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The Honourable William F. Morneau
Minister of Finance
Department of Finance Canada
90 Elgin Street
Ottawa, Ontario
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Dear Minister Morneau,

Budget 2020 – tax policy issues for consideration

We believe that Budget 2020 will provide the Government with an opportunity to drive business performance and improve economic prosperity for all Canadians. As discussed in Deloitte's most recent quarterly Economic outlook,[1] Canada's economy has experienced growth in 2019, but continued growth may be challenging going forward amid global economic uncertainty.

To achieve a better outcome, Canada must boost the economy's potential to sustain stronger growth over the long-run. As Deloitte has highlighted in its past research, this is ultimately about improving our competitiveness, productivity and innovation.

In addition to the risk of a weakening economy, businesses today are facing a frenetic pace of technological change which is also changing the economic landscape. To be successful in this turbulent environment, is it crucial to ensure that Canada's economy is built on strong fundamentals and is productive and adaptable.

The Government already has a number of important initiatives underway to protect Canada's economy from emerging challenges. The Government should continue—and in fact accelerate and expand—its efforts to diversify trading relationships, reduce barriers to foreign investment and invest in infrastructure by complementing public funds with private capital. These efforts are essential and should remain areas of focus for Canada.

In March 2019, together with the Business Council of Canada, Deloitte Canada released its first-ever competitiveness scorecard[2] measuring eight critical dimensions of Canada's economic performance on the global stage. The report highlights a number of areas of strength in Canada. However, it concludes that taxes and regulation are two areas that stifle growth in Canada and that Canada is not strong regarding innovation.

More must be done to improve business competitiveness and productivity in Canada. 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 still supporting the objectives of

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[1] https://www2.deloitte.com/ca/en/pages/finance/articles/economic-outlook.html
[2] https://www2.deloitte.com/ca/en/pages/finance/articles/canada-competitiveness-scorecard.html

a balanced budget over time and a gradual reduction in 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.

Accordingly, to ensure that Canadian businesses can compete around the world, our tax policy recommendations for Budget 2020 are summarized in ten broad categories:

1. Conduct a comprehensive review of Canada's tax regime
2. Protect Canada's competitiveness in respect of corporate income tax
3. Attract and retain the world's most talented people
4. Consider the introduction of a patent box model
5. Spur a "start-up and growth economy" with improved financing support
6. Incent research and development (R&D) through refundability of scientific research and experimental development (SR&ED) tax credits
7. Refine the recent private corporation legislation
8. Provide clear, prospective application of revised Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines
9. Resolve the unintended and undesirable consequences of transfer pricing proposal from 2019 budget
10. Enhance certainty and efficiency of tax administration

Deloitte's budget 2020 tax policy recommendations

1. Conduct a comprehensive review of Canada's tax regime

The last comprehensive review of Canada's tax regime was conducted by the Royal Commission on Taxation under Kenneth Carter, which issued its report in 1966. To state the obvious, the world has changed dramatically since that time. Our tax regime must be competitive in order to attract and retain talent, investment and jobs. A comprehensive review of the tax regime will provide an opportunity to review the mix of taxes that are levied, the tax base and the rates. It will also provide an opportunity to assess incentive regimes with a view towards encouraging investments that will increase productivity and growth, and to reassess the competiveness landscape and where possible simplify our tax regime. There is broad consensus that a tax review must be a priority for the Government. National organizations – such as the Business Council of Canada, the Canadian Chamber of Commerce, the Canadian Manufacturers and Exporters, the Chartered Professional Accountants of Canada and the Coalition for Small Business Tax Fairness (representing over 70 organizations) – have all recommended a comprehensive tax reform.

There are several tax proposals on the horizon that we believe should be folded into such a comprehensive review. This includes the stock option proposals announced in Budget 2019 and reconfirmed in the Prime Minister's mandate letter of December 13, 2019. (We address the stock option proposals in our submission of September 16, 2019.[3]) We appreciate the fact that the Government has delayed implementation of the stock option proposals, pending finalization of the rules. Likewise, the Liberal party platform included proposals to implement restrictions on the

[3] https://www2.deloitte.com/content/dam/Deloitte/ca/Documents/tax/ca_en_deloitte_submission_stock_option_consultation_2019_AODA.pdf

deductibility of interest expense by corporations along the lines of the recommendations in Actions 2 and 4 of the OECD's base erosion and profit shifting (BEPS) project. These measures seem to be alluded to in the above referenced mandate letter. In our view, these base broadening measures should not be introduced in isolation. Rather they should be part of a broader review of the tax regime. Could such measures help finance a reduction in the corporate tax rate? Could these measures result in a streamlining of other anti-avoidance measures in this area, such as the overly complex foreign affiliate dumping rules that were introduced several years ago and the existing thin capitalization rules? A comprehensive review would provide an opportunity to optimize the overall result rather than simply adding additional anti-avoidance measures on top of the existing patchwork of anti-avoidance measures. Should these measures proceed without the benefit of a comprehensive review, we would ask that ample opportunity be provided for businesses to offer input via a consultation.

