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Abstract

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Larry Chapman: Our objective today is to discuss the tax expenditure review that is currently being performed by the federal government. The review has not garnered much attention, unless one reads the fine print in the 2016 budget or is a close follower of the Department of Finance’s press releases. We are going to tell you why we think the review is significant. Kenneth McKenzie will discuss the theory and the measurement of tax expenditures and the benchmark that should be used. Whether something is or is not a tax expenditure depends
somewhat on the base you are measuring it against. When we finish that discussion, we will dive into the tax expenditure reports. The Department of Finance publishes these reports every few years. The most recent one is dated 2016. We are going to examine some numbers from the most recent report and talk about significant ways in which the government provides incentives and tax relief through the Income Tax Act and whether these items are or are not tax expenditures. At the end of the session, we are going to predict—or, maybe more correctly, speculate on—what the government might do as a result of this review.

The 2016 budget contains a few code words that help to set the context for the tax expenditure review—words like “fair, efficient, [and] fiscally responsible.” We all agree that these attributes are good things. The budget announcement also says that the objective of the review is to determine whether the tax system works well for Canadians, with a view to eliminating poorly targeted or inefficient tax measures. The panel members’ first message is that we believe that a tax expenditure review is quite different from a review of the tax system. A review of the tax system is and should be a much more comprehensive exercise than examining a number of tax expenditures and deciding whether they are fair, efficient, and appropriately targeted.

Lindsay Tedds reminded me that this review is part of the Liberals’ election platform. The platform said that tax expenditures would be reviewed with an objective of finding $3 billion of expenditures that were ineffective or poorly targeted and thereby obtaining $3 billion of savings over the four-year mandate.

In a June 17, 2016 press release, Finance announced the appointment of a panel of external experts to advise it on the tax expenditure review. The members of the expert panel are Robin Boadway (Queen’s University); Kim Brooks (Dalhousie University Law School); Kevin Dancey (retired—formerly the president of CPA Canada and senior partner of PwC); Luc Godbout (Université de Sherbrooke); Jinyan Li (Osgoode Hall Law School); Kevin Milligan (University of British Columbia); and Jennifer Robson (Carleton University).

The members of the panel were obviously selected for their knowledge of the Canadian tax system, but also with a view to avoiding the appearance of conflicts of interest; thus, most of them are academics. Not surprisingly, a number of them have done research and published papers on various fiscal policy matters, so they come to the review with opinions on the tax system.

The next event of significance is the November 1, 2016 economic statement, which reported that the government expected to incur deficits as follows:

- 2016-17, −$25.1 billion;
- 2017-18, −$27.8 billion;
- 2018-19, −$25.9 billion;
- 2019-18, −$19.3 billion.

Another election promise was to incur relatively small budget deficits and return to balanced budgets before the end of the Liberals’ first mandate.
Looking at the economic statement and the relatively large deficits that we are facing, the panel members feel that it is reasonable to question whether or not this tax expenditure review is solely a review of the fairness, efficiency, and effectiveness of expenditures, or whether it might be described with some other code words —such as “finding a way to raise some money to pay for the deficit.” If the government’s real objective is to address a structural deficit, we are far beyond tinkering; the government should be undertaking a much more comprehensive review.

The 2016 tax expenditure report provides estimates for tax expenditures for 2010-13 and projections for 2014-17. The use of the term “estimate” reflects the imprecision inherent in determining the cost of tax expenditures; “projections” reflects the fact that without the benefit of tax data, the results of looking into the future are even more imprecise. When one reads the report, it is immediately apparent that there are some sacred cows (one might also call them changes) whose disappearance would be politically toxic.

Some of the larger tax expenditures are the following:

- RPPs and RRSPs, $35-42 billion;
- charitable donations, $2.6 billion;
- age credit, $3 billion (and growing);
- non-taxation of gambling and lottery winnings (not estimated by Finance); and
- non-taxation of private health and dental plans, $2.8 billion.

It is hard to imagine a government proposing changes to some of these features of the income tax, even though their cost is very large, because they are so entrenched and taxpayers have come to expect them. One of the themes that runs through the tax expenditure report is the amount of support given to senior citizens. The non-taxation of gambling winnings is an interesting item, and contrasts with the tax treatment in the United States. Possibly one of the more politically sensitive items is the non-taxation of the cost of providing private health and dental benefit plans because of the impact on a large part of the population and the social policy implications of appearing to tax expenditures that promote health and welfare. Moreover, this tax policy benefits a large segment of the middle class, a Liberal election priority.

On the possibly less toxic list, and thus on the list of tax expenditures that are more likely to get close examination, might be the following:

1) the preferential treatment of capital gains:
   a) 50 percent inclusion rate; personal income tax, $4-6 billion; corporate income tax, $4-7 billion;
   b) lifetime exemption, $1 billion;
   c) principal residence exemption, $4-5 billion;
d) employee stock option deduction (equivalent to capital gains treatment), $600-$800 million;  
2) the small business deduction, $3-$4 billion; and  
3) scientific research and experimental development (SR & ED), $3 billion (refundable and non-refundable credits).

Finally, some expenditures are purely targeted tax cuts that in the view of some economists have very little economic justification. These include the following:

• boutique credits (such as transit and volunteer firefighting), at least $500 million and possibly more than $1 billion;  
• employment tax credit, $2 billion;  
• pension income splitting, $1 billion (and growing); and  
• pension income credits, $1 billion (and growing).

Many observers have speculated that there might be changes to the preferential treatment of capital gains. Apparently there was even a flurry of activity before the November 1, 2016 economic statement, when taxpayers took action to realize capital gains just in case the economic statement announced a change to the capital gains inclusion rate. It is clear that the capital gains inclusion rate is a big number—$4 billion to $6 billion—and that is just the personal tax revenue impact; there is another $4 billion to $7 billion of corporate tax revenue impact. The lifetime capital gains exemption is $1 billion, and the principal residence exemption is $4 to $5 billion. Employee stock options represent a smaller number, but this is a topic that we are going to talk about because we think it is significant from a tax fairness perspective. The small business deduction is $3 billion to $4 billion; SR & ED is another big number. Finally, the so-called boutique credits have been roundly criticized from the time that they were first introduced, and yet they just seem to multiply. It was thought that the Liberals were going to do something about them, but in their first budget they introduced the teachers’ tax credit. Collectively, these credits costs between $500 million and $1 billion in lost tax revenue. By eliminating the credits, the Liberals could fulfill their election promises to find $3 billion over four years. Unfortunately, we doubt that is going to happen as a result of the review.

