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The Honourable Bill Morneau
Minister of Finance
Department of Finance Canada
90 Elgin Street
Ottawa, Ontario
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Dear Minister Morneau,

Budget 2016 – tax policy issues for consideration

Budget 2016 will provide the newly elected Government of Canada with an opportunity to improve economic prosperity for Canadians. Although we have long enjoyed a high standard of living relative to most countries, we are currently facing challenges in growing our economy, due in part to the global slowdown in the resource sector. As well, Canada continues to lag many other nations in terms of productivity, one of the most important drivers of prosperity. Canada's productivity challenges can be attributed to a number of factors, including business leader risk aversion, underinvestment in machinery and equipment, lack of risk capital for start-up enterprises, increased competition for global talent and insufficient support for innovation. As discussed in our report series, *The future of productivity*[1], we believe that Canada has an opportunity to address these challenges and, thereby, significantly improve productivity.

Canadian tax policy can play an important role in helping Canada to be more productive and globally competitive by creating a tax ecosystem capable of fostering innovation and investment while supporting the objectives of a balanced budget over time along with gradually reducing the level of debt to GDP. The available mix of taxes - corporate, personal and indirect - allows the Government to encourage economic growth through targeted tax incentives or allowances while allocating the tax burden across elements of the economy in a fair and equitable manner.

As Canada requires capital that must often be sourced from outside of our borders, fiscal policy should ensure that Canada remains competitive in attracting foreign capital. Recent legislative changes – as well as the anti-treaty shopping proposals in the 2014 budget – risk discouraging foreign investment by creating uncertainty as to the interpretation and scope of these proposals.

Accordingly, our policy recommendations for Budget 2016 can be summarized in six broad categories:

1. Protect Canada's competiveness in attracting inbound investment
2. Consider the introduction of a patent box model

[1] http://www2.deloitte.com/ca/en/misc/litetopicpage.MF-CA-Tags.future-of-productivity.html

3. Spur a "start-up economy" with improved financing support
4. Encourage foreign investment through full refundability of SR&ED tax credits
5. Attract and retain the world's most talented people
6. Enhance certainty through efficient tax administration

DELOITTE'S BUDGET 2016 RECOMMENDATIONS

1. Protect Canada's competitiveness in attracting inbound investment

Canada's competiveness in attracting inbound investment must be protected. We are concerned that the anti-treaty shopping proposals contained in the previous Government's 2014 budget would, if enacted as proposed, hurt Canada's ability to attract such investment by being too far-reaching and creating significant uncertainty as to the tax consequences of inbound financing arrangements. Foreign investors may choose to invest elsewhere. Since the announcement of the anti-treaty shopping proposals, we have observed that the uncertainty has negatively affected investment decisions into Canada.

Canada is a relatively small, open economy and has capital needs well beyond that which its residents can provide. Foreign investors have a broad range of opportunities as to where to invest their capital. Thus, introducing Canadian tax policy changes - such as the anti-treaty shopping proposals - that create uncertainty and reduce investment yields, will undermine foreign inbound investment into Canada. To attract foreign capital, Canadian projects generally must support higher potential yields than comparative investments located in the home country of a capital source (e.g., the United States). This is a particular issue for the energy and resources sector, given this sector's significant need for and difficulty in accessing capital. We refer you to our submission on the anti-treaty shopping proposals[2] for a more in-depth discussion of our concerns with the anti-treaty shopping proposals.

In considering the base erosion and profit shifting (BEPS) recommendations of the Organisation for Economic Co-operation and Development (OECD), which were recently endorsed by the G20, we encourage the Government to engage in consultations with stakeholders and to carefully consider the impact that any changes may have on the inbound investment into Canada, on the competitiveness of Canadian multinational enterprises and on Canada's broader economy.