At present, the OECD is working on a significant project which, if successful, will impact how corporations are taxed around the world. Canada is a member of the steering group that is leading this project on behalf of the G20 and the 136 countries in the Inclusive Framework. Pillar One of this project is proposing new rules regarding the allocation of income between countries and new rules regarding nexus, while Pillar Two of the project is considering a global minimum tax. Given the significance of these changes to existing rules which have been in place for decades, we think that it would be an opportune time for Canada to conduct a review of its taxing regime, taking into account these new developments. One of the objectives of this project is for countries in the Inclusive Framework to reach a consensus and thereby adopt a common approach thus avoiding the proliferation of unilateral action such as the Digital Services Tax (DST) that some countries have either implemented or proposed. In the recent federal election campaign, most of the party platforms proposed such a tax. Unilateral measures like the DST, which vary by country, result in increased complexity, double-tax (as they are generally not eligible for foreign tax credit relief) and therefore may impede trade and growth. As such, it would be preferable for Canada to avoid taking unilateral action in this area. Again, if Canada moves forward with the DST, input should be sought from the business community through a consultation.

2. 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. In a highly globalized world, companies are mobile and looking for the best places to do business. Foreign investors have a broad range of opportunities as to where to invest their capital. As a result, Canada's competiveness in retaining investments in Canada and attracting inbound investment must be protected.

Corporate tax rates

Significantly, the United States has moved from a 35 percent federal corporate tax rate to a 21 percent federal corporate tax rate under the recent US Tax Reform. The average US combined federal/state rate has dropped from 38.91 percent (2017) to 25.89 percent (2019) in comparison to the Canadian combined federal/provincial rates of 26.7 percent (2017) and 26.8 percent (2019).[4] This has contributed to a decrease in the US marginal effective tax rate (METR) from 34.6 percent in 2017 to 21.8 percent.[5] In a world where businesses are increasingly mobile, tax rates are a significant consideration and this 14-point swing is a competitive challenge for Canada. Even beyond the United States, the average tax rate in OECD countries for 2019 is 23.5 percent and countries continue to

[4] OECD, Table II.1. Statutory corporate income tax rate, 2017 and 2019.
[5] See Philip Bazel, Jack Mintz and Austin Thompson, "2017 Competitiveness Report: The Calm Before the Storm", The School of Public Policy Publications, University of Calgary, Volume 11:7, February 2018 and P. Bazel and J. Mintz, "Canadian Policy Makers Respond to U.S. Tax Overhaul," Tax Policy Trends, School of Public Policy Publication, University of Calgary, February 2019, https://www.policyschool.ca/wp-content/uploads/2019/02/TPT-Feb_Response-to-US-Tax-Overhaul_Final.pdf.

announce planned reductions. For example, the Netherlands has recently announced a planned reduction to 21.7 percent in 2021.

While tax rates are only one dimension of business competitiveness, they are an important one for Canada. Many international companies locate in Canada not only to serve the domestic market but also to access the much larger US market. In these instances, companies can take on currency risks and logistical costs when serving US customers. Faced with less favourable tax rates, cost-sensitive companies based in Canada may rethink local expansion plans and may seek to relocate to the United States (all else being equal). In addition, uncompetitive tax rates could discourage foreign direct investment. Reducing Canada's attractiveness to foreign investment could have lasting consequences to the Canadian economy as foreign companies in Canada drive significant net benefits to the Canadian economy, including knowledge transfers, new management, better wages and productivity.[6] Ensuring tax competitiveness can be an impactful means to secure Canada's overall attractiveness for investment and talent and diversification of the economy. While restoring our earlier tax rate advantage may be too costly to consider, we would recommend some rate reduction in coordination with the provinces to maintain some level of competitive advantage. The rate reduction in Alberta is a step in the right direction.

Accelerated tax depreciation

The accelerated tax depreciation measures announced in the November 21, 2018 Fall Economic Statement were welcome. These measures assist in narrowing Canada's competiveness gap and incent new investment by reducing Canada's METR on new investments in capital assets. A number of countries in the world are introducing such measures which were also introduced in the United States as part of US Tax Reform. These measures will benefit certain sectors more than others and, as such, will not provide as broad a benefit as a tax rate reduction. Also, in a relatively low interest rate environment, the present value benefit of the timing difference is inherently less. Nevertheless, we applaud the measures in this area.

