective wealth and, particularly, the maintenance of adequate support for the most disadvantaged.

In the elaboration of its recommendations, the committee acknowledges the importance of pursuing the government's initiatives to combat poverty and social exclusion.

In its analyses, it has taken into account the repercussions of its recommendations on certain target groups and, in particular, on the financial situation of the most disadvantaged.

##### **Enhancement of the solidarity tax credit**

To protect the poorest members of society against the deterioration of their financial situation that may result from the proposed new tax mix, the committee recommends a **\$310-million** enhancement of the solidarity tax credit.

The proposed increases would be:

- \$75 of the base amount, i.e. a 27% enhancement in relation to the current base amount of \$278;
- \$75 of the spousal amount, i.e. a 27% enhancement in relation to the current spousal amount of \$278;
- \$50 of the additional amount for a single individual, i.e. a 38% enhancement in relation to the current amount of \$133.

##### **Other measures**

In addition to the enhancement of the solidarity tax credit, the committee recommends that the basic personal amount be increased in order to raise to \$18 000 the amount of income shielded from taxation, which is considerably higher than the current figure of \$14 281, below which a taxpayer does not pay tax.

The reduction in the rates of the first tax brackets in the tax rate schedule that the committee is proposing will benefit low-income taxpayers and all taxpayers.

Furthermore, the committee's recommendations concerning the work premium would ensure an additional amount of roughly \$107 million would benefit households with more modest incomes and, in particular, the most disadvantaged.

## 3.2 Better management of tax expenditures

The committee's proposed reform consists in reducing personal income tax, corporate income tax and the payroll tax for the benefit of all taxpayers and in partially funding the reduction through a reduction of tax expenditures.

Accordingly, the committee conducted a systematic analysis of existing tax expenditures pertaining to individuals and to corporations.

Once the analysis has been completed and the recommended tightening measures have been carried out, it is essential to ensure for the future sound management of tax expenditures that illustrates the adaptation of the Québec taxation system to changes in society. The committee is of the opinion that it is essential to better manage tax expenditures and, in particular, to:

- avoid in the future a new multiplication of such measures;
- put an end to measures for which there is no longer any rationale;
- ensure better transparency in the tax expenditures adopted;
- respond to the tax competition that is developing between jurisdictions.

The question of tax competition is of particular concern to the committee.

For Québec, such tax competition comes into play both at the international and interprovincial levels.

The committee recommends that the question of interprovincial tax competition be put on the agenda of interprovincial or federal-provincial meetings, for example within the framework of the finance ministers' conferences or the Council of the Federation.

### 3.3 Erosion of the tax base

The committee has focused on the erosion of the tax base, which is occurring in Québec and in all jurisdictions.

The new information and communications technologies and the globalization of trade have given a new dimension to tax evasion and tax avoidance.

What is more, the advent and development of e-commerce are raising the question of the collection of taxes related to such commerce.

The question is a crucial one. The erosion of the tax base compromises funding for public services. Individuals do not accept the injustice of the non-collection of all tax revenues.

To enable Québec to collect all of its tax revenues, the committee is proposing a threefold approach:

- the fight against tax evasion and tax avoidance;
- the collection of sales tax and income tax pertaining to e-commerce;
- better oversight of provisions respecting trusts.

## □ **The fight against tax evasion and tax avoidance**

Tax evasion and tax avoidance refer to an array of initiatives that certain taxpayers, both individuals and corporations, undertake to reduce the amount of tax payable.

### ■ **In Québec's territory**

In Québec's territory and more generally speaking in the fields under its jurisdiction, the Québec government has assigned to Revenu Québec a mandate to combat tax evasion, tax avoidance and aggressive tax planning schemes. In recent years, Revenu Québec has stepped up its fight against tax evasion. Bearing in mind the initiatives already undertaken, the committee recommends that Québec pursue the fight against tax evasion, tax avoidance and aggressive tax planning schemes.

### ■ **At the interprovincial level**

Revenu Québec is focusing, in particular, on the fight against tax avoidance and, more specifically, aggressive tax planning schemes.

A number of interprovincial aggressive tax planning schemes have been identified, of which a significant number have been eliminated.

The committee recommends that the Québec government step up discussions with the other provinces and the federal government in order to further promote collaboration between the different jurisdictions.

In practical terms, this question should be put on the agenda of interprovincial or federal-provincial meetings, for example within the framework of the finance ministers' conferences or the Council of the Federation.

### ■ **At the international level**

At the international level, the fight against tax evasion, tax avoidance and aggressive tax planning schemes is of a different order.

Tax evasion and tax avoidance raise major, highly complex challenges.

However, an examination of changes in direct Canadian investments abroad offers some indication of the scope of the phenomenon.