We also recommend the continued monitoring of the competitiveness of Canada's corporate tax rates. Even as BEPS recommendations are being endorsed and plans are under way for their incorporation into national tax regimes, countries are making changes to their corporate tax rates. For example, the United Kingdom recently announced a gradual reduction of the corporate tax rate to 18 percent by 2020 and the intent of the Northern Ireland Assembly to reduce the corporate tax rate in Northern Ireland to 12.5% by 2018 to match that of the Republic of Ireland. As well, internationally, there has been significant interest in patent box regimes.

2. Consider the introduction of a patent box model

Global competition to attract research and development (R&D) spending has increased significantly in recent years. Not only are countries adopting or expanding R&D tax incentives to promote such activities, but they are also providing new tax incentives to encourage the commercialization of that R&D. This is

[2] http://www2.deloitte.com/content/dam/Deloitte/ca/Documents/tax/ca-en-tax-deloitte-comments-on-anti-treaty-proposals.pdf

outlined in our recent report[3]. These incentives, often referred to as "patent boxes", allow corporate income related to the sale of patented products to be taxed at rates which are significantly lower than the rates applied to regular business income. This preferential treatment of intellectual property income is meant to provide firms with a stronger incentive to innovate and commercialize the innovations domestically.[4]

As identified in our productivity series[5], Canada's patent intensity has been poor when compared internationally, despite strong performance in academic research. To encourage companies to commercialize and retain patents in Canada, we recommend that the Government study whether a patent box regime should be implemented in Canada. The House of Commons Standing Committee on Finance, before which Deloitte appeared as a witness, made a similar recommendation in its 2014 pre-budget consultations report.[6] Our country may be at a competitive disadvantage without such a regime, as Canada's trading partners that are also members of the G20 (e.g., the United Kingdom, China and France[7]) are continuing to utilize and support these regimes. Furthermore, based on the October 5th 2015 OECD BEPS project report *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance – Action 5: 2015 Final Report*[8], it is clear that patent box regimes will continue to be acceptable tax incentive regimes, in a modified nexus version which requires in-country R&D. In fact, Ireland, Italy, Spain, Switzerland and the United Kingdom have recently announced new or revised intellectual property regimes and the U.S. House of Representatives released a new patent box proposal in the summer of 2015. Furthermore, the European Union is also adopting the modified nexus approach.

3. Spur a "start-up economy" with improved financing support

In the OECD's report *Supporting Investment in Knowledge Capital, Growth and Innovation*, private sector risk capital is recognized as playing a critical role in supporting business growth, innovation and new employment creation.[9] Also, as identified in our productivity series[10], one of the factors contributing to Canada's relatively low productivity is the lack of capital for start-up enterprises. From early seed financing through to initial public offerings, it is our observation that Canada's financing ecosystem does not provide enough support to home-grown enterprises with world-class potential. As a result, start-up firms may not be able to secure financing and may be leaving Canada for jurisdictions where risk capital is more readily available.

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[3] https://www2.deloitte.com/content/dam/Deloitte/at/Documents/Tax/at-tax-2015-global-survey-of-RD-taxincentives.pdf
[4] Atkinson, R.D. and S. M. Andes. "Patent Boxes: Innovation in Tax Policy and Tax Policy for Innovation." The Information Technology & Innovation Foundation Report. October 2011.
[5] http://www2.deloitte.com/ca/en/misc/litetopicpage.MF-CA-Tags.future-of-productivity.html
[6] House of Commons Standing Committee on Finance, "Towards Prosperity: Federal Budgetary Priorities for People, Businesses and Communities," December 2014, http://www.parl.gc.ca/content/hoc/Committee/412/FINA/Reports/RP6830258/finarp08/finarp08-e.pdf.
[7] Other countries with patent box regimes include Belgium, Hungary, Ireland, Liechtenstein, the Netherlands, Spain and Switzerland.
[8] OECD, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance – Action 5: 2015 Final Report* (Paris: OECD, October 2015), http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/countering-harmful-tax-practices-more-effectively-taking-into-account-transparency-and-substance-action-5-2015-final-report_9789264241190-en#page1.
[9] OECD, *Supporting Investment in Knowledge Capital, Growth and Innovation* (Paris: OECD, October 2013), http://www.keepeek.com/Digital-Asset-Management/oecd/industry-and-services/supporting-investment-in-knowledge-capital-growth-and-innovation_9789264193307-en#page1.
[10] http://www2.deloitte.com/ca/en/misc/litetopicpage.MF-CA-Tags.future-of-productivity.html