BEPS-related measures

We commend the Government for pursuing the OECD/G20 BEPS project's multilateral treaty negotiations rather than implementing the domestic anti-treaty shopping proposals that were contained in the 2014 budget, which would have unilaterally overridden Canada's tax treaties and adversely impacted Canada's competiveness. The OECD/G20 BEPS Multilateral Instrument (MLI) was released on November 24, 2016 , signed by Canada on June 7, 2017, deposited with the OECD on August 29, 2019 and entered into force on December 1, 2019. With respect to Article 7, *Prevention of Treaty Abuse*, which addresses treaty shopping, Canada has at present adopted the principal purpose test (PPT). This provision, while adopted by many countries, will create a lot of uncertainty for business. We applaud the formation of the Treaty Abuse Prevention committee by the Canada Revenue Agency (CRA), as it will ensure consistent interpretation by the CRA. As the withholding tax provisions of the MLI take effect on January 1, 2020, we would strongly encourage the Government to issue detailed guidance regarding its interpretation of the PPT. Uncertainty in this area may impact inbound investment in Canada. In addition, at present Canada has reserved on Article 7(4). This article provides the competent authorities of governments increased flexibility in applying the PPT. In certain circumstances, this might result in a reduced treaty benefit rather than a complete denial of benefits, if that flexibility is available. As a result, we would encourage the Government to adopt Article 7(4).

Canada has, to date, announced adoption of some but not all of the BEPS recommendations. We recommend a measured approach in considering additional measures, taking into account the effect of such measures on competiveness (both in terms of attracting investment and jobs and the potential for success of Canadian-headquartered companies relative to foreign peers). As discussed above, this

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[6] Matt Krzepkowski and Jack Mintz, "Canada's Foreign Direct Investment Challenge: Reducing Barriers and Ensuring a Level Playing Field in Face of Sovereign Wealth Funds and State-Owned Enterprises", The School of Public Policy, SPP Research Papers, University of Calgary, Volume 3, Issue 4, October 2010.

should be done as part of a comprehensive review of Canada's taxing regime and with the benefit of consultation with stakeholders.

3. 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 and encouraging retirement savings.

Competitiveness of top personal tax rate and threshold

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 at 54 percent is now significantly higher than that of the OECD average of 42.5 percent and G7 average of 49.7 percent.[7] Furthermore, the threshold for reaching that top rate is much lower than that of many of those countries, further eroding our tax competitiveness.[8] In comparison to the United States, under US Tax Reform, among other changes, the top federal personal income tax rate is reduced from 39.6 percent to 37 percent thus reducing the average top rate to 46.3%.[9] The income threshold at which this rate applies was increased to US$500,000 (US$600,000 in the case of married couples filing jointly). In addition, the current preferential rates on both capital gains and qualified dividends remain unchanged. As a result, Canada's competiveness with the United States in this area, has been diminished. This may discourage immigration to Canada and make it much more expensive for Canadian businesses to recruit top talent, as tax is one of the factors that will 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 reflect 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[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.

To improve Canada's competiveness in this area, we recommend coordinating with the provinces to reduce the top rate to 50 percent and/or consider increasing the threshold at which the top rate is reached. As well, to encourage continued immigration into Canada, the Government may want to consider the possibility of adopting measures along the lines of Quebec's temporary personal tax relief for certain categories of immigrants.

As an alternative to personal income tax rate increases, we believe that there may be room to increase consumption taxes, which are low by global standards. An increase in consumption taxes, with appropriate credits for low income individuals and families, may provide a less costly and more reliable source of revenue.

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[7] OECD, Table I.7. Top statutory personal income tax rate and top marginal tax rates for employees, 2018.

[8] See Robert R. Murphy, Milagros Palacios, and Jake Fuss, "Canada's Rising Personal Tax rates and Falling Tax Competitiveness," Fraser Institute, March 19, 2019, https://www.fraserinstitute.org/sites/default/files/canadas-rising-personal-tax-rates-and-falling-tax-competitiveness_0.pdf.

[9] Business Council of Canada and Deloitte, Canada's Competitiveness Scorecard, supra note 2.

[10] See Kevin Milligan 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; Alexandre Laurin, "Shifting the Federal Tax Burden on the One-Percenters: A Losing Proposition", *C.D. Howe E-brief*, December 3, 2015; and Alexandre Laurin, "Unhappy Returns: A Preliminary Estimate of Taxpayers Responsiveness to the 2016 Top Tax Rate Hike", *C.D. Howe E-brief*, September 27, 2018.

Encourage retirement savings – planning for tomorrow

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 registered retirement savings plans (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 in Canada.

Furthermore, we recommend delaying the age that triggers mandatory minimum withdrawals from registered retirement income funds (RRIFs). As discussed in the C.D. Howe report *Outliving Our Savings: Registered Retirement Income Funds Rules Need a Big Update*[11], 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 reduced the required minimum withdrawals requirements, we believe that adjusting the starting age at which withdrawals are required would help further help solve this problem.

We also recommend that the Government consider increasing the limits on tax-deferred retirement savings. As individuals are living longer and are realizing lower returns on their retirement investments, the limits on retirement savings on tax-free savings accounts, defined contribution plans and RRSPs should be updated to allow individuals to save enough for retirement.[12]

We support the Government's concern for adequate retirement savings, and the focus on cooperation with the provinces in this regard. We applaud the Government for reaching an agreement with most of the provinces to gradually expand the Canada Pension Plan over five years starting in 2019. The gradual introduction is welcome given the increased cost to business.

