Recommended tax measures to enhance economic prosperity for Canadians

Deloitte's pre-budget 2016 submission to the House of Commons Standing Committee on Finance

July 2015

Executive summary

As Canada's largest tax practice and as a global tax practice that advises governments and private sector clients in more than 150 countries, Deloitte has a unique perspective on competitive tax policy around the world and on the key drivers of national economic prosperity that include productivity, competitiveness and innovation. With this global perspective and our commitment to support a strong and growing Canadian economy, we are pleased to provide our recommendations for consideration by the House of Commons Standing Committee on Finance (the Committee) during the upcoming pre-Budget 2016 consultations.

Although Canadians have long enjoyed a high standard of living relative to most countries, we are currently facing challenges in growing our economy. 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, chronic underinvestment in machinery and equipment, lack of risk capital for start-ups, a sheltered economy, 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.

Canada requires capital that must be sourced from outside of our borders; fiscal policy must 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, it is our view that the following initiatives should be among the Government's key priorities in the upcoming budget in order to improve Canada's global competitiveness and achieve sustainable economic growth in Canada:

- **Encourage innovation investment in Canada to improve productivity**
  The scientific research and experimental development (SR&ED) tax regime could be improved by adding partial refundability of the investment tax credit (ITC) for businesses and providing full refundability to small public corporations. Furthermore, the Government should consider the introduction of a patent box regime to encourage corporations to commercialize and retain patents in Canada.

- **Adjust Canada's personal income tax thresholds to attract global talent**
  Personal income tax thresholds should be adjusted to retain productive individuals in Canada and to attract immigrants with the requisite skills to support Canada's long term economic prosperity.

- **Protect Canada's competiveness regarding inbound investment**
  The scope of the proposed anti-treaty shopping proposals should be narrowed.

We welcome the opportunity to discuss our recommendations with the Committee and to lend our support and expertise as needed.

---

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

Deloitte's recommendations

Budget 2016 will provide the Government of Canada with an opportunity to continue its commitment to improving economic prosperity for Canadians. We believe that sustained economic growth in Canada will be impeded without improvement to our nation's lagging productivity, as discussed in our report series *The Future of Productivity*[2].

Our recommendations have been developed in accordance with the key themes proposed by the Committee and focus on the personal and business taxation recommendations that would result in desired incentives for work, saving, spending, investment, job creation and other positive outcomes. We share the Committee's view that these are important areas of concern and opportunity and our tax policy recommendations for Budget 2016 reflect the Committee's goals of competitiveness of Canadian businesses and job creation while balancing the budget. We strongly support the Government's focus on maintaining a balanced budget. Our recommendations should be considered in this light and can be phased in over time if necessary.

Encourage innovation investment in Canada to improve productivity

Improve incentives for R&D

It is our view that Canada's position as a leading global destination for innovative businesses is under threat. While innovation is one of the most important contributors to sustained economic growth and a key solution to Canada's lagging productivity, we believe that our research and development (R&D) regime is not doing enough to foster investment in this area. To enhance Canada's global attractiveness and encourage foreign investment, we believe that the R&D regime should be improved by extending refundability of investment tax credits (ITCs) to corporations beyond the limited category of private companies currently eligible for refundability. In our prior submissions[3] to this Committee and 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 maintaining a balanced budget, 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 ITCs in years with corporate taxes payable. Long-term planning is difficult for these other organizations as many operate in cyclical industries and cannot predict the years in which they will have sufficient corporate tax liability to benefit from the SR&ED tax credits. 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. Since refundability will allow the corporation to record the ITCs "above the line", refundable SR&ED ITCs would increase the value of the credits to the corporation.

In addition, we recommend that the Government extend full refundability of SR&ED ITCs to small public corporations. Even though a corporation may be public, it may remain small and still have difficulty accessing financing. Accordingly, we would recommend the determination of eligibility based on size

---

[2] http://www2.deloitte.com/ca/en/misc/litetopicpage.MF-CA-Tags.future-of-productivity.html
[3] See, for example, our 2015 submission: http://www2.deloitte.com/content/dam/Deloitte/ca/Documents/tax/ca-en-tax-deloitte-pre-budget-2015-submission.pdf

rather than status. A model for determining eligibility by reference to size already exists in that qualifying private companies are entitled to refundability based in part on taxable capital.