We believe that the first priority in enhancing Canada's financing regime should be to improve support for the early stages of innovation when risks are higher, as we have previously noted in our comments[11] on July 27, 2012 to the Department of Finance in response to the Government's request for feedback on the issue of support for venture capital. We strongly recommend the introduction of an angel tax credit. Targeted credits will serve to encourage investing in high-growth small businesses by mitigating the risks associated with these investments. An angel tax credit is the logical starting point for the creation of a sustainable venture capital industry financed by the private sector and it is the incentive that can have the greatest impact on growing our economy.

With regard to the Government's plan to consider the reintroduction of a tax credit for labour-sponsored venture capital funds, we suggest that the reasons for the elimination of the prior version of this program be carefully reviewed. As we understand it, the tax credit was eliminated in 2013 because it was found to not be adequately effective in stimulating the venture capital sector. We would suggest that a new program should only be introduced if it can be designed to overcome the deficiencies noted in the prior program.

4. **Encourage foreign investment through full refundability of SR&ED tax credits**

Innovation is one of the most important contributors to a nation's sustained economic growth and R&D is the lifeblood of innovation. Encouraging business expenditures on R&D through the implementation of programs that ensure globally competitive businesses is therefore essential.

This last decade has been a period of global economic turbulence. Governments are competing vigorously for international investment and are seeking opportunities to encourage domestic growth through industrial R&D. In *Deloitte 2015 Global Survey of R&D Incentives*[12], we review the various incentives offered around the world.

While innovation is one of the most important contributors to persistent and sustained economic growth and a key solution to Canada's lagging productivity, Canada's position as a leading global destination for innovative businesses is under threat. To enhance Canada's global attractiveness and encourage foreign investment, we believe that the scientific research and experimental development (SR&ED) investment tax credit (ITC) should be made refundable for all corporations carrying on business in Canada, rather than only for certain private companies. In our prior submissions[13] to the Department of Finance, we have recommended a broad based extension of ITC refundability to all businesses. While we continue to support that goal, in light of the important objective of achieving a balanced budget over time along with gradually reducing the level of debt to GDP, we recommend that the Government consider offering partial refundability to all businesses at this time.

Currently, only qualifying small Canadian-controlled private corporations may claim a refundable credit while all other companies only receive the benefit of the ITCs in years with corporate taxes payable. Long-term planning is made difficult for these organizations, as many operate in cyclical industries and cannot predict the years in which they will have sufficient corporate tax liability to make the SR&ED tax credits of any value. Expanding the refundable credit to all corporations would appropriately reward the

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11 http://www2.deloitte.com/content/dam/Deloitte/ca/Documents/tax/ca_en_tax_Deloitte_comments_Venture_capital_270712_AODA.PDF

12 https://www2.deloitte.com/content/dam/Deloitte/at/Documents/Tax/at-tax-2015-global-survey-of-RD-taxincentives.pdf

13 http://www2.deloitte.com/ca/en/pages/tax/articles/budget-2015-tax-policy-issues-for-consideration.html

risks inherent in performing R&D in Canada, communicating a strong message of encouragement to foreign companies seeking new investment opportunities.

An additional issue to consider arises in the case of Canadian companies that are subsidiaries of U.S. parent companies and perform R&D in Canada. Such structures benefit only from a timing difference and do not realize a permanent savings from SR&ED ITCs. Although a Canadian subsidiary would benefit from a reduction in their Canadian tax payable, ultimately a parent company's U.S. tax increases when funds are repatriated from Canada to the United States due to the U.S. foreign tax credit rules. If the ITCs were refundable, from a U.S. tax perspective, they would not reduce Canadian tax otherwise payable but rather would reduce the R&D expenditure.[14] Thus, for many of these U.S.-based multinationals, refundability means the difference between the incentive being a permanent tax savings and a tax deferral which can be a powerful distinction in perceived value.

