Deloitte & Touche LLP
Brookfield Place
181 Bay Street
Suite 1400
Toronto ON M5J 2V1
Canada

Tel: 416-643-8753
Fax: 416-601-6703
www.deloitte.ca

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The Honourable James Flaherty
Minister of Finance
Department of Finance Canada
140 O'Connor Street
Ottawa, Ontario
K1A 0G5

Dear Minister Flaherty,

Budget 2013 – tax policy issues for consideration

Despite the continued challenges of slow global recovery and sovereign debt issues in Europe and the United States, Canada remains better positioned to weather this difficult economic cycle. However, we believe that sustained economic growth in Canada will be impeded without improvement to our nation's lagging productivity. This issue is discussed in our 2011 productivity report, *The future of productivity: An eight-step game plan for Canada*.

Canadian tax policy can play an important role in helping Canada to be more productive and globally competitive. The key lies in creating a tax ecosystem capable of fostering innovation and investment while supporting the objective of a balanced budget. The available mix of taxes — corporate, personal and indirect — permit the allocation of the tax burden across elements of the economy in a fair and equitable manner while encouraging economic growth through targeted tax incentives or allowances.

In shaping our recommendations for Budget 2013, we observe in our 2012 report, *The future of productivity: Clear choices for a competitive Canada*, that high growth firms are the engine of productivity in Canada. Thus, a key priority for the Government in formulating its tax policies should be to ensure that such policies support growth businesses. The Government should consider incentives that drive business growth for businesses of all size, type, sector or location.

Our policy recommendations for Budget 2013 can be summarized in four broad categories:

1. Foster business innovation through improvements to the scientific research and experimental development (SR&ED) program
2. Spur a "start-up economy" with improved financing support
3. Attract and retain the world's most talented people
4. Enhance certainty through tax administration

DELOITTE'S BUDGET 2013 RECOMMENDATIONS

1. Foster business innovation through improvements to the SR&ED program

Budget 2012 measures – concerns

Innovation is one of the most important contributors to persistent and sustained economic growth and a key solution to Canada's lagging productivity. There is broad recognition that government support of innovation is critical to ensuring that Canada remains a leading global destination for innovative businesses. However, in the 2012 budget, the Government has proposed to reduce support for the SR&ED tax incentive program, making Canada's regime less attractive than those of competing countries who are improving their incentive programs. In fact, Canada's ranking in tax incentive generosity has declined from 3rd to 5th for small companies (9th to 13th for large companies) from 2008 to 2012.[1] With the changes announced in the 2012 budget, we anticipate that these rankings, especially for large companies, will drop further.

Our recent post-budget survey of Canadian companies indicates that reactions to the reduction in government support through the SR&ED program have generally not been positive and suggests that Canada's SR&ED tax regime will be less attractive after the changes.[2] In addition, although Budget 2012 proposes more direct funding that is applauded by industry, the details of these supposedly compensatory measures are, for the most part, not yet available. But the survey also shows that industry is looking for universal incentives and for more certainty so that the related funding can more readily be taken into consideration in investment decisions.

We are concerned about the elimination of incentives for capital expenditures in the 2012 budget. In our view, removing capital expenditures from the SR&ED regime does not recognize that capital investments are needed to perform R&D and that certain industries will be put at a distinct disadvantage as a result of this measure. For example, computers and related equipment is often required in order to undertake R&D. Rather than completely eliminate all capital costs, we recommend that the Government distinguish between short term capital expenditures, such as computers and related equipment, and longer term ones, and treat the short term capital expenditures in the same manner as material costs, eligible for SR&ED tax credits.

In addition, we recommend the introduction of an intent test, similar to that for shared-use equipment, instead of the broad elimination of capital expenditures. Thus, if capital equipment would have an eventual commercial use, it would be excluded from eligibility for SR&ED incentives. The proposals could contain a cap on the amount that would qualify as a capital expenditure for this purpose in order to limit particularly large expenditures from being eligible for the SR&ED incentives.

The proposed changes to SR&ED in the 2012 budget are to be fully implemented by 2017 with some changes applied as soon as 2013. We believe that this short transition period does not take into account the fact that companies have made investment decisions in the recent past which may be adversely affected. Thus, we suggest that Government defer the introduction of these proposed measures.

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[1] Stewart, L.A., J. Warda, and R.D. Atkinson. July 2012. "We're #27: The United States Lags Far Behind in R&D Tax Incentive Generosity." The Information Technology & Innovation Foundation.
[2] The results of our survey are summarized in our July 11, 2012 *R&D Tax Update*, "Budget 2012's impact on innovation investment: Survey results and opportunities".