In the context of this background, Kenneth McKenzie is going to talk about tax expenditure theory; Lindsay Tedds and Shawn Porter are going to talk about capital gains and items that receive the equivalent treatment; and I am going to discuss the small business deduction. We will wrap up with some thoughts on how the expenditure review will conclude and what the government should be doing more broadly with the tax system.

Kenneth McKenzie: My purpose today is to highlight some conceptual and theoretical issues that are important to keep in mind when one is thinking about
tax expenditures. In this regard, I will start with the most basic question: What are tax expenditures? Tax expenditures are in some ways in the eye of the beholder, and there are many conceptual issues that need to be confronted in order to measure them. I will touch on a few of the more important ones here.

The key issue is the benchmark system—what are you comparing the current tax system to? If one is to estimate how big a particular tax expenditure is, the answer is absolutely vital. I will return to this question later, but first I want to talk about two different approaches to thinking about tax expenditures, regardless of what the benchmark system is. One approach is to treat any deviation from the benchmark system, whatever that benchmark system may be, as a tax expenditure. This approach reflects a very broad view of tax expenditures. Another, narrower, view is that only a deviation from the benchmark system that could conceivably be offered through the expenditure or the spending side of the fisc is a tax expenditure. This narrow view is consistent with the somewhat oxymoronic label “tax expenditure”; it fits with the idea that these are really expenditures that are being delivered through the tax system because it makes more administrative sense to do so. For example, consider two countries, A and B. Country A imposes a low 15 percent on tax on incomes that are less than $30,000. Country B doesn’t use the rate structure to deliver tax relief to low-income taxpayers but rather employs credits that are targeted at taxpayers who earn $30,000 or less. Assume that the tax burden imposed on individuals who earn less than $30,000 income is exactly the same in the two countries; they have achieved the same outcome using different approaches. The standard approach, which is followed by the Department of Finance, is to treat the rate structure, but not tax credits, as part of the benchmark system. Under this approach, country B reports tax expenditures but country A does not. The economic outcome is the same in both cases, but it is achieved in different ways. The point of this example is to emphasize that there is some degree of arbitrariness in the measurement of tax expenditures. For example, the basic personal amount is reported as a tax expenditure of $36 billion, but it could equivalently be delivered through the rate structure, in which case it wouldn’t be called a tax expenditure at all.

My own view is that “tax expenditures” are a subset of “tax concessions,” and that not all tax reductions should be viewed as tax expenditures. This view suggests a three-step approach. First, identify the benchmark system (I will return to this point below). Second, determine the tax concessions relative to that benchmark. Third, determine whether the tax concession could be delivered on the spending side. If the answer is yes, it is a tax expenditure; if the answer is no, then it is not. Does the Department of Finance follow this approach in its tax expenditure accounts? In my view, the answer is sometimes yes and sometimes no; the devil is in the details. When I look at the tax expenditure accounts, my overall impression is that for the most part Finance takes steps 1 and 2—defining a benchmark system and the deviations from it—but doesn’t really take step 3, which involves asking, “Is this an expenditure that is just hidden as a tax credit, or is it a tax expenditure?” This approach results in an overly broad view, one
that treats things like the basic personal amount as a tax expenditure, for example, and (unfortunately, in my view) gives rise to the notion of sacred cows—things that we simply will not touch—which drastically reduces the value of the tax expenditure exercise.

There are many other issues; I will touch on just a few here. Interestingly, the most common entry in the tax expenditure account is “not available,” which means that no data are available to support a meaningful estimate or projection. This reflects the fact that some things are very difficult to estimate in the context of tax expenditures. Most of these relate to the timing of when taxes are collected or deductions made. For example, tax expenditures are not typically reported for things like accelerated tax depreciation deductions, yet these can generate significant “subsidies” for particular activities. Identifying them as tax expenditures with no associated dollar amount misrepresents their impact and purpose.

Another issue relates to the adding together of tax expenditures as a way to estimate the revenue implications of eliminating them. This is commonly done, but it is not appropriate for two reasons. First, such calculations do not take account of interactions between the various features of the tax system, of which there are many. It is therefore absolutely inappropriate to add them together. Indeed, the Department of Finance states this explicitly in the accounts, but it is often done in any event. Second, tax expenditure estimates do not take account of any behavioural responses to tax changes; they assume that there are none. These behavioural responses can significantly affect revenues. Therefore, tax expenditure accounts should be used very cautiously from the perspective of estimating the revenue implications of eliminating them.

I will now turn to the benchmark tax system. This is an extremely important issue because tax expenditures are computed as deviations with respect to a benchmark. There are two basic benchmarks that might be considered: comprehensive income and comprehensive consumption. It is fair to say that the Department of Finance tax expenditure accounts lean heavily toward some notion of comprehensive income as a benchmark. The problem is that it is not at all clear that this is the appropriate benchmark.

To illustrate, take as a starting point the Carter commission. The lens through which the Carter report viewed the tax system was comprehensive income—“a buck is a buck is a buck.”

We know that many of the Carter commission’s recommendations were not actually implemented, but I think it is fair to say, perhaps arguably, that the notion of comprehensive income guided tax policy discussions at the time. Since then, however, our tax system has evolved in a piecemeal fashion into a system that is very far removed from the Carter commission’s view of comprehensive income. And that evolution, again perhaps arguably, has been informed by insights into the benefits of consumption as opposed to income taxation. As it stands now, we actually have a hybrid income/consumption tax system, which leans much closer to being a comprehensive consumption tax than a comprehensive income tax, at least on the personal tax front. The treatment of registered
retirement savings plans (RRSPs), registered pension plans (RPPs), tax-free savings accounts (TFSA), principal residences, etc. are all consistent with consumption taxation, not income taxation. This, then, suggests that a more appropriate benchmark to use in the computation of personal tax expenditures may well be a comprehensive consumption tax.

