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Recommended tax measures to enhance economic prosperity for Canadians

Deloitte's pre-budget 2017 submission to the House of Commons Standing Committee on Finance

August 2016

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 2017 consultations.

Although Canadians 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, 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 risk discouraging foreign investment by creating uncertainty as to the interpretation and scope of these changes.

Accordingly, it is our view that the following initiatives should be among the Government's key priorities in the upcoming budget to assist Canadian businesses:

- **Protect Canada's competiveness in respect of corporate income tax**
  Canada needs a favourable corporate tax regime in order to continue to attract and retain inbound investment and ensure the competiveness of our Canadian headquartered companies relative to their foreign peers. Having competitive corporate tax rates is a key feature of such a regime.

- **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. Furthermore, the Government should consider the introduction of a patent box regime to encourage corporations to commercialize intellectual property developed in Canada.

- **Monitor Canada's personal income tax rates and thresholds to attract global talent**
  Canada's personal income tax rates should be competitive vis a vis those of our trading partners.

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

Deloitte's recommendations

Budget 2017 will provide the Government of Canada with an opportunity to improve economic prosperity for Canadians. Accordingly, our recommendations for Budget 2017 are outlined below.

Protect Canada's competiveness in respect of corporate income tax

Canada is a relatively small, open economy and has capital needs well beyond that which its residents can provide. However, foreign investors have a broad range of opportunities as to where to invest their capital. As a result, Canada's competiveness in attracting inbound investment must be protected.

We commend the Government for pursuing the OECD/G20 Base Erosion and Profit Shifting (BEPS) project's multilateral treaty negotiations rather than implementing the domestic law anti-treaty shopping proposals that were contained in the previous Government's 2014 budget, which would have unilaterally overridden Canada's tax treaties and adversely impacted Canada's competiveness.

More broadly, regarding the BEPS project recommendations, Canada has, to date, announced adoption of some but not all of the recommendations. It is our submission that Canada should continue to take a measured approach, and as part of assessing the impact of adoption of any additional measures, should consider the effect on competiveness (both in terms of attracting investment and jobs and the potential for success of Canadian headquartered companies relative to foreign peers).

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 announced a gradual reduction in the corporate tax rate to 17 percent by 2020 and the intent of the Northern Ireland Assembly to reduce the corporate rate in Northern Ireland to 12.5 percent by 2018 to match that of the Republic of Ireland. More recently, the possibility of reducing the UK corporate rate to 15% has been raised by government officials, as a consequence of "Brexit".

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. While other countries are introducing or enhancing R&D tax regimes,[2] Canada has recently weakened the benefits of its SR&ED tax regime. As a result, Canada's SR&ED regime is falling behind in its support of R&D through the tax system in comparison to other countries.

To enhance Canada's global attractiveness and encourage foreign investment, we believe that the SR&ED regime should be improved by extending refundability of the SR&ED ITCs to corporations beyond the

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[2] Countries that have recently introduced or enhanced regimes include Austria, France, Ireland, Italy, Japan, Latvia, Russia, Singapore, Slovakia, South Africa, Spain and the United Kingdom. See Deloitte LLP, 2015 Global Survey of R&D Tax Incentives.

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 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.

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 made 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 make the SR&ED tax credits any value. 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.

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, in line with economic strategies. 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 type 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 providing for some recognition of the significant capital elements of R&D by, for example, allowing accelerated amortization of capital expenditures used in R&D or reflecting the investment in the proxy amount. Special treatment of R&D of capital expenditures would be in line with other countries such as Australia, France and the United Kingdom.

Consider a patent box regime

Global competition to attract 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. as outlined in our *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 developed domestically.

This increasingly popular tax policy instrument has been the subject of some interest and discussion in Canada. In fact, at the provincial level, British Columbia has had a reduced rate for certain international patent income since 2006 and Quebec has just recently announced proposals to introduce a type of patent

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[3] See, for example, our 2016 submission - http://www.parl.gc.ca/Content/HOC/Committee/421/FINA/Brief/BR8126217/br-external/Deloitte-e.pdf.

[4] http://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-2015-global-survey-of-rd-tax-incentives-102015.pdf

box regime in its 2016 budget.[5] To encourage companies to commercialize and retain patents in Canada, we recommend that the Government study whether a patent box regime should be implemented at the federal level. 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 October 5, 2015 OECD BEPS 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, India, Ireland, Italy, Liechtenstein, the Netherlands, Portugal, Spain, Switzerland, and the United Kingdom have announced new or revised intellectual property regimes and the U.S. House of Representatives released a patent box proposal in the summer of 2015. Furthermore, the European Union is also adopting the modified nexus approach.

Monitor Canada's personal income tax rates and thresholds to attract global talent

A key goal must be attracting and retaining the individuals most likely to drive innovation in the economy and improve Canada's productivity and competitiveness. Accordingly, we encourage the Government to focus on the competitiveness of the personal tax regime.[9]

We believe that Canada's personal tax rates should be similar or lower than 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 recently introduced higher personal tax rates will actually result in the anticipated increase in revenue for the Government. Recent studies[10] 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. As an alternative to personal income tax rate increases, we believe that there is room to increase consumption taxes, which are

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[5] For further details on these two provincial regimes, please see our recent *R&D Tax Update* newsletter - http://www2.deloitte.com/content/dam/Deloitte/ca/Documents/tax/ca-en-RD-16-1-patent-box-AODA.PDF

[6] House of Commons Standing Committee on Finance, *Towards Prosperity: Federal Budgetary Priorities for People, Businesses and Communities*, December 2014.

[7] Other countries with patent box regimes include Belgium, Hungary, Ireland, Liechtenstein, the Netherlands, Portugal, 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).

[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] 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.

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.

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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 2017.

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