Therefore, we recommend that the Government implement a model of refundability for corporations currently not eligible for refundable ITCs that allows these corporations to earn at least partial refundability of ITCs if they meet certain requirements. For example, a corporation could receive partial refundability of SR&ED ITCs if it can demonstrate an increase in its labour force over a prior period. This approach would support the creation of employment in an important sector of the Canadian economy, and would align with the Government's goal of increasing the number and types of jobs for Canadians.

We also recommend that the Government reconsider the treatment of capital expenditures under the SR&ED regime. Excluding capital expenditures from the SR&ED regime does not recognize that capital investments are needed to perform R&D and that certain industries are put at a distinct disadvantage as a result. For example, computers and related equipment are often required in order to undertake R&D. Rather than completely exclude all capital costs, we recommend that the Government consider allowing at least an accelerated amortization of capital expenditures used in R&D, similar to the treatment of capital expenditures in other countries such as France.

Enhancing the Government's support for innovation through the SR&ED incentive program is a critical step that will allow Canada to be a leader in innovation, both in the knowledge economy and in new technologies designed to exploit energy and resources.

5. Attract and retain the world's most talented people

A key focus must be attracting and retaining the individuals most likely to drive innovation in the economy and improve Canada's productivity. Accordingly, we encourage the Government to focus on monitoring the competitiveness of the personal tax regime, improving immigration policies, encouraging retirement savings, considering consultations regarding proposals to amend taxation of employee stock options, and updating salary deferral arrangement legislation.

Monitor competitiveness of top personal tax rate and threshold

We recognize that the increase in the top personal income tax rate was part of the Government's election platform, and is a current priority. We encourage the Government to monitor the impact of that increase in order to assess whether it is achieving the anticipated results.

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[14] Even delayed refundability (e.g., refunding ITCs if not used within three years) would achieve the U.S. tax benefit with a modest cost to the Government.

We believe that Canada's personal tax rates should be competitive with those of our trading partners (in particular, the United States). Our top rate is now significantly higher than that of most of our global trading partners and the threshold for reaching that top rate is much lower than that of many of our trading partners. This may discourage immigration to Canada and make it much more expensive for Canadian business to recruit top talent as tax is one of the factors that will have to be taken into account in establishing competitive remuneration. This could also impede transfers to Canada within multinational organizations by making Canada a less attractive destination for business due to the cost of having to gross-up employee compensation to take into account the higher income tax cost in Canada.

A second concern, to be monitored, is whether or not the increase in rates will actually result in the anticipated increase in revenue for the Government. Recent studies[15] have shown that higher tax rates can motivate individuals to increase their focus on tax planning strategies and may cause a reduction in hours worked, both of which impact government revenue. This issue seems to also be a concern for certain provinces such as New Brunswick which has announced a review of its personal tax rates to determine whether a reduction to the top personal income tax rate is required as a result of the increase in the federal rate. As an alternative to personal income tax rate increases, we believe that there is room to increase consumption taxes, which are low by global standards. An increase in consumption taxes, with appropriate credits for low income families, may provide a less costly and more reliable source of revenue.

Increase targeted immigration – meeting Canada's future needs

While we fully understand and support the Government's current focus on the humanitarian crisis, additional long term immigration concerns should also be addressed. With Canada's aging population and skills shortage, our country's human capital needs should be articulated in a reasoned and practical multi-year plan aimed at increasing immigration to fill gaps in the Canadian workforce and to support a sound knowledge base. We applaud the Government for already announcing steps to transform Canada's immigration system to ensure that more individuals with necessary skills will have ready access to the appropriate sectors of the Canadian economy. We encourage the Government to continue improving the immigration process by increasing overall targets and sharpening existing programs. It is vitally important that skill shortages will be able to be addressed in an expedient fashion in order to maintain a competitive position in the global marketplace.