Under this approach, items are labelled “tax expenditures” in the Department of Finance accounts that are benchmarked (roughly) against a comprehensive income tax would not be tax expenditures benchmarked against a comprehensive consumption tax. For example:

- RPPs, $27.5 billion;
- RRSPs, $16.3 billion;
- TFSA, $855 million; and
- non-taxation of gains on the principal residence, $5 billion.

The principal residence exemption is interesting. It can be thought of as a big TFSA with no cap on it, invested in one particular asset—your home. The home is purchased with after-tax dollars, there is no deduction when you buy it, the income accrues tax-free, and the home is not taxable when you sell it. This is precisely how a TFSA works. This is perfectly consistent with consumption taxation, and would not be viewed as a tax expenditure under that benchmark, but it is identified as a substantial tax expenditure in the tax expenditure accounts as they stand now. Interestingly, many of these items (RPPs, RRSPs, TFSA, and the principal residence exemption) are viewed as untouchable sacred cows, which I think reflects at least in part the understanding that comprehensive income is not the appropriate benchmark.

In light of all of this, are tax expenditure estimates useful? On balance, I would say a qualified yes; but they need to be interpreted very carefully. Further in this connection, can a systematic review of tax expenditures yield positive results? Again I would say a qualified yes, in part because I have confidence in the people involved in the exercise and their understanding of these issues. There is some benefit in incrementally cherry-picking tax expenditures like boutique tax credits, and possibly some others. But at the end of the day, I think that viewing tax reform through a tax expenditure lens is fundamentally wrong and that we need to take a much more comprehensive approach to tax reform. It is time for another Carter commission.

Larry Chapman: From some of the comments that we are about to make, it is clear that there are so many interactions between the various tax expenditures and the tax system more broadly that looking at them in silos makes no sense.

Shawn Porter: I’m generally in agreement with what Ken had to say. I am just a practitioner, so I tend not to look at these things through a theoretical lens. One distinguishing comment that I would make about the tax expenditure review
process is that I am not quite as bearish on the prospects that something useful will or could come out of it. I think it can be useful to look at parts of the system as long as you are mindful of the broader context in which the parts you are looking at fit. It’s a much more ambitious job to try to reform the whole system all at once, so I am not quite as skeptical about the review. What I would like to see—and this is a common refrain from those of us outside government—is a little more sunlight on the process. It would be better if the analysis and advice of the tax expenditure review panel was produced and made available for the public to see. My own sense is that a lot of these tax expenditures border much more closely on political decision making than on evidence-based policy analysis. But whatever the rationale, interested stakeholders and the public would benefit from an opportunity to review the report. We get the government we elect, and I don’t begrudge them their right to make political choices; but I think the system, and ultimately the quality of the choices, would benefit from a bit more sunlight.

Now I will turn to a discussion of the inclusion rate for capital gains. The timing benefit for capital gains—which are taxed only upon realization—and the capital gains exemption are also significant aspects of (and benefits under) the Canadian tax system, but we are going to focus on the inclusion rate. As Larry mentioned, the less than full inclusion rate for capital gains is a large tax expenditure, both at the corporate level and at the personal level, so presumably it is going to get some attention in the context of this review.

As Ken mentioned, these tax expenditure estimates do not take into account behavioural responses. I think that we would all agree intuitively, and there is ample economic evidence on this point, that if you increased the inclusion rate to 100 percent it would not yield additional tax revenue equal to the amount of the tax expenditure. You would obviously get significant behavioural reaction to a complete elimination of the tax expenditure. On the other hand, a modest increase in the inclusion rate would likely produce some meaningful amounts of incremental government revenue over time, particularly taking into account the fact that individuals are deemed to dispose of property at fair market value on death in Canada. That said, this is a great example that illustrates Ken’s point about the interdependence of tax expenditures. For example, individuals may defer dispositions (or realizations) during their lifetimes, increase donations of publicly listed securities to take advantage of tax expenditures in that context, or increase charitable giving on death, all of which would reduce the revenue yield from an increase in the capital gains inclusion rate. And I haven’t even touched on the impact of reduced incentive effects on government revenue. If revenue raising is the goal, then increasing the inclusion rate, in and of itself, has its limitations.

The following is the typical list of justifications for less than full inclusion of capital gains in income:
• incentive for the risk taking, saving, and investing that foster economic growth;
• relief for taxation of inflationary gains;
• relief for higher tax rates due to bunching of income; and
• partial relief for double taxation of corporate profits.

These justifications are commented on extensively in the academic literature, Finance publications, and government budget documents whenever any tinkering occurs with respect to the taxation of capital gains and related rules. My main observation is that this is a somewhat disparate list, although commentators often refer to all of these rationalizations and justifications together as support for the argument that less than a full inclusion rate is appropriate for capital gains. There is no real quantitative, structural linkage between the capital gains inclusion rate and the items on the list, which gives rise to the question: which one of these justifications is the most compelling, or, asked differently, at which one of these justifications is the less than full inclusion rate really targeted?

I do not suggest that the middle two items are unimportant, but I think that the first and last bullet points are really the drivers. I will return to these points, but I want to touch briefly on the middle two first.

With respect to the taxation of inflationary gains, it is true that it is inherently unfair and inequitable to tax inflationary gains, but that’s what the tax system does. Generally speaking, we tax nominal income or nominal GDP. Not all employment income growth is real, but it is taxed nonetheless. Capital gains are not singled out for special treatment in that context. The inflationary element of a capital gain is more apparent when properties are held over a long period, but it doesn’t change the fact that the tax system is generally based on the notion that we tax nominal income. And the fact that we defer the taxation of capital gains until the realization event is a very significant benefit, particularly for assets that produce real returns held over a long period. I take no issue with the deferral benefit for all the practical and liquidity reasons that have traditionally been given, but it’s important not to lose sight of it in the balance of the analysis.