4. Consider the introduction of a patent box model

We believe there is opportunity to do more to improve our competitive advantage regarding innovation. Canada's poor performance in R&D spending despite our strong publication credentials suggests that our leading-edge academic discoveries and intellectual property (IP), more generally, are not reaching the point of commercialization, thus limiting their impact on productivity. Therefore, to encourage companies to commercialize and retain patents in Canada, we recommend the government study whether a tax favourable regime (commonly called a patent box) for IP commercialization should be implemented.

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. This is outlined in our recent report.[13] Patent box regimes allow corporate income related to the commercialization of IP to be taxed at rates which are significantly lower than the rates applied to regular business income. This preferential tax treatment is meant to provide firms with a stronger incentive to innovate and commercialize the innovations domestically.

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[11] W.B.P. Robson and A. Laurin, *Outliving 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), https://www.cdhowe.org/public-policy-research/outliving-our-savings-registered-retirement-income-funds-rules-need-big-update.

[12] W.B. P. Robson, *Rethinking Limits on Tax-Deferred Retirement Savings in Canada,* C.D. Howe Institute Commentary No. 495 (Toronto: C.D. Howe Institute, November 7, 2017), https://www.cdhowe.org/public-policy-research/rethinking-limits-tax-deferred-retirement-savings-canada.

[13] https://www2.deloitte.com/us/en/pages/tax/articles/global-survey-of-investment-and-innovation-incentives.html

As identified in our productivity series,[14] Canada's patent intensity has been poor when compared internationally, despite strong performance in academic research. As indicated above, to encourage companies to commercialize and retain patents in Canada and more generally to commercialize IP generated here, we recommend that the Government study whether a patent box-type regime should be implemented in Canada. 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[15]) are continuing to utilize and support these regimes. In addition, amongst many other changes, the US Tax Reform introduced the foreign-derived intangible income (FDII) regime which has certain features of a patent box regime. Furthermore, based on the October 5, 2015 OECD BEPS final report on Action 5,[16] it is clear that patent box regimes will continue to be acceptable tax incentives, in a modified nexus version which requires in-country R&D. In fact, Belgium, Cyprus, France, Greece, India, Ireland, Israel, Italy, Luxembourg, the Netherlands, Panama, Poland, Portugal, Russia, Singapore, Spain, Switzerland and the United Kingdom have recently announced new or revised intellectual property regimes. The European Union has also adopted the modified nexus approach as outlined in the BEPS project.

5. Spur a "start-up and growth 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.[17] Also, as identified in our productivity series,[18] 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.

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. We strongly recommend the introduction of an incentive for angel investment. Targeted incentives will serve to encourage investing in high-growth small businesses by mitigating the risks associated with these investments. An angel tax credit may be the logical starting point for the creation of a sustainable venture capital industry financed by the private sector, and it is the incentive with the greatest potential impact on growing our economy. Other such incentive models (such as allowing capital gains which would otherwise be taxed, to be reinvested in defined enterprises) exist elsewhere and should be considered.

Support is also need to help companies "scale-up" and grow. Although Canada is growing its private equity capability, our recent report, *Outlast and outperform: Insights from Canada's most successful companies*[19], shows that only about 55 percent of the companies that existed five years ago are still in business today, and even when firms survive, they often struggle to grow. Going forward, rewarding sustained business growth should be a key principle in the design of business support and tax credit programs, including growth into new markets outside of Canada.

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[14] http://www2.deloitte.com/ca/en/misc/litetopicpage.MF-CA-Tags.future-of-productivity.html
[15] Other G20 countries with patent box regimes include Belgium, Hungary, India, Ireland, Italy, Liechtenstein, the Netherlands, South Korea, Spain and Turkey.
[16] 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.
[17] 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.
[18] Supra note 14.
[19] https://www.canada175.ca/en/research/best-managed?id=ca%3A2or%3A3or%3Aawa_FCC_BM_report%3Afrom_d.ca&nc=1

6. Incent R&D through 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. However, companies face many challenges when incorporating innovation into their businesses. Companies need access to a skilled workforce, capital markets and customers, along with support for business transformation including R&D. As both people and projects are mobile in the global marketplace, companies have global options to address these challenges. The decision on where to invest will be dependent on many factors, one of which is government support for business innovation. Ensuring that government support for business R&D expenditures is globally competitive is therefore essential.

Governments are competing vigorously for international investment and are seeking opportunities to encourage domestic growth through industrial R&D. More countries are introducing new indirect tax incentives, with 29 out of 35 OECD countries having R&D tax incentives in 2016 compared to only 12 in 1995.[20] In addition, countries with existing programs are enhancing the benefits with increased scope or increased rates from tax credits and deductions as described in our report, *Deloitte 2018 Survey of Global Investment and Innovation Incentives.*[21] These incentives have become more generous as countries hope to improve competitiveness and stimulate long-term economic growth.[22] In fact, research studies in the United Kingdom and the United States provide empirical evidence that tax incentives for R&D lead to an increase in R&D spending.[23]

Despite the increase in global support for innovation through policies such as R&D incentives and empirical support for the effectiveness of government incentives, Canada is lagging behind as total government support for R&D has been cut back since 2008. To enhance Canada's global attractiveness and encourage foreign investment, we believe that the 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 certain of our prior submissions to the Department of Finance,[24] we recommended a broad-based extension of ITC refundability to all businesses. While we continue to support that goal, we acknowledge that full refundability may be costly and may hinder achieving the important objective of a balanced budget over time while gradually reducing the level of debt to GDP. Therefore, we recommend that at this time the Government implement partial refundability for corporations currently not eligible for refundable 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 align with the objective of employment creation in an important sector of the Canadian economy.