Currently, Canada grants the right for an individual who is here on a study permit to receive a work permit for up to three years post-graduation. Although in the past these highly-skilled educated individuals had a direct path to permanent residence, under the express entry regime, they now cannot obtain permanent residence in most cases without a Labour Market Impact Assessment (LMIA) which are difficult to obtain. Therefore, there is the real danger of losing an entire generation of qualified, needed applicants.

In addition, the LMIA process has become so lengthy and difficult that employers are not participating in the process or when they do, they are receiving refusals. As a result, Canada is losing skilled individuals who could assist in our country's growth and success. Furthermore, employers are "offshoring" in order to avoid this process, which is undesirable.

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[15] See Milligan, Kevin and Michael Smart, "Provincial Taxation of High Incomes: The Effects on Progressivity and Tax Revenue" in *Income Inequality: The Canadian Story* edited by David A. Green, W. Craig Riddell and France St. Hilaire, 2015. and Laurin, Alexandre, "Shifting the Federal Tax Burden on the One-Percenters: A Losing Proposition," C.D. Howe E-brief, December 3, 2015.

Increased immigration to Canada by individuals who are educated, productive and innovative will not only improve the ability of Canadian enterprises to compete globally, but will also enhance government revenues from corporate and personal taxation. A larger population of well paid, skilled individuals will contribute significantly to an increase in the overall amount of personal taxes collected.

Encourage retirement savings – planning for tomorrow

Canadians still do not save enough for retirement, with more than $800 billion in registered retirement savings plan (RRSP) contribution room remaining unused.[16] Although the Government has recognized the importance of encouraging retirement savings, new approaches are needed, as noted by Deloitte and others before the Standing Senate Committee on Banking Trade and Commerce. A specific proposal put forward by Deloitte to the Committee is a flow-through of the tax benefit of certain forms of income (e.g., dividends paid by Canadian corporations and also the capital gains preference) when withdrawn from Canadian retirement vehicles. We strongly encourage the Government to introduce creative and appropriate incentives to increase savings such as the recommendations outlined in The Final Report of the Standing Senate Committee on Banking, Trade and Commerce, *Canadians Saving for their Future: A Secure Retirement*.[17]

Enhancing Canada's incentives for retirement savings will further improve the attractiveness of Canada to new immigrants. Thus, we recommend that new immigrants be allowed to contribute to their RRSPs in the year that they arrive in Canada. Currently, since earned income is measured on a one year lag basis, new immigrants can only contribute to their RRSPs in the year following their arrival into Canada. Allowing a carryback of contributions made in the first four months of the following year for new residents with deemed contribution room based on their first year eligible income would allow an efficient mechanism to encourage such activity.

Furthermore, we recommend moving out the age that triggers mandatory minimum withdrawals from registered retirement income funds (RRIF). As discussed in the C.D. Howe report *Outliving Our Savings: Registered Retirement Income Funds Rules Need a Big Update*,[18] life expectancy rates for Canadians have increased but the rules for the age at which mandatory withdrawals are required have not. With people expecting to live longer after retirement and lower returns on investments, RRIF holders are in danger of inadequate tax-deferred savings in their later years. Although the 2015 budget has reduced the required minimum withdrawals requirements starting in 2015, we believe that adjusting the age at which withdrawals are required would help further help solve this problem.

We would recommend that the Government monitor the impact of its decision to reduce the tax-free savings account (TFSA) annual contribution to $5,500, on overall retirement savings to ensure that the desired overall impact is in fact being achieved.