As for the bunching of income, I’m not sure that’s as big a problem as it is often made out to be. There is obviously no bunching issue for capital gains at the corporate level. The corporate rate structure is flat. As for the personal tax rate structure, one hits the top rate relatively quickly, and most of the gains are concentrated among individuals in those upper income groups. It is true that there will be cases where individual taxpayers will realize a significant capital gain once in their lives (or perhaps a few times, but infrequently over their lives), and they will pay considerably more tax than they would have paid if that income was averaged over the holding period. But if the less than full inclusion rate is intended to compensate for the bunching effect, it is a crude approach. And other sources of income (for example, employment income) can also spike at different times in a person’s life. We’ve had averaging in our tax system before.
I take no issue with the fairness aspects of averaging, but the complexity is significant, especially in the context of capital gains. Coupling the deferral of capital gains taxation with averaging would be particularly generous. It’s interesting to note that deferral contributes to the lock-in effect, which in turn (or eventually) exacerbates the bunching-of-income problem. From this viewpoint, expecting a less than full inclusion rate to address, or compensate for, such interdependent (and, in the case of deferral, self-inflicted) problems seems a bit ambitious.

That brings me to corporate rates and the role that a less than full inclusion rate plays in providing some relief from double taxation as it relates to corporate profits. The main message here is that we’ve had significant reductions in corporate tax rates over the last 15 years with no change to the capital gains inclusion rate, and the rates are out of alignment here. This misalignment manifests itself now in a very wide gap between dividend tax rates imposed on individuals and capital gains rates. Even if we do not take into account GRIP and LRIP (the general-rate and low-rate income pools) and those sorts of distinctions, that gap is quite wide. If the inclusion rate was increased today to two-thirds, $100 of income earned by a corporation would, in rough terms, bear $25 of corporate-level tax, and two-thirds of the $75 residual taxed personally at 50 percent would result in $25 of individual-level tax for a roughly 50 percent tax burden. The calculation is not perfect, in part because the provinces have not followed the federal example in truing up the dividend tax credit rate as a result of recent rate changes, so there will still be a gap, but that might go a long way toward taking the fun out of a lot of the corporate surplus-stripping transactions that the tax community engages in today.

A few words on economic effects: I am probably the least qualified person up here to comment on this topic, but I will give you some perspective as a practitioner. A key observation about the 50 percent inclusion rate is that it applies across the board, which is one of the reasons that this tax expenditure is so large. There is no holding-period requirement. The same inclusion rate applies whether the gain is earned in corporate solution or at the individual level. Perhaps of most interest, it is not conditioned on whether the property is a corporate share or any other capital property, even though, as I mentioned previously, one of the more compelling rationales for the less than full inclusion rate is the role that it plays in relieving double taxation on corporate profits and helping to facilitate neutral tax burdens in relation to dividends. Many capital gains emanate from property other than corporate shares (for example, real estate, passive investments, and personal-use property), and the 50 percent inclusion rate is equally available for those.

It seems reasonably apparent that the goal of the less than full inclusion rate is to encourage risk taking in Canada and innovation-producing and productivity-enhancing activities with a view to improving Canada’s economic performance and our standard of living. The challenge lies in how to define a target (the object of the preference) that produces the desired outcomes.
Legislators would have to deal with a few key design questions if we were to aim the preferential inclusion rate at a narrower category of properties. Targeting capital income incentives is not particularly new in Canada. Canada has a rich history of tinkering with the capital gains deduction, not to mention various other incentive regimes for investing and risk taking. Interestingly, we have not tinkered much with targeting the capital gains inclusion rate. For the first 17 years after the introduction of capital gains taxation in the 1971 tax reform, we had a 50 percent inclusion rate. Generally speaking, we went to $66\frac{2}{3}$ percent in 1988, to 75 percent in 1990, and (in two steps) back to 50 percent in 2000. That’s quite a bit of stability in terms of the inclusion rate over a 45-year period. Canada has targeted and experimented with the capital gains exemption, but the inclusion rate has been remarkably stable. I think that’s probably wise because of the difficulty in targeting activities, expenditures, and behaviours effectively through legislative language. Each time you try to target, you are going to open up a cottage industry whereby the planners will seek to convert (or divert) income into the targeted box. Although not targeting the inclusion rate seems wise, it does give me pause because the across-the-board preferential inclusion rate makes the tax expenditure relatively expensive, and at least parts of it are likely ineffective in achieving its goals.

I should also point out the asymmetrical treatment of capital losses. If we are talking about wanting to encourage expenditures and risk taking, we continue to have a long tradition in Canada of less than generous asymmetrical treatment of losses. Although to do otherwise would be expensive, the government shares more equally in realized capital gains than it does in realized losses, as a result of requiring losses to be deducted only against realized gains.

I have a few concluding comments on the capital gains inclusion rate preference. One point runs to the desired mix of income and consumption taxes. (Ken touched on this when he inquired about the appropriate benchmark against which to measure tax expenditures.) There is a tension and an evolution in the Canadian tax system in terms of striking the right balance between taxing income and taxing consumption. Conventional wisdom suggests lower tax burdens on income (especially capital income), militating against any increase of the inclusion rate for the taxation of capital gains. A competing viewpoint—for those who believe that capital income taxation preferences generally are contributing to, if not driving and widening, the income inequality problem—is that the inclusion rate should be increased to enhance overall progressivity and redistribute the incremental revenue through the tax system. There are of course many combinations of options available to deal with these competing notions.

Putting all of this together, I am open to a modest increase in the inclusion rate in the environment today. I am influenced most by the difference between rates on dividends and capital gains—perhaps because I am an accountant and that’s something tangible that I can get my mind wrapped around—and the belief that we should narrow the gap from the perspective of integration policy and curtail surplus-stripping activities. But I would condition that modest capital
gains inclusion rate increase on a reduction in the top rate on the individual side, or at least significantly increasing the threshold at which the top rates begin to apply to, say, $400,000 or more.

