INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

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President & Chief Executive Officer

January 31, 2007

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

Dear Minister:

Re: Investment Industry Association of Canada Budget Recommendations

On behalf of the Investment Industry Association of Canada (IIAC) and its member firms, thank you for the opportunity to participate in the Vancouver pre-budget roundtable. The topics of what it takes to make sure Canada "remains internationally competitive, continues to attract investment and creates value-added jobs" are important for not only our industry, but also every Canadian. The federal government has done a commendable job of improving the business climate by reducing the general federal corporate tax rate to 15 per cent, eliminating capital taxes and lowering dividend taxes, as well as by modernizing insolvency legislation. However, there is more to be done. Below are our answers to the specific questions posed in your Office's pre-budget consultation request:

1. **What steps should the Government take in Budget 2008 (and beyond) to ensure that Canada is prepared to deal with the implications of an aging population?**

   Apart from measures described below to promote a strong economy generally, the two most important financial measures for an aging population, from our perspective, are to:

   - Lower taxes on capital gains consistent with the 2006 Conservative Party platform promise
   - Increase the maximum annual RRSP limit from 18 to 25 per cent of earned income to encourage further savings for retirement.

   To help seniors already in retirement who experience cash flow and other problems when transferring registered retirement income funds (RRIFs), we ask you to undertake one further measure:

   - Amend the *Income Tax Act* to allow investment dealers to transfer RRIF minimum payment information electronically to the receiving institution and to remove the existing unfair penalties on seniors when errors occur.

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2/3. Should the Government be implementing broad-based policies that will help all sectors of the economy to succeed or should it focus on developing policies to assist specific industries facing special challenges? In what areas should the Government focus its resources in Budget 2008 (and beyond)? If resources need to be redirected from other areas, what areas should these be?

We believe we must rely on market forces and not governments to find the winning companies and winning sectors. Future growth and prosperity in Canada will depend on how successful we are at improving the competitiveness of our large companies and building innovative companies and ensuring their ability to move from niche players to companies of size in the domestic and global economy.

The government has taken positive steps to strengthen the competitiveness of large companies. It needs to implement a unique policy agenda to promote innovative small and mid-sized businesses with modest revenue and assets, and dependence on external sources of capital. These companies have benefited proportionately less from the government's income and dividend tax reduction initiatives. Therefore, what fiscal incentives there are should be directed to helping small and medium-sized businesses. As well, because these companies are more affected by government red tape that delay and discourage innovation, governments should focus on removing obstacles that add cost but little value as discussed further in the answer to question 4. below. Our recommendations in answer to questions 2. and 3. are to:

i. ***Lower taxes on capital gains to encourage more risk-taking and productive investment in the economy.*** To contain the cost of this measure, it could be limited to gains on common shares of small and mid-sized companies listed on the TSX and TSX Venture Exchange.

ii. ***Encourage research and development spending by enhancing the Scientific Research and Experimental Development (SR&ED) tax credit program.*** We believe that the program should be extended from small Canadian-controlled private corporations (CCPCs) to small and mid-sized companies listed on the TSX Venture Exchange so that they no longer lose access to SR&ED as a source of financial help just when they are at the critical stage of expansion. As well, at least for CCPCs, provide refundable benefits rather than tax credits, which may never be able to be used when most needed, that is, at the start-up phase when income is low or non-existent.

iii. ***Compensate provinces for any net loss from eliminating sales tax and harmonizing with the GST in a way that avoids a net increase in provincial sales tax paid by intermediaries***. This would create a more efficient consumption tax and relieve the sales tax burden of beleaguered manufacturing companies – the potential rate reductions from this are significant, as recently estimated by the C.D. Howe Institute, potentially supporting your efforts to encourage provinces to lower their income taxes for a combined federal-provincial income tax rate of 25%.

4. What steps should the Government take in Budget 2008 (and beyond) to ensure that the Canadian economy remains internationally competitive, continues to attract investment and creates high value-added jobs?

