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

Budget 2014 – tax policy issues for consideration

Canada has maintained relative economic stability despite the recent challenges of a slow global recovery and sovereign debt issues in Europe. Despite some improvements in the global economy, 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 report series *The Future of Productivity*.

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

As identified in our 2012 report, *The future of productivity: Clear choices for a competitive Canada*, high growth firms are an engine of productivity growth in Canada. Thus, we believe a key priority for the Government in formulating its tax policies should be to ensure that such policies support these growth businesses.

Our policy recommendations for Budget 2014 can be summarized in six broad categories:

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

DELOITTE'S BUDGET 2014 RECOMMENDATIONS

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

While innovation is one of the most important contributors to persistent and sustained economic growth and a key solution to Canada's lagging productivity, Canada's position as a leading global destination for innovative businesses is under threat. To enhance Canada's global attractiveness and encourage foreign investment, we believe that the scientific research and experimental development (SR&ED) investment tax credit (ITC) should be made refundable for all corporations carrying on business in Canada, rather than only for certain private companies; this is already the policy of several provinces and a number of countries with which Canada competes for corporate research and development (R&D) spending.

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, communicating a strong message to foreign companies seeking new investment opportunities.

In addition, 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 and not a permanent savings. Although they benefit from the Canadian SR&ED ITCs reducing their Canadian tax payable, ultimately a parent company's U.S. tax increases when funds are repatriated from Canada to the United States due to the U.S. foreign tax credit rules. If the ITCs were refundable, from a U.S. tax perspective, they would not reduce Canadian tax otherwise payable but rather would reduce the R&D expenditure.[1] Thus, for many of these U.S.-based multinationals, refundability means the difference between the incentive being a permanent tax savings and a tax deferral which can be a powerful distinction in perceived value.

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 the Organisation for Economic Co-operation and Development's (OECD) 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.[2] Also, as identified in our 2011 productivity report *Future of Productivity: An eight step game plan for Canada* and our 2012 productivity report *Future of Productivity: Clear choices for a competitive Canada*, one of the factors contributing to Canada's relatively low productivity is the lack of capital for start-up enterprises.

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

[2] OECD, *Supporting Investment in Knowledge Capital, Growth and Innovation* (Paris: OECD, October 2013).

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 encourage the Government to commit to a long-term strategy, developing the management expertise and investor base required for a successful venture capital community. Although the Government's new funding announced in the 2012 federal budget is 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 believe that the first priority in enhancing Canada's financing regime should be to improve support for the early stages of innovation when risks are higher as we have previously noted in our comments on July 27, 2012 to the Department of Finance in response to the Government's request for feedback on the issue of support for venture capital. We strongly recommend the introduction of an angel tax credit. Targeted credits will serve to encourage investing in high-growth small businesses by mitigating the risks associated with these investments. 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. Consider introduction of patent box model

The 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 research activities 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*. These incentives, often referred to as "patent boxes", allow corporate income related to the sale of patented products to be taxed at rates which are significantly lower than the rates applied to regular business income. This preferential treatment of IP income is meant to provide firms with a stronger incentive to innovate and commercialize the innovations, domestically.[3]

As identified in our 2011 productivity report, Canada's patent intensity has been poor when compared internationally, despite a strong performance in academic research. To encourage companies to commercialize and retain patents in Canada, we recommend that the Government should study whether a patent box regime should be implemented in Canada. We recognize that the introduction of a patent box in Canada arguably may not be congruent with the OECD's base erosion and profit shifting (BEPS) initiative. However, with certain of Canada's trading partners (e.g., the United Kingdom) proceeding with the implementation of such a regime, Canada may be at a competitive disadvantage without one.

4. 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, improving immigration policies and encouraging retirement savings.

[3] Atkinson, R.D. and S. M. Andes. "Patent Boxes: Innovation in Tax Policy and Tax Policy for Innovation." The Information Technology & Innovation Foundation Report. October 2011.