The last thing that I would say to the government is that if consideration is being given to increasing the inclusion rate, it would be appropriate to provide a transitional rule in one form or another, and I think it would be a good idea to signal that there would be a transitional rule any day now. There is a paranoia in the taxpayer and adviser communities that an inclusion rate increase will be effective immediately upon announcement, resulting in a lot of wasted effort with taxpayers undertaking crystallization or step-up transactions before every budget (and economic statement). Although there is no precedent for tightening changes to the inclusion rate having been made with immediate effect, this paranoia is traceable in large part to the 2010 budget’s tightening of the stock option deduction: that measure took effect for option exercises immediately after the announcement. I prefer what Finance Minister Bill Morneau did last December in connection with the stock option deduction debate. Comments had been made by the Liberals in their 2015 election platform, and people were concerned that there could be tightening on that front. The government responded in December 2015 (well in advance of the 2016 federal budget) that if there were to be changes in that context, such changes would be prospective. I think that is the preferred approach—not only to avoid the deadweight transactional costs, but also to avoid what I suspect would be a regressive outcome, reflecting the practical reality that high net worth individuals primarily would undertake the protective planning.

Lindsay Tedds: Ken has spoken about the need to use a clearly defined benchmark tax system to appropriately identify tax expenditures. Shawn has set out detailed considerations related to the capital gains inclusion rate. These two aspects come together nicely as part of an analysis of the employee stock option deduction. I am sure that we all know by now that there is nothing mystical or magical about stock options. They are simply a form of deferred compensation, one of many tools that are used to compensate employees. Because stock options are deferred compensation, the benefit derived from the stock option award is considered to be employment income.

How, then, is the income benefit from stock options taxed? The tax treatment of stock options originally evolved out of case law because the taxation of stock options was not included in the original Act. The tax treatment was eventually incorporated into the Act in the 1970s. In contrast to other forms of employment income, there is no immediate income benefit when stock options are granted or when they vest, and therefore no tax liability accrues at either point. Rather, an income benefit arises when the stock options are exercised. At the time of exercise, the benefit that must be included in employment income for tax purposes is the difference between the fair market value of the stock on the date that the options are exercised and the price at which the options were granted.
(the strike price). If the exercised options—the shares in the stock—are held for a time and sold sometime after the exercise date, then the difference between the proceeds of the disposition of the stock and the fair market value of the stock on the date that the option is exercise is taxed as a capital gain or a capital loss, as the case may be. This is the benchmark tax treatment of stock options; the income benefit is taxed at exercise, and everything else that accrues after that point is a capital gain or loss, because the employee is now holding a risky asset. To link this point back to Ken’s comments, this benchmark tax treatment holds regardless of whether the tax system is based on income or on consumption (in this case, defined as income less savings).

There are, however, two important deviations from the benchmark system in Canada, meaning that the income benefit from employee stock options is treated differently from any other form of immediate or deferred employment compensation. First, under the benchmark system, issuers of employment income should be permitted to deduct the employment income from their own taxable income, ensuring that double taxation of the income does not take place. With respect to employee stock options, in Canada no deduction is (or ever has been) permitted to the issuer of the stock options. Second, the employee is permitted to deduct a portion of the income benefit, set at the capital gains rate, which is currently 50 percent. That is, as the capital gain rate varies so does the employee stock option deduction. An important caveat that is often overlooked, however, is that the employee stock option deduction is allowed only if certain conditions are met: (1) the shares to be acquired are common shares; (2) the employee is at arm’s length with the issuer; and (3) at the time the options are granted they are not in the money. It is not clear to what extent these conditions are scrutinized by the Canada Revenue Agency (CRA) when a tax filer claims the employee stock option deduction. There is certainly room to be concerned about compliance with these conditions, given the evidence regarding the manipulation of the grant dates of stock options in the 1990s and 2000s. And while it appears that fraudulent dating practices have been curtailed in recent years, evidence both in Canada and the United States suggests that this is still an ongoing issue of concern.

With respect to who claims the employee stock option deduction, table 1 summarizes information compiled from the tax-filer statistics available from the CRA’s website. In total, just over 48,000 tax filers (0.18 percent) claimed the stock option deduction in 2013, deducting a total amount of nearly $2.3 million. Most of this amount (98 percent) was deducted by individuals who reported more than $100,000 in income; of that amount, 90 percent was deducted by individuals who reported more than $250,000 in income in the tax year. Finance estimates that the cost to government in lost revenue was $630 million in 2013; that amount grew to about $840 million in 2015. This is not an insignificant amount, and it does not include amounts lost by the provincial treasuries. However, this revenue is only potentially lost, which is a point we will return to because it is not as simple as it seems.

[catch table 1 near here]
What were the policy reasons for supporting the creation of the employee stock option deduction? The deduction was originally available only to Canadian-controlled private corporations (CCPCs) in 1977. The rationale was that the deduction would allow a small business to attract and retain employees without impairing its working capital. In particular, it was a way for CCPCs to compete for talent with larger public companies. The employee stock option deduction was extended to all corporations in 1984; it was billed as a way to encourage more widespread use of employee stock option plans, with the idea that doing so would increase productivity. More recently, it has been argued, mostly by the tech industry, that the employee stock option is required to curb the brain drain to the United States.

These policy arguments, however, are easily refuted. First, since the employee stock option deduction was extended to options issued by most companies in Canada, CCPCs no longer have a competitive advantage in using the employee stock option deduction to attract and retain talent. Further, the employee does not have to remain with the company to benefit from the deduction; when an employee leaves a company, stock options typically vest immediately and expire within a set time following the departure, but the departing employee can still exercise the options within the required period and claim the stock option deduction. Second, with regard to encouraging the use of employee stock option plans, we know that employee stock options are more widely used in the United States, which does not provide a deduction to the employee (at least for non-qualified stock options, which are at least 95 percent of the options available). Instead, in the United States, issuers of stock options are permitted a deduction. Third, there is no clear evidence that employee stock options have any discernible effect on employee productivity at the micro level. While firms that grant options broadly to employees tend to grow more rapidly, there is no conclusive evidence that this is the result of employees working harder and more innovatively. In addition, not only are stock option grants to non-executive employees too small to provide any incentives, but few of these lower-level employees have the necessary authority to make the types of decisions and effect the changes necessary to greatly increase productivity. Fourth, there is little evidence to suggest that tax rates on income are primary drivers of the brain drain. There are many reasons why talented, educated individuals remain in or leave any given country. Certainly, opportunity is an important factor, but so too is the overall quality-of-life bundle, which extends far beyond tax rates. Combined with these factors are obvious concerns associated with tax neutrality and fairness that arise because one form of compensation is being tax-preferred over all others.