The steps mentioned in answer to questions 2. and 3. above will help improve the efficiency and competitiveness of Canadian capital markets, however, more is required. Below we describe some of the measures we see from the perspective of capital markets – all find their foundation in reducing the cost of regulation, enhancing productivity and improving the environment for Canadians, Canadian businesses and the Canadian economy.

i. ***Continue to encourage provincial regulators to adopt more principles-based regulation, streamline rules and move towards a common regulatory structure***.

ii. ***Mandate the filing on the CDS Innovations Inc. website of income from private income trusts/limited partnerships and eligible/other-than-eligible dividends that issuers must provide to investors and the CRA.*** This will promote more timely, efficient and cost-effective information flows for investors, issuers, intermediaries and the CRA itself. Going forward, any new measures should similarly require central reporting of all non-client-specific tax information.

iii. ***Facilitate a modern securities transfer law system by removing securities transfer rules from federal statutes.*** Repeal the *Depository Bills and Notes Act* and harmonize other federal laws governing securities with provincial uniform securities transfer legislation.

5. What tax and other measures should the Government take to ensure that Canada keeps its best and brightest, attracts highly skilled immigrants, encourages as many people as possible to enter the workforce, and rewards Canadians for their hard work, while respecting the Government's fiscal goals?

The fiscal position of the Canadian government has improved so that Canada's debt now represents only an estimated 36% of GDP compared to over 60% ten years ago. We are confident the federal government can both meet its debt reduction targets and deliver tax relief. Canada's rights and freedoms, strong economy and natural assets all attract people here. The federal government needs to begin lowering the personal tax burden, subject to maintaining fiscal manoeuvrability. Our personal income tax system, however, discourages some people with talent and drive because of high marginal tax rates that start at a relatively low level of income, encourage spending over investment and discourage people from increased work efforts or education to improve their future earnings.

Reducing capital gains taxes and increasing the maximum RRSP limit, mentioned above, are measures consistent with continuing to attract new Canadians and keep hardworking Canadian-born individuals engaged in building prosperity for themselves and for the country as a whole. Two other areas, we believe, will also be important:

i. ***Develop measures to promote stronger liaison of businesses with universities through encouraging R&D-through-to-development-and-commercialization partnerships that will lead to clusters of expertise in regional or national sectors.*** Examples of successful collaborations are increasing in number and include Memorial University's public-private partnerships in areas such as hydrometallurgy and large-scale marine transportation of compressed natural gas; the University of Waterloo's well-known technology-related partnering; and the University of Saskatchewan's partnerships in agricultural products and human and livestock vaccine R&D. Environmental improvement are another clear area of opportunity.

ii. ***Work collaboratively with provincial partners where possible to support a dismantling of interprovincial trade barriers***.

We believe that our recommendations will help businesses seize unfolding opportunities in a rapidly globalizing world and build on our economic success. Our attached submission – amended following discussions with your officials in November – provides additional detail on our views.

Yours sincerely,

cc: Bob Hamilton
Brian Ernewein
Gerry Lalonde
Rob Stewart

ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

INVESTMENT INDUSTRY ASSOCIATION OF CANADA

BETTER CAPITAL GAINS TREATMENT

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GAINS IN CANADA'S PRODUCTIVITY

Submission to Finance Canada, January 2008

The Investment Industry Association of Canada (IIAC) is a member-based, professional association that advances the growth and development of the Canadian investment industry. IIAC acts as a strong, proactive voice to represent the interests of the investment industry for all market participants. Our member firms range in size from small regional firms to large organizations that employ thousands of individuals across the country. Our members work with Canadians to help build prosperity and investment security for investors and their families.

The IIAC's mandate is fourfold:

Advocacy: To be the voice of the investment dealer and brokerage industry, advocating on regulatory and public policy issues for an investment environment that is efficient for our members and that fosters savings and investment by Canadians

Industry profile: To build a better appreciation of the contribution that the securities industry makes to Canadians, to Canada's capital markets and to the Canadian economy

Member support: To offer operational support that contributes to the ongoing success of our members and to their ability to cost-effectively serve investors and issuers

Market advancement: To promote globally competitive capital markets for Canada.