In 2013, direct Canadian investments abroad were substantial in a number of countries with favourable taxation such as Switzerland (\$6.9 billion), Bermuda (\$10.7 billion), Ireland (\$16.0 billion), Luxembourg (\$30.2 billion), the Cayman Islands (\$30.9 billion) and Barbados (\$63.0 billion).

▪ **Recommendations of the committee**

The committee believes that the Québec government must clearly indicate its concern about the fight against tax evasion, tax avoidance and aggressive tax planning schemes.

Québec should vigorously support international efforts to fight against tax evasion, tax avoidance and aggressive tax planning schemes.

The committee recommends that Québec establish a centre of expertise devoted to the fight against tax evasion, tax avoidance and aggressive tax planning schemes. Such an initiative is one means of playing a leading role in the fight.

The committee also recommends that the federal government be asked to inform the provinces and the public of the extent of the problem and the solutions that it is implementing or intends to implement.

## ❑ **Collection of sales tax and income tax relative to e-commerce**

The generalization of the Internet has spawned a veritable revolution in trade relations with the introduction and development of e-commerce.

From a fiscal standpoint, the development of e-commerce has engendered major problems as regards the collection of sales tax and income tax.

This problem is not specific to Québec and affects all jurisdictions.

In the case of Québec, Revenu Québec estimated in 2012 at \$165 million the tax losses sustained by the Québec government because of online purchases made by Quebecers from suppliers established outside Canada.

It is difficult to estimate the losses stemming from online purchases that Quebecers make from suppliers in other provinces but the amount is undoubtedly significant. Revenu Québec has advanced a figure of \$300 million.

The committee wishes to emphasize that the tax losses that the Québec government has already sustained are considerable and can only increase in the future if the problem of collecting sales tax on e-commerce transactions is not resolved.

### ■ **We urgently need to act**

We therefore urgently need to act, but the initiatives to be taken are not easy to define and implement.

The committee recommends that the Québec government initiate discussions to obtain the federal government's consent to administer, on behalf of the Québec government, the registrations that would become compulsory under the QST regime for businesses located outside Québec that make supplies to Québec without maintaining there a physical or significant presence.

In the case of the collection of sales taxes on online transactions conducted by suppliers from foreign countries, the committee recommends that the Québec government pressure the federal government to step up its efforts within the framework of the OECD's ongoing deliberations.

The committee is of the opinion that the Québec government should assume leadership among the Canadian provinces overall with respect to the collection of the sales tax linked to e-commerce conducted with the rest of Canada and foreign countries.

## ❑ Better oversight of provisions respecting trusts

Furthermore, the committee recommends better oversight of provisions respecting trusts.

A trust is an entity that has the capacity to hold property rights on all tangible and intangible property for the benefit of one or more persons called the beneficiaries.

It offers several advantages from a legal standpoint, which explains its popularity. A trust allows flexibility in wealth management, the possibility of protecting assets against financial setbacks, and control over remittances to the beneficiaries.

The committee has been made aware of several impacts of trusts on the Québec taxation system and has focused, in particular, on three of them:

- the shifting outside Québec of the tax base;
- the circumvention of the concept of associated companies;
- the splitting of income from corporations.

The committee is formulating recommendations to eliminate or limit these impacts. Several of them require the cooperation of the federal government.



## CONCLUSION

By establishing the Québec Taxation Review Committee, the Québec government sought to initiate thorough reflection on a tax reform that would make the taxation system more competitive, efficient and equitable.

At the conclusion of its eight months of deliberations, the committee is submitting to the government the outcome of its reflection.

### **□ A major reform**

The committee is proposing the reorganization of methods of taxation that consist in reducing personal income tax, corporate income tax and the payroll tax and in financing the reduction by means of lower tax expenditures and a new tax mix. The reform would be at zero cost for taxpayers and neutral for public finances.

In the medium and long term, the committee is formulating suggestions that should sustain future reflection by recommending a revision of the method of capital gains taxation and reflection on a dual income tax system.

The committee is convinced that the initiatives would directly, significantly affect economic growth and a higher standard of living.

The committee's proposed reform includes numerous other recommendations that target the objectives pinpointed. The committee believes that it is indeed possible to rely on taxation to promote business investments, encourage people to work, foster personal savings, engage in sustainable development and adapt the funding of public services to a changing society. It has formulated several proposals to this end.

In particular, it has focused on the collection by the government of all tax revenues. Moreover, it has ensured that the proposed reform would not call into question the equitable redistribution of collective wealth and adequate support for the most disadvantaged.

### **□ Focusing on Québec's future**

It is now incumbent upon the government to ensure the appropriate follow-up to the recommendations presented.

Through the proposed reform, the committee is proposing to rely on taxation to "focus on Québec's future."







# FOCUSING ON QUÉBEC'S FUTURE