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 risks inherent in performing R&D in Canada.

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[20] OECD, OECD Science, Technology and Industry Scoreboard, 2017 and 2011.
[21] https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-surveyof-global-investment-and-innovation-incentives.pdf
[22] I. Guceri and L. Liu, "Effectiveness of fiscal incentives for R&D: quasi-experimental evidence", Oxford University Centre for Business Taxation, Working Paper, 2016.
[23] See R. Fowkes, J. Souse and N. Duncan, "Evaluation of Research and Development Tax Credit", HMRC Working Paper, March 2015, and US Treasury Department, Office of Tax Analysis, "Research and Experimentation (R&E) Credit", October 12, 2016 (online: https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/RE-Credit.pdf).
[24] For example, see https://www2.deloitte.com/content/dam/Deloitte/ca/Documents/tax/ca-en-budget-2017-tax-policy-issues-for-consideration.pdf.

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 amortization of capital expenditures used in R&D or reflecting the investment in the proxy amount (i.e., increasing the proxy). Special treatment of R&D capital expenditures would be in line with other countries such as Australia, France and the United Kingdom.

Furthermore, we commend the Government's support of collaborative research between original equipment manufacturers (OEMs) and small and medium-sized enterprises (SMEs) through the business-led innovation "superclusters" announced in the 2017 budget. To further encourage OEMs to collaborate with SMEs, the Government could allow OEMs to claim the enhanced refundable SR&ED tax credits available to SMEs, but only on specific collaborative projects with SMEs.

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.

7. Refine the recent private corporation legislation

Uncertainty in the marketplace is widely regarded as a key impediment to growth. According to Deloitte's recent report, *Global perspectives for Canadian private companies,*[25] more than 50 percent of executives surveyed feel that there is the same or more uncertainty today than there was last year. This continued skepticism in the Canadian marketplace is perhaps best reflected by the fact that three times as many global businesses rank new product development as their biggest competitive advantage compared to Canadian private companies surveyed.[26] While it is true that today's geopolitical environment and external factors in the global economy are drivers of much of that uncertainty, it does not diminish our view that the Government should aim to reduce the impact of uncertainty where the cause of that uncertainty is within its control. The inclusion of ambiguous language in tax policy is one such area.

As a specific example, consider the "reasonableness" test applied to the Government's tax on split income rules. This wording has created an environment in which businesses have not been provided with firm guidance as to whether their practices will be considered reasonable in nature. There is no mechanism by which a business can self-assess and be certain that its interpretation will match that of the CRA. Further, as a result of the inclusion of this language, the CRA is now in a position whereby it will require expertise with respect to compensation practices in all industries in order to be able to fairly assess whether an arrangement is reasonable. Uncertainty and unnecessary disputes are anticipated.

Conversely, the introduction of "bright line" tests related to the same overall provisions provides improved clarity and certainty to taxpayers. In particular, specifying that more than 20 hours per week of employment activities would be sufficient to satisfy select tests reduces anxiety and subjective assessments, and allows businesses to focus on more pressing considerations.

Ultimately, it is our view that the Government should aim to create certainty and stability in areas where it has the ability to do so. With respect to tax policy specifically, removing unclear language in favour of specific, measurable wording is one way in which the Government can achieve this. Doing so will help to facilitate more stable and predictable market conditions, which in turn should serve as a

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[25] https://www2.deloitte.com/ca/en/pages/deloitte-private/articles/global-perspective-for-canadian-private-companies.html
[26] Ibid.

catalyst for investment in Canada while freeing up Government resources to achieve other legislative priorities.

In addition to recommending the refinements noted above, as we discussed in our October 2, 2017 comments on the consultation paper "Tax Planning Using Private Corporations",[27] we recommend that spouses be excluded from the tax on split income provisions to mitigate a large portion of the inequity and complexity associated with these provisions. From a policy perspective, this would be consistent with the rules applicable to retired Canadians and seniors. Current policy allows for pension income splitting between spouses/common-law partners, which includes the splitting of RRSP and RRIF receipts annually.

8. Provide clear, prospective application of revised OECD Transfer Pricing Guidelines

Certainty and clarity in tax law and administration are important to avoid unnecessary disputes. Uncertainty in the administration of transfer pricing guidance is detrimental to the Canadian economy, as a lack of certainty may impact cross-border trade, investment flows and Canada's competitiveness in general.