We believe that expanding the refundable credit to all corporations would appropriately reward the risks inherent in performing R&D in Canada, and would send a strong message to foreign companies seeking new investment opportunities.

Consider a patent box regime

Countries are not only adopting or expanding tax incentives to attract R&D spending but they are also providing new tax incentives to encourage the commercialization of that R&D, as outlined in our recent *Global Survey of R&D Tax Incentives.*[4] 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 ordinary 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.

As identified in our 2011 productivity report[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 Committee 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 September 2014 Organisation for Economic Co-operation and Development (OECD) report *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance*[8] , it appears that patent box regimes will survive the OECD's base erosion and profit shifting (BEPS) initiative, in a modified nexus version which requires in-country R&D. In fact, Ireland, Italy and Switzerland have recently announced new or improved intellectual property regimes and the U.S. Senate Working Group has endorsed a patent box regime in the United States. Furthermore, in November 2014, Germany and the United Kingdom reached agreement to move existing innovation box regimes to a modified nexus approach which was subsequently adopted by the G20, OECD and European Union.

Adjust Canada's personal income tax thresholds to attract global talent

A key focus must be attracting and retaining the individuals most likely to drive innovation in the economy and improve Canada's productivity and competitiveness. Attracting and retaining globally mobile and highly productive individuals depends on many factors — not only economic drivers. Canada is a wonderful place to live and a stable environment in which to raise a family. These factors are already

---

4 https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-global-rd-survey-aug-2014.pdf

5 http://www2.deloitte.com/content/dam/Deloitte/ca/Documents/insights-and-issues/ca_en_insights_issues_future-of-productivity_2011_AODA.pdf

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, Luxembourg, the Netherlands, Spain and Switzerland.

8 OECD, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance* (Paris: OECD, September 2014), http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/countering-harmful-tax-practices-more-effectively-taking-into-account-transparency-and-substance_9789264218970-en#page1.

a powerful source of attraction to Canada. We believe, however, that more educated, risk-taking and entrepreneurial individuals would stay in Canada or move to Canada if the Government were to increase the threshold at which the top rate of tax begins.[9]

Changes to the personal tax thresholds can be scheduled over the next five to ten years. However, a signal of this intention now would be attractive to Canadian residents and potential immigrants. To the extent that the adjustment to the top threshold resulted in an overall reduction in personal income tax collected, we believe that the shortfall could be recouped with consumption taxes, which are low by global standards.

Protecting Canada's competiveness 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 2014 budget will, if enacted in their current form, 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 and may discourage inbound investment 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[10] for a more in-depth discussion of our concerns with the anti-treaty shopping proposals.

In the context of inbound investment as well as in considering the broader BEPS initiative, we encourage the Government to engage in consultations prior to drafting new legislation related to BEPS and to carefully consider the impact the changes may have on the broader economy, on the competitiveness of Canadian multinational enterprises and on Canada's attractiveness for investment. In addition, we recommend that the Government bear in mind that unilateral actions which could adversely impact competitiveness should not be undertaken unless Canada's trading partners are in fact implementing corresponding changes at the same time. It will also be necessary to monitor the competitiveness of Canada's corporate tax rates because countries will continue to compete in this area after BEPS recommendations have been put in place, as suggested by the international interest in patent boxes and the recent reduction of the United Kingdom's corporate tax rate to 18 percent.

* * * * *

[9] Robert P. Murphy, Jason Clemens and Niels Veldhuis, *The Economic Costs of Increased Marginal Tax Rates in Canada*, Studies in Budget and Tax Policy at the Fraser Institute (Vancouver: Fraser Institute, October 2013). This study compares the competitiveness of Canada's top personal tax rate with that of the United States. Although Canada's top federal rate is lower than the U.S. federal rate, when the combined federal/provincial personal tax rate and the threshold at which the top tax rate applies are considered, the study concludes that Canada is not competitive.

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

Deloitte is committed to playing a role in shaping Canada's future. We trust that our policy recommendations will provide helpful guidance as you move forward with Budget 2016. We look forward to appearing before the Committee during pre-budget hearings in the fall of 2015.

Albert Baker, FCPA, FCA
Tax Policy Leader
Deloitte LLP
(416) 643-8753