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

We believe that to enhance Canada's global attractiveness and encourage foreign investment, the investment tax credit (ITC) should be made refundable for all corporations carrying on business in Canada, rather than only for certain private companies; this is already the policy of several provinces and a number of countries with which Canada competes for corporate R&D spending. For many U.S.-based multinational corporations, for example, refundability means the difference between the incentive being a permanent tax savings or a tax deferral, which can be a powerful distinction in perceived value.[3]

Currently, only Canadian-controlled private corporations (whose income does not exceed the specified limit) may claim a refundable credit — all other companies only receive the benefit of the credits in years with 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 carrying out R&D in Canada, sending a strong message to foreign companies seeking new investment opportunities.

If, for various reasons, full refundability of the SR&ED ITCs for large companies cannot be achieved, we recommend that some blend of non-refundable and refundable ITCs be considered for large companies. Even partial refundability of ITCs for large companies will send a powerful signal to industry of the Government's commitment to support R&D investment in Canada.

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.

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

In our view, private sector risk capital plays a critical role in driving business growth and innovation. As identified in our 2011 productivity report, one of the factors contributing to Canada's relatively low productivity is the lack of capital for start-up enterprises. The financing ecosystem in Canada is fundamentally broken — from early seed financing through to initial public offerings, it is our observation that Canada has not done enough to support 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.

While we welcome the Government's new funding announced in the 2012 federal budget as an important step in the right direction, it is our view that this one-time contribution of funds is unlikely, in and of itself, to be adequate support to create a vibrant self-sustaining venture capital ecosystem. We encourage the Government to commit to a long-term strategy, developing the management expertise and investor base required for a successful venture capital community.

As we have previously noted in our comments on July 27, 2012 to the Department of Finance, we believe that the first priority in enhancing Canada's financing regime should be to improve support for the early

[3] Canadian companies that are subsidiaries of U.S. parent companies and perform R&D in Canada benefit from the SR&ED ITCs only as a timing difference. Although they benefit from the Canadian SR&ED tax incentives reducing their Canadian taxes 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.

stages of innovation when risks are higher. As such, we strongly recommend that consideration be given to introducing an angel tax credit. By mitigating the risks associated with these investments, targeted credits will serve to encourage investing in high-growth small businesses. We recommend that priority be given to an angel tax credit as it 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.

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 enhancing the competitiveness of the personal tax regime.

Reduce personal tax rates

Attracting and retaining globally mobile and highly productive individuals depends upon 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 a powerful source of attraction to Canada. We believe, however, that more individuals would stay in Canada or move to Canada if the Government were to lower personal tax rates, starting with an increase to the threshold at which the top rate of tax begins and also reducing the top rate of tax.

The suggested enhancements to the personal tax regime can be scheduled over the next five to ten years, in much the same manner as the reductions to corporate tax rates were phased in over a number of years. The benefit of the lower rate drove corporate behaviour before those reductions were complete and we believe that this same effect will apply to individual behaviour, attracting and retaining the most productive, innovative, and mobile individuals to Canada.

We believe that a reduction in personal income tax rates in conjunction with other measures designed to increase productivity and overall prosperity should not result in a reduction of overall personal income tax collected. However, if the Government believes that it must offset these reductions with increases elsewhere in the tax system, we believe that there is room to do so with consumption taxes, which are low by global standards.

Increase targeted immigration – meeting Canada's future needs

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.

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, even with our recommended personal tax rate reductions.

We applaud the Government for 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.

Encourage retirement savings – planning for tomorrow

The Government has recognized the importance of encouraging retirement savings today to avoid an economic crisis in the future. However, Canadians still do not save enough, with almost $600 billion in RRSP contribution room remaining unused[4] — clearly, other approaches are required, 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) 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*.[5]

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.

4. Enhance certainty through 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. For example, foreign employers are currently required to withhold tax on employees who have Canadian business days regardless of whether or not they are subject to tax in Canada.

- Legislative amendments addressed in comfort letters should be enacted on a timely basis to increase the certainty of doing business in Canada

- Tax proposals with detailed explanatory notes should be introduced and advanced through the legislative process within a reasonable timeline, while keeping in mind the need for consultation in regard to any significant changes to complex legislation

- While not within the exclusive purview of the Department, we believe that the relationship between the Canada Revenue Agency (CRA), business, and the broader tax community could be

[4] Statistics Canada. CANSIM table 111-0040.
[5] Some of the recommendations from the report, *Canadians Saving for their Future: A Secure Retirement*, 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 RRSP to be made until the age of 75, and educating all Canadians on the importance of saving for retirement.

improved. We would welcome forums that allow for greater communication between the CRA, the Department of Finance, taxpayers and tax practitioners. Improving communication should enhance certainty and allow for increased efficiency in both compliance with and administration of the tax legislation.

Deloitte is committed to playing a key role in shaping Canada's future. We trust that our policy recommendations will provide helpful guidance as you move forward with Budget 2013. 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 & Touche LLP

Albert Baker, FCA
Tax Policy Leader

Copy to: Mr. Brian Ernewein
General Director, Tax Policy Branch
Department of Finance Canada

Mr. Shawn Porter
Director, Tax Legislation Division, Tax Policy Branch
Department of Finance Canada