If there is a need to provide tax preference for compensation, why provide it only for stock options? Why not for shares, deferred stock, or income compensation? Why are stock options treated so differently? And why is it that taxpayers rather than employers are the ones that need to ensure that employees are properly compensated? After all, any change in tax treatment to stock options can be easily offset by the employer simply issuing more options. There is, however,
one potentially plausible and defensible argument in favour of the tax preference of stock options: if those employees who receive the stock options are risk-averse individuals, the options actually have a subjective value that is less than the market value. In that case, reducing the inclusion rate reflects the difference the individual’s valuation and the market valuation. However, many of the people who receive stock options are not risk-averse individuals, so the blanket deduction that currently exists is poorly targeted. In addition, to the extent that the stock option deduction promotes the increased use of stock options by employers, then the portfolio of risk-adverse individuals continues to lack the degree of asset diversification that would be congruent with their risk preference.

One last point to consider concerns insider disclosure rules related to stock options. Individuals who receive stock option awards, exercise stock options, and sell the shares from an exercised stock option are required to publicly disclose these events as a way to curb improper granting and trading practices. With respect to stock option grants, this includes concerns related to (1) “spring loading” or issuing grants immediately before the release of good news; (2) “bullet dodging,” or issuing grants immediately following the release of bad news; and (3) “backdating,” or the act of choosing a date for a stock option grant after the date has occurred but claiming to have granted the options at the earlier date in order to take advantage of the historical price performance of a company’s stock. The Canadian Securities Administrators/Autorités canadiennes en valeurs mobilières have clearly noted that disclosure requirements for stock option grants limit these improper dating practices, and studying actual compliance with these requirements is important to understanding their deterrence efficacy. Recent evidence regarding compliance with the reporting rules for stock option grants in Canada is concerning, and provides further reasons to question their preferential tax treatment.21

When the evidence is considered in its totality, it suggests that Canada should return to the benchmark tax treatment of stock options. This treatment includes allowing the issuer to take the deduction and fully taxing the income benefit in the hands of the recipient, and doing so is consistent with either a consumption-based or an income-based benchmark tax system. This proposition then circles back to the point made by Larry regarding whether or not doing so would lead to a resulting increase in tax revenues. That is, would doing so be considered a tax grab by Finance? The answer is easy: Absolutely not. The primary motivation for this tax change is purely one of tax fairness and tax neutrality, not one of accruing revenues. Mintz and Venkatachalam22 recently found that reverting to this benchmark treatment would raise virtually no revenue. However, this finding was based on an analysis of Canada’s top 100 corporations. If smaller companies are included, there may be some marginal revenue gains. However, changing the benchmark system would also likely result in behavioural changes as companies shift into other compensation devices, so it is not clear what the end effect would be. But again, the argument regarding the needed change to
the tax treatment of stock options is not about revenues; it is about the appropriate taxation of compensation.

**Larry Chapman:** I’m going to deal briefly with the principal residence exemption. It’s another big number. You have to go back to the Carter commission to find the policy reasons supporting the tax-exempt treatment that we have now. The main reasons cited by the commission were as follows:

- Gains are primarily inflationary.
- Practically speaking, it is difficult to calculate the gain.
- Non-taxation would be broadly equitable.
- There would have to be a complex set of rules to defer taxation for gains that were reinvested after one sold a home and then purchased a replacement home.

It is questionable whether principal residence gains are primarily inflationary in today’s environment. In some Canadian markets that might be true, but in others it is clearly not. Two of the other reasons (difficulty of calculation and simplicity) are still valid. The difficulty of calculating is probably applicable to almost everyone. Most people don’t keep detailed records of how much money they spend improving their homes. Finally, I think that there are good reasons for questioning whether the exemption is still broadly equitable and whether the continuation of a complete principal residence exemption is appropriate. Consider someone who makes a $2 million gain on his or her home and someone who makes a $2 million gain from selling a qualified small business corporation. The tax system rewards the person for selling the house more than it does for building up $2 million of value in a company. The Carter commission also discussed the possibility of putting a cap on the amount of the principal residence exemption that could be claimed. An exemption with a cap may have some merit at this time to make the exemption more broadly equitable. As noted above, reinvestment rules would be required if gains were invested in a replacement principal residence. Selecting a principled basis for determining the amount of the cap would be a challenge. Could it be the same amount as the lifetime capital gains limit, or would one select an arbitrary amount (such as $1 million) that would be indexed? Would it be appropriate to have a minimum holding period before the exemption could be claimed? Would it be necessary to have transitional rules? All of these questions would require study, analysis, and consultation, but if fairness is the goal then this is a topic that is crying out for examination.

With respect to the small business deduction, it is clear that this is also a big number—$3-4 billion. The first and probably the most significant policy reason offered to support the small business deduction is that it’s very difficult for small businesses to raise funds to expand. The small business deduction is justified as an effective way to deal with the market failure arising from the inability of
small businesses to get the financing they need to expand their businesses. The tax savings provide small businesses with an additional source of financing.

On the critical side, there are two reasons why the small business deduction might be questioned:

1) Is it an effective way to deal with the market failure? Does it really do what it is supposed to do? (There are good reasons to raise that question.)
2) Does it encourage small businesses to remain small? (There are very differing views on this issue. On one side you have Chen and Mintz, who supported this theory. Dachis and Lester reached a different conclusion.)

Ted Mallett of the Canadian Federation of Independent Business has written in support of the small business deduction. Given his affiliation, that is not too surprising. Wolfson et al. focused on the use of the small business deduction by highly paid professionals to achieve a significant tax deferral advantage. They were very critical of that use of the small business deduction.

Regarding the market failure justification, it is reasonable to question whether the lower tax rate provides small businesses with funds that are sufficient to expand (see table 2).