PURPOSE

To recommend a suitable course of action to the Department of Finance to improve productivity and capital markets efficiency through a more competitive tax regime

> **"The key objective of public policy is to increase the well-being of the population in a sustainable manner… There are two basic ways of improving a country's standard of living: employment growth and productivity growth… As [demographic trends of an aging population] unfold, the critical challenge facing Canada is to increase productivity growth so that our standard of living continues to rise. Productivity is basically a measure of how well people and physical capital interact within the economy to produce goods and services."**
>
> – *"Canada's success is no accident, and it isn't a given"*
> Kevin Lynch, while executive director, International Monetary Fund
> *Policy Options*, April-May 2006

SUMMARY

- The Canadian government has already identified solving Canada's lagging productivity growth as a priority – boosting productivity is the key to fostering economic growth. The rise in value of the Canadian dollar should help firms that would import technology and other goods to improve productivity; a stronger Canadian dollar may drive some firms suffering from the high exchange rate to seek greater efficiencies that should enhance productivity.
- Relative to the lower-cost BRIC countries – Brazil, Russia, India and China – Canada must compete on the basis of higher-end and highly-innovative products and services, and widely available high-quality life-long education. Relative to developed countries, Canada must have a competitive tax and legislative/regulatory policy framework.
- Improved productivity and competitiveness, employment and economic growth are best achieved through reductions in direct and indirect taxes on capital, income and labour at both the personal and business level. Positive steps taken on October 30, 2007 by Minister Flaherty in his Economic Statement make Canada's tax system more competitive internationally, but more needs to be done for small and medium-sized businesses and to attract productive investment and skilled human capital in light of a tax system that favours consumption over investment.
- The federal government's current fiscal position provides the opportunity to deliver meaningful tax relief that, if structured properly, will bolster productivity, while still enabling the government to meet debt reduction targets.

PRINCIPLES

1. **Lower taxes on investment:** Tax policy should target productivity improvements by shifting taxes proportionately from the current burden on labour, investment and savings to bases less affected by taxation.
2. **Reduced taxes on income:** Taxes on corporate and personal income should be at the lowest possible rates and on the widest base possible above the basic exemption.
3. **Meaningful consultation/timely and efficient implementation:** Consultation is required to ensure that policy takes into account stakeholder views and changes are feasible. Sufficient consultation and implementation time should lead to the most effective execution of changes.

4. **Simplicity and certainty:** The tax system should be as simple and clear as possible, consistent and expressed in plain language. Certainty, as well, is critical to supporting the flexibility, adaptability and innovation needed for Canadian firms to take advantage of opportunities and solve challenges in the fast-paced, increasingly competitive global marketplace.

5. **Competitiveness:** Canada's tax system must be competitive with that of the U.S., Europe and other major trading partners, if not on a tax-by-tax basis, then at least overall.

ISSUES

1. **Improved productivity not seen as an imperative**: Between 2001 and 2006, of the six G7 countries showing positive hourly macroeconomic productivity improvements, Japan and the U.S. showed 13 per cent growth, the U.K. – 11 per cent, France – nine per cent, Germany – 7.5 per cent and Canada – only five per cent. The C.D. Howe Institute's *2007 Tax Competitiveness Report* highlights the lack of Canadian capital investment – the foundation of improved productivity – on a per-worker basis. According to the report, Canadian businesses spend annually about $700 per worker *less* than businesses in OECD countries and $1,600 per worker less than businesses in the U.S. Demographic trends over the coming decades will result in a contraction of the Canadian workforce, leading to further productivity challenges unless there are offsetting productivity improvements. Lower productivity impacts all Canadians through lower wages and lower tax revenues than could be collected if productivity improved, generating economic growth and jobs. We are pleased by recent federal measures that should support improvements to productivity and look forward to further positive steps in the coming budget.

2. **Investment and income taxed comparatively heavily:** As shown in the table below, income and investment are today taxed proportionately more heavily than consumption compared to five years ago, which is contrary to efforts to increase productivity on a long-term basis.