The setting of transfer prices in accordance with the arm's length principle is not a formulaic exercise and, therefore, very often multiple approaches and outcomes are possible with a given fact pattern. This inherently gives rise to difficult controversy and dispute issues. While some degree of disagreement between taxpayers and tax authorities cannot be avoided, having a common framework and consistent understanding and application of the OECD Transfer Pricing Guidelines can limit the disagreements. At least, it can provide certainty over which guidance to consult before even considering the technical aspects of a given case.

In this context, we commend the Government for providing clear expectations and timelines for country-by-country (CbC) reporting requirements. The depth of consideration, clarity in guidance and proactive notification to taxpayers regarding the implementation of CbC reporting requirements should be heralded as the gold standard for enacting changes to Canadian transfer pricing guidance. Canadian taxpayers were given sufficient time and explicit details to understand and apply the substantial changes stemming from the new guidance contained in the 2017 edition of the OECD Transfer Pricing Guidelines released on July 10, 2017 (the 2017 Guidelines) in respect of CbC reporting.

Paradoxically, all other new guidance contained in the 2017 Guidelines have garnered no additional clarity from the Government. Despite the significant new content contained in the 2017 Guidelines, the general position communicated in the 2016 federal budget is that revisions to the Guidelines are being applied by the CRA as they are consistent with current practices. However, this assertion that the 2017 Guidelines are consistent with the CRA's current practices is problematic for at least two reasons:

- First, this assertion indicates that even prior to the 2016 budget, the CRA had stopped relying on the 2010 version of the OECD Guidelines, in favour of different guidance without any update or notification to the Canadian public about such a policy change. This, despite the fact that the most up-to-date formal policy communication from the CRA on the topic of international guidance, as contained in TPM-14 was "(i)t is important to note that the CRA endorses the application of the arm's length principle and the 2010 version of the Guidelines for the administration of the Income Tax Act regarding transfer pricing matters". It is our view that a clear transfer pricing memorandum should be drafted and made available to the public before the CRA starts relying on new OECD guidance instead of the guidance provided in TPM-14.

[27] https://www2.deloitte.com/content/dam/Deloitte/ca/Documents/tax/en_DP_Policy_Submission_private_corporations_AODA.pdf

- Second, this assertion clearly contradicts the view of Canadian courts which apply the OECD guidelines that were available at the time the transaction was entered into, particularly as noted by the Tax Court of Canada in *Alberta Printed Circuits Ltd. v. The Queen* (2011 TCC 232), where, in reference to the OECD Transfer Pricing Guidelines, the court stated "[t]here was a further update in 2010, but, since this update is well beyond the taxation years in issue, I will refer only to the applicable 1995 Commentary."

Furthermore, the 2017 Guidelines do not offer only CbC reporting requirements and improved interpretations of the arm's length principle, as the budget comments seem to indicate. The 2017 Guidelines content that calls for risk-free returns or risk adjusted returns in certain circumstances and certain guidance in respect of non-recognition of transactions deviate materially from the 2010 Guidelines and, in our view, go beyond simply improved interpretations. In addition, we are of the view that the 2017 Guidelines content intended to combat cash boxes and limited functional entities represent special measures that have a potential to go beyond the arm's length principle as stipulated in section 247 of the Income Tax Act.

The problems associated with retroactive adoption of the OECD Guidelines as discussed above in respect of the 2017 Guidelines may be further aggravated as the OECD continues to develop new content that goes beyond improved interpretations of the arm's length principle. Some examples include:

- On June 21, 2018, the OECD released a final report containing *Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles,*[28] under BEPS Action 8. This new release is now incorporated as an annex to Chapter VI of the 2017 Guidelines. The OECD guidance concerning hard-to-value intangibles includes measures that go beyond the arm's length standard, including the use of after-the-fact profit information, as presumptive evidence of the appropriateness of transfer prices. To avoid an *ex post* approach, taxpayers must meet difficult documentation expectations considering various possibilities that address the certainty of profit and risk possibilities, and prove that different profit results were due to an unforeseen circumstance. Even if a good faith effort is made, there is much uncertainty concerning how a taxpayer can prove the original valuation properly took into account a particular possibility or that the development that affected profit was unforeseeable.

- Additionally, the OECD also released *Revised Guidance on the Application of the Transactional Profit Split Method*[29] on June 21, 2018, under BEPS Action 10, and released a non-consensus discussion draft on the transfer pricing aspects of financial transactions on July 3, 2018. These two reports continue to extend the applicability of the so-called "delineation of transaction risk framework" to additional aspects of the transfer pricing field, broadening the notion that the entities whose capital is at risk may not be eligible for more than a risk-free return due mostly to their limited functional footprint. This particular trend has been increasing the tension between the Canadian legislative framework and the jurisprudence and the 2017 Guidelines and related ongoing additions and reports.

The decision by the CRA to apply the 2017 Guidelines or ongoing additional new content in development by the OECD retroactively may create a dichotomy where taxpayers will have to choose in some circumstances between following the legislation and existing jurisprudence or following the special OECD measures in the 2017 Guidelines. It is our view that retroactive indiscriminate application of the 2017 Guidelines is inappropriate and that increased guidance from the CRA regarding its interpretation of the 2017 Guidelines is required.