[catch table 2 near here]

The lefthand column in table 2 shows the amount of capital that is invested in a small business, and the next three columns show the return on capital that would be achieved if a business had a 10 percent return, a 5 percent return or a 2.5 percent return on capital. The last three columns show the tax savings that arise from the small business deduction based on those returns. These calculations are based on Alberta corporate rates, which are a little lower than the Ontario rates. The Ontario differential between the regular corporate rate and the small business rate is only 11.5 percent, whereas the Alberta differential is 13.5 percent. A 10 percent return on $1 million of invested capital gives rise to $100,000 of profit; the tax saving from the small business deduction is $13,500. If the owner wants to expand the business, he or she has an incremental $13,500 to invest as a result of the tax savings from the small business deduction. If the owner decides to do a 10 percent expansion, which is a relatively modest expansion, he or she will need to accumulate those savings up for seven years before having enough money to finance the expansion. Is a small business owner going to wait seven years to finance an expansion? The market will have changed, the expansion opportunities will likely be different, and more capital may be required. Successful entrepreneurs are not going to wait several years to save enough money to finance their expansion. They will find another way. It can certainly be argued that (as my mother used to say) that every little bit helps. I agree, but I don’t think that the small business deduction is really the answer to the financing issue that small businesses face.

With respect to the barrier-to-growth argument, the main reason for suggesting that the small business deduction is a growth barrier is the high marginal
tax rate that can arise when the deduction is phased out as taxable capital employed in Canada rises above $10 million. During the phaseout, and depending on the profitability of capital expansion, very high marginal tax rates can arise. The theory clearly suggests that this could be an issue. But empirical evidence, obtained from talking to small business owners and advisers, suggests that small business owners who think they can make more money rarely factor into their decision making the loss of the small business deduction.

In 2014, the Department of Finance published an analysis of the small business deduction as part of its tax expenditure report (see figures 1 and 2). Figure 2 is supportive of the proposition that the small business deduction is not a serious barrier to growth. The large number of companies that are nowhere near the $10 million taxable capital threshold suggests that other factors are much more relevant in constraining their growth. Even for the corporations that have taxable capital in excess of $10 million, there does not appear to be any noticeable spike just before the $10 million capital threshold is reached. In contrast, it is clear from the spike in figure 1 just before the annual business limit is reached that tax planning is occurring: the benefit of the small business deduction is obtained by bonusing out income in excess of the maximum amount qualifying for the deduction.

The other point to note is the number of businesses earning less than $100,000 that benefit from the small business deduction. The vast majority show income between $0 and $100,000. Those are small or very small businesses that, as noted previously, are not getting huge benefits from the small business deduction. There are probably better ways to help them out. Moreover, Dachis and Lester put forward a strong argument that the small business deduction is not a significant barrier to growth.

I may not agree with Jack Mintz that the small business deduction provides a barrier to growth, but I am in his camp, which favours its elimination and the development of more effective ways to deal with the financing market failure that clearly exists. The result should not be to give the government $3 billion more to spend on other programs or help to finance the spending deficits that it has created. If the small business deduction is to be eliminated, the government needs to think about how it could use the additional funds. For example, it might consider the following:

1) Further reduce the general corporate rate. (A reduction could have a very positive impact on business investment, but it takes money away from the small business sector.)

2) Give small businesses a better writeoff for capital assets or a simpler writeoff by not requiring them to capitalize their capital assets. This is another one of Jack Mintz’s suggestions that has simplification, economic, and cash flow benefits.)
3) Create a fund that small businesses can access to finance their expansions and deal directly with the market failure that the small business deduction is intended to address.

Our conclusion, in a few words, is that what is needed is a much broader review of the tax system than a tax expenditure review can accomplish.

Shawn Porter: What should the government do?

Kenneth McKenzie: As I indicated earlier, I would argue that we need to think about these issues from a much more comprehensive perspective. The Carter commission published its report 50 years ago, and our understanding of tax systems and their behavioural effects—in particular, in light of international tax-planning issues—has changed a lot since then. There is a great deal of insight generated by that research that can be brought to bear on the issue, and I don’t think a piecemeal tax expenditure review is necessarily the best way to go about it. I am realistic enough to admit, as per Shawn’s point, that perhaps, and sometimes, a piecemeal approach is better than nothing. But that is not true all of the time—and the danger is that we will end up with a bit of a dog’s breakfast of logical inconsistencies and contradictions using this approach. Indeed, I think a case can be made that this is precisely what we have after several decades of piecemeal changes. I really think that it is time to do a reset and look at tax reform in a more systematic and comprehensive way.

Lindsay Tedds: One of the things that bothers me is that myths percolate throughout the development of public policy, and we let those myths guide us. There are so many myths about the underlying issues with tax expenditures; but the world has changed and technology has changed, and we really have got to stop basing our tax policy on myths about what we believe to be true versus what is in fact true.

Larry Chapman: It’s been 50 years since the Carter commission’s report. I agree with Ken. It’s time to have a more comprehensive look at the whole tax system—in particular, the personal tax system, which has had less comprehensive attention than the corporate tax system, which has undergone a number of reviews.

Questions from the Floor

Shawn Porter: One questioner has challenged the wisdom of even a modest increase to the capital gains inclusion rate generally on competitiveness grounds. I agree with the sentiment, and I may not have adequately acknowledged the competitiveness point in my formal remarks. Clearly, we do need to keep an eye on what goes on south of the border. I am mindful of that. The only thing I would
say to this questioner, though, is that Larry set the context earlier in terms of significant deficits as far as the eye can see. I think it is incumbent on the questioner to finance the forecasted level of government expenditures in some manner. If you are not going to increase the inclusion rate, then maybe you increase consumption taxation on high-income consumers. But I think that something has to be done unless you believe, in good faith, that the financial position of the country, federally and provincially, is sound. Time doesn’t permit a broader philosophical discussion about the size of government and the operation of our federation, but I’m not inclined to think that Canada should be running deficits indefinitely in today’s economic environment. We’ve already seen how that movie ends.

Interestingly, another person has questioned whether a 75 percent inclusion rate for capital gains might result in a higher degree of convergence between the tax rates on dividends and capital gains. First, we need to introduce this person to the person who asked the previous question. Second, that may be true. I deliberately undershot in terms of trying to narrow that gap between capital gains and dividends in the spirit of moderation and in deference to the concern expressed by the first questioner. And there is another aspect to this question—in effect, the questioner wonders whether there is a way to structurally assimilate dividend taxation and capital gains taxation in the corporate context. That’s a good and valid question, but a very large one that is best left for another day.