Increase top personal tax rate threshold

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 increase the threshold at which the top rate of tax begins. [4]

The suggested changes to the personal tax thresholds can be scheduled over the next five to ten years, starting when the budget is balanced. 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.

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. We applaud the Government for already announcing steps to transform Canada's immigration system to ensure that more individuals with necessary skills will have ready access to the appropriate sectors of the Canadian economy. We encourage the Government to continue improving the immigration process by increasing overall targets and sharpening existing programs.

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

Encourage retirement savings – planning for tomorrow

Canadians still do not save enough for retirement, with more than $700 billion in RRSP contribution room remaining unused.[5] Although the Government has recognized the importance of encouraging retirement savings, new approaches are needed, as noted by Deloitte and others before the Standing Senate Committee on Banking Trade and Commerce. A specific proposal put forward by Deloitte to the Committee is a flow-through of the tax benefit of certain forms of income (e.g., dividends paid by Canadian corporations and also the capital gains preference) when withdrawn from Canadian retirement vehicles. We strongly encourage the Government to introduce creative and appropriate incentives to increase savings such as the recommendations outlined in The Final Report of the Standing Senate Committee on Banking, Trade and Commerce, *Canadians Saving for their Future: A Secure Retirement*.[6]

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[4] Murphy, Robert P., 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 federal rate in the United States, 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.

[5] Statistics Canada. CANSIM table 111-0040.

[6] Some of the recommendations from this report include: encouraging multi-employer pension plans, ensuring withdrawals from RRSPs, while taxable, have no impact on eligibility for the amount of federal income-tested

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

5. Anti-avoidance considerations

Limit scope of Stop International Tax Evasion program

In light of the recent global focus on tax transparency and base erosion and profit shifting (BEPS), we recognize that Canada has taken necessary steps to address tax evasion and will be party to certain G20 initiatives. However, we are concerned about the broad scope of the Stop International Tax Evasion (SITE) program introduced in Budget 2013, as the Canada Revenue Agency's (CRA) website currently indicates that the program will cover both evasion and avoidance. We recommend that the program be limited to tax evasion.

The concepts of tax evasion and tax avoidance are often inappropriately commingled. The two concepts are very different – tax evasion is a crime while tax avoidance, in and of itself, is not. Since tax laws are often complex and proper interpretation is often unclear, the scope of tax avoidance is often resolved by the courts. It is ultimately up to the courts to distinguish between abusive tax avoidance and acceptable tax planning. We believe that including tax avoidance with illegal tax evasion is inappropriate and misleading not only within the SITE program but in general as well.

Balance need to address BEPS with maintaining Canada's competitiveness

We encourage the Government to consider Canada's economic stability and growth in considering measures to address BEPS, and to ensure that Canada remains competitive vis-á-vis its important trading partners. 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.

6. Enhance certainty through efficient tax administration

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

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

- Administrative red tape and filing complexities should be reduced to create a more competitive business environment. For example, foreign employers are currently required to withhold tax on

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benefits or tax credits, allowing contributions to RRSPs to be made until the age of 75, and educating all Canadians on the importance of saving for retirement.

employees who have Canadian business days regardless of whether or not they are subject to tax in Canada.

- Increased resources for the CRA together with streamlined processes to enhance the timely completion of audit activity would reduce frustrations associated with carrying on business in Canada. Resolving stale issues is very resource intensive given normal labour turnover and the erosion by time of memories, whether personal or corporate.

- Legislative amendments addressed in comfort letters should be enacted on a timely basis to increase the certainty of doing business in Canada. Delays in this area also create financial reporting issues for public companies which are required, for financial reporting purposes, to record their tax expense based on enacted or substantively enacted legislation.

- Tax proposals with consistently 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. In that regard, we commend the quality of recent technical notes and applaud consultation processes that the Department of Finance has initiated regarding "treaty shopping" and testamentary trusts.

- While not within the exclusive purview of the Department, we believe that the relationship between the CRA, business, and the broader tax community could be 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 2014. 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,

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