We support the Government's concern for adequate retirement savings, and the focus on cooperation with the provinces to streamline any process that is ultimately undertaken. Given the current fragility of the economy, we would recommend that any enhancements to the Canada Pension Plan be postponed and

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[16] Statistics Canada. CANSIM table 111-0040.
[17] Some of the recommendations from this report include: encouraging multi-employer pension plans, ensuring withdrawals from RRSPs, while taxable, have no impact on eligibility for the amount of federal income-tested benefits or tax credits, allowing contributions to RRSPs to be made until the age of 75, and educating all Canadians on the importance of saving for retirement. http://www.parl.gc.ca/Content/SEN/Committee/403/bank/rep/rep04oct10-e.pdf.
[18] Robson, W.B.P, and A. Laurin, *Outlining Our Savings: Registered Retirement Income Funds Rules Need a Big Update*, C.D. Howe Institute E-brief (Toronto: C.D. Howe Institute, June 4, 2014), http://www.cdhowe.org/pdf/e-brief_175.pdf.

revisited in 2017. At that time, the enhancements through mandatory increased contributions by employees and employers should be made gradually.

Consider consultation regarding proposals to amend taxation of employee stock options

We commend the Government for its decision to provide grandfathering provisions in the proposed stock option amendments. This certainty is greatly appreciated and will ensure that investment decisions will be made without undue emphasis on tax consequences at the possible expense of business stability. However, as discussed in our recent submission[19], some outstanding issues merit consideration, such as corporate deductibility. As you move forward in developing legislation, we would strongly recommend that you consider consulting with stakeholders during this process.

Consider updating salary deferral arrangement legislation

International norms should be considered in assessing whether Canada's salary deferral arrangement limit of three years is adequate. A number of jurisdictions have extended the delay of taxation of deferred compensation to four or five years, to match corporate governance trends which are providing for longer deferrals in order to encourage longer term behavior among executives. Adjusting the salary deferral arrangement limit would help to maintain Canada's competitiveness in attracting top international talent.

6. Enhance certainty through efficient tax administration

Tax administration plays a key role in advancing competitive tax policy.

Sound tax policy requires efficient tax administration. Moreover, certainty in tax law is key to attracting and retaining corporate investment and global talent. The tax community as a whole - revenue authorities, taxpayers and tax advisors - all benefit from a clear understanding of the law at any point in time. In this context, we respectfully offer the following recommendations:

- Administrative red tape and filing complexities should be reduced to create a more competitive business environment. We commend the Government for providing relief from payroll withholding tax obligations for business travellers in the 2015 federal budget.

- Increased resources for the Canada Revenue Agency (CRA) together with streamlined processes to enhance the timely completion of audit activity would reduce frustrations associated with carrying on business in Canada. Resolving stale issues is very resource-intensive given normal labour turnover and the erosion by time of memories, whether personal or corporate. In addition, with the likely introduction of new rules and increased transparency globally as a result of the BEPS project, the volume of tax disputes is likely to increase globally. As such, increased investment in areas that help resolve disputes (e.g., competent authority, advance pricing agreements, mutual agreement procedures, rulings, appeals, voluntary disclosures, etc.) will be required. Increased use of technology, in particular data analytics, can also assist in making audits more efficient. Increased training and ensuring that assessments continue to be principled and based on enacted law would also be welcome.

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[19] http://www2.deloitte.com/content/dam/Deloitte/ca/Documents/tax/ca-en-deloitte-comments-employee-stock-options-AODA.PDF

- We congratulate the CRA for its Framework Agreement with CPA Canada which was announced in December 2014. It creates a cooperative and useful forum to address issues. While this is a step in the right direction, we believe that more can be done to improve the relationship between the CRA, the business community and the broader tax community. We would welcome forums that allow for greater communication between the CRA, the Department of Finance, taxpayers and tax practitioners. Improving communication would enhance certainty and allow for increased efficiency in both compliance with and administration of the tax laws.

Deloitte is committed to playing a key role in shaping Canada's future. We trust that our policy recommendations will be helpful as you move forward with Budget 2016. We would be happy to meet with you personally or with anyone you suggest from the Ministry of Finance to discuss any of these matters further.

Yours truly,

Deloitte LLP

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