% of Net Tax Revenues	2002-03	2003-04	2004-05	2005-06	2006-07	Avg. Change
Personal Income Tax	55.0%	54.1%	56.3%	55.7%	55.7%	1.2%
Corporate Income Tax	15.0%	17.5%	17.1%	17.0%	19.0%	27.2%
Goods and Services Tax	19.0%	18.0%	17.0%	17.7%	15.8%	-17.0%
% of Total Revenues	**2002-03**	**2003-04**	**2004-05**	**2005-06**	**2006-07**	**Avg. Change**
Personal Income Tax	46.0%	45.6%	45.3%	46.7%	46.8%	1.7%
Corporate Income Tax	12.5%	14.7%	15.1%	14.3%	16.0%	28.0%
Goods and Services Tax	15.9%	15.2%	15.0%	14.9%	13.3%	-16.4%

- Canadians trying to save for retirement are subject to high tax rates on their investments, lowering their after-tax returns and making it difficult to accumulate the wealth they will need to cover an increasingly lengthy retirement phase. The result of higher capital gains taxes is lower levels of investment spending in Canada and, by extension, fewer opportunities to improve productivity.

- Canadian individuals are burdened by a misaligned personal income tax system with high marginal tax rates that start at a relatively low level of income, encouraging spending over investment and discouraging people from increased work efforts or education to improve their future earnings. The highest tax bracket is reached much earlier in Canada than in the U.S. – anyone in Canada with an income of $121,000 pays the highest tax rate, whereas in the United States, the top bracket is not reached until one earns $350,000 a year. And the top combined marginal tax rate in Canada is much higher – 48 per cent in some provinces, compared to the 35 – 45 per cent range typical in the U.S. In some cases, this not only slows savings and investment in Canada, but may also speed up a "brain drain" of talent that may best be able to bring about innovation that is also critical to productivity enhancements.

3. **Consultation is limited; implementation challenges limit efficiency:** While appreciating efforts of Finance staff, their workload is significant meaning limited opportunity for the type of consultation that could, in almost all cases, lead to more cost-effective implementation of changes and greater benefits for Finance, the Canada Revenue Agency (CRA) and the Canadian taxpayer. Also, limited Finance resources have meant that legislation and regulation formalizing changes is sometimes introduced too late for practical responses to be taken by those affected. Governments in some areas are slow to accept electronic solutions that could reduce errors, speed information delivery and help offset development costs, as well as the $20 million in annual investment dealer operating costs associated with reporting on investment income.

4. **Uncertainty discourages investment:** Delays in implementation or apparent changes in policy may contribute to uncertainty as to whether Canada is "open for business" (as an example, a widely-circulated daily e-letter by a credible non-Canadian global investment analyst said that the Alberta government's publication of the oil and gas royalty scheme, on top of the October 30, 2006 income trust change, was sufficient to push this advisor, and possibly others through him, into divesting from Canada due to the inability to obtain certainty). Certainty is uncertain in Canada as the following examples suggest:

   - The content of comfort letters received in the late 1990s and early in this decade were not embodied in legislation and regulations until last year, which introduced significant uncertainty.
   - A goods and services tax (GST) guide reflected changes that had not been passed in legislation or regulation.

5. **Comparatively lower productivity and higher taxes than trading rivals:** Investing in Canada is an option and not a necessity for many investors given that Canadian capital markets are only three per cent of the global marketplace. Therefore, Canada's tax system must be made more attractive and must target improving productivity and the benefits that this brings.