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[28] OECD, *Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles,* (Paris: OECD, June 21, 2019), http://www.oecd.org/tax/transfer-pricing/guidance-for-tax-administrations-on-the-application-of-the-approach-to-hard-to-value-intangibles-BEPS-action-8.pdf.
[29] OECD, *Revised Guidance on the Application of the Transactional Profit Split Method,* (Paris: OECD, June 21, 2018), http://www.oecd.org/tax/transfer-pricing/revised-guidance-on-the-application-of-the-transactional-profit-split-method-beps-action-10.pdf.

Finally, on October 9, 2019, under BEPS Action 1 the OECD released a public consultation document, the *Secretariat Proposal for a "Unified Approach" under Pillar One*[30] (the Secretariat's Proposal). This document followed the *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy*[31] (the Programme of Work) that the OECD approved on May 28-29, 2019 and the initial and interim reports issued under BEPS Action 1 on October 5, 2015[32] and March 16, 2018.[33] These documents are aimed at arriving at a consensus-based long-term solution to address the tax challenges associated with the digitalization of the economy. The proposed solutions being examined and developed by the OECD have been grouped in two pillars which will form the basis for consensus. Pillar One focuses on the allocation of taxing rights, and seeks to undertake a coherent and concurrent review of the profit allocation and nexus rules. Under the Secretariat's Proposal (and previously the Programme of Work) a new profit allocation rule going beyond the arm's length principle is proposed. The new profit allocation rule would be applicable to taxpayers with highly digital business models (scope is yet to be defined but will extend to taxpayers engaged in consumer facing activities) irrespective of whether they have an in-country marketing or distribution presence or sell via unrelated distributors. This rule consists of a three tier profit allocation mechanism: (a) deeming a share of residual profit to be allocated to market jurisdictions using a formulaic approach; (b) fixing remuneration for baseline marketing and distribution functions that take place in the market jurisdiction; and (c) binding and effective dispute prevention and resolution mechanisms relating to the proposal. Including this additional layer of complexity to the already present tension between the Canadian transfer pricing legislative framework (which contains the arm's length principle), the jurisprudence, the 2017 Guidelines and related ongoing additions and reports is concerning for taxpayers. As such, it increases the necessity for clarification and guidance from the Government on the 2017 Guidelines, as by the end of 2020,[34] there may be three inconsistent standards for cross-border related party transactions involving Canadian taxpayers: (i) the arm's length principle as it is in the Canadian transfer pricing legislative framework and jurisprudence, (ii) special measures and other aspects associated with the arm's length principle as introduced in the 2017 Guidelines; and, (iii) the potential new profit allocation rule going beyond the arm's length principle as introduced under Pillar One of the OECD's work on BEPS Action 1.

9. Resolve the unintended and undesirable consequences of transfer pricing proposal from 2019 budget

On March 19, 2019, as part of the 2019 budget, and then subsequently in the draft legislative proposals released by the Department of Finance on July 30, 2019, the Government has proposed to amend the Income Tax Act to clarify that the transfer pricing rules in Part XVI.1 have priority of application over other provisions in the Income Tax Act through the introduction of draft subsection 247(2.1) (the proposed ordering rule).

This proposed ordering rule has raised concerns among the tax community. Specifically, the Joint Committee on Taxation of The Canadian Bar Association and Chartered Professional Accountants of

[30] OECD, *Public consultation document: Secretariat Proposal for a "Unified Approach under Pillar One,* (Paris: OECD, October 9, 2019), https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf.
[31] OECD, *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digialisation of the Economy,* (Paris: OECD, 2019), https://www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.pdf.
[32] OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report,* (Paris: OECD, October 5, 2015), https://www.oecd.org/tax/beps/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report-9789264241046-en.htm.
[33] OECD, *Tax Challenges Arising from Digitalisation – Interim Report 2018,* (Paris: OECD, March 16, 2018), https://www.oecd.org/tax/beps/tax-challenges-arising-from-digitalisation-interim-report-9789264293083-en.htm
[34] This is in reference deadline set by G20 leadership to find a consensus solution to BEPS Action 1.

Canada (the Joint Committee) has raised its concerns in its letters to the Department of Finance dated May 24, 2019 and November 5, 2019 to which Deloitte is in concurrence. We refer the Government to the commentary in these letters, but highlight the following:

- In its November letter, the Joint Committee concluded that "the proposed amendments introduce considerable scope for unintended and undesirable consequences." This was demonstrated in the letters through examples, particularly in the application of the "rollover" rules in subsections 85(1), 86(1) and 51(1) and relating to section 17 and the thin capitalization rules.

- The Joint Committee went on to recommend that, "a more nuanced approach would achieve the intended result without the afore-mentioned unintended and undesirable consequences". The Joint Committee has made specific drafting recommendations in its May letter, but added in the November letter that "it would be helpful if the Explanatory Notes could, at a minimum, set out examples clarifying that section 247 is not intended to override the application of rollover provisions, or apply to arrangements that would not give rise to any income adjustment under the existing rules".