Finally, there is a general question about complexity in the context of capital gains and dividend tax rates and corporate tax rates and the small business deduction. I would refer to something Larry said. If Larry did not actually say, “Repeal the small business deduction,” I think he came pretty close. And I think Kim Moody said almost the same thing in another session, because the complexity has gone off the charts in terms of all of the legislative detail required to maintain the integrity of that rule. Perhaps simplification is grounds enough to justify the repeal of the small business deduction. But when you couple that with ambivalent economic evidence in favour of the incentive, I think it makes the answer fairly clear, ignoring politics. The repeal of the small business deduction would be a substantive simplification measure (ignoring transitional rules), obviating the need for GRIP and LRIP distinctions and relieving the associated corporation rules from a significant amount of pressure.

**Larry Chapman:** I agree that there’s a strong simplification argument for repealing the small business deduction.

**Kenneth McKenzie:** I’ll paraphrase the next question: “When the cost of a tax expenditure is considered, should we consider the cost of administration and verification? Any tax preparer can tell you that the cost of the arts credit vastly exceeds the $75 credit.” This is an excellent point. As I indicated in my earlier remarks, one view is that, in principle, when thinking about a tax expenditure we should ask whether it is cheaper or more efficient from an administrative
and compliance point of view to deliver the benefit by way of the tax system rather than the spending system. But as the questioner very correctly points out, this may not always be the case. Another example that most of you are probably familiar with is the SR & ED credit for research and development conducted by small businesses. My understanding is that there is a bit of a cottage industry, whereby tax preparers contact small businesses and offer to go back over past tax returns with a view to refiling to claim forgone R & D tax credits. This is clearly not the tax policy objective; the underlying R & D expenditures have already been made, and for whatever reason—lack of knowledge and the perception of high compliance costs are probably at the top of the list—the small businesses simply didn’t fill out the forms to receive the tax credit. This hypothesis is consistent with my general view that we need to think about all of this, including administrative and compliance issues, in a more comprehensive way; just focusing on the tax expenditures as they are currently calculated can be very misleading.

Notes

1 Canada, Department of Finance, 2016 Budget, Budget Plan, March 22, 2016.
2 For readers who are interested in an in-depth discussion and analysis of tax expenditure theory and practice, the Canadian Tax Foundation supported a symposium organized by Osgoode Hall Law School: Lisa Philipps, Neil Brooks, and Jinyan Li, eds., Tax Expenditures: State of the Art (Toronto: Canadian Tax Foundation, 2011).
3 Canada, Department of Finance, Report on Federal Tax Expenditures 2016 (Ottawa: Department of Finance, 2016).
4 Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”). Unless otherwise stated, statutory references in this paper are to the Act.
5 The budget (supra note 1) contains numerous instances of the terms.
8 Canada, Department of Finance, Fall Economic Statement, November 1, 2016.
9 Ibid., at 66, table A1.2. The plan sets out broad revenue and spending estimates and shows a small surplus in the government’s 2019-20 year.
10 Supra note 3, at 30-39.
13 The lock-in effect is the tendency of investors to hold on to investments to avoid the realization and thus the taxation of gains. Economists have studied the effect of rate of tax rates on the realization of gains without reaching definitive conclusions. For a review of the older studies, see George R. Zodrow, “Economic Issues in the Taxation of Capital Gains” (1995) 21:1 Canadian Public Policy 27-57.
Employment income is generally taxed on a received basis rather than an earned basis. With respect to a stock option, an income benefit does not accrue to the employee until he or she has the unconditional legal right to exercise the option. In theory, then, stock options could be taxed on their vesting date, as is done in Australia. However, the value of the options is more easily determined at the time of exercise, which is the model used to tax options in both Canada and the United States.

The majority of employee stock options are exercised and sold on the same date, meaning that no capital gain or loss is experienced; only an income benefit is derived. See, for example, Jennifer N. Carpenter and Barbara Remmers, “Executive Stock Option Exercises and Inside Information” (2001) 74:4 Journal of Business 513-34; Chip Heath, Steven Huddart, and Mark Lang, “Psychological Factors and Stock Option Exercise” (1999) 114:2 Quarterly Journal of Economics 601-27; and Eli Ofek and David Yermack, “Taking Stock: Equity-Based Compensation and the Evolution of Managerial Ownership” (2000) 55:3 Journal of Finance 1367-84.

If the stock options are issued by a CCPC, the inclusion of the employment benefit can also be deferred to the taxation year in which the employee sells the shares, provided that the shares are held for two years after the exercise date.


Tedds, supra note 17.


Geoffrey R. Conway, The Taxation of Capital Gains, Studies of the Royal Commission on Taxation no. 19 (Ottawa: Queen’s Printer, 1967), at 144, discusses the issues involved in taxing gains from the dispositions of residential properties (principal residences).


Benjamin Dachis and John Lester, Small Business Preferences as a Barrier to Growth: Not So Tall After All, C.D. Howe Institute Commentary no. 426 (Toronto: C.D. Howe Institute, May 2015).


28 See subsection 125(5.1), which provides for a phaseout of the small business deduction for corporations with taxable capital employed in Canada that is greater than $10 million. The small business deduction is eliminated entirely when taxable capital employed in Canada equals or exceeds $15 million.

29 If a $5 million expansion of the business results in very low or no profit, the marginal tax rate on the additional profits could exceed 100 percent.


31 Supra note 25.
Table 1  Tax Filers Claiming the Employee Stock Option Deduction, 2013a

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<th>All filers</th>
<th>$100,000-$149,000</th>
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Table 2  Tax Savings from the Small Business Deduction at Various Returns on Capital

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<th>Return on capital</th>
<th>Tax saving</th>
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</thead>
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<tr>
<td></td>
<td>At 10.0%</td>
<td>At 5.0%</td>
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</tr>
<tr>
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</tr>
<tr>
<td>$10,000,000</td>
<td>$1,000,000</td>
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</tr>
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</table>
**Figure 1  Number of Small CCPCs Claiming the Federal Small Business Deduction, by Taxable Income, 2000, 2001, and 2007**


**Figure 2  Number of Small CCPCs Claiming the Federal Small Business Deduction, by Taxable Capital, 2000, 2001, and 2007**