   - Despite recent further reductions in rates, Canada's tax system remains less than competitive compared to key economic blocks such as the U.S. and within the European Union. In Canada, the tax on long-term capital gains is 24 per cent, compared to 15 per cent in the United States. While some think taxing capital gains is taxing the rich, that is far from the case. Approximately half of Canadian adults invest in equities – either directly or indirectly through mutual funds. With comparatively higher capital gains taxes, we punish individual Canadians for building their investment portfolios and leave too little incentive for Canadians to invest and keep investing. This leads ultimately to lower standards of living for Canadians and may lead to investment and employment decisions being swayed for the wrong reasons.
   - Canada's GST, which (like in other value-added tax (VAT) countries) is applied to financial and investment services in a way that limits input tax credits (in contrast to the benefits that most businesses gained from repeal of the manufacturers' sales tax), is currently more onerously applied than in other VAT countries. An example of Canada's stricter regime includes Canada's taxation of the labour component of imported non-arm's-length services. As well, recent draft GST amendments would cap recovery rates (refer IIAC April 30, 2007 letter to Finance), contrary to fair and equitable taxation. Thirdly, it appears that some of Finance's data needs could be achieved by sampling rather than by a requirement demanding extensive changes for the annual financial

institution return. Such burdens would become even more onerous should P.E.I. and provinces from Ontario west harmonize with the GST.

RECOMMENDATIONS

1. a) **Lower the capital gains tax to incent capital investment and help restore the balance between consumption and investment taxes by** reducing the effective capital gains tax rate for the common shares of at least small and mid-sized public and private companies consistent with the Conservative platform promise.

b) **Improve the scientific research and experimental development (SR&ED) tax credit program to encourage private research and development (R&D) spending** for small Canadian-controlled private corporations (CCPCs), ensuring that such firms can still qualify for the SR&ED credits when listing on the TSX Venture Exchange and can know quite quickly, and with some certainty, whether or not spending will qualify for tax credits; at least for CCPCs, provide refundable benefits rather than tax credits, which may never be able to be used when most needed, that is, at the start-up phase when income is low or non-existent.

c) **Develop measures to promote stronger liaison of businesses with universities through encouraging R&D-through-to-development-and-commercialization partnerships that will lead to clusters of expertise in regional or national sectors.** Examples of successful collaborations are increasing in number and include Memorial University's public-private partnerships in areas such as hydrometallurgy and large-scale marine transportation of compressed natural gas; the University of Waterloo's well-known technology-related partnering; and the University of Saskatchewan's partnerships in agricultural products and human and livestock vaccine R&D. Environmental improvement are another clear area of opportunity.

d) **Work with provincial and academic counterparts to broaden knowledge of and focus attention on productivity, including monitoring and reporting on progress on key measures**, for example, average annual productivity growth, average investment in machinery and equipment, private sector R&D as a percentage of industry value-added, and rate of high-school drop-out and university completion rates as compared to international standards. While productivity is the most challenging economic issue this country faces, the government has been quite silent on this topic. Our government should explain to all Canadians exactly what improved productivity will mean to our competitiveness and to our ability to sustain a high standard of living in the long-term in the same way that previous governments were finally able to explain to Canadians the need to get Canada's debt and deficit under control, which is yielding huge benefits today. Canadian businesses, Canadian capital markets and individual Canadians must become more productive.

2. Continue to reduce personal income taxes to make work, saving and investing more rewarding for Canadians of all income groups by, for example:

- Increasing the maximum annual RRSP limit from 18 to 25 per cent of earned income to encourage further savings for retirement as Canada faces an aging population
- Further reducing income tax rates or setting higher thresholds for existing tax brackets
- Extending income-splitting beyond pension income to include all forms of income

To help seniors already in retirement who experience cash flow and other problems when transferring registered retirement income funds (RRIFs), we believe that the federal government should undertake one further measure:

- Amend the *Income Tax Act* to allow investment dealers to transfer RRIF minimum payment information electronically to the receiving institution and to remove the existing unfair penalties on seniors when errors occur.

3. **Reduce unnecessary government-generated costs borne by industry by consulting on an open and timely basis on implementation issues to minimize unnecessary and unintended costs:**

   In the case of the securities industry specifically and the financial services industry generally, we believe that Finance Canada should:

   - Mandate greater use of utilities such as the CDS Innovations Inc. website to facilitate collection and transmission of tax data – specifically, for eligible dividend information and income on private income trusts and limited partnerships – and ensuring sufficient implementation time (the federal government is to be commended for mandating T3 and T5013 filing centrally as demonstration of its commitment to reduce the paper and administrative burden for intermediaries and the IRS)
   - Do an estimated cost-benefit analysis of proposed changes, for example, in the case of the GST changes tabled in January 2007 (refer IIAC April 30, 2007 letter to Finance); should other provinces choose to harmonize their sales taxes with the GST, ensure that application in the case of the financial services sector is straightforward to apply and work with provincial counterparts to identify how to offset harmonization's negative impact on intermediaries
   - Work co-operatively with the Canada Revenue Agency, Revenu Québec (where relevant) and the industry to achieve policy goals in the most cost-effective way for the entities subject to any related administrative burden; when implementation of a measure is necessarily retroactive or must be introduced quickly, ensure that the CRA (or Finance) has the administrative authority to provide flexibility/administrative relief (refer Appendix 1, Case Study: Eligible Dividends)).

4. **Be consistent and clear in announcements and tax changes to avoid undesired impacts on the capital markets**

   - Ensure legislation and regulations are drafted in plain language – or that explanatory notes explain the reason for complexity – and ensure that there is the shortest possible delay between announcements and introduction of the related legislation and sufficient implementation time
   - Work with provincial counterparts to promote understanding of the importance of certainty and the risks of confusion for investment and the Canadian and provincial economies.

5. **Monitor tax rates and models of Canada compared to those of competing jurisdictions** – understand the implications of variances in rates and different tax practices, and move towards parity or better (e.g., as regards application of GST to the financial sector, adopt the standards of the European VAT countries for imported supplies and do not cap the prescribed recovery rates). Minister Flaherty's October Economic Statement announcing accelerated reductions to corporate tax rates are welcomed and will help make Canadian companies more competitive with their rivals in other countries. Competing nations will also be taking action on their tax policies, so it is important for Canada to continuously monitor these developments and take decisive action sooner rather than later.

APPENDIX 1

CASE STUDY: ELIGIBLE DIVIDENDS

May 2006 budget provisions announced the federal government's intention to eliminate the double taxation of large corporation dividends through the designation of eligible and ineligible dividends, retroactive to January 2006. Retroactive provisions are always problematic in volume-intensive industries as no systems in place will have caught the information automatically, meaning a very manual process.

- The IIAC provided comments on technical challenges in August and September of 2006. The draft legislation (Bill C-28) did not pass until December and then did not get through the Senate review process until late February of 2007, almost two months into the tax reporting season. While proclamation occurred quickly, the requirement for issuers to file was not effective immediately even then – issuers had until the final week in May 2007, three weeks *after* personal taxes had to be filed and nearly three months after intermediaries had to mail T5s.

- Other challenges in administering the eligible dividend legislation included the requirement for *all* issuers to file whether their dividends were eligible or not, although our estimates were that 90-95 per cent of dividends would be eligible – and this proved to be the case. Moreover, intermediaries were to report all dividends as "other than eligible" in circumstances where an issuer had failed to provide notice of dividend eligibility status, which was in virtually all cases. Reporting the majority of dividends as other than eligible would mean millions of taxpayers would either not enjoy the tax benefits that they were promised or have to refile amended tax returns.

- While relief was requested, and was provided to mutual fund trusts in December 20, 2006, tax reporters for dividends relating to other securities were not given relief.

- Without apparently considering the implications for tax reporting firms, the CRA also advised issuers that they could meet their requirements by a variety of means. While appreciating the CRA's efforts to try to facilitate dividend eligibility notification for issuers, the multiple alternatives offered made it extremely difficult for intermediaries and investors to find the issuers' dividend declarations – there are millions of press releases issued each year, internet search engines did not capture all possible reporting options and notification could occur *after* dividend payment had occurred, which made systems solutions even more challenging. By the end of February, there were only a handful of eligibility statements that could be found on the Internet. In answer to intermediary suggestions for the CRA to communicate to issuers directly, we were told that the CRA does not have a database of issuers that could have been used to communicate the recommendation to file early.

- After legislation requiring the reporting of dividend eligibility finally was passed in late February, IIAC members continued to face challenges in getting required data. As an example, two major corporations refused to provide the information saying that they had given it to their transfer agent.