10. Enhance certainty and efficiency of tax administration

Competitive tax policy requires efficient tax administration. Moreover, certainty in tax administration 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 encourage the Government to review the scope, application and administration of the 15 percent withholding requirement under section 105 of the Income Tax Regulations (Regulation 105) applicable to payments made to non-residents in respect of services rendered in Canada. Although the CRA announced a new simplified process for obtaining a waiver from regulation 105 withholding tax requirements, for non-resident artists and athletes who earn gross revenue of no more than CDN$15,000 in Canada in a calendar year, we feel that this simplification is too limited in application. Generally speaking, the purpose of the Regulation 105 withholding requirement is to provide the Government with security in the form of an income tax instalment from a non-resident person who may be liable to income tax in Canada.[35] As currently drafted, Regulation 105 often applies to non-residents who do not maintain a permanent establishment in Canada and who, therefore, are not taxable in Canada on income by virtue of an income tax treaty. Regulation 105 results in hardship to Canadian businesses as the foreign enterprise rendering the services will often gross up its fees payable by the Canadian payer to compensate for the withholding requirement, putting Canadian businesses at a competitive disadvantage. In our view, the Government should adjust the scope of the Regulation 105 security regime such that its application is more consistent with the widely accepted international tax concept of permanent establishment. We applaud the Government for its efforts on the recent modernization of the Regulation 102 regime with respect to payroll withholding tax of non-resident business travelers in Canada, and encourage the Government to take a similar approach to updating Regulation 105.

- We recommend that the Government review administrative thresholds to ensure that they are still appropriate. Specifically, the small supplier threshold of $30,000 for the purposes of GST/HST administration has not been updated since 1991.

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[35] *Weyerhaeuser Co. v R*, 2007 TCC 65, at para 7.

- We encourage the Government to continue to monitor the effectiveness of the new limitations that were introduced into the Voluntary Disclosure Program. We remain concerned about the new limitations. However, we were pleased that some of the recommendations we made in our letter of August 4, 2017[36] were incorporated into the final version of "IC00-1R6 Voluntary Disclosures Program" which was released on December 15, 2017.

- Increased resources for the CRA, together with streamlined processes to improve the timely completion of audit activity, would enhance the experience of carrying on business in Canada. We commend the CRA for recent administrative improvements provided for in Budget 2019. Resolving stale issues is very resource-intensive for both the administration and taxpayers, given normal labour turnover and the erosion of memories over time. In addition, with the introduction of new rules and increased transparency globally as a result of the BEPS project, the volume of tax disputes is likely to increase. As such, additional increased investment in areas that help to efficiently resolve disputes (e.g., competent authority, advance pricing agreements, mutual agreement procedures, rulings, appeals, voluntary disclosures, the use of technology, etc.) would be welcome.

- We urge the CRA to consider easing the requirements of support for foreign tax credit claims. In recent years, the CRA has begun to require proof of final assessment in support of a foreign tax credit claim when conducting tax return reviews. This requirement assumes that all countries issue an assessment, that such an assessment is readily available, and that the taxpayer has the expertise to obtain such proof. This change also leads to the denial of foreign tax credit claims where a foreign assessment is not yet complete at the time of the CRA review, thus burdening taxpayers with a tax liability in both jurisdictions. This change in policy is administratively inefficient, as reviews on average take longer to conclude, the CRA may assess without the credit, and later need to reassess with the credit, and collections personnel may even get involved.

- We recommend that the CRA consider raising the threshold for issuing T4s under employer certification. Presently, exempt individuals earning more than $10,000 are required to have a T4 issued. As the intent of employer certification is to ease the administrative burden on companies wishing to comply with reporting requirement for business travelers to Canada, it is notable that the low threshold obligates employers to still issue a large number of T4s for otherwise exempt individuals.

- In the interest of fostering compliance, the CRA should consider expanding the eFile program to accept part year departing and non-resident personal tax returns. Of particular note, allowing for the electronic filing of penalty bearing forms, such as form T1161, would allow for greater compliance, and ease the administrative burden of reviewing filings by mail for timeliness.

- Greater standardization of elections, and codification of such elections into standard CRA forms, would provide much greater clarity to taxpayers, and allow for improved compliance. Currently, many elections - for example a subsection 45(2) election - are submitted as written documents which cannot be filed electronically. As the CRA denies late-filed elections, taxpayers should be afforded clearer options for making and filing such elections with their tax return.

- We would welcome an increase in opportunities 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

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[36] https://www2.deloitte.com/content/dam/Deloitte/ca/Documents/tax/ca_en_tax_Deloitte_Comments_on_VDP_AODA.pdf

laws. We think that this would help improve the relationship between the Government, the business community and the broader tax community.

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Deloitte is committed to playing a key role in shaping Canada's future. We are grateful for the opportunity to provide our policy recommendations and trust that they will be helpful as you move forward with Budget